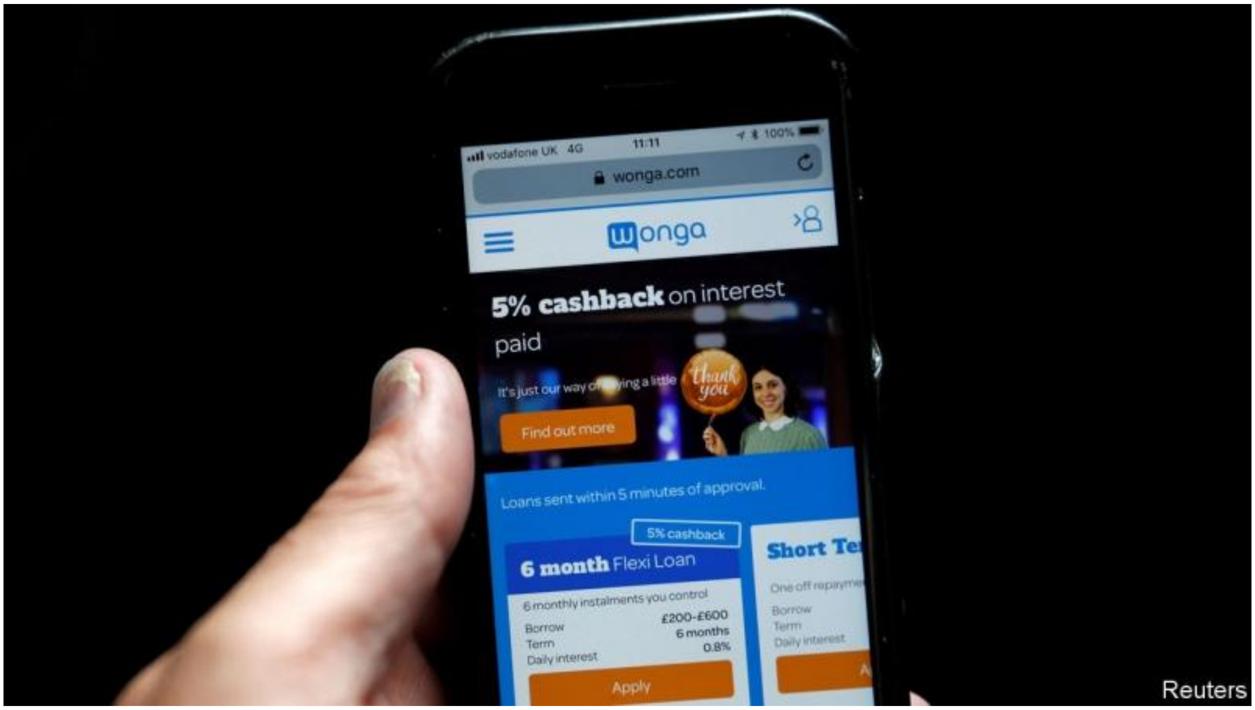
The Economist

Wonga’s woes spell the end of the payday-loan era

But as short-term lenders go under, Britain’s debt problem is growing



UPDATE Aug 30: *Shortly after this article was published Wonga said it was putting itself into administration.*

THE death of Kane Sparham-Price came to symbolise all that was wrong with Britain’s “payday lenders”. The 18-year-old, who suffered from mental illness, hanged himself. A coroner’s report in 2014 noted that on the day he died, Wonga, a provider of short-term, high-cost credit, had taken from him part-payment for a debt, emptying his bank account and leaving him in “absolute destitution”. Small wonder that many Britons welcomed the news this week that Wonga was apparently nearing collapse, seeing it as a sign that the country had kicked its reliance on such lenders. Yet focusing on Wonga’s woes misses the bigger picture. Britain’s household finances look increasingly shaky.

Regulatory changes introduced by the Financial Conduct Authority (FCA), which came into force from 2014, have undermined Wonga and other lenders’ business models. The new rules include limiting the daily interest rate, including fees, to 0.8% of the amount borrowed, where daily rates of over 10% were once common. The FCA also limited the total amount that borrowers could pay in interest and fees. All this has made much payday lending unprofitable. Although it is perhaps the most notorious lender, Wonga is not the only one struggling. Our analysis suggests that the FCA’s reforms have reduced the number of firms operating in the payday-loan market by more than 90%.

Britons who enjoyed the speed with which they could get credit may bemoan the demise of the payday-loan business. Many took out short-term loans with no problem. Yet, overall, households are probably better off for the industry’s demise. Many lenders’ business models relied on “sweatbox lending”, in which debtors were encouraged to take out new loans again and again when they entered or neared default, says Joseph Spooner of the London School of Economics.

What of the most common objection to toughening rules on payday lenders—that it would force borrowers to turn to loan sharks, who charged even more? Research from the FCA “found no evidence that consumers who have been turned down for [high-cost credit] are more likely to have subsequently used illegal moneylenders.” Meanwhile, over 60% of those rejected for high-cost loans after the reforms ultimately say that they are better off as a result.

A smaller payday-loan market is likely to lead to fewer cases where minor debt problems morph into crises, and thus to fewer tragic stories like that of Kane Sparham-Price. But the reforms do little to address the root causes of indebtedness. And here things are looking worse.

In the past two years, both the labour market and the welfare state have squeezed many Britons. Real wages have not grown. Since April 2016 the government has frozen most working-age welfare benefits in cash terms, as higher inflation has eroded their purchasing power. Britons have thus dipped into their savings in order to keep spending.

Though there is no perfect measure, it appears that financial distress has risen. A survey from the Bank of England points to a rising share of Britons who are “very concerned about debt”. The number of people turning to StepChange, a debt charity, for help fell after the financial crisis of 2008-09 but has since increased again. Last year 620,000 people contacted the charity, more than ever before. The rate of personal insolvencies started going up in 2016. In the second quarter of 2018 the pace of increase quickened. Those in financial distress are likely to cut back sharply on spending, which is bad for the economy. They are also more likely to fall into physical or mental ill-health.

The government has promised to help “just-about-managing” families. Yet its measures to aid people in debt are limited. Ministers have proposed a statutory “breathing space”, whereby a person with debt troubles could get legal protection from creditors for six weeks. That would increase demand for debt-advice services, points out John Fairhurst of PayPlan, a debt-management firm. Yet so far the government has said little about the extra funding for such services that would surely be necessary. Meanwhile, it seems unwilling to unfreeze welfare benefits. Wonga’s passing would mark the end of a grim chapter in British economic history, but it is far from the end of the country’s personal-debt troubles.

This article appeared in the Britain section of the print edition under the headline "The Wonga paradox"