Pay-day lenders: why can we consider them as being bad players on the credit market?

When credit use difficulties of the clients are a good business for lenders

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Summary:
The study analyses the specificities of pay-day lenders products and industry (especially active in the US and in the UK) and looks deeper in their economic models. It seems that the inappropriate uses of pay-day loans (arrears, repeated uses...) by the clients are precisely the ones that boost their incomes !

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1. Introduction

This paper will explain the extent to which exclusive consumer microfinancing can harm the consumers and will offer a few solutions that could be applied to avoid it in the future. Payday lenders have a controversial reputation among other credit providers, policy makers and the consumers, being accused for irresponsible lending and creating financial difficulties for those who are already in trouble. Nevertheless, they are loosely regulated in a lot of EU states, hence some possible regulations that have been applied in a few countries and have succeeded will be explained. The main idea behind the research is, however, to find a way to identify toxic crediting practices by creating an indicator that can be clearly compared to a benchmark to see whether firms, providing consumer microfinance products, profit from inappropriate lending and their customers consequential inability to repay. As the information required for such calculations cannot be obtained easily, only a suggested methodology will be offered. Even so, it will help policy makers understand the underlying problem and its possible resolution.

2. Financial Inclusion

European Commission describes financial exclusion[1] as a process, by which people struggle to access or use financial services and products in the mainstream market that are appropriate to their needs and enable them to lead a normal social life.

Hence, full financial inclusion can be characterized as a condition where every rightful person has access to a range of financial services that are reasonably priced, appropriate, convenient and respectful. These services are obtained from different competitive providers, delivered securely and efficiently, and can only be granted to financially capable consumers.

This research is concentrated on the latter. It is not enough for the financial services to be accessible - they have to be of good quality, match consumer's needs and not cause harm. Nevertheless, in the current state of consumer microfinance market some industry players seem not to comply with this idea. There are products and services in the market that not only are accessible by financially incapable consumers but are overpriced, take advantage of less financially sophisticated and cause harm. However, it can be hard to recognize these practices as they might actually be appropriate and helpful to a part of the customers while being damaging to the other.

On European level, a good example of this exclusive formal practice is payday lending: excessive interest rates, practically no financial assessment of the borrowers, causing distress and often leaving the consumers in a worse state than pre-borrowing.

3. Payday Lending

Payday loans are small short-term single-payment high-interest loans intended to carry the borrower through a temporary cash deficiency. As it is described by the payday lenders themselves, they are quick one-time loans expected to cover unexpected expenses, such as sudden medical costs or a breakdown of a car used for commuting. However, shiny from the surface, it has been a controversial topic for researchers and policy-makers.

On one hand, the advocates of payday lending state that these loans are the best option for the less fortunate who encounter unforeseen expenses. This claim does make sense: payday loans can be cheaper than paying overdraft fees to the bank or late fees for utilities. Nevertheless, neither

the assertion of "one-time" borrowing nor "to cover unexpected expenses" is true: as it will be shown in the following chapters, their business model seems to actually heavily depend on borrowers’ inability to afford the loan and their subsequent necessity to borrow multiple times.

3.1. Assessment

A significant reason for unfortunate consequences to the customer is a lack of assessment when applying for a loan. An appropriate assessment of credit worthiness should ensure that the borrowers do not experience substantial discomfort when returning the credit, however, a number of examples show that the ability to pay back is too often not evaluated properly.

A research[2] conducted by the Office of Fair Trading (OFT) in the UK found that most payday lenders do ask for a bank statement from their customers, however, it seems to be used only to validate employment or for fraud checking purposes, rather than to actually assess affordability.

Adding to this argument are the figures found by Lietuvos Bankas (the central bank of Lithuania)[3] : in Lithuania, 39% of all payday borrowers are under the age of 25. More importantly, for a lot of these young customers, their relatives are the ones who pay back the loan. Hence, it raises questions about the thoroughness of the assessments if such a high number of young people who are still dependent on their families can receive a loan. Additionally, this brings up another point - a lot of companies still advertise and issue loans to unemployed people just proving the the assessment process in these firms is inadequate.

The already mentioned research by OFT also discovered that 74% of lenders handle affordability assessments for all new customers, 67% - for all new loans and only 23% - for each rollover. And even with such low figures of assessing affordability, lenders usually ask for statements of one month only and then fail to keep evidence of assessing their clients' disposable income.

Not only is the lack of assessment harmful to the consumers, it also has negative impact on public funds. Lenders neglect pre-contractual assessment because it is costly - it is more profitable to issue loans to practically anyone and have a high chance of never recovering them than to conduct a proper check on credit worthiness. In consequence, those customers who do default or find it hard to recover after repaying the loan, often need help from counsellors, people who specify in over-indebtedness, etc. And the latter are usually publicly funded, hence generating more public costs.

Even if these arguments were ignored, a simple common sense question can be asked: doesn't the fact that a high percentage of borrowers fail to pay back the loan or need to extend it prove that providing such credit is irresponsible?

3.2. Rolling Over, Refinancing and Repeat Borrowing

The main flaw of these loans is that they are not used the way they are said to be supposed to: instead of being taken out once and repaid on the agreed upon time, they are often extended (rolled over[I]) or refinanced[II] numerous times. OFT came to a shocking conclusion: in the UK, 28% of loans are rolled over or refinanced at least once and 5% - four or more times. Excluding rollover and refinancing, 58% of customers took out more than one new payday loan in a year[4], 15% took out more than 5. In Lithuania, the first figure of rolling over is found to be as high as 37%[5].

[I] "Rolling over" beyond the original repayment date so the duration of the credit is extended but the amount of the credit and the terms and the conditions are unchanged while extra fees are charged.

[II] Refinancing on different terms and conditions; the outstanding loan amount is repackaged into a new loan, possibly with additional borrowing and/or over a longer term.

Moreover, it has been shown that multiple borrowers are responsible for most of the payday lenders' revenue. In the UK, borrowers who had already taken out a loan from a firm, account for more than 80% of all loans issued by that firm[6].

What also should be noted is that although payday lending market in the USA might be considered quite different from the EU, after closer examination, it seems to have a lot of similarities and even some of the same players. Hence, looking at statistics obtained by researches conducted in the USA might be of help to understand the problems in the EU.

Center for Responsible Lending (CRL) in the USA[7] found that over 80% of borrowers take out more than one loan per year. Out of this group of repeat borrowers, 87% take out a new loan during the first following pay period and, disturbingly, 50% of new loans are taken out at the first opportunity after paying the previous loan. In states where they have cooling off periods (a length of time after paying off the last loan during which borrowing is not allowed), the first opportunity is considered to be after such a period; where no such regulations exist, the first opportunity arises on the same day.

The same research by OFT also found that 32% of all loans are repaid late or not repaid at all. In the USA[8], 64% of new borrowers in a year become renewers and 20% default on their loans. Hence, the borrower is left with not only the origination fees but also late fees or default fees.

To understand what these statistics mean to an average borrower, let's take an instance. A person borrows £100 for two weeks with interest of £25[III]. At the end of this period he realizes he cannot repay the full amount of £125, so he rolls over the loan, meaning he agrees to pay £25 now and £125 in another two weeks. Hence, the interest grows from initial £25 to £50. If he rolls over 4 times, the interest payment becomes higher than the principal itself: for a £100 loan he would pay £125 in interest just after less than 3 months from the initial borrowing date. Unfortunately, as mentioned above, this scenario is not uncommon: 5% of borrowers actually roll over their loans to such an extreme extent.

In conclusion to this chapter, approximately a third of payday borrowers roll over their loans and more than half take multiple loans in a year. Together they make up more than 80% of payday lenders revenue meaning that only a fifth of their revenue actually comes from one-time borrowers for whom the product is supposedly created. Moreover, around a third of borrowers default on their loans.

Leaving numbers aside, it is obvious that for a large part of payday loans users, such kind of crediting leads to even more financial distress than at the moment of borrowing. What is even worse, the payday lenders' revenue is heavily dependent on such misfortune of their customers.

3.3. Lack of Competition and Unfair Advertising

Irresponsible lending seen in payday lending market is not a problem occurring in a few short-term lending firms but is rather the essence of this kind of business. It seems that the competition between payday lenders relies on the speed and ease of the approval instead of the price and the risks being taken: 60% of payday lending websites emphasize speed and simplicity over price[9]. A more disturbing note on this fact is that most of the consumers at the time of borrowing are in a weak bargaining position and the firms take advantage of that by concentrating on the speed. Just the idea of such business model shows that it can hardly be called perfectly competitive - consumers who need an immediate loan "right here, right now" do not shop around looking for the best prices or the best terms especially when the products are differentiated by advertising and not price.

Not only is the product offered basically identical in all instances, its price is also the same. It has been suggested[10] that there might be two reasons for this situation: either the cost of payday

[III] In the UK, the average origination fee for £100 loan is £25.

loans is adequate because of high operational costs, or the lenders do not lower the price because borrowers are desperate for a loan and will pay any price to obtain it.

Furthermore, even if they do shop around, the payday lending market is monoline: lenders offer basically the same product to everybody: short-term (two-week or one-month) single-instalment loans. And as the industry itself claims, this model only works when consumers suffer from a temporary lack of funds. However, it is already more than obvious that a lot of the customers of payday lenders suffer from a long term financial problems. Hence, a question arises – why don't the lenders offer a different product that fits the needs of the second group of customers? A multi-instalment longer term loan would seem to serve these customers better – but almost no payday lenders offer such an alternative.

Moreover, after looking closer at the advertising tactics used by payday lenders, they are aggressive and create inadequate expectations to the consumers, offering gifts and discounts for loyal customers. Let's take Lithuanian instance [Appendix: 1 table] where some firms offer:

- Free movie tickets, coffee or ice-cream for paying back the loan on time;
- A loyalty program where customers can collect electronic "money" for taking out loans or paying them on time and then spend this "money" on interest payments;
- A cash bonus for recommending the service to your friends;
- 5 extra days to repay the loan if rolled over;
- 50% discount on interest if loan is taken out on your birthday.

The list goes on with different discounts and incentives. What is worth mentioning is that 9 out of 29 lenders checked offer the first loan for free thus making lending more appealing to the consumer. 6 out of 29 work late at night which can often lead to alcohol and gambling caused decisions.

3.4. Profiting from the Misfortune

It has become quite obvious that payday lenders go out of their way to build customer loyalty and turn them into high-frequency borrowers. They not only generate more revenue for the payday lenders by rolling over or taking out new loans, they are also less costly[11]. The two main reasons for that are:

- The loss ratios are lower for repeat borrowers. Just the mere fact that they have taken out loans multiple times and repaid every one of them, shows their reliability.
- The operating costs are lower. Verification of a new customer (validation of identity, of a bank account, of a telephone number) might be rather expensive but it can be excluded for the repeat customers.

Another way to look at it is: the payday lenders claim that the price of lending is so high because of high risk of default. It makes sense in economic background. However, shouldn’t a product be considered toxic just because it causes so many people to default and consequently cost them a lot in fees and, probably even worse, damage their credit history irretrievably?

Additional charges after repaying late or defaulting are not included into APR. Hence, they are a legal way for the price of the loan to be increased. And the consumers often fail to recognize them as fees that could apply directly to them. It might be because there is a lack of clarity from the lenders' side but it also might be caused by the consumers' overconfidence. A research explaining patterns of borrowing[12] have found that most of the people are overoptimistic about their ability to repay or to encounter financial shocks.

3.5. Other Harmful Characteristics

Another consequence to be looked at is financial exclusion in the way of forced bank

account closures. An empirical research carried out in the USA[13] shows that access to payday loans has positive correlation with rates of involuntary bank account closures, which makes consumers have limited access to routine financial transactions that become riskier and more expensive.

Furthermore, deceptive debt collection has been often brought into attention as a fault of payday loans. Automatic electronic withdrawals are still used widely by payday lenders stripping the customers from the right of stopping the payments. OFT in the UK also found that 61% of customer complaints are related to aggressive or unsatisfactory debt collection practices and that some lenders subject customers to repeated and intensive contact over short periods.

To sum up, the existence of payday lending has been a contentious topic with industry advocates insisting that it offers an irreplaceable service to the consumers and industry critics highlighting its harm. The latter have a lot of proof supporting their argument. The assessment of credit worthiness is either not carried out at all or done inattentively, hence issuing loans to unemployed and financially incapable customers. Moreover, the lenders encourage their clients to renew their loans and pay fees not included in the APR, often leaving them in the cycle of debt or defaulting. By using harsh advertising, having lack of transparency and being inflexible, they profit from the consumers in a weak bargaining position. Therefore, all this evidence argues for tighter regulations or even banning the service altogether.

3.6. Possible Solutions

To control the way excessive use of payday loans have been harming the consumers, a lot of different solutions have been implemented in the EU and other places around the world. To understand the regulation strategies and their effect on the market, we will take a look at the the most widely used solutions.

3.6.1. Limiting Simultaneous Borrowing

Restrictions on simultaneous borrowing signifies limiting the number of loans a certain consumer can receive at a given time either from a single lender or all the lenders countrywide. To implement the latter, a mutual database for all the payday lenders has to exist and be used.

Restriction on borrowing from the same lender has basically no impact on neither the number of outstanding loans nor the amount borrowed. It is obvious as the market of payday lending is gigantic and receiving credit from a different lender is uncomplicated. Not so apparent is the ineffectiveness of limiting simultaneous borrowing countrywide. It has been proved to be unsuccessful where it has been implemented (e.g. Virginia and South Carolina, USA[14]). Nevertheless, this restriction can be beneficial if combined with size caps.

3.6.2. Size Caps

A size cap is a limitation on the maximum amount that can be borrowed. Specifically for payday loans, they have been set as a fixed amount or as a percentage of the borrower’s monthly income. Let's take an example of a few states in the USA:

Wisconsin:	$1500 including fees or 35% of gross monthly income[15]
Nebraska:	$500 excluding fees[16]
Nevada:	25% of gross monthly income[17]

A quantitative research[18] of payday lending restrictions have found that maximum size caps

affect the amount consumers are borrowing, however, not significantly. There might be various reasons for such results. If the size ceiling is not lower than the amounts usually borrowed, it evidently has very little effect. Also, if simultaneous borrowing from different firms is allowed, the consumers can effortlessly receive credit from multiple lenders at the same time, hence receiving more than the size cap imposes. Thereby, if size ceiling as a restriction were practised, it should be combined with a ban of simultaneous borrowing and be low enough to have impact.

3.6.3. Cooling-off Periods

Cooling-off period is a length of time after paying off the last loan during which borrowing is not allowed. Intended to stop repeat borrowing, it usually lasts for a few days, sometimes the length depends on the amount of rollovers already exercised and, in rare cases, a cooling-off period can be set up as a maximum number of loans per period for a single individual. A few examples:

New Hampshire:	60 days[19]
Virginia:	1 day after payment; 45 days after 5th loan within 180 day period; 90 days after payment plan[20]
Ohio:	2 loans limit in 90 days period[21]

Although this prohibition does not have the popularity other regulations do, it has been shown that when Virginia, Washington and South Carolina, USA, implemented cooling-off periods, they experienced an immediate and steep drop in repeat borrowing[22].

3.6.4. Rollover Limitations

To decrease the scale of repeat borrowing, rollover limitations have become a widely applied tool. They can prohibit rolling over completely or set an upper limit to the number of rollovers. Sometimes rollovers are permitted only if some part of the principal has been paid or if a maximum rollover fee limit is respected. Some instances of these restrictions in the USA can be seen below:

North Dakota:	One renewal allowed if the fee does not to exceed 20% of amount being renewed[23]
Oklahoma:	No renewals: a loan made within 13 days after a previous one was entered into is considered a rollover and is not allowed[24]
Minnesota:	Repayment with proceedings of another loan by the same lender is prohibited[25]
Missouri:	Six but upon each renewal the principal has to be reduced by 5% or more[26]

Establishing rollover limitations has had a negative impact on repeat borrowing[27]. It might seem intuitive but if no cooling-off periods are in place, instead of rolling over, the borrower could just take a new loan to repay the last one. However, even when it is the case, rollover ban still seems to have an emotional impact on borrowing repeatedly.

3.6.5. Minimum Term Limits

Minimum term limits put a lower cap on the length of a payday loan. It varies from a few weeks to a few months. In some cases, it can be described as pay periods. Its intention is to tackle the problem of short maturity that often does not allow the customers to receive financing to repay the loan. Some instances include:

Colorado:	Minimum 6 months[28]
Ohio:	Minimum 31 days[29]
Virginia:	Minimum 2 pay periods[30]

It can be argued that if the loan is repaid in one instalment, it makes little difference whether the length of the loan is a bit longer. However, it definitely grants more time for the customers to balance their finances and probably avoid borrowing in the future.

3.6.6. Maximum Term Limits

Maximum term limit puts an upper cap on the length of a payday loan. Usually, it falls somewhere in between one and six months. This regulation has been very popular in the USA and it has been set up as protection from harmful debt collection practices[31]. Specifically, to protect the consumers from deferred loans that strip them from control of their own income. Nonetheless, in countries where payday lenders do not have direct access to their customers' bank accounts, such a restriction is meaningless as it has no other visible impact.

3.6.7. Extended Repayment

Extended repayment requirement makes amortizing option available. Its application varies: it can be optional or obligatory; it can be made available when entering into contract or after a certain number of rollovers. A few instances from the USA:

Wisconsin:	Consumer can pay in 4 equal instalments with no additional cost. Limited to one payment plan offer per 12 months[32]
Indiana:	After 3 consecutive loans, lender must offer an extended payment plan of at least 4 equal instalments with no additional cost[33]
Washington:	If borrowers notify the lender on or before the loan is due, they are eligible for an instalment plan with no extra cost: 90 days for debt of $400 or less and at least 180 days for larger debts[34]

The effects of optional requirements are shady because if payday lenders can avoid amortization, they do, but compulsory amortization seems to have a positive impact on the well-being of the borrowers.

In 2010, Colorado, USA, policy makers completely changed the law regulating payday lending[35]. It is quite complicated but essentially lump-sum two-week product was replaced by multi-instalment six-months minimum without prepayment penalty. It also ensured that payday lenders cannot earn the origination fee immediately thus discouraging them from motivating their

clients to refinance. The consequences of this law were instantly obvious:

- Lower costs - the average cost to a single borrower fell by 42% and the APR dropped by 60%.
- More transparency - before only 13% of fees paid were represented by the contracted cost, after it grew to 87%.
- Less rollovers - the percentage of loans renewed or refinanced fell by 51% and average number of loans per person in a year plummeted by 71%.
- Public savings - public debt counsellors started servicing considerably less clients with payday loan debt.

3.6.8. Price Caps

Price caps put an upper limit on the price of the loan. Usually ceiling is placed on APR but sometimes it is described as a maximum cost per amount lent. It has probably been the most widely used restriction and there are a few reasons why[36]: to increase risk-averseness of the consumers, to prevent excessive interest rates and the abuse of over-indebted consumers.

Setting APR limit to 36% (fees included) or less, practically establishes prohibition of payday lending overall. In 18 states of the USA where such a regulation exists, only 3 still have operating payday lenders[37]. In Slovenia, after passing the law capping APR at 200% of average APR of banks and savings institutions, online lenders who were providing loans via SMS left the market immediately[38]. Other EU countries with maximum APR lower than 36% (Belgium, France, Germany, Italy, etc.) do not experience the presence of payday loans, while in countries where the ceiling is significantly higher or does not exist at all (Lithuania, Poland, Sweden, Spain, etc.), payday lending business is flourishing. The following APR ceilings apply for consumer loans in corresponding EU member states[39] :

Lithuania:	200%[40]
Slovenia:	Twice the size of average APR of banks and savings institutions
Poland:	The interest rate has a ceiling of 4 times the central bank Lombard rate. Fees and additional charges are capped at 5% of total loan size
Estonia:	3 times the market average APR
Slovak Republic:	Twice the average APR of the type of consumer credit
Belgium:	Adjusted every 6 months. For consumer loans under 1250 EUR, the APR is currently 18,5%[41]
France:	133% of average APR. Currently 20,28% for loans under 3000 EUR[42]
Germany:	Twice the average APR in a certain sector but not higher than the average APR in a certain sector plus 12 percentage points
Italy:	150% of average APR of a certain sector. Currently 19,15%[43]

Netherlands:	Legal interest rate plus 12%. Currently (12+3 =)15%[44]
Portugal:	Based on average APR of credit institutions for a certain purpose of the loan. Currently 16,1%[45]

Hence, the easiest way to ban payday lending is in fact setting APR ceiling low enough for the lenders not to be capable of operating profitably. However, price caps are surrounded by controversy: industry advocates insist that low APR caps cause more over-indebtedness and increase illegal borrowing. But there seems to be no hard proof of such an argument. Contrariwise, in France and Germany, where payday lenders do not operate, bank credit is more accessible than in the UK, where payday lending is extremely popular. Moreover, banks in Germany voluntarily open bank accounts for everyone and in France they are required to even include credit facilities, thus lowering the scale of financial exclusion[46].

While all of these possible regulations have been used and are to be considered by policy makers in the EU, they do not tackle the underlying problem of actually identifying a practice that is not only harmful when overused but is rather toxic in its essence: particularly practices that profit from their customers defaulting.

4. Identifying Exclusive Practices

It seems that payday lenders might be issuing loans to people knowing that they would eventually default because it is profitable to their firm. This kind of profiting may come in different forms: late fees, default fees, rollover fees and just the basic lending to as many clients as possible without assessing their ability to pay back. A way to see whether a practice/product is exclusive by profiting from its customers inability to pay back the loan could be comparing revenue, profits, loan losses and the share of contracts that have been defaulted on, rolled over or refinanced of firms which play in the same market. To conduct such comparisons, a simple methodology that could be used to see the overall pattern will be explained and advice for future steps will be given. However, commercially sensitive data is required for this analysis and it cannot not be acquired by the public. Nevertheless, as this paper is intended to give advice to policy makers who could obtain such information, guidelines of the methodology will be briefly explained.

Considering consumer microfinance, a comparison between payday loans, loans of credit unions and revolving credit could be made. These 3 types of consumer loans have been selected because they are similar in their purpose and size. Obviously, payday loans have received the most criticism in both this paper and in public. However, an appropriate indicator could not only recognize that a firm’s product is toxic and should not be offered to the consumer: it could also help honest firms get rid of a black shadow cast on them.

4.1. Methodology

The hypothesis for following methodology is that payday lenders' experience more loan losses and have more customers who default than the average of the industry. Considering the evidence in Chapter 3, it seems that this hypothesis might be true when, from the financial inclusion’s standpoint, consumer’s inability to pay back the loan should not be fuelling the profits of a firm.

To calculate loss rates and profit margins, the necessary data is annual income, annual profit,

annual losses and annual principal lent. However, not all of this information is included in the balance sheets of payday lenders: loan losses are not.

The percentage of income absorbed by loan losses

A widely used measurement for loan losses is taking annual loan losses as a percentage of current receivables. This methodology cannot work in our case as payday loans are usually issued for 2-4 weeks, so comparing loan losses of the whole year to the current receivables blows the metric out of proportion. If by any chance it were compared to classic loans (longer than 1 year term), this comparison would not be compatible. Hence, a better way to measure loss rates would be by comparing loan losses to an annual figure.

One way to look at them could be comparing loan losses to total income: we would obtain a metric that shows us what part of the revenue is taken by the losses.

$$loss\ rate=\frac{annual\ loan\ losses}{annual\ income}.$$

However, while loss to income ratio provides information about the percentage of charges encountered by the borrowers that are absorbed by loan losses, it does not show the real level of defaults.

Losses as a Percentage of Originations

Principal losses as percentage of principal lent could be a good way to acquire some general information about how many loans are defaulted and to see the overall credit-riskiness of a lender.

$$loss\ rate=\frac{annual\ loan\ losses}{annual\ principal\ lent}.$$

This rate is of course far from perfect as it does not include neither roll overs nor refinancing but it could be a beneficial and uncomplicated place to start.

Profit Margin

To obtain an absolute metric for profit of a firm, a traditional gross profit margin can be used. Basically, it compares firm’s profit to its revenue:

$$profit\ margin=\frac{gross\ annual\ profit}{annual\ revenue}.$$

Finally, after acquiring the three main measurements, a comparison can be made. An elementary way to achieve this would be comparing loss rates of every company in the concerned industry to a benchmark. This benchmark could be considered as 150% of industry’s average or a similar appropriate number. If the loss rate of a certain firm exceeds this benchmark, there is obviously some suspicion about its appropriateness.

The next step could be comparing profit margins. If the firm with the excessively high loss rate also has profit margin higher or not significantly lower than the industry’s average, the practice of that firm could be considered as possibly financially exclusive. Such a conclusion would be fairly straightforward. A firm with higher than average default rates manages to maintain high profits: this is suspicious given the nature of the business and probably is a sign of profiting from generating damage to its customers.

Nevertheless, this is just a proposition of what actions could be taken to identify a certain practice as toxic. If after making a comparison a firm seems to be having inappropriate profits compared to its default rates, a more thorough investigation should follow.

4.2 Example

As it has been already mentioned, the data required is not publicly available. However, a small example to see the scope of this problem can be taken if instead of loan losses, loss provisions are applied (even if they do not correspond to the real loan losses, a clear trend can be distinguished).

In 2012, Wonga.com (biggest payday lender in the UK) had a loss rate, calculated using this methodology, of 40.78% while the average loss rate of credit unions in the UK was only 15%. The difference in default rates was also clearly visible: 2.15% for credit unions and 8.58% for Wonga.com, while the profit margins were more similar: 35% for credit unions and 27% for Wonga.com.

	Credit Unions[47] (in millions)	Wonga.com[48] (in millions)
Income	172,298.63	309.29
Profit	60,577.70	84.48
Principal Lent	1,103,906.86	1,160.00
Loss Provisions	27,413.86	126.12
Loss Rate	15.91%	40.78%
Default rate[IV]	**2.15%**	**8.58%**
Profit Margin	**35%**	**27%**

Obviously, the default rate was significantly higher for Wonga.com as not only does it exceed the threshold of 150% - it is more than 4 times higher. As for the profit margin, it is higher for credit unions but not significantly. Hence, a conclusion could be made that Wonga.com had an excess of defaulted consumers to keep their profits high.

4.3 Suggestions and Steps for the Future

The already proposed methodology is rather straightforward and does not fully tackle the main issue proposed in this paper: the identification of harmful crediting practices. To accomplish this mission, further investigations ought to be performed, discussions on this subject should be carried out and changes in policies have to follow.

A first step to be taken could be improving the proposed indicator to take into account not only the loan losses but also all other objectives which are harmful to the consumers. They could include possible scenarios that result in extra fees, damage customers' credit history and place them in the circle of debt. These scenarios are defaulting (breaking the contract by not repaying or repaying late), extension of the loan (rollover) and taking out a new loan in 30 days after repaying the last one. The number of contracts with these outcomes as percentage of total number of contracts would indicate the negative impact of a practice quite properly and could be easily compared between different credit providers.

$$Financial\ Difficulty\ Indicator = \frac{Annual\ number\ of\ loans\ defaulted\ or\ rolled\ over\ or\ refinanced\ in\ 30\ days}{Annual\ number\ of\ loans\ issued}$$

It should be mentioned again, however, that this indicator is just a rather simple way to

[IV] When calculating the default rate, the denominator in the proposed equation is multiplied by (1+revenues/principal lent) as the provisions include lost interest and the principal does not, hence without it we would overestimate.

externally see whether a practice has signs of inappropriateness and damaging nature. To be more definitive, internal investigation should probably be carried out. Moreover, important information should be made easily accessible to at least the policy makers. Indeed, payday lenders now do not have to follow the same rules or accounting principles as banks or credit unions do.

Finally, to choose the best possible solutions to the ongoing situation, formal discussions of credit providers, consumers protection and financial authorities have to be organized. Only this way can appropriate decisions be reached and improvement in both identification of damaging practices and current policies made.

5. Conclusion

The industry of consumer microfinancing has received a lot of attention in the past years and it is obvious why: a lot of firms issue loans irresponsibly, market their products unfairly and encourage the consumers to borrow multiple times when such behaviour should not be supported. Some countries in the EU have banned such practices or have been attempting to regulate then, however, it is still a sore subject.

This paper tried to explain the negative ways in which payday lending companies carry out their business by showing the negative effects they have to the consumers: starting by getting stuck in a debt circle and finishing by increasing the chances of filling for bankruptcy. For this problem to be solved, a lot of different regulations can be applied but what has not still been done is identifying those practices. A good way to achieve this goal could be looking at the issue from financial exclusion's standpoint. That is, to identify practices which consciously profit from their customers' misfortune by causing long-term damage, especially for the low-income consumers. The approach suggested is fairly simple: comparing loss rates and profit margins of the industry to find which of them have excessive default rates and in consequence obtain excessively high profits. However, to carry out these calculations, commercially sensitive data has to be accessible, hence, this suggestion should be taken into account by the policy makers who would be able to access such information. And finally, improved indicator that would identify the percentage of contracts with negative impact on the consumers is proposed together with suggestions for policy change and formal discussions.

Appendix

1 table. Marketing tactics of Lithuanian payday lenders (last checked on 28th of October, 2014)

Website	First Loan Interest Free	Other Offers	Excessive Working Hours
www.bigcredit.lt	Yes	50% discount on your birthday; 5 extra days for rolling over	-
www.bigbank.lt	-	-	-
www.blickreditas.lt	-	-	All day
www.bobutespaskola.lt	-	Free movie tickets, coffee or ice-cream for paying back on time	8.00 - 22.00
www.smscredit.lt	Yes	50% discount on borrowing more than 500 LTL (144.81 EUR)	7:00 - 24:00
www.creditday.lt	-	-	-
www.creditplus.lt	-	-	-
www.creditor.lt	Yes	-	-
www.vivus.lt	-	-	7:00 - 24:00
www.credit24.lt	-	50% discount on most popular loans, e.g. 1000 LTL (289,62 EUR)	8.00 – 22.00
www.dolcecredit.lt	-	-	-
www.euroecredit.lt	-	-	All day
www.minipaskola.lt	Yes	-	-
www.gf.lt	-	-	-
www.greitaskreditas.lt	-	-	-
www.sohocredit.lt	Yes	-	All day
www.kreditas5000.lt	-	25% discount on first month interest if liked on	-

		Facebook	
www.kreditucentras.lt	-	30% discount on interest if borrowed for one month	-
www.viasms.lt	-	-	-
www.manokreditas.lt	-	-	All day
www.mazaskreditas.lt	-	-	-
www.mikrokreditas.lt	-	50% discount on interest if borrowed for 15 days	-
www.pinigine.lt	-	Loyalty program where customers can collect electronic "money" for taking out loans or paying on time and then spend this "money" on interest payments; 50% discount on interest if borrowed from 500 to 1500 LTL (144,81-434,43 EUR) for 1 to 12 months period	All day
www.smspinigai.lt	Yes	Cash bonus for recommending the service to your friends; if first loan is of 500 LTL (144,81 EUR), repayment is 490 LTL (141,91 EUR)	I - V: 08-22; VI - VII: 10-20
www.momentcredit.lt	Yes	Loyalty program where customers can collect electronic "money" for taking out loans or paying on time and then spend this "money" on interest payments; 30% discount on interest for first loan for 12 months	-
www.paskoliukas.lt	-	50% discount on borrowing for 30 – 55 days	-
www.paskolosjums.lt	Yes	-	-
www.paskolostau.lt	-	-	-
www.provident.lt	-	-	-
www.popkreditas.lt	Yes	-	8.00 - 22.00

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