

# **Review of high-cost credit**

Interim research report

December 2009

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# 1 INTRODUCTION AND APPROACH TO THE REVIEW

## Launch of the review

- 1.1 The review of high-cost credit was launched on 2 July 2009. The review followed an informal consultation from 7 April 2009 on the scope of a review of the credit sector. As explained at the time of the launch, we considered the responses to the informal consultation in detail and had regard to concerns expressed by respondents about the potential overlap with the Department for Business, Innovation and Skills' (BIS) Consumer White Paper,<sup>1</sup> BIS' consultation on the implementation of the Consumer Credit Directive<sup>2</sup> and the OFT's anticipated consultation on its Irresponsible Lending Guidance.<sup>3</sup>
- 1.2 As a result, following the informal consultation, we narrowed the review's scope to focus on high-cost credit. The users of high-cost credit are often vulnerable consumers with, in many cases, limited choice. Considering only high-cost credit also avoided overlaps with other Government initiatives, so reducing potential information-gathering burdens on stakeholders and addressing such concerns raised by some respondents.
- 1.3 This report gives the emerging evidence from our research. The final report, to be published in spring 2010, will contain the further research undertaken, the results of our analysis and the key issues and concerns in the sector. In addition, where relevant, the final report may include recommendations for change. In publishing this report we are keen to understand whether there is anything significant that we have missed in

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<sup>1</sup> A better deal for consumers: Delivering real help now and change for the future, Consumer White Paper Cm7699, 2 July 2009.

<sup>2</sup> Consultation on the implementation of the Consumer Credit Directive, 2008/48/EC, 14 April 2009 to 10 June 2009.

<sup>3</sup> The consultation on OFT's Irresponsible Lending Guidance was launched on 30 July 2009.

our evidence gathering process that would shed more light on the issues that we are considering in this review.

## **Financial Services Plan**

1.4 The review is an important part of the OFT's Financial Services Plan.<sup>4</sup> The credit sector is noted in the Plan as being one where the impact of the recession will be relatively significant, and high-cost credit is one area where consumers are likely to be relatively vulnerable.

## **Aims and focus of the review**

1.5 With an overarching aim of establishing whether high-cost credit is working well for consumers, the review is focused on four areas:

- the level of competition in the market, including the impact of the economic downturn on competition and whether suppliers compete vigorously to deliver benefits for consumers
- the business models of lenders within the sector
- the behaviour and decisions made by consumers when purchasing credit, and
- whether consumers get the information that they need to make good decisions.

## **Research timing**

1.6 The review is assembling a significant amount of information from a variety of sources including two primary data-gathering exercises to inform the forthcoming analysis. The presentation of this research is split between the interim and final reports. The information published as part of the interim report includes:

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<sup>4</sup> See: [www.of.gov.uk/of\\_at\\_work/markets/services/fss](http://www.of.gov.uk/of_at_work/markets/services/fss)

- an overview of high-cost consumer credit products
- preliminary results from our survey of consumers
- the effects of the recession on consumers and suppliers, and
- evidence from our international research on credit markets in Australia, Canada, Ireland, Germany and the USA (specifically Pennsylvania, Michigan and Wisconsin).

1.7 The final report will include details of the following further research:

- the results of a behavioural economics experiment, which is examining consumers' understanding of credit products and the information that they use in making decisions, and
- an assessment of suppliers and their business models, the profitability of their products and the extent of competition in the sector.

1.8 The final report will provide analysis of all the research undertaken and the consideration of key issues and concerns raised. In addition, where relevant, this may include recommendations for change.

## **This report**

1.9 The rest of this report is set out as follows:

- Chapter 2 provides an introduction to consumer credit and a description of the consumer credit market in the UK and the products available, as well as details of the products which are the focus of this review.
- Chapter 3 provides details of the methodology and some of the headline results from our survey of consumers.
- Chapter 4 provides an analysis of the effects of the recession on consumers generally and suppliers of high-cost credit.

- Chapter 5 provides a summary of our work to date on international comparisons of credit markets, including the regulations and relevant cultural factors, problems faced, and the policies in place to address specific problems.

## **Annexes**

1.10 There are four annexes to this report. Annexe A provides additional detail on the survey of consumers. Annexe B provides further detail of our international research on Germany, Ireland and the USA. Annexe C provides further detail of our international research on Australia and Canada. Annexe D provides a detailed overview of the relevant regulations for consumer credit in the UK and summarises the key stakeholders in this area.

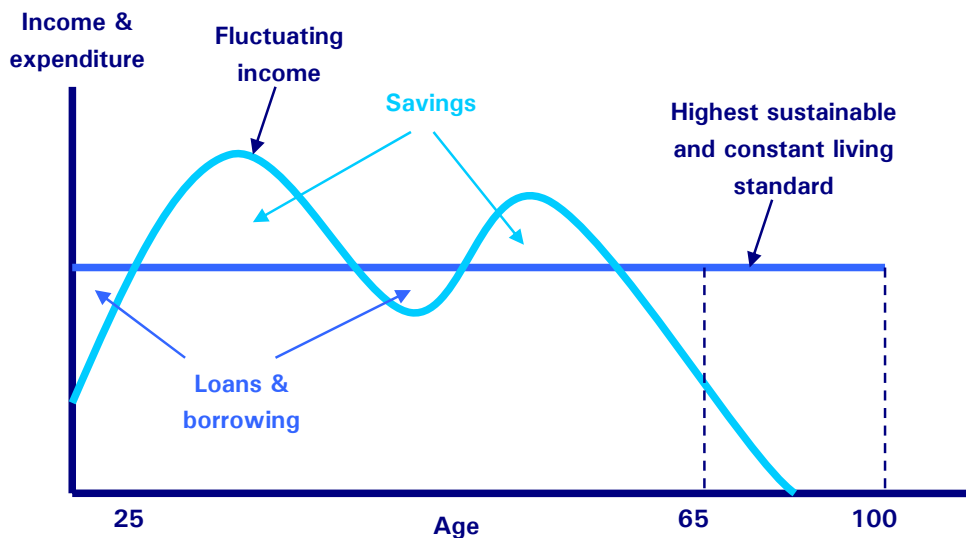
## 2 INTRODUCTION TO CONSUMER CREDIT

### Overview

#### The benefits of consumer credit

- 2.1 Consumer credit is beneficial to consumers and the economy as a whole, as it allows consumers 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 expenditure at times when their income rose.
- 2.2 Allowing consumers to borrow money to smooth their consumption gives them a higher potential living standard across their life. This is illustrated in Figure 2.1 below.

Figure 2.1 Lifetime consumption smoothing



- 2.3 As the graph in Figure 2.1 indicates, while income fluctuates over a lifetime, the periods of borrowing and saving tend to even out allowing the consumer to maintain a consistent and high standard of living through their lifetime.

- 2.4 In practice many consumers are likely to face constraints on borrowing and uncertainties over the income that they will earn in the future. Both of these may prevent this balancing of consumption from being perfect, but would not prevent consumers from desiring some more limited form of consumption smoothing. It is this consumption smoothing that underpins the rational demand for credit from consumers.

### **The costs of consumer credit**

- 2.5 While using consumer credit to smooth consumption is considered to be beneficial for consumers, there are situations where credit can be damaging for consumers' welfare. Such situations typically occur when the amount borrowed is in excess of the borrower's ability to repay, whatever the reason for this mis-match.

### **Chapter structure**

- 2.6 The first section of this chapter shows the products considered to be within the scope of this review. The second section provides an overview of the different types of consumer credit products available, including mainstream products with a broad customer base and some high-cost supply, specialist high-cost products, low-cost credit products and illegal lending. It describes the key features, costs and the main suppliers of credit products. The third part of this chapter provides a summary of the regulatory responsibilities in this sector.

### **High-cost consumer credit**

- 2.7 There is no formal and accepted definition of the term 'high-cost credit'. In its Consumer White Paper in July 2009, the Department of Business Innovation and Skills (BIS) defined high-cost credit as having, 'typical APRs of 50 per cent or more'.<sup>5</sup> We have considered this as a working

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<sup>5</sup> 'A Better Deal for Consumers – Delivering Real Help Now and Change for the Future', Cm 7669, July 2009.

definition at the start of this review, but this is an overly simplistic definition which does not take into account factors such as:

- the length of the loan
- the size of the loan
- the risk posed by the borrower<sup>6</sup>
- the frequency of repayments
- the extent of any fees and charges payable
- the complexity of the loan product, including whether it is linked to the purchase of a product, whether there is any security on the loan, and
- the extent of any additional charges on default.

2.8 As part of the review we are seeking to develop a more sophisticated definition of high-cost credit that incorporates both consumer and supplier factors affecting the substitutability of products. This will draw on the results of our research with suppliers, our consumer survey and behavioural economics experiment. A summary of our analysis and the outcomes in this area will be included in the final report in spring 2010.

2.9 It is possible to consider high-cost credit products in terms of whether they are **mainstream**, that is used by a wide range of consumers, typically supplied by providers involved in other mainstream financial markets, such as banking or insurance, or **specialist**, that is sold to a narrower group of consumers, typically by more niche firms. Generally, mainstream products are less likely to be high-cost than specialist products. There are, however, some high-cost mainstream products, an example being the current account overdrafts provided by some banks, given in some instances the level of charges and interest for these

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<sup>6</sup> Hence the type of borrower to whom the products are typically targeted.

overdrafts, particularly unarranged overdrafts. An example of a specialist product would be a payday loan provided by a specialist payday lender.

- 2.10 It should also be noted that a relevant third category would be low-cost specialist products. These are typically provided to higher risk consumers, similar to specialist products, but at relatively low cost. An example would be a loan from a credit union.
- 2.11 These product types are shown in the diagram below for illustrative purposes.<sup>7</sup>

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<sup>7</sup> This diagram neither indicates the boundaries of high-cost credit, nor acts as the definition of a relevant economic market. Our analysis of the relevant markets in this sector will be part of the final report.











































































































































































