SUBMISSION FROM VERITEC SOLUTIONS LLC

CONTENTS

A note on definitions

We have observed that various parties in the public debate on payday regulation have sought to confuse real-time data-led supervision and enforcement with 'credit data sharing'. For the avoidance of doubt, below we set out the definitions and roles of these very different concepts.

Credit data sharing is an industry practice whereby lenders provide customer data to credit reference agencies under reciprocity agreements with the aim of improving creditworthiness assessments.

Real-time data-led enforcement is when regulators use automated systems to collect transaction data on an individual loan basis and in real time in such a way as to either 1) monitor the compliance of individual firms and, if desired 2) stop, at the point-of-sale, non-compliant loans being made.

While the former is something that lenders may or may not do as part of their current business processes, the latter is a radically streamlined approach to regulatory supervision that delivers vast improvements in lender behaviour at a reduced resource cost to the regulator and a less-burdensome regime for industry.

Q1: Do you have any comments on our general approach to developing our proposals for the price cap? Q2: Do you have any comments on the proposed price cap structure? Q3: Do you have any comments on the price cap levels?

The FCA is to be commended for avoiding the trap of a simple APR cap and the proposal for a total repayment cap of 100% is welcome. Veritec currently operates in jurisdictions that all have a price cap in place. Therefore Veritec does not take a position on what is the reasonable amount of cap the FCA should implement.

However, we observe that the daily price cap of 0.8% (equivalent to £24 for a £100 loan over 30 days) is almost double the average price cap in those American states with enforced payday product rules.

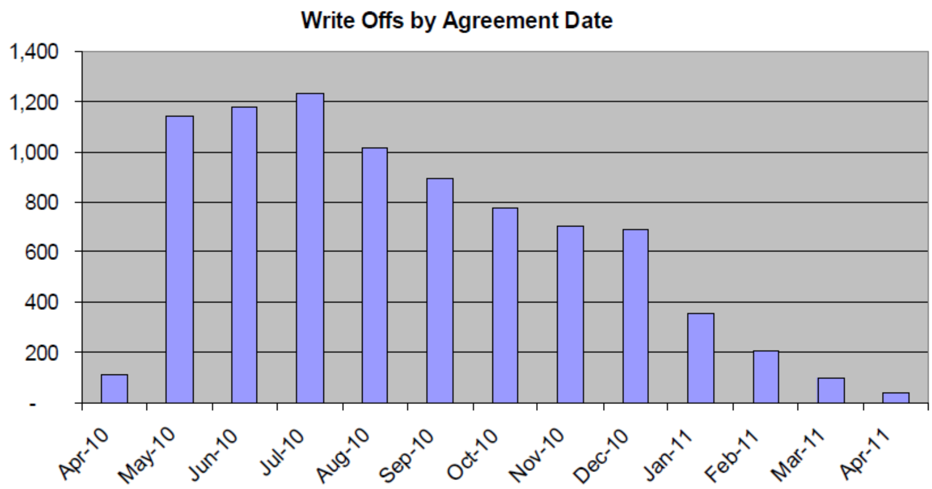
We believe the FCA should have examined more closely the reasons why firms in the US can operate with very generous profit margins under much stricter caps. Moreover, we have not yet seen evidence to suggest that a price cap in itself delivers an appropriate degree of consumer protection and leads to a reduction in profits for firms and a mass exit of the market (p.11). Furthermore, we introduce evidence that, contrary to this position, the only evidence of lenders leaving the market (along with loan volume declining) is when jurisdictions enforce the prohibitions that the FCA is currently proposing in real-time at the point of sale. **However, consumers still have access to credit and robust protections are put in place.** While we expect some exits from the market, market volume will not decline as a result of the price cap.

Regulatory data in the US, collected over the space of 12 years, demonstrates that the effective enforcement of product rules via a regulatory database will lead to a reduction in lenders' defaults and therefore lower the cost of doing business and maintain business profitability. Jurisdictions like the State of Florida operate at almost ¼ the cost structure of the proposed price cap and industry growth has been consistent on all measurements.

An examination of the business modelling in Kentucky shows that, after the introduction of a regulatory database, the effective enforcement of a much stricter price cap coupled with specific loan prohibitions has led to the number of transactions in write-off status declining significantly.

Lenders in Kentucky loaded all outstanding customer transactions onto the regulatory database before point-of-sale (POS) enforcement came into force. Veritec's data shows that there were 133,176 unique customers before the implementation of POS enforcement. The enforcement of state lending rules led to a 20% drop in unique customers in the first month after implementation. However, over the following 6 months this level recovered so that nearly 90 per cent of borrowers (119,051 customers) with transactions in the database before implementation continued to be in the market following the enforcement of lending rules.

Kentucky - loans opened during the period from April 30, 2010 through April 30, 2011 is 8,448.



When you compare a jurisdiction like Kentucky, a market with a price cap and real-time database enforcement, to a jurisdiction like Tennessee, a market with a price cap and no real-time enforcement database, the contrasts can be quite startling:

Tennessee Loan Activity			
Year	Dollar volume ($m)	Transaction volume	Bad debt % operating income
2005	1,197	5,063,705	9.25%
2006	692	5,724,827	10%
2007	1,092	4,688,093	14%
2008	1,139	4,882,065	14%
2009	1,052	5,218,410	14%
2010	1,012	4,579,726	15%
2011	1,125	4,598,847	18%
2012	1,049	4,575,385	18%

Data Source: Tennessee Department of Financial Institutions, Annual Reports

Kentucky Loan Activity			
Year	Dollar volume ($m)	Transaction volume	Bad debt % operating income
May 2010-April2011	632	1,988,524	2.0%
2012	709	2,150,118	1.7%

Data Source: Kentucky Department of Financial Institutions, Deferred Deposit Trends

As seen in the data above, lenders in Tennessee are not constrained by the price restrictions in Tennessee. While volume has levelled off since its recent peak in 2009, the dollar volume of transactions has remained fairly consistent. The price cap has been in place for over a decade. However, contrary to the position that price caps will yield more responsible lending, bad debt as a percentage of income continues to increase in this jurisdiction despite price caps.

Additionally, the population of Kentucky is approximately 68% of the State of Tennessee, yet the volume of transactions being conducted in Tennessee is 2X the rate in Kentucky. (2.1MM loans conducted in 2012). To understand the transaction volume, one needs to look at the Tennessee law in comparison to Kentucky.

Tennessee law only allows a fee of 15% on $500 lent or a flat $30 fee, whichever is less. The average loan transaction size in 2005 was only $116. The average transaction size in 2013? It was still only $229. The explanation is that lenders are using two distinct transactions to avoid the price cap imposed on a single $500 transaction.

Veritec asserts that despite a price cap being put in place for the United Kingdom, bad debt experienced by remaining operators will not significantly decline. In turn, lending decisions will not be made on the basis of the price cap. Veritec has observed that price caps in the United States have not changed consumer detriment issues. At the most, price caps will drive some online operators out of business, move some other operators to disguised payday loan operations, and the remaining lenders will manipulate their lending activity to yield the same or higher margins from the same customers. In fact, lending consolidation may even drive down operational cost but this will not be reflective in lowering consumer detriment.

Based on the Kentucky data as shown above, it is only with prescribed rules enforced at the point of sale do lenders experience a significant reduction in loan losses and can operate profitably at lower costs. The enforcement database also ensures lenders do not allow borrowing outside of the limits, which eliminates borrower over-indebtedness.

Further evidence can be drawn from the jurisdiction used by HM Government in explaining the decision to impose a price cap on the industry: Australia. In Australia price caps have now been in place for over a year and the effects on borrowers and lenders are beginning to become clear. We note that Cash Converters, one of the largest lenders and also present in the UK, has seen strong revenue growth since acclimatising to the regime. Cash Converters' growth is based on a number of factors[1] including:

- Increasing personal loan interest
- Increasing store revenue
- Growth of online personal loan and cash advance business

Cash Converters is also lending to more consumers than in previous years but default rates have crept up, despite the implementation of the price cap. We note that the last Australian government passed a law that gave provision for a real-time regulatory database to help the Australian Securities and Exchanges Commission police the new law, though the commissioning of a system has been delayed.

Based on the available evidence from other jurisdictions, our predictions for the UK payday market following the implementation of the price cap are as follows:

- Some lenders will exit the market but the total volume of loans will not drop significantly. The exit of lenders will not affect demand, and other lenders will be willing to meet such demand.
- Online-only lenders are likely to be most affected by the price cap. Any intervention that increases costs will make market conditions harder for online lenders as their business models are more reliant on costly lead-generators. We believe that is why most of the firms exiting the market are online lenders.
- Borrowers seeking short-term loans will still be able to obtain finance as the larger, well-capitalised firms will take on customer share even from borrowers who might be on the border of 'affordable lending' because the lenders are able to absorb losses in order to retain market share.
- The lack of restrictions on multiple, simultaneous loans means that significant numbers of consumers will continue to get into problem debt despite a total cost cap.

[1] Cash Converters 2014 corporate review

- Loan losses will not significantly decline as a result of “responsible” lending and lenders will continue to chase profits through disguised rollover and multiple borrowing techniques.
- However, we do expect the growth of the market to slow but this is almost inevitable with or without price caps because the market has been approaching saturation for some point.

It is only with prescribed rules that specifically address product design and delivery will the FCA reach a balanced result for both consumers and lenders.

Q4: Do you agree with our proposals on repeat borrowing?

The FCA states that it will be ‘particularly alert to firms using repeat borrowing to avoid the effects of the total cost cap and will challenge firms with high levels of repeat lending to demonstrate how they identify borrowers whose repeat borrowing behaviour suggests problems with affordability’.

This approach to repeat lending will only introduce uncertainty into the market. While the FCA has put in restrictions on ‘rollovers’ it will be very difficult for the FCA to enforce rules on repeat borrowing and refinancing. There are a number of ways for lenders to evade rules on repeat and refinanced borrowing and the product sales data (PSD) provided by lenders to the FCA will not assist. This is because the PSD is aggregate data and will not include individual borrower data – only very intensive, burdensome and costly supervision and enforcement visits will uncover such practices. In the US we have consistently seen that lenders do not consider the welfare of their customers and it is unwise to trust lenders not to take advantage of this wiggle room. In fact, recent findings in Mississippi where robust rules are in place (albeit with no real-time enforcement database) lenders have figured out a way to work around the rules.

> *It (the program) specifically instructs employees to accept only the fee (interest) on a delayed deposit check and further instructs them on how to illegally 'roll' a check during the middle of each month," the order states.* – The Clarion-Ledger, 7-2-2014, Payday Lender Company Investigated

The above news article is just one example of the coverage of continued violations that occur daily in those US jurisdictions which do not have real-time enforcement. It was only through intensive and very costly on-site examinations that regulators have started to figure out this one example of a lender violating the State law on roll-over prohibition.

The suggested approach of questioning firms about changes in the number and frequency of repeat loans after the introduction of the price cap is not a proactive approach or solution. It will not help indebted costumers who are encouraged to take out new loans as by the time this practice has been uncovered, through questioning, the consumer has already suffered.

By contrast a regulatory database would allow you to monitor each and every loan issued at the point of sale. It would flag lenders who are averting the total cost cap through repeat lending and allow immediate action to be taken.

Q5: Do you have any comments on the scope of the price cap?
Q6: Do you have any comments on our proposed Handbook rules?

While we support the definition of high cost short term credit, the exclusion of home credit does constitute a big oversight. We also note that firms will continue to develop products that blur the lines between different rule sets in order to game the system. This has been especially true in both US and Canadian jurisdictions. In fact, lenders in Ontario Canada were just recently put on notice that their "instalment" product was simply a payday loan with multiple "roll-overs" built in. The product was not underwritten, credit scored, or had fees that were not close to traditional instalment loans. Lenders were simply trying to work around the prohibitions that are in place in the Province.

Q7: Do you agree with our proposals on unenforceability?

We have a number of concerns with the FCA's approach to unenforceability. The suggestion that agreements are unenforceable if they are in breach of the price cap will not act as a deterrent to firms that have very little regard for their customers' wellbeing. More importantly, the action of making a loan unenforceable depends on a consumer knowing their rights and the correct price for a loan within the cap. This FCA approach could be considered to be delegating enforcement to the very borrowers that need protection by the regulator. Given the financial and technical knowledge of consumers in this market, we cannot envisage a situation in which this power is used by the regulator before significant harm has already taken place. For example, it is very likely that borrowers (even those that are aware of their rights) only seek to make their agreements unenforceable after they are in problem debt, and once they are already suffering from stress and other forms of psychological harm.

As recent headlines have demonstrated, these companies cannot be trusted. In only a fortnight, four payday loan adverts were banned, we have seen the number of complaints double since 2012, and Wonga was recently found guilty of sending intimidating letters purporting to be from law firms, which did not exist. Additionally, StepChange has found that payday lenders bombard debt-ridden families with unsolicited marketing calls pushing them to take out more loans.

We have consistently seen that payday lenders fail to act in consumers' best interests. Previous efforts to allow the payday lending industry in the UK to self-regulate have not succeeded and the FCA should want the technology to ensure compliance. By the FCA's own admission in implementing proscriptive rules (CPA limits, roll-over limits, cost of credit cap), the FCA is acknowledging that intervention is required for this sector. As we have seen repeatedly demonstrated in the US and Canada, a self-regulatory environment will not sway lenders from making lending decisions which will cause consumer detriment. We believe this sector has demonstrated that the success of their product simply relies on a consumer's immediate need for funds, and the lender's immediate ability to provide them with those funds. There is ample evidence already published by the FCA that the industry does not operate in a high street lending fashion where credit is underwritten via sufficient creditworthiness assessments.

Additionally, the FCA's approach to unenforceability relies heavily on vulnerable consumers flagging bad practice to the regulator. For those who do not seek help, or do not realise firms are not following the rules, there can often be tragic consequences.

There is a simple option which the FCA could implement which would empower them and improve the level of oversight rather than putting all the power in the hands of the lenders. Through the use of a regulatory database with real-time information the FCA can track the action of lenders and ensure responsible lending guidelines are being adhered to, including rollover protections, price caps and would also tackle the issue of multiple payday loans. Where these systems are deployed in the US, a call centre is staffed to further aid consumers when they have disagreements, concerns or complaints about unethical or illegal lending activity.

Q8: Do you agree that we should prevent UK‑based debt administrators from enforcing HCSTC agreements on behalf of ECD lenders which include charges in excess of the price cap?

As with the approach to unenforceability, this policy depends on borrowers being aware of all their rights and understanding whether their individual case fits within particular circumstances, or becoming mired in problem debts and court actions. The FCA's retrospective approach to enforcement means that regulatory action, such as banning debt administrators from collecting on agreements with ECD lenders in breach of the price cap, is unlikely to occur until after significant harm to the individual consumer has already taken place.

Q9: Do you have any comments on the proposed approach to data sharing?

We understand and recognise the role that credit reference agencies play in the payday lending market, however they should not be viewed as a substitute for regulation. Relying on payday lenders to provide information to credit reference agencies amounts to leaving the industry to self-regulate. Once again the power is in the hands of the lenders as there is no requirement to share data with CRAs only an expectation. Moreover, international evidence shows that using credit reference agencies (CRAs) is an approach which ultimately will not work.

Given the nature of the work Veritec does in the real-time monitoring of payday lending, we have several observations on why the use of CRAs is not a replacement for a real-time database monitored by the regulator, such as those in place in the US.

- **It will not eliminate the problem of multiple simultaneous loans:** The limitations of the proposed system and the fast-paced nature of the payday lending process means that customers will still be able to take out multiple loans they cannot afford to pay back.

- **It is not real time:** Despite claims about reporting in real time, this proposal is merely increasing the level of data sharing. The data passed to lenders will still only be a limited snapshot which reflects the last time all lenders reported. It is difficult to see what impact these proposals will have as they will not report in real-time and will do nothing to prevent consumer detriment at the point of sale. A system should only be considered real-time if every inquiry and every lending decision is updated instantaneously across 100% of the market. This allows for lenders to know immediately if a consumer is eligible for a loan under the FCA's responsible lending guidelines, or more prescribed rules. It would also immediately detect any attempt for lenders to work around the prohibition against 2 roll-overs. It would also ensure that **no loan** was granted in excess of the cap on the cost of credit. CRAs cannot nor should not replace the need for the FCA to utilise 21st century technology in providing for enforcement and oversight.

- **One credit reference agency will not capture 100% of the market or 100% of data:** There are multiple credit reference agencies that lenders can choose to use. CRAs operate in a competitive market and no one CRA is likely to accrue 100% of all credit data. Furthermore, the service announced does not include any proposals for doorstep or other smaller forms of consumer finance. Additionally, any attempts to mandate that all data be reported to one single agency, or all of them, would respectively give one firm an unassailable market position or destroy any competitive pressures.

- **Will not stop lenders making non-compliant loans:** It does not include any stipulations on lenders to check the credit-worthiness of individuals taking out a loan. Payday lenders in particular, may choose to extend credit to all borrowers that meet certain basic criteria without adapting the product or price to individual circumstances, or assessing risk on a case-to-case basis.

- **Lenders will be reluctant to submit data:** Lenders guard their customer data fiercely and are often wary of providing competitors of this information via CRAs.

- **There is no guarantee of correct data:** We have repeatedly seen lenders failing to report accurate data to CRAs, which means other firms are depending on flawed data sets for credit assessments. (The US federal regulator has recently taken action against a log-book lender in a state without a regulatory database.)

- **It does not help the FCA regulate better:** It includes no reporting requirement to the FCA and so it is unclear how regulation will be improved. Information held by credit reference agencies is not always up-to-date and often does not reflect instances where customers have rolled over their loans or where the original loan has morphed into another product. Already, all 34 jurisdictions in the US require some form of quarterly or annual product reporting. It is very apparent that consumer detriment has not been abated by reporting aggregate loan data to their respective regulator.

Unintended consequences that will negatively affect consumers

- **CRAs use credit data to sell marketing solutions to businesses:** Some CRAs use the personal data they collect to sell to marketing firms and lead generators, meaning it is in their interest to acquire this information and it is in the interest of lead generators/marketing firms to generate revenues from this costly data. By forcing the usage of traditional and non-traditional CRA's, the FCA is putting at-risk consumers in the spotlight for existing lenders and those who wish to enter the market. Instead of developing a costly marketing and sales plan, all a prospective lender would need to do is buy a complete listing of all consumers who current have a payday loan listed on a particular CRA.

- **Detrimental impact on consumers' creditworthiness:** an increasing number of mainstream lenders (particularly mortgage lenders) are refusing to lend to anyone with payday loan on their credit record. It is questionable whether a very short-term product should have such a bearing on consumers' attempts to take out a completely different and much longer-term product. Mortgage lenders' attitudes in this regard are symptomatic of the general lack of faith that payday products are lent and used as intended (i.e. very short-term, one-off credit smoothing facilities).

- **No major improvement on status quo:** Lenders have always been able to draw upon CRA data, yet major problems in the market persist. The US and Canadian payday lending industry have had decades in which to operate with CRA data sharing. Not one regulatory agency has relied on CRAs to ensure lender compliance.

Multiple Loans

As listed above, one of the most pressing issue about using CRAs is that there is no method to prevent irresponsible lending and the issuing of multiple loans. The example of California reinforces the view that tackling multiple, simultaneous loans in the UK market will be a major challenge for the FCA.

Under California law, the maximum loan amount a consumer can borrow in a payday loan is $300. The maximum fee a payday lender can charge is 15% of the face amount of the check (up to a maximum of $45). Additional fee restrictions apply for military service members and their dependents.

The fee is equivalent to an annual percentage rate (APR) of 460% for a two-week loan. The actual APR may vary, depending on the term of the loan. APR is the total annual interest rate that a borrower pays on a loan, including all fees and charges. APR is used to reveal the total cost of borrowing money. By comparison, a loan for a new car may have an APR of 4-7%. Additional restrictions are on roll over prohibitions and the number of loans.

Research by the Californian Department of Corporations shows that while Californians borrowed more than 12 million payday loans in 2012, over one-third of those loans were given to consumers who obtained from more than 1 lender at the same time. In fact, when real-time databases were implemented in US jurisdictions after the introduction of product rules, historical data loaded to the database revealed that almost 1-in-3 loans were in violation of state law. All of these states had restrictions on roll-overs, multiple loans, and price caps.

Numerous hearings, bills and debates[2] have continued in California to further reform the industry as advocacy and policy stakeholders have not seen the problems and consumer abuses negated in the California market.

We expect California to introduce legislation for a real-time database early next year and we note Ontario province in Canada, which has also endured years of ineffective self-regulation, is moving to implement a point-of-sale enforcement system.

FCA regulatory database

The use of a regulatory database would remedy all of the issues outlined above.

All applications for loans are processed using the database, which provides instant and up-to-date information on a customer's existing loans. It would still allow lenders to undertake creditworthiness assessments using CRAs or any other means, but it would give regulators certainty that rules were being followed at point-of-sale in store or online.

This allows regulators to police compliance of borrowing and rollover restrictions and would effectively eliminate mis-selling. And because the data is not shared among creditors and is only used by the regulator, commercially sensitive information and customer data is not bought and sold. All creditors are required to report and are assured that their customer base is protected from other creditors marketing and sales efforts.

We think the FCA should ensure that any real-time data is used to ensure compliance at every step of the lending process and this can only be achieved if all lenders of short-term high cost credit report data into a FCA real-time database.

Application of a real-time data-led enforcement solution in the UK

The FCA states that a regulatory database is not suitable for the UK because it removes the need for lenders to conduct affordability assessments and because the FCA has chosen not to introduce prescriptive product rules. However, this view misunderstands the utility of such a database for a regulator that seeks to rigorously enforce product rules, which the FCA has introduced with its price cap and ban on more than two rollovers. While some policy decisions of the various US states might not be applicable the UK, there are two common lessons that are:

- Firms still undertake credit reference checks and conduct other affordability assessments; the database used in 14 US states only shows whether a lender *can*

[2] See Mercury News (1); SF Public Press; Mercury News (2)

extend credit to the individual, not *whether it should* extend credit to the individual borrower.

- Rules in this market without effective enforcement will not adequately tackle consumer harm. This has been the lesson in many US states, Canadian provinces, and is under active consideration at the Australian federal level.
- The costs saved by a regulator in receiving detailed lending and borrower data means the regime costs less for reputable businesses and more resources can be put into tackling rogue lenders, thus (over time) improving the image of the industry and the regulatory body.

About Veritec Solutions

Veritec provides a data system that enables regulators to effectively enforce regulation of payday, doorstep and other short term consumer lending. 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.

We have also many years' experience of watching the market develop as US firms – in many senses the pioneers of payday lending – have diversified into other jurisdictions including the UK. In fact, several of the largest operators that together constitute a significant part of the UK market, are US-owned firms. Most of these companies use the same business model in the UK as they do in the US.

We recognise that there are differences between the UK and US markets but it should be remembered that the many of the operators, the business models and product features are the same regardless of the jurisdiction.

Veritec Solutions

August 2014