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The Wonga delusion [1]

Written by **Sam Bowman** [2] | Thursday 25 July 2013

The Church of England?s plan [3] to drive payday lenders like Wonga out of business by competing with them is wonderful. After years of politicians demanding ?action? on the payday loan industry [4], an organization has finally decided to tackle this perceived social evil by giving people a better alternative, not trying to legislate problems away.

Critics of payday lenders quote the loans? astronomical APRs ? Wonga?s representative APR is 5853%. But this is extremely misleading. Representative APR is designed to show interest-on-interest compounding over a year, and is an inappropriate measure to use for a loan whose term is a month or so. A Wonga loan does not and cannot compound for longer than 60 days beyond the initially agreed loan period (which can be between 1 and 46 days).

Borrowing £200 over 46 days accrues £100.03 in interest and fees, an effective interest rate of 50% over this period. After this point, interest only continues to accrue for 60 days, after which point it stops [5]. It simply does not make sense to look at representative APR for a short-term product that does not keep compounding for long enough for anything like that APR to ever apply.

No Wonga borrower can end up with a 5853% interest rate ? the existence of this number is just an quirk of our financial regulations which require all lenders to express their rates in annualized terms. Journalists and politicians who report [6] this 5853% APR figure as the ?standard? Wonga rate are mistaken and are misleading the public.

The real problem is that people are poor enough to have to rely on these sorts of lenders. Wonga *et al* only exist because their customers have no better alternative. Before the emergence of the formal payday loan sector, people had to rely on tattooed guys with a Rottweiler who?d happily break your legs to recover their investment. Nobody wants to borrow from a firm like Wonga, but they're a damn sight better than the existing alternatives.

The Archbishop of Canterbury appears to recognise this. Giving people more choices by offering a cheaper alternative is the sensible way to help payday borrowers.

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