PRO BONO ECONOMICS

Externalities arising from use of high cost credit in the UK

A feasibility study for Fair4All Finance

In association with Ian Moore

Disclaimer

This report (the “Report”) has been prepared by Pro Bono Economics ("PBE") based on information provided to it. This information has not been independently verified by PBE. No liability whatsoever is accepted and no representation, warranty or undertaking, express or implied, is or will be made by PBE or any of its directors, officers, employees, advisers, representatives or other agents (together, “Agents”), for any information or any of the views contained herein (including, without limitation, the accuracy or achievability of any estimates, forecasts or projections) or for any errors, omissions or misstatements. Neither PBE nor any of its respective Agents makes or has authorised to be made any representations or warranties (express or implied) in relation to the matters contained herein or as to the truth, accuracy or completeness of the Report, or any associated written or oral statement provided.

The Report is necessarily based on financial, economic, market and other conditions as in effect on the date hereof, and the information made available to PBE as of the date it was produced. Subsequent developments may affect the information set out in the Report and PBE assumes no responsibility for updating or revising the Report based on circumstances or events after the date hereof, nor for providing any additional information.

The Report is not an opinion and it is not intended to, and does not, constitute a recommendation to any person to undertake any transaction and does not purport to contain all information that may be required to evaluate the matters set out herein.

The Report should only be relied upon pursuant to, and subject to, the terms of a signed engagement letter with PBE. PBE only acts for those entities and persons whom it has identified as its client in a signed engagement letter and no-one else and will not be responsible to anyone other than such client for providing the protections afforded to clients of PBE nor for providing advice. Recipients are recommended to seek their own financial and other advice and should rely solely on their own judgment, review and analysis of the Report.

Contents

Executive summary

Based on regulatory returns, the Financial Conduct Authority (FCA) has estimated that 1.7m people take out short-term, high-cost credit loans each year, with an average of three loans per person per year (FCA, 2019b). High-cost credit (HCC) is predominantly used by the poorest socio-economic groups. These groups have multiple deprivations arising from lower levels of employment, education, and income, much of which are mutually reinforcing, and can therefore create high levels of demand on public services.

This report reviews the literature on the negative externalities (e.g. poor mental health and other medical impacts) caused by the use of HCC with a view to constructing an economic model of the societal costs. At this stage, it has not proved possible due to the lack of robust estimates for the impact of HCC on individuals.

The report outlines two recommendations on the key evidence gaps:

1. Develop a theory of change for affordable credit solutions that considers the findings of the literature review provided. Once developed, this theory of change can map out where existing research can be used or where there is a need for new research.
2. Build an evidence base by developing a standardised user questionnaire for credit outcome measurement. This questionnaire should utilise metrics from mental and physical health research so that results can merge with existing datasets and results can be contextualised against social norms/averages and other studies.

1. Introduction

Fair4All Finance exists to improve the financial resilience of people in vulnerable circumstances by increasing access to fair, affordable and appropriate products and services.

Fair4All Finance commissioned Pro Bono Economics to review the literature on negative externalities (costs imposed on wider society) caused by use of high cost credit (HCC) and determine if and how estimates of the wider societal economic costs can be estimated. Our detailed bibliography and commentary-cum-review notes on the main sources are contained in the separate appendix.

Examples of the direct impacts affecting users are lower wellbeing scores, mental health issues, and other medical impacts. In turn, these can translate into externalities such as higher demand on public health services such as GPs, hospital admissions, NHS mental health programmes and other agencies. Other wider impacts are likely to be found in other areas of social policy, such as: loss of housing, crime, education, foodbanks.

2. Background: what is "high cost credit"?

"High cost credit" (HCC) refers to lending products where the cost of credit is substantially higher than mainstream credit products.

This is a fairly broad definition of a market, and from the demand side includes all customers who are outside the mainstream lending providers (i.e. high street banks and building societies) or cannot access mainstream finance products (e.g. 0% motor or furniture deals), typically because of low credit scores, low and/or irregular income, or not having a bank account.

The Financial Conduct Authority (FCA) has regulated commercial high cost lenders since 2014. Typical forms of HCC are: store credit (particularly rent-to-own), payday loans, catalogue credit, home-collected credit. According to the FCA, the average APR charged by commercial high cost lenders in 2018 was around 1,250%.

The FCA's handbook includes a definition of a high-cost short-term credit product (HCSTC) centred on APRs being greater than 100% and term less than 12 months but excluding loan agreements which are either mortgages or are provided by community finance organisations. This definition largely covers payday loans.

The FCA (FCA, 2019c) discusses alternatives to high cost credit, sometimes referred to as "affordable lending" or "lower cost credit". Such alternatives include credit unions (whose APRs are capped at 42.6%) and community development finance institutions (CDFIs) where loans are often offered at rates above 100%. Fair4All Finance estimate that the affordable credit sector provides c.£250m lending each year, compared to c.£3bn from commercial high cost lenders (Fair4All Finance, 2020).

In looking at the costs to wider society (see section 4), implicitly our hypothesis is that negative outcomes are reduced if consumers who are excluded from mainstream credit are able to access more affordable lending options, such as those outlined in the FCA report, rather than relying on commercial high cost lenders.

Since taking on the regulation of the sector, the FCA has introduced several remedies aimed at protecting consumers from harm, covering product pricing caps as well as measures on disclosure and simplifying fees, etc , particularly designed to "enhance protection against harmful repeat borrowing" (FCA 2019a). These regulations cover HCSTC as above and also the rent-to-own sector. As a result, some companies have closed or reduced operations significantly.

HCC needs to be distinguished from "problem debt". The National Audit Office definition of this is as follows: "Over-indebtedness, or problem debt, is when someone becomes unable to pay their debts or other household bills." Thus over-indebtedness may arise from: a customer with a mainstream mortgage getting behind on payments; a household unable to keep up with rent, electricity or say council tax payments. It may also include debt that originated as HCC. In general, "problem debt" has much wider demographics than HCC which is largely concentrated in the poorest socio-economic groups.

3. Economic and social context

HCC is predominantly used by the poorest socio-economic groups. These groups have multiple deprivations arising from levels of employment, education, and income, much of which are mutually reinforcing, and can therefore create high levels of demand on public services such as education, health, social services, housing services and so on.

Therefore, in exploring estimates for the externalities of HCC we need to address two particular issues around causality:

1) *Uniqueness* – given the common multiple deprivations in the relevant socio-economic groups, it is critical to isolate any impacts attributable solely to HCC from those derived from other causes
2) *Direction* – at its core, the question here is whether HCC is a product solution taken out by those in poor economic/social circumstances or whether HCC in and of itself causes or worsens such situations?

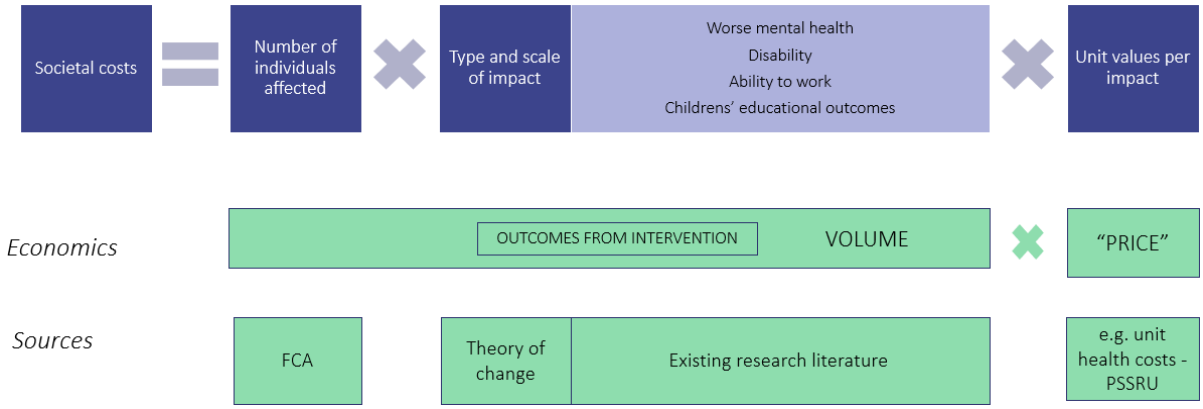
As is clear from the FCA's regulatory agenda, HCC often results in poor customer outcomes. These can arise from the cost and/or frequency of repayments, creating or adding to worry and stress in the household. Predatory or egregious collection practices have also been identified as leading to negative health outcomes.

However, it is important to note that HCC does have some positive characteristics and can be seen as an effective solution for some users, for example, enabling the acquisition of white goods leading to better family diet, or funding transport that enables a more stable employment pattern. Davies et al (2016) also stress users' "desire for close budgeting control" and characterise HCC as "both 'imposed' and 'choice'".

There may also be adverse impacts on household budgets. When a high proportion of income is spent on repayments, this reduces the residual disposable income available for food, clothing, children's education or other purposes. In turn, this may increase dependence on social provision, either public or third sector.

4. Construction of an economic model

Our broad framework to constructing an economic model is set out in the following diagram:



In this feasibility study, we therefore examine each of these components in turn.

Step 1: How many people are affected?

There is good data on the size of the population we are interested in. Based on regulatory returns, the FCA have estimated that 1.7m people take out short-term high-cost credit loans each year, with an average of 3 loans per person per year (FCA, 2019b)[1].

[1] Note: this is a much smaller figure than the 3.1m individuals reported as using "high cost loans" in the Financial Lives Survey (FCA, 2018). In the Financial Lives Survey summary tables, a different definition of "high cost loans" is used which includes certain products / providers where APRs are below 100%.

Step 2: What are the personal and societal impacts?

Although we have not developed a theory of change as part of this work, existing work such as RSPH (2018) has set out the impacts, citing linkages to "poorer self-rated mental health, disability, chronic fatigue and obesity" (p.6). Our literature review has found that these impacts are demonstrated repeatedly in academic studies covering a wide variety of geographies and types of debt.

However, these studies are predominantly focused on "problem debt" and many start with indicators such as mortgage arrears which differ significantly from HCC products. Others draw on niche segments such as gambling debts or (in US studies) medical debts. We are extremely cautious whether these niche studies can be used in analysis of the HCC market due to differing socio-economic contexts.

Nonetheless, there is a clear consensus in the literature that higher levels of problem debt are directly associated with higher levels of poorer mental health and other medical impacts. For example, using the Millennium Cohort Study, Pinter et al (2016) show how children's mental health scores worsen with increasing numbers of debt types in lower income households with financial difficulties (but, crucially, not in higher income families with no financial difficulties). One study that is specific to HCC is Eisenberg-Guyot et al (2018), and, based on US census datasets, this found 38% higher prevalence of worse self-rated general health (ie scored as poor or fair health, rather than good, very good or excellent) among individuals with fringe borrowing compared with a propensity matched control group. Only negligible health effects were found for other high APR products (notably refund anticipation loans), suggesting that one-off transactions have a different impact to enduring borrowing.

From our literature review, it is also noticeable that most of the detailed studies are typically very cautious about causality and attribution. This leads us to conclude there is an amplification or aggravation effect from debt being added to already stressed livelihoods in the poorest socio-economic groups. This pattern was also found by Gathergood (2012) using the UK Household Longitudinal Survey, whose results show that firstly, pre-existing mental health difficulties were a key indicator of later problem debt, and secondly that mental health scores become worse following onset of problem debt.

Turning to evidence specific to HCC, various of the case studies (and in particular third sector evidence) draw a direct link from the behaviours of commercial HCC providers to users' mental health subsequently worsening. Some of the SROI studies on alternative providers' impact also demonstrated improved self-assessed health as a social outcome for their user groups. While there is very strong consensus that these effects are real and widespread (in part drawing on the conclusions of the "problem debt" literature), to turn these into economic estimates of impact requires more robust statistical evidence on the prevalence, direction and strength of these links (see Step 3 below).

Almost all of the literature we reviewed is focused on the medical impacts on individuals with problem debt, and there is little to none exploring other personal or societal impacts, such as ability to work, or children's educational attainment for example. Some of the third sector organisations in the UK have done some qualitative research or present results from small user surveys, and in general these support the expected direction of impact. But overall, the studies are small-scale and do not yield any systematic results.

Step 3: Can we quantify the impact?

To estimate the wider societal impact, we need to split the question into two parts:

1) what is the quantifiable impact of using HCC products on the individuals (e.g. how much does mental health worsen); and
2) what is the increase in demand for public health services (or other agencies) for each unit of outcome?

The first part of the quantification is very specific to the research topic and needs to be clearly about HCC products. As above, we are cautious about extrapolating from the broader literature based on problem debt. The second part of the quantification can often be estimated using wider studies or more general population sets.

From our literature review, we were able to identify two approaches to estimating the scale of impact on individuals/households:

Econometric work

NAO (2018) used the UK Household Longitudinal Survey and found that problem debt caused an 8% increased likelihood of experiencing anxiety or depression. This translated into 81,000 additional persons impacted, of which 39% (assumption based on prior academic literature) would seek treatment.

We have explored if this approach could be replicated for HCC rather than problem debt, but the necessary indicator variables (i.e. individuals with an HCC product holding, rather than questions of household financial stress) do not currently exist in the main panel surveys we have examined[2].

We have also considered Eisenberg-Guyot et al's work which similarly used longitudinal datasets. To our knowledge, this cannot be replicated in the UK as there is no equivalent of the FDIC's supplement on fringe banking that is part of the US Census Bureau's Current Population Survey.

User surveys

Results from SROI studies such as CfRC (2017) and Centre for Social Impact (2014) have demonstrated an improvement in various wellbeing scores amongst users when using the respective social loan schemes compared to users' previous experiences.

The main difficulty in extrapolating from these studies is the question of attribution and counterfactual. Thus, we need to distinguish whether the positive outcomes being reported are driven by successful access to credit (rather than being turned down), or because the loan comes from a third-sector organisation at lower cost (rather than a commercial provider). Potentially the results are being driven by the positive features of HCC and hence "choice" (as described by Davies et al 2016), rather than a counterfactual scenario based on different HCC providers. This question could be addressed with proper counterfactuals (e.g. undertaking similar survey / scoring for equivalent individuals who are using higher cost credit solutions).

Given the complex needs of the socio-economic group most likely to be taking out HCC products, an alternative (weaker) approach is to compare outcomes to the next worst group (i.e. if groupings were thought of as deciles, it would be taking results for the 1st decile and comparing to results for the 2nd decile).

Step 4: What is the unit cost of the impacts?

If we were able to produce estimates that quantify the impacts, then translating this into economic benefits for the individual and wider society (including potential fiscal savings for government) would be relatively straightforward. Sources such as PSSRU publish unit costs of individual treatments in the NHS, while other research has estimated wellbeing and other benefits (e.g. Kings Fund). Given the evidence gaps above, this area was not researched in detail but based on Pro Bono Economics' prior experience, we would not expect this component to be problematic for the construction of an economic model.

5. Conclusions and recommendations

At this stage, it has not proved possible to construct an economic model to estimate the externalities associated with HCC, due to the lack of evidence on such externalities. In particular, we are lacking robust estimates for the impact of HCC on individuals.

[2] In particular, we have checked the question banks in the following three surveys: Household Longitudinal Survey ("HLS", also known as "Understanding Society"), Adult Psychiatric Morbidity Survey ("APMS"), and the Millennium Cohort Study ("MCS").

Compared with the topic of "problem debt", where the available literature and evidence for externalities is well developed, we have identified two key evidence gaps that need to be filled before an economic model of societal costs can be constructed:

Theory of change

The HCC "market", and affordable credit solutions (i.e. alternatives), is a relatively narrow economic and social space compared to the wider issues of problem debt, and while there are some overlaps, there are also notable differences. Further development of a robust theory of change for affordable credit solutions (i.e. replacements for existing commercial HCC products) taking on board the findings of this literature review is recommended. This should clearly state the impacts attributable to affordable solutions or HCC, as opposed to problem debt, and also look to isolate unique HCC impacts rather than wider mix of problems common in the relevant socio-economic groups. It should also articulate differences between the various product types and original underlying consumer needs, since much of the US literature in particular finds marked differences here.

Once developed further, the theory of change will help map out where existing research can be used or where there is a need for new research. Thus most of the literature focuses on mental health issues, and there is a relative dearth of evidence in areas such as physical health or children's' educational achievements.

Quantification of impacts

Existing SROI studies unique to HCC are small scale and do not yield any systematic results. In the short term, the most obvious route to building an evidence base would be develop a standardised user questionnaire for repeated use by organisations across the sector. If possible, such a questionnaire should use existing best practice from mental and physical health research so that results dovetail to existing datasets and results can be contextualised against existing social norms/averages as well as other studies. As the range of alternative credit providers expands it would also be interesting to explore the relative benefits of the different solutions (e.g. housing association loans to tenants for white goods, vs other solutions), as well as contrast the results for the period since the implementation of the various FCA remedies to the type / scale / prevalence of outcomes that were occurring prior to the current regulatory regime.

In the longer term, it may be valuable to work with the owners of the main surveys to develop additional questions (or modules) specific to HCC, for example expanding the scope of the FCA's Financial Lives Survey.

Appendix: Description of approach / sources

For this work, we conducted a rapid literature review using five strands:

1) Fair4All Finance suggested the "Life on debt row" report (Royal Society for Public Health, 2018) as a key source. We then followed its references for further primary sources, and also did citation searches of certain of those primary sources to look for more recent studies.
2) From the regulatory/government sector, we reviewed various FCA reports from its work on the high-cost credit sector, plus the data and insights from the FCA's "Financial Lives Survey 2017". We also examined the National Audit Office 2018 report on "Tackling Problem Debt".
3) From the third sector (charities and research/policy organisations including: Centre for Responsible Credit, Responsible Finance, Joseph Rowntree Foundation), we searched for policy documents, research findings, SROI studies and similar.
4) From the What Works Network, we used the Money Advice Service's FinCap Evidence Hub and the listing of What Works grant funded research for 2018 and 2019. At this point, many previously identified studies started reoccurring.
5) From the academic sector, we focused on institutions which were frequently cited in the first four strands, notably the University of Bristol Personal Finance Research Centre.

We supplemented this desk-based research with discussions with the FCA High Cost Credit team and also individuals at the NAO. We are grateful for their support for our work.