

Protecting Danish Consumers from the Hazards of Payday Lending



Abstract

Our project goal was to develop potential initiatives for the Danish Consumer Council to protect consumers from excessive indebtedness. Payday loans are short term, high interest loans which are intended for emergency expenses. These loans have very high interest rates which can trap consumers in a cycle of debt if not paid off on time. Through our research, we found that the three major reasons for payday loan indebtedness are: consumers are trapped in a cycle of debt, payday lenders are running a delinquency intensive business, and payday loan advertisements are targeting impulsive consumers. To address these three problems, we identified four initiatives and one recommendation that can regulate the industry and help protect Danish consumers. The first initiative we propose is a charge cap that will prevent excessive interest payment and cycles of debt. The second initiative is prohibition on images or intended use content in payday loan advertising, in order to reduce targeting of impulsive consumers. Our third initiative is strengthening the current cool-off period regulation in Denmark to reduce impulsive utilization of payday loans. Our fourth suggestion is creating a government-run database that has all loan information on record, to reduce delinquency in payday loan use. Data limitations have been a significant obstacle to understanding the industry and its effect on consumers. To overcome this issue, we recommend lenders be required to report key business metrics for the purposes of further monitoring of consumer health by the Financial Supervisory Authority.

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Payday loans: Predatory lending or a useful financial tool?

Payday loans are small cash loans usually provided online with no collateral. Payday loan companies charge excessively high interest rates, sometimes sending those with difficult financial situations into even more precarious positions. These loans have annual percentage rates (APR) that are often greater than 400% when compounded monthly (See Figures 1 and 2).¹ Compared to the average 14% APR of a credit card, the APRs of payday loans are extremely high.² The high interest rates of payday loans combined with the low incomes of the borrowers makes it easy to become locked in

a cycle of debt, which leads the borrower to owe multiple times the original loan amount.³

In recent years the payday lending industry in Denmark has increased dramatically. Between 2010 and 2014 the number of loans issued increased by 700% from 20,000 to 160,000.⁴ The large increase in the number of loans taken out combined with the potential for a consumer to become trapped in a cycle of debt exacerbates the problem of excessive indebtedness. The risk associated with the increase in payday loan use warrants a need for consumer protection.

Governments across the globe have been realizing the risks of payday loans and have implemented legislation to protect consumers by regulating the industry. Denmark's government has also begun to take steps toward regulating this industry, but the legislation that was enacted

proved ineffective in dealing with this problem. The Danish Consumer Council is looking to develop and investigate additional initiatives to protect consumers from excessive indebtedness that could be a result of payday lending.

The final goal for our project was to identify effective initiatives to protect Danish consumers from excessive indebtedness as a result of payday lending. To achieve this goal, we determined the problems within the lending industry, potential solutions, and previous initiatives. To identify these problems, possible solutions and past initiatives, we interviewed various stakeholders; including a payday lender, a behavior specialist, two financial advisors, and three politicians spanning from left to right; we conducted literature reviews; and performed content analysis of payday loan websites and advertisements. Through our findings we were able to make recommendations to the Danish Consumer council in order to protect consumers.

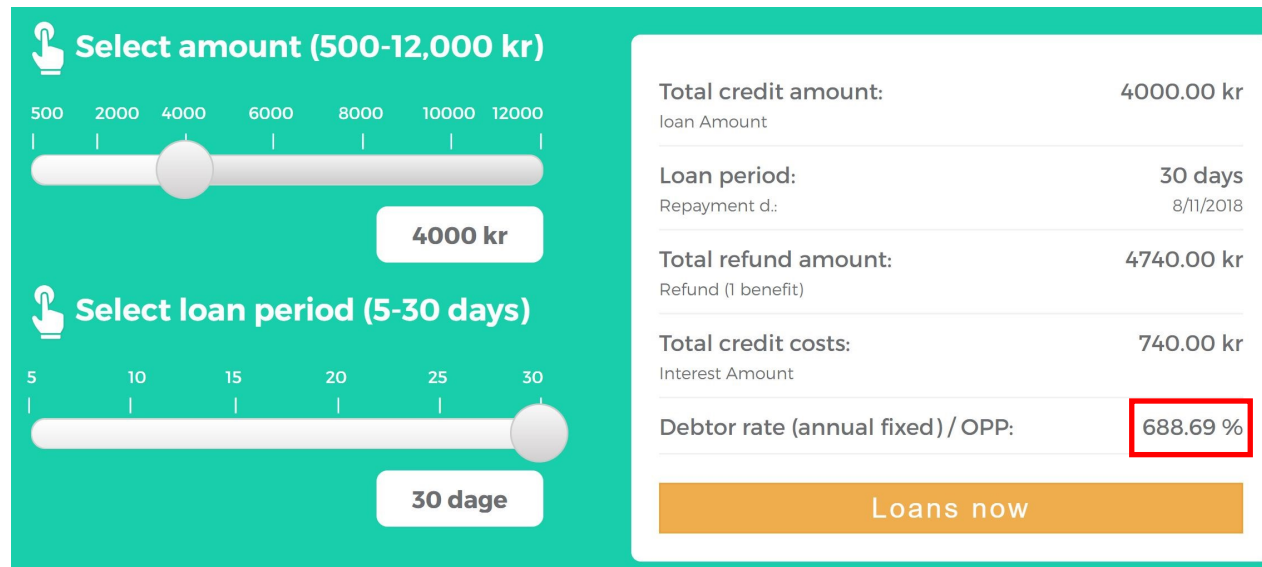


Figure 1. An example of a payday website showing an APR of 688.69%

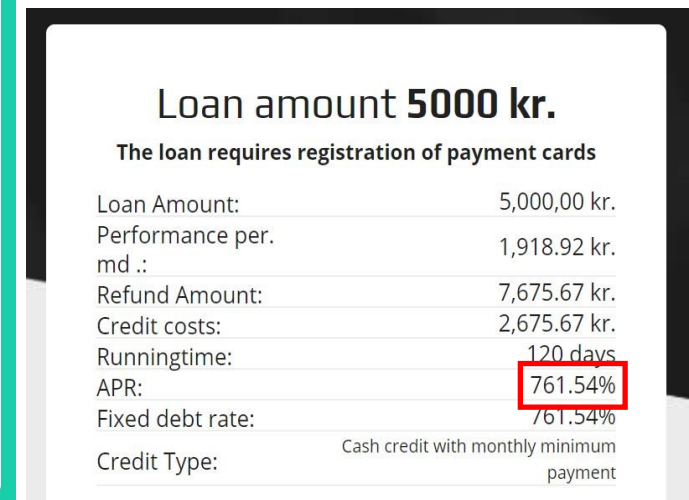


Figure 2. Another example showing 761.54% APR

Creating a safer consumer environment

In this section, we first establish the characteristics of a payday loan and provide some history behind the payday lending industry. We then discuss how the payday lending industry can be harmful to consumers. Once we establish the problem, we discuss the individuals who are most likely to use payday loans. After characterizing typical borrowers, we switch our focus to discuss the payday lending businesses and legislation related to payday lending. We first explore the profitability of payday lenders. A major part of the profitability of payday lenders is their high customer acquisition cost which we go on to explain. We then discuss how other countries have begun to take action to regulate the industry. Finally, the focus moves to discuss details on the Danish payday lending market.

Payday loans can lead consumers to a cycle of debt

Payday loans are short-term, small-dollar, high interest, unsecured loans, designed to provide credit for customers facing unexpected expenses or financial crises. Payday loans are structured as closed end loans, meaning that the initial amount must be repaid in full at the end of the term on a specified date. However, payday loans are often rolled over and incur a much higher cost for consumers. This common pattern of chronic borrowing in payday lending leads consumers to excessive indebtedness.

Payday loans are mainly distinguished by their high interest rates and low credit standards. If the typical 15% interest rate for a two-week

payday loan in the United States is converted to an APR, it would be approximately 3700%.⁵ This is far higher than the 14% average APR of a credit card.² Moreover, payday loans have lower credit requirements than other financial products, as consumers with poor or no credit history still have access to them.¹

The payday loan industry has its origins in the 1980s and has since grown into a multibillion dollar industry in the United States and internationally.⁶ The industry experienced explosive growth in the 1990s as mainstream banks stopped offering small unsecured loans due to the introduction of credit cards. The absence of this type of loan allowed payday lending entities to develop, therefore satisfying the demand for short term credit.¹

Offering credit to people with limited options is a good service, but the combination of high prices, short terms, and low credit requirements can trap individuals in a cycle of

debt. Borrowers in a cycle of debt cannot repay the loan in full when it is due (See Figure 3). They take out new loans or pay the rollover fees to postpone paying off their debt, which causes these loans to last for months or even years. The rolling over of loans results in a much higher total cost for the consumers.³ Empirical evidence shows that only some of the individuals who utilize payday loans can repay the loans on time. In 2009, 12 million of the 19 million Americans who took out payday loans found themselves trapped in a cycle of debt. Nearly two thirds of payday loan customers are repeat borrowers with at least 12 loan transactions per year.⁷ Similarly, in the United Kingdom 52% of payday loan borrowers experienced debt problems between 2009 and 2014. In 2011 alone, 28% of payday loans were rolled over at least once and five percent were rolled over more than four times.⁸

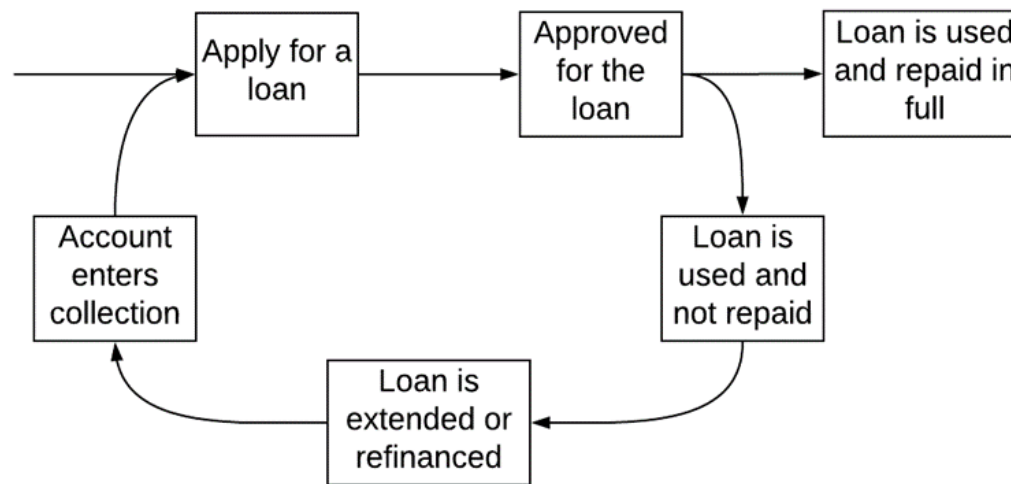


Figure 3. The Cycle of Debt

Payday loan borrowers are most likely to be underbanked and financially vulnerable

Consumers with poor access to traditional financial services (underbanked) are more likely to use alternative financial services such as payday loans. In 2011, the Federal Reserve found that 40% of underbanked households in United States used payday loans. This is significantly greater than the five percent of fully banked households who utilized these loans.⁹ Similarly, an Australian study found that only seven percent of payday loan borrowers had a credit card, while 87% of the general population had a credit card (See Figure 4). When there is less access to traditional forms of credit, payday lenders are used instead.⁶

Borrowers of payday loans are also more likely to be financially vulnerable. These individuals have very little wealth and find themselves in need of money during financial emergencies. A 2010 Australian study revealed that almost 80% of the individuals who took out payday loans were receiving a pension or social welfare payment. Many of the individuals interviewed did not feel as though they had a choice in the management of their finances.⁶ Meanwhile, in a study of United States consumers, the majority of payday loan borrowers earned USD\$10,000-USD\$20,000 annually per capita and 25% of borrowers were on some form of public assistance.¹⁰ This aligns with an Australian study that found borrowers from low income households use payday loans more often.⁶ Denmark has a similar situation, with the majority of payday loan borrowers being outside the labor market: sickness benefit

Credit Card Status vs Payday Borrowing in Australia

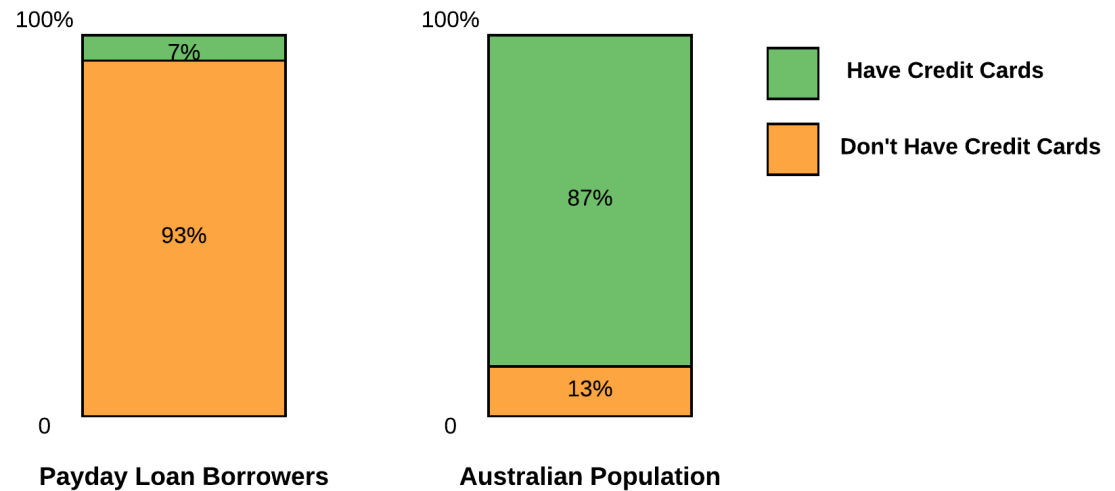


Figure 4. Credit Card Status vs. Payday Borrowing in Australia⁶

recipients, retirees, or others without a steady income. Eleven percent of Danes outside the labor market have used a payday loan whereas only four percent of the population in the labor market have taken out a payday loan. The lack of a steady income creates barriers to the borrowers' ability to pay back their loans, while it also creates subsequent risks for payday lending companies.⁴

Profitability is low in payday lending

Payday companies are less profitable than traditional banks. The CEO of Community Financial Service Association, who is the voice

for the small-dollar, short-term lending industry in the United States, said payday loan companies were making an average of four percent return on investment.¹¹ Cash America is one of the few public payday lenders which allows for a detailed look at the flow of money within the company. Cash America is a multinational company and had a 10.2% return on investment.³ Both of these return on investment rates are quite low compared to a 32% return on investment for the commercial bank industry.¹²

The low profitability is a result of the high risk of default combined with the relatively high processing costs and customer acquisition costs borne by the lending companies. The high

default risks stem from the methods that payday lending companies use to price risk.¹ Traditional lending businesses use rate-for-risk pricing by basing their interest rates on the potential risk posed by the borrower.¹³ Instead of this, payday lenders use a cost plus pricing methodology, meaning the interest rate of each loan is a fixed rate. Because the interest rate is fixed, there is no way to price the varying credit risk of borrowers. Payday lending companies use the cost plus pricing methodology to make up for the high processing and customer acquisition costs with high interest on the loans.³

Second, payday lenders have relatively high processing costs. Processing costs for lending companies mostly consist of manual credit checking and other paperwork. While payday lenders bear the same fixed costs per loan as traditional lending institutions, they have much higher relative processing expenses than banks because they issue loans that are both smaller in amount and greater in quantity.³

Third, the customer acquisition costsⁱ of payday lending companies are much higher than traditional lenders'. The high cost is due to the relatively high amount of advertising required per successful sale.³ Moreover, payday lenders do not have an established customer base compared to traditional lending institutions, so they must spend more money to seek out and attract new customers. The relatively higher risks and higher costs borne by payday lending companies create a lending situation that requires chronic borrowing. Chronic borrowing of payday loans can lead consumers to excessive indebtedness, warranting legislation to regulate the industry.

ⁱ The customer acquisition cost includes research, marketing, and advertising costs associated with convincing a customer to use a service.

Payday lenders have a high customer acquisition cost

Payday lenders use a variety of costly strategies to acquire first time customers, such as 'refer a friend' programs, discounting of first loans, and deferred interest payments. For example, in 'refer a friend' programs the company rewards customers who bring in other individuals to utilize the business. The reward paid to the existing customer increases the consumer acquisition cost. The discounting of an initial loan to entice new customers is also considered a customer acquisition cost. The discount can be thought of as the payday lender paying for the first time customer's loan to be less expensive.³ Payday lenders high customer acquisition costs are shown in their operating

expenses; for example, Ferratum spends 13-17% of revenues in its small consumer loans segments on marketing.¹⁴ A report by the Association of Chartered Certified Accountants found that a payday lending company, Cash America spent 17-20% of revenues on advertising and marketing.³ In comparison, Sparekassen Sjælland-Fyn, a mid-sized European consumer bank, does not even break out the marketing costs on the income statement due to their negligible value.¹⁵ In fact, Cash America's customer acquisition cost is so high that the cost is not covered until a customer's third loan (See Figure 5).³ To cover their high customer acquisition costs, some payday lenders raise their interest rates, which in turn makes the loans less attractive for consumers, and causes the company to spend even more on customer acquisition.

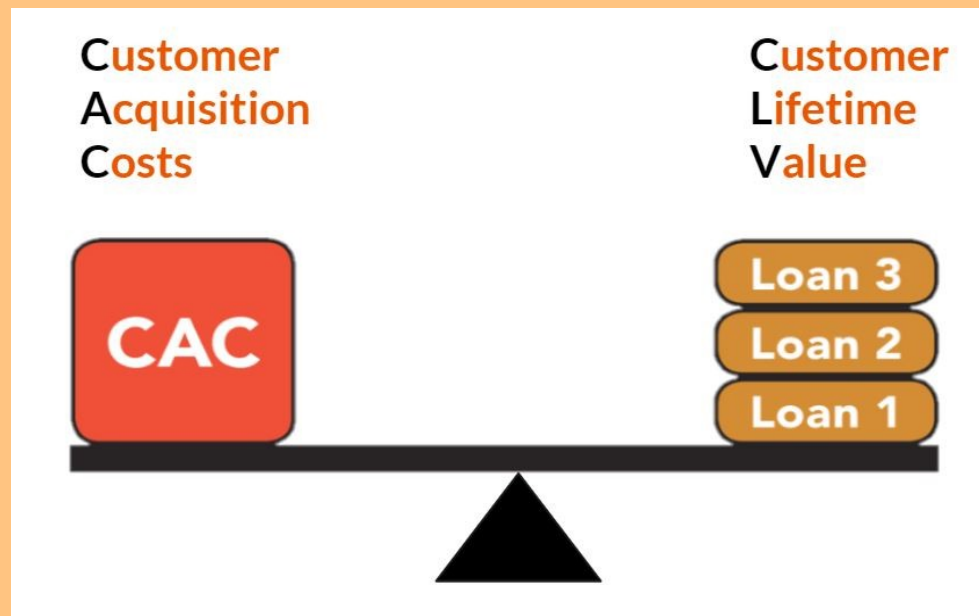


Figure 5. Customer Acquisition Costs vs. Customer Lifetime Value³

Internationally, regulations have been implemented to protect consumers from payday loan indebtedness

Many countries have developed national regulatory bodies to supervise the payday lending industry and protect consumers. Typical regulations include components such as interest rate limits, cool-down periods, cool off periods, regulation of advertising, loan extension limits, and mandatory due diligence. The cool-down period is a way to prevent consumers from taking out multiple loans within a certain period of time.¹⁶ Mandatory due diligence requires companies to reasonably determine a customer's ability to repay the loan.¹ A cool-off period allows customers to consider whether the loan is necessary by giving them a period of time to cancel the loan.¹⁶ Denmark has only enacted a 48-hour cool-off period, which leaves several more regulatory options on the table.¹⁷

The international payday lending industry has a problem with the cycle of debt. Because the cycle of debt is common within the global payday lending industry, it is worthwhile to regulate the growing Danish payday lending industry for the purpose of consumer protection. In 2010, Danish consumers took out 37 million DKK (USD\$6.3 million) in payday loans. Four years later this number had jumped more than tenfold to 430 million DKK (USD\$76 million) (See Table 1).⁴ The rapid expansion of the industry has made it difficult for consumer protection measures to keep up, and amplifies the importance of identifying effective consumer protection measures.

Year	Number of Loans	Amount of Loans
2010	20,000	37 Million DKK
2014	160,000	430 Million DKK

Table 1. Payday Lending Market Expansion in Denmark

Determining potential initiatives: Our process

The goal of this project was to develop initiatives that protect consumers from excessive indebtedness resulting from misuse of payday lending. We researched payday loans using interviews, content analysis, and a literature review. Our project objectives were:

1. Assess the business models of payday lenders to understand their costs and revenues
2. Evaluate customer acquisition methods of payday lenders
3. Identify the role of legislation on the payday lending industry in Denmark and internationally.

An overview of our methods is shown in Figure 6. The methods used were literature review, interviews, and online surveys. Literature review sources included academic reports and professional studies on payday lending practices, the industry and legislative initiatives. The literature review prepared us for our semi-structured interviews with various groups of stakeholders and assisted in the development of a website survey and marketing survey for the online payday lenders in Denmark. Furthermore, this literature review was used to triangulate the findings from interviews and supplement the information gathered from our surveys. Our website survey was performed by collecting data about usability, product pricing, and credit rating methods on the major Danish payday lender websites. Finally, our marketing survey evaluated the marketing materials of payday lenders. We gathered opinions on all sides of the payday lending issue to craft a solution that protects consumers and preserves the market.

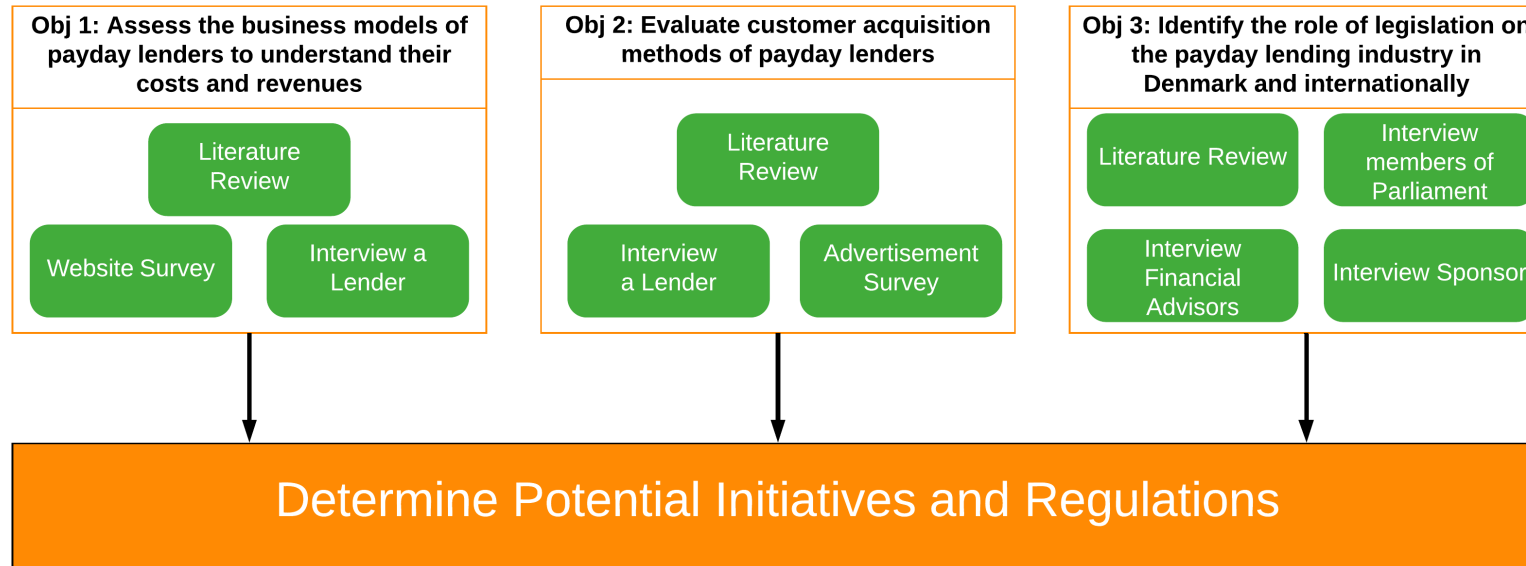


Figure 6. Methodology Overview

Assess the business models of payday lenders to understand their costs and revenues

Business models articulate the ways in which companies interact with and acquire customers, as well as methods of profit generation. The main components of a business model are the cost structure, value proposition, key activities, revenue streams, customer segments, customer relationships, and customer communication.¹⁸ Our project documented relevant aspects of these components through an interview with a lender and a survey of payday lending websites (See Appendices B and G for the protocol and questions).

Our interview with a payday lender

covered a range of topics from credit rating, customer demographics, sources of revenue and expenses. The responses to these questions gave us information from a direct source on the operation of payday lending companies. For the assessment of online payday lender business models, we performed a content analysis of 14 Danish payday lenders' websites. To choose our sample, we identified the first 14 payday lending websites shown on a Google search for "Kviklån" (payday loan) because we deemed these to be the most likely customer choices. The survey allowed us to gather data on over 80% of the Danish retail payday loan market in Denmark.¹⁹ Information gathered included interest rates, policy terms, and the number and content of the fields required to apply for a loan. The survey gave us insight to the online business

model, and helped us to understand the current interest rates, loan amounts, and process of payday lending in Denmark (See Appendix L for details). The information gathered from the website survey was cross referenced with the supplemental research on business models to determine common practices within the industry.

Evaluate the customer acquisition methods of payday lenders

Payday lenders use a variety of different customer acquisition methods, however advertising is the most prevalent. To get a better understanding of how lenders market to new customers, we performed an advertising survey, read academic journals on advertisement, interviewed a consumer behavior expert and a

payday lender.

The interview conducted with the behavioral specialist yielded further information on how advertisements affect consumers. The behavioral specialist helped refine our coding process and analysis of our marketing survey through their understanding of consumer influence techniques. Additionally the consumer behavioral specialist had a unique perspective on what future programs or initiatives may be most effective (See Appendix C for questions).

We conducted a content analysis of 32 payday loan video advertisements. The advertisements were obtained from a variety of media sources including online and public transport. By identifying demographic information such as the age of the actor and psychographic informationⁱⁱ, such as the overall themes and experiences shown, we were able to determine the common themes for payday loan advertisements. This analysis revealed those targeted by these ads and the most prominent visual triggers in payday lending advertisements (See Appendix K for rubric). The information gathered from the advertisement survey was cross referenced with the supplemental research on marketing to determine common advertising themes within the industry.

Identify the role of legislation on the payday lending industry in Denmark and internationally

With a knowledge of previous and current initiatives and regulations, we performed a

ⁱⁱ Psychographic information describes the values and opinions and interests potential customers.

comparative analysis of legislation from various countries. We first categorized the broad types of initiatives such as cool down periods and interest rate caps. Next, the components of each country's legislation were sorted into these categories. This comparison showed us possible initiatives which Denmark could implement and the groups of stakeholders that support these initiatives.

To investigate Denmark's payday lending legislation, we conducted semi-structured interviews with three members of Parliament spanning the left, center, and right of the political spectrum (See Figure 7) (See Appendices D, E, F for questions). Using this range of political views and the main factors that go into these regulations, we were able to formulate potential regulations in a more impartial manner. The knowledge gained from these interviews helped us in drafting the initiatives we proposed to the Danish Consumer Council.

We interviewed a senior economic advisor from the Danish Consumer Council.²⁰ The Danish Consumer Council has been researching payday loans and the senior economic advisor knows about the previous initiatives taken in Denmark. Learning about initiatives that the Danish Consumer Council has proposed and how they perceive the effect of previous initiatives helped us in determining our initiatives (See Appendix H for questions).

Another interview was conducted with an industry researcher from the United Kingdom. The industry researcher has been researching the payday lending industry in the UK for several years and has contributed to multiple reports. The researcher was able to provide information on the effects regulations had on the UK payday lending market and the process in developing these regulations (See Appendix J for questions).

Interviews were conducted with two financial advisors, which allowed us to obtain the consumer perspective of payday lending. This consumer perspective is important to consider when designing legislative initiatives with the goal of consumer protection. The financial advisors had a unique perspective as a result of working closely with those negatively affected by these loans. In order to identify legislation that will prevent indebtedness, we asked how they advise individuals who are indebted to payday lenders and how these people get indebted. Also the advisors knew the demographics of people who tend to need assistance getting out of debt. By identifying the financial difficulties of payday borrowers, we began to construct initiatives which will protect these vulnerable individuals (See Appendix I for questions).



Figure 7. Junhong interviewing a member of Parliament

The interviews provided ideas and opinions that were sorted into two categories: information about problems in the industry and details on possible solutions. The proposed solutions were cross referenced with legislation enacted in the United Kingdom, Australia, Sweden and Canada. This allowed us to determine the specific problems that each piece of legislation targets.

A multipronged initiative will help protect consumer

We identified three main problems with the international payday lending industry: the high risk of delinquency, the targeting of impulsive consumers, and the cycle of debt (See Figure 8). Due to the similarities between the Danish and international payday lending industries, we can reasonably determine that these problems with the industry and their potential solutions are applicable to Denmark. We drew these similarities according to the data gathered from our research. The high APRs, short terms, and the focus on speed of Danish payday loan products match the payday lending practices of international industries. For instance, from our website survey we learned online payday products in Denmark have an average APR of 610%. These loans range in principal from 100 DKK to 25,000 DKK (USD\$15 to USD\$3,850), with loan terms starting at five days. Danish payday loan applications have only 6 information fields on average. This suggests that Danish payday lenders also use speed as a key competitive factor. Similar to the international payday market, the business practices of Danish payday lenders are detrimental and harmful to consumers.

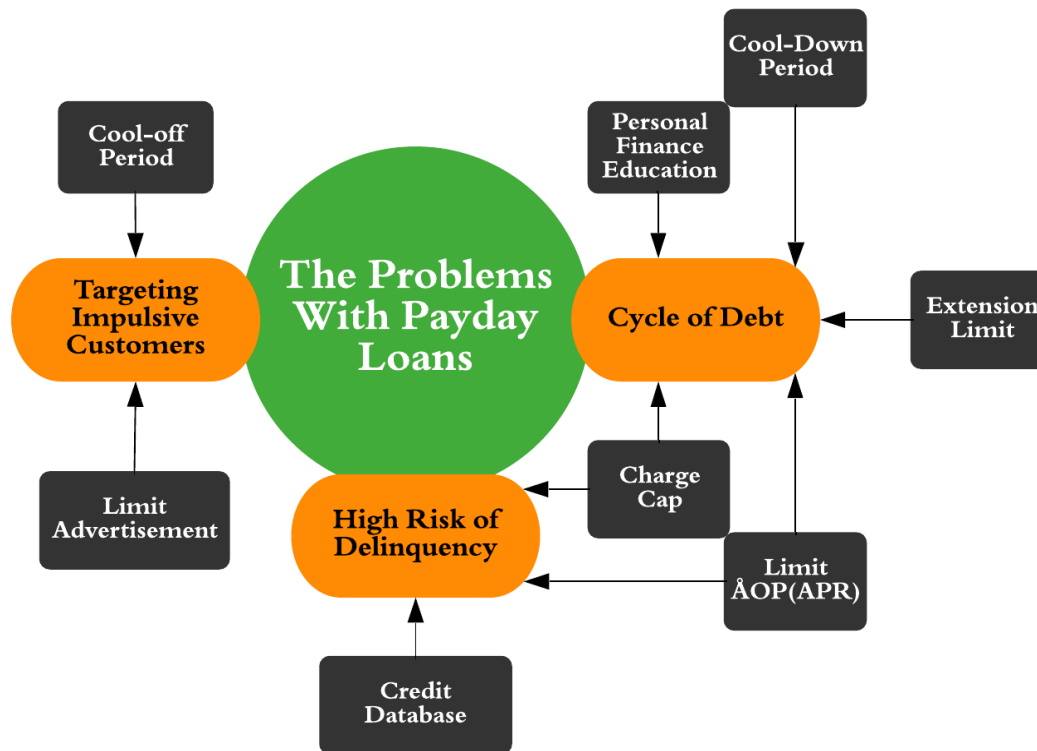


Figure 8. Consumer Issues and Regulatory Solutions

Current credit checking methods allow unqualified consumers to borrow payday loans

Danish payday lending companies perform an incomplete sequence of credit checks for loan applications (See Figure 9). The first step of a payday loan credit check is to examine the applicant's basic information, including name, address, phone number, bank account number, as well as their claimed monthly expenses that are not verified by any form of rent or utility bills. In the second step, payday lenders go through their

own internal databases to check for records of the applicant's past loan usage. However, the database only has a list of the lenders' previous customers, and information on the borrower's debts in other locations cannot be obtained. After conducting an internal check, lenders pay the Danish Ministry of Taxation 5 DKK (USD\$0.77) per customer to obtain the applicant's income information. The data yielded includes the applicant's net income in the year before, and their salaries for recent months. Nevertheless, current income status such as employment is not verified.

For the last step, lenders spend 15 DKK

(USD\$2.30) per customer to check if applicants are registered as ‘bad payers’ in the RKI system. The RKI system is a registry of individuals who have not repaid their debts in the past. This step is flawed because it can take up to one year to update this list of bad payers, allowing unqualified borrowers to use the lending system and default multiple times before they are listed in the RKI. In addition, credit history is not required for payday loan application, so consumers with

bad or no credit history can also take out payday loans.

Payday lenders harm customers with a delinquency-intensive business

Borrowers who are not able to repay payday loans can become delinquent, which increases the cost of the loans and harms their credit. In 2014, 30% of Danish payday lending

borrowers were over 10 days delinquent.²¹ In 2017, more than 30% of the value of loans issued by 4Finance (a Danish payday lending conglomerate) were expected to have difficulties with repayment. From the same company, over 46% of Danish loans have not been paid back in full within at least 30 days.¹⁹

Most Danish payday lenders are privately traded, and it is therefore difficult to evaluate the effects of business practices on consumers. However, it is possible to make some extrapolations onto the broader Danish market

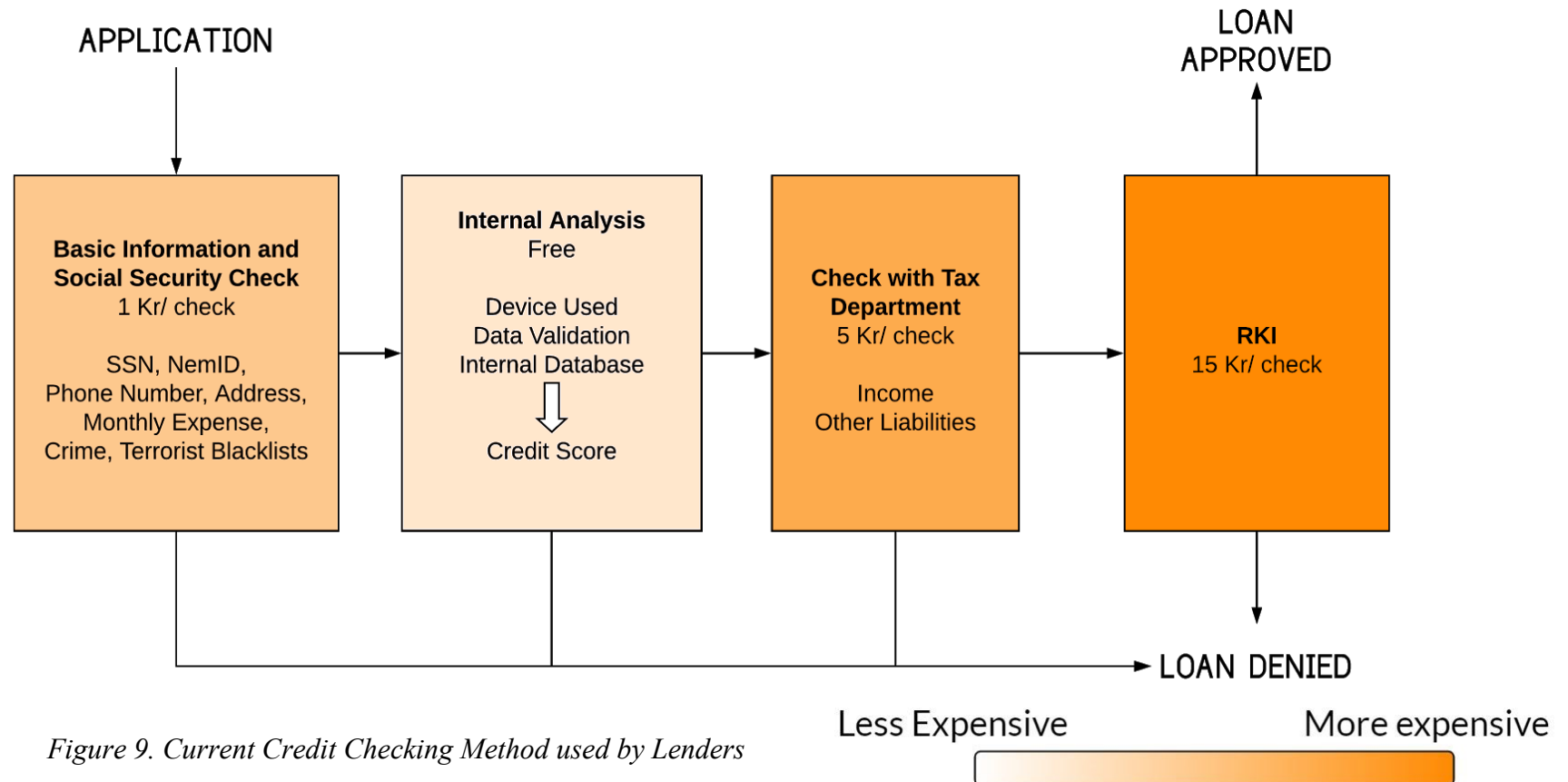


Figure 9. Current Credit Checking Method used by Lenders

using the financial statements of two companies operating in Denmark, 4Finance and Ferratum, combined with general market data from our website survey and the Danish payday lenders industry group. For year end 2017, 4Finance had approximately nine percent of the 646 million DKK (USD\$94 million) outstanding payday lending liabilities in Denmark.^{19, 22} Additionally, the two companies 4Finance owns in Denmark, Vivus and Zaplo, have similar product profiles to those of companies in our survey (See Table 2). This similarity justifies the extrapolation of our analysis to represent the broad Danish payday lending market.

Danish payday lenders expense far more on impairments as a percent of total operating costs than a typical consumer bank. Impairment is a measure used by financial entities to estimate the amount of money loaned out that will not be returned, and it is also an estimate of the rate of future delinquencies. The measure of impairments is standardized through the International Financial Reporting Standards, which allows for a consistent comparison. A loan is considered impaired if an “Objective loss event has occurred” (See Appendix O).²³ Impairments are used as a basis of comparison and proxy for defaults because large commercial banks do not disclose their delinquency rates.

Impairments account for 46.3% of Ferratum’s operating expenses and 30.7% of 4Finance’s operating expenses (See Figure 10).^{14, 22} High impairment expenses are further corroborated by our interview with a payday lending industry representative, who said that defaults is the largest expense in their lending operation. These rates are extremely high when compared to a Danish multinational savings bank such as Sparekassen Sjælland-Fyn. Sparekassen

	Vivus	Zaplo	Ferratum	Website Survey Avg
APR (%)	791.6	151.8	124.22	610.2
Available loan size (DKK)	100-6000	5000-2500	1500-20000	1107-13875
Available Loan Term (Months)	.16-1	3-24	5-47	2.25-10.75
Average Loan Size (DKK)	1,558	-	-	7,417

Table 2. 4Finance and Ferratum’s Products Compared to the Industry Average^{19, 22}

Sjælland-Fyn’s, impairments account for only 4.2% of operating expenses.¹⁵

When impairment is substantiated by real losses, it becomes delinquency. Of 4Finance’s total outstanding loans, 46% are over 30 days delinquent (See Figure 11). This rate of delinquency is actually expected by 4Finance. 4Finance categorizes 30% of its current outstanding Danish short term loans ‘doubtful

debt’. This means that 30% of the value of loans are not expected to be returned in full. The high rate of delinquency represents a large group of consumers who were approved for loans they could not afford.

The high rates of delinquency are the result of an intense “splash marketing” strategy. ‘Splash marketing’ was a term used in interviews to describe the marketing strategy of inserting the

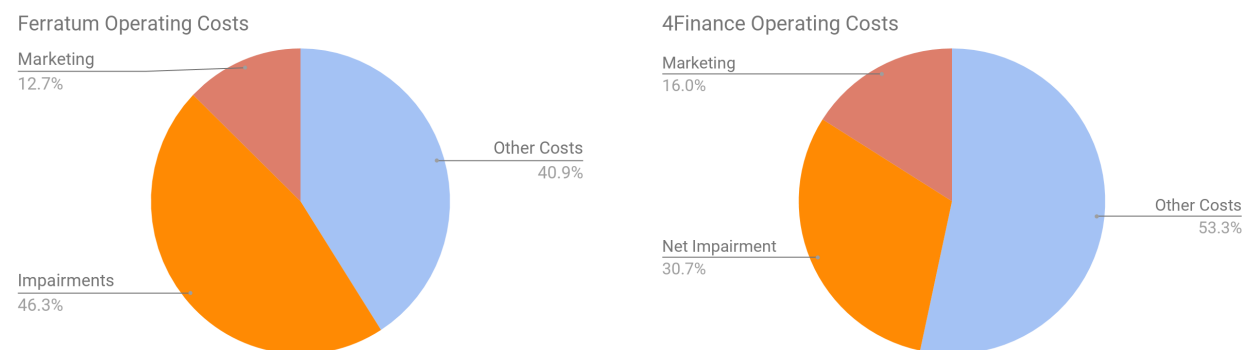


Figure 10. Danish Payday Lender’s Impairments as a percent of Operating Expenses^{14, 22}

message in as many places as possible. This intensive marketing brings in customers with varying creditworthiness, which increases the payday lenders' delinquency rates. For payday lending companies, Ferratum and 4Finance, marketing costs are about 15% of overall costs, far higher than marketing cost for consumer banks (See Figure 10). The consumer savings bank has marketing costs so low they are not broken out in their operating expenses.

Extensive marketing captures borrowers who are not expected to repay. Credit checking may actually be occurring after the loan is issued as a test to determine a borrower's likelihood to payback future loans. Using loans to check for credit worthiness contributes to high delinquency and default rates. This phenomenon was found in the UK lending market as well. By broadening the pool of applicants accepted, lenders can screen large numbers of customers with a small cash loss because of the low value of the loans. The marketing strategy behind this practice to broaden the customer profile suggests a delinquency intensive business practiced by

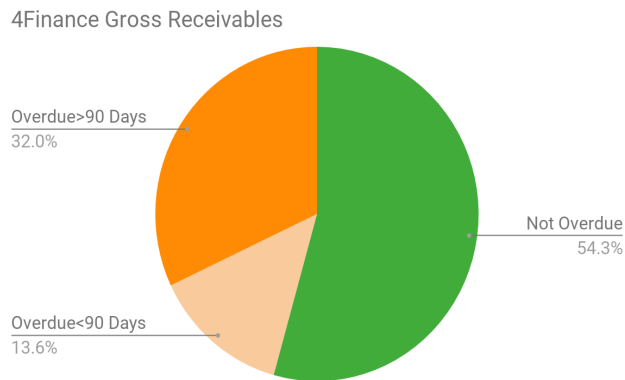


Figure 11. 4Finance Gross Receivables¹⁹

payday lenders, which pushes consumers into a cycle of debt.

Payday loan advertisements target impulsive consumers

Impulsive individuals are more likely to borrow for non-essential items because of the low barriers to acquire a loan. Marketing is a major customer acquisition strategy and helps to bring in the types of customers a business wants. However, advertisements sometimes attract individuals who could be harmed by the product. From our interviews, both the behavioral specialist and the senior economic advisor said that some payday lenders advertise towards impulsive individuals. Impulsive people can be targeted with the marketing of items such as electronics, vacations, and other consumer products, which non-impulsive people could save for instead.²⁴ Our advertising survey of 32 video advertisements supports these claims.

Most payday lenders advertise towards impulsive individuals by showing non-essential items as the intended uses of payday loans. In these 32 ads there were 40 different instances of an advertised use for the loan, and three instances with no advertised use. While four of the 40 intended uses were for school or emergencies, the other 36 advertised towards impulsive individuals. The fact that ninety percent of the intended uses target impulsive individuals verifies the behavioral specialist's claim that payday loan advertisements are tailored to be attractive towards impulsive consumers (See Figure 12). Given that impulsive individuals have greater difficulty paying back loans,²⁵ targeting them with payday loan advertisements can put them in a dire financial situation.

The cycle of debt is evident in Danish payday lending

The Danish Competition and Consumer Authority's 2015 study on Danish payday lending revealed that 30% of payday lender's revenues are generated from consumers unable to repay on time.²¹ The significant portion of revenue coming from consumers who are delinquent suggests that there is a cycle of debt within Denmark's payday lending industry. The cycle of debt is detrimental to consumer health because it drastically increases the final value of the loan.

The existence of a cycle of debt in Denmark was confirmed by two financial advisors who observed that individuals take out payday loans to cover previous loans. They see individuals trapped in a cycle of debt because they can only afford to pay the minimum monthly amount on their loans. This causes the principal value of the loan to decrease very slowly because the minimum payment is essentially the interest accrued from that month. Our interview with a parliamentarian from the Socialists People's Party also reinforces that people are using payday loans to pay for their outstanding debt. The parliament member said a cycle of debt could turn small loans into huge debts, making them much harder to repay. Therefore, initiatives should be implemented to protect Danish consumers from the hazards of payday loans. One of these initiatives is a public debtor database.

30% of payday lender's revenues are generated from consumers unable to repay on time.²¹

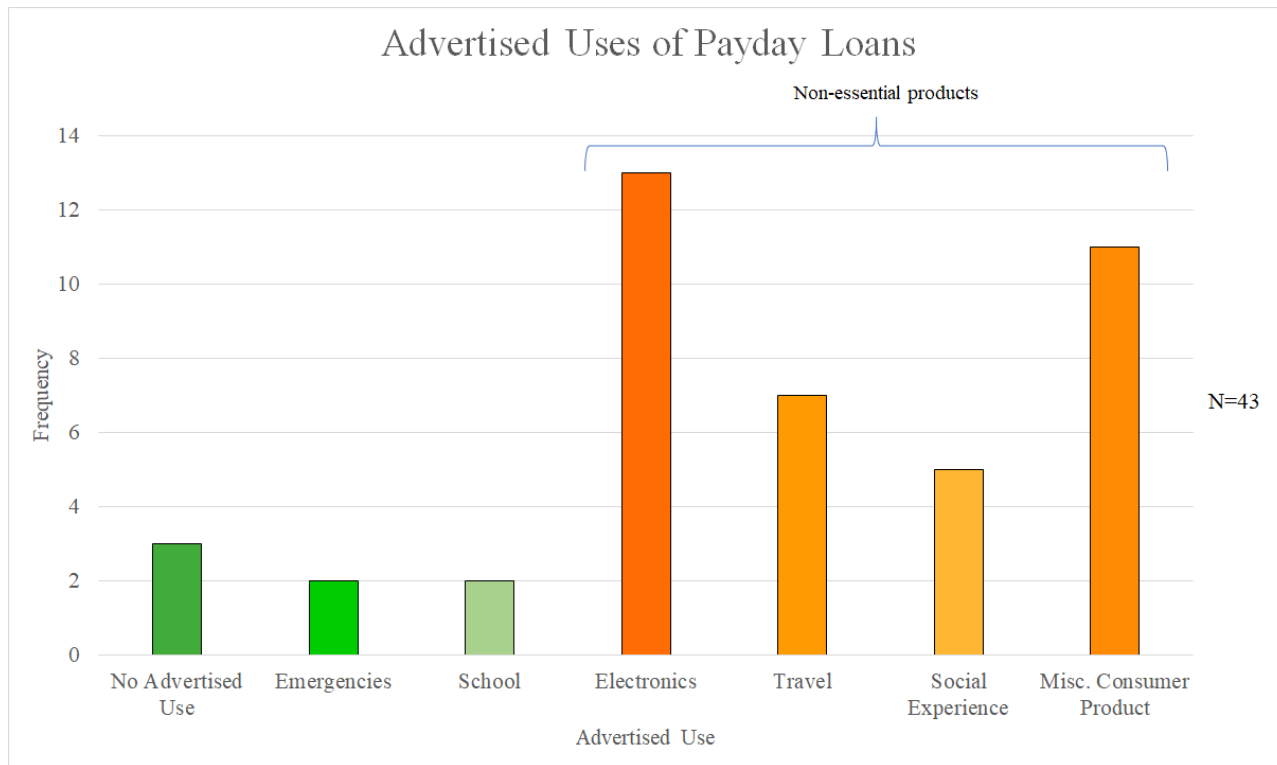


Figure 12. Advertised Uses of Payday Loans

Initiatives should be taken to improve the payday lending market

Throughout the process of determining Denmark’s payday lending situation, we have identified possible initiatives to help protect consumers. These initiatives protect consumers to various degrees of success by targeting the problems identified prior.

Regulations tend to target either the supply side or the demand side. On the supply side, regulations affect business performance by limiting the type of product sold. Regulations on

this side include the interest rate cap, charge cap, extension limit, cool-off period, database, and cool-down period. On the demand side, regulations shape consumer behavior. Regulations on this side include the warning statement, advertising, cool-down period, and education initiatives. To have an effective policy package, it is important to both regulate the products as well as inform customers.

A database has the potential to improve credit checking and lower delinquency

A database of consumer credit would be helpful in lowering delinquency by providing more credit information to lenders. Access to more credit information has been shown to lower default rates. In the United States, increasing borrower information sharing reduced default rates among high risk borrowers by 14%.²⁶ This finding is also consistent with a study on the introduction of a credit rating agency in Albania, which reduced the overall possibility of arrears (no or late payment) by 35%. The reduction in delinquency was found to be even more pronounced for repeat borrowers. This is an ideal result as the cycle of debt is caused by repeat borrowing. In addition, this same study also found that the database’s effect on access to credit and cost of credit was negligible.²⁷

Credit databases internationally are either run by the government (public) such as the Albanian solution, or privately run by companies such as Experian in Denmark and the United States. A global study of over 40 credit rating agencies nationally concluded that both public and private registries have the same effect on lowering defaults.²⁸ Using these examples, we can infer that the introduction of a database will lower defaults and may reduce the number of repeat borrowers with delinquent payments. Credit rating agencies tend to have privacy concerns associate. Different countries afford individuals privacy protections such as mandatory data deletion after five or seven years (United States, Finland), or bans on the collection of certain data types.²⁸

The current proposed solution in Denmark would be a government-run database. With the database, lenders would input private information provided to them by individual customers, and receive information specific to that customer. The

government would require all debts to be reported to the database, and this information could be supplemented with government tax data.

In this solution, the advantages for the lender are clear: the database would be free for lenders to query, making costly credit checks obsolete. Reducing the cost of credit checks would lower customer acquisition costs and directly boost the lenders' bottom line. For consumers, a government-run database would protect them from unaffordable loans. By increasing transparency in the credit rating space, credit-worthy individuals would have easier access to capital, and individuals concealing debt within the current system would not be able to take out loans they cannot afford.

Five out of seven interviewees from different viewpoints were in favor of creating a government-run database (See Figure 13). There is broad support for this initiative with the lending industry representative being the most in favor. The behavioral specialist expressed the most concern about the database. He was concerned that the database would help the lenders more

than the consumers. The senior economic advisor also expressed concerns with the database, but his concerns were rooted in the privacy aspect of the database.

Regulations can prevent advertisements from targeting impulsive consumers

Marketing is very prominent in the payday lending industry, and some countries have begun to regulate the way their payday lending products are advertised. Australia, the UK, and Sweden require a warning statement on payday lending websites and advertisements.^{29, 30, 31} According to the regulations, the statement must include a warning about the high risk of debt and contact information for debt advisors. For example, the UK regulation requires all payday lending websites and payday loan advertisements on television to include the risk warning: "late repayment can cause you serious money problems". The regulation also requires all payday lending websites to include a price

comparison with other payday products.

Views on this solution varied throughout our interviews. The payday lender that we interviewed did not support restrictions on advertising. The lender claimed that consumers should be able to use the loans for whatever they want, and the marketing should reflect that. On the other side, two of the parliament members believed that these loans should have advertising regulations similar to those imposed on alcohol and tobacco. Meanwhile, the financial advisors also believed that less exposure would help in reducing the number of people taking out these loans. The behavioral specialist took a different approach, by suggesting a limit on the locations in which payday loan advertisements can be shown. To prevent impulsive individuals from being tempted to buy consumer goods, the specialist suggested a limit on the content of payday loan advertisements, where payday loan advertisements only show text. No pictures or intended uses for the loans should be shown. This reasoning matches the idea that consumers tend to buy impulsively when their attention is grabbed

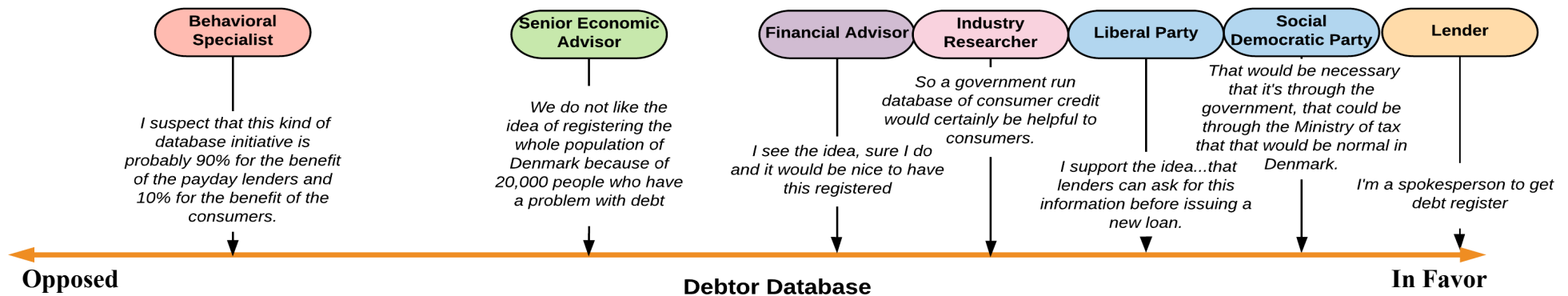


Figure 13. Stakeholder Favorability of Debtor Database

by pleasing goods.³²

Denmark has taken steps towards protecting impulsive borrowers. In 2017, a cool-off period of 48 hours was enacted to prevent impulsive decisions, by giving consumers 48 hours before receiving the money to think over the loan, and have a chance to cancel. The theory behind this regulation is rooted in delayed gratification, which suggests that impulsive purchases are more likely to be reconsidered rationally, if the consequences of the immediate purchase are reviewed.³³ The 48 hour cool-off period allows for this review of the consequences, and can therefore help stop impulsive purchases. However, the cool-off period regulation was worded to apply only to unsecured consumer loans with terms under three months. As a result, lenders created new products including installment loans that had terms longer than three months, and cash credits, which were not considered “loans”, to bypass the new legislation.³⁴ Because these new products either have longer terms, or are lines of credit from the lender rather than a cash loan, they are free from the cool-off period restriction. From our website survey, 85.7% of payday lending websites in Denmark are now using these new forms of credit or installment, and only two lenders are still providing traditional payday loans exclusively (See Figure 14). Moreover, about half of the payday lenders are now only offering products with terms longer than three months to get around the regulation (See Figure 15). This demonstrates the flexibility of short term high cost consumer credit products. When crafting regulations, it is important to design the regulation to capture all aspects of the industry.

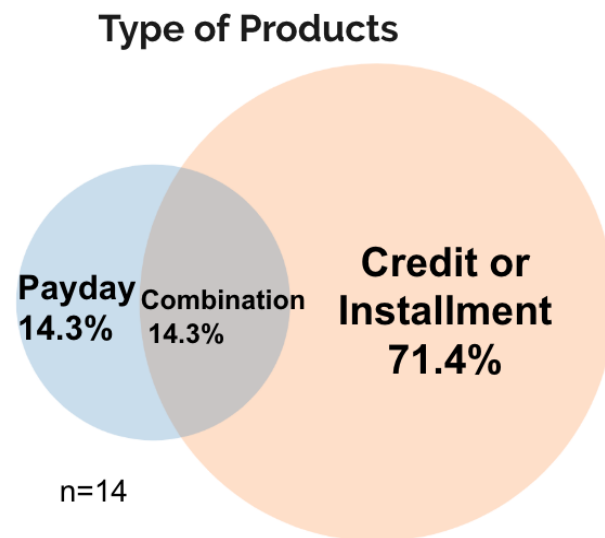


Figure 14. Payday Lender’s Product Types

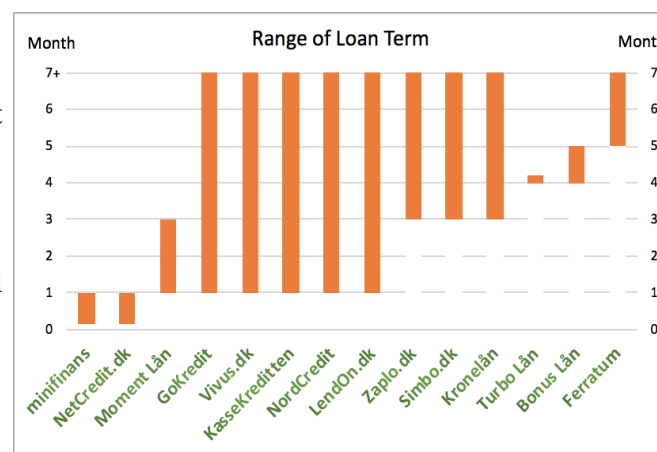


Figure 15. Range of Loan Terms

Several initiatives have the potential to curb the cycle of debt

One regulation to help prevent the cycle of debt would be the implementation of a charge cap on loans. These caps are a limit to the amount charged on top of (not including) the principal loan amount. A charge cap would prevent consumers from having to pay multiple times the original loan amount, making repayment more manageable. Charge caps have been implemented in Australia, the UK, and Sweden.^{16, 29, 35} The UK and Sweden established a charge cap that made interest and fees not exceed 100% of the original loan.^{29, 35} Australia has this same cap with the stipulation that it only applies to borrowers that default on the loan.¹⁶ The UK tested caps between 50% and 200% and believe that the 100% cap balanced the protection of consumers, while allowing lenders to continue offering loans for varying amounts of time. The 100% value also allowed consumers to better understand the loan.³⁶ According to both financial advisors, charge caps are an effective way to limit the APR indirectly, as it stops the interest from further accrual after reaching the cost limit.

Another regulation to prevent the cycle of debt is the APR limit (interest rate cap). Similar to the charge cap, this limits the total cost of the loan by reducing the rate at which interest accrues. This is a popular regulation amongst countries with strong payday lending regulations: the United Kingdom, Australia, and Sweden have all implemented some sort of interest rate cap. The UK established a cap of 0.8% each day (1733% APR) on payday loans in 2014.³⁵ As of 2012, Australia has a 20% cap on the initial loan

following (85% APR).¹⁶ In 2018, Sweden created an APR cap of 40% in addition to the national bank's current interest rate.²⁹ The UK had tested several different caps between 0.4% to 1% per day before ultimately deciding on a limit of 0.8%. Having a low daily cap decreases the cost of loans paid on time; it also means that the cost is reliant on the duration of loans.³⁶ In 2017, the Socialists People's Party in Denmark proposed an interest rate cap similar to the Swedish cap. The proposed cap was 15% in addition to the national bank's current interest rate. One representative from Parliament explained that 15% was a starting point and the party was willing to go up to 30%. Our analysis of lender websites in Denmark revealed the average APR of a loan was 610%. This proposed cap is significantly lower than existing rates.

Both the charge cap and limiting the interest rate also help with the risk of default. The charge cap helps with the risk of default by limiting the total repayment amount of the loan. The interest rate cap lowers the risk of default by

slowing the growth of the loan. Limiting the maximum repayment amount and slowing the growth of the loan make the repayment of a loan more manageable, therefore triggering fewer defaults. We believe that the charge cap would be a better alternative than the interest rate cap. The implementation of an interest rate cap would lead lenders to the same interest rate on products, while a charge cap allows for more autonomy in their business models. The behavioral specialist said that an APR limit could destroy the market by forcing lenders to have the same business models (See Figure 16).

Restricting the number of times a loan can be extended is another potential solution to prevent the cycle of debt. Extensions to payday loans generate more interest on the loans and create more fees for consumers. With extension limits, borrowers cannot continuously extend the loan, which reduces accumulation of interest and rollover fees. The UK and Sweden have both enacted regulations to limit loan extensions. In the UK, there is a limit of two extensions for a

loan, while in Sweden only one extension is allowed per loan.^{29, 37} The Sweden extension limit also requires that the extension is either no cost to the consumer, or that there is a clear repayment plan for the additional interest along with the original cost.²⁹ An extension limit has the potential to increase the risk of default, as it eliminates the option of continued rollovers and forces consumers to repay the principal. Therefore, we decided that the extension limit would not an optimal solution, as it might amplify the risk of default while preventing the cycle of debt.

Cool-down periods also help prevent debt cycles by restricting the frequency of payday loan use. With a cool-down period enacted, companies are not allowed to give a second loan to customers until the cool-down period has expired. In Australia, a cool-down period of 90 days was implemented in 2012. Implementing this cool-down period prevented consumers from taking out new loans to cover previous loans.¹⁶ The cool-down period restricts consumers from payday

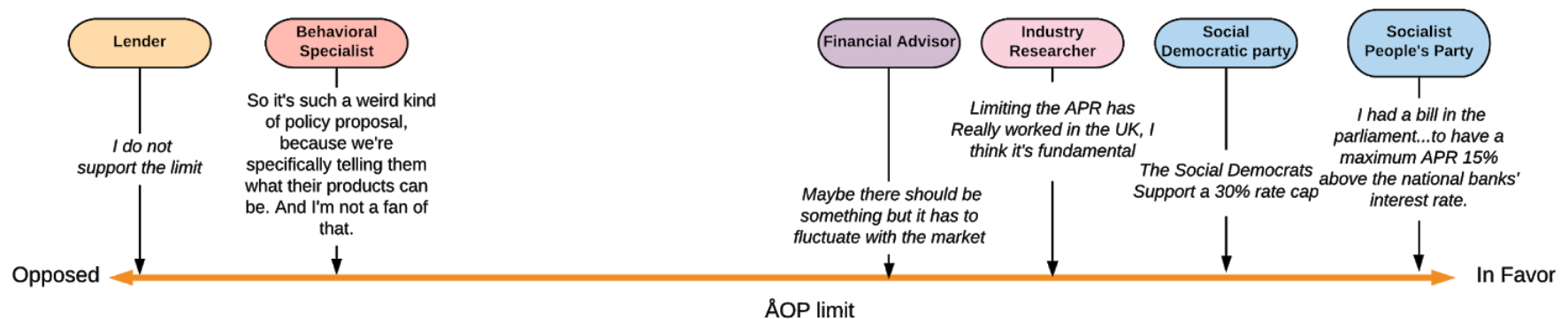


Figure 16. Stakeholder Favorability of an APR Cap

loans for a period of time, which can result in a situation where a consumer is unable to access necessary capital.³¹ Due to this disadvantage of the cool-down period, we determined that a cool-down period would be less effective than the combination of a charge cap and a database. Making loans easier to repay would reduce the need to take out additional loans, while a database would allow lenders to see any current loans a potential customer has, when going through the credit checking process.

Through a combination of sources, we have determined that financial education is not a viable option to protect consumers from payday loan indebtedness. The Financial Consumer Agency of Canada has created educational resources on consumer credit. These resources explain the effect of payday loans on a borrower's financial stability, as well as the alternatives to these high cost loans.³⁸ However, a meta-analysis of 168 papers covering 201 studies found that interventions to improve financial literacy only account for 0.1% of variance in financial behaviors.³⁹ Therefore, we can conclude that the resources required to carry out this initiative would not justify the outcomes. The behavioral specialist confirmed that educational initiatives are often ineffective. The financial advisors on the other hand strongly supported this idea, and believed that consumers would be able to make better decisions if they were more informed. They suggested a system where lenders are required to pay a fee towards financial counseling and education. Financial education is important and should be added to school curricula, but would not be effective as an intervention mechanism to fix the current payday lending problem, so more regulatory initiatives should be imposed. While regulatory initiatives would be able to actively

protect consumers, proactive education allows them to make better choices in the long run.

Gauging the effectiveness of specific regulations is difficult

Our research identified some evidence to determine the effectiveness of regulations. In both the UK and Australia, there has been a decline in the industry after regulations were implemented (See Figure 17). In Australia, the number of lenders in the industry had a six percent decline in the 12 months following the implementation of a charge cap, APR cap, cool-down period, and warning statements in 2012. This shows that the impact on the industry was noticeable, as there was a large amount of growth in prior years.¹⁶ In the UK, after the 2014 regulations, including a

charge cap, an interest rate cap, an extension limit, and warning statements, 38% of UK lenders stopped operating by the end of 2016.⁴⁰ The Financial Conduct Authority of the UK performed a market review in 2017, and found evidence of a healthier payday lending market under the regulations. Their study showed that 800,000 customers had saved 150 million pounds (1.26 billion DKK/ 23 million USD) in fees, and payday loan approval rates dropped by 50% just six months after the regulatory change.⁴⁰ Citizen Advice, the largest debt advice provider in UK, reported that the number of clients seeking payday loan advice dropped by 45% in the year following the regulation.⁴⁰ Moreover, UK's largest debt charity, Step Change, also showed a 30% reduction in both the number and proportion of clients seeking payday loan advice after the

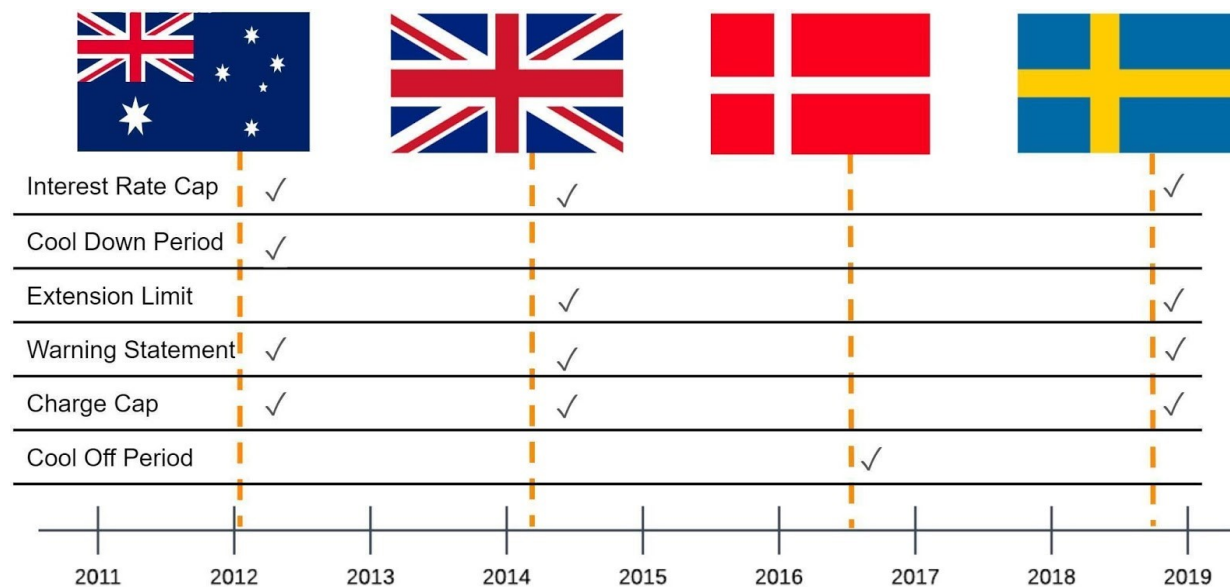


Figure 17. International Payday Lending Regulations

dropped by 45% in the year following the regulation.⁴⁰ Moreover, UK's largest debt charity, Step Change, also showed a 30% reduction in both the number and proportion of clients seeking payday loan advice after the legislation was enacted.⁴¹ Despite industry declines, a healthier market for consumers is an ideal outcome.

However, data concerning the effectiveness of specific payday lending regulations is limited throughout our research. When several regulations are implemented at once, it is difficult to determine the direct impact each regulation had on the industry and consumers. Further, unexpected effects such as the introduction of new products or changes in consumer behavior may be caused by the regulation. The rapid shift to credit products from closed end loans highlights how regulations can be circumvented with relative ease, if they are not broad enough. Therefore, the target of regulation for this industry should not be specific to the payday loan product. It should be designed to protect consumers from high cost short term credit products, including overdraft fees as well as high interest rate credit of any kind. Although legislation on a broader range of industries may deter the implementation of these regulations, it's the best for the purpose of consumer protection.

We propose a combination of regulations to protect Danish consumers

For the purpose of protecting Danish consumers from payday loan indebtedness, a multipronged approach is the optimal way to regulate the industry. Our policy proposal consists of four initiatives designed to work well

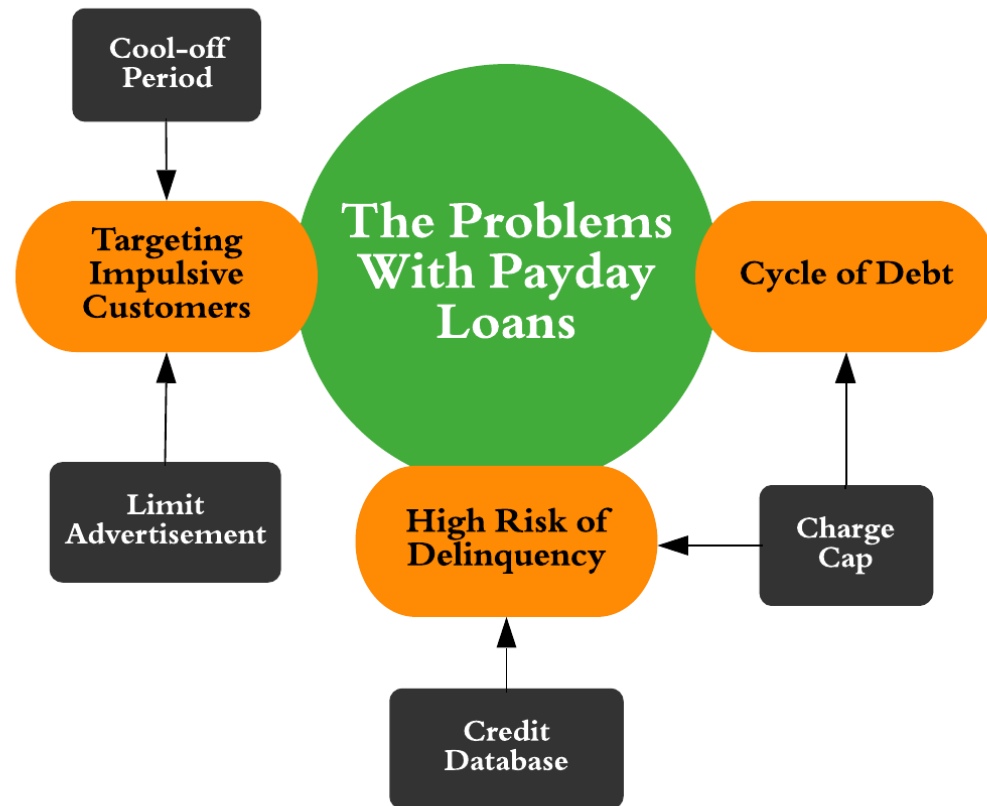


Figure 18. The proposed regulations and the problems they target

together. We propose the use of a charge cap, advertising regulation, an expansion of the cool-off period, and a database (See Figure 18). A piece of legislation with multiple initiatives would be the best choice to handle the flexibility of payday products as well as the sophistication of the market.

First, A database will lower the rate of defaults and delinquencies by increasing the level

of information sharing among lenders. The increased data sharing enhances the effectiveness of credit checks. This will be a publicly run database which the lenders can query in order to check the credit history of potential borrowers. All lenders would be required to contribute borrower information to this database.

In order to deal with the targeting of impulsive individuals through marketing,

advertising restrictions should be implemented. Payday loan advertisements should not have images associated with them because images increase their attractiveness in the eyes of impulsive consumers. Additionally, payday lenders should not be able to advertise a proposed use for the loan. Banning the content of proposed use prevents the advertisements from encouraging impulsive purchases of consumer goods with payday loans.

If the advertising limit is not effective in deterring impulsive consumers, the 48-hour cool-off period will be another preventative measure. To recapture credit products in 48 hour cool-off period, we advise broadening the definition of regulated product to reduce impulsive use of payday loans. The new cool-off period will involve all unsecured consumer loans and credit with APRs at least equal to 30% plus the national bank's interest rate. However, this initiative will be more restrictive of consumer credit. This recommendation works with the advertising limits to lower payday lenders' targeting of impulsive consumers.

The charge cap will provide backup consumer protection of the advertising limit, 48 cool-off period, and database enhanced credit check are not successful in preventing individuals from taking out payday loans when they are unable to afford the loan. Preventing further debt growth via a charge cap makes it so that the consumer is less likely to spiral into excessive indebtedness. We recommend not including the stipulation that a consumer must default on the loan for the charge cap to apply. This ensures that all consumers, especially people who default on loans and those who pay minimal amounts towards the loan, are protected from the cycle of debt. The charge cap will also help the consumers

and payday lender lower the risk of default. Once the cap is reached the consumer can be placed on a payment plan that will prevent them from defaulting on the loan. Since the loan no longer grows, this plan can fit the consumer's budget.

Finally, it is difficult to gauge how the payday lending industry is affecting consumers without data from an impartial third party. The move to regulate lenders under the Danish Financial Supervisory Authority is a good step in this direction. The Financial Supervisory Authority now requires the reporting of Key Performance Indicators. These indicators are measures of the health of banks operating in Denmark. The Key Performance Indicators will facilitate comparison of these lenders to other types of financial institutions. Additionally, under the Financial Supervisory Authority, Payday lenders will be required to obtain a banking license, which will ease future enforcement measures. Requiring lenders to report the number of borrowers and the total amount of loans as well as delinquent payments will strike a balance between high compliance costs and effective government oversight. Information about how many rollovers a customer uses per year as well as the total number of loans a customer takes out per year should be recorded. These metrics will assist in the monitoring of industry growth, consumer health, and effects of regulation.

The path forward

When considering the types of initiatives that should be taken in Denmark to protect consumers, we rooted our recommendations in managing the three problems with the payday lending market. The initiatives taken need to deal with the targeting of impulsive consumers, the

cycle of debt, and the risk of default. No one initiative can successfully protect consumers, so we suggest a combination of regulations which will regulate the supply and demand side of the issue and mitigate the three consumer threats.

We suggest the following initiatives to involve all Danish payday loan products, including all unsecured consumer loans and credit offered in Denmark, with annual percentage rates at least equal to 30% plus the Danish national bank's interest rate.

- **A consumer credit database:** we propose establishing a government-run credit database, in order to improve sharing of credit history and strengthen credit checking systems.
- **Limitations on payday loan advertisements:** we suggest banning the use of images in advertisements of Danish payday loan products to prevent the targeting of impulsive consumers with attractive intended uses.
- **A strengthened 48 hour cool-off period:** we propose broadening the scope of the current 48 hour cool-off period in Denmark to apply all forms of high cost consumer credit.
- **A 100% charge cap:** we suggest imposing a 100% charge cap on all Danish payday loan products, such that the interest rate plus fees cannot exceed the original loan amount.

Recommendation for more data disclosure regarding the issue of payday loans:

we suggest the Danish government require more data disclosure from providers of payday loan products. This increased transparency will help to measure the magnitude of payday lending problem in Denmark, as well as evaluate the effectiveness of different initiatives.

Limitations

Throughout our research on payday lending in Denmark, we consistently had difficulty accessing data relating to the payday lending market because most payday companies are privately owned and not required to disclose data. More accessible data related to the payday lending market would allow researchers to determine the magnitude of the payday lending problem in Denmark. More data would also allow a better analysis of the regulations' effectiveness on the industry and consumers.

During our study, we were generally lacking the perspective of the lenders. One interview cannot summarize the opinions and operations of an entire industry, especially when our proposal is burdensome on the lenders overall. We also used numerous studies on the payday lending market in other nations to fill in gaps in Danish research. Other countries have their own unique set of social, economic, and political dynamics. This limits the degree to which consumer problems and the effects of regulation can be translated to Denmark. Although our study examined the applicability of other regulations to Denmark, we were not specific on how Denmark could leverage existing government programs and create new ones to

ease the implementation of our regulatory recommendations.

Future Research

Data should be gathered related to both the customer profile and the lending practices. Information about the age, financial status, borrowing practices, and reasons for payday loan use of the typical borrower would allow for the creation of initiatives more tailored to the Danish consumers. Information gathered from lenders regarding the number of payday loans, rate of defaults and number of late payments would give a greater understanding of the market. Collecting data on the number of canceled loans during the cool-off period would allow researchers to determine if that initiative is useful.

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Supplemental materials for this project can be found at: <https://wpicpc.org/projects/>

Action Shots of the Project



