

Annexe E: Competition and profitability

Detailed analysis

June 2010

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1 COMPETITION ANALYSIS – INTRODUCTION

Introduction

- 1.1 This annexe sets out our assessment of suppliers and their business models, the profitability of their products, and the extent of competition in the high-cost credit sector. This is structured as follows:
- In the remainder of this chapter we set out our approach and methodology.
 - Chapter 2 presents the main characteristics of the high cost credit sector.
 - Chapters 3 to Chapter 7 discuss each product in detail: we look in turn at payday lending, pawn broking, home credit, credit unions and retail credit. For each product, we define the relevant market, estimate its size, analyse the competitive dynamics and assess the profitability of lenders.
 - Chapters 8 to 11 provide further detailed analysis, including an assessment of price and non-price competition, profitability of suppliers and barriers to entry.
 - Chapter 12 provides a conclusion of the assessment of the above product markets.
- 1.2 It should be noted that around 101,000 firms are licensed under the Consumer Credit Act 1974 and our research was focused on a small number of suppliers of different credit products, primarily to minimise the administrative burden on firms at a time when several regulatory changes are being implemented, in line with the principles of better regulation. While the information provided was variable in quality, we believe that it has provided a useful insight into the competitive dynamics of the different product markets and provides a good evidential basis for the differences between credit products.

- 1.3 Any assessment of competition requires an assessment of the appropriate frame of reference (sometimes called market definition) examining the product against other products and the geographic markets in which they are supplied. This is to see the extent to which firms supplying the product are competitively constrained from raising their prices by the presence of other firms in the market. The competitive assessment considers the extent to which firms active in supplying these different products compete against each other and on what terms, while the profitability assessment considers the level of profits being earned.

Competition

- 1.4 Competition is viewed by the OFT as a process of rivalry between suppliers seeking to win customers' business over time by offering them a better deal. Rivalry may take various forms. Firms may seek to undercut each other on price, produce more output, outperform each other by reducing costs, improving quality, enhancing productivity or increasing innovation to create new or improved products or markets. For customers, rivalry can therefore have many beneficial effects, since it may result in reduced prices, increased output or improvements in the quality and variety of products on offer.

Market definition

- 1.5 Assessing the degree of competition in a market requires an assessment of the parameters of that market. The OFT has published guidance about the process of defining markets¹ but the process itself is intended to provide a helpful framework for assessing the relevance of different competitive constraints. Market definition is a useful tool but is not an end in itself and allows an assessment of the degree of competition in a market and the competitive state of that market.

¹ For example, OFT403 Market Definition, December 2004.

- 1.6 There are normally two dimensions to the definition of the relevant market: a product dimension and a geographic dimension. The products that should be included in the relevant market, and the geographic boundaries of that market, are generally determined by reference to the extent of demand and supply side substitutability. This includes the extent to which consumers could find an alternative product (demand side substitutability) and the likely reaction of firms not currently supplying the product (supply side substitutability).
- 1.7 The generally accepted conceptual approach to market definition is the hypothetical monopolist test.² This is used in competition analysis to determine whether, if there was only one supplier of the product in question, that supplier would be able unilaterally to raise prices.

Methodology

- 1.8 The OFT requested detailed information from a sample of suppliers of each product in August 2009. Additional information and clarification was requested from some of the respondents in September 2009 and again in December 2009. In February 2010, the OFT engaged in discussions with some respondents to clarify and discuss issues that required further elaboration.
- 1.9 The information was requested under section 36B of the Consumer Credit Act 1974 (as inserted by section 46 of the Consumer Credit Act 2006), and under section 5 of the Enterprise Act 2002 (which sets out the OFT's general function of obtaining, compiling and keeping under review information). Under Part 9 of the Enterprise Act 2002, the OFT is required to have regard to various considerations before disclosing any 'specified information' (see section 244). Specifically, the OFT needs to exclude from disclosure (so far as is practicable) commercial information

² The hypothetical monopolist test is used to identify constraints on the ability of the hypothetical monopolist that arise because of demand-side substitution. As a result, when applying the test, it will generally be assumed that prices of products outside of the candidate market and the supply decisions of those firms outside the candidate market are held constant.

whose disclosure we think might significantly harm the legitimate business interests of the undertaking to which it relates. We also consider how far disclosure is necessary to achieve our statutory functions/purposes.

- 1.10 The OFT is of the view that it cannot disclose much of the commercially sensitive information which we have received over the course of this review. In consequence, material may appear in an anonymous, aggregated or otherwise redacted form in this report, such that the legitimate business interests of undertakings are not harmed.

2 COMPETITION ANALYSIS – HIGH-COST CREDIT

- 2.1 Gross advances of consumer credit in 2008 accounted for some £200 billion,³ with most borrowers having access to mainstream credit, which is credit used by a wide range of consumers and typically supplied by suppliers involved in other mainstream financial markets, such as banking or insurance.
- 2.2 A relatively small proportion of borrowers use specialist high-cost products: the survey undertaken for the OFT interviewed 7,557 people before it found 300 respondents that had experience of high-cost credit products, equivalent to four per cent of respondents.⁴ This percentage is similar to those reporting themselves to be unbanked,⁵ those who reported that they were turned down for credit cards or other loans applied for,⁶ and those who believed that they had impaired credit status.⁷ It is also similar to the number of respondents to our behavioural experiment who reported that they had experience of payday lending, pawnbroking and home credit, hire purchase and log book loans in the last 12 months.⁸

³ Datamonitor 2009 with additional OFT estimates in relation to high-cost credit.

⁴ See Annexe A from the Interim Research Report on high-cost credit, page 30.

⁵ See Annexe A from the Interim Research Report on high-cost credit 9, page 8.

⁶ See Annexe A from the Interim Research Report on high-cost credit, page 13.

⁷ See Annexe A from the Interim Research Report on high-cost credit, page 14.

⁸ See Annexe A.

2.3 Our research and internal analysis suggests that the value of loans made in 2008⁹ by specialist high-cost credit suppliers is around £7.5 billion. This estimate can be disaggregated by type of loan product:

- around £900 million of payday loans
- around £600 million of pawnbroking loans
- around £1.26 billion of home collected credit
- around £340 million of loans from credit unions, and
- around £4.25 billion of sub-prime retail credit.

What is high-cost credit?

2.4 High cost credit products are typically small loans borrowed over short periods – while the cost expressed as a total charge (in pounds) may seem reasonable, the annual percentage rate (APR) is often high because of the short time over which the loan is taken and the high charge relative to the loan value.

2.5 In 2005, Collard and Kempson noted that:

'Lending to people on low incomes differs from mainstream (or prime) lending in a number of key respects. First, there is a higher risk of default as their circumstances are more likely to change. Second, people on low incomes want (and often need) to make weekly repayments in cash. Both these factors increase the costs of lending. Third, the amounts they want to borrow tend to be relatively small and for short periods of time. As the costs of lending are largely fixed, this means that the charges for borrowing are high in relation to the amounts borrowed. This explains why

⁹ Responses to our questionnaire include full-year data until 2008 and first semester data for 2009. Due to substantial seasonality in demand for high cost credit (being highest in December due to Christmas shopping) we do not attempt here to estimate the size of the market for 2009.

charges among commercial sub-prime lenders are high, why not-for-profit lenders with lower charges require subsidies, and why mainstream lenders are reluctant to enter this particular market.¹⁰

- 2.6 Some credit products (payday loans, pawnbroking, home credit) are high-cost because they incur significant charges relative to the amount borrowed. However, other credit products (credit cards, store cards and retail credit) may often be high-cost where the borrower makes extended use of the credit facilities offered.

Definition of the relevant market

- 2.7 In this section we set out the main elements of our market definition of high cost credit. More detail is provided in the product-specific chapters which follow. It should be noted that our definitions of relevant markets for the review are based on research conducted within the review and are indicative rather than definitive definitions based on in depth analysis. These will not fetter the OFT's discretion in defining markets in the future.

Mainstream and specialist high-cost credit markets

- 2.8 Due to the small relative size of the high-cost credit sector, the competitive constraint which it can exercise on the mainstream market is likely to be insignificant.
- 2.9 The extent to which mainstream lenders constrain high-cost credit lenders is unclear, not least because some users of high-cost credit will have been rejected by mainstream lenders as unsuitable. Research by Policis with funding from the Friends Provident Foundation highlighted that around 50 per cent of home credit users do not use mainstream credit, and half of these only used home credit because they had no

¹⁰ Sharon Collard and Elaine Kempson, Affordable credit – the way forward, Joseph Rowntree Foundation, February 2005.

other credit options.¹¹ In addition this research investigated the credit repertoires for mainstream and non standard credit users using different types of credit over the last five years. It found that the two groups of credit users had quite different repertoires,¹² although the long time frame (five years) makes it difficult to assess whether these users actually considered the products as feasible substitutes or used them at different times.

- 2.10 Mainstream lenders do not offer high-cost credit but many of them provide wholesale funding for companies in this sector. Further information can be found in the interim research report of this review.
- 2.11 Many borrowers of high-cost credit are unable to borrow from mainstream lenders because they are on low incomes or because they have poor credit ratings. Research by Policis with funding from the Friends Provident Foundation found that credit refusals were rising, with a significant minority of non-standard lending and higher risk borrowers experiencing refusals in the previous year.¹³ It also found that for home credit borrowers the incidence of loan refusals doubled in the last year compared to the previous year. Consumers' choice of loan may depend on their circumstances and employment status: payday loans are only available to employed people whereas pawnbroking and home credit are not so restricted. Consumers' choice of loan may depend on the

¹¹ The new demand landscape for credit provision to those on low incomes and the implications for the provision of affordable credit, Policis and the Friends Provident Foundation, 2010.

¹² On the one hand, overdraft, credit card (used to buy goods and services) and personal loans from banks are the three most widely used products by mainstream credit users (respectively by slightly less than 50 per cent, 40 per cent and 30 per cent of the sample). On the other hand, non-standard credit users are more likely to use catalogue credit (more than 50 per cent of the sample) and informal borrowing from friends and family (more than 35 per cent) than overdrafts (less than 30 per cent). The Social Fund, home credit (both more than 25 per cent) and home credit vouchers (almost 20 per cent) are more used than credit cards to buy goods or services or personal loans from bank (slightly more than 15 per cent).

¹³ The new demand landscape for credit provision to those on low incomes and the implications for the provision of affordable credit, Policis and the Friends Provident Foundation, 2010.

timescale over which they choose to borrow, which may in turn affect the affordability (weekly payments) of the loan and the overall cost of that loan.

Economic markets within the high cost credit sector

- 2.12 We have found that the high-cost credit products that are the focus of this review represent distinct product markets.
- 2.13 There appears to be little substitutability on the demand side between payday lending, pawnbroking and home credit, because of:
- Different lending requirements by lenders, which result in different demographics for borrowers of different products. For example, you need to be in employment to get a payday loan. In addition, you need to have a valuable item to deal with a pawnbroker.
 - Different inherent characteristics of the products, such as the length of the loan period, which limit the choice of products for different groups of consumers, because of affordability constraints. For example, people with very low incomes may perceive that they are not able to afford a single-payment short term product such as a payday loan.
- 2.14 On the supply side, substitutability opportunities appear to be limited, since different products require different business models (for example, a network of local agents for home collected loans, compared to more traditional high-street business premises) and skills (for example, a pawnbroker must possess skills related to evaluating the value of items pawned, which are not required for other high cost credit products).
- 2.15 As a result, most suppliers specialise in offering one of these specialist high cost products. The most notable exception is the joint provision of payday lending and pawnbroking, which are frequently offered by the same suppliers who take advantage of economies of scope by better utilising their high-street premises to attract a broader range of customers.

2.16 We also investigated whether online provision of a specialist high cost credit product constitutes a separate market from the in-store lending on the high street of the same product. We consider this issue in detail within the relevant product-specific chapters that follow, as the nature of some products (in particular, home credit and pawn broking) means that online lending is a marginal part of the product market.

2.17 For the above reasons, we consider that each of the specialist high-cost products within the scope of the review constitutes a separate economic market.

2.18 The following chapters examine the products on which we have focused our analysis, including the assessment of the market, the nature of competition and levels of profits. The products that are examined are the following:

- payday lending
- pawnbroking
- home credit
- credit unions and
- retail credit.

3 COMPETITION ANALYSIS – PAYDAY LENDING

- 3.1 The shortest loans available from specialist lenders are often referred to as short-term small sum or payday loans, since the loan period often ends on the borrower's payday.¹⁴ The payday loan product was developed by cheque cashers and many lenders still offer this service, as well as other financial services such as international money transfers.
- 3.2 The short length of the loans means that payday loans have high APRs, but as noted elsewhere there are problems in using APRs as a measure of cost for short-term loans. From our sample of payday lenders, we found that the total charge for credit (TCC) in June 2009 was as little as £12.00 per £100 borrowed on the high-street and as high as £34.14 per £100 borrowed online, suggesting that consumers could shop around to get the best price.

Market definition

Product market – demand side

- 3.3 Consumers borrow money to smooth their consumption over a period of time. If consumers' consumption expenditure followed income closely, they would be unduly constrained at times when income was relatively low and have more income than needed for consumption at times when their income rose. For payday borrowers, the period of time over which their expenditure exceeds their income is very short, suggesting that payday borrowing serves largely to alleviate immediate and short-lived cash-flow problems.

¹⁴ However, some suppliers of short-term (generally less than one month) small sum loans offer products which charge daily interest according to the actual loan period and irrespective of when payday occurs. Unless otherwise specified, in the following we use the terms 'payday loans' and 'payday lenders' to include also suppliers of such short-term small sum loans.

Customer demographics

- 3.4 A wide range of borrowers use payday loans, although if one was to generalise the typical customer is more likely to be a young male, earning more than £1,000 monthly, and in rented accommodation. Many are unmarried with no children. Borrowers may choose to use payday loans because their main financial supplier will not know of their borrowing, for the ease of the transaction or because there is more certainty in the charges levied for payday loans than those levied by banks for (particularly unarranged) overdrafts. Returning customers are often given better loan rates than new customers, reflecting the reduced risk they pose to the lender.
- 3.5 On the demand-side, the other credit options available to payday borrowers include mainstream products such as overdrafts and credit cards or specialist products such as pawnbroking and home credit. The distinguishing feature of payday lending is that it is **short-term** – the majority of pawnbroking and home credit loans are generally offered for considerably longer periods – and that it is available to people in employment with personal current accounts.
- 3.6 Payday loans are not available to prospective borrowers who are unemployed or who do not have a personal bank account. By contrast, pawnbroking and home credit suppliers are happy to lend to unemployed people who are unbanked or who have basic bank accounts. While customers of payday loans could switch to borrowing by means of pawnbroking or home credit, the converse is not always true.
- 3.7 High-street customers are likely to be loyal customers, returning to the same lender for repeat loans. One reason for this is the high level of customer satisfaction with payday loans.¹⁵ This is in part also because of

¹⁵ For example, Harvey and Thompson commissioned a survey in December 2006 which showed that over 88 per cent of customers rated their satisfaction 8 or more out of 10. See www.harveyandthompson.com/HandT_media_our_customers.htm
More recently, a survey carried out on behalf of Pay Day UK (a brand of MEM Consumer Finance Limited) found that nine out of ten MEM customers rated the service as a convenient way to

the initial effort required to complete the loan application process and because such borrowers may be worried that they will be rejected by other lenders and are happy to stay with their original lender. Repeat customers may also be offered more favourable terms in an attempt to build customer loyalty.

- 3.8 This customer loyalty suggests that there is little switching by customers between lenders. Payday lenders themselves were unable to comment on the degree of switching, since none of them had measured it.

Lending criteria and purpose of loans

- 3.9 Payday lenders generally require that borrowers show proof of their identity, their address in the UK, their employment status and information about their income and bank account. Online lenders (and increasingly often also high-street ones) use the services of credit reference and fraud prevention agencies. Payday lenders will generally limit the value of the first loan made to less than £300, to limit exposure to customers with unknown repayment history. Borrowers are generally employed and have personal bank accounts and may well have access to overdraft facilities and credit cards from mainstream lenders.
- 3.10 Research by Policis with funding from the Friends Provident Foundation¹⁶ showed that the most common reasons to use payday loans by borrowers on low incomes is related to cash constraints (30 per cent of respondents), the need to cope with an emergency or pay an urgent bill (around 30 per cent), or keep up with mortgage rent or utility payments (around 15 per cent).

obtain cash quickly to cover unexpected bills or expenses understand. See also:
www.paydayuk.co.uk/pages/what-our-customers-say.php

¹⁶ The new demand landscape for credit provision to those on low incomes and the implications for the provision of affordable credit, Policis and the Friends Provident Foundation, 2010.

Payday loans versus unarranged overdrafts

- 3.11 Payday loans have gained a poor reputation in some media coverage because of their high APRs. Lenders themselves are often keen to explain their product and the benefits of the product to sceptics who believe that the lenders must be making excessive profits because of such high APRs. Customers of payday loans often take them out in preference to unarranged overdrafts which may be more expensive (but where the APR is not publicised). Indeed, many lenders compare their payday loans with unarranged overdraft charges.¹⁷
- 3.12 Several factors affect the relative convenience of payday loans and unarranged overdraft facilities. In particular, the diverse and complex structure of banks' charges, compared to the linear charge levied by payday lenders, means that unarranged overdrafts may be more or less expensive than a payday loan according to the number of transactions requested in a billing period and the amount of money borrowed.
- 3.13 Also, there is an inherent uncertainty as to what amount of unauthorised overdraft (if any) is available to the borrower. An ATM will not dispense cash where the account lacks sufficient funds (or authorised overdraft), and purchase transactions by debit card involve an element of discretion on the part of the issuing bank.
- 3.14 Where a customer makes a purchase using a debit card¹⁸, and the transaction is authorised despite insufficient funds, an unarranged overdraft will ensue when the item is debited from the account (usually a number of days later)¹⁹. However, until the moment of the purchase,

¹⁷ For example see lenders such as www.cashtilpayday.co.uk and www.harveyandthompson.com/pawnbroker_shops_payday_advances.htm

¹⁸ Or by cheque, with a guarantee card which is swiped by the retailer to gain the issuing bank's electronic authorisation.

¹⁹ Since payment to the retailer is guaranteed and cannot be refused by the card-issuing bank once the transaction has been authorised and entered into the system for clearing and settlement.

there is no certainty that a payment will be authorised: the card may simply be declined. As such, payday loans are a more dependable means of gaining purchasing power: the borrower essentially receives 'cash in hand' following a single loan request. With repeated debit card purchases, each attempted transaction is in effect a separate request and carries the same uncertainty for the would-be borrower.²⁰

3.15 In the following paragraphs we compare the cost of borrowing via unarranged overdraft from three banks (characterised by different charging structures)²¹ with a payday loan costing £25 per £100 lent. We do not include arranged overdrafts in the comparison, as we consider that the costs of such products are much lower and therefore they are less directly comparable.

3.16 For some payday borrowers whose alternative is to go overdrawn without authority and who need to make multiple withdrawals on different days of the month, the payday loan will be much cheaper because they will be able to avoid the unarranged overdraft charges levied by the banks.²² This is illustrated in figure 3.2.²³

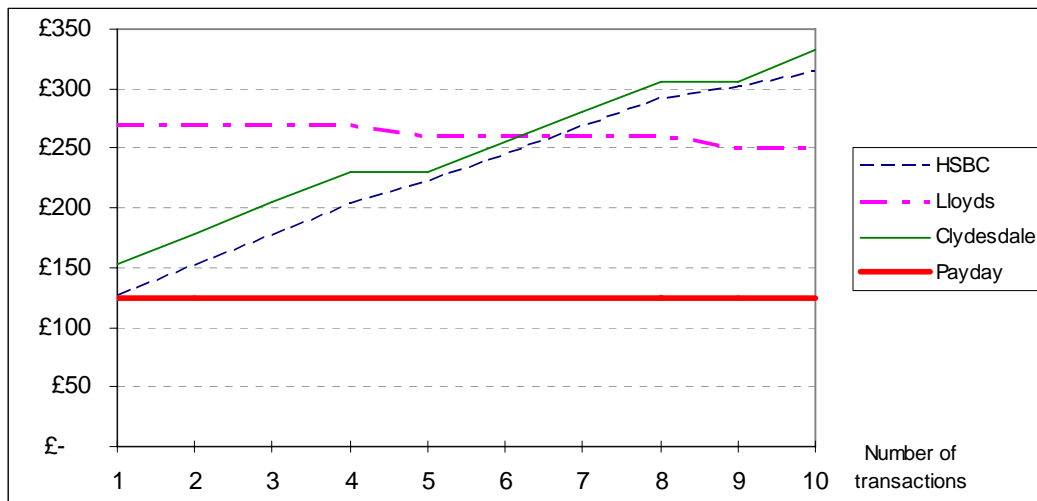
²⁰ Indeed it becomes increasingly likely that authorisation will be declined, except where a retailer does not have on-line electronic authorisation or where authorisation is given automatically by virtue of the operation of certain floor limits (that is, transaction values below which real-time authorisation is not required).

²¹ At the time the analysis was carried out (November 2009) HSBC levied a transaction charge only, Clydesdale levied a transaction charge and a monthly charge, Lloyds levied a daily charge (capped at ten charges per billing period). For the purposes of this exercise, we assume the loan is taken and repaid within a single billing period, and (where applicable) the customer requests one transaction per day.

²² The broad categories are paid item charges (payable when a payment instruction takes the account into unarranged overdraft), overdraft excess charges (payable when an account is in unarranged overdraft) and unpaid item charges (payable when a payment instruction is declined/returned by the bank).

²³ Lloyds's curve is slightly decreasing because as the number of transactions increase, the daily charge falls into a lower tier for one or more days. For example, under our assumptions a

Figure 3.1 Comparison of total amount to be repaid to borrow £100, according to the number of transactions requested



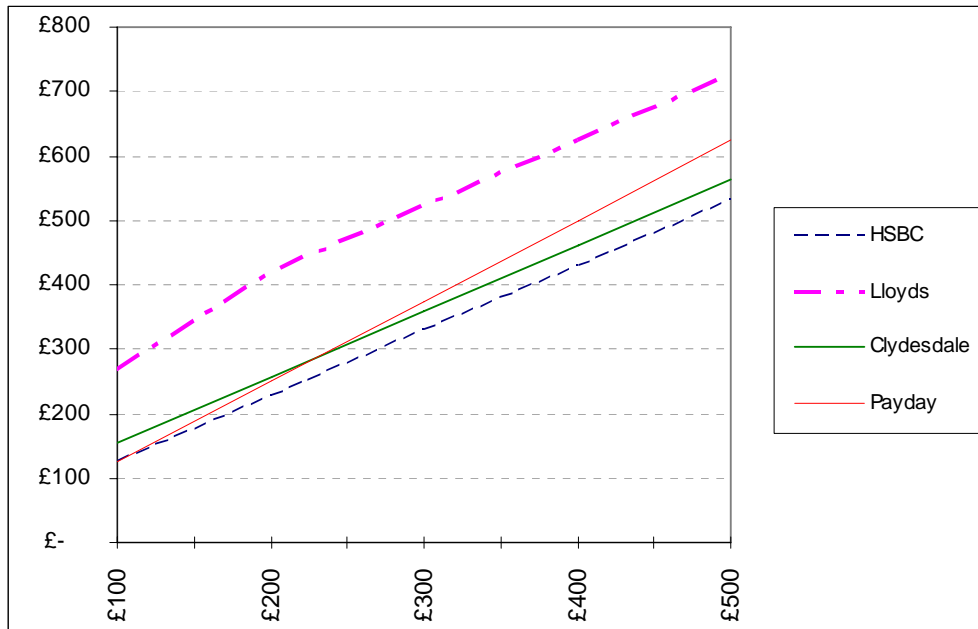
Source: OFT analysis, based on banks' charges from October 2009.

3.17 For others who do not need to make multiple withdrawals, the unarranged overdraft may be cheaper. Figure 3.2 shows that as the amount borrowed in a single transaction increases, the banks' overdraft facilities tend to become cheaper per £100 borrowed than a payday loan. This is because lower monthly interest rates are usually charged on the amount lent, which compensates for the fixed charges. However, what is certain is that the costs of the payday loan are much more transparent than the costs incurred by the unarranged overdraft and for many customers this certainty about charges is valuable and may be sufficient to persuade them to borrow from the payday lender.

3.18 Payday lending also has a far greater certainty for the consumer given the opacity of the banks' discretion in authorising or declining card transactions.

customer who requested up to four transactions to borrow £100 will be charged ten daily £15 charges. However, if a customer used five to eight transactions, the unarranged overdraft balance on the day the first request was made is less than £25 and as such triggers a lower daily charge (£6). Hence the customer attracts one £6 daily fee and nine £15 daily fees.

Figure 3.2 Comparison of total amount to be repaid, according to the amount borrowed



Source: OFT analysis, based on banks' charges from October 2009.

3.19 There is no legal requirement for mainstream banks to publicise their APRs on all their overdrafts so that there is less clarity for borrowers on the cost of an unarranged overdraft. Payday lenders frequently compare their product against unarranged overdrafts, claiming that the payday loan is cheaper. While this is not always the case, the borrower may be clearer on the charges payable than if they opt for an overdraft (particularly an unarranged overdraft). Customer satisfaction with payday loans is reported to be high, whereas it is well publicised that there is more widespread concern with unarranged overdraft charges.

Product market – supply side

3.20 In 2003, there were an estimated 1,500 high-street stores offering payday loans in the UK, out of an estimated 2,000 cheque-cashing

outlets.²⁴ The exact number of payday stores today is still unclear, with some respondents to our consultation considering that there were as many as 2,000 high-street stores in 2009.

- 3.21 Some lenders, such as The Money Shop, are predominantly payday lenders operating on a national basis with several hundred stores. Some lenders, such as Albermarle & Bond and Harvey & Thompson, are predominantly pawn-brokers but offer payday loans as well. Some other businesses, such as travel agents or insurance brokers, may even offer payday loans in addition to their primary business, therefore the exact number of outlets offering short-term small sum loans is difficult to estimate.
- 3.22 High-street payday lending requires a credit licence, premises, back office systems, and access to credit (to fund the loans). This last requirement may have inhibited the ability of small independent lenders to expand in the past few years. Some lenders may use the back office systems of larger lenders in a franchise (or licensing) arrangement that allows them to offer payday loans without incurring the significant costs of developing their own systems.
- 3.23 High-street payday lenders offer other products such as international money transfers, foreign currency exchange, pre-paid (or stored value) payment cards,²⁵ pawnbroking, and gold-buying, not all of which activities require a credit licence. Indeed one respondent advised us that relying only on payday lending was a risky strategy that might lead the outlet to be unprofitable.
- 3.24 A number of payday lenders may be better known as pawn-brokers, reflecting the economies of scope available from offering both products.

²⁴ Nicola Dominy and Elaine Kempson, Pay Day Advances: The companies and their customers, Personal Finance Research Centre, 2003, p. 4.

²⁵ For example, see the Moneyshop's Titanium Card: www.moneyshop.tv/titanium-cashplus-mastercard/holiday-cash-card/

Expanding from the payday lending market into the pawnbroking market requires an understanding of the relevant processes and systems, and an ability to value the items pledged.

- 3.25 Online payday lenders serve a different type of customer compared to borrowers through high-street stores, according to respondents in our sample of lenders. In the first place, online borrowers are more likely to make multiple online applications because the number of declined applications is high. Secondly they are more likely to prefer the anonymity and convenience offered by online lenders. Third, lenders are less able to assess risk (and must take steps to avoid fraud) since they are less able to assess a customer's creditworthiness. Finally, the prices charged by online lenders are generally much higher than those offered on the high-street.

Geographic markets

- 3.26 Payday lenders operate on the high street and on the internet. They need to be UK based²⁶ (as do payday borrowers) and the licensing regime is UK wide. However, at least one US online lender complies with this requirement by having an office in the UK while its back office functions and call centres are based in the United States.
- 3.27 Most payday lenders operate on the high-street and report that their customers are generally local. Customers visiting a high-street store can write a post-dated cheque and present the lender with their cheque guarantee card. One payday lender explained to us that the cheque guarantee card was a good indicator of customer risk, since banks are quick to withdraw cards from high-risk or indebted customers.

²⁶ Lenders based in the European Union do not need to be based in the UK, although they are subject to the UK's licensing regime.

Increasingly high-street payday lenders are accepting payments by debit card, which is the norm for online lenders.²⁷

Conclusion on market definition

- 3.28 The appropriate frame of reference appears to be the supply of small sum short-term loans from payday lenders in the UK, although it should be noted that competitive rivalry is likely to be greatest at a local level for high-street lending. It is likely that the differences between high-street and online payday lending would put them in different product and geographic markets, although further analysis would need to be undertaken to see the extent to which the high-street constrains the online market.²⁸ However, for the purposes of this review, the market is defined as the payday lending market in the UK.

Size and value of the payday market

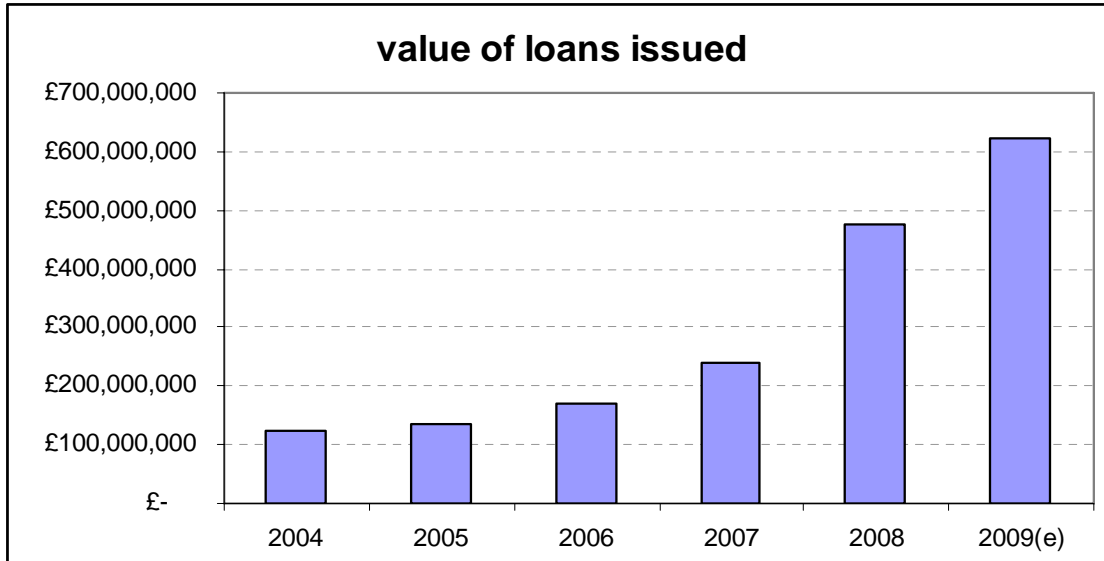
- 3.29 The number of stores in the UK and the increase in the value of loans made year on year suggests that this is a dynamic and competitive market, as the following figure illustrates. The rapid growth in the market size is due both to growth of existing lenders as well as entry by new competitors.
- 3.30 There is no publicly available data on the size of the market but we believe that for 2008, the value of loans made was between £700 and £900 million, and that the market continued to grow in 2009. We also believe that the loans made have increased by a huge amount. The chart

²⁷ Some online payday lenders also accept repayments via Direct Debit, so as to expand the base of potential customers to include people without a debit card.

²⁸ Our sample is too small to track price variations in the high-street and online markets and draw meaningful conclusions, but it seems unlikely that the online market constrains the high-street.

below shows the rapid increase in the value of loans issued by our sample of lenders.²⁹

Figure 3.3: value of loans issued by a sample of payday lenders



Source: OFT's analysis of submissions to the review of high-cost credit

3.31 High-street payday lenders compete in a number of ways, including on price, branding, and store presentation. For example, there is some price dispersion in high street lending, with prices for a £100 loan varying from around £12 to almost £20. Online charges are generally higher than those charged on the high-street. Online lenders consider that these higher charges reflect the additional level of service provided as well as higher costs borne for credit referencing and fraud prevention.

Competition between payday lenders

3.32 An estimated £700-£900 million was borrowed in 2008 by way of payday loans. With the typical loan being for £300, this equates to around 2.3 to 3 million loans. It was not possible to estimate with

²⁹ The 2009 datum is estimated by doubling the actual data we received for the first semester..

certainty the proportion that is derived from high-street and online lending but there are indications of significant growth in online payday lending in the UK.

- 3.33 We believe that our sample of payday lenders accounts for one half to two thirds of the market by value. The four largest lenders issued around £400 million loans in 2008, or around 80 per cent of our sample. The concentration ratio for the four largest firms would be around 44 to 57 per cent.³⁰ This means that the largest four firms together could be supplying up to 57 per cent of the market.
- 3.34 Customer service is seen as a key competitive element, with one lender advertising in foreign languages (Polish, Ukrainian and French) as well as employing native language speakers in stores where its potential customer base is new migrants (who may be excluded from mainstream lending because of their lack of credit history). All respondents to our questionnaire commented that they invested heavily in staff training to ensure high standards of customer service.
- 3.35 The number of online lenders is less clear, and is made more complex by the presence of lead generators and brand proliferation. Lead generators often set up their own websites designed to look like the sites of online lenders, but they then provide leads to licensed payday lenders.³¹ Online lenders, such as MEM Consumer Finance, operate under a number of brand names (such as Payday UK, Payday Now, The Payday Store,

³⁰ These concentration ratios are based on our best estimates for the total value of the market (£700 million to £900 million in 2008). Concentration ratios are often used to indicate the competitive state of the market and this would suggest that the market is competitive (by contrast a four firm concentration ratio of 4:95 would indicate a highly concentrated market).

³¹ Whilst such a business should hold a licence under the Consumer Credit Act 1974, it need not hold a licence of the same category as that required of the actual payday lender. A Category A (Consumer Credit) licence allows a business to lend money or provide other types of credit, including hire purchase, from its own funds. A Category C (Credit Brokerage) licence allows a business to introduce people to third party sources of consumer credit or consumer hire, or to other credit brokers, but not to provide credit itself.

Payday Loans UK, My Payday Loan, Month End Money), while many high-street lenders themselves use online websites as a means of marketing their high-street product.

- 3.36 Specialist online payday lenders are able to offer loans that provide immediate access to funds and sophisticated pricing so that lower risk borrowers are offered cheaper loans than their higher risk counterparts. Variations to terms are also offered so that there may be more than one payment period, or the borrower can determine the length of the loan and the amount borrowed. On the whole, the typical³² rates offered by online lenders are not as low as those offered on the high-street.

Box 3.1 Innovations in high-cost credit (1)

Text loans

What is a text loan?

Text Loans are a hi-tech version of the payday loan. There are suppliers of these loans both online and on high-streets throughout the UK. The service offers registered customers the ability to obtain a loan by simply sending a text message from a mobile phone. These loans are normally credited to the customer's account shortly afterwards, making them a fast and convenient way to access credit. Similarly to existing payday loans, many people use the money for unforeseen or emergency expenses. Text loans appear to be for shorter periods of time than normal payday loans.

What is the application process?

Potential borrowers need to register through the loan suppliers' website. The application process involves a number of questions similar to those for normal online payday loans. Where the borrower can confirm details such as being resident in the UK, having a UK debit card on a UK bank account, and not being bankrupt or having outstanding debt problems they may be accepted by the lender. Lenders often charge a small registration fee and having paid this and qualified for the service, the consumer has a fixed period of time to request by text message their initial loan. Security can be provided by a PIN code with details of how to request a loan being provided to the consumer by email.

How much does it cost?

There is typically a small cost of registration, in one case £1. The borrower is charged an additional fee of around £10 for each £100 loan they use.

³² Typical rates are those offered to at least 66 per cent of borrowers.

How responsible are lenders?

The loan supplier may use data that identifies the borrower to identify and prevent fraud, money laundering and other criminal activities, to assess lending risks and carry out other checks as necessary.

Profitability of payday lenders

- 3.38 Return on capital employed (ROCE) is a traditional accountancy measure of profitability, and is found by dividing profit (from interest income and fees less costs) by the amount of capital required to run a business.
- 3.39 A value for ROCE significantly greater than a firm's weighted average cost of capital (WACC)³³ would raise concerns that the firm was earning excessive profits. Chapter 10 provides further detail on our assessment of the profitability of high cost credit providers.
- 3.40 During the period 2004-06, firms involved in payday lending were generally profitable, and most of the profits made were in excess of WACC. In 2007-08, firms already operating in the market generally continued to make returns in excess of WACC, despite large increases in their costs of bad debt as loan defaults grew. In contrast, a number of firms in our sample entered the market during 2007-08, and each of these firms made losses during this period.

Barriers to entry

- 3.41 There is evidence of entry, particularly from US firms that have entered directly or through acquisition. There is increasing brand proliferation in the online market, partly because of increased activity by lead generators.

³³ The weighted average cost of capital is a measure of the return that the market would expect from a firm in certain conditions. As a conservative approach, we have used the top end of the range of WACC estimates provided by firms in our sample. Chapter 10 provides further detail on our approach.

- 3.42 Respondents were generally positive about prospects for expansion although some noted that the value of the market may have peaked and that firms might need to innovate by offering alternative products to existing customers.

Box 3.2 Market innovations (2)

iPhone application

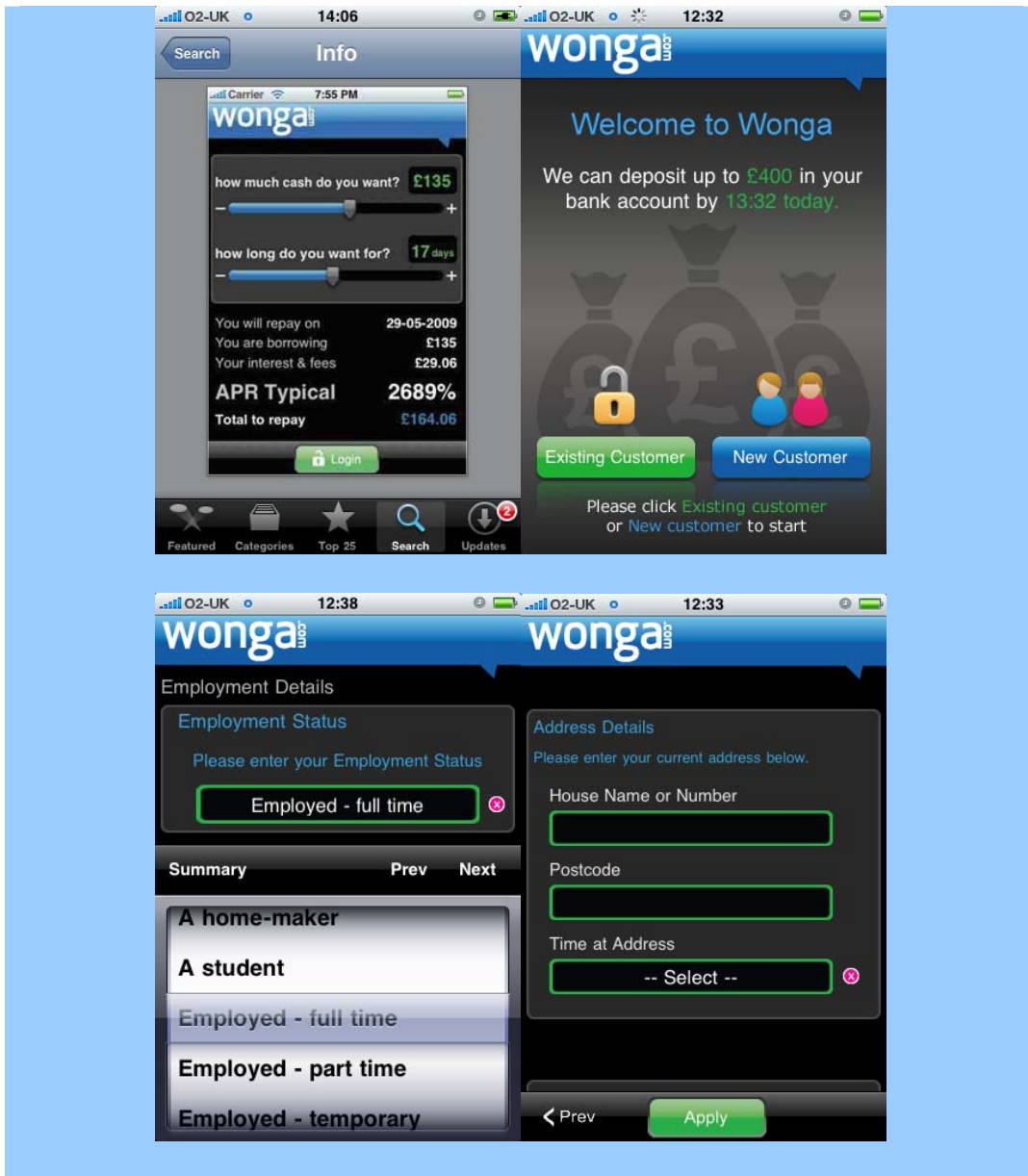
We are aware that one short-term small sum lender, Wonga.com has launched an application for the Apple iPhone that allows consumers to apply for a loan using the iPhone. As consumers increasingly go online and to their mobiles to solve everyday problems, companies like Wonga.com are responding that demand and providing innovative, yet regulated and compliant solutions.

Unlike text loans, the application created by Wonga.com allows consumers to complete an application process on an Apple iPhone directly with no need to register their details on a website. The iPhone's user interface enables presentation of regulated information generally equivalent to that enjoyed online.

Wonga.com is able to process applications using its iPhone application in the same way as those provided on its website, allowing it to undertake the same checks and analysis of the potential customers that apply for loans. These checks involve taking the 30 odd pieces of information supplied by the applicant and adding more than 3,000 data points from public sources, including credit reference agencies and other relevant sources. Wonga then uses a series of algorithms to make objective and selective lending decisions, typically rejecting around 80 per cent of first-time applicants regardless of the device used to access the service. This back-end technology and intensive use of data allows the company to offer an extremely simple consumer-facing service while still being selective.

Screen shots

The following images provide an indication of some of the steps in the application process using the Wonga.com iPhone application:





Source: Wonga.com

Conclusions

- 3.43 Loans made in the past few years have increased dramatically, but while respondents believed that there was scope to increase their presence in the market (by opening new stores) many believed that the market itself (the value of loans made) had peaked.
- 3.44 While the rates charged by payday lenders are high, they are in some cases cheaper than some mainstream alternatives such as unarranged overdrafts, and the increase in payday lending over time suggests that there is unmet demand for this service. An increasing number of suppliers operate in the market and appear to compete with each other with different means to attract such growing demand. However, consumers are failing to drive competition since they do not usually shop around for the best price.
- 3.45 Online payday lending is growing at substantial rates, despite being more expensive compared to payday loans available on the high street. Price does not seem to be a primary driver of competition, with suppliers attracting customers with the convenience and speed of the application process. However, we are also concerned by the confusion that brand

proliferation is likely to be causing, preventing consumers from shopping around effectively.

- 3.46 The websites of some lead generators are not transparent and this may lead consumers to believe that they are dealing directly with a lender, and not be aware of the relationship between lead generator and ultimate underwriter of the payday loan. In this respect, we note that the Consumer Credit Directive imposes new disclosure requirements on credit intermediaries (which overlap significantly with the definition of credit brokerage under the Consumer Credit Act 1974). Credit intermediaries are required to disclose, in advertising and other documentation intended for customers, the extent to which they are acting independently and in particular whether they work exclusively with a creditor.³⁴

³⁴ See Regulation 41 of The Consumer Credit (EU Directive) Regulations 2010, which inserts a new section 160A on credit intermediaries into the Consumer Credit Act 1973. It is an offence, under Regulation 41(6), for a credit intermediary to fail to comply with the requirements of this section.

4 COMPETITION ANALYSIS – PAWNBROKING

- 4.1 Pawnbroking loans are generally offered for a period of six or seven months although the pledge is typically redeemed earlier than that. The borrower requires something of value which is held as collateral against the loan until the amount borrowed and the interest payable are repaid and the pledge is redeemed.

Market definition

Product market – demand side

- 4.2 Pawnbroking has long been a means by which people have borrowed money in times of need. However, it has been experiencing resurgence, driven in part by the economic downturn (which has created increased demand) and by the higher gold price and the increase in the number of gold-buyers (which increases awareness of pawnbroking as an option where the gold-buying service is offered by a pawn-broker).
- 4.3 Loans are usually for £100 to £150, with the loan representing approximately 50 per cent of the item's value. The typical interest payable is 7 per cent per month, or an APR of 100 per cent.

Customer demographics

- 4.4 Research undertaken in 2003 by Collard and Kempson³⁵ found that a typical customer was likely to be woman in her twenties or thirties, with children, and in low-paid work or unemployed and receiving state benefits. Some of the larger lenders have undertaken their own research, some of which is publicly available on their websites, which appears to corroborate the findings of Collard and Kempson.

³⁵ Collard and Kempson, *Pawnbrokers and their customers*, University of Bristol, 2003.

Lending criteria and purpose of loans

- 4.5 Pawn-brokers will lend to prospective borrowers that own something of value. The broker will take steps to verify the individual's identity and personal details (including their address). There is no requirement to have a personal current account although most customers will.
- 4.6 The small size of the typical loan makes it unclear why the average borrower has borrowed money, but it seems likely that it is to reduce short or medium term cash-flow issues. Some borrowers might borrow in anticipation of higher future income but there is no research that identifies clearly the purpose of the loan (probably because individuals' personal situations will vary considerably).
- 4.7 The majority (some 80 per cent) of loan pledges are redeemed, with most loans redeemed in three and a half months rather than the full six-month loan. Anecdotal evidence suggests that borrowers frequently pawn the same valuable to alleviate their cash-flow problems.

Product market – supply side

- 4.8 Pawn-brokers were traditionally located on the high-street, with their stores identifiable by three gold balls, although many pawn-brokers are indistinguishable from jewellery outlets and indeed may earn more of their revenue from jewellery sales than from pawnbroking.³⁶ We are aware of an online presence from some pawnbrokers, some of which have been establishing websites to assist in marketing their products and stores.
- 4.9 Pawn-brokers need some expertise in being able to value goods pledged to be able to make appropriately sized loans. The trade associations run a number of courses for their members to assist in this. The skill

³⁶ For example, Albemarle & Bond trades under two brands, with the Herbert Brown brand being more focused on jewellery retailing and having a more subdued high-street presence than Albemarle & Bond outlets.

involved in valuing pawn and setting a price to the borrower (who may be a repeat customer pledging a sentimentally valued item of jewellery that they are highly likely to redeem) means there can be an asymmetry of information between the lender and the borrower and this can reduce the transparency in this market compared to other high-cost credit markets.

- 4.10 A number of pawn-brokers may be better known as payday lenders, reflecting the economies of scope available from offering both products in the same shop. Expanding from the pawnbroking market into the payday lending market requires an understanding of the relevant processes and systems, and additional funds for lending.

Geographic market

- 4.11 Pawn-brokers are typically located on the high-street and can be found in most UK towns. Physical proximity between brokers facilitates a prospective borrower in seeking the views and appraisal of a second or third supplier and thus gets a better price.
- 4.12 Some brokers operate a large number of stores and have a national as well as local presence as a result. While a national presence may give a company reputation advantages and better access to funds, even the largest pawn-brokers do not have complete coverage across the UK, and it appears more likely that the geographic market for pawnbroking is local, with many suppliers reporting that customers do not travel far to visit their stores. The OFT considered that geographic markets may be as narrow as a one-mile radius.

Conclusion on market definition

- 4.13 The appropriate frame of reference for this review of high-cost credit markets is the supply of loans from pawn-brokers in the UK (given the presence of some players active in several regions, with the majority of prices and conditions set uniformly across locations), although it should be noted that competitive rivalry is likely to be greatest at a local level.

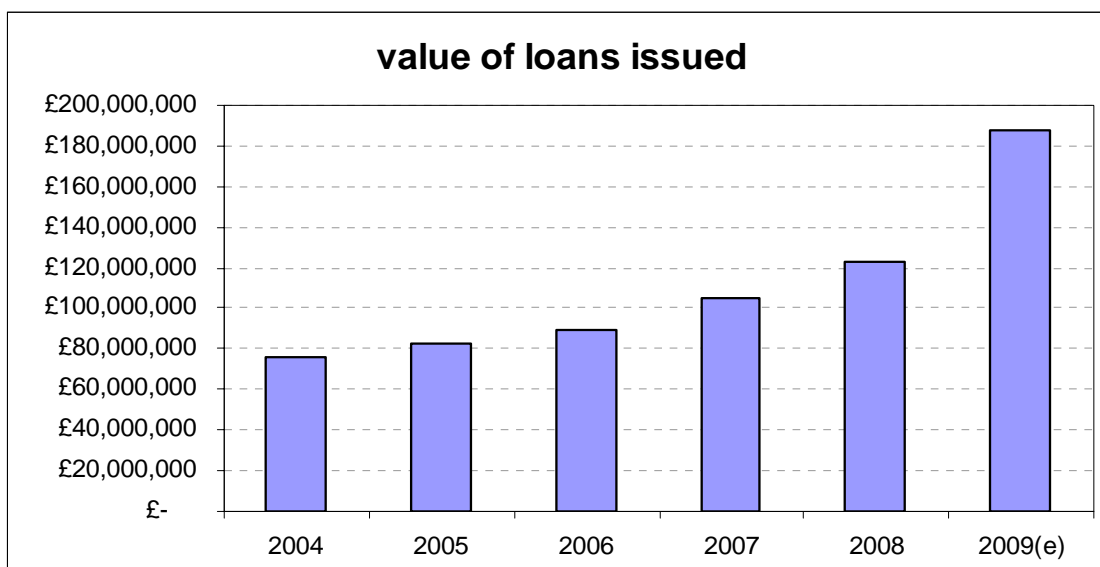
Size and value of the market

- 4.14 Reliable figures on the size of the UK pawnbroking market are not available, although the National Pawn-brokers Association (NPA) estimates that there are an estimated 1,200 pawnbroking shops across the UK, that 50 new shops open each year, that around six million agreements are made each year and that the sector is growing in size by 10 per cent per annum.³⁷
- 4.15 There is no publicly available information about the size of the sector. We estimate that in 2008 the value of the annual loan book is between £500 million and £600 million. This figure is consistent with views expressed by several stakeholders, including the NPA, to the OFT in this review.
- 4.16 The value of loans made by our sample of lenders has increased in recent years, as the following graph makes clear:³⁸

³⁷ While there has been entry into online pawnbroking, the OFT's view is that this is currently dwarfed (in value) by the size of the high-street market.

³⁸ The 2009 datum is estimated by doubling the actual data we received for the first semester.

Figure 4.1: value of loans issued by a sample of pawnbrokers



Source: OFT's analysis of submissions to the review of high-cost credit

- 4.17 One respondent suggested that the increase in the price of gold has inflated the size of the market in terms of value of loans against the number of transactions completed. However, the relative market positions of the larger firms have remained relatively stable over time.
- 4.18 Taking these estimates of the size of the market, the four firm concentration ratio is between 21 per cent and 25 per cent according to the estimate of market size used.³⁹ This suggests that, at the national level, the sector is relatively not concentrated, although concentration can be much higher at the local level.

Competition between pawn-brokers

- 4.19 Pawn-brokers told us that they compete on price and customer service. One broker told us that brand and trust were particularly important factors in competing for customers, and that building relationships with customers was also important.

³⁹ See paragraph 3.33 for more details on the concentration ratio.

- 4.20 Our research showed that there is far less competition on price than for payday lenders, although different valuations may make this comparison meaningless. The range of prices quoted by five brokers ranged from £7.00 a month to £8.01, a range that has not varied much over the period 2004-09.
- 4.21 Customer service seems to be important, with many brokers ensuring the administration process for new and subsequent loans is as simple as possible, to reduce the stigma that some customers may feel on entering a pawn-shop. Many brokers are indistinguishable from mainstream jewellery stores, which again will reduce any possible stigma.
- 4.22 Some of the larger brokers have a clearly identifiable brand, which is intended to appeal to their target audience. For example, Albemarle & Bond stores have high-impact, high-contrast shop fronts unlike those of their sister stores operated under the Herbert Brown brand. The Money Shop store front has a different visual appeal, looking like building societies.
- 4.23 Pawn-brokers do not generally advertise other than in their stores and through local flyers, relying much more on word-of-mouth advertising. However, repeat customers who have built up a relationship with the broker may be given preferential rates.

Profitability of pawnbrokers

- 4.24 Our sample of pawn-brokers suggests that pawnbroking, as an industry, appears to be profitable. Firms in our sample that operated in the market throughout the period 2004-08 made returns in excess of the estimated cost of capital in most years.
- 4.25 Pawn-brokers in our sample made just 70 per cent of their revenue from interest and fees on average in 2008, substantially less than providers of other types of high cost credit. We understand that pawnbroking firms

generate substantial revenue from selling items not redeemed, after, in some cases, returning any surplus to the customer.⁴⁰

- 4.26 This additional revenue may help to reduce the bad debts sustained by pawn-brokers, in comparison with other high cost credit providers, and may have contributed to the industry's ability to sustain its profitability through the economic downturn. Consistent with this, bad debt costs as a proportion of outstanding loans appears to be lower in the pawn-broking sector than for high cost credit providers on average, and this measure has increased less for pawn-brokers than for other high cost credit providers over the period 2004-08.

Barriers to entry

- 4.27 Barriers to entry appear to be low, particularly for existing jewellers and credit licensees. The high price of gold has led to increased sales of gold and this has apparently increased awareness of pawn-brokers.
- 4.28 An estimated 50 new stores open each year, so there appear to be low barriers to expansion. In the main, pawn-brokers operate in local markets and do not require a national presence or high-cost advertising.

Conclusions

- 4.29 The nature of pawnbroking makes it mainly a bricks and mortar business and the role of online lending has so far remained marginal. There are some regional and national pawnbrokers, however, many are smaller local businesses.
- 4.30 There are strong economies of scope between pawnbroking and jewellery retailing, as demonstrated by the number of players that offer both in the same outlets. An increasing number of pawnbrokers also

⁴⁰ This may be a retail sale, or proceeds from scrap for items damaged beyond repair (for example, smelting items and selling gold at spot price less a commission).

offer payday loans, so as to exploit economies of scope with provision of different credit products.

- 4.31 The number of pawn-brokers across the country, the likely low level of entry barriers (especially for established jewellers) and the low level of concentration suggest that this is a reasonably competitive market.
- 4.32 Competition on price appears mostly absent however, with customer service being the most relevant driver of competition. Protecting brand reputation and establishing trust with consumers are important competitive factors.
- 4.33 Increasing profits are driving entry and expansion but firms in our sample had not reduced their rates in response to this.

5 COMPETITION ANALYSIS – HOME CREDIT

- 5.1 Home credit (also known as doorstep lending) is the provision of small, unsecured cash loans, repaid in fixed instalments collected by agents who call at the customer's home. Some home credit lenders also sell shopping vouchers or hampers on credit.
- 5.2 The length of a home credit loan is typically 26-52 weeks, although money can be borrowed for between 15 and 106 weeks. As might be expected, higher value home credit loans are typically taken for longer periods. The average sum borrowed is £380, based on responses to our questionnaire, whereas the Consumer Credit Association (CCA) estimates the average home collected loan to be around £280. For short and medium term loans (up to 55 weeks) the TCC was generally between £40 and £80 for a £100 loan, while the APR varied from around 150 per cent to nearly 500 per cent.

Market definition

Product market – demand side

- 5.3 Customers borrowing on home credit may have few alternative options but they may consider borrowing from alternative suppliers or may be persuaded by word-of-mouth recommendation to go with a particular agent.⁴¹ The convenience of arranging the loan at home, and the social acceptability of this form of borrowing may be more attractive than alternative short-term loans such as payday lending or pawnbroking. Agency mail order shares many of the characteristics of home credit (particularly in respect of shopping vouchers), as payments are made in cash weekly and there is a strong personal relationship between the borrower and the agent.
- 5.4 On the demand-side, customers borrowing money from home credit suppliers may see alternative forms of retail credit as substitutes.

⁴¹ The Consumer Credit Association estimates there are some 20,000 agents in the UK.

However, research undertaken for the OFT showed that many home credit customers did not even consider alternative forms of credit, with most customers believing that home credit was a good or the best option for them, that they had got a good or the best deal, and that they were borrowing from a good or the best supplier. The Competition Commission (CC) found that a substantial but declining proportion of home credit customers use agency mail order (AMO), and several factors reduce the extent to which AMO imposes a competitive constraint on home credit.⁴² More recently, Research by Policis with funding from the Friends Provident Foundation confirms this, showing that only 30 per cent of home credit users resorted to catalogue credit in the past five years, and less than 10 per cent used rent-to-own or store card credit over the same time period.⁴³

- 5.5 The CC also considered the constraint imposed on home credit lenders by a variety of alternative credit options (including pawn broking, payday lending and rent-to-buy) and concluded that they pose only a limited competitive threat to home credit.⁴⁴

Customer demographics

- 5.6 Customers using home credit are more likely to be female than male, and more likely to be below the age of 45. Most are tenants rather than home owners. Our survey also suggests other common characteristics of home credit users, such as being part of a one-parent family, with lower final educational achievement.

⁴² Competition Commission, Home Credit Market Investigation, paragraphs 4.10 and 4.11, 30 November 2006. In particular, the CC mentions the purpose-specific nature of AMO credit, the different operation of the agency structure and the difficulty of comparing the cost of AMO credit (which is often included in the retail price rather than indicated separately).

⁴³ The new demand landscape for credit provision to those on low incomes and the implications for the provision of affordable credit, Policis and the Friends Provident Foundation, 2010.

⁴⁴ Competition Commission, Home Credit Market Investigation, paragraphs 4.53, 30 November 2006.

- 5.7 Customers are generally earning low incomes (less than £1,000 net monthly) or in receipt of government benefits, and are classified as being in socio-economic groups C2, D and E.⁴⁵ Research by Policis with funding from the Friends Provident Foundation indicates that income is perennially inadequate compared to outgoings for more than 60 per cent of home credit users who are excluded from other credit options.⁴⁶
- 5.8 Many home credit customers may use multiple sources of credit, including loans from more than one home credit company.⁴⁷ OFT's own survey showed substantial levels of dependency and concurrent and repeated use of credit. Research by Policis with funding from the Friends Provident Foundation shows that about one third of all home credit loans are refinanced, and of these roughly 50 per cent are half way through their term or less.⁴⁸

Lending criteria and purpose of loans

- 5.9 Borrowing on home credit is not purchase-specific but the majority of loans are used to purchase goods. The most common reason for a loan is buying Christmas/ birthday presents or household white goods, although loans are used to buy clothes or consumer electronics, or to pay for holidays.⁴⁹ This is confirmed by research undertaken by Policis with funding from the Friends Provident Foundation, which found that around 30 per cent of home credit users are borrowing for aspirational

⁴⁵ C2: Skilled workers/unskilled manual workers with responsibility for others, D: Semi-skilled/unskilled workers and their trainees, E: Benefits dependent/casual workers.

⁴⁶ The new demand landscape for credit provision to those on low incomes and the implications for the provision of affordable credit, Policis and the Friends Provident Foundation, 2010.

⁴⁷ Kempson et al, March 2009, page 14.

⁴⁸ The new demand landscape for credit provision to those on low incomes and the implications for the provision of affordable credit, Policis and the Friends Provident Foundation, 2010.

⁴⁹ Information from the Consumer Credit Association (CCA).

purchases (entertainment, holidays or Christmas) whereas around 20 per cent borrow to spread the cost of purchasing major items and another 20 per cent to pay for an emergency bill.⁵⁰ Similarly, a survey conducted for the OFT found that the most common reasons for taking up a home credit loan are to purchase a particular item or to have money available for a special occasion (around 30 per cent each).⁵¹

- 5.10 The implication of this research is that borrowers use home credit to fund cash-flow problems and are unable to save sufficiently in anticipation of known forthcoming expenditure (such as Christmas). Research also suggests that unanticipated expenditure such as emergency bills or bad budgeting are also reasons why customers borrow through home credit.
- 5.11 The particular features of home credit, including the ability to pay weekly (making repayments more affordable), defer payment without incurring penalties, and being visited at home by the agent, make it particularly valued by its customers.⁵²

Product market – supply side

- 5.12 Home credit suppliers need to build a strong relationship between their agents and customers. Most agents are self-employed. The agent plays a key role in determining who can borrow money, how much they can borrow, and in collecting repayments. The personal relationships built up by the agent and their customers are critical to the success of a home credit supplier.

⁵⁰ The new demand landscape for credit provision to those on low incomes and the implications for the provision of affordable credit, Policis and the Friends Provident Foundation, 2010.

⁵¹ Annex A, A factual report prepared for OFT by Ipsos MORI – a survey of consumers of unsecured and high cost credit, December 2009, page 36

⁵² Kempson et al, March 2009, pages 12-14.

- 5.13 While some home credit suppliers use credit scoring criteria to assess potential customers, it seems that the general method of assessing credit-worthiness is to lend a customer a small amount of money and see how well the borrower does in paying it back. One supplier noted that the agent visits the customer's home and is better placed to assess credit-worthiness as a result.
- 5.14 One supplier offers some interest-free loans, primarily to new customers, which may prove a successful marketing tool in attracting (and retaining) new customers. Customers of home credit are not generally good payers – a quality customer is someone who makes 60 per cent of their payments on time.⁵³ This may be because no explicit charge is made for late payments or it may be because customers are generally on low incomes and financially constrained. Lenders therefore incorporate such additional risk in the upfront price of the product.
- 5.15 Provident, the largest home credit lender, is a FTSE250 company listed on the London Stock Exchange. While home credit is Provident's main business, its Consumer Credit Division also provides loans under the brand of Real Personal Finance and credit cards under the Vanquis Bank brand. It also offers payday lending under the Cheque Exchange brand (which has 31 stores). Provident's experience shows that there is some opportunity to offer alternative products to home credit customers.

Geographic market

- 5.16 The largest home credit supplier is Provident Financial, which claims that every week 11,500 local agents visit 1.8 million customers (around one in 20 UK households) to issue loans and collect repayments.⁵⁴ Three other suppliers operate on a national scale, leaving a long tail of smaller and often local suppliers.

⁵³ Kempson et al, March 2009, page 24.

⁵⁴ www.providentfinancial.com/index.asp?pageid=19.

- 5.17 The CC considered that competition between home credit lenders has both a local dimension (for example, the service offered by an agent and his decisions on credit availability) and a national dimension (for example, the vast majority of prices are set nationally, irrespective of competitors present in specific local areas).⁵⁵
- 5.18 Since the CC investigated the market in 2006, prospective customers have been able to access the Lenders Compared website⁵⁶ to assess which suppliers operate in their local area.

Conclusion on market definition

- 5.19 The appropriate frame of reference for this review is the supply of home credit loans and shopping vouchers in the UK, although some dimensions of competition (those related to the agent) are more local in nature.

Size and value of the home credit market

- 5.20 There are an estimated 500 companies supplying home credit in the UK,⁵⁷ to an estimated target of three million low income customers, making an estimated six million loan transactions each year. Our analysis indicates that the total value of loans issued in 2008 can be estimated between £1.2 billion and £1.3 billion. This is in line with the Competition Commission estimate that in 2005 the advances of home credit loans to 2.3 million customers totalled around £1.3 billion.⁵⁸

⁵⁵ Competition Commission, Home Credit Market Investigation, paragraph 6.3, 30 November 2006.

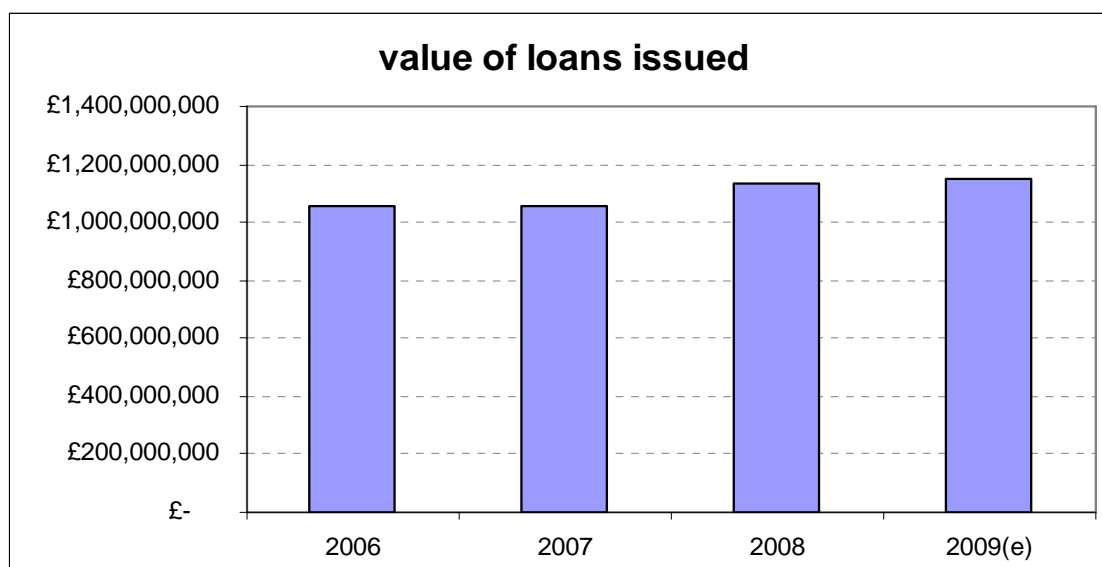
⁵⁶ www.lenderscompared.org

⁵⁷ The CCA has around five hundred members.

⁵⁸ Competition Commission, Home Credit Market Investigation, paragraph 2.92, 30 November 2006.

5.21 The figure below shows the value of loans issued by home credit lenders included in our sample. The market has been growing slowly, and the recent downturn has likely impacted availability of wholesale finance and the risk appetite of lenders. These home credit suppliers lent more than £1.1 billion in 2008, and we estimate this to have increased slightly in 2009⁵⁹.

Figure 5.1: value of loans issued by a sample of home credit suppliers



Source: OFT's analysis of submissions to the review of high-cost credit

5.22 At the time of the CC Inquiry, there were six large lenders but since then two of these had sought to reduce their exposure in the market,⁶⁰

⁵⁹ Our 2009 estimate is based on respondents' data up to 30 June 2009, multiplied by a factor of 2.3 to account for the seasonality of home credit loans. Figure 6.7 of the CC report (2006) shows a substantial increase in the run up to Christmas (and a smaller one in July).

⁶⁰ At the end of 2008, LSB went into administration. In addition, at the beginning of 2009, Cattles stopped lending to new customers in an effort to preserve liquidity. For more details, refer to the OFT's Review of High Cost Credit – Interim Research Report (published in December 2009) paragraph 2.24.

allowing two others (Provident Financial and S&U plc) to increase their balances in the market.

- 5.23 This is a highly concentrated market: At the end of financial year 2005, the six largest firms accounted for over 90 per cent of the market, with Provident Financial alone exceeding 60 per cent on most concentration measures used by the CC.⁶¹ The four firm concentration ratio in 2007 was around 90 per cent,⁶² and we believe that concentration has remained at that level. It is worth noting that competition authorities have considered much lower levels of concentration to cause concern previously.

Competition in the market

- 5.24 There is very little price competition: all lenders in our survey charged essentially the same price for equivalent products, and have been changed only occasionally. The CC similarly concluded that price competition is weak.⁶³ The products offered are essentially similar, albeit with minor differences in the loan terms.
- 5.25 There may be some competition between agents, although given the requirement to build close relationships with customers this appears to be a difficult forum on which to compete.
- 5.26 Provident Personal Credit is the largest supplier in the market in size and scale. It also has publicly stated plans to be the leading non-standard lender in the UK for other specialist credit products (such as longer-term

⁶¹ Competition Commission, Home Credit Market Investigation, paragraph 6.145, 30 November 2006. The CC considered several measures of concentration: advances, collections, turnover, gross receivables, number of employees, number of agents and number of customers.

⁶² Datamonitor, UK Non-Standard Unsecured Personal Loans (DMFS2256), October 2008, pp. 33-34 and 47.

⁶³ Competition Commission, Home Credit Market Investigation, paragraph 6.36, 30 November 2006.

larger direct repayment loans⁶⁴ and sub-prime credit cards), to serve a potential customer base of around 10 million consumers around the UK (equivalent to one in three households). Provident considers that the fall-out from the recent credit crunch reinforces medium-term opportunities to build a leading position in the UK non-standard unsecured consumer loans market.⁶⁵

Box 5.1 Market innovations (3)

Linking payment cards and loans

What new products are there?

Pre-paid payment cards, sometimes referred to as stored value cards can be linked to a loan facility.

In essence, these are payment cards that are loaded up with funds that have been loaned to the consumer.

How do they work?

The consumer borrows cash from a home-credit supplier and instead of the loan physically being handed out to them at the doorstep by an agent, the loan supplier's new card gives the consumer the option of having that cash loaded onto a card instead. It then functions much like a debit card, allowing the user to pay for goods in shops, online, and abroad.

How do they differ from existing loans and debit/credit cards?

What makes it different to a normal debit card is that most references to a debit card imply a card connected to your bank account and that money is deducted from that account. This therefore does not involve providing credit. These new mechanisms provide loans pre-loaded onto the card so it is a form of credit.

These are not, however, a credit card as such within the normal meaning of this term, since credit cards usually involve the extension of credit at the point of purchase and revolving credit. This is a single loan on a pre-loaded card.

⁶⁴ This product is underwritten face-to-face in the customer's home but collected by direct debit. Provident tested the market for this product in 50 locations during 2009 under the brand Real Personal Finance.

⁶⁵ Provident Financial plc, 2009 Results Presentation: Maintaining the flow of credit through turbulent times, 2 March 2010, p.3-4.

Profitability of home credit suppliers

- 5.27 We collected data from a small sample of firms in the home credit market, and hence any findings on profitability are extremely tentative. Data from our sample does suggest, however, that home credit providers generally made returns in excess of their cost of capital during the period 2004-08.
- 5.28 Costs of providing home credit may be higher than other sectors and to an extent this may explain the high APRs charged by providers. Work undertaken by Kempson developed a model that found that a hypothetical reasonable sized not-for-profit home credit provider would need to charge an APR of at least 100 per cent to be viable (against rates offered by a major commercial lender of 183 per cent).⁶⁶ We are aware that the 100 per cent APR figure in this research would vary notably dependent on the performance and default levels of the customers.

Barriers to entry

- 5.29 Small scale entry is possible and, indeed, there are an estimated 500 home credit suppliers and the Lenders Compared website may have made entry at a local level easier by making potential customers more aware of their local suppliers.
- 5.30 Advertising spend is low, but the key issue in home credit is the relationship built by the agent with their customers. Customers are visited in their own homes by agents and this may well lead to close social friendships which may complicate the issue of independence (where the customer believes they need to take a loan to maintain that friendship and social contact) between the agent and the customer. For

⁶⁶ Kempson et al, March 2009, page 5.

less-mobile or house-bound customers, this may lead customers to take out loans that they really do not require.

5.31 Entry on a regional or national scale is considerably more difficult, since the new entrant would need to acquire a significant number of agents, each with their own group of customers. The difficulties faced by LSB and Cattles has allowed S&U and Provident to increase their customer base, which will make it harder for Morses Club (formed from LSB's home credit business) and Cattles to compete in the market.

5.32 Barriers to entry (on a regional or national scale) are therefore very high.

Conclusions

5.33 Our review highlighted that home credit users are likely to be on very low incomes or receiving some form of benefit. They generally place great emphasis on the convenience of home collection, on the affordability of weekly repayments and on the possibility of missing or delaying payments without incurring penalties. Another important factor is the close relationship of trust with the local agent. For these reasons, price is not a main driver of competition in the home credit market.

5.34 The market for home credit is highly concentrated with one large supplier in the market. This market structure, combined with the lack of price competition, the presence of barriers to entry (in the form of the need for a network of agents, costs of business acquisition, importance of personal relationship with the agent and word of mouth advertising) imply that competition is limited and not very effective in this market.

6 COMPETITION ANALYSIS – CREDIT UNIONS

- 6.1 Credit unions are financial cooperatives that are owned and controlled by the people who save with them – their members. They are regulated by the Financial Services Authority (FSA).
- 6.2 Like banks they provide financial services such as savings accounts and personal loans. Some of the larger unions also provide products such as current accounts, ISAs and Child Trust Funds. Unlike banks, however, they are not-for-profit organisations and must re-invest or return operating surpluses to their members (or in some cases, the community from which the membership is drawn).

Market definition

Product market – demand side

- 6.3 Each credit union has a common bond which determines who can join that union. The common bond may be for people living or working in the same area, people working for the same employer or people who belong to the same association, such as a church or trade union. Nearly half of all credit unions in Great Britain are live-or-work unions.⁶⁷

Customer demographics

- 6.4 Credit unions are used by a wide range of people, but members are most likely to be white middle-aged females on a relatively low income living in rented accommodation.⁶⁸ In community-based unions, one in five members lived in a household where no-one was in paid employment.

⁶⁷ Live-or-work credit unions have a common bond based on the area of residence or employment, such as the Scottish Police Credit Union Ltd which serves members of the Scottish Police, including retired officers and family members.

⁶⁸ Collared and Smith, April 2006.

Lending criteria and purpose of loans

- 6.5 One reason for joining a credit union, and saving money with the union, is that it gives members the opportunity to borrow money. Borrowing from a credit union can require the member to join and save for a specified period of time before a loan is given. An important exception is the Department of Work and Pension's Growth Fund. This was created in 2004 to allow credit unions (and other third sector (not-for-profit) lenders such as community development finance institutions) to lend to low income people who were financially excluded.⁶⁹
- 6.6 The rates charged are considerably lower than other forms of high-cost credit but individuals need to be able to save and this may be beyond some individuals even though it would be cheaper for them in the long-run. The amounts borrowed are generally small – in a survey for Association of British Credit Unions Limited (ABCUL), Collard and Smith noted that 51 per cent of those surveyed borrowed less than £1,000 and 82 per cent of those surveyed borrowed less than £2,500.⁷⁰
- 6.7 For many years, credit unions would lend only to their existing members, usually in proportion to their contribution to the pool of members' savings. The Growth Fund, established in 2004 by the Department of Work and Pensions (DWP) as part of the government's Financial Inclusion agenda, provides credit unions with money to lend to those who are financially excluded, including prospective members who had yet to build up savings with the credit union.

⁶⁹ Further details available here: www.dwp.gov.uk/other-specialists/the-growth-fund/

⁷⁰ Collard and Smith 2006.

Product market – supply side

- 6.8 Credit unions are set up with a specific common bond and there is unlikely to be substitution on the supply side between different credit unions.
- 6.9 ABCUL gives advice on setting up a credit union, and notes that the process from conception to implementation is likely to take around three years.

Geographic market

- 6.10 The common bond may itself define the geographic market of the credit union, since a live-and-work bond requires members to live and/or work in a particular area. (Some common bonds are employment related and do not impose a geographic restriction as such, unless the nature of the employment itself is geographically limited (such as, for example, the Blues and Twos Credit Union Ltd for the staff, retired members and families of the Emergency Services and County Councils of Lancashire & Cumbria).
- 6.11 There are an estimated 500 active credit unions in Great Britain. Just under a quarter of these are located in Scotland and a similar percentage is located in the North of England. Elsewhere, they appear to be more thinly dispersed. This reflects variations in penetration rates (which often reflect underlying religious and cultural differences): in Scotland and Northern Ireland an estimated 35 and 26 per cent of the population are members of credit unions. In the South East of England this falls to 4 per cent, with the figure for the whole country being less than 1 per cent.
- 6.12 Most credit unions located in England and Wales are members of ABCUL. In Northern Ireland, they are affiliated with the Irish League of Credit Unions

Conclusion on market definition

- 6.13 The appropriate frame of reference is the supply of loans from credit unions in Great Britain and Northern Ireland.

Size and value of the market

6.14 The number of credit unions has fallen in recent years, from a peak in 2001 when there were 698 credit unions.⁷¹ According to the most recent FSA's statistics available, at the end of September 2008, there were 508 registered credit unions,⁷² although a few of these are inactive. We estimate that in 2008 the market size in terms of loans issued by credit unions was slightly below £340 million,⁷³ increasing more than ten per cent in nominal terms from the 2007 level of £302 million⁷⁴.

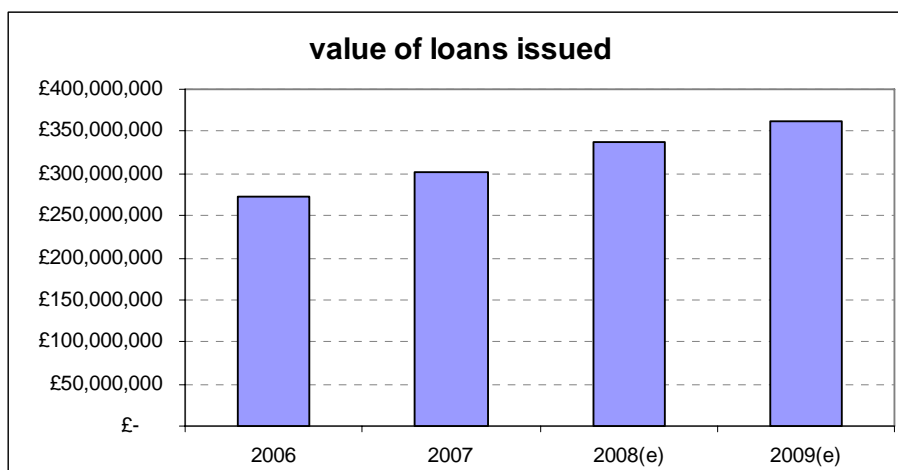
⁷¹ Collard and Smith, April 2006, page 6.

⁷² FSA, Annual statistics on the credit unions sector 2007, October 2009, p.2.

⁷³ Based on the outstanding loan balance reported by credit unions in (unaudited) quarterly returns to the FSA (full year data for 2008, only the first two quarters of 2009).

⁷⁴ FSA, Annual statistics on the credit unions sector 2007, October 2009, p.8 (based on 504 returns).

Figure 6.1: Value of loans issued by credit unions



Source: FSA statistics for 2006 and 2007, un-audited quarterly returns for 2008 and 2009

6.15 Credit unions are generally small: the total assets of the credit unions in 2007 were £548 million.⁷⁵ By way of comparison, the assets of the UK's 52 building societies were around £359 billion.⁷⁶ The largest credit union, Glasgow Credit Union, had assets of over £64 million as of June 2009,⁷⁷ which makes it slightly larger than the two smallest building societies, Century and City of Derry, (which had assets of £24 and £36 million respectively in December 2008) but smaller than the third smallest building society, Penrith (which had assets of £85 million in December 2008).⁷⁸

⁷⁵ FSA, Annual statistics on the credit unions sector 2007, October 2009, p.5 (based on 504 returns).

⁷⁶ Building Societies Association, statistics on Building society assets 1995-2008, available at: www.bsa.org.uk/docs/statisticspdfs/mortgages/2005fsa4.xls

⁷⁷ ABCUL, The big two Oh for Glasgow Credit Union, news of 19 June 2009, available at: www.abc.ul.org/page/news.cfm

⁷⁸ Building Societies Association, statistics on List of societies by asset size, available at: www.bsa.org.uk/docs/consumerpdfs/assetslist.xls

- 6.16 Some credit unions are much smaller by comparison, being run by volunteers, at a local level. Such small credit unions often have limited opening hours, often being available in village halls and other areas for a few hours a day or week, in some cases with only a few hundred members and small volumes of loans.
- 6.17 Membership of credit unions trebled between 1995 and 2005,⁷⁹ and in September 2008, the FSA recorded the number of members as being 652,163,⁸⁰ or around two per cent of the mid-2008 working-age population.

Competition and profitability

- 6.18 By law, credit unions are not allowed to charge any more than two per cent per month on borrowed funds (limiting the APR to a maximum of 26.8 per cent).⁸¹ In practice, the majority of credit unions charge no more than one per cent which equates to an APR of 12.7 per cent.⁸² One respondent explained that credit unions whose common bond was linked to employment were able to require payroll deductions and could offer a lower APR than community credit unions whose customers were more likely to be financially excluded.
- 6.19 Credit unions give membership to people within their common bond, a delineation that suggests there is likely to be little competition between different credit unions.

⁷⁹ 'Consumer Credit and Debt', Key Note Ltd, 2007, page 45.

⁸⁰ FSA, Quarterly Credit Unions Statistics September 2008, p.1, available at: www.abcul.org/page/statistics.cfm

⁸¹ Credit Unions Act 1979, as amended by The Credit Unions (Maximum Interest Rates on Loans) Order 2006.

⁸² Keynote, page 45.

- 6.20 Most community-based credit unions consider that home credit companies and other sub-prime lenders are their main competitors.⁸³ This is confirmed by survey evidence that considered the borrowing of home credit customers and found that, while other forms of credit were also used, there was some evidence that members of credit unions had stopped using home credit (or used it less) since joining the credit union.⁸⁴ In the same survey, it was found that nearly a quarter (22 per cent) of credit unions members had had experience of home credit at some time.
- 6.21 The Lenders Compared website is used by credit unions, although there is no evidence that this has resulted in prospective borrowers joining a credit union rather than taking a home credit loan. However, the credit union APRs are publicly available on the site and will provide a benchmark of cheaper alternatives.
- 6.22 By contrast, 71 per cent of work-based credit unions identify banks or building societies as their main competitors.⁸⁵ Not surprisingly in work-based credit unions, the member was more likely to live in a household where at least one person was in full-time employment.
- 6.23 Some credit unions are considerably larger than others: 11 per cent of credit unions hold assets worth over £2 million each and have over 56.2 per cent of total union members.⁸⁶ Only seven credit unions have more than 10,000 members.
- 6.24 Quite clearly, the small size of the majority of credit unions may make it difficult for them to operate effectively, even as a not-for-profit body. There has been considerable analysis of the viability of credit unions, and

⁸³ Paul Jones, *Breaking through to the future*, December 2008, page 7.

⁸⁴ Collard and Smith, April 2006, page 21.

⁸⁵ Paul Jones, December 2008, page 7.

⁸⁶ Goth et al (2006).

their relative efficiencies, with detailed analysis revealing that the cost to a credit union of servicing a £300 loan varies, and that at best the union would make a surplus of £20.36 and at worst would lose £39.60.⁸⁷

- 6.25 The reduction in numbers of credit unions reflects some merger activity between some of the smaller credit unions although credit unions can and do fail.⁸⁸

Barriers to entry

- 6.26 The small scale of many credit unions prevents them from spreading overheads over a large customer/ credit base. Consolidation would allow them to improve the service offered (and extend their opening hours) and allow them to enjoy economies of scale.
- 6.27 The size of credit unions may, however, be capped by FSA presumptions about the common bond. For credit unions with up to 100,000 members the FSA presumes that there is a common bond: for credit unions with between 100,000 and one million members, there is no such presumption and the credit union will have to make a case. Beyond one million members, there is a presumption against the common bond and the credit union will have to give particularly strong arguments.⁸⁹ Since the largest credit union (by membership size), Scotwest, has only 19,700 members⁹⁰ there is some way to go before the FSA presumptions become a barrier to expansion.

⁸⁷ Paul Jones, 2008, page 4.

⁸⁸ Failures in 2009 include those of Hull Northern Credit Union Limited, Derby City Credit Union Limited, Eastbourne Community Credit Union, Irvine North Credit Union Limited, South West Durham Credit Union, and St Brendan's Credit Union.

⁸⁹ <http://fsahandbook.info/FSA/html/handbook/CRED>.

⁹⁰ Scotwest is based in Glasgow and open to anyone who lives or works in the West of Scotland. For more details, see: www.abcul.org/page/members.cfm

Conclusions

- 6.28 Credit unions may provide a low-cost alternative, particularly to people borrowing from higher-cost sources (for example, home credit but also mainstream finance such as unauthorised overdraft or unsecured loans). There is however a limit to access, since individuals must qualify for the common bond and join the union.
- 6.29 At present the effectiveness of credit unions is limited by their number and scale of activities, which prevents them from enjoying economies of scale and improving their services (for example, offering extended opening hours). The sector has experienced some degree of consolidation, which explains why the number of credit unions has been decreasing since 2001 while the value of loans issued has increased in recent years.

7 COMPETITION ANALYSIS – RETAIL CREDIT

7.1 Retail credit refers generally to the credit facilities made available in relation to purchases of retail goods or services by customers who do not have immediate availability of funds. Many retail purchases are beyond the immediate means of many customers and so purchases of such goods, particularly furniture and electrical equipment, require access to credit.

- Generic mainstream products such as overdrafts, credit cards, and personal loans may be used to buy such goods on credit and pay for them over time. Such products are not considered further in this chapter.
- As we have seen, other high-cost credit products such as payday loans, pawnbroking loans, home credit loans (or shopping vouchers) and loans from credit unions may be used to fund retail purchases. These products have already been considered in detail, and are not considered further in this chapter.
- Retail specific credit such as store-cards, mail order and rent-to-buy provide a means of purchasing goods, with some of these products available to customers with an adverse credit history. These purpose-specific credit facilities are the focus of consideration in this chapter. We note that the Competition Commission has already looked at the market for home shopping,⁹¹ and in the rest of this chapter we focus on the issues that we consider more relevant to the OFT's Review.

⁹¹ Competition Commission, March UK Ltd and the home shopping and home delivery businesses of GUS plc: A report on the merger situation, Chapter 4 on Home Shopping, December 2003, available here: www.competition-commission.org.uk/rep_pub/reports/2004/fulltext/486c4.pdf

Market definition

Product market – demand side

- 7.2 Customers buying products in high-street retailers have the choice of paying by cash or cheque, using a debit or credit card, taking out a credit facility or a store-specific card.
- Cash and cheque payments or debit card payments involve no credit facilities⁹² and are not considered further.
 - Credit cards may be provided by mainstream high-street banks, or sub-prime suppliers (such as Provident's Vanquis card which is used by an estimated 400,000 borrowers⁹³) and, while there are differences in the customer groups served by these alternative options and the interest rates charged, the Department for Business Innovation and Skills has undertaken work considering these products,⁹⁴ and therefore, these products are not considered further.
- 7.3 Three types of retail credit by mainstream suppliers:

⁹² Except insofar as these payment mechanisms make use of credit provided under a current account overdraft or a personal loan. However, such credit is unrestricted-use credit (that is, it is not provided solely to finance the purchase transaction between the customer and the retailer) and is distinct from the restricted-use retail credit which is the focus of this chapter.

⁹³ www.vanquis.co.uk/about/

⁹⁴ More details on the outcome of the BIS review on credit and store cards are available here: www.bis.gov.uk/Policies/consumer-issues/consumer-credit-and-debt/new-approach-to-consumer-credit/credit-and-store-card-review

- Larger national retailers selling consumer electrical products offer finance (sourced from third parties⁹⁵) for their more expensive appliances but the third party may impose strict lending criteria that make this option unavailable to those on low incomes or credit-impaired customers.⁹⁶
- Some retailers offer a bundled product and finance package whereby the finance is offered at low or zero per cent interest but no discount is given if the customer pays upfront. We will consider how some retailers may adjust the prices of the products themselves so as to reduce the cost of credit supplied.
- Some stores may offer store cards which are operated directly⁹⁷ or by a third-party supplier.⁹⁸

7.4 These do not appear to raise any concerns, although store-cards may be high-cost if the borrower does not pay off the balance in full at the end of each month. They are not considered further in this report, given that the review by BIS covers both credit and store cards.

7.5 Some forms of retail credit have been developed for higher-risk borrowers:

⁹⁵ For example, the small print reveals that Comet's Edge card, and its term finance is underwritten by Santander cards: www.comet.co.uk/shopcomet/advice/637/Payment-Finance#finance-options

⁹⁶ On 6 March 2010 the website of Comet showed that its Edge card was not currently available: this was not the case in 2009 when this analysis was undertaken.

⁹⁷ For example, the John Lewis, Waitrose and Peter Jones Account Cards are managed by John Lewis Financial Services Limited, which is a member of the HSBC Group, formed for the purpose of providing financial services to customers of the John Lewis Partnership.

⁹⁸ For example, store-cards for Top Shop, part of the Arcadia Group, are provided by Santander Cards UK Limited: www.topshopcard.com/en/faq

- The rent-to-buy model⁹⁹ (of a company such as Brighthouse) allows customers effectively to rent products and make a weekly cash payment until the agreement is terminated or the goods paid for, at which point ownership of the goods transfers to the customer.
- Catalogue companies (such as Littlewoods, Freemans, Grattan) offer credit facilities for direct mail order (DMO) or agency mail order (AMO) customers.¹⁰⁰

7.6 These products are likely to be substitutes for some of the other high-cost credit products discussed in this report, although many customers may make use of more than one type of credit product.

Customer demographics

7.7 Rent-to-buy stores cater specifically to the sub-prime market: For example, Brighthouse and Perfect Home Stores allow customers to pay for their goods weekly and to take ownership only when the goods are paid for in full. Customers are generally not able to get finance from other sources. One respondent advised us that its typical customer earned less than £20,000 per year or was dependent on state benefits.

7.8 Mail order suppliers may offer their customers a credit facility as part of the agreement which customers can take up as an alternative to other forms of short-term credit. In some cases, the credit facility is explicit (and the retail price in line with high-street prices) but in others the goods may be sold at a higher retail price (particularly where low or zero per cent APR credit is offered as part of the bundled package) that implicitly recovers credit costs. These arrangements appear particularly palatable to consumers on low incomes or benefits (social classification

⁹⁹ Also called rent-to-own.

¹⁰⁰ Most online retailers require payment before delivery and do not offer credit facilities. Some of these retailers (for example, Cotton Traders) may give away free catalogues but are not themselves catalogue companies.

C2, D and E), which make up around two-thirds of the customer base of our sample of respondents.

- 7.9 The demographics of rent-to-buy customers and agency mail-order customers are similar to those borrowing through home credit loans, as are the features of weekly cash instalments and frequent contact with the store/ agent.

Lending criteria and purpose of the loan

- 7.10 The lending criteria imposed by rent-to-buy and some mail order companies are generally low, making their products accessible to low-income and credit-impaired borrowers.
- 7.11 While rent-to-buy companies require identity checks (to confirm the individuals' address and personal details) they are unlikely to undertake formal credit checks, although in some cases they may seek guarantors for borrowers.
- 7.12 Mail order companies sell the goods in their catalogues directly to customers (direct mail order) or through agents (agency mail order). Low-income or credit-impaired customers can buy goods through agents (often their friends) and pay them weekly in cash for goods order through the catalogue. Individuals with better credit histories can buy the goods themselves directly.
- 7.13 Rent-to-buy shops such as Brighthouse sell white goods (fridges, washing machines, etc), electrical appliances (televisions, etc) and household furniture (sofas, beds, etc). Mail order catalogues sell clothes, household linen, white goods, electrical appliances, furniture, and garden accessories. The range of products on offer in each catalogue varies, with some retailers specialising in specific niches such as French fashion or clothing for larger-sized, or younger, or older people.

Product market – supply side

- 7.14 Retail credit allows customers without the necessary funds to make purchases now, and as such it is a complementary element of the retail

offering. The availability of credit enables additional sales of retail merchandise. Retailing is a competitive activity and the availability (or lack of) of retail credit may be an important element of competition between retailers.

- 7.15 Retail credit can, and often is, offered by a third-party finance supplier. Credit cards, store-cards, and financing contracts are all offered by companies with links to mainstream financial suppliers.
- 7.16 Rent-to-buy stores and mail order retailers must fund their own finance, but the costs of this are covered by higher prices to end-customers. The credit facility is only available to retail customers and is intended to facilitate increased expenditure by cash-constrained customers.

Geographic market

- 7.17 One rent-to-buy company advised us that it has 190 stores nationwide at the beginning of 2010, located in urban areas. Its own research indicates that its customers are local, living within three miles radius of its stores. Another large rent-to-buy chain has around 30 stores.
- 7.18 Mail order companies will sell to UK and BFPO¹⁰¹ residents with a personal current account. Mail order catalogues provide a means by which people buy retail goods from the comfort of their own home.¹⁰² They may appeal particularly to individuals living in remote areas (where shopping opportunities are rare) or the less mobile, or even to time-constrained customers.
- 7.19 A number of players offering subprime retail credit have chains of shops with a national scale or sell via catalogue nationwide, and they set prices

¹⁰¹ British Forces Post Office, which provides postal services to armed forces personnel and their families living overseas.

¹⁰² Respondents indicated that 35-55 year old females are heavily represented in their customer base.

nationally. Hence the appropriate reference is the supply of subprime retail credit in the UK.

Conclusion on market definition

- 7.20 The relevant frame of reference in relation to this review of high-cost credit markets is the supply of rent-to-buy finance and agency mail order in the UK. The cost of credit is uniform across the country, and advertising is undertaken on a national scale. At the shop level, however, competition is local and one respondent suggested that competitors tend to locate their shops in close proximity to each other.

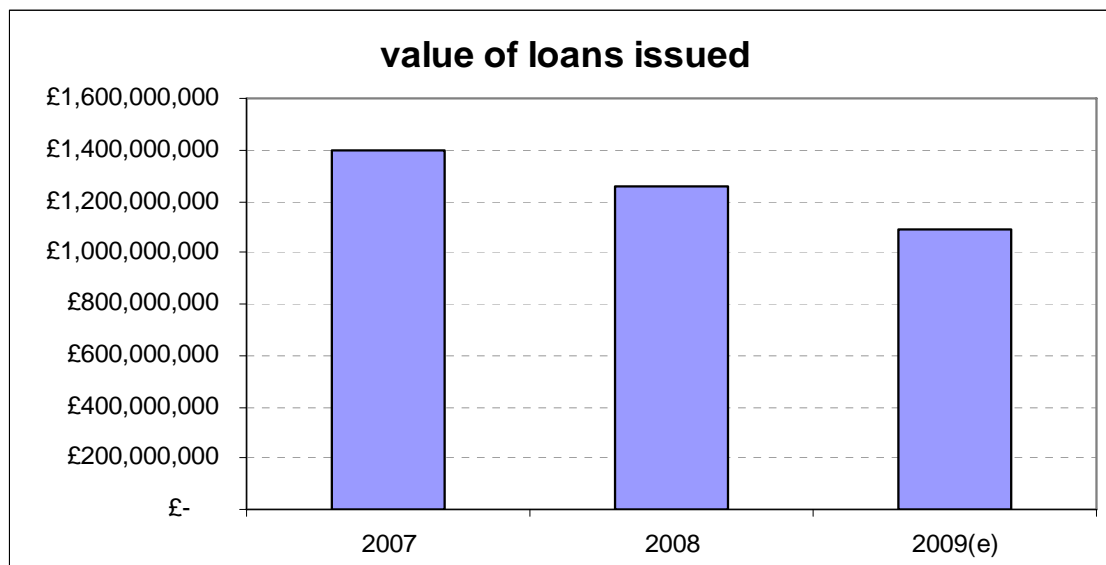
Size and value of the market

- 7.21 Based on the information available to the OFT on rent-to-buy gross advances and the number of rent-to-buy stores, the size of the market is estimated to be around £250 million to £300 million.
- 7.22 Gross advances in the mail order sector totalled almost £4 billion in 2008,¹⁰³ an increase of three per cent on sales in 2007. The mail order sector has been declining over the last five years, although recently the unavailability of credit cards and unsecured personal lending has revived gross advances in the sector in 2008 (around £130 million increase over 2007).¹⁰⁴
- 7.23 The declining trend in the sub-prime retail credit castor is apparent when looking at our sample of lenders, as Figure 7.1 shows.

¹⁰³ Datamonitor, UK Personal Lending 2009, August 2009, page 14.

¹⁰⁴ Ibid.

Figure 7.1 Value of sub-prime retail credit loans



Source: OFT's analysis of submissions to the review of high-cost credit

Competition in the market

- 7.24 We understand that there are two significant rent-to-buy retailers in the UK, Brighthouse and Perfect Home Stores, with the former much larger than the latter in terms of number of stores.
- 7.25 The main players in the mail order market are groups that own several brands: NBrown, Next Directory, Otto Group, Redcats, and Shop Direct. Not all of these offer agency mail order. Mail order retailers were clear that they compete primarily on the retail offering, with the credit facility being an enabler of additional retail sales (especially in cases where potential customers would otherwise have no access to alternative forms of credit).
- 7.26 We carried out a price-comparison exercise on a sample of products, and found that the retail prices charged by (some) mail order companies are higher than the cost charged by mainstream high-street retailers.
- As a result of this pricing, the short term finance options available to AMO customers imply very high APR, compared to high street cash

prices. In the case of electronic products and appliances, consumers buying from two mail order companies can easily face three-digit figures (APR from around 100 per cent up to 400 per cent) when buying with shorter-term credit products often marketed as 'interest free'.

- In the case of clothing products, results are not clear-cut (probably a result of the very limited sample of comparable product): in general, APR for clothing products are much smaller than for electronic products, and in several of the cases examined low also in absolute terms.

7.27 Customers may be unaware of the price premium being charged if they are not particularly mobile or if they do not bother to shop around. This may be because they know they cannot afford the cheaper product because they do not have the funds available to buy it outright, or cannot satisfy the stricter lending requirements set by high-street retailers.

7.28 Many customers may be confused, being unable to compare the higher cash price and interest repayment free period against an explicit credit offer on a lower retail price. Our experiment showed that Total Repayment Amount (TRA)¹⁰⁵ is more meaningful than APR.¹⁰⁶

Profitability

7.29 Data from firms in our sample indicates a mixed picture on profitability. A minority of firms earned returns in excess of WACC in certain years, while the remainder earned returns below WACC or made losses in each year during the period 2004-08. In general, established providers of retail

¹⁰⁵ Principal borrowed plus interest payable and other charges, if applicable.

¹⁰⁶ OFT, Annexe A, A report prepared for the OFT by Dr Stephen Woodcock and Dr Benny Cheung at Decision Technology Ltd, Consumers decisions, information and understanding – A behavioural economics perspective, April 2010.

credit appear to be less profitable than established providers of other types of high cost credit.

- 7.30 We speculate that this is related to the price premium issue outlined above. Some firms providing retail credit may be run primarily to support associated businesses that supply goods to customers. Such firms may therefore charge prices that are not sufficient to cover the costs (including cost of capital) that are involved in providing retail credit.
- 7.31 Given these complications, levels of profits may not in themselves be a good indication of the level of competition in the retail credit sector. Further work in this area would need to examine the overall profitability of the good and the finance used to purchase it.

Barriers to entry

- 7.32 The costs of entry are similar to those faced by any other high-street retailer. Set up costs for a new rent-to-buy store include investment in stock of around £200,000, training costs for new staff of around £25,000¹⁰⁷ and cash-flow of around £350,000. The cost of the lease will vary with the area in which the store is located, and high-street rental costs are likely to be high for prime retail sites. Retail leases are generally for a period of five to ten years, with the lessee liable to pay rent even if the business folds and this represents a barrier to entry, but one which is faced by all retailers.
- 7.33 Both buy-to-rent retailers that we considered are expanding the number of stores that they operate. The business model of buy-to-rent is based on the North American concept of 'rent-to-own' and one respondent

¹⁰⁷ Staff costs are higher because they need to understand the credit licensing arrangements and legal requirements.

believed that the two biggest North American retailers could, if conditions were right, enter the UK market.¹⁰⁸

Conclusions

- 7.34 Retailers offering credit often advertise these facilities as interest-free or at relatively low APR (for example, 29.9 per cent APR) but this can be misleading since it does not take into account that the bundled price may already include a premium (compared to high-street prices) related to the provision of credit. The possibility for suppliers to allocate the cost of credit either (implicitly) to the retail price or (explicitly) to the APR figure may lead consumers to make a suboptimal choice, if they focus on the explicit cost of credit offered.
- 7.35 This is particularly a risk for customers who have high search cost (for example, customers of mail order companies tend to be less mobile) or consumers with low levels of financial literacy, who may not be aware of cheaper alternatives or may struggle to compare offers with different pricing structures.

¹⁰⁸ Best Buy (a consumer electronics retailer) has recently announced plans to enter the UK market in competition with high-street retailers such as Curry's and Comet.

8 PRICING LEVELS AND CHANGES IN PRICING

Price competition

- 8.1 In many markets, consumers are very conscious of price variations and will shop around for the cheapest product.
- 8.2 In some markets, particularly where the product is complex and the consumer has imperfect knowledge about their intended usage of the product, price comparisons are considerably more difficult to undertake. This makes accurate and realistic price comparisons for complex products challenging.
- 8.3 Complex products may take time to understand before two products can be compared and this might raise the search costs. Comparison of loans requires similar quality standards to avoid examining non-comparable products.
- 8.4 Where loans differ in length, or where there is a risk that different charges may apply, it is very difficult to estimate how much one might pay overall with different products, even for the most financially literate consumers.
- 8.5 Financial services are often complex products and there is an information asymmetry between the seller and the buyer: a survey from the FSA showed that only one in two people buying a financial product had read the terms and conditions in detail, and that in nine per cent of cases these had not be read at all.¹⁰⁹ In some cases, products are sold by agents or brokers (who may be on commission from a particular seller) and this may make it more difficult for customers to know what they are buying and what the real price of that product is.

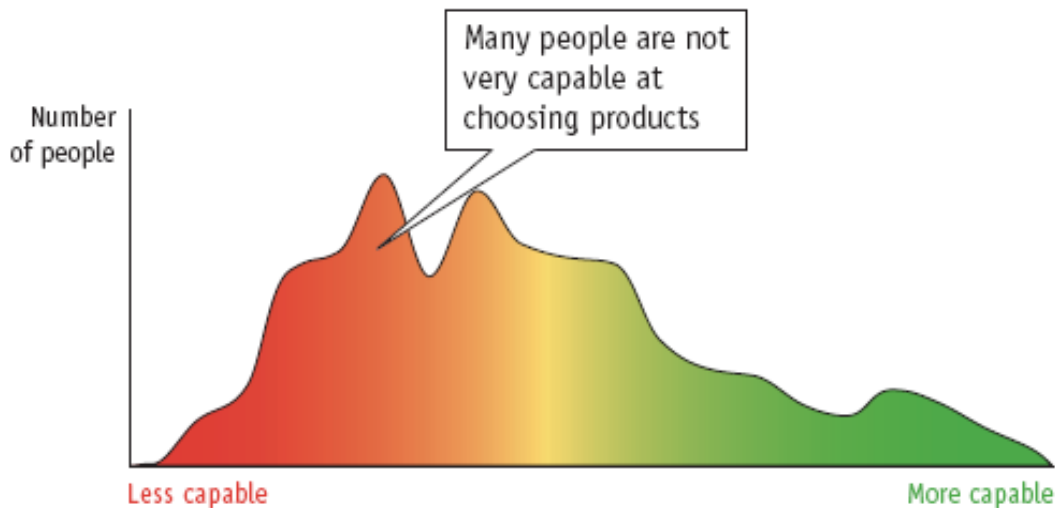
¹⁰⁹ Financial Services Authority, Levels of Financial Capability in the UK: Results of a baseline survey, March 2006.

Inelasticity of demand

- 8.6 Customers requiring credit may be unconcerned about the cost of that credit if the need is urgent. For people on low incomes, the key factors they consider are the affordability of the loan repayments as well as the ability to obtain credit quickly, rather than the absolute or total cost of that loan. Our survey showed for example, that quick arrangement times and the affordability of low weekly payments are the two main features that users like about home credit, rent-to-buy and other credit products.¹¹⁰
- 8.7 People might also consider the opportunity cost of not taking out the loan. So, for example, a large family which needs a new washing machine may consider the cost of going to the laundry each week against the instalments required if the product is purchased on a rent-to-buy contract or if they borrow from a home credit supplier.

¹¹⁰ See Annexe A from the Interim Research Report on high-cost credit, p.42-43. Please note that other credit products includes responses for Payday loans, Logbook loans, Mobile phone loans by text, Pawnbroker loan, Credit union loan, Personal loan from impaired credit supplier.

Figure 1.1: Consumers' ability to choose suitable products



Source: FSA 2006.

8.8 Consumer apathy in considering alternative options may explain why borrowers often stick with the same financial supplier. For example, the OFT's market study on personal current accounts found that 64 per cent of surveyed customers had never switched their account and 74 per cent of these had not even considered switching.¹¹¹

8.9 However, it is worrying that consumers are not bothering to compare the price of alternative financial products since it means that some suppliers will be able to charge higher prices without those borrowers even considering switching to other suppliers. The potential for and ability for consumers to switch are key elements for competition since they allow firms to compete against each other in the process of rivalry to win consumers.

¹¹¹ OFT, Personal Current Accounts in the UK – An OFT market study, July 2008, p. 32. Additional research on switching can be found in the OFT's Annexe D: Personal Current Account Consumer Research and Annexe E: The Psychology of Personal Current Accounts.

Information provision requirements

- 8.10 Legislation is intended to protect consumers of credit from failings or inadequacies in information provision. Annexe D of our interim research report¹¹² sets out the principal legislation governing consumer credit in the UK.
- 8.11 The consumer credit regime lays down rules governing credit advertising and the provision of pre-contractual, contractual and post-contractual information. The regime consists of the principal Consumer Credit Acts of 1974 and 2006, supported by supplementary secondary legislation (regulations).
- 8.12 On credit advertising, the Consumer Credit Act 1974 (CCA 1974) lays down rules governing advertisements for consumer credit or credit brokerage. The relevant supporting regulations are the Consumer Credit (Advertisements) Regulations 2004,¹¹³ as amended in 2004¹¹⁴ and 2007.¹¹⁵
- 8.13 On pre-contractual information, the CCA 1974, as amended by the Consumer Credit Act 2006 (CCA 2006), lays down rules requiring information to be given to borrowers or hirers before entry into a consumer credit or hire agreement. For agreements entered into following face-to-face discussions, the relevant regulations are the Consumer Credit (Disclosure of Information) Regulations 2004.¹¹⁶ If the agreement was entered into at a distance, without face-to-face contact

¹¹² See Annexe D from the Interim Research Report on high-cost credit.

¹¹³ www.opsi.gov.uk/si/si2004/20041484.htm

¹¹⁴ www.opsi.gov.uk/SI/si2004/20042619.htm

¹¹⁵ www.opsi.gov.uk/si/si2007/uksi_20070827_en_1

¹¹⁶ www.opsi.gov.uk/si/si2004/20041481.htm

between the parties, the relevant regulations are the Financial Services (Distance Marketing) Regulations 2004¹¹⁷ made by HM Treasury.

- 8.14 On contractual information, the CCA 1974 lays down rules about how consumer credit agreements and consumer hire agreements must be documented. The detailed rules on the documentation of agreements are set out in the Consumer Credit (Agreements) Regulations 1983, as amended in 2004.¹¹⁸
- 8.15 On post-contractual information, the CCA 1974 lays down rules requiring information to be given to borrowers or hirers during the lifetime of a regulated consumer credit agreement or consumer hire agreement. The requirements were as a result of changes in the CCA 2006, and implemented by the Consumer Credit (Information Requirements and Duration of Licenses and Charges) Regulations 2007¹¹⁹ (as amended in 2008¹²⁰).
- 8.16 Consumer credit legislation is undergoing reform, as the UK implements the Consumer Credit Directive (CCD).¹²¹ This is a maximum harmonisation directive which seeks to harmonise key aspects of consumer credit laws within Europe. The Directive will be implemented in the UK by five sets of regulations. The principal regulations, made under the European Communities Act 1972, will make various amendments to the CCA 1974 and its existing supporting regulations. Four further new regulations will focus on credit advertising, pre-contractual information, credit agreements (contractual information) and

¹¹⁷ www.opsi.gov.uk/si/si2004/20042095.htm

¹¹⁸ www.opsi.gov.uk/si/si2004/20041482.htm

¹¹⁹ www.opsi.gov.uk/si/si2007/uksi_20071167_en_1

¹²⁰ www.opsi.gov.uk/si/si2008/uksi_20081751_en_1

¹²¹ Directive 2008/48/EEC. See:
<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2008:133:0066:0092:EN:PDF>

the calculation of TCC and APR. Section 5 of Annexe D to our interim report of December 2009 gives an overview of the main changes flowing from the CCD implementation.

- 8.17 The five CCD implementing regulations were laid before Parliament on 30th March 2010, and are available to view on the OPSI website. Links to the regulations and to the accompanying Explanatory Notes are given below.
- 8.18 The Consumer Credit (EU Directive) Regulations 2010¹²² implement the CCD¹²³ by inserting provisions into the CCA 1974 and by making amendments to the existing supporting regulations of the CCA regime.
- 8.19 The Consumer Credit (Advertisements) Regulations 2010¹²⁴ implement article 4 of the CCD and impose requirements concerning the form and content of advertisements that relate to the provision of credit.
- 8.20 The Consumer Credit (Disclosure of Information) Regulations 2010¹²⁵ implement paragraphs 1 to 5 of article 5 of the CCD and set out the pre-contractual information which is required to be disclosed to a debtor in good time before an agreement is entered into, and the information requirements in relation to agreements made over the telephone. The Regulations also implement the pre-contractual information requirements of Directive 2002/65/EC¹²⁶ (concerning the distance marketing of consumer financial services).

¹²² www.opsi.gov.uk/si/si2010/uksi_20101010_en_1

¹²³ Except for article 4, paragraphs 1 to 5 of article 5, article 10 and article 9, which are implemented by the further four new regulations as detailed below.

¹²⁴ www.opsi.gov.uk/si/si2010/uksi_20101012_en_1

¹²⁵ www.opsi.gov.uk/si/si2010/uksi_20101013_en_1

¹²⁶ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2002:271:0016:0024:EN:PDF>

- 8.21 The Consumer Credit (Agreements) Regulations 2010¹²⁷ implement article 10 of the CCD and impose requirements about what information has to be included in a regulated consumer credit agreement.
- 8.22 The Consumer Credit (Total Charge for Credit) Regulations 2010¹²⁸ implement article 19 of the CCD and set out the basis on which APR and TCC must be calculated for the purpose of an actual or prospective regulated consumer credit agreement.

Annual Percentage Rates

- 8.23 Consumers may face further problems where they do not understand the paperwork they are given by suppliers, or are easily confused by the information provided.
- 8.24 Comparing the cost of any range of different credit products is difficult, because of their various different characteristics (including the duration of the loan, the interest rates and other borrowing fees payable). For this reason, the APR must be included in credit agreements and pre-contractual information. A typical APR must be included in most credit advertisements.¹²⁹ This is intended to help consumers to compare the cost of different credit deals.
- 8.25 The APR is based on the TCC which includes interest and other charges which affect the cost of borrowing. The APR is an annualised rate reflecting the timing of such charges, as well as the rates and amounts.

¹²⁷ www.opsi.gov.uk/si/si2010/uksi_20101014_en_1

¹²⁸ www.opsi.gov.uk/si/si2010/uksi_20101011_en_1

¹²⁹ www.ofc.gov.uk/advice_and_resources/resource_base/legal/cca/apr##

8.26 The rules for the calculation of the TCC and APR are set out in the Consumer Credit (Total Charge for Credit) Regulations 1980.¹³⁰ These include a number of assumptions which must be used where information is unknown or cannot be calculated accurately.

8.27 High-cost credit loans for small amounts over relatively short periods of time can have significant impacts on the APRs. Short term loans with high cost relative to the value may see very high APRs that are not representative of the cost of the product. Equally, comparing loans of different duration and cost can affect the simplicity of using the APR as a cost measure. It is not clear that borrowers fully appreciate these subtleties of the APR calculation when comparing different products. The following table illustrates the issue with respect to a sample of different high-cost credit products.

Table 8.1: Comparison of TCC and APR by product

Company/ product	Length of loan	TCC (cost per £100)	APR
High-street payday loan A	< 28 days	£12.00	338%
High-street payday loan B	< 28 days	£17.92	765%
High street payday loan C	< 28 days	£20.48	977%
Online payday loan D	< 28 days	£24.85	1,734%
Online payday loan E	< 28 days	£34.14	4,438%
High-street pawn-broker F	6 months	£42.00	116%
High-street pawn-broker G	6 months	£48.06	119%
Home credit supplier H	57 weeks	£71.00	189.2%
Home credit supplier J	41 weeks	£64.00	281%
Home credit supplier K	34 weeks	£70.00	469.8%
Home credit supplier L	32 weeks	£60.00	399.7%

Source: Submissions to the OFT review of high-cost credit

¹³⁰ The CCD, as implemented by The Consumer Credit (Total Charge for Credit) Regulations 2010, introduces a new method of calculation of APR to be used by lenders. The new formula has a mathematical effect identical to the current UK formula

8.28 Penalty and default charges are not included in the TCC and APR. Therefore, customers defaulting on a loan may be hit with costs that they may not have been fully aware of at the time they took out the loan.¹³¹

Price competition between lenders

8.29 In general, we found that price is not considered as one of the main drivers of competition for the specialist credit products we focused on. However, this does not apply uniformly to all products, as we discuss below.

8.30 There is evidence of some price competition among suppliers of payday loans. For example, we noted some degree of price dispersion in our sample, leading to levels of profitability generally in line with (or slightly above) the normal level, and different across lenders.¹³² We also noted that several new entrants undercut the price of incumbent lenders in order to gain market shares. However, we are not aware of any lender that has attempted to gain competitive advantage by moving away from the established pricing model, which is not cost reflective.

8.31 Online payday loans are priced at a premium, compared to high-street loans. Payday lenders claim that this is to reflect the additional level of service and convenience offered, as well as higher lending costs (in

¹³¹ Any charge payable to the lender as a result of a failure by the borrower to carry out his obligations under the credit agreement does not form part of the TCC. For example, if the agreement levies charges for late repayments or for the sending of reminder letters, these are not included in the TCC. There are common law rules on penalties which may invalidate penalty charges if they are excessive (that is, if they are more than a reasonable pre-estimate of the lender's costs resulting from the default). Also, the provisions of the Consumer Credit Act 1974 invalidate any term which levies interest on arrears at a higher rate than the interest payable under the credit agreement.

¹³² Please see the chapter on profitability (below) for more details. With the term normal profitability we refer here to a level of (accounting) profits that is in line with the weighted average cost of the capital employed, as an approximation of the concept of normal (economic) profits that would emerge in a competitive market.

terms of higher risk of fraud and difficulties of assessing customer's creditworthiness remotely).

- 8.32 One online payday lender offers bespoke terms to its customers, relying on their personal and credit history to assess the risk to the lender and thus the cost of the loan to the customer.
- 8.33 There is less evidence of price competition in pawnbroking. Analysis of our sample of pawnbrokers found that price dispersion is limited, and prices have been stable over the past five year at a level that has generated profits consistently in excess of the cost of capital,¹³³ and despite changes in underlying drivers of cost (for example, the cost of wholesale funding).
- 8.34 The structure of the home credit sector, with one leading supplier means that the home credit market is less competitive. Suppliers are likely to be following the prices of the lead supplier. In our sample we found instances of lenders matching each other's APR on loans with the same repayment period.¹³⁴ However, there are also introductory offers for new customers and rehabilitation loans for customers who have got into financial difficulties.
- 8.35 Across the spectrum of the products we focused on, customers are often able, through repeat business, to improve their credit record with one supplier to get more advantageous terms, by representing a lower risk, through repaying on time with the loans they take out. Some suppliers may also offer special introductory conditions to new customers, or rewards to customers who recommend a friend (provided the latter takes up a payday loan).¹³⁵

¹³³ See Chapter 10 for details.

¹³⁴ For example, three lenders offered a 30 week loan with 399.7 per cent APR (more precisely, 399.0 per cent for one of them). Similarly, three suppliers offered 52 week home credit loans with 254.5 per cent APR.

¹³⁵ See for example: www.harveyandthompson.com/pawnbroker_shops_payday_advances.htm

Conclusions

8.36 We consider that there is some price competition in the payday lending sector, particularly between high-street lenders but also between the high-street and online lenders, while only to a lesser extent in the pawnbroking sector. In the home credit market there is little difference between the APR charged by home credit suppliers for loans of comparable length, although there is some difference in the length of the loan term.

9 NON-PRICE COMPETITION

Introduction

- 9.1 Where the product being supplied is standardised,¹³⁶ competition is generally focused on price, with firms competing to supply their customers with a cheaper product. However, where there are perceived (or actual) differences in the product or service, competition might be focused on factors other than price, such as the speed of delivery, customer service, or quality of the product. Such competition is sometimes referred to as non-price competition.
- 9.2 Some of the types of non-price competition observed in the high-cost credit sector are discussed in this chapter.

Customer service

- 9.3 Customer service is a key feature on which suppliers of high-cost credit stated that they compete. Our sample of suppliers told us that they thought this aspect very important, and that they focused on making the borrowing process as simple as possible, and in offering products that were easily understood by consumers.
- 9.4 Payday lenders and pawn-brokers compete on price and customer service, by:
- developing simple products
 - investing in staff training (including the selection of staff whose demographics and language skills reflected those of the firm's borrowers), and
 - developing a good reputation to build trust with their customers.

¹³⁶ Such products are often referred to as being homogeneous.

- 9.5 The CC found that customer satisfaction for home credit customers was high,¹³⁷ and many lenders appear to have a high level of repeat business. This appears to be the case across the high-cost credit sector: for example, H&T (a pawn-broker and payday lender) undertook a detailed survey of 250 of its customers in December 2006 and found that 88 per cent rated their satisfaction with H&T as being eight or more out of ten.¹³⁸ According to the British Cheque & Credit Association (BCCA) 'the majority of [payday loan] customers trust and like the product'.¹³⁹ We also note that there are few complaints related to high cost credit products in front of the Financial Ombudsman Service (FOS),¹⁴⁰ although this may be due to the existence of sector-specific schemes: for example, since the launch of the BCCA's own two-step complaints in 2008 not a single complaint has gone to the FOS.¹⁴¹
- 9.6 Some lenders offer preferential terms for new customers, which may be particularly attractive to customers with few other options.
- 9.7 In the US, there has been particular concern about the practices of payday lenders which has led some states to impose measures such as strict criteria on lending and roll-overs. On the whole, our review found little evidence of significant problems in this area.

¹³⁷ Competition Commission, Home Credit Market Investigation, paragraphs 3.160-3.164, 30 November 2006.

¹³⁸ www.harveyandthompson.com/HandT_media_our_customers.htm

¹³⁹ Credit Today, Payday Loans: Sign of the times, January 2010, p.34.

¹⁴⁰ In an effort to persuade companies to improve their complaint handling, the FOS began publishing details of companies with 30 or more new or closed cases in a six-month period. www.ombudsman-complaints-data.org.uk/

¹⁴¹ Credit Today, Payday Loans: Sign of the times, January 2010, p.34.

Administrative processes

- 9.8 For many borrowers, the speed in which the application is processed is important, since they have an urgent need for money. Some lenders have advertised that they do not undertake credit reference checks, which may imply an easier and quicker process, while others have stated that loans with them will not affect a consumers' credit rating. This is aimed to make the loan offer more attractive to potential borrowers.
- 9.9 The lender may invest heavily in its own systems to ensure that the experience for the borrower is as easy and as quick as possible. This may include giving customers an identity card to facilitate the administrative process and identification.¹⁴² These cards are similar to credit cards and may give the borrower kudos as well as providing them with a means of identification.¹⁴³

Agent-borrower relationships

- 9.10 Good customer service improves the relationship between the lender and the borrower. People value good service and will return to a supplier that provides it, and this can make customers rather reluctant to switch to competing lenders, irrespective of the service they may receive from such other lenders.
- 9.11 Customer switching is low, as the CC found when it investigated home credit in 2006.¹⁴⁴ In part, this is because of the time spent by suppliers

¹⁴² Nicola Dominy and Elaine Kempson, Pay Day Advances: The companies and their customers, Personal Finance Research Centre, 2003, p. 5.

¹⁴³ Some lenders also offer pre-paid cards – for example, The Money Shop's Titanium card – which may allow people with low incomes to enjoy some of the benefits associated with mainstream credit cards.

¹⁴⁴ Competition Commission, Home Credit Market Investigation, November 2006, paragraph 3.173.

to ensure they give their customers good service and the products they want.

- 9.12 Few high-cost lenders impose penal terms when the loan is not paid off on time. This is a particularly valued feature of home credit loans, whose users may find even a small weekly repayment difficult to find. Such flexibility in payment terms benefits borrowers in the short term, however, by building up such a close relationship between the lender (via the local agent) and the borrower, it may lead to fewer consumers searching for (and switching to) better deals. A further medium-term effect of this flexibility is that consumers are not educated about financial discipline, potentially preventing them from borrowing from (lower-cost) mainstream lenders, which generally impose penalties on late payments and default.
- 9.13 Many high-cost credit agreements require weekly payments to be made and this provides an opportunity for the lender to build close relationships with its customers. This may be beneficial or detrimental: beneficial if it means the lender is better able to assess the credit risk of the customer, detrimental if the customer believes that they need to keep borrowing money to maintain the relationship that has developed.
- 9.14 In home credit agreements, the agent is often a friend or relative of the borrower and this may be a worry because neither the agent nor the borrower will be making a completely independent decision about the loan taken out. In an unhealthy relationship, the agent may persuade their friend/ relative to take a loan that they do not really need.

Brand identity and proliferation

- 9.15 We have found that high cost specialist lenders, like many other firms in other retail markets, place a great value on brand recognition and brand loyalty. Consumers value brands as a way to see which lenders to trust in a market, hence a well established brand gives potential customers reassurance about the business credibility of the lender. Brand loyalty is also encouraged as it not only generates repeat business, but it also improves the risk profile of the customer base.

9.16 However, we observed that some online lenders pursued a multi-brand strategy, which may indicate that at present the value of a recognised online brand is not as crucial as having multiple entries in the result page of a search engine or a lead generator website.

High-street lenders

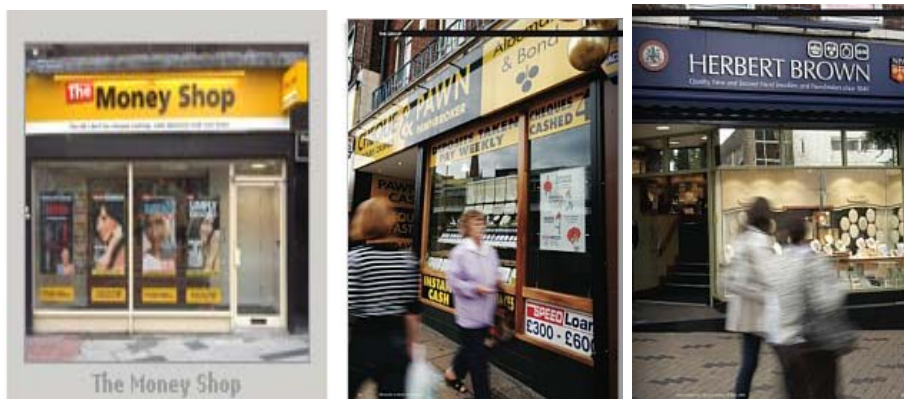
9.17 Each firm has its own brand and identity which is intended to appeal to a particular customer group, although some companies operate under multiple brands.

9.18 For shops on the high-street, the brand may be reflected in the shop-front appearance:

- The Money Shop has an appearance similar to a building society.
- Albemarle and Bond has two distinct brands within its corporate group:
 - the Albemarle & Bond image is bright yellow and may appeal to sub-prime customers, while
 - the Herbert Brown image is muted and the shop appears to be a jewellery shop, albeit one that offers pawnbroking, and this may appeal to mainstream customers.

9.19 These three brand images are illustrated below:

Figure 9.1: Shop-front brands



Source: www.moneyshop.tv and Albemarle and Bond Annual Report 2009.

Online lenders

- 9.20 While it is relatively easy to distinguish between different high-cost suppliers in their high-street shops, the situation online is quite different, especially for payday lenders.
- 9.21 A search online for UK payday lenders reveals a multitude of sites and, one might believe, suppliers offering payday loans. This gives the impression that there are significant numbers of online lenders. In reality however, there are two large lenders, some smaller lenders, and a proliferation of brand names and lead generators.
- 9.22 One of the biggest online payday lenders, Month End Money Consumer Finance (MEM), uses a number of brands, the most successful of which is Payday UK. Potential borrowers can read the terms and conditions on websites to see who the ultimate supplier of the loan is, but the presence of lead generators¹⁴⁵ means that it is not always clear who is providing the loan.
- 9.23 Another significant lender, QuickQuid, is owned by a US parent and operates under one brand only, indicating that its strategy is to focus on one brand rather than a number of them.
- 9.24 As noted at the beginning of this chapter, firms invest in brand names and identities and there is nothing wrong with developing different brands for different target customers. Indeed, many mainstream banks and insurance companies offer products under different brands.

¹⁴⁵ Lead generators are companies who set up websites offering payday loans. Potential borrowers fill in forms, and the lead generators then sell these applications to payday lenders. We believe that a successful lead will generate a payment of around £80 (regardless of the sum borrowed by the borrower) from the payday lender to the lead generator. We also believe that lead generators, as credit brokers, should be licensed under the Consumer Credit Act, and will take action where we find that lead generators are not so licensed.

- 9.25 Brand proliferation becomes a problem only where the customer does not understand that the products they are comparing are actually provided by the same (ultimate) supplier. It also increases search costs to consumer, who will have to put further search efforts in order to find alternative suppliers. Hence, because of brand proliferation there is less competition in the market than there appears to be at first sight.
- 9.26 The presence of lead generators and multiple brand offerings by some suppliers means that the OFT has some concerns about the level of actual competition in the online payday market.

Innovation

- 9.27 We noted earlier that high-cost lenders are focused on their customers, and this extends to innovation in new products. To an extent this innovation is limited. However we have found evidence that high-cost lenders do:
- vary the types of products they offer
 - offer different lengths of the term of the loan
 - vary the interest payable (particularly for known customers who represent a lower risk)
 - vary the fees and charges payable, and
 - vary the default terms should the customer be unable to repay their loan on time.
 - In addition, some online suppliers of pawnbroking have been seeking to make this easier, by offering an appraisal and loan by post.
- 9.28 As is common in many other retail businesses, information on customers might also be used to cross-sell other products that the company offers. This may be seen through suppliers offering consumers larger loans, or loans of a different type or over a different period of time to suit their changing needs.

Conclusions

- 9.29 In the main, high-cost credit suppliers are retailers of short term, small sum loans, and in common with many other retailers, will engage in non-price competition by trying to provide better customer service than their competitors, brands that their customers identify with better, better locations on the high-street, and innovation in products and services.

10 PROFITABILITY

Introduction

- 10.1 Financial analysis can give an indication of the level of competition in an industry, through considering the level of profitability. In general competition would be expected to reduce profits to a normal level as any instances of high profitability in the absence of barriers to entry should encourage new entry, leading to increased competition.¹⁴⁶ Evidence of high profitability, could suggest lower levels of competition, possibly pointing to competition not working effectively.
- 10.2 Suppliers in our sample of high cost credit providers were asked to provide financial data, with the intention of using this data to derive the most appropriate measure of profitability.¹⁴⁷ Due to issues arising with this data, which are explained in more detail below, we also made use of published annual accounts to clarify or supplement data provided by suppliers.
- 10.3 This chapter covers:
- a number of measures of profitability, how they can be benchmarked to indicate whether profits are high and the preferred measure
 - the methodology used in this investigation and how it was applied in practice
 - issues arising and practical limitations encountered and
 - the implications for our analysis.

¹⁴⁶ References to normal profits mean profits in line with the return required by investors, while high profits means returns above this level.

¹⁴⁷ We collected detailed financial data from suppliers operating in the pay day lending, pawnbroking, home credit and retail credit markets. Credit unions were not asked to provide this financial data, as we wished to minimise the reporting requirement for these organisations.

Alternative Measures of Profitability

10.4 There are a number of measures of profitability that could be used. We consider briefly four possibilities below:

Table 10.1 Financial metrics and their calculation

ROE	Return on equity	Profit before tax / Shareholder funds ¹⁴⁸
ROCE	Return on capital employed	Profit before interest and tax (PBIT) / (Shareholder funds + long term debt)
ROA	Return on assets	PBIT / Total assets
IRR	Internal rate of return	In a discounted cash flow model the IRR is the annual discount rate that would discount future income streams to the value of the initial investment.

- 10.5 The internal rate of return has the disadvantage that it relies on estimates of uncertain future income and cost streams. It would be practically difficult to ensure that any estimates provided were consistent between suppliers, while requesting this information would place a considerable burden on those suppliers responding to data requests. This measure was consequently excluded from our data request and subsequent analysis.
- 10.6 In contrast, ROE, ROCE and ROA could all be calculated using historical data, making data gathering easier for suppliers, and they are commonly used and understood measures of profitability.
- 10.7 An important part of profitability analysis is being able to benchmark levels of profitability to determine whether profits are high or low, so the availability of benchmarks was also considered.

¹⁴⁸ Shareholder funds includes both capital originally invested by shareholders, and reserves (including profits retained by the company rather than paid out as dividends to shareholders)

- 10.8 ROE is a measure of the supplier's profitability compared with its shareholder funds. ROE could be benchmarked against the cost of equity, a measure of the return expected by shareholders.¹⁴⁹ To attract equity investment a supplier must usually earn shareholder returns at least in line with the cost of equity. In a perfectly competitive market we would expect to see companies making profits in line with this minimum level of required return, as any excess would eventually be competed away.
- 10.9 ROCE considers a supplier's profitability compared with all of the capital invested in the business whether as equity or from long term borrowing. A supplier's ROCE could therefore be benchmarked against the expected return of all its equity investors and long-term lenders. This benchmark, called the weighted average cost of capital (WACC), is an average of the returns expected by each group.¹⁵⁰
- 10.10 ROA is a measure of the supplier's profitability compared with its total assets, linking its earnings to the size of its balance sheet. While this is a useful way of getting a relative measure of profitability, it is more difficult to benchmark, since it is not possible to determine a normal level of return in the same way as for ROE and ROCE. Consequently, this measure was not the focus of our analysis.
- 10.11 ROE and ROCE both measure relative profitability and can be more easily benchmarked than other measures. However ROCE measures profits relative to all long term financing (long term debt and shareholder funds) whereas ROE only measures profits against equity (shareholder funds). As a supplier can choose to use different combinations of equity or debt for finance, this could lead to differences in the ROE reported.

¹⁴⁹ A supplier's cost of equity may be calculated in a number of ways, for example using the Capital Asset Pricing Model, which takes account of factors including the volatility of a traded company's share price compared with that of the market as a whole.

¹⁵⁰ For example, if a supplier has £1m of equity funding with a cost of equity of 12 per cent, and £3m of long term debt funding with a cost of debt of 8 per cent, its WACC is $((£1m * 12 \text{ per cent}) + (£3m * 8 \text{ per cent})) / (£1m + £3m) = 9 \text{ per cent}$.

10.12 To avoid a possible distortion due to the supplier's financing decision, our profitability analysis has focussed on ROCE. This is similar to the position taken by the Competition Commission in its profitability analysis of the home credit market,¹⁵¹ when it chose to use ROCE because this was a commonly calculated ratio, which placed a lower regulatory burden on respondents and was less affected by corporate financing decisions than some other measures.

Methodology

10.13 Our data request to companies asked them to supply details of revenue and costs for products considered in the study as well as for the debt and equity attributable to those parts of their business.

10.14 This exercise was relatively straightforward for companies that only operated in one product market, as this would be expected to align with information in their annual reports. However suppliers that offered more than one high cost credit product, or provided the product only as part of their wider business, were asked to submit only the cost, revenue and capital attributable to high cost credit.

10.15 Each supplier was asked to provide the data for the five financial years ending between 2004 and 2008 inclusive, to reduce the effect of any exceptional results in one or two years.

10.16 Some suppliers did not trade throughout the period 2004-08. For these suppliers we examined data from the years during which the supplier did trade and for which financial information was available.

10.17 Several suppliers in the OFT's sample provided estimates of their WACC. Estimates from those suppliers that provided justification for their figures ranged from 8-11 per cent. In the absence of detailed information on the cost of capital for each supplier in the sample, we have used the upper

¹⁵¹ 'Home credit market investigation', 30 November 2006, paragraphs 3.68-3.70

end of this range as a conservative estimate of the cost of capital faced by all the suppliers in this study.

Issues arising from the data submissions

Suppliers operating in more than one product market

- 10.18 As discussed in chapters 3-7 we have looked at different types of high cost credit separately and we were consequently interested in the trends within the individual product markets of pawnbroking, payday lending, home credit and retail credit.
- 10.19 However while some suppliers operated in several markets, the information we received was sometimes provided on a company basis rather than on a product-specific basis. In other cases, while revenue and costs were split between products, suppliers did not attribute capital between different products.
- 10.20 Such allocation issues are common when attempting to calculate the profitability of one part of a company. It may be relatively easy for a supplier to determine which parts of its revenue come from individual products. However it can be more difficult to determine which costs relate to which product, particularly where there is a high proportion of shared costs that relate to more than one product. Similarly, it may be difficult to allocate capital employed between different products.¹⁵²
- 10.21 Where this was an issue, the combined position across all products was used in the analysis for each product market in which the supplier operated. In assessing profitability for each product type, we therefore

¹⁵² We note that a similar issue may arise when considering suppliers that are part of a wider group. The amount of capital allocated by the parent to the subsidiary is a notional amount that may not reflect the suppliers' actual funding needs. For suppliers in this position, where annual accounts were available, we took the sum of intra-group loans and accounting equity as a proxy for capital employed. We have taken a cautious approach when interpreting the results of this analysis, to reflect the potential inaccuracies in this approach.

placed greater reliance on the results for suppliers providing only one product than for those providing several.

Limited number of data sets

- 10.22 The small data set meant that we were able to place only limited reliance on differences observed between providers of different high cost credit products, or on apparent trends over time. In addition, when comparing ROCE against WACC, we needed to observe a substantial disparity before being able to conclude that returns were significantly higher or lower than WACC.
- 10.23 The data limitations indicate a potentially wide margin of error so a significant disparity between ROCE and WACC would need to be observed before we would have confidence that those profits were excessive.

Reporting of capital

- 10.24 A further complication was determining the amount of loan capital to be included within the capital base. Data on interest costs provided by suppliers did not generally separate between interest relating to long-term borrowing and shorter-term funding. While we would have preferred to exclude from the ROCE calculation short term borrowing with its related interest, where this was used to fund lending rather than to provide long-term financing, it was not possible to do this consistently.
- 10.25 Consequently, we included all borrowing within the capital base, while using the PBIT figure before deduction of any interest on short-term or long-term debt. The effect of this methodology would be to increase the amount of capital used in the ROCE calculation, which may have reduced ROCE compared with a measure that excluded short-term funding, particularly for a supplier with greater reliance on shorter term funding.

Data Quality

10.26 As part of our review of the accuracy of the data submissions and as a reasonableness check we compared the submissions with published results for a number of the companies. Where we considered that it would improve the accuracy of our analysis, we substituted published data for the information provided to us by suppliers.

Implications for the OFT's analysis

10.27 Our analysis made use of the best available data on the profitability of suppliers in the OFT's sample of high cost credit providers. However, due to the data issues outlined above we have been able to draw only relatively limited conclusions regarding the differences between high cost credit products, trends over time, or the relationship between ROCE and WACC for providers of each product.

10.28 The results of our analysis are set out in the profitability sections of chapters 3-5 and chapter 7 of this Annexe.

11 BARRIERS TO ENTRY

Introduction

- 11.1 Incumbent firms may be able to maintain high prices and high profits if prospective competitors are unable to enter the market and compete on equal terms. A competition assessment needs to consider actual and potential competitors and the barriers to entry faced by potential competitors.
- 11.2 Barriers to entry may be absolute or strategic. Absolute barriers may include a licensing process that regulates the access of perspective licensed lenders in the market. Strategic barriers include such things as high expenditure on advertising to make consumers aware of the new entrant's product or service, customer loyalty, or cost disadvantages (for example, related to available shop locations or higher cost of business acquisition).
- 11.3 Entry which is sustained can provide evidence that markets are contestable. Actual or potential entry in contestable markets may prevent existing players from exploiting market power and could hence drive down profit to competitive level (potentially forcing less efficient firms out of the market. For this reason, incumbent firms may have an incentive to try to raise barriers to entry
- 11.4 In this chapter, we consider some of the potential barriers to entry faced by new entrants to the high-cost credit markets, and assess the significance of those barriers and their impact on competition.

OFT functions in consumer credit licensing

- 11.5 Under the Consumer Credit Act 1974 (as amended), the OFT has responsibilities for consumer protection in relation to consumer credit activities, including the provision of high-cost credit. It issues licences to businesses but will refuse or revoke licences where businesses are not assessed as fit – with regard to integrity and/or competence. It can also

impose requirements, positive or negative, to ensure maintenance of standards of trading and conduct.

- 11.6 The law requires that a licence is required to carry on a consumer credit business.¹⁵³ Standard licenses may be issued to a named individual, a partnership or a corporate entity, but are not assignable (that is, they cannot be transferred to another person or legal person). This is because the application process considers all the individuals who will be running (or associated with) the company to be licensed and their previous financial history (bankruptcy and disqualification provisions, criminal records, etc.). Initially licences were issued for a period of five years, but they are now issued for an indefinite period¹⁵⁴ (there is however a five-year payment period (so that licensees are required to pay the fees due every five years).
- 11.7 Applicants are required to complete an application form for a licence, and must pay a nominal fee.¹⁵⁵ Since 2008, the OFT has adopted a more targeted, risk based, approach to consumer credit licensing, focusing resources on the areas of highest risk to consumers. As part of this approach, applicants for a licence to carry out any activities that the OFT deems to be high risk have to provide evidence of their credit competence.¹⁵⁶ They may also be subject to an on-site visit by officers

¹⁵³ Consumer Credit Act 1974, Part III, section 21(1).

¹⁵⁴ The OFT has the power to revoke, suspend or vary a licence, or to impose requirements, at any time.

¹⁵⁵ These are £480 (sole trader) and £970 (partnership, company or other organisation). These fees cover the OFT's costs in administering an effective licensing regime and include a consumer credit jurisdiction (CCJ) levy of £150 which funds the Financial Ombudsman Service's extended role in considering complaints about consumer credit products and services.

¹⁵⁶ Credit competence means being able to operate a credit business in such a way as to meet legal obligations to customers and comply with all relevant legislation and with generally accepted standards of business practice. To be competent, a business needs to have the necessary skills and knowledge of the credit activities it wishes to undertake and to have (or intends to implement) appropriate safeguards in its practices and procedures.

from their Local Authority Trading Standards Service or the OFT, who seek to verify the evidence of competence.

High-risk activities

- 11.8 Applicants engaged in high-risk activities¹⁵⁷ must complete additional forms intended to assist the OFT in assessing the competency of the applicant. Credit competence assessments were introduced in recognition of the risk which can be posed to consumers as a consequence of lack of competence to operate a business carrying out licensable activities. The OFT identified activities in which that risk could be particularly acute, based on our experience of regulating consumer credit businesses and have put in place arrangements which allow it to give more scrutiny to these activities.
- 11.9 For the applicant, the process of completing the application forms requires time and reasonable care but we did not hear from any respondents that they considered it a barrier to entry.
- 11.10 The OFT has a self-imposed administrative target to process 90 per cent of low risk licences within 25 working days, and 75 per cent if high-risk licences within 90 working days. The later target has been met throughout 2009-10. Since it cleared a backlog of applications and in late 2009 activated the computerised clock-stopping on its operating system (whereby the elapsed time clock is stopped when the OFT is waiting for the applicant to provide additional information) the OFT has met both these targets.

¹⁵⁷ The OFT has identified the following credit activities as being high-risk: debt adjusting, debt counselling, debt collection and credit information services (including credit repair). Here, the OFT exercises greater scrutiny and requires further information about the type of business and its credit competence. The same is true for credit reference agencies, and for consumer credit, credit brokerage and debt administration businesses who are engaged in secured or sub-prime activities (namely lending, brokerage or debt administration), or who are engaged in home-credit activities.

11.11 The OFT can revoke a licence if the OFT has good reason to believe that a trader is unfit to hold one. Between April 2008 and March 2009, the OFT received a total of 3,653 complaints about licensed traders, all of which were investigated under established procedures. In the same period 34 licences were revoked by the OFT.

11.12 We do not consider that the OFT licensing process and the licence fee represent barriers to entry in this sector.

Costs of setting up

11.13 There seemed to be some agreement from respondents that the cost of setting up and opening a high-street store (for payday lending and/ or pawnbroking) was between £200,000 and £250,000 although this of course might vary depending on region. Firms lending money need access to funds and this might pose more of a barrier to entry, particularly since 2007.

Economic conditions and access to funding

11.14 In December 2009, the OFT set out its views about how the recession had affected the behaviour of consumers and suppliers in this sector. While the recession led consumers to reduce their overall expenditure and (where possible) their borrowings, it was noted that many specialist lenders borrow from banks to finance their activities and the well-publicised failures in the banking sector has reduced the availability of funding to the specialist sector.

11.15 Specialist and some mainstream lenders typically draw on a combination of internal finance and debt to make loans to consumers. Internal funds include money invested by business owners, investors and specialist venture capital firms, while debt finance includes money borrowed from banks.

11.16 We requested information from respondents about their equity and borrowings. Some new entrants are subsidiaries of parent companies and they are funded by internal borrowings. Over time, firms are able to

reduce their debt finance in favour of equity finance as they build their own equity stakes through retained profits.

- 11.17 Many respondents noted that they had tightened their lending criteria in response and were lending less to higher-risk borrowers. New entrants to the market would be less aware than existing lenders about the risks of potential borrowers, and this might deter new entry (although this risk can be reduced by using Credit Reference Agencies).
- 11.18 One respondent commented that the recent downturn in economic activity had made some banks less willing to open commercial accounts for firms engaged in high-cost lending and that there were significant delays in acquired merchant transaction equipment (which enable firms to process debit card payments).
- 11.19 Entering the online market may be more expensive since companies need to introduce systems that protect themselves against fraud, as well as systems that identify higher-risk borrowers. One online lender entering the UK from the US estimated that their set up costs had exceeded £1 million (although acknowledged that some of this was incurred in understanding the UK legislative requirements).
- 11.20 The cost of entering the home credit market on a local level are low, but to acquire the scale of the national suppliers is likely to be expensive and time consuming. The CC, in its 2006 Inquiry, concluded that barriers to entry on a small scale were low but on a larger scale were considerably higher.¹⁵⁸ Kempson found that trust and reputation are key features of home credit¹⁵⁹ as is the customer-agent relationship, with many customers seeing the agent as a personal friend, and that these features would make it difficult for a new doorstep lender to attract new

¹⁵⁸ CC, paragraph 5.67.

¹⁵⁹ Kempson et al, March 2009, page 14.

customers as would high levels of customer satisfaction with their existing lender.¹⁶⁰

Advertising and marketing costs

- 11.21 High-cost credit lenders do not advertise heavily, relying more generally on word-of-mouth, cheaper in-store advertising, or online websites. Advertising costs do not appear to present a barrier to entry.
- 11.22 Many respondents advised us that they invested heavily in developing relationships with borrowers and in offering good standards of customer service. The agent-borrower relationship in home credit markets provides home credit lenders with new leads, but also allows the agent to assess the creditworthiness of the potential customer. The cost of running a large network of agents is high, particularly on a national scale, and this may present a barrier to entry to the market.
- 11.23 Many firms use their company website to provide potential borrowers with information about their products. Some payday lenders operate on the web and have set up systems that allow them to assess the creditworthiness of potential borrowers and avoid fraudulent applications. We were advised that lead generators sell details of prospective borrowers to online payday lenders and that the costs charged by the lead generators are high.¹⁶¹ Setting up a website does not require significant investment, although the systems required to guard against fraud and comply with legislative requirements can be a significant cost to a new business. Given the degree of payday lending that is conducted online, these costs appear to be insufficient to act as a barrier to entry.

¹⁶⁰ Kempson et al, March 2009

¹⁶¹ One respondent suggested that lead generators charge up to £80 per successful lead.

Conclusions

- 11.24 Generally, it would appear that absolute barriers to entry are low for prospective entrants, particularly given the profits achievable following entry.
- 11.25 The most significant barrier across the high cost specialist credit sector is likely to be access to funds, at least until the conditions on the wholesale market ease.
- 11.26 Brand loyalty is actively encouraged by lenders, since customer retention has the additional benefit of improving the risk profile of their customer basis, whilst leaving potential entrants with higher than average cost of business acquisition.
- 11.27 Barriers to expansions appear similarly low across the spectrum of products we looked at. Most firms that we spoke to saw opportunities for expansion in the market, and were funding their expansion through retained profits.
- 11.28 However, there are also types of entry barriers that are more relevant to specific credit products:
- Pawnbroking require specific skills and expertise to evaluate the pawn, and dedicated safe premises to store valuable items. As such, natural candidates for potential entry are limited to retail jewellers, whereas other entrants would incur substantially higher learning and setup costs.
 - Similarly, the business model of home-credit lending requires a network of local agents which resembles a local natural monopoly. An entrant would hence have to incur high fixed cost and reach a critical mass of customers to sustain its own network of agents.
 - We also noted that some online payday lenders opted for a strategy of brand proliferation, which may act as a strategic entry barrier by increasing search costs to consumers.

12 COMPETITION ANALYSIS – CONCLUSIONS

12.1 The specialist high cost credit sector has generally exhibited substantial growth rates in recent years, even during the recent financial turmoil. However, this varies across product markets:

- Payday loans have experienced the fastest growth, although they started from very low levels (having been commercially offered in the UK only since 1997). More recently, online lending has been growing at substantial rates, despite being more expensive than payday loans offered on the high-street.
- The number and value of loans issued by pawnbrokers and home credit lenders have increased steadily in the last five years. A relevant factor in the growth in the value of pawnbroking is the substantial increase of the price of gold.
- Credit unions, while not high-cost credit, grew during the same period, but still represent a minor borrowing channel for six- to 12-month loans, compared for example to home collected credit and other unsecured personal loans.
- Overall, sub-prime retail credit is declining, although more stringent criteria on credit and store cards have somewhat revived advances recently. Rent-to-own credit appears to be a growing niche of sub-prime retail credit.

12.2 The growth in high cost credit products suggests that there may be unmet demand for this type of credit from customers that do not have access to (or find it more onerous to borrow from) mainstream lenders. The tightening in lending practices from the recession is likely to exacerbate this divide, especially for people on very low incomes. Hence we consider that there is limited substitution between mainstream and specialist high cost credit products.

12.3 What is generally referred to as specialist high cost credit encompasses several separate products markets characterised by a limited degree of

substitutability. However, there is a relatively wider scope for substitution between:

- Payday loans and pawnbroking - often the same supplier offers both products and (despite different lending requirements) they may respond to the same need for urgent access to money for a short period of time.
- Home credit and credit unions, provided that the prospective borrower qualifies for membership with the credit union. We note however that this is likely to be a one-way substitution, from more expensive home credit to cheaper credit union loans (legally capped at two per cent monthly interest rate, or 26.8 per cent APR).
- Home credit and retail credit, in instances where the need for the credit is to finance the purchase of durable goods.

12.4 Price competition among specialist high cost lenders is generally weak, as it appears that consumers' decision are not primarily informed by the relative price of a product. We have found that prices tend to be stable over time despite changes in underlying cost drivers, and price dispersion is often limited.

- Nevertheless, there appears to be some price competition among high-street payday lenders as well as between high-street and online payday lenders. One source of concern, however, is the potential confusion generated by online brand proliferation and the lack of transparency of some lead generators' websites.¹⁶²
- Prices are more aligned in pawnbroking, and there is remarkably little difference between the APR charged by home credit suppliers for loans of comparable length. Credit unions prices are capped by law,

¹⁶² Although, as noted above, compliance with The Consumer Credit (EU Directive) Regulations 2010, once they come into force in February 2011, should go some way towards improving lead generator transparency.

and we are aware of many credit unions that price well below the cap rate of interest.

- Sub-prime retail credit is seen mostly as an enabler of additional sales, hence there is hardly any competition on the credit facility. We note however that credit offers marketed as low-cost (such as, interest free or 19.9 per cent APR) may potentially mislead customers with high search cost about the total cost of their purchase, where the retail price already includes a premium to cater for credit-related costs.
- We also found, across the spectrum of products we focused on, that many lenders encourage customer retention by offering better deals to returning customers, on whom they place a lower risk premium.

- 12.5 Non-price competition is important in the specialist high cost sector, as consumers place value on the ease of the process and quick access to the funds. Specialist lenders engage in non-price competition by providing better customer service than their competitors, brands that their customers can identify with, more appealing and conveniently located high-street outlets and innovation in products and services.
- 12.6 Profitability is one potential indicator of the degree of competition in a market. Consistently high profits across a range of providers of a particular high cost credit product may indicate that competition is not working effectively in that sector. Our analysis suggests that a number of pawn-brokers and home credit providers are earning profits in excess of their cost of capital. Conversely, the majority of retail credit providers in our sample appear to be making losses, or profits below their cost of capital. With only a limited number of firms examined in each sector, however, these conclusions can only be very tentative.
- 12.7 Generally, it would appear that absolute barriers to entry are low for prospective entrants, particularly given the profits achievable following entry. Barriers to expansion appear similarly low across the spectrum of products we looked at. The most significant barrier across the sector is likely to be access to funds, at least until the conditions in the wholesale

market ease. Brand loyalty is actively encouraged by lenders, since customer retention has the additional benefit of improving the risk profile of their customer basis, whilst leaving potential entrants with higher than average cost of business acquisition. However, there are also types of entry barriers that are more relevant to specific credit products:

- Pawnbroking require specific skills and expertise to evaluate the pawn, and dedicated safe premises where to store valuable items. As such, natural candidates for potential entry are limited to retail jewellers, whereas other entrants would incur substantially higher learning and setup costs.
- Similarly, the specific business model of home-credit lending requires a network of local agents which resembles a local natural monopoly. An entrant would hence have to incur high fixed costs and reach a critical mass of customers to sustain its own network of agents.
- We also noted that some online payday lenders opted for a strategy of brand proliferation, which may act as a strategic entry barrier by increasing search costs for consumers.