REAL TIME DATABASE ENFORCEMENT
A RESPONSE TO POLICIS' REPORT ON THE FUTURE OF ILLEGAL LENDING

Summary

- Veritec Solutions welcomes Policis' report on the future of illegal lending but warns that the report is missing some critical analysis and is based on incomplete data.

- The development of regulation in US states clearly shows the value of consumer protections in the payday market. The vast majority of lending is legal and the vast majority of consumers are therefore protected.

- What we can see in the US is that consumers benefit from having a properly regulated market <u>where the regulations are enforced</u>. Cheaper loans which comply with consumer protections are available.

- Policis suggest that the introduction of a regulatory database drives illegal lending. The evidence demonstrates, however, that this is not the case.

- While illegal activity is a growing problem, it is the regulatory standards, which drive this activity. <u>The presence of a database is agnostic</u>. <u>It is the standards in place, not the enforcement of them, which effects illegal activity</u>.

- There needs to be further work on how Policis' findings are presented and derived. The data used to underpin the report is taken from Clarity Services and is neither complete nor up to date.

Taking the wealth of evidence from the US, clear lessons for regulators and policy makers can be drawn:

1) Consumer protection is essential in providing fairer, lower cost, short term, high cost credit options to consumers
2) If the FCA is seeking (as any regulator should) to have 100% compliance with its regulatory framework then utilising a real-time regulatory database has been the only proven method to achieve those results.
3) The payday loan market operates best, and consumers are best protected, when a database is in place.
4) Alongside this, high-level scrutiny and enforcement activity is required to limit and prohibit illegal lending.
5) A key part of limiting illegal activity is for the FCA to ensure that banks are not enabling illegal lending. Unlicensed lenders should not be able to operate through UK banks. In the US, 12 to 15 banks were enabling illegal lending. Operation ChokePoint acted to cut-off this banking access and the illegal market has shrunk significantly as a result.

Background
The use of high-cost short-term credit or payday loans has grown rapidly in recent years as consumers look for quick, easy borrowing to support their finances. Policis correctly point out that demand for these products will not dissipate regardless of regulatory intervention.

The FCA has taken important steps to regulate the market through introducing a cap on credit, protecting against excessive charges, and encouraging market participants to share data.

With any new regulation, scrutiny of its effectiveness and impact are critical. This is particularly the case in an area that is ripe for illegal activity and fast mutating products, such as the payday loan market. In other markets, for example, which are similarly profitable and attractive to illegal activity such as the alcohol and tobacco industries, there was a growth in illegal activity following the introduction of new regulations.

Issues arising from the Policis report
As Policis highlight, it is always important to carefully review the lessons from elsewhere in evidence based policy making. In the case of payday lending, the US provides a rich case study from which regulators and policy makers in the UK can, and must learn:

1. The development of regulation in the US states clearly shows the value of consumer protections in the payday market.

   The evidence from individual states demonstrates this. North Carolina, for example, has no legal market for short term, high-cost credit or small dollar lending for licensed lenders. Consequently, there are high levels of illegal lending where costs to the consumers run between $25 and $30 per $100.

   In American states with legal lending, much lower cost, regulated options are available. Consumers are protected and have a regulated market from which to take out loans. In Florida for example, legal lending means that loans are available to consumers at $10 per $100, with a loss rate for lenders under 1.5%. This has resulted in robust market of over 200 lenders. The penetration rate of loans in Florida indicates around a 37.5% loan rate to the population. In California, which has legal lending at $15 per $100, far lower than in illegal markets one finds a high loan-to-population rate of around 31.6%.

2. Policis suggest that the introduction of a regulatory database drives illegal lending, as compliance among legal lenders is effectively enforced. The evidence demonstrates, however, that this is not the case.

In fact the critical point to note is that it is the regulatory standards which drive illegal activity and that the presence of a database is agnostic. It is the standards in place, not the enforcement of them, which effects illegal activity.

Looking at the evidence from the US, when you compare states with regulatory databases and states without, there is no correlation between having a database and the use of illegal lending. For example, it is in states like Washington, Virginia and Delaware with relatively high regulatory standards (such as restricting the number of loans that a consumer can have over a year) where illegal lending is driven upwards.

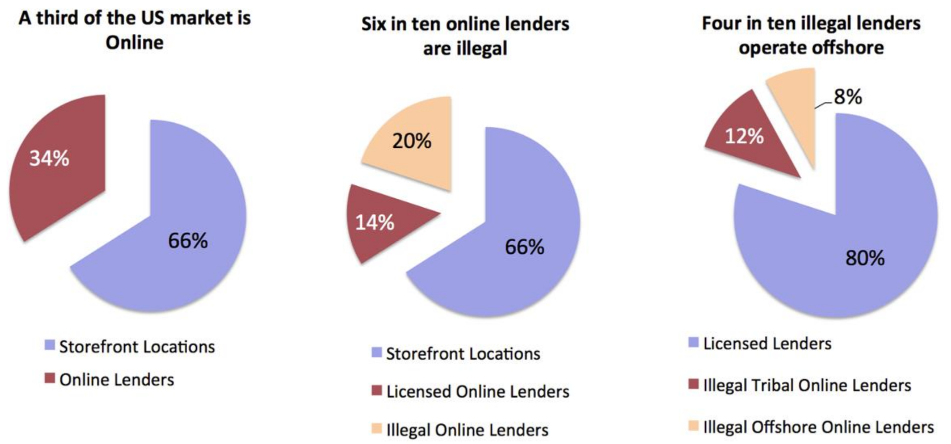
Additional Concerns

Additionally, there needs to be further clarity on how Policis' findings are presented and derived.

1. Firstly, there is still on-going debate in the US as to which areas are categorised as legal and illegal, which makes defining exact levels challenging at this stage. One example is whether or not online lending which is conducted on Federally Protected Indian Tribal areas is illegal. Many lenders have set up these affiliations upon the advice of counsel. However, most of these lenders are either now licensing under state licensing laws, or simply closing as a result of Federal intervention and increased scrutiny by the courts. For a clear comparison, it would be necessary to look at those online lenders who are domiciled outside of the United States.

   When reviewing Policis' own data, they only represent about 8% of the online lending space. One would assume based on the way the graphs are presented in the report, that the majority of US consumers are getting illegal loans, but this is simply not supported by the data. The vast majority of lending is legal and the vast majority of consumers are therefore protected.

   Furthermore, with the intervention of the US Federal Government, Operation Chokepoint seems to have drastically cut back the number of illegal lending operations. Before the UK market compares illegal activity in the US to the overall US market, Policis should request a data set of loans conducted during 2014 and determine if the market is still at 8%.



Policis estimates based on Clarity Services data

2. It is disappointing that the Policis analysis did not include any data or analysis about how consumers fair in states with access to short-term lending with real time database enforcement. For example, over 2 million consumers have used the product in Florida over the past decade. In looking through the data, almost 40% of Florida consumers take out fewer than 5 loans in an annual period. Clearly access to credit is not an issue. And when comparing $10 per $100 which is the legal rate to $25 per one hundred, which is the average amount in the illegal market, it is clear that the vast majority of Florida consumers benefited from the legal environment. It would of course be wrong to suggest that Florida should eliminate its real-time enforcement of payday lending laws because some consumers may choose to utilize the illegal market.

Other aspects of the Policis report which we would urge scrutiny of include:

- The data used to underpin the report is taken from Clarity Services. This data is neither up to date nor complete. This data is mostly from illegal lenders and lenders operating in non-database states. This is because the lenders in states with databases have clear regulations to follow and do not need extensive recourse to data services. Since Policis does not have access to the State real-time database, there is no way to know if those borrowers who were found in the Clarity database were even borrowers on the legal market at all.

- The overall cost of a payday loan is driven by several factors one of which is expected loss rates. Policis should conduct research as to the loan loss rates in database states verses non-database states to see if by lowering loan loss rates to under 2%, the data base delivers benefits to consumers through the availability of cheaper loans with lower fees.

- The estimated growth of the illegal online market is not supported by the known level of growth in the legal market. It seems unlikely that the market would be saturated with payday loans to that extent.

- Policis also seem to suggest that the drive from storefront to online applications is being driven by regulatory activity and the growth of illegal lending. There are of course, other factors at work such as local level regulation driving down the storefront presence and increasing trends such as shop front lenders setting up terminals in their shops and allowing customers to make online applications. This has been a significant factor in Texas. This change could also be influenced by cultural changes as well, moving further away from traditional brick and mortar stores and into more digital marketplaces. With the rapid changes in technology and innovations driving the movement of money, it is hardly surprising that more and more consumers are conducting financial transactions on the internet.

Conclusion

We welcome the call for increased scrutiny of the payday market following the introduction of regulation in the UK. This is a large market of financially vulnerable consumers, which disreputable lenders will seek to manipulate. Equally, in any newly regulated market of this kind close scrutiny of the growth of illegal activity is essential.

That said, given the growth of the market and the high levels of consumer detriment, ensuring consumer protection is in place is of course essential. What the US evidence shows is that where this regulation is enforced, with a regulatory database, there are the highest levels of consumer protection. And if the underlying regulations are not overly restrictive, the vast majority of the marketplace will utilise legal lending.

The evidence also shows that there is not a correlation between illegal activity and the presence of a database but between the level of the regulation set or the strength of regulation and illegal activity.

Taking the wealth of evidence from the US clear lessons for regulators and policy makers can be drawn:

1) Consumer protection is essential in providing fairer, lower cost short-term high cost credit options to consumers
2) If the FCA is seeking (as any regulator should) to have 100% compliance with its regulatory framework from 100% of the legal lending market then utilising a real-time regulatory database has been the only proven method to achieve those results.
3) The payday loan market operates best, and consumers are best protected, when a database is in place
4) Alongside this, high-level scrutiny and enforcement activity is required to limit and prohibit illegal lending
5) A key part of limiting illegal activity is for the FCA to ensure that banks are not enabling illegal lending. Unlicensed lenders should not be able to operate through UK banks. In the US, 12 to 15 banks were enabling illegal lending. Operation ChokePoint acted to cut-off this banking access and the illegal market has shrunk significantly as a result.

About Veritec Solutions

Veritec provides a data system that enables regulators to effectively enforce regulation of payday, doorstep and other short-term consumer lending in real time at the point of sale before a transaction is conducted. Veritec does not provide any goods or services to the consumer credit industry, but provides regulatory services to regulators. We have over a decade of experience working with US regulators in 14 different states, covering 88 million consumers. In addition to our work in the United States, we have also advised the Provincial Governments of Ontario and British Columbia in Canada, and the Federal Government of Australia.
Veritec's system covers:

- 88 million consumers
- Over 1,000 licenced lenders
- 7,200 store locations
- Internet lending
- 300 million-plus credit transactions

Our experience has allowed us to build an unrivalled store of unfiltered data documenting borrowing in the high cost credit market. This has allowed us to provide empirical evidence to governments to ensure their policies are fit for purpose.