

# High-cost consumer credit – emerging evidence from the review

December 2009

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## Summary

1. The review of high-cost credit was launched on 2 July 2009. This document provides a summary of the research being undertaken for the review and some of the emerging evidence.
2. Our emerging evidence covers the following areas:
  - high-cost credit and the products examined in the review, including the features that potentially define high-cost credit
  - consumers of credit products generally and high-cost credit specifically, drawn from the results of our survey of consumers and initial analysis of the results of our behavioural economics experiment
  - suppliers of high-cost credit, where we describe some typical business models, and their sources of funds
  - the effects of the recession, including on consumers of credit generally and specifically for specialist suppliers of high-cost credit, and
  - our international research, where we present some evidence on the use and significance of products and policy responses to certain concerns around high-cost credit.

3. In publishing this document and the interim research report, we are keen to test the completeness and robustness of our emerging evidence and research. Consequently, we welcome submissions from interested parties concerning these published documents. Please send any submissions to the OFT at the address detailed below, **to arrive at the OFT by 8 January 2010.**

## **Background to the review**

4. The review of high-cost credit was launched on 2 July 2009.<sup>1</sup> 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>2</sup> BIS' consultation on the implementation of the Consumer Credit Directive<sup>3</sup> and the OFT's anticipated consultation on its Irresponsible Lending Guidance.<sup>4</sup>
5. 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.

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<sup>1</sup> OFT Press Release 78-09, available at: [www.oft.gov.uk/news/press/2009/78-09](http://www.oft.gov.uk/news/press/2009/78-09)

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

<sup>3</sup> Consultation on the implementation of the Consumer Credit Directive, 2008/48/EC, 14 April 2009 to 10 June 2009.

<sup>4</sup> The consultation on OFT's Irresponsible Lending Guidance was launched on 30 July 2009.

6. The review is an important part of the OFT's Financial Services Plan.<sup>5</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.
7. 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.
8. There have been a number of different investigations and studies launched in recent years into products within this sector. These include the Competition Commission's Home Credit Inquiry of 2006<sup>6</sup> and the OFT's work on unarranged overdrafts.<sup>7</sup>
9. To minimise overlaps, we have sought deliberately to focus our attention on those areas of the sector where there has been less attention from previous and current investigations or other Government initiatives. In cases where overlaps relate to products that are central to

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<sup>5</sup> See: [www.oft.gov.uk/oft\\_at\\_work/markets/services/fss](http://www.oft.gov.uk/oft_at_work/markets/services/fss)

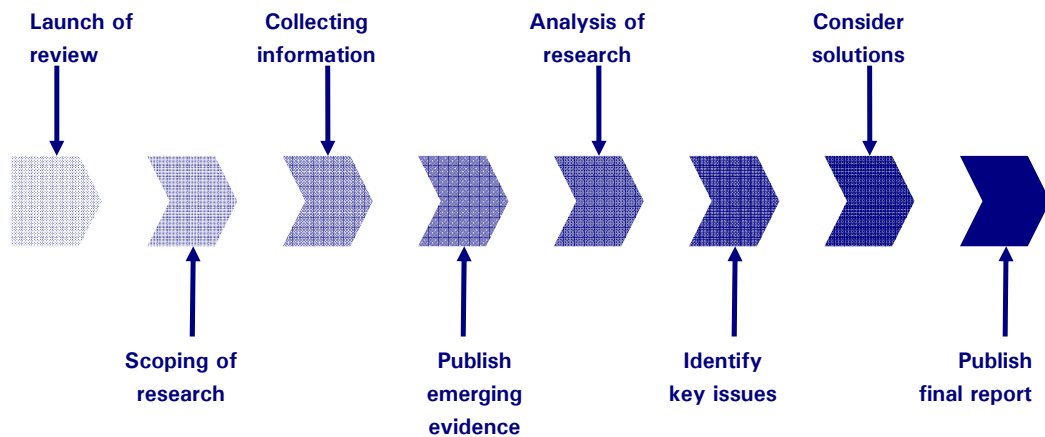
<sup>6</sup> Home Credit Market Investigation, published on 30 November 2006, see: [www.competition-commission.org.uk/inquiries/current/homecredit](http://www.competition-commission.org.uk/inquiries/current/homecredit)

<sup>7</sup> See: [www.oft.gov.uk/advice\\_and\\_resources/resource\\_base/market-studies/completed/personal/personal-test-case](http://www.oft.gov.uk/advice_and_resources/resource_base/market-studies/completed/personal/personal-test-case)

the review, we have sought to limit our work to updating previous analysis where possible. In practice, this has meant that we have gathered some information from a wide variety of businesses, but have considered a narrower selection of types of business and product in greater detail.

## Methodology and work undertaken

10. The different stages of the review can be seen from the diagram below. We intend to publish our final report in spring 2010.



11. We are assembling a significant amount of information from a variety of sources including two primary data-gathering exercises to inform the forthcoming analysis. The main elements of our research include the following:

- examining a range of consumer credit products, including those that have been the focus of our research
- a survey of consumers, which is considering the decisions made by consumers and the products they examined
- a behavioural economics experiment, which is investigating consumers' understanding of credit products and the information that they use in making decisions

- examining the effects of the recession on consumers and suppliers
- comparative international research on credit markets in Australia, Canada, Ireland, Germany and the USA (specifically Pennsylvania, Michigan and Wisconsin), and
- an assessment of some suppliers and their business models, the profitability of their businesses and the extent of competition in parts of the sector.

## **Emerging evidence from our research**

12. In this section, we present the emerging evidence from some of our research. This evidence is necessarily incomplete, as it is only based on the research that we have completed to date, and should not be regarded as representing an OFT view. The areas on which we present some evidence are the following:

- the nature of high-cost credit and the type of products examined in the review
- consumers of credit products generally and high cost credit specifically, drawn from our survey of consumers and initial analysis of the results of our behavioural economics experiment
- suppliers of high-cost credit
- the effects of the recession, and
- international research.

## **High-cost credit and the products examined**

13. The evidence in this area relates to the characteristics of high-cost credit from our research across the credit sector. In this section we also describe in more detail the scope of our research and the products we have considered.

- There is no formal and accepted definition of the term high-cost credit. However, there are a number of important factors that appear to characterise high-cost credit, other than the headline interest rate alone. These include:
  - the length of the loan
  - the size of the loan
  - the risk posed by the borrower<sup>8</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.
- The most important of those characteristics from this list appear to be the typical small size, short length of the loans and the risk posed by the borrower.
- 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 overdrafts,

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<sup>8</sup> Hence the type of borrower to whom the products are typically targeted.

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

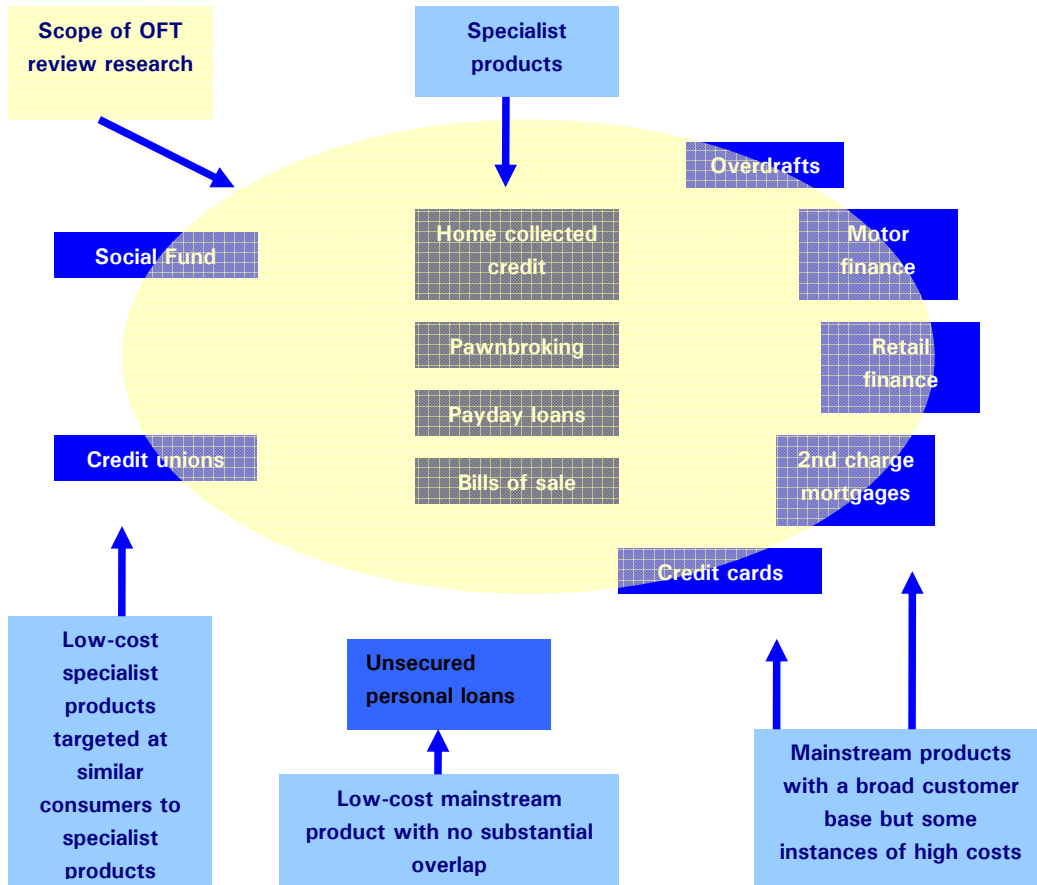
- It should also be noted that a relevant third category would be low-cost specialist products. These are typically provided to higher risk consumers, similar to specialist products, but at relatively low cost. An example would be a loan from a credit union.

14. These product types are shown in the diagram below for illustrative purposes.<sup>9</sup>

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<sup>9</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.

**Figure 1: Credit products examined in the review**



### Consumers of credit products

15. We set out below some evidence in relation to the consumer profile, decision-making and use of products based on information from our survey of consumers. The evidence in relation to consumer understanding is based on an initial analysis of the results of our behavioural economics experiment and comments made by a number of stakeholders to the review team.
16. Both these elements of our research examined the decisions of UK adults as a whole as well as considering the narrower group of consumers of a more limited range of higher-risk credit products (often but not exclusively specialist products).

## Consumer profile

- A substantial proportion of consumers do not appear to access unsecured credit:
  - Around 60 per cent of consumers with bank accounts claim never to go overdrawn.
  - When shown a wide range of credit products, 61 per cent of those interviewed reported not having used any of the products listed.
- Consumers using certain products,<sup>10</sup> have the following range of behaviours that may impact on their ability to obtain the product best-suited to their needs:
  - The amount of time in which they thought about their options before taking out an agreement was a few days or less in a high proportion of cases.
  - They show little inclination to search the market for other forms of credit to the one they chose.
  - A relatively small proportion sought information from a provider other than the one eventually used.
  - Large proportions of consumers appear to use little or no information to help them decide between different product types or different providers.
  - Among the reasons given for choosing a particular credit product, quick access to money was mentioned more often than any other reason.

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<sup>10</sup> Pay-day loans, pawn-broking, rent-to-buy, hire-purchase, home credit, credit union loans, mobile phone text loan, and log-book loans.

## Consumer decision-making and use of products

- As may be expected, consumers' level of comfort in keeping up with regular financial outgoings was strongly associated with income, with 27 per cent of consumers in the lowest income band being uncomfortable with keeping up with regular financial outgoings.
- In order to gain a feel for the financial resilience of consumers, we examined the ease with which consumers could cope with modest financial shocks. Our survey showed a strong association between users of these products<sup>11</sup> and those consumers that found it more difficult to cope with modest financial shocks, specifically, having to find £250 at short notice.
- Many consumers perceive certain products as fairly poor or very poor value ways of borrowing. The proportion of consumers that gave this response for the following products was:
  - 65 per cent for home credit
  - 63 per cent for pawn-broker loans
  - 61 per cent for overdrafts beyond an agreed limit.
- Between 29 and 36 per cent of users of certain products<sup>3</sup> would still take the product if the interest rate was raised so that monthly repayments were one-third higher.
- Significant numbers of consumers reported being fairly or very dependent on credit in their day-to-day lifestyle, for example, 27 per cent of home credit users reported that they have more than one loan outstanding at any one time, and 26 per cent use home credit on a continuous basis. For rent-to buy agreements, 17 per

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<sup>11</sup> Pay-day loans, pawn-broking, rent-to-buy, hire-purchase, home credit, credit union loans, government social fund, mobile phone text loan, and log-book loans.

cent have more than one loan outstanding at any one time, and 10 per cent use such agreements on a continuous basis.

### **Consumer understanding**

- Concerns have been expressed in relation to annual percentage rates (APRs):
  - Consumers appear to find the inclusion of the total repayment amount more helpful than an APR in understanding the cost of short-term credit. This may be due to the information distortion which results when an APR is applied to low sums over short periods.
  - Some consumers do not understand APRs and the time-cost of money and may use APRs erroneously to make comparisons between very different loan products.

### **Suppliers of specialist credit products**

17. We have considered some aspects of the business models of a number of suppliers of credit. Given that the funding models of banks, credit card providers and other large institutions are typically well understood and under considerable attention at the moment, we have deliberately focused our research instead on understanding aspects of the business models of smaller and more specialist suppliers of high-cost credit.

### **Business models of high-cost lenders**

- Many specialist lenders borrow funds for onward lending to consumers from banks.
- We are aware of the three typical forms of wholesale borrowing used by specialist lenders to fund their business models:
  - Revolving credit lines appear to have been used by smaller lenders that required relatively little capital (the largest such credit line mentioned to the OFT was less than £10 million).

- For larger amounts, mainstream banks have either provided a term loan or a syndicated term loan. Syndicated term loans appear to be preferred by banks when a particularly large amount of finance had been requested because it allows them to spread the burden and risk.
- It appears that banks typically place caveats and restrictions on how their loans to specialist credit providers can be used. Loan arrangements appear to require lenders to contribute a proportion of their own funds to each of the loans that they make to consumers. The internal funding requirement in loans appears to vary from around five to 20 per cent.

### **Effects of the recession**

18. Our research on the effects of the recession has examined the effects on consumers and more specifically on the specialist suppliers of high-cost credit. Our evidence from this research is presented below.

#### **Effects of the recession on consumers**

- Consumers have reduced their expenditure and worked to rein in borrowing to protect themselves against the effects of a recession.
- Consumers have indicated that they are less likely to borrow funds to finance their lifestyles in the future.
- Expenditure on credit cards has reduced while other forms of mainstream credit such as overdrafts and retail finance appear to have been used as substitutes to some extent.
- Mainstream lenders have restricted their lending, particularly to more risky consumers. Therefore, some consumers that were previously able to access some mainstream products have been forced to consider higher-risk and, in some cases, more expensive sources of finance.

## Effects of the recession on suppliers of high-cost credit

- Problems of liquidity among banks and in wholesale financial markets have had a mixed effect on providers of specialist credit products.
- London Scottish Bank, a significant home credit provider, entered administration in 2008 following increases in bad debt.<sup>12</sup> Another significant home credit provider, Cattles, suspended its shares from trading during 2009 due to being unable to meet a deadline for publishing its accounts.<sup>13</sup> These problems do not appear to be directly related to the recession, but the difficulties in obtaining wholesale finance seem likely to have compounded the significance of these problems.
- The remaining home credit providers and many pawnbrokers have been performing relatively well during the recession, with some large pawnbrokers planning expansion in the near future.
- Suppliers of specialist credit products have not typically sought to increase prices in the recession but to restrict both the amount that they lend and the types of consumers to whom they lend.
- The availability and price of ongoing access to funding from banks is a key determinant of whether a specialist lender is able to lend to consumers and the price it charges or the type of consumer (that is the level of risk) to whom it lends.
- The number of competitors among providers of second-charge mortgages, which typically lend over £1,000 to consumers<sup>14</sup> has

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<sup>12</sup> See [http://business.timesonline.co.uk/tol/business/industry\\_sectors/banking\\_and\\_finance/article3436379.ece](http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article3436379.ece) and [www.london-scottish.com/](http://www.london-scottish.com/)

<sup>13</sup> See [www.cattles.co.uk/index.php?stock\\_exchange\\_announcements](http://www.cattles.co.uk/index.php?stock_exchange_announcements)

<sup>14</sup> Hence rather larger sums than many forms of specialist credit.

decreased significantly. This is because wholesale funds have not typically been available to sustain this type of lending.

- The number of competitors among providers of payday loans, that typically lend less than £1,000 to an individual consumer for a short period of time, has increased significantly during 2009. Such lenders are less dependent on wholesale funding, due to the smaller loan size and the quicker returns available on small-sum short-term loans.

### **International research**

19. Our international research has examined the consumer credit sectors in Australia, Canada, Germany, Ireland and the USA (specifically Michigan, Pennsylvania and Wisconsin). We present evidence on the use and significance of products and policy responses to concerns around the cost of credit.

#### **Use of consumer credit**

- The countries studied generally displayed a trend towards increasing levels of debt-funded consumer spending, with debt levels rising in Australia, Canada, Ireland and America. Germany represented the exception, as the use of consumer credit has declined in the last few years, and the German attitude to borrowing and lending is conservative.

#### **Availability and significance of products**

- Payday lending has flourished in the USA, Australia and Canada, and is growing significantly in the UK. In contrast, it has not achieved a notable presence in Ireland or Germany.
- Some countries' markets display evidence of competition among suppliers of the same product, for example among pay-day lenders in the USA and among home credit providers in Ireland.

- Credit unions have not achieved a significant presence in the UK, with membership rates for England, Wales and Scotland estimated at 0.9 per cent, 1.8 per cent and 5.6 per cent respectively in 2009. By contrast, they are much more significant in Canada and Ireland, with a reasonably significant presence in the USA. In 2003, Canada had the world's highest per capita membership of credit unions. In Quebec, where the sector is strongest, 70 per cent of the population belonged to a credit union.

### **Policy responses to concerns around high-cost credit**

20. The countries examined have introduced a range of policies to address issues in relation to high-cost credit. Significant policies are outlined below.

#### Interest rate caps:

- A variety of approaches has been taken to interest rate caps among the countries examined.
  - In Australia and the USA, some state-level jurisdictions operate caps and others do not.
  - Canada has set an interest rate cap, inclusive of fees, which has general applicability at a rate of 60 per cent. It has also made exemptions for specific products, meaning that, for example, the level and type of caps on payday loans vary between provinces.
  - Ireland has no general interest rate cap, but there are specific caps for loans by credit unions and moneylenders.<sup>15</sup>

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<sup>15</sup> Moneylenders in Ireland are generally either individuals or companies whose main business is to lend money. Banks, building societies, insurance companies and credit unions are not considered moneylenders.

- Germany has an interest rate cap determined by case law. This typically sets the limit at twice the average interest rate for the product concerned.
- Where interest rate caps have been adopted, two broad approaches have been used. The first is to set a cap at a level considered to be a fair market rate, such as certain Canadian provinces' approaches to payday lending. The second is to set a cap at a higher level, intended to restrict only extreme charges, leaving most lenders unaffected, such as the cap for moneylenders in Ireland.
- Experiences of the interest rate caps we examined show that market participants seek to circumvent these controls.
  - Interest rate caps based solely on interest rates can easily be circumvented. For example, in Victoria State in Australia, lenders have found it easy to increase fees and charges on loans as an alternative.
  - Even inclusive interest rate caps can be circumvented, as has taken place in other parts of Australia, Canada, the USA and in Germany. One such approach is to locate a lender outside the jurisdiction and provide cross-border loans. This has been made easier by the use of the internet for applications and payments across borders. In addition there are examples of restructuring credit transactions as different financial arrangements to avoid legislation in Australia.

Other specific policy responses to concerns around high-cost credit:

- A number of other significant policies have been introduced in the countries studied, including:
  - In Canada, several provinces have introduced regulations that require payday loan companies to display posters showing their interest rates. In addition, Ontario has made provision for a payday lending education fund which licensed payday

lenders are required to contribute to and exists to promote financial literacy and increase consumer protection.

- The National Australia Bank launched a scheme to test the break-even interest rate of small loans, where revenues fully cover costs. The aim is to expose the true costs of lending in one part of the fringe consumer credit sector.
- More generally, the USA Community Reinvestment Act 1977 encouraged depository institutions to meet the credit needs of all parts of the communities in which they operate, including moderate and lower-income segments.

### **Reasons for publication**

21. In publishing our emerging evidence and research, and highlighting the extent of the information being gathered as part of the review, we are keen to test the completeness and robustness of this evidence. In addition, we are keen to understand whether there is anything significant that we have missed in our information gathering process that would shed more light on the issues that we are considering in the review.
22. Moreover, we recognise the value of being transparent with our stakeholders, and this publication is one way in which to facilitate this transparency in relation to the emerging evidence base which we are obtaining through the review of high-cost credit.

### **Submissions on our evidence and research**

23. If you wish to provide a submission to the OFT regarding the emerging evidence and research which the OFT has published, please send this to the review team as detailed below, **to arrive at the OFT by 8 January 2010.**
24. Greater consideration will be given to submissions which advance views which are supported by relevant and available evidence.

## Next steps

25. We will continue to collect information and undertake detailed analysis of the information received. We will also continue to meet key stakeholders in the sector to understand their views and evidence. From our analysis, we will seek to identify the key issues and concerns in the sector, assess their significance and consider whether there are proportionate solutions to these issues and concerns that we could recommend in our final report.
26. The final report will contain the remaining elements of our research, as well as our analysis and the consideration of the key issues and concerns and related solutions where these are considered necessary. The final report will be published in spring 2010.

## Contact details

Submissions on the emerging evidence and research should be sent to:

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