Coronavirus Crisis – Mitigating the effects on UK households of lending by banks and other lenders – Antony Elliott OBE makes crisis recommendations on interest caps for high interest loans, overdrafts and credit cards.

Summary

In health it has been shown that acting late causes more distress, the same applies in relation to financial well-being. People who feel there is nowhere else to turn will naturally use overdrafts, credit cards and high interest loans, including payday loans. These recommendations are tough, but there is a lot of evidence that the long-term pain caused to households and society in the UK by allowing excessive borrowing does not compensate for any short term needs that are met. It is important that existing and potential loan customers are treated with great care in their own interests. This paper sets out the following recommendations:

High Interest Loans (including Payday Loans)

- Cap the interest rate for all new loans at 42.6% APR until 30th October 2020 or a later date. The only exception being Community Development Finance Institutions (CDFIs). This action will allow a breathing space for lenders to reconsider policies in the context of the crisis.
- From 30th October 2020 (or a later date if industry is not prepared) cap the interest rate for all loans at 146% APR (fixed) or 0.4% per day. This is half the current level, which is very high by international standards. The only exception being loans from CDFIs. For short term loans (less than a year), the maximum cost of interest and charges would be fixed at 75%, a reduction from the current level of 100%.

Overdrafts

Cap overdraft interest rates at 25%. Banks were going to introduce overdraft interest rates of 35% to 49.9%; these are unacceptable in the current environment. *

Credit cards

- Interest rates on existing cards cannot increase above the level of 1st May 2020, the rates can be reduced. *
- Credit cards with zero per cent or other discounts on balance transfers expiring in the next 6 months must allow customers to request a six-month extension to allow them time to consider their position.

*It can be a temporary measure for a maximum of two years during which a different mechanism linking the cap to underlying interest rates can be agreed.

Background

The government has taken significant action to maintain employment in the UK by way of policy interventions. These will have mitigated some of the short-term damage to personal finances and alleviated some financial anxiety. It is unrealistic to think that all households can be rescued from financial consequences of the economic contraction that has resulted from lockdown. There will be more than one wave of problems as different industries adjust.

Financial health and physical/mental health have a lot in common and it is worth considering some of the similarities.

1. **Speed of action –** the countries that responded quickest and in the best organised way have fared significantly better in terms of the health outcomes for their populations.

   Financial well-being interventions – there is evidence[i] from studying cases of people in financial difficulty that the earlier a person takes action, the less will be the financial consequences of a change in circumstance. This applies to contacting creditors, not increasing borrowing, seeking support from family, obtaining government benefits and reducing expenditure wherever possible, even at some short-term household cost to well-being. Unfortunately, taking what may be the easiest short-term solution by taking a loan

2. **Existing resilience –** certain groups are far more vulnerable to coronavirus than others e.g. elderly, obese and those with pre-existing health conditions.

   Financial well-being interventions - we are entering this crisis with a very large proportion of households in a poor state of resilience; their pre-existing financial health is poor. A combination of no or little savings and excessive unsecured debt is widespread in the population. If they suffer a loss of income, even if only temporary and/or partial, the household finances will be put under considerable strain. The groups of the population in this category are very substantial, using the Money and Pensions Service data, around 46% of household are struggling (22m households with low income, but c.50% working in 2018) or squeezed (13m working age families with significant financial commitments).[ii] StepChange Debt Charity in a 2019 report state “over 3 million people are in problem debt in Great Britain with *(a further)* almost 9.8 million showing signs of financial distress.[iii] Households with poorer credit history are particularly vulnerable to borrowing at high interest rates.

3. **Behavioural interventions beyond advice/information –** despite giving good information (e.g. on hand washing), this does not mean individuals take the right course of action. For example, hand washing is communicated, but still people use gym equipment in public places; the equipment must be removed temporarily. People travelled to beaches where social distancing was impossible to maintain; beaches were closed temporarily. There are numerous examples where for the common good, strong behavioural interventions are required in relation to social distancing.

   Financial well-being interventions – the consequence of poor financial decisions in times of crisis will be bad for the individual, the household and society. The very short-term benefit of a bad decision, such as taking on more debt, will have a long-term consequence for the family in anxiety or maybe worse. Recent evidence from StepChange Debt Charity is that 98 percent of people using high interest loans as a form of support after a life event were in problem debt (53 percent) or showing signs of financial distress (45 percent). Similarly, 83 percent of those using credit cards or overdrafts as a form of support were in problem debt (35 per cent) or showing signs of financial distress (51 percent). For society, it will lead to unpaid debt and ultimately greater state support. The resulting consequences on mental health of the financial anxiety are well documented and lead to personal and societal costs.[iv]

   Ultimately there is no such thing as a “free lunch”, the costs of default are paid by other bank customers initially and if they become too great could become taxpayer issues as banks

are supported once again. The use of high interest credit is never a solution to the life event problems coming out of the crisis. The use of overdrafts and credit cards will rarely be a good form of support.

Intervention Proposals

The UK is more vulnerable to personal financial well-being detriment from borrowing than many other countries; it requires considered action. Action needs to be taken as soon as possible to ensure that people do not access high interest loans, overdrafts, and credit cards without policy safeguards. These are the reasons:

1. *Desperation* – many people will be desperate and turn to these lenders as a "solution". The evidence is that high interest lending taken under these circumstances only leads to anxiety and worry later.
2. *Societal cost* – high interest lending is normally profitable because the high default rate is covered by the interest rate. Implicit in the business model is the assumption of many customers being unable to repay on time. Each customer unable to repay cause significant worry for a household. In the current environment it becomes even more unclear that the benefit to those that repay on schedule offsets the significant worry and anxiety for those that cannot.
3. *Models cannot be substantiated at this time* – underlying the business is an assumption about default levels. Given the lockdown and its economic effects are unprecedented, it is impossible for the companies granting the loans to be certain that the default rates used in the modelling are correct. Simply charging a higher rate in order to offer the loans does not justify the business being allowed or legal.
4. *International comparisons* – the UK has a relatively "advanced" high cost credit market, it is never been clear that this is something of which the UK should be proud. It appears to be more of an accident of financial regulatory history, combined with innovation in technology. Many other countries have done far more to restrict the level of interest rates that can be charged and thus reduce the number of customers who will be lent to and subsequently default (see Appendix). The UK can improve on its position by acting quickly.

These are recommendations to mitigate the problem for each of high interest personal loans, overdrafts and credit cards:

A. **High Interest Short Term Credit (upto 1 year) and High Interest Over One Year Loans**

   1. **Ban new Loans from High Interest Lenders –** ideally there would be a temporary ban on the basis that the lenders will be unable to do a proper assessment in the current environment and the desperation of customers will mean that they are not able to coolly estimate the risk of not repaying. It is very difficult to argue that there is a public benefit in these loans, which would be illegal in many countries. Many, probably most, people will underestimate how long their financial challenges will last and not evaluate that the short-term high interest loan is only adding to their difficulties.

      Recommendation: stop all new personal loans with an interest rate above 42.6% APR, equivalent to 3% per month (the maximum rate for credit unions) until 30th October 2020, except for loans offered by CDFIs. Payday lenders will have to stop new business, which some have done already. It is important for lenders that have not stopped to reconsider policies fundamentally.

2. **Reduce the cap on the interest rates charged –** the interest rate charged by some payday lenders and others cannot be justified ethically in the current environment. The maximum rate permitted by FCA regulation for short term loans is 292% APR (fixed), expressed as 0.8% per day. In addition, there is a cap of 100% of the loan amount for the accumulated interest and charges. Given that it is very difficult to evaluate customers in the current environment, this rate allows for far too high a default rate among customers. It is well known that a high proportion of customers will have payday loans at the point they seek advice and is a factor in reduced financial well-being.

   N.B. It is difficult to identify the maximum rates being charged currently given that the representative APR is the lowest rate offered to a minimum of 51% of customers. 49% of customers may be paying more than the advertised representative rate. The current regulatory cap only applies to loans under one year.

   Recommendation: from 30th October 2020, declare the intention to reduce the permitted APR for short term loans by half to 146% APR (fixed) or 0.4% per day. The maximum for the total amount of interest and charges for loans under one year would be 75% of the loan amount (reduced from 100%). It is recommended that the cap on interest rate (APR) would apply to all loans regardless of period. The exceptions are loans from CDFIs (a very small proportion of loans from CDFIs would exceed this figure).

   It is proposed that the cap on interest rates of 146% APR (fixed) should apply to all loans. This should be reviewed in the next year or sooner because it is possible that a better approach would be to have a lower cap on loans over one year, but to have a cap at all would be an improvement on the current position. The Appendix gives information on interest rate caps in other countries.

   N.B. The proposed amendment would mean that the maximum period that a loan under a year could be at the maximum rate of 146% APR (fixed) would be c.6 months; a £500 loan would cost £860 to repay after 6 months (£500 principal and £360 interest).

B. Overdrafts

Overdraft Interest Rates

In order to compensate for the loss of income from unauthorised overdrafts and rate simplification, major banks were in April 2020 introducing overdraft interest rates of 35% to 50% EAR. Temporary measures were put in place by the FCA in April involving £500 of interest free overdraft and maintaining existing costs for customers that would have been adversely affected by the charge increases.

Due to the Coronavirus crisis many customers will start using their existing overdraft limits. Unless banks act, following unemployment or an income reduction, customers will turn to the overdraft as the easiest method of raising money.

The high rates for overdrafts may have been acceptable if overdrafts were being used to smooth short term cash flow issues. If an overdraft is going to be outstanding for a year, these are high rates. They are not as high as pay day loans, but they are high considering the risk of default. Historically, the bank will be able to monitor account behaviour

(income and expenditure) and can determine whether the overdraft is at an appropriate level in that context. The crisis undermines the historic data and has made overdraft lending riskier. The rates of 35% to 50% were determined to ensure the overall profitability of current accounts. It should be possible to write off overdrafts without customers having to close accounts.

Recommendation: with effect from 1st July cap interest rates on overdrafts at 25% EAR (or a lower figure). This can be a temporary measure for a year during which a cap linked to underlying interest rates can be agreed and the cap rate reviewed.

C. Credit Cards

1. Interest rates generally

These need to be monitored closely as raising interest rates to compensate for defaults in the short term is not socially acceptable. Shareholders should bear the cost of increased defaults.

Recommendation: a ban on interest rate increases on credit cards to a rate higher than applied on 1st May 2020. This can be a temporary measure until a cap with a link to underlying interest rates is agreed.

2. Zero percent and other offers

The industry has adopted a practice of offering 0% deals on credit cards. The industry has chosen to run the risk that in a crisis this would not be socially acceptable. Many customers are likely to be trapped by the crisis effects and are unable to move credit card provider to another low rate offer elsewhere. Action should be taken in the context of the crisis.

Recommendation: any zero or special offer deals maturing in the period 1st May 2020 until the end of the year must be extended for a further 6 months. This will give the credit card provider time to contact customers and plan for a fair arrangement to be entered into rather than simply being on the high rate of the contractual agreement.

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Appendix – International Interest Rate Restrictions

A comprehensive report was written by academics at the University of Cork in 2017 entitled "Interest Rate Restrictions on Credit for Low Income Households". It was input into a review of the law in this area by the government of Ireland.

It is available on-line (https://sff.ie/wp-content/uploads/2018/11/irr.pdf) and has comprehensive tables of the different restrictions in place internationally.

At the time the UK cap was new (introduced in 2015) whereas many other countries have evolved restrictions over time, gradually reducing the cap due to the evidence of so many customers having high rate loans when reaching out for debt counselling.

The following examples will show that for reasons that are difficult to explain the UK is exceptionally tolerant of high interest credit and the many problems that result for many users.

Countries in Europe with no restrictions in 2017: Austria, Croatia, Denmark, Latvia, Luxembourg, Romania, Sweden

European countries with cap related to another variable e.g. average rate in market:

Belgium (c.18.5% APR), **France** (c. 20% APR), **Germany** (rate must not exceed 2 times average for a given loan type), **Estonia** (3 times), **Italy** (1.5 times), **Portugal** (1.33 times), **Slovakia** (2 times), **Slovenia** (2 times). All of these countries have low caps.

Australia: Payday loans have a cap of 4% per month on the interest rate, so approx. 0.13% per day (48% p.a.), in addition, small loans under A$2000 can have an additional maximum set-up charge of 20% of the loan amount (for a 60 day loan this is equivalent to a daily rate of 0.5%, APR 182.5%).

Canada: a matter for each state. Quebec limits the rate for all lenders to 35% p.a. with the effect that payday lenders do not operate in the state. Newfoundland has an interest rate cap of 60% p.a. Other states cap only payday loans at 1.1% to 1.28% per day, depending on the state. A quarter of people filing for bankruptcy in Ontario had pay day loans, which was considered very high.

Japan: In the period 1954 to 2006 the maximum interest rate has reduced from 109.5% to 20%.

USA: c.14 US states and the District of Columbia either ban or limit the rates on pay day loans to 36% APR. Federal regulation limits the interest rate charged to active duty armed forces member to 36% p.a.

A report entitled "Price rules in consumer credit – should the EU act" was published by the European Credit Research Institute in 2019 (https://www.ceps.eu/wp-content/uploads/2019/03/ECRI%20RR%2022_Price%20rules%20in%20consumer%20credit-should%20the%20EU%20act.pdf). It draws out the different approaches in Europe.

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[i] See “Better Debt Advice” (The Money Advice Service, December 2017) –“Many people do not fully understand the extent of their debts or understand where the line between manageable and unmanageable debt lies"

See “Life Happens” (StepChange Debt Charity, July 2019) – a recent comprehensive review of coping with life events. “Using credit to cover essential spending, a common strategy employed by people following a life shock, heightens peoples risk of debt. People who used credit cards or an overdraft to cope after a life event were ten times more likely to be in problem debt than those who got by without using them”. The report contains a chart showing 98% of people using high cost credit as a coping strategy and 86% of those using credit cards or overdrafts as a coping strategy after a life event were in problem debt or showing signs of financial distress.

[ii] 2018 Adult Financial Capability Survey (The Money Advice Service)

[iii] “Life Happens” (StepChange Debt Charity, July 2019)

[iv] “A silent killer – breaking the link between financial difficulty and suicide” (Money and Mental Health Policy Institute, December 2018) – “People in problem debt are three times as likely to have thought about suicide in the last year”; “…420,000 people in problem debt thought about suicide in England last year and over 100,000 people in problem debt attempted suicide”.