The future of Illegal Lending in the UK

Online, unregulated – and coming soon to a market near you?

Emerging findings presentation to MALG

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Methods, data sources and definitions

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Emerging Findings on Illegal Lending

Online, unregulated and coming soon to a market near you?

About the project

- A Policis public-interest project
- Research findings shared today are part of wider international project looking at outcomes for consumers of different approaches to credit market regulation
- We are sharing emerging findings in order to make compelling and timely new evidence available to the policy maker, regulator and stakeholder community
- Today's event is focused on:
  - Headlines around scale and impact of illegal lending in the US and implications for UK
  - Lessons from US on addressing detriment in high cost short term (HCST) credit market and efforts to tackle illegal lending
- Further data releases and formal report will include analysis of other selected jurisdictions, notably Japan and Australia, more detailed analysis of the US experience and consumer outcomes in 2014

Analysis rests on qualitative interviews with US regulators and analysis of robust quantitative data from large transactional databases

- **Quantitative data sources:**
  - Both licensed and unlicensed lenders use credit reference agencies to support credit decisions
  - Direct analysis of a representative sample of 9.4 million sub-prime small sum credit transactions 2010–2014 from across the US, drawing on the Clarity Services Inc database, the leading provider of credit reference analytics for the US online non-prime credit market
  - Aggregated data from a time-series data set of a representative sample of 28.9 million anonymised small sum credit transactions in the period from 2001 to 2011 and drawn from across the US – from Teletrack, the sub-prime credit reference agency
- **Qualitative interviews with state and federal regulators**, commissioners and supervisors from across the US:
  - Interviews undertaken on an unattributable, anonymised basis to facilitate frank disclosure and discussion
  - States selected to provide a mix of more or less permissive / restrictive approaches to regulation of small sum credit
  - States with the largest "sub 701" FICO score populations
  - States with notable approaches to tackling illegal lending
  - Urban and rural areas and mix of population types

US small dollar credit market regulation

- US small sum credit markets regulated at state level
- Wide mix of approaches in part reflecting historical origins, local politics and population
- General direction of travel in recent years has been towards reinforcing consumer protections and tightening of regulation
- Lenders lending into any of US states must be licensed by that state if to lend legally to residents of that state
- Licences to lend in one state cannot be used to lend into another state*
- Lenders based outside the US require a licence for any state into which they wish to lend

* albeit that some lenders with a single state licence make claims to legitimacy when lending into another state by referencing their single state licence

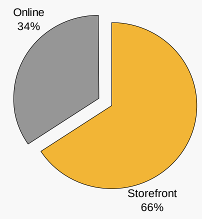
Definitions of terms and of legal and illegal lending

- Definitions of legal / illegal lenders are intended to mirror the approach of the US state and federal regulators
- Illegal and illegal lending have both been defined in relation to individual loan transactions within the database
- **Legal lenders** are defined as those with a licence to lend in the state in which the lending transaction takes place (defined by the residence of the borrower)
- **Illegal lenders** are defined as lenders which are not licensed to lend in the state in which the loan is made (defined by the residence of the borrower):
  - Lenders have been classified as illegal / offshore if the lender is unlicensed by the state into which they are lending and the lender is based outside the US
  - Lenders have been defined as illegal / Tribal if they are unlicensed by the state in which they are lending into and they are also asserting immunity from state regulation by means of an affiliation with an Indian tribe on a "sovereign nation" basis
- Throughout "Share of lending" refers to the share of numbers of actual loan transactions
- "Small dollar high cost" loans refers primarily to loans made by payday lenders but includes also small dollar loans made on an instalment basis
- Reference year is 2012 unless otherwise stated

The experience of the US online market is particularly pertinent for the UK because the UK is already a predominantly online market

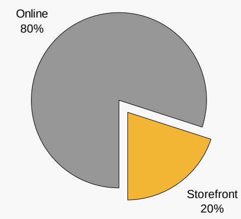
The UK HCST market is already 80% online and the regulator is on record that the UK market may be 100% on line by the end of 2015[3]

Split between online and storefront lending US[1]



Share of small sum high cost lending volumes by distribution channel

Split between online and storefront lending UK[2]



Policis estimates based on Clarity Services data

[1] Source: Stephens Inc
[2] Source: Competition and Markets Authority CMA Annotated Issues Statement 31 Jan 2014 page 11 of PDF
[3] http://www.bbc.co.uk/news/business-30000472

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The scale and impact of illegal lending in the US

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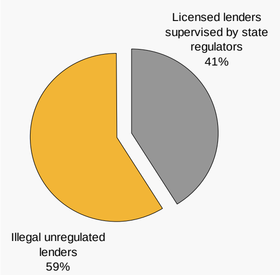
Illegal lenders dominate online small sum lending in the US

Six in ten online lenders are illegal

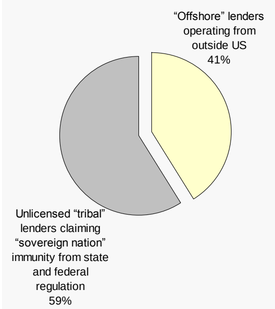
Online small sum high cost ending volumes by regulatory status of lender. % of the online market



Base: Online HCST loan transactions 2012

Four in ten illegal lenders operate offshore

Online small sum high cost illegal lending volumes by type of illegal lender



Base: Online illegal HCST loan transactions 2012

Policis estimates based on Clarity Services data

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The sheer scale of online illegal lending market in the US illustrates the challenges faced by regulators once an illegal market becomes established

- Illegal lending in the US is overwhelmingly online
- Within US online market, just 41% of all small sum high cost loans were made by lenders with a licence to lend into the state in which borrower lived
- 6 in 10 (59%) of all online small sum high cost loans were made by unregulated illegal lenders with no licence to lend into the state in which borrower lived:
  - 21 million illegal loans p.a. representing some $9.7 billion dollars p.a.
  - Online illegal lenders used by 2.4 million US consumers, primarily the higher risk and more vulnerable borrowers
- Represents 21% of all payday lending in the US
- Of all online small sum high cost loans, 41% were made by offshore lenders based outside the US

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State regulators report that online illegal lending now their major challenge

"If you went to Google right now and you typed in payday loans, you'd probably get over a million results. And we licence 1,300. You do the math…The challenge in regulating the lenders and, sort of implementing the regime, is the illegal activity that goes on, on the internet and online."

US regulator

Illegal lending highly damaging for consumers – featuring both detrimental and exploitative practice and clearly criminal activity

- There is a spectrum of conduct risk associated with illegal lenders
- At one end lenders may ignore price and responsible lending controls, continually roll over loans and engage in high pressure debt collection
- Products may be structured so as to both disguise and increase true borrowing costs
- At the other end of the spectrum, there is a cross-over with serious criminal activity, including unauthorised bank withdrawals, fraud, identity theft and extortion
- One survey of online borrowers by PEW research[1] suggests that:
  - 46% of online borrowers report that lenders had made withdrawals that overdrew their checking accounts (twice the rate reported by storefront borrowers)
  - 32% experienced an unauthorised withdrawal in connection with an online payday loan
  - 39% reported that their personal or financial information had been sold to a third party without their knowledge
  - 22% report closing a bank account or having one closed by their bank in connection with an online payday loan
  - 30% report being threatened by a lender or debt collector
- Regulators report both that complaints are overwhelmingly concentrated on illegal lenders and that the (mainly large) licensed online lenders attract very low levels of complaint

[1] http://www.pewtrusts.org/en/research-and-analysis/reports/2014/10/fraud-and-abuse-online-harmful-practices-in-internet-payday-lending

US state regulators are clear both that significant consumer detriment is occurring and that it is overwhelmingly associated with illegals

"The real harm to the consumers is that they take an ACH (Automatic Clearing House payment) with your account and so the money is just removed out of your bank without your control and it's not a one-time event. They keep grabbing money out of your account. That can be very damaging to consumers and the collections element is very damaging to consumers. If you don't pay money into your bank then you're harassed into paying the debt collectors."

US regulator

"The ones that are not licensed are just loan sharks. They roll people over, they wipe out bank accounts and they do not respect any legal authority whatsoever."

US regulator

"I would say 99% of the complains that we get from consumers have to do with unlicensed internet lenders."

US regulator

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The regulatory framework and the impact on supply and demand

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Regulators report series of benefits in authorised space arising from consumer protection measures and regulatory reform

- Lower cost of credit
- Enhanced lender conduct
- Improved underwriting / responsible lending standards
- Reduced "cycle of debt" issues
- Improved collection practice
- Fair debt resolution
- Improved treatment of financial difficulties

The scale and impact of illegal lending appears to depend on the balance between underlying demand and legitimate supply

- Complex framework of linked consumer protection provisions and price controls which differ considerably between states:
  - 45 states have some form of usury cap or price control
  - 14 states either ban high cost small sum credit outright or set caps at a level which precludes licensed lenders operating in the state
  - Only 3 states have no limit to prohibit lenders extending credit if borrowers have existing loans
  - 14 states use a Veritec-style regulatory database to enforce lender compliance
  - 20 states have legislative provisions which make debt to unlicensed lenders void and uncollectable
- Regulatory reform has clearly delivered consumer benefits within the authorised space and has gone some way to reducing demand for HCST credit
- Impact on licensed loan volumes rests on how various consumer protection provisions are combined with caps to make lending more / less profitable
- Lending volumes fall more sharply in states where combination of provisions and caps put greatest pressure on margins / business models
- Unintended effects in the form of online unlicensed lending arises most strongly where legitimate credit supply and loan volumes are most constrained or HCST is banned

Where supply is restricted demand is moderated by reduced market stimulus but remains significant because underlying drivers remain

- Restriction of supply appears successful in suppressing "impulse" demand and thus in reducing consumer requirement for HCST
- But relatively high proportion of short term borrowing is driven by distress and need to address "emergencies" and cash flow crises
- Applications fall in states where legal lenders (often the largest) not actively soliciting for business and where state lenders primarily storefront
- Where restrictions cause suppliers to withdraw because lending becomes unprofitable:
  - Some of demand falls away – that element that stimulated by advertising and marketing activity of lenders and brokers
  - Underlying demand remains – driven by events, cash flow constraints, uneven earnings and lack of savings safety nets
- In states where legitimate supply more restricted applications tend to shift online where unlicensed lenders a high proportion of overall suppliers

The experience of US regulators is that demand for credit does not go away when supply is restricted – and is served by illegals

"Well, essentially, what happened is that the legislation got rid of the supply. I should say, got rid of the local supply, but it did nothing to address demand…well they turned to unregulated, you know, unlicensed lenders, primarily internet based. They don't follow the cap rate or anything along that line."

US regulator

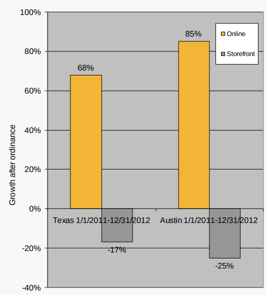
"You talk to the (named state) regulatory, they will probably tell you that they don't have payday lending in their state and everything is just fine. But, guess what, they do have payday lending in their state but it's just illegal online payday lending that they have."

US regulator

In the US where legal supply has been restricted – demand has been displaced from storefront to online and from legal to illegal lenders

Texas: Following regulatory change 2012 demand was displaced from storefront to online while applications to lenders rose

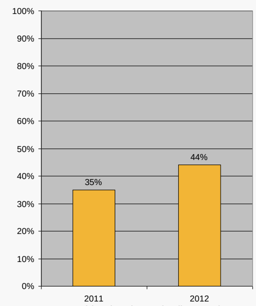
Changes in applications for payday loans by distribution channel Texas YOY 2011/ 2012



Following introduction of payday loan ordinance in Texas on 1st Jan 2012 In Texas state-wide, storefront lending fell by 17% while the number of consumers applying for an online payday loan rose 68% and in Austin, it rose 85%. Source: Tim Ranney blog Non Prime 101.based Clarity Services inc data.

Texas: Following regulatory change 2012 Illegal lenders increased their share of online lending volumes

Share of all online small sum high cost lending in Texas represented by illegal lenders 2011 / 2012.



In Texas state-wide, the share of online payday lending represented by illegal lenders rose from 35% in 2011 to 44% in 2013 following the introduction of a new payday loan ordinance in Texas on 1st Jan 2012 which restricted supply. Source: Policis estimates based Clarity Services data.

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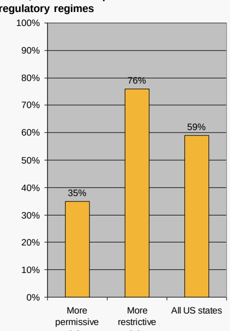
In states with more restrictive regimes online lending is dominated by illegals – with a disproportionately high share of online illegal lending occurring in states where payday is banned or effectively banned

Illegal lending represents a much higher share of online lending in states with more restrictive regimes

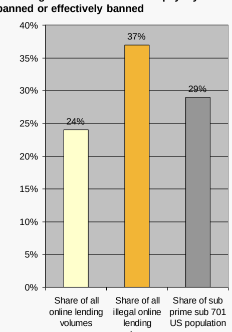
Illegal lending as share of all online lending all, US states, more or less permissive / restrictive regulatory regimes



Base for restrictive regimes exclude those states where payday actually or effectively banned

Almost 4 in 10 illegal payday loans in US are being made in states where payday actually or effectively banned

Share of all online and illegal online lending in US occurring in 14 US states where payday lending banned or effectively banned



Base: 14 states where payday banned or effectively banned. Source: Policis estimates based Clarity Services data.

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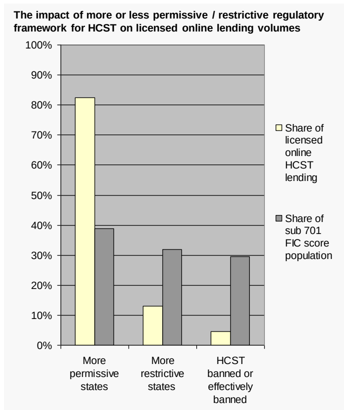
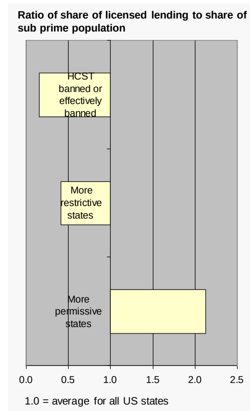
Licensed online lending is overwhelmingly concentrated in those states with relatively permissive regimes

8 in 10 legal loans are made in states with more permissive regimes



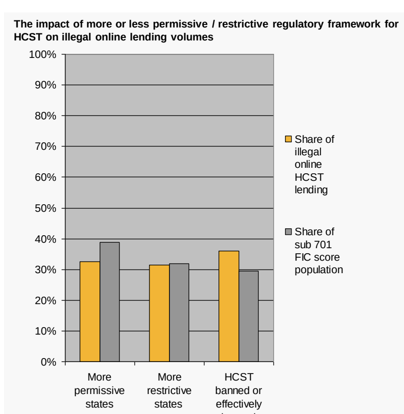
Consumers in the more permissive states are more than twice as likely to be using a licensed lender



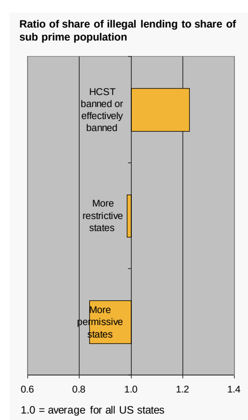
Source: Policis estimates based Clarity Services data

Almost all US states have an online illegal lending problem but illegal lending is disproportionately higher in the most restrictive states

In the more permissive states consumers are almost 20% less likely than average to use illegal lenders



Consumers in states where payday is banned are 20% more likely than average to use illegal lenders



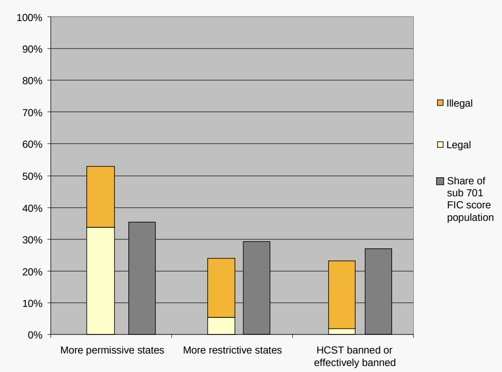
Source: Policis estimates based Clarity Services data

The power of demand: Taking licensed and unlicensed lending together total borrowing in more restrictive states and states where payday banned is close to the "natural" level implied by share of the sub prime population – but most of it is illegal

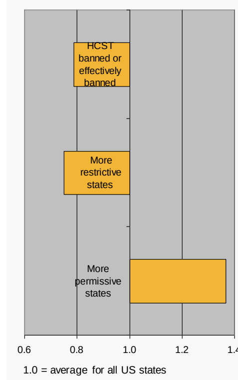
There are higher levels of borrowing in the permissive states – but the share represented by illegals is relatively low

In restrictive states and those where payday banned share of total borrowing is only slightly lower than these states' share of the sub prime population

The impact of more or less permissive / restrictive regulatory framework for HCST on total online lending volumes



Ratio of share of total lending to share of sub prime population



Source: Policis estimates based Clarity Services data

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Underlying demand has not gone away in US when supply restricted and position of low income borrowers suggest unlikely to do so in UK

- A significant proportion of those who have historically turned to payday lenders in UK exhibit characteristics which would imply ongoing need for credit
- Among low income UK consumers who use credit and are banked and in work:
  - 56% have no savings
  - 64% could not raise £200 – £300 in an emergency without borrowing
  - 15% have been refused credit in last twelve months
- Among UK payday borrowers:
  - 59% have no savings
  - 71% could not raise £200 – £300 in an emergency without borrowing
  - 57% have been turned down for mainstream credit in the last 12 months

UK payday lending volumes fell 35% in first 4 months of FCA regime[1] and have halved since inception of the regime – but payday applications are not falling significantly[2] – rather decline rates have been rising[3]

[1] Source: FCA press release 11/11/14
[2] https://assets.digital.cabinet-office.gov.uk/media/5435a640ed915d1336000005/Payday_lending_PDR_and_appendices.pdf See page 222
[3] FCA PS14/16 PDF page 13

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The effort to tackle illegal lending

Efforts to enforce compliance and tackle illegal lending have rested on a variety of approaches

- Central “regulatory database” to capture and validate all transactions
- Consumer education / awareness building on illegal lending
- Cease and desist actions
- Pursuit through the courts
- Court mandated rebates / compensation for consumers
- Null and void provisions
- Denial of payment and banking services
- Alternative supply

Approaches focused on enforcement, deterrence, education, alternative supply have been fragmented, small scale and largely ineffective

- Considerable variation between states in rigour of enforcement and supervision and resource, funds and political will to tackle illegal lending
- Consumer education and awareness building appears to have had limited impact in deterring consumers from using illegal lenders
- Measures intended to enforce compliance standards in authorised space appear also to have provided stimulus to illegal lending
- "Cease and desist" actions often ignored or evaded by lenders mutating identities, with few states having resource required to pursue
- Compensation / redress schemes have been successful only on very small scale – and have require significant resource and funds to achieve
- "Null and void" provisions to render illegal lending unattractive to suppliers appear ineffective – in large part because appear insufficiently promoted
- Efforts to create alternative supply – through social lenders or mainstream banks – have thus far failed to achieve meaningful scale

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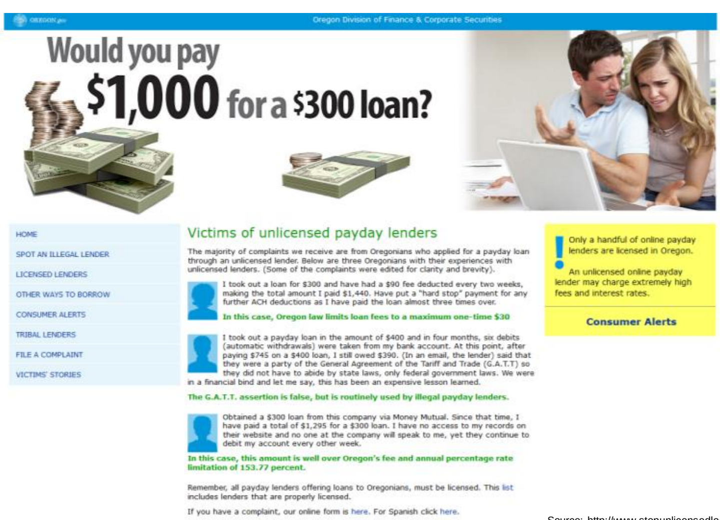
Regulators' efforts to educate consumers on the risks of using unlicensed lenders have largely failed to stem the tide of consumer detriment



Illegal lenders represent 74% of all online small sum lending volumes in Oregon

(Source: Policis analysis of Clarity Services data)

Oregon State Regulator's consumer-facing public education web-site

Source: http://www.stopunlicensedloans.com/victims_stories.html

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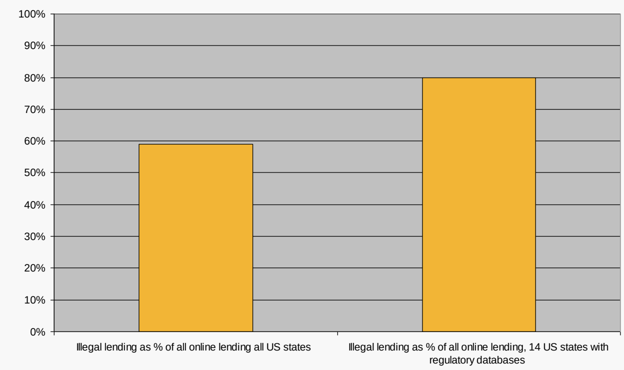
Regulatory databases which ensure effective enforcement, high levels of compliance among legal lenders and consumer benefits in authorised space also act to stimulate illegal lending and consumer detriment outside it

Regulatory databases in 14 states enforce compliance and raise conduct standards among licensed lenders but also have the effect of diverting higher risk and more vulnerable borrowers to illegal lenders



Proportion of online lending volumes which sourced from illegal lenders
All US states and 14 states with regulatory database to enforce compliance

Cease and desist actions are frequently ineffective – and require prohibitive resource. Publication of enforcement action appears to deter few consumers

“Maybe 25% of the time they respond to us and take notice. Most of the time they don’t.”
US regulator

“We sent out cease and desist letters to these institutions asking them to stop. You’re breaking the law, so basically don’t do it anymore…Some of them said they have stopped. Some of them say they won’t stop and some of them just said ‘we don’t have to listen to you because you don’t, you can’t do anything to us.”
US regulator

“We try to keep track of them as best we can…in terms of you know serving them and subpoenaing them and that kind of thing, and auditing them. We are limited because of the lack of resources to go after them. But in doing that, what we do as well is we publish our actions and so what we hope is that people have enough presence of mind to just even Google the company that they’re looking at and they’ll see that there’s a caution alert or even an enforcement action from our department and they might think twice about using them…you may maybe prevent a few hundred from getting into some kind of debt trap.”
US regulator

US regulators report that, when challenged, illegal lenders mutate identities and are frequently effectively beyond the reach of the law

"It's like 'Whack-A-Mole'. Some of these folks they operate under several different business names and, you know, you may close down one and open up another and it's as easy as just getting a web-site."

US regulator

"They open as Cash Ferry today and ABC lending tomorrow. You don't even know where they are operating from, Dubai, China…"

US regulator

"It's been very ineffective with tackling the online payday lending and it's not from lack of trying…by the time you file the charges the company just kills that website and opens a new one…you can't get to the person who owns it and, if they're outside the country, it's beyond, you know, the long arm of the law."

US regulator

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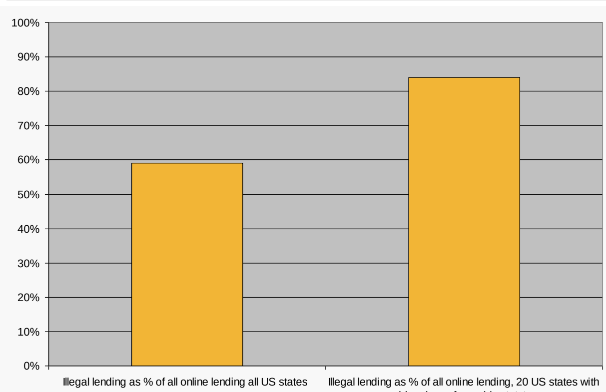
Even "void and unenforceable" provisions have not deterred illegal lenders

States where debt owed to illegal lenders is void and uncollectable are among those with the highest incidence of illegal lending



Proportion of online lending volumes which sourced from illegal lenders
All US states and 20 states with statutes whereby illegal lending debt void and unenforceable

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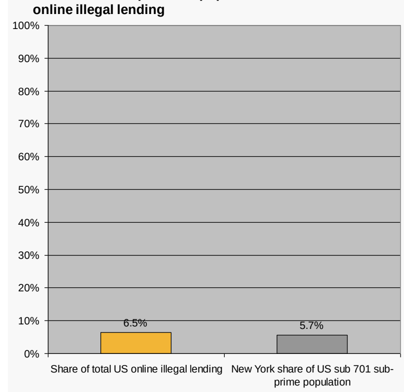
Most committed states which have put significant material effort into tackling illegal lending have had some success but have not eliminated problem

New York best funded, most pro-active and assertive state regulator in pursuing illegal lenders and has had some success both in court and in reducing illegal lending but illegal lending remains a problem in the state

NY regulator has pursued illegal lenders aggressively across series of fronts

- Payday lending ban
- Storefront lenders closed down
- Monitor and analyse consumer complaints on online lending into NY
- Consumer education and publication of enforcement actions
- Co-ordinated "Cease and Desist" action on all identified online lenders
- Successful court action against "Tribal" lenders
- Work with banks to deny lenders access to payment systems
- Tackle broking and payment intermediaries
- Alternative credit supply

NY share of sub prime US population and share of US online illegal lending



The most effective actions appear to be co-ordinated, multi- agency and undertaken at federal level, targeting infrastructure on which illegals depend

- Effort at federal level to choke-off access to the payments infrastructure on which illegals depend initially had dramatic impact in closing down lenders
- Regulators have since back-tracked in face of legal and other challenges
- However "fear factor" among banks and their aversion to regulatory risk continues to constrain lenders' access to banking, funding & payments system
- In practice, as lenders mutate ID / business models, payments to illegal lenders have proved difficult to identify within billions of payments in payments systems
- There appears also to be significant collateral damage for legal businesses
- Indications are however that over time illegals have adapted products / business models / infrastructure and are re-building share
- Some states reaching view that accommodation with illegals or building supply solutions only realistic way forward in controlling / mitigating impact of illegals

Thus far US efforts to create alternative mainstream supply have not achieved any scale. Some states now considering new alternative supply solutions

- **US FDIC small dollar loan programme (2 year pilot 2008/9)[1]**
- Intended to act as template for safe affordable small dollar loans delivered by mainstream banks as alternative to HCST:
  - $2,500 or less
  - APR 36% or less
  - 90 day term
- Low take up among mainstream banks:
  - 28 volunteer banks, mostly small
  - 15 banks offered fewer than 50 loans of less than $1,000 in Q4 2009
- Volumes achieved a small fraction of HCST lending:
  - 31,000 total loans in period of pilot
  - 18,100 loans less than $1,000
- Pricing not feasible without "origination" fee:
  - Average $31 on average $724 small dollar loan over 12 months

[1]https://www.fdic.gov/bank/analytical/quarterly/2010_vol4_2/FDIC_Quarterly_Vol4No2_SmallDollar.pdf

"So, so long as there's demand, there will be somebody trying to meet that demand…even if that demand is seeking a product that's banned and illegal in the state. It's just really kind of…so I think the strategy presently is to really come up with alternatives to meet demand,

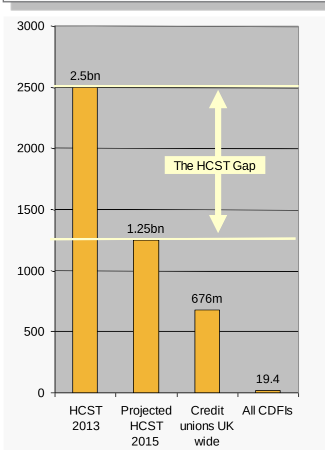
US regulator

"The end game really is to…I guess the end game is twofold, so of course stop payday lending into (named state) period, and secondly help those who…the only way you're going to stop this transaction is to give alternatives…So we're thinking about alternatives to dealing with these out of state, shady characters."

US regulator

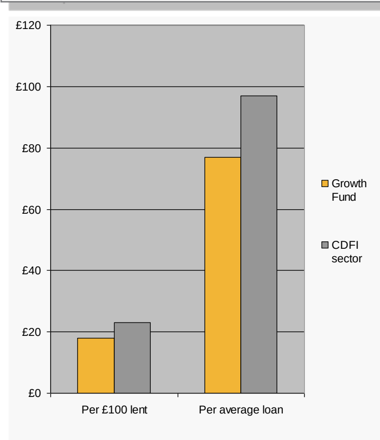
Even scaled up CU sector will not be sufficient to fill HCST gap in UK – and historically small sum social lending has required significant subsidy

Lending volumes p.a. High cost lenders, credit unions and social lenders 2013



Source: Payday 2013 FCA CP 14 – 10, Policis estimates 2015 based decline in lending volumes, ABCUL end Dec 2013, FCA, CDFA Inside community finance 2013.

Subsidy per £100 lent and subsidy for average loan – Growth Fund credit unions small sum loans and CDFI sector personal loans



Source: DWP Growth fund evaluation Table 7.8, page 58
CDFA, Inside Community Finance 2013

Key take outs for the UK from the US experience

- The future of illegal lending is not the loan shark with a baseball bat of popular imagination but online and at scale and can be highly detrimental to consumers
- UK facing very similar conditions to those in US which gave rise to large illegal lending market – but risk more acute in overwhelmingly online UK market
- Demand does not go away when supply is restricted
- Unmet demand will likely be served by unlicensed, unregulated lenders, potentially off-shore or in EEA
- Once illegal lending market becomes established, it is very difficult to tackle
- Illegal lenders will look just like licensed lenders and consumers will find it hard to differentiate between them
- If regulators measure impacts and realised consumer benefits in authorised sector alone, they may miss larger detriment arising in illegal sector

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The UK must not sleep-walk into what would be a disaster for consumers – while also creating a disorderly credit market

- US experience suggests there is no room for complacency on illegal lending
- FCA's assumption that illegal lending will not be a problem in UK following significant shrinkage in private sector supply appears misplaced
- The regulator's contention that demand will fall away or be served by family and friends is not credible in light of US experience (and that of other markets)
- UK consumers facing real and present danger of highly damaging black credit market developing
- Real possibility of disorderly credit market arising that manifestly does not work well either for consumers or legitimate market participants

Urgent need for action to prevent large-scale illegal lending market emerging in the UK

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Government, regulators, the justice sector and consumer advocates need to come together to develop coordinated strategy

- Revisit the FCA stance on potential risk of illegal lending as a matter of urgency
- Develop a co-ordinated multi-agency and multi-dimensional strategy for prevention with resource and funding which proportionate to the potential threat
- Take urgent steps to monitor indicators of illegal lending activity effectively
- Educate consumers on the risks of dealing with online unlicensed lenders
- Build alternative supply through credit unions and other social lending partners
- Ensure that the 2017 review of the rate cap:
  - Does not focus narrowly on evaluating the outcomes for consumers within the authorised space
  - Critically – the review must consider the impact that the cap has had for the emergence of illegal lending and any associated detriment for consumers
  - Focuses on the optimal balance between consumer protection and damaging credit exclusion
- Be prepared, if necessary, to bring the review forward to 2016 / 2015

The time to act is NOW!!

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Next Steps

- Independent expert working group set up with view to:
  - Understanding how most effectively to monitor potential emergence of Illegal lending in UK
  - Explore how best to prevent illegal lending market develop in UK
  - Work with policy makers, regulators and stakeholders to frame effective policy anmd strategic response
- Further analysis of US market will:
  - Seek to quantify differences in outcomes for consumers between state-licensed and unlicensed lenders in terms of costs, benefits and detriment
  - Quantify the numbers of consumers experiencing the outcome that regulators intended and those experiencing unintended effects in different regulatory regimes
  - Seek to understand outcomes for lenders (state licensed and illegal) and consumers of regulatory intervention at federal level over 2013 / 2014
  - Potential outcomes of new affordability and responsible lending requirements
- Additional analysis of Japanese and Australian markets will provide further context around consumer outcomes and different regulatory approaches

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Contact

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