

Debt consolidation

A report on an OFT study

March 2004

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1 EXECUTIVE SUMMARY

Introduction

- 1.1 This report sets out the findings of a study by the Office of Fair Trading (OFT) into the use of debt consolidation by consumers. The study was launched in June 2003 and has been carried out under section 5 of the Enterprise Act 2002 (EA).
- 1.2 The study was undertaken in the light of growth in the marketing and use of credit for debt consolidation. Its primary objective has been to provide better knowledge and understanding of the nature of debt consolidation, the types of credit product involved, the kinds of consumer who consolidate their debts and the issues that may arise. The study will inform the OFT's enforcement of the Consumer Credit Act 1974 (CCA) and the Regulations made under it, and developments in the regulatory framework governing consumer credit.
- 1.3 We have consulted consumer organisations, lenders, brokers and trade associations. We have also examined large scale survey data on how consumers make decisions, commissioned a consumer survey, analysed consumer complaints and advertising, and undertaken a comparative analysis of debt consolidation in the United States.

What is debt consolidation?

- 1.4 Debt consolidation is a process whereby a consumer takes out a loan or other credit agreement in order to pay off two or more¹ existing debts.² There is a variety of types of credit product that can be used including:
 - an unsecured loan
 - an advance from an existing mortgage provider secured against property but leaving the original mortgage intact
 - a second charge mortgage (a loan secured on property, from a lender other than the existing mortgage provider, that leaves the first charge mortgage in place)
 - a remortgage (which will replace any pre-existing first charge mortgage); and

¹ Taking out a credit agreement simply to replace a single existing agreement is better described as refinancing than as consolidation.

² The term 'debts' covers existing credit agreements, which may or may not be in arrears, but also covers other forms of debt such as rent or utility bill arrears. For the purposes of this study no distinction is drawn between credit and other forms of debt.

- the transfer of balances to a credit card (including the use of credit card cheques to pay off non-credit card debts).

Key findings

DEBT CONSOLIDATION ACTIVITY

- 1.5 Statistical data are available about overall levels of borrowing but are not often broken down by specific purpose, such as debt consolidation. Borrowers do not always state the reason for their borrowing (there may in any case be more than one reason) and many lenders do not collect such information systematically. It has, therefore, proved difficult to estimate accurately the value and volume of debt consolidation. However, for certain types of loan, debt consolidation appears to be the single most important reason given by consumers for obtaining a loan. In 2002, up to a half of secured personal loans and up to 40 per cent of unsecured loans were taken out with debt consolidation as the main purpose.³
- 1.6 We estimate that, in 2002, £32 billion of unsecured lending and £8.8 billion of secured personal lending⁴ was used for debt consolidation.⁵ These figures compare with an estimated £18.4 billion of unsecured lending and £2.4 billion of secured personal lending for this purpose in 1999. Therefore, we estimate that unsecured lending for debt consolidation increased by more than 70 per cent over the three year period and that secured personal lending for this purpose more than trebled over the period.
- 1.7 Credit card balance transfer data are only available since 2001.⁶ In 2002, 7.7 million balance transfers occurred with a total value of £11.6 billion. In the first 10 months of 2003 alone, 8.6 million balance transfers occurred with a total value of £13.6 billion, an increase of 42 per cent (by value) over the equivalent period in 2002. Not all of these transfers will be debt consolidations. Mori

³ Finance and Leasing Association (FLA) *Annual Consumer Finance Survey, 2002*.

⁴ Secured personal lending includes second charge mortgages and remortgages not for the purpose of property purchase.

⁵ This paragraph is based on data on purpose of loan from the FLA's *Annual Consumer Finance Survey* and an estimate of the total market size for unsecured lending from Datamonitor (*UK Personal Lending, 2003*). A more recent report from Datamonitor, *UK Personal Lending 2004*, uses a slightly different methodology to provide a somewhat lower estimate of £21.7bn of unsecured lending used for debt consolidation in 2003. Datamonitor's estimate of loan use comes from consumer data provided by NOP. Our estimates are based on industry data provided by the FLA. The FLA's survey covers (approximately) the fifth of all unsecured and secured personal loans accounted for by their members. The absence of systematic industry-wide data collection on purpose of loan has required us to make estimates based upon surveys, but such estimates must be treated with caution.

⁶ Credit card balance transfer data provided by the British Bankers' Association.

Financial Services (MFS) estimate that about 15 per cent of all transfers involve consolidation of more than one credit card balance.

- 1.8 As with the use of consumer credit generally, debt consolidation is more likely to be undertaken by younger people, and by those in full time employment. The demographic profile of consumers who consolidate their debts in general is not substantially different from that of those taking out credit for other purposes. Survey data has shown that, on average, loans taken out for the purpose of debt consolidation are slightly larger than equivalent forms of loan for other purposes.
- 1.9 The largest suppliers of each of the different types of financial product used for debt consolidation are the high street banks and their subsidiaries, and building societies. Fifty per cent⁷ of all personal loans⁸ (secured⁹ and unsecured) used for debt consolidation are taken out with Lloyds TSB, Barclays, HSBC and RBS/NatWest.¹⁰ Most lending occurs through direct contact between the lender and the customer. However, for second charge mortgages, which are frequently advertised with debt consolidation as a purpose, a substantial proportion of lending is conducted via brokers.
- 1.10 Many different types of borrower, ranging from those regarded by lenders as highly creditworthy to those regarded as high risk, engage in debt consolidation, although they may use very different types of product to do so. Some of the issues we discuss arise primarily in relation to certain types of product and/or borrower, while others apply across the board.

THE PROS AND CONS OF DEBT CONSOLIDATION

- 1.11 Many consumers benefit from consolidating their debts on better terms. The potential advantages of debt consolidation over multiple credit agreements include lower interest rates, lower monthly payments and having to deal with only one creditor. However, the costs of settling existing loans (eg early settlement charges), and finding and arranging a new one (possibly including broker commission) can be significant. Debt consolidation loans often have lower monthly payments than the existing multiple debts because the debt is spread over a longer period of time and because it may be secured on property, so lowering interest rates. This means, however, that consumers could well pay

⁷ From MORI's financial survey.

⁸ Personal loans are loans other than for property purchase.

⁹ Being secured against property means that the borrower's home is at risk if they default (by missing a certain number of payments).

¹⁰ This compares to 48 per cent of all personal loans sold through these banks.

more for the credit overall, have a larger debt for a longer period of time and may encounter complications if unsecured debts are consolidated into a secured loan.

- 1.12 Different considerations apply to debt consolidation through credit card balance transfers. Consumers can benefit by consolidating their debts on to one credit card with a lower interest rate. However, they need to be clear about the details of the operation of the credit card and any associated credit card cheques, including limits on introductory offers, different interest rates that may apply for different purposes, and how payments are allocated to different elements of debt. They need to think about the types of debt they are consolidating – the individual amounts and the length of the terms of any loans as well as the interest rates (these could be credit card balances or, for example, household bills). Consideration needs to be given to how long it will be before they can (or want to) pay off the balance. This is particularly important for time-limited special offers.
- 1.13 Many borrowers see debt consolidation as an easy short-term solution to multiple debts and a way of obtaining more credit. However, the possible long term implications may not always be understood. Without clear information on, and understanding of, the costs involved (not just monetary), debt consolidation can create real problems for some people.

CONSUMER SATISFACTION

- 1.14 Most consumers in our survey said they were satisfied with their experience. This satisfaction may have been based on the immediate effects of consolidation and not always have taken account of the long-term consequences. (These consumers had consolidated their debts within the last two years.) Debt consolidation has featured in some serious complaints to bodies such as Citizens Advice. Problems often arise when borrowers lose jobs and cannot keep up repayments, or when they want to settle the loan early or move home. We describe some of the factors that may explain why many borrowers are unprepared for difficulties with debt consolidation when their circumstances change. The factors we have identified are more likely to affect those who were in financial distress¹¹ when they committed themselves to the product (for some of whom it may have been inappropriate). However, they can also affect other consumers, not in distress, who are refinancing simply to try to obtain more advantageous borrowing terms.

¹¹ Those people who are unable to meet repayments currently or are in imminent danger of being unable to do so.

CONSUMER BEHAVIOUR

- 1.15 The most common reasons consumers gave for choosing to consolidate debt were that it was an easy option, that interest rates were lower, and that the amount of their monthly payment would fall.¹² Brokers and lenders often draw attention to these factors in marketing their products for debt consolidation.
- 1.16 Factors such as the length of the term over which the loan would be paid back and the total cost of repayments should be very important for borrowers in deciding whether consolidating debt makes overall financial sense for them. However, these were only volunteered as important factors in their decision by a small proportion of survey respondents. Those consumers who were dissatisfied after taking out a debt consolidation loan emphasised that their decisions had been based on short-term considerations but had had long-term consequences.
- 1.17 Most consumers do not shop around for credit for debt consolidation, a feature that appears true of credit generally. The growth in personal risk-based pricing¹³ of lending products may make it more difficult to compare loan offerings. Although advertising material reviewed included information on typical rates, the consumer will not know the rate they will receive until after an application has been made. Two-thirds of borrowers who consolidated their debts obtained information from only one provider.¹⁴ However, as terms such as the APR,¹⁵ the price of add-ons like payment protection insurance (PPI) and additional costs such as early settlement charges vary across lenders, shopping around can save large amounts of money.
- 1.18 We found that many consumers, particularly those in financial distress, lack awareness of the alternatives to debt consolidation that are open to them, such as negotiating with creditors themselves, getting help from free debt counselling services or, in extreme cases, entering into an Individual Voluntary Arrangement (IVA)¹⁶ or bankruptcy. Moreover, advertising aimed at those in debt does not

¹² From the consumer survey conducted by Wirthlin Europe Ltd.

¹³ A fee structure used by some lenders where the rate offered to a borrower is based on the perceived risk presented by that borrower.

¹⁴ 'Provider' includes lenders and brokers.

¹⁵ The Annual Percentage Rate of Charge (APR) is an expression of the total charge for credit for each year of a credit agreement.

¹⁶ IVAs are negotiated settlements between a debtor and their creditors that allow the debtor to repay their debt in affordable monthly instalments over a fixed period. They may allow for a proportion of the debt to be written off.

always indicate whether what is being offered is a loan or the services of a debt management¹⁷ company.

- 1.19 Most advertisements that are specifically for debt consolidation loans also suggest that borrowers can take a holiday, buy a car, get a new kitchen or just have money to spend in addition to paying their debts. Just over half of those surveyed took out extra cash when consolidating debts. For those who can afford it, this may be a sensible way of refinancing and obtaining further credit. However, for those who are in, or near, serious financial difficulties, it can exacerbate problems.
- 1.20 Many fixed-term loans are settled early as part of debt consolidation and a significant minority of those who consolidate go on to do so again. This may be a costly exercise because of the way that interest payments are apportioned on such loans. For example, where loans are 'churned'¹⁸ the capital deemed repaid may be small and the debt may increase.

COMPETITION

- 1.21 A wide variety of lenders provide products that can be used for debt consolidation. Banks and building societies are the largest providers of remortgages, unsecured loans and credit cards. Therefore, it is unsurprising that they provide the majority of debt consolidation. Many borrowers, particularly those in regular employment with a good credit history, have a wide choice of lenders. Other borrowers, such as those wishing to take out more specialised products, those with a less conventional background, and those with an impaired credit record, may have a much more limited choice of lender. Even when borrowers have a large choice, if they do not shop around they will not necessarily get the best – or even a good – deal because of the variability in rates and terms offered.

PROVISION OF INFORMATION

- 1.22 Clear, accurate and relevant information is critical if a consumer is to make a sensible decision, whether in relation to debt consolidation or a loan for any other purpose. A review of advertising and marketing material for products that could be used for debt consolidation revealed some instances where key

¹⁷ Debt managers do not usually give consumers access to more credit but manage existing debts for a fee. Consumers of debt consolidation products, where the lender does not pay pre-existing creditors directly, have the opportunity to use the money loaned as they wish (not necessarily to pay their debts).

¹⁸ Refinanced before running to term.

information required, such as the APR, was either not included or not given the required prominence. Similar issues have been revealed in more general OFT monitoring of the credit market. Any breaches of the Regulations on advertising will be pursued by the OFT.

- 1.23 Loans that are advertised specifically as being for debt consolidation are often second charge mortgages that turn several unsecured debts into one larger, secured debt. Although most advertising of secured loans is required to include warning statements about borrowers' homes being at risk if they default, consumers may not realise the full implications of turning unsecured debts into one secured debt. For example, not only could they lose their home if they fail to keep up payments, but they could also face possible difficulties if they want to move house, in which case they may have to pay off the loan in one go. In our survey of consumers who had consolidated debts, approximately a third of those with secured loans said that the status of the loan was not explained at all or was explained poorly.¹⁹

SALES TECHNIQUES

- 1.24 The consumers in our in-depth interviews tended to view the loan provider as a financial expert and well placed to provide advice. However, most brokers and lenders do not offer independent advice, but instead focus on providing information in order to sell a product. Similarly, consumers tended to be unaware that brokers often work on commission from the lender.
- 1.25 Some of the in-depth interviewees felt hurried into making decisions and some thought that the offer was available for a limited period only. They had typically signed for their loans there and then, without taking time to consider, to shop around or (in some cases) to discuss with their partner. Insofar as it results from efficiency on the part of lenders in processing applications, and meets consumers' needs, speed of decision-making clearly has positive aspects. Our interviews suggested, however, a perception on the part of consumers that the system is set up to be speedy not for their benefit, but to reduce the time they are given to think about the consequences.

BROKER COMMISSIONS

- 1.26 Brokers frequently work on a commission basis, often with additional bonus payments known as 'volume overrides', payable when they can offer large volumes of successful loan applicants to a lender. Although brokers may not act

¹⁹ However, we have not found evidence of systematic breaches of the CCA and Regulations in respect of giving the required warnings.

upon it, such arrangements provide an incentive to push one lender's product over others.²⁰

SALE OF PAYMENT PROTECTION INSURANCE

- 1.27 Evidence from brokers and Citizens Advice Bureaux (CABx) suggests that PPI for debt consolidation loans is sometimes sold inappropriately to borrowers who are unlikely to be able to claim on it. The Financial Services Authority (FSA) is currently consulting on proposals for the regulation of the administration and sale of general insurance, including PPI, for which it assumes responsibility from January 2005.

INVOLUNTARY DEBT CONSOLIDATIONS

- 1.28 The study also found evidence from CABx that indicated that some banks had required customers with debt problems to take out consolidation loans. In the circumstances of these cases it is far from clear that a practice of this kind would be in the best interests of the customers concerned. This issue is being considered separately by the OFT.

RESPONSIBLE LENDING

- 1.29 Lenders should normally base their decisions primarily on whether borrowers can afford repayments out of their income. For secured lending, decisions should not simply be based on the equity available in the borrower's house. Without access to the details of lenders' decisions it is not possible to assess whether these principles are followed in any given case. We have, however, identified some practices which, at least, have the potential to raise questions about responsible lending. In relation to some of these practices, our consumer survey and complaints analysis appear to show evidence of real problems.
- 1.30 Just over half of borrowers in our survey of people who had consolidated their debts said that they were not asked to provide details of existing debts. The survey also indicated that confirmed offers are sometimes made very quickly. This could be a reflection of efficiency, but may not be consistent with making proper assessments of ability to repay. Advertising for debt consolidation frequently emphasises the speed with which credit can be offered. In some advertisements it is also implied that loans are available irrespective of credit history. If true this could indicate irresponsible lending; if false the

²⁰ The FSA regulation of first charge mortgages will prohibit the payment of volume overrides (Section 2.3.6, *Regulating Mortgage Sales: final conduct of business rules*) from 31 October 2004.

advertisements are misleading. Each case would need to be judged on its merits.

- 1.31 Many debt consolidation loans are refinanced before running to term (sometimes known as churning). Sometimes this may be in the consumer's best interests (eg when a lower interest rate is obtained) but the calculation is not straightforward. Each time a loan is refinanced using a broker, the broker earns further commission, and the borrower may have to pay for new PPI and be subject to early settlement charges. In the early period of a loan most of the payments are in the form of interest rather than capital repayments.

What the OFT is doing

- 1.32 The use of consumer credit continues to grow rapidly. The provision of credit generally, and credit for debt consolidation in particular, is characterised by vigorous product development and marketing. Whether consumers are considering debt consolidation simply to improve the terms on which they are borrowing or to relieve a position of distress, they are faced with a number of complex decisions. If this part of the market is to work well, action is needed at a number of levels:

- financial literacy and numeracy
- enforcement and regulatory action
- improving regulation and the law.

FINANCIAL LITERACY AND NUMERACY

- The OFT produces consumer leaflets giving advice about credit and debt. This includes advice on borrowing, budget planning, comparing credit cards, top ten credit tips and what to do to get out of debt.
- A new OFT consumer education team has been set up to improve consumer knowledge and awareness of credit and debt issues. In the autumn of 2004 an information campaign will be launched about different forms of credit and credit cards.
- A consumer education strategy is being developed by a national group of public and private sector members, chaired by the OFT's Executive Director. It will bring together and coordinate consumer education in the UK to avoid gaps or duplication. The OFT strategy will mesh with the FSA's financial capability strategy.

- The OFT will feed information on matters relating to debt consolidation into the FSA's consumer financial capability strategy.

ENFORCEMENT AND REGULATORY ACTION

- The study has identified some practices in the market which may be regarded as unfair – for example, lenders requiring existing customers to take out consolidation loans as a way of tackling a debt problem. This is being pursued as a separate investigation that may lead to enforcement action.
- The OFT will consider how far problems relating to transparency and responsible lending can be addressed through trade association codes of practice and OFT guidance on fitness to hold a credit licence.
- The study identified a number of breaches of credit advertising rules. These are being pursued separately. The OFT will be undertaking a further monitoring and compliance review of credit advertising later this year.

IMPROVING REGULATION AND THE LAW

- Proposals for reform of the CCA and associated secondary legislation, including the Advertisements Regulations, were set out by the Government in the White Paper *Fair, Clear and Competitive: The Consumer Credit Market in the 21st Century* and the consultation paper *Establishing a Transparent Market*, both of which were published on 8 December 2003. In addition to its enforcement of the current Act and Regulations, the OFT has been, and will be, working with the Department of Trade and Industry (DTI) on the reform package and advising what amendments to current law are necessary to improve the availability of information to consumers, to prevent them from being misled and to facilitate shopping around.
- The OFT's *Non-status Lending Guidelines (NSLG)*²¹ already discourage the use of volume overrides and the FSA regulation of first charge mortgages will prohibit their payment. The OFT will consult on the approach taken towards volume overrides as a part of a general review of the NSLG. This review will look at the content and scope of the guidelines including whether there is a need to extend parts of the guidelines to all borrowers and unsecured forms of lending.

²¹ OFT 192, November 1997.

- The FSA is consulting on proposals for regulating the sale and administration of general insurance, including PPI. We are making them aware of the details of our findings.

2 INTRODUCTION

Background to the study

2.1 The study was undertaken in the light of growth in the marketing and use of credit for debt consolidation. Its primary objective has been to provide better knowledge and understanding of the nature of debt consolidation, the types of credit product involved, the kinds of consumer who consolidate their debts and the issues that may arise. The study will inform the OFT's enforcement of the CCA and the Regulations made under it, and developments in the regulatory framework governing consumer credit.

2.2 Accordingly, we aimed to:

- develop a clear picture of debt consolidation activity (overall size and size of the composite segments, the number of suppliers and their role, trends and likely developments)
- assess the process by which consumers obtain credit for debt consolidation purposes and how the CCA regulations on transparency (advertising and the form of credit agreements) affect that process and the outcome for consumers
- identify the main areas of consumer complaint and the risks of detriment
- assess the conduct of brokers and lenders in light of the NSLG and the concept of responsible lending
- consider the current regulatory framework and proposed revisions
- assess how developments overseas may inform developments in, and regulation of, debt consolidation in the UK.

Methodology

2.3 We consulted lenders, brokers, consumer organisations, trade organisations and other government departments. We received complaints data from CABx, Citizens Advice Scotland, the Consumer Credit Counselling Service and Money Advice Scotland, and commissioned market research and a review of advertising and marketing material. We met consumer, trade and regulatory

bodies in the United States in order to gain an insight into debt consolidation there.

Structure of the report

- 2.4 The structure of the remainder of this report is as follows. Chapter 3 defines debt consolidation, provides estimates of the value and volume of agreements used for debt consolidation and gives a description of the borrowers and lenders. Chapter 4 considers the pros and cons of consolidating debt. Chapter 5 discusses issues arising from the use of debt consolidation. Chapter 6 outlines what the OFT is doing to address the issues we have highlighted in the study. Included in the annexes are a list of consultees, a list of terms, information on how debt consolidation is regulated under the CCA and an overview of debt consolidation in the US.

3 WHAT IS DEBT CONSOLIDATION AND HOW DOES IT FIT INTO THE CONSUMER CREDIT MARKET?

What is debt consolidation?

3.1 For the purposes of this study, debt consolidation is defined as a process in which a consumer takes out a credit agreement, in the form of a fixed period loan or revolving credit (such as a credit card or flexible loan), and uses some or all of the funds advanced to pay off two or more existing debts, in full or in part. Debt consolidation is one possible purpose for obtaining credit rather than a specific type of credit, although some kinds of credit are more suited to the purpose of debt consolidation than others.

WHAT KINDS OF CREDIT AGREEMENT CAN BE USED FOR DEBT CONSOLIDATION?

3.2 All credit agreements that are not linked to a particular purchase could be used in whole or in part for the purposes of debt consolidation. There are, therefore, a wide range of products that could, in principle, be used for debt consolidation including:

- an unsecured loan
- an advance from an existing mortgage provider secured against property but leaving the original mortgage intact
- a second charge mortgage (a loan secured on property from a lender other than the existing mortgage provider that leaves the first charge mortgage in place)
- a remortgage (which will replace any pre-existing first charge mortgage); and
- the transfer of balances to a credit card (including the use of credit card cheques to pay off non-credit card debts).²²

3.3 In order to assess accurately what proportion of loans and credit agreements are used for debt consolidation it would be necessary to observe the use to which the money advanced is put. Some lenders make direct payments to existing creditors when the new credit is agreed, a practice which would identify a loan as for the purpose of debt consolidation. However, many lenders simply advance money to the borrower who is then able to use it as they wish. Some lenders ask for, and record, the reason for which the loan is being made,

²² Store cards have not been examined as part of this study as they can usually only be used for purchases in the relevant store(s) rather than for consolidation of existing debts.

others do not. However, even where a reason has been given, it may be difficult to identify accurately all of the credit agreements taken out for the purpose of debt consolidation. A consumer may have more than one reason for taking out an agreement (for example, to consolidate debts and to have a holiday), not all of which may be stated or recorded. Even when the reason for taking out a credit agreement has been supplied it may not reflect accurately the borrower's motives. In addition, consumers may think that saying that the loan is for debt consolidation will be regarded as a negative signal, or they may be embarrassed to admit to being in financial difficulty. They may, therefore, report the reason for the loan incorrectly.

3.4 In order to make an estimate of value and volume we decided that an agreement should be considered to be for the purpose of debt consolidation when one or more of the following applies:

- the agreement provides for direct payments to existing creditors by the lender
- the borrower has stated that one purpose of the loan is consolidation or repayment of existing debts
- the advice or marketing of the lender or the intermediary identifies the loan or agreement as a potential means to consolidate or repay existing debts.

ALTERNATIVES TO DEBT CONSOLIDATION

3.5 Consumers who are not in arrears or struggling to meet payments have the option of continuing to make existing contracted payments. Alternatively, they could refinance existing credit agreements individually rather than in a single consolidated loan or agreement (changing the interest rate or the term of the loan, or changing from unsecured borrowing to secured). Those who are in distress may seek a non-consolidating loan, that is, a loan to cover existing repayments rather than a loan to repay existing agreements in full.

3.6 For those who are in difficulties meeting existing commitments and those in distress, other options are available. Commercial debt managers do not usually give consumers access to more credit, but manage existing debts for a fee. Insolvency practitioners arrange and supervise IVAs. Consumers may also opt for Administration Orders²³ or their Scottish equivalent, Debt Arrangement

²³ An Administration Order is an order for the administration of the payment of debts by an individual. It deals either with the insolvent estate of a deceased debtor, or with an individual with small debts (usually under £5,000) to pay. While an Order is in force no legal action can be taken by any creditor listed on the Order to recover debts. The debtor's payments to creditors are made directly to a court as a single payment, which is then shared out.

Schemes. In extreme distress situations, bankruptcy is an option for some borrowers.

- 3.7 Free debt advice is available from organisations such as CABx or National Debtline, while non fee-charging debt management services are supplied by organisations such as the Consumer Credit Counselling Service and PayPlan.

How much debt consolidation is going on?

- 3.8 The main products used for debt consolidation are unsecured loans, advances on existing mortgages, second charge mortgages, remortgages and credit cards. As explained, data on some of these products are difficult to obtain.²⁴ We have nevertheless identified broad indicators of the value and volume of some of them. We are unable to provide figures for advances, as some data sources do not record them separately but include them under remortgages or under second charges.
- 3.9 Few official data are published in this area. We have drawn mainly on our own analysis of figures from the MFS omnibus survey and figures published by Datamonitor. The latter are based on data from the Council of Mortgage Lenders (CML) and the Finance and Leasing Association (FLA).
- 3.10 We discuss the use made of each type of product in more detail below. Our estimates of the value and volume of each are summarised in the following table. Note that individuals could have used more than one type of product.

TABLE 1: ESTIMATES OF VALUE AND VOLUME OF PRODUCTS USED FOR DEBT CONSOLIDATION

	Individuals holding the product and having used it for debt consolidation in 2003	Gross advances in 2002
Unsecured loans	950,000	£32bn
Remortgages	313,000	not known
Second charge mortgages	105,000	£8.8bn
Credit cards	not known	not known

Source: OFT

²⁴ It should be noted that in the US banks are obliged under the 1975 Home Mortgage Disclosure Act to report the value, volume and purpose of loans to the Federal Reserve. As a result the Federal Reserve were able to report statistics over time by purpose of loan. However, the unreliability of both consumer reporting of purpose of loan and inconsistencies in banks' collection of the data mean that the series is not considered to be accurate.

- 3.11 Our analysis of MFS data shows that about 9 per cent of adults - around 4 million people - have one or more unsecured loans. About a quarter of these (2.1 per cent of adults, 950,000 people) used this loan partly or wholly for debt consolidation.
- 3.12 The FLA's *Annual Consumer Finance Survey* estimates that, in 2002, almost half of unsecured loans by value were for debt consolidation (see Table 2 below). The FLA's survey covers (approximately) the fifth of all unsecured and secured personal loans accounted for by their members. The estimates for value of loans by all lenders are calculated on the assumption that FLA members are representative of all lenders but we have been unable to obtain data on the remaining lenders to verify this. Given this caveat, if we then take the methodology used by Datamonitor in previous years, we can apply the FLA's figure to Datamonitor's estimate of the total value of the use of that product.²⁵ This suggests that unsecured loan gross advances for debt consolidation were worth £32 billion in 2002 out of a total of £65 billion (49 per cent of unsecured loan advances). This compares with a Datamonitor estimate for 1999 of £18.4 billion worth of unsecured loan gross advances for debt consolidation out of a total of £44.3 billion (41.5 per cent of unsecured loan advances).
- 3.13 According to MFS, the average value of unsecured loans taken out in the 12 months prior to their survey for the purpose of debt consolidation, was around a third higher than for all unsecured loans. The median unsecured loan size was £5,400 for debt consolidation purposes compared with a median of £3,900 for all purposes. The same is true for secured loans, where the median size of a loan used for debt consolidation (taken out in the 12 months prior to the MFS survey) was £8,700 compared with £6,400 for all secured loans.
- 3.14 MFS estimate that around 0.8 per cent of adults (equivalent to 340,000 people) hold a second charge mortgage.
- 3.15 Again, taking usage data from the FLA and information from Datamonitor (which is originally sourced from CML and their 'further advances' series), we estimate that £8.8 billion of the total secured personal loan advances²⁶ of £14.4 billion was used for debt consolidation in 2002 (60 per cent of secured loan advances). This compares with a Datamonitor estimate for 1999 of £2.4 billion of secured loan advances being for debt consolidation, out of a total for secured loan advances of £4.9 billion (50 per cent of secured loan advances). The FLA

²⁵ Datamonitor: *UK Personal Lending 2003*.

²⁶ Secured personal loan advances include second charge mortgages and remortgages not for the purpose of property purchase.

Annual Consumer Finance Survey showed debt consolidation was by far the biggest reason (61 per cent by value) for taking out a secured loan.

TABLE 2: FLA ANNUAL CONSUMER FINANCE FIGURES, 2002

	<i>Unsecured loans</i>		<i>Secured loans</i>	
	Value per cent	Volume per cent	Value per cent	Volume per cent
Debt consolidation	49.0	37.5	61.0	49.5
Cars	23.7	22.6	10.3	13.0
Home improvements	12.7	14.5	17.8	26.0
Holidays	1.7	3.8	1.1	2.1
Furniture and electrical goods	1.3	2.7	0.9	1.2
Other	11.6	19.0	9.0	8.3
Total	100.0	100.0	100.0	100.0

Note: Value is the monetary amount of new business. (The capital advanced during the period - it is stated exclusive of finance charges but may include insurance premiums charged and financed at the outset.) Volume is the number of agreements.

3.16 MFS estimate that around 5 per cent of adults, or 2.2 million people, have withdrawn equity in their homes while remortgaging. Around 14 per cent of these (or 0.7 per cent of the total sample, which implies approximately 313,000 people) have used all or part of this for debt consolidation. These data cover all those who have remortgaged, some of whom may have done so several years ago. The average value of further advances taken out for the purpose of debt consolidation was slightly larger than for all further advances. The median additional borrowing was £15,800 for debt consolidation compared with a median of £13,400 for all purposes.

3.17 The Bank of England and the CML also studied equity withdrawal in a one-off survey, conducted by MFS, in 2001.²⁷ The survey showed that 20 per cent of those who had withdrawn equity in their home had used the money in the first six months to pay off debts (though it is not known whether this was more than one debt). The CML's *Annual Housing Finance Survey 2002* (again conducted by MFS) found that 18 per cent of those who had increased the amount borrowed on their mortgage had used this money to pay off a credit card or loan. The survey also found that 4 per cent of those who had been able to withdraw equity when moving home had used equity to pay off other debts.

²⁷ Council of Mortgage Lenders: *Mortgage Equity Withdrawal*, 2001.

3.18 The total value of credit card transactions was £123.7 billion in 2002.²⁸ Data on balance transfers are available since 2001. In 2002 there were £7.7 million balance transfers with a total value of £11.7 million. Table 3 presents complete figures since 2001. According to survey data from MFS, 85 per cent of balance transfers are simple transfers from one card to another. These are, therefore, better described as refinancing than as consolidation. The remaining 15 per cent involve transfers from more than one credit card, consolidating the debts. As far as we are aware there is no centrally collected data on the use of credit card cheques and we have not received any data on the extent of use of credit card cheques from the banks contacted as part of our study.

TABLE 3: BRITISH BANKERS' ASSOCIATION (BBA) CREDIT CARD BALANCE TRANSFER FIGURES

Year	Volume transfers 000s	Value transfers £million	Average value per transfer
2001	5,416	7,828	£1,445
2002	7,715	11,659	£1,511
2003*	8,662*	13,657*	£1,577

* Figures for 2003 apply to first 10 months only.

Who is using debt consolidation? – the borrowers

3.19 Borrowers are often defined by lenders as 'prime' and 'sub-prime', or 'status' and 'non-status' (with a middle category of 'near prime' or 'semi-status'). The 'status' borrower is usually someone in regular, salaried employment, with a good credit history. The NSLG describe non-status borrowers as 'those with impaired or low credit ratings and who would find it difficult generally to obtain finance from traditional sources on normal terms and conditions'.

3.20 Lenders have developed sophisticated methods for assessing the risk of certain types of borrowers. As a result, the category 'non-status' is subdivided into different kinds of potential borrower. For example, some lenders will treat applicants who are self-employed as a specific category. Lenders may subdivide applicants who have impaired credit histories into those with current arrears and those with past arrears. They may also differentiate according to the type of credit in arrears.

3.21 The responses to this study and discussions with lenders and brokers have indicated that some lenders offering to 'non-status' borrowers will specialise in

²⁸ Data supplied by the British Bankers' Association.

rather narrow bands of customers. Consequently, for some borrowers, with a particular profile, there may be only a few potential suppliers. For example, it appears that only one lender offers secured loans to borrowers who own former local authority flats in high rise blocks.

- 3.22 There is another way of categorising borrowers: distress and non-distress. The distress situation is one where the consumer is not meeting current payments or there is a strong likelihood that they will not meet payments in the near future (eg because they have just been made redundant). A proportion of distressed consumers will have developed adverse credit histories. The overlap between distress and non-status is large, but not complete.
- 3.23 During our consultation a further distinction was suggested, between those debt consolidations that are voluntarily undertaken and those that are involuntary. The involuntary situations are those where a bank approaches borrowers once they have fallen into arrears and recommends that they take out a fresh loan as part of a debt recovery plan.²⁹ The focus of such lending is on obtaining payment of the bank's debts (eg overdrafts, credit cards, loans) and the bank probably would not take any other creditors into account. The banks argue that debt recovery is distinct from debt consolidation because they do not advertise debt recovery as a product available to consumers.
- 3.24 Our main source of information about borrowers engaged in debt consolidation comes from the MFS financial survey. Survey responses from the first nine months of 2003 have been analysed. This survey allows a customer profile to be developed for users of credit cards, remortgages and personal loans (both secured and unsecured)³⁰ who are consolidating debt. However, the credit card section of the survey looks at single major purchases of over £500 which featured on the respondent's last statement. In absolute terms only a very small number of respondents revealed that the single purchase was to consolidate debts. This limits the amount of analysis possible and the weight that can be attached to the results on the usage of credit cards for debt consolidation.
- 3.25 Our analysis of the MFS financial survey indicates that in general the profile of consumers who have taken out loans or credit agreements for the purpose of debt consolidation does not differ substantially from the profile of consumers who have taken out loans or credit agreements for other purposes.

²⁹ The term involuntary implies that the borrower has no choice. In practice the borrower may have alternatives, although these may be limited and their bargaining power will be weak.

³⁰ For the purposes of assessing the customer profile it has not been possible to disaggregate between secured and unsecured personal loans.

- 3.26 Those holding personal loans were more likely to be in employment (71 per cent of those with loans were in full-time employment compared with 41 per cent of the adult population as a whole). There was little difference in the employment status of those who used the loan for debt consolidation and those who did so for any other purpose. Respondents using at least some of a mortgage for debt consolidation were more likely to be in employment (77 per cent employed full-time) compared with all mortgage holders (67 per cent) and the adult population as a whole (41 per cent). Respondents using their credit card for debt consolidation were also more likely to be in full-time employment (82 per cent) compared with credit card holders generally (52 per cent) and the adult population as a whole (41 per cent).
- 3.27 Respondents who used their loan for debt consolidation tended to be slightly younger than all those with personal loans and younger than the adult population generally. Fifty-four per cent of those with a debt consolidation loan were under 35 compared with 43 per cent of all those with loans and 34 per cent of the adult population as a whole. Of those consolidating debt using a credit card, 48 per cent were under 35. A recent survey for the Bank of England found that those in the 25-34 age group were more likely to be in debt than the rest of the adult population and this age group was also more likely to experience that debt as a problem or a heavy burden.³¹
- 3.28 There was little difference in the marital status or sex of all those with loans and those who used their loan for debt consolidation. Compared with all holders of credit cards, those using their card for debt consolidation were more likely to be male (61 per cent for consolidators, 53 per cent for all with credit cards) and single (29 per cent compared to 17 per cent).
- 3.29 The proportion of the population from ethnic minorities taking out a personal loan or remortgaging, whether for debt consolidation or other purposes, varies little from that of the adult population as a whole. However, those who are from ethnic minorities and have taken out a debt consolidation product form a very small proportion of the population. This makes it difficult to say with any confidence whether those from ethnic minorities are more likely to consolidate debts than the adult population as a whole.
- 3.30 Although the median income band for people who consolidate debts and for the adult population as a whole was £25,000 to £30,000, the household income of respondents who used a personal loan for debt consolidation was very slightly

³¹ M Tudela and G Young, *The distribution of unsecured debt in the United Kingdom: survey evidence*, *Bank of England Quarterly Bulletin*, Winter 2003, page 422, Table F.

lower than that of all those with personal loans. Respondents who used their credit card for debt consolidation tended to have higher incomes. Sixty-three per cent of those using their card to consolidate debts had a household income of £30,000 or more, compared with 42 per cent for all those with cards.

- 3.31 Six per cent of respondents who used their loan for debt consolidation had county court judgments (CCJs), marginally more than the proportion of the adult population as a whole with CCJs.
- 3.32 Those who had a loan for debt consolidation tended to have more credit products than those with loans generally. This included credit agreements for a mail order catalogue (17 per cent for consumers who consolidated their debt versus 10 per cent for all loans), hire purchase agreements (8 per cent versus 6 per cent) and car financing (8 per cent versus 5 per cent). The consumers who consolidated their debts were also slightly more likely to have a credit card (69 per cent versus 65 per cent) and when they did, to have more credit cards (1.9 cards for consolidators versus 1.7 cards for all loan holders). Those who had taken out a loan for debt consolidation were also more likely to have more than one personal loan (11 per cent) than all respondents with a personal loan (7 per cent). Those who used their credit card to consolidate their debts were more likely to have multiple credit cards (average 2.8 cards) than all those with a credit card (average 1.5 cards).

Who are the providers?

- 3.33 The number of suppliers of credit products used for debt consolidation differs according to the type of product. While the high street banks offer a full range of products from credit cards to secured loans,³² other lenders tend to focus on supplying a more limited range, for example, monoline credit card issuers³³ or specialist second charge mortgage providers.
- 3.34 The established high street lenders such as banks and building societies are the major providers of mortgages, including remortgages. A 2002 CML report³⁴ listed Halifax, Abbey National, Lloyds TSB, Nationwide and Woolwich as the top five mortgage lenders in terms of balances outstanding.

³² Those high street banks that offer second charge mortgages usually do not do so directly under their own brand name, but rather via specialist subsidiaries.

³³ A company whose focus is on issuing credit cards rather than offering a wide range of banking services.

³⁴ *The Changing Structure of the UK Mortgage Market*, April 2002, CML.

- 3.35 Although a large number of suppliers provide unsecured loans, the high street banks still account for a large proportion of business. According to Datamonitor, the top three providers of unsecured personal loans are Barclays, Lloyds TSB, and NatWest. In 2001 they made up 27 per cent of unsecured lending in terms of balances outstanding.³⁵ The remainder is accounted for by a large number of lenders, many of whom specifically advertise loans for debt consolidation purposes.
- 3.36 In 2003 at least 45 financial institutions issue credit cards in the UK.³⁶ A number of them offer a variety of types of card under various brand names. Balance transfers at 0 per cent interest for an introductory period have been offered by at least 40 card brands.³⁷
- 3.37 A smaller number of lenders offer mortgages to non-status borrowers.³⁸ The value of mortgage lending to non-status borrowers is much smaller than the value of lending to mainstream borrowers.
- 3.38 The supply of second charge mortgages is probably the most high profile type of loan used for debt consolidation as a result of the extensive television advertising undertaken by lenders and brokers.³⁹ Some of the lenders offering second charge mortgages will only lend to status borrowers with a clean credit history. Others may offer loans to status borrowers but will in addition, and on different terms, offer second charge mortgages to borrowers with limited credit impairment. Others still will offer loans to borrowers with more complex or seriously impaired credit histories, for example those with one or more CCJs.
- 3.39 Second charge mortgages are mainly sold through brokers. Some brokers specialise in second charge mortgages, while others offer both second charge mortgages and unsecured loans. Most of the large brokers offering second charge mortgages have panels of between seven and 15 lenders from which they offer loans. Many brokers' panels are made up of roughly the same group of lenders. The panels will usually include lenders ranging from status lenders to those offering second charge mortgages to non-status borrowers.
- 3.40 A small number of lenders will offer unsecured loans to borrowers without property, with historic or current credit impairment. The amounts of such loans are likely to be small, and the potential for consolidating debt using this route is

³⁵ Datamonitor *UK Personal Lending 2003* Table 67.

³⁶ APACS *Plastic Card Review 2003*.

³⁷ Ibid.

³⁸ While these lenders will lend to non-status borrowers, they may also lend to borrowers with a more conventional profile. Therefore not all their lending may be considered non-status.

³⁹ OFT review of advertising.

therefore limited. Home collected credit providers can also offer an alternative source of credit facilities to some non-status borrowers.

4 THE PROS AND CONS OF DEBT CONSOLIDATION

How debt consolidation differs from other forms of credit provision

- 4.1 Debt consolidation can be an attractive option for consumers with multiple debts. Sometimes, however, it does not benefit consumers. This chapter explains factors that make debt consolidation either a good or a bad option for consumers. It also looks at the risks that are not always apparent to consumers when making the choice to consolidate.

BENEFITS OF USING CREDIT

- 4.2 Before examining debt consolidation, it is necessary to consider why people use credit at all. The principal purpose of credit is to smooth income and expenditure over time. People generally receive income in discrete lumps at weekly or monthly intervals, although extra income may be received on an irregular basis. Expenditure can also take place in small amounts over time but sometimes large purchases are required, for example a house, car or washing machine. The benefits of these purchases are received over time depending on how long the purchase lasts or how frequently it is replaced. Credit enables the purchase of large items with repayments spread out over a time period suited to the borrower's income stream and to the life of the purchase.
- 4.3 Consumers may benefit from lower prices if they switch from one product and/or provider to another. Such switching by consumers plays an important part in competition in many markets since it forces providers to price more keenly if they are not to lose customers. As such, simple refinancing of a loan or revolving credit facility by means of a lower cost loan or facility with the same repayment term will normally be good for consumers and good for competition.

WHY DEBT CONSOLIDATION IS MORE COMPLICATED THAN SINGLE CREDIT AGREEMENTS

- 4.4 However, debt consolidation involves more than a simple refinancing; it involves the consolidation of *more than one* debt. Debt consolidation takes multiple existing credit agreements or other debts and converts them to a new, single agreement, which in most cases will be repaid over a fixed period. Debt consolidation, therefore, not only affects the interest rate charged, but will almost always change the term over which some or all of the debts are repaid, and alter other related charges, for example, for early settlement. It may also

affect the consequences of default. As only part of a loan may be for debt consolidation and many consumers, when consolidating, take the opportunity to increase their borrowing (eg to pay for a holiday, home improvements, or a car) the total amount borrowed will often also change. All these factors are relevant to the decision whether to consolidate debt.

Search and switching costs

- 4.5 In making the decision whether to consolidate their debts, consumers need to take into account the costs of finding a new provider and transferring their debts to them. These costs (known as search and switching costs) may be explicitly financial (for example, the fee charged by an independent financial adviser), or may be less tangible - for example the time and effort required on the part of the consumer, and the potential stress and uncertainty involved.
- 4.6 It is relatively easy for potential borrowers to see that there are many providers of credit and many different products. It may be a different matter when they try to obtain all the relevant information about alternative products. This can be a long and complicated task, particularly because much important information is only reproduced in the small print. Even apparently easy to observe aspects of an agreement, such as the APR (which is often highlighted in advertisements) or the interest rate, may not actually be known until after an application has been made.
- 4.7 Advertisements may quote a 'typical APR'.⁴⁰ Given that not all consumers understand what 'APR' means, the term 'typical APR' can cause confusion. Consumers can be disappointed when they find that they do not qualify for the 'typical APR'. This will be the case with the many lenders, offering different products relevant for debt consolidation, who now practise personal risk-based pricing. The APR on an agreement is only determined after a credit assessment of the applicant has been made. The presence of such search costs can make consumers reluctant to shop around. Moreover, the APR is only one of the factors that affect the total cost of credit.
- 4.8 Debt consolidation may involve switching between lenders and/or types of product.⁴¹ For example, a customer may take out a credit card with provider A and transfer the balances on their existing credit cards issued by provider B and

⁴⁰ Regulation 3, Consumer Credit (Advertisements) Regulations 1989 provides that a 'typical APR' would be the APR at (or below) which the majority of loans by number arising from the advertisement are expected to be (or have been) made.

⁴¹ The exception would be the rare instances where a credit agreement is used solely for the purpose of repaying non-credit debts.

provider C. Alternatively, the customer may replace existing credit agreements with a new agreement with the same lender. For example, provider A supplies an unsecured loan, which pays off the overdraft on the current account provided by A and the balance of a credit card, which is also issued by A.

- 4.9 Costs may arise for the borrower as a result of switching either lender or product. The potential cost of switching between lenders is created by the knowledge that an existing lender has of the borrower. The existing lender may have more information relevant to the credit status of the borrower than is shared with credit reference agencies. The borrower may, therefore, approach an existing lender first rather than apply to another lender who they think may be less likely to offer a loan. Borrowers may prefer to stick with their existing provider rather than risk a bad experience with a new lender. For example, credit agreements contain numerous terms and conditions that may not be read, or understood, leaving the borrower unsure of how an unfamiliar lender will act in different situations. Some lenders have indicated that they may waive early settlement charges when an existing borrower consolidates their debts with them.
- 4.10 The costs of switching products can be divided into two components, those of taking out a new loan (legal fees, broker fees, valuation fees, balance transfer fees etc) and those of redeeming existing debts (early settlement charges, annulment of PPI, interest charges in early period of loan).⁴² These switching costs may be magnified when multiple existing credit agreements are settled as part of the consolidation.
- 4.11 An increase in refinancing may be an indicator of healthy competition in the market. If consumers are switching suppliers, replacing one high cost loan with an equivalent, but lower cost, loan, then that is an indication that switching costs are low and competition may be effective. It is likely that many credit card balance transfers are of this form. However, if switching costs are either hidden or not factored into the consumer's decision to consolidate, consumers may be switching more often than is to their benefit.

⁴² However, lenders can treat further advances in a different manner to a new loan. The existing loan need not be redeemed and early settlement charges can be waived by the existing lender.

What consumers need to know

4.12 There are many factors to consider in deciding whether debt consolidation is a good idea for a particular borrower. Some of these will be specific to the situation and preferences of the borrower and some will vary according to the types of product which are being used to consolidate or are being consolidated. In general, in addition to working out what they can afford, consumers need to know:

- what debt consolidation is and what the alternatives are
- what the interest rate and APR are and whether they are variable
- what the overall cost of the loan is
- how long the loan is for
- what the monthly repayments are
- whether there are additional features which will change the rate at which the capital sum is paid back (eg introductory rates or balloon payments⁴³ at the end)
- what will happen if they miss a payment
- what happens if they want to repay or refinance early
- if the loan is secured on their home, the consequences of not keeping up with payments and what happens if they want to move.

WHY DOES THE TERM OF THE LOAN MATTER?

4.13 The term of the loan is important for two reasons. Firstly, extending the period of the loan for a given loan amount and a given APR will reduce the monthly payment but increase the total amount payable. This trade-off between the monthly payment and total amount payable is at the heart of debt consolidation. Secondly, the need to keep borrowing sustainable requires that the term of the loan is appropriate to the use to which the funds are put. For example, if a consumer buys a car, and on average replaces the car every three years, it is not sustainable to take a loan over a term of 10 years. In three years' time a new loan would be required on top of the existing loan to replace the car. Therefore, it must be expected that borrowing will increase or that consumption will be cut back (by not replacing the car).

⁴³ A balloon payment is a scheduled final payment that is more than twice as large as the average of earlier scheduled monthly payments.

- 4.14 Debt consolidation typically combines loans of different terms and converts them to a single term. Careful thought needs to be given as to whether the term of the consolidation loan is appropriate to the kind of borrowing being consolidated. A consolidation loan may combine credit for relatively short-term expenditure, such as a holiday paid for using a credit card, with credit for more long-term expenditure, such as home improvements.

WHY DOES SECURITY MATTER?

- 4.15 The level of security given when taking out a loan has implications for the risks that a borrower faces in the event of default. If a loan is secured on property (eg a house or car) the borrower runs a risk of repossession if they fail to meet repayments.⁴⁴ The process of consolidating unsecured debt into secured debt, therefore, increases the risk borne by the borrower. For a borrower who is adept at managing their finances and has a very small likelihood of default, the additional risk may be small. For those borrowers whose finances are already heavily committed and/or who have difficulty managing their finances, the additional risk may be more considerable.
- 4.16 Consolidation may also change the priority of debts. Priority debts are those with the greatest adverse consequences in case of default – usually rent, mortgage payments and debts to the Inland Revenue. Debt counsellors usually advise borrowers to make every effort to repay priority debts. Converting low priority, unsecured debts into high priority, secured debt increases the number of priority debts. This is a problem for the borrower as priority unsecured debts, such as council tax and utilities, can be pushed down the repayment list resulting in loss of supply or legal action.

⁴⁴ If a borrower does not meet repayments on an unsecured loan then they may still ultimately face repossession of property through the enforcement of a court judgment by means of a Charging Order.

Examples

4.17 We have created some examples to show the effects of changing the period over which debts are paid back using debt consolidation loans:

1. After Christmas 2003, Mr A owes £2,500 on a credit card, mostly composed of expenditure on a late summer holiday and Christmas. A loan of £7,000 was taken out just under a year ago to buy a car which it is planned to replace in just over two years' time. Also, there are repayments on a loan taken out to refurbish the bathroom four years ago, which is scheduled to run for another six years. These are all consolidated into a 10 year secured loan. This means presents given for Christmas 2003 will still be being paid for at Christmas 2012.

2. Mrs B takes out two loans, one for £4,000 and one for £6,000, both at a fixed APR of 9.9 per cent, over 10 years. After two years (24 payments) she decides to consolidate her loans, at an APR of 7.9 per cent over eight or 10 years. Assuming that no early settlement penalties are charged, but using Rule of 78⁴⁵ to calculate the redemption value⁴⁶ of the initial loan:

the total payable if Mrs B continues with payments on the existing loan will be £12,430.08 and the monthly payments £129.48;

the total payable on the new loan if Mrs B consolidates over eight years will be £12,004.80 and the new monthly payment £125.05;

the total payable on the new loan if Mrs B consolidates over ten years will be £12,846 and the new monthly payment £107.05.

By choosing to extend the term from eight to 10 years, the monthly payment is lowered by £18 per month. However, by making an additional 24 payments, the total cost increases by more than £800.

⁴⁵ A formula used by lenders to calculate an early settlement figure for instalment loans.

⁴⁶ The cost of paying off the rest of the loan.

3. Mr C takes out two loans, both for £5,000 at a fixed APR of 13.9 per cent over 10 years. After two years (24 payments) he decides to consolidate his loans at an APR of 7.9 per cent over 10 or 15 years. Assuming that no early settlement penalties are used, but using Rule of 78 to calculate the redemption value of the initial loan:

the total remaining to pay if Mr C continues with payments on the existing loan will be £14,405.76 and the monthly payments £150.06;

the total payable on the new loan if Mr C consolidates over 10 years will be £13,454.40 and the new monthly payment £112.12;

the total payable on the new loan if Mr C consolidates over 15 years will be £15,807.60 and the new monthly payment £87.82.

Clearly, refinancing over 15 years rather than 10 years can make a substantial difference to the monthly payment but will also substantially increase the total amount payable.

5 ISSUES ARISING FROM THE USE OF DEBT CONSOLIDATION

5.1 Our main source of information on issues arising from the use of debt consolidation was the survey of 250 consumers⁴⁷ who had experience of debt consolidation in the last two years. This was supplemented by in-depth interviews with 14 respondents taken from the sub-group who had expressed dissatisfaction with their debt consolidation. We also looked at complaints data from CABx, Citizens Advice Scotland, the Consumer Credit Counselling Service and Money Advice Scotland. Additionally, we consulted with stakeholders on what, if any, problems they perceived with debt consolidation, we looked at problems experienced by consumers in the United States, and we conducted a review of advertising.

Consumer satisfaction

5.2 Relatively few consumers in our survey said they were dissatisfied with their debt consolidation. Seven per cent of respondents (17 people) were not satisfied that the debt consolidation product had helped with their finances. A further 4 per cent were neither satisfied nor dissatisfied.

5.3 In the OFT's view, this low level of dissatisfaction needs to be treated with some caution. Particularly with complex financial products, consumers may not always be aware whether they have received a good deal or taken the course of action most appropriate for them. Problems may not become apparent immediately, or even for several years. If a borrower's circumstances change suddenly (such as their being made redundant) or if the economic climate changes (such as an increase in interest rates), problems with servicing the loan could arise. Where the debt consolidation has occurred through a secured loan, the borrower is liable to more serious consequences than they would have experienced with several smaller, unsecured debts.

5.4 Reasons for dissatisfaction given by respondents in the survey included:

- *I would have preferred to shop around more*
- *I could have obtained a loan at a much cheaper rate*

⁴⁷ The size of the consumer survey conducted was constrained by the detailed data required, and the relatively low take-up of these products in the population as a whole (eg only 0.8 per cent of adults hold a second charge mortgage). We surveyed 250 respondents and backed up this data with analysis of the MFS consumer survey. This provided around 600 additional responses from those who had consolidated their debts (from a total of more than 16,000 interviews conducted by MFS in the 12 months up to September 2003).

- *they are making a lot of unnecessary money from me*
- *the interest is too much at one third of the debt*
- *the APR wasn't explained until I signed*
- *I couldn't get an accurate figure for the interest rate*
- *the rate was supposed to go down but it's gone up*
- *the monthly payments were more than I agreed*
- *things weren't explained, I felt pressured*
- *I was told I was not allowed to cancel because I had the house valuation paid for*
- *it was insufficient to cover my debts*
- *the consolidation made it easier but that's the only advantage*
- *I built up debt again*
- *it doesn't solve the problem.*

5.5 Some of these comments suggest a failure on the part of consumers either to shop around, or to read and understand the details of the transaction. Some borrowers may have been over-optimistic about the ability of debt consolidation to solve their financial problems. On the other hand, the comments may indicate a lack of transparency and responsible practices on the part of lenders and brokers. Notwithstanding the low level of dissatisfaction indicated by our survey, the complaints data from consumer organisations and advice services that was made available to us revealed evidence of serious problems. The scale of this is difficult to judge because these organisations do not usually have a distinct category for debt consolidation complaints. Often the problem comes to their attention as a matter concerning debt or borrowing generally. These issues are considered in more depth later in this chapter.

5.6 Half of those who were dissatisfied had consolidated their debts before (8 out of 17). Regulators and consumer groups in the US said that repeated debt consolidations were a problem there because of the accumulation of charges involved. In our UK consumer survey a large proportion of those who took out debt consolidation did so to pay off consolidated debts.

5.7 The consumer survey also found a low level of awareness of where to take problems that were not addressed satisfactorily by the lender. Less than one fifth of respondents would go to a CAB. A few people mentioned some sort of ombudsman but no one mentioned anything as specific as the Financial Ombudsman Service or any of the trade associations.

Consumer behaviour

WHY CONSUMERS CHOOSE TO CONSOLIDATE THEIR DEBTS

- 5.8 Consumers who choose to consolidate their debts vary widely in their financial circumstances. At one end of the range, some will be rearranging their finances to take advantage of better terms without being in financial distress, while at the other end will be some who are unable to cope with their debts. Clearly, this will affect their choices.
- 5.9 Those who are in financial distress may be attracted by advertisements using phrases such as: *'In debt? We can help'*. Often, such advertisements do not specify what service is on offer. They could be for debt consolidation, fee-charging debt management⁴⁸ or insolvency practice⁴⁹ and it is a matter of chance as to which type of service the consumer contacts. Borrowers interviewed for the in-depth study were shown a range of press advertisements. When asked to explain the difference between debt management and debt consolidation they all struggled to do so.
- 5.10 What these advertisements tend to have in common is a focus on the attraction of *'one easy, lower monthly payment'*. These words often featured in consumers' responses to our survey when asked about why they chose debt consolidation (by whatever means) rather than another option. The most commonly cited reason was that it was the 'easiest' or 'easier' option (28 per cent of respondents). Nineteen per cent chose to consolidate debts because of lower interest rates and 13 per cent because it would reduce their monthly payments.
- 5.11 Under half of respondents (42 per cent) took out a consolidation product purely to pay off debts. The remaining 56 per cent⁵⁰ took out a product that gave them cash in addition to paying off their debts. This was more common among socio-economic groups C2DE⁵¹ and respondents aged over 55. The proportion of the loan used to pay off debts varied greatly. About a third (35 per cent) said that they used three quarters of the loan to pay off debts but a fifth (19 per cent) said that they used only a quarter.

⁴⁸ A small number of debt management companies also offer other services such as debt consolidation loans and IVAs.

⁴⁹ Insolvency practitioners arrange and supervise IVAs through the court. They are paid separate fees for arrangement and supervision. IVAs typically lower payments by renegotiating with creditors so that, frequently, creditors are not repaid in full.

⁵⁰ Two per cent of respondents were 'don't knows'.

⁵¹ C2 is classified as skilled working class, eg engineer, D is unskilled and manual workers, eg factory worker and E is the lowest level of subsistence, eg state pensioner.

- 5.12 When respondents in the survey were prompted with a list of possible reasons for taking out a consolidation product (as opposed to the open question referred to earlier), the desire to reduce monthly payments came out much more strongly, with over half saying this reason applied to them and more than a third saying it was the single most important reason. The next most popular reason was that it was easier to manage one loan than having to remember about lots of different ones (just under half said this applied to them and just over a fifth said it was the single most important reason).
- 5.13 More than a third said that they thought it would be good to pay off their debts and have money to spare for DIY, a holiday or a car and around one in seven said that this was the single most important reason. Most advertisements for debt consolidation (over three quarters in our review) highlight the option of also being able to take a holiday, buy a car, do some home improvements or just have money to spend. For some consumers this extra borrowing may not cause difficulties but for those in financial distress further borrowing could exacerbate their problems.
- 5.14 Consumers' focus on lower monthly payments and on extra cash seems to be at the expense of proper consideration of the length of the loan. One of the reasons that debt consolidation loans have lower monthly payments is because they are spread over a longer period of time. Consumers' focus on the initial cost at the expense of other features has also been emphasised in *The FSA's approach to regulated mortgage sales*.⁵² The FSA states that when using a mortgage for debt consolidation purposes the costs associated with transferring shorter term debt to longer term debt need to be accounted for.
- 5.15 The importance of relating the term of the loan to the life of the asset has been discussed in Chapter 4. Yet only 13 per cent of respondents in the consumer survey spontaneously mentioned length of loan as an important feature when comparing products.
- 5.16 A borrower from the in-depth interviews said:

'It has made things easier for the last six months because it has reduced my monthly outgoings but six months down the line I would have been a lot nearer to paying off my other loan.'

Another borrower felt that this aspect of debt consolidation had not been sufficiently highlighted by the loan provider:

⁵² Published in August 2002.

'What they didn't make clear was the new loan was over the length of the mortgage (15 years) whereas the original personal loan would have been clear in three years time.'

This information would, however, have been included in the agreement documentation.

WHY CONSUMERS CHOOSE NOT TO CONSOLIDATE THEIR DEBTS

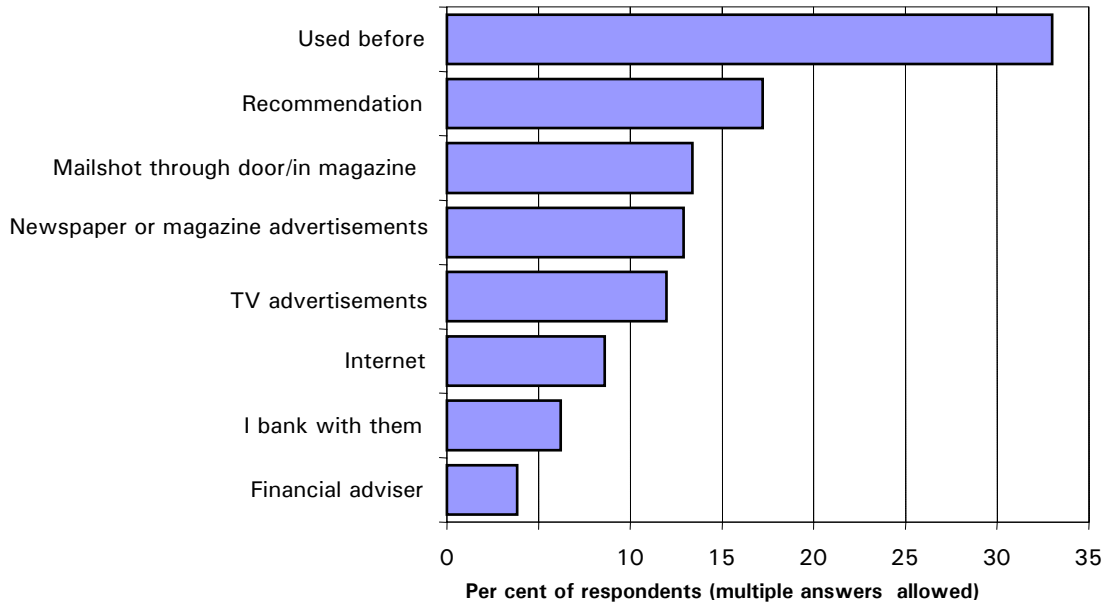
- 5.17 We wanted to find out why consumers who had considered debt consolidation, but rejected the option, did not go ahead. The sample of 250 consumers who had consolidated debts was drawn from a larger sample of 582 people. Of those who had not consolidated debts in the last two years, one third had considered doing so. The most common reasons for not going ahead were that they had been refused (13 per cent) or that it was too expensive (11 per cent). There were more than a dozen other reasons volunteered that indicated that respondents had not taken any action at all. The only exception was the 3 per cent who said that they used a debt management company instead.

DO CONSUMERS SHOP AROUND?

- 5.18 Our surveys showed that consumers do not generally shop around, whether to compare providers or to compare products. The MFS survey found that two thirds of debt consolidation loan purchasers obtained information from only one provider (this is about the same rate as for all loans). Our analysis of MFS data showed that whether the borrower had used the provider before was the most important single feature when choosing providers of unsecured personal loans and second-charge mortgages (for 33 per cent of respondents who consolidated their debts by these means).
- 5.19 Some consumers were prompted to buy a debt consolidation product at the direct suggestion of a broker or lender. The consumer survey revealed that 16 per cent consolidated debts with a provider who had initiated the contact with them (although there is variation by product: contact was initiated by the provider for 30 per cent of those using credit cards but only 11 per cent of those using an unsecured loan).
- 5.20 Where respondents had proactively contacted a provider, most knew about the provider they chose because they had used them before. The second major factor was recommendation and then advertisements of various types. Thirty

per cent of respondents heard about the provider through one or more forms of advertising.

FIGURE 1: HOW RESPONDENTS HEARD ABOUT THEIR PROVIDERS



5.21 Many advertisements do not make it clear whether the company featured is a lender or a broker. Where this is the case, consumers are initially unlikely to know which they are contacting. In some cases brokers answer calls to a number advertised by a specific lender, so that the consumer is likely to think that they are calling the lender direct. Larger brokers have a number of agencies with a panel of lenders. They may also act as 'packagers' for smaller brokers with these same lenders.

FACTORS HINDERING SHOPPING AROUND

5.22 There are many reasons why most people do not shop around. Consumer inertia may play a part, as may difficulty in making comparisons. Given that many respondents to the consumer survey volunteered that they chose debt consolidation because it was the easiest or easier option, consumers who have chosen consolidation are unlikely to want to have to make complicated comparisons. These comparisons are all the more complicated because most consumers borrow extra cash on top of the consolidation. This compounds the problem of comparing like with like.

5.23 As noted in Chapter 4, personal risk-based pricing means that consumers do not necessarily know what APR they will obtain until after an application has been made. When checks are made at credit reference agencies by lenders, in order

to determine whether to make a confirmed offer at a specified interest rate, 'footprints' remain on the agencies' databases. While it is important for lenders to check details, such as other credit arrangements, these footprints may hinder shopping around. Several lenders have informed us that they would consider a number of such footprints to indicate that the borrower was being refused credit by other providers. Some lenders said that they might regard the enquiries as shopping around if they occurred in a short period of time but not otherwise. However, we understand that, by April 2004, the procedures of all three major credit reference agencies will have changed so that lenders will be able to set their systems to undertake a quotation search if there is a risk-based decision involved, either on the cost or on the amount of the credit, without a credit application footprint being left.⁵³ Other quotations that do not require access to credit reference agency data can be given without a search. Only if a quotation converts to an application will a credit application footprint be recorded at the credit reference agency. We welcome this change, which should reduce one of the obstacles to shopping around, and we will reappraise the situation after the new procedures are instituted.

5.24 According to our consultation, consumers' own perceptions of their creditworthiness can lead to them taking the first offer made, thinking it will be the best they can get. While recognising the existence of a wide range of products and providers, respondents to the in-depth interviews typically saw their own options as being very limited, because of the particular problems they had. This perception was a factor in their failure to shop around.

5.25 For others interviewed for the in-depth study, shopping around just added to the complexity of the situation. Distress borrowers are seeking simple solutions, minimising hassle rather than complicating the process further:

'I did look around, I went to, I think it was x, but they wanted me to transfer all my accounts over to them in order to help me.'

'The other banks wanted ALL your business which involved a lot of messing about which I didn't want.'

5.26 For some respondents the only alternative appeared to be bankruptcy, the consequences of which were felt to be more serious than those of the solution offered by the loan provider.

⁵³ This will help to bring the agencies in line with requirements under FSA PS186 (*Regulating Mortgage Sales: final conduct of business rules*) which will be effective from October 2004.

Competition

- 5.27 As indicated in Chapter 3, there are a number of suppliers of each kind of credit product that can be used for debt consolidation. In their responses to our consultation, almost all brokers and lenders felt that barriers to entry into supplying credit were low. One respondent felt that a business entering into the supply of secured loans, particularly to non-status borrowers, would find it difficult to raise finance externally and that there was a limited pool of staff with the necessary expertise, so that recruitment could be difficult.
- 5.28 In our consumer survey 46 per cent of respondents felt that there were 'too many' providers to choose from. Mainstream borrowers with a good credit history are indeed likely to have many options. Even though a large number of providers is available to such status customers, this does not mean that competition will ensure that all interest rates offered are pushed down to the lowest rate. Substantial price dispersion has been noted in the provision of unsecured personal loans,⁵⁴ and has been sustained over time.⁵⁵ At the beginning of March 2004, a borrower with a good credit record could more than halve the cost of credit on an unsecured loan offered by one of the major high street banks, by choosing an alternative provider.⁵⁶ The failure to shop around when there are many alternative providers can therefore substantially increase the cost of borrowing.
- 5.29 Borrowers who do not conform to the standard criteria of mainstream lenders, either because they are not in regular employment (or are self-employed) or they have some adverse credit history, may have more limited options. Some lenders stated in their responses that they do not lend to non-status individuals (as defined in the NSLG). One lender indicated in discussion that they did not lend to self-employed people. Nevertheless, even though some lenders will not lend to non-status individuals, there are a number who will do so on a secured basis. Some of these specialise in certain kinds of non-status borrower. Therefore, a borrower with particular circumstances may have only two or three lenders willing to consider them. We discovered a very limited number of lenders,

⁵⁴ It is not possible to make similar comparisons for secured lending because it is not a homogenous product and there are too many variables (eg variable interest rates, degrees of risk, restricted availability).

⁵⁵ See, for example, Datamonitor *UK Personal Lending 2003* Tables 70, 72 and 73 and Datamonitor *UK Personal Lending 2004* Tables 56 and 57.

⁵⁶ On a £5,000 loan repaid over three years the total charge for credit for a loan from a high street bank at 13.9 per cent APR would be £1,072.35. On an equivalent loan from another provider available at 6.7 per cent APR the total charge for credit would be £517. Source: <http://loans.ftyourmoney.com> on 5 March 2004. Interest rates verified as advertised on relevant provider websites.

offering only small loans, who were willing to lend to non-status borrowers without security.

- 5.30 Brokers offering second charge mortgages all tend to use roughly the same panel of lenders. Therefore, shopping around between brokers for a second charge mortgage may not give a wider choice of lenders, although brokers may compete on the basis of the speed and efficiency of their service. In addition, there are many more brokers than lenders offering/advertising second charge mortgages. This may give potential borrowers the perception that there is more competition than really exists. The consumer survey reported that in 50 per cent of cases brokers provided only one quotation.

Provision of information

ADVERTISING

- 5.31 From our review of advertising and consultation responses it is obvious that there is considerable expenditure on marketing loans and credit cards. Many advertisements are specifically for debt consolidation and many more mention it as one possible use. However, advertisements do not always give a clear message about what they are promoting and there is potential for confusion among consumers about what is on offer. Consumers may find it difficult to make comparisons and thus be less likely to shop around.
- 5.32 Advertisements for credit are regulated by the Consumer Credit (Advertisements) Regulations 1989 and section 46 of the CCA which prohibits false or misleading advertising. Credit advertisements must comply with both and a breach is a criminal offence. The OFT has issued the NSLG for lenders and brokers further to section 25 of the CCA. These guidelines set out practices that may call a trader's fitness and right to hold a consumer credit licence into question and include guidance about advertising.
- 5.33 The advertisement regulations are currently subject to review by the DTI. Although the NSLG apply only to secured lending to non-status borrowers, the then Director General of Fair Trading expressed the hope, when they were published, that all lenders and brokers would consider the extent to which the principles of good business practice contained in them might be applied to all aspects of their business activity. The scope of the guidelines will also be considered as part of an internal OFT review.

5.34 Interested parties have noted, and our own advertising review has confirmed, that some advertisements appear to breach the regulations and/or the NSLG. For example:

- Several advertisements offered credit products of 125 per cent loan to value (LTV).⁵⁷ We are told that few lenders offer these and then only to very creditworthy clients. The mention of high LTVs is frequently found juxtaposed with statements that CCJs and arrears are not a problem. Where advertisements are placed by brokers, they may be advertising a number of different products to customers with different profiles. The 125 per cent LTV is therefore highly unlikely to be available to those with CCJs. This may not be apparent to consumers who have not understood the cost implications, may spend time and money in enquiring about the product and are less likely to shop around having made one enquiry.⁵⁸
- Advertisements of a certain type should contain the name of the business that it is advertising but several did not.
- Some advertisements should give a postal address for the business but this was not always present.
- Warnings about borrowers' homes being at risk if they do not keep up payments if the credit is secured on property were not always prominent and not always in the correct format.
- Certain types of advertisements must include a statement to the effect that a written quotation is available on request. Some did not.
- APRs were sometimes not prominent and sometimes had less prominence than the interest rate, on occasion they were not quoted at all.
- Businesses should not claim that they are 'licensed by OFT' (because it implies that the whole range of a trader's activity has been licensed) but some did.⁵⁹

5.35 These apparent breaches are being pursued separately by the OFT. We will also be undertaking a further monitoring and compliance review of general credit advertising later in 2004.

5.36 The DTI's White Paper announced the Government's intention to make new regulations designed to bring greater clarity and simplicity to the rules that govern the content of credit advertisements. We support the DTI proposals and, in particular, we are recommending that all financial information be shown

⁵⁷ Loans of up to 125 per cent of the value of a borrower's property.

⁵⁸ The NSLG specify that advertisements should not suggest that loans are available regardless of circumstances.

⁵⁹ Permissible forms are 'Licensed under the Consumer Credit Act 1974' or 'Licensed credit broker'.

together as a whole. This should mean that no part of a credit offer can be highlighted over others. For example, a low monthly payment cannot appear in the body of the advertisement when the lengthened term of the loan appears separately in the small print. We are also supporting the DTI and FSA view that a 'typical APR' must be the highest rate reasonably expected to be given to at least two thirds of borrowers who accept a credit agreement in response to the advertisement. These measures should go some way to addressing the issues we have identified. Additionally, the OFT's published response to the White Paper will take the findings of this study into account. For example, we are recommending that advertisements should, where issued other than by a lender, include a brief factual statement of the business's occupation (in relation to which the advertisement is published). The FSA is addressing issues relating to mortgage advertising separately and we will be informing them of our concerns.⁶⁰

INFORMATION PROVIDED TO INDIVIDUAL CONSUMERS

Verbal information

- 5.37 Borrowers from the in-depth interviews tended to view the broker/lender as a financial expert, and thus well placed to advise on solutions. If a relationship already existed between the provider and the recipient this belief was even stronger. Other avenues for advice are rarely explored once an offer of a solution has been proposed. None of the in-depth interviewees were encouraged to 'go away and think about it' or to 'check it out against other deals'.
- 5.38 In-depth interviewees said that they gained the impression from the loan providers that their financial situation was thoroughly assessed based on their individual circumstances. They thus saw the solution then offered, in the form of a loan, as the advisable route to take:

'She knew my circumstances, and she said she was trying to help me. This is what they say. They give you the impression that they are helping you, you're tempted.'

'They knew me personally, but when I tried to get help [with the loan] this is what I ended up with.'

- 5.39 The in-depth interviewees tended to find a loan provider and then take out whatever product they suggested. There was a limited awareness of the range of products likely to be offered or how these might vary between providers.

⁶⁰ See Annexe D for further information.

Interviewees rarely mentioned the words 'debt' and 'consolidation'. The general view was that all loans, whether designed for debt consolidation or not, were the same.

- 5.40 The borrower's perception that the loan being offered to them was being endorsed by a financial expert was particularly strong when a bank approached the customer suggesting the solution, rather than the customer approaching the bank:

'They didn't really offer me an alternative.'

- 5.41 Many interviewees did not feel in a strong position to make demands:

'It probably wouldn't have made any difference at the time to know what the interest rate was or what I was paying back because I was in trouble at the time and just needed to sort myself out.'

Promotional material

- 5.42 Eighty-eight per cent of consumer survey respondents said that information provided was easy to understand and 79 per cent said that the information answered their queries. Only 19 people had further questions and of these nine contacted the provider. Of these nine, only two were satisfied with the responses. This apparent high level of understanding assumes that consumers know the right questions to ask. Given the complexity of these products, this will not always be the case. It may also be that some promotional material appears to be very clear but omits certain important details (for example, about how much more expensive the overall debt can become). While all the necessary information may be in the credit agreement, it is not necessarily read and it may be difficult to understand.⁶¹

Issues important for consumers to understand that need to be explained well by brokers and lenders

- 5.43 There are certain issues that should be explained verbally and reinforced by printed information which consumers can read in their own time. The level of complexity of the information will depend on the complexity of the debt consolidation. The Consumer Credit (Agreements) Regulations 1983 require all credit agreements to specify key financial information, such as the APR, amount

⁶¹ The DTI Consumer Credit Awareness survey (2003), as referred to in the White Paper (*Fair, Clear and Competitive – The Consumer Credit Market in the 21st Century*, p 19) highlighted the need for greater consumer awareness of the terms and conditions of agreements.

of credit and instalments due. If the loan is secured, they also require a description of the security. We know that some consumers may not read or take in information provided. Therefore, it is important to try to present it in the most accessible but comprehensive way possible.

- 5.44 One of the key issues about certain forms of debt consolidation is that of turning unsecured debts into secured ones. The possibility of rises in interest rates and/or adverse personal events accentuates concern about this issue. We asked consumers who had consolidated their debts how well the term 'secured loan' had been explained. Approximately a third of those with secured loans said that the status of the loan was not explained at all or was explained poorly.⁶² CCA regulations⁶³ require the secured status of a loan to be stated in the credit agreement and in certain types of advertisements. Despite the findings of the consumer survey, we have not discovered any systematic breaches of the CCA in this respect.
- 5.45 Consumers may not appreciate all the implications of securing their credit on property, particularly with regard to second charge mortgages. As well as the possibility of losing their home should they default, consumers may face difficulties when moving. They may be required to pay the loan off completely, because the provider of the original mortgage may be reluctant to allow transfers of second charges from one property to another and there may not be sufficient equity available in the new home to facilitate this.
- 5.46 As with credit generally, a clear understanding of the advantages and disadvantages of fixed and variable interest rates is essential, particularly where large sums are involved. By their nature, debt consolidation loans are designed for the long term and several changes of interest rates may occur during that time. If early settlement charges are high, changing products mid-term may be costly.
- 5.47 Borrowers also may not realise the total cost of the loan and how much of it will be interest. (In an open question in the consumer survey, only 4 per cent mentioned the total cost of the loan as an important feature in comparing products, whereas 52 per cent mentioned the interest rate.)

⁶² Consumers may also not realise that an unsecured loan can become secured at a later date if the lender seeks a Charging Order. Department for Constitutional Affairs proposals, as set out in the White Paper - *Effective Enforcement: Improved methods of recovery for civil court debt and commercial rent and a single regulatory regime for warrant enforcement agents* - March 2003, will make this easier.

⁶³ Consumer Credit (Advertisements) Regulations 1989, Consumer Credit (Agreements) Regulations 1983.

'I took out £10,000 and paid off £7,500 in my consolidation but over fifteen years it is costing me £33,000 which I am very dissatisfied about.'

- 5.48 Concerns have been expressed generally, including by some businesses in the credit industry, that introductory offers of low or no interest for a period of time for credit card transfers may not be explained properly, thus making it more difficult to compare products. The OFT recently acted to require Barclaycard to withdraw advertising and market material promoting its '*0 per cent Forever*' credit card offer because it considered it to be misleading.⁶⁴ In 2001 OFT also acted against a general problem in the credit card market where issuers were incorrectly advertising introductory interest rates as an APR. Although this practice has been brought to an end there remains a problem over product comparability. This arises because of a difference in interpretation over how to calculate the APR on a credit card where there is an introductory offer – although the difference in the APR figure that results is generally small. Most card issuers base the APR on the highest rate they will charge over the year whereas the OFT view of the law is that the rate should be a blend of the introductory offer and the rate over the lifetime of the credit. The DTI has proposed a change in the law in its White Paper to ensure a uniform approach.
- 5.49 High early settlement charges may compound problems with certain features of a loan because consumers find it too costly to change to a more appropriate product. Moreover, consumer groups are concerned about early settlement charges, particularly on debt consolidation loans, because they believe that they discourage borrowers from paying off debt when it would be sensible to do so. They argue that it is predictable that a certain proportion of borrowers will want to settle early so this could be factored into the original offer.
- 5.50 The OFT's view is that early settlement charges should reflect the real cost to the lender of early settlement and no more. The DTI White Paper includes proposals to abolish the Rule of 78 and replace it with a rule that is fair to both lender and borrower and to further limit the right of the lender to delay the settlement date and the charges that may be applied.
- 5.51 Around a quarter of respondents in the survey of consumers who had consolidated their debts said that they received no explanation about early settlement charges. (This may indicate breaches of the NSLG with regard to secured lending.) It is possible that respondents had forgotten that they

⁶⁴ OFT press release 149/03, 18 November 2003.

received explanations, but of those who received some explanation, only about half of them said they were well explained.

- 5.52 A characteristic of many of the complaints to CABx was that borrowers had not realised the full consequences of making even one late payment. They were surprised to see how much the sum they owed had escalated. This emphasises how important it is for borrowers to receive adequate explanations of procedures and charges for arrears and defaults before they sign the credit agreement, and to read them carefully. It also points to the need for statements of account to be provided sufficiently frequently. Around a quarter of respondents in the survey of consumers who had consolidated their debts said that they received no explanation about default charges. Of those who received some explanation, only about half of them said they were well explained.
- 5.53 Credit agreements are required to include details of any default charges that the consumer is liable to pay if the agreement is breached.⁶⁵ However, there is no legal requirement to keep consumers informed about accumulating default charges. The NSLG recommend lenders to notify the borrower in writing, each month, while the borrower is in arrears, of key information about the account including the current amount of the arrears. There is also a statutory obligation in section 78 of the CCA to provide periodic statements for running account credit, such as credit cards. The DTI is considering changes to the requirements on the provision of statements.⁶⁶
- 5.54 The DTI is also reviewing the core information that consumers need before entering into a credit agreement. Defining what information is required, at what stage and in what form is not easy. Our research of debt consolidation in the United States revealed that encouraging transparency about fees and conditions has to be carefully judged.
- 5.55 Legislators in the United States were concerned that consumers were not aware of how charges made in relation to mortgage/remortgage credit provision (including advances) were arrived at. Requirements for disclosure of these details were brought into legislation. However, this resulted in long lists of fees being issued which even lawyers claim they do not read. These lists are not helpful because many of the fees are 'junk fees' for services that do not really exist. They are invented either to inflate the final bill or to avoid trigger points in other legislation governing high cost loans (by keeping the total cost of the loan below a threshold). The volume of information overwhelms many borrowers and thus frustrates the shopping around process. To remedy the situation,

⁶⁵ Consumer Credit (Agreements) Regulations 1983, Regulation 2, Schedule 1, para 22.

⁶⁶ Details can be found on the DTI website at www.dti.gov.uk/ccp/topics1/pdf1/creditwp.pdf

authorities in the United States are now streamlining the information required by legislation by consolidating the fees into a number of major categories for genuine services.

- 5.56 With regard to credit cards, a summary of essential information is provided in the United States in the form of a 'Schumer box' so that consumers do not miss important details which may be difficult to see in pages of small print. The DTI's proposed changes require key information to be shown 'together as a whole', which could be in the form of a summary box appearing on agreements. This will be particularly useful for credit cards because the introductory APR alone does not give consumers sufficient information. Consumers also need to know the length of the period the introductory rate will last for, the rate that it will change to subsequently, any annual fee, the credit limit, the minimum repayment, the duration of any interest-free period, charges for late payment or for exceeding the credit limit, additional charges for cash advances and other fees/charges and the order in which payments are applied to the account.
- 5.57 These summary boxes are intended primarily for mailshots and application forms in the UK but could also be used on monthly statements. Statements would then alert consumers to the implications of making only the minimum repayment, by indicating clearly how long it would take to repay the current balance on that basis and how much this would cost. If the debt would never be repaid on that basis, this would be made clear.

Sales techniques

- 5.58 Consumer organisations have expressed concern in the past about consumers feeling under pressure when credit agreements are made in the home. Our consumer survey found that just under half of respondents met face-to-face with the lender or broker but this was usually at the lender's office and usually at the borrower's request. A little under 10 per cent said that they felt under pressure to take out the loan offered.
- 5.59 The NSLG say that lenders and brokers, in certain circumstances, should advise their clients to get legal or other advice (eg from Citizens Advice, a money advice centre or a law centre) before entering into agreements. The extent to which this is done in practice is unclear. Our consumer survey found that 31 per cent sought advice before deciding to consolidate debts. Of these, 37 per cent went to their bank or building society for advice and 28 per cent to an independent financial adviser. Use of non-commercial sources of money advice was very low.

5.60 From the perception of half of the in-depth interviewees (eight out of 14), loan providers are quick to take advantage of the vulnerability of their customers. These respondents felt that they had placed trust in their provider which, with hindsight, was misplaced:

'They keep on helping you get into more debt.'

5.61 These respondents thought that they were receiving financial advice. They now feel that they were subject to a hard sales pitch. They are not claiming that providers have broken any rules. Rather they feel that the providers have taken advantage of them when they were down, by implying that they were being given sound advice, when in fact they were being sold to:

'It wasn't disinformation; it was just an emphasis on the good not the bad.'

'I think they were pushing the fact this was going to be cheap, that it was going to reduce my outgoings and that the interest rate was very low. I don't think they emphasised the fact that it was going to be over 10 years.'

5.62 Some of the in-depth interviewees felt hurried into making decisions. One respondent reported that she applied for a loan over the telephone with a high street bank. She stated that the courier arrived the next day with the cheque and that she was told that she had 15 minutes to complete the agreement forms in the courier's presence. She said that once he had left she read the paperwork thoroughly and realised that the total cost of the loan was bigger than she imagined. She said that this was because she had not been told what the total cost of the credit insurance would be, nor the extent to which the APR would increase the total amount owing.

5.63 Some borrowers in the in-depth study thought that the offer of a loan was available for a limited period only:

'I got the impression that if I didn't say yes then the deal might be off.'

5.64 Respondents in the in-depth study had mostly signed for their loans there and then, without taking time to consider, to shop around or (in some cases) to discuss it with their partner. They believe that the system is set up to be this efficient not for the benefit of customers, but to make the process too quick to allow potential customers the time to think:

'It did seem to run away a bit quickly, I could really have done with a bit more time to think about what I was getting into.'

Broker commissions

- 5.65 Around a quarter of respondents in the survey of consumers who had consolidated their debts said that they received no explanation about commission or fees. Of those who received some explanation, only about half said they were well explained.
- 5.66 Consumers do not always realise that brokers may be working on commission and how this can influence their behaviour. Advertisements that state 'No broker fees' may attract consumers who do not understand how commission is paid and its implications. The in-depth interviews with borrowers dissatisfied with their debt consolidation provided an example of how consumers may not understand, for some time after signing the credit agreement, the way that brokers are often remunerated:

*'I realise **now** that these people must be on a commission.'*

Some advertisements specify 'no broker fees on advertised plans'. This means that plans mentioned in the advertisement do not incur broker fees because brokers are remunerated by lenders through commission. Other plans not mentioned in the advertisement, however, may require the consumer to pay broker fees.

- 5.67 Sixteen per cent of respondents to the consumer survey did not know whether they obtained their debt consolidation loan directly from a lender or through a broker. Certainly, it is unlikely that this group would know whether broker incentives such as volume overrides were being offered by their lenders. We understand from our consultations that volume overrides are common for second charge mortgages and that they are not generally revealed to consumers. The FSA regulation of first charge mortgages will prohibit the payment of volume overrides. Section 2.3.6 of the FSA handbook *Conduct of Business* states: 'A *firm* must not operate a system of giving or offering inducements to a *mortgage intermediary* or any other third party whereby the value of the inducement increases if the *mortgage intermediary* or third party, such as a packager, exceeds a target set for the amount of business referred (for example, a volume override)'.
- 5.68 The NSLG recommend that links between lenders and brokers are disclosed, and encourage the disclosure of commission amounts and of volume overrides. In

fact, the guidelines discourage the use of volume overrides altogether. They also specify that brokers should not be able to influence the commission rate by encouraging the borrower to take out a bigger loan or to suggest one at a higher interest rate.

- 5.69 Whether there is actual consumer detriment from the use of volume overrides would be extremely difficult to prove. Therefore, the OFT will consult on the approach taken towards volume overrides as part of a general review of the NSLG. This review will look at the content and scope of the guidelines including whether there is a need to extend parts of the guidelines to all borrowers and unsecured forms of lending.
- 5.70 We have been told by brokers and lenders that many consumers 'pay off' their debt consolidation loans early (about three years into the loan term). This may not mean that the debt no longer exists. Instead, it may have been refinanced or restructured with a new loan. This loan could be with another lender, at a more advantageous interest rate and/or over a different term. For some borrowers this may be a good deal, but it is not always in their best interest. Each time the loan is 'churned' through brokers they will earn more commission. Ultimately the consumer pays for this, and for rearranging new PPI where applicable (refund policies on PPI vary). In the United States, legislation to restrict churning⁶⁷ of high-cost loans specifies that loans cannot be churned within a year and that there has to be a 'tangible net benefit' to the consumer in so doing. It is not clear how successful this has been because of difficulties in defining a 'tangible net benefit'.

Sale of payment protection insurance

- 5.71 It is noticeable that sales of PPI on second charge mortgages appear to be much higher than on remortgages (lenders and brokers frequently mentioned around 70 per cent take-up on second charges). This raises questions about commission incentives for brokers who are selling PPI.
- 5.72 Our consultation has shown that in some cases the cost of PPI and the commission payable on it are very high in comparison to the loan itself. Some of the in-depth interviewees complained that they had only realised in retrospect how much the PPI cost monthly and overall. Moreover, consumers may not be aware that PPI can be added to the value of the loan on which interest can be charged. We have anecdotal evidence of such cases.

⁶⁷ Known as 'flipping' in the US.

- 5.73 Often, PPI is payable as a single premium on the credit. Consumers may not understand that there are alternatives (eg critical illness insurance, personal savings) and that, if they have the means, they can pay for the premium in cash. One broker said that he refused to sell PPI on a single-premium basis as the sums were too high. He offered a free-standing contract payable on a monthly basis.
- 5.74 Many PPI policies last for only five years, even though secured debt consolidation loans are often set up to run for longer than this. (The MFS data showed that the term was greater than five years for 43 per cent of secured loans.) CABx have cases that suggest PPI has been sold inappropriately to borrowers who found that they could not claim on the policies, for example, because they were self-employed, had pre-existing health conditions or were over a certain age.
- 5.75 Several of the in-depth interviewees had chosen not to take out PPI on their debt consolidation loans because of previous bad experiences (when they may not have read the detail of eligibility for payouts):
- 'I don't take Payment Insurance, because when I was off work for a year, everything had payment protection on and the only one that paid out was x.'*
- 5.76 Given that most consumers do not shop around for credit, it is probably a reasonable assumption that they are even less likely to shop around for PPI than for the credit product itself and will probably accept the PPI offered through their broker without comparison. Many brokers and lenders were of the view that taking out PPI was a sensible course of action and that borrowers should not be taking out credit if they could not afford PPI.
- 5.77 From January 2005, the FSA will be regulating the sale and administration of general insurance, including PPI, and we are raising these specific issues with them. Currently they are proposing to clarify the conditions of PPI policies, including limitations and exclusions, and PPI's standalone cost when bundled into the total credit amount. The FSA also propose to ensure that consumers are aware whether the PPI is compulsory or voluntary and that sales staff are appropriately trained.
- 5.78 Federal legislation (together with peer pressure) in the United States has been successful in dealing with problems encountered with single premium insurance. Legislation requires that the premium be counted as part of the trigger to make

the loan regulated. The extra compliance costs were sufficient to discourage abuses with regard to single premiums.

Involuntary debt consolidations

5.79 We received details (from several sources) of a number of reported instances of lenders (mainly high street banks) requiring consumers to take out debt consolidation loans as the only solution to their financial difficulties. This occurred even where the borrower had got into financial difficulty and approached a debt counselling service such as a CAB. After assessing all income and priority and non-priority debt, the borrower or a CAB representative would approach the local bank branch to explain the position and offer an affordable repayment plan. It was reported that the banks were refusing to accept the plans and required that the borrower take out a debt consolidation loan or 'recovery plan/managed account' with them. Concerns were expressed by CABx that the repayments on these loans were not affordable for the borrower and placed the bank in an advantageous position, by concentrating solely on clearing their own debts, over other creditors. One of the banks involved has taken steps to address the issue and another is in the process of assessing it. OFT is considering these issues separately.

Responsible lending

5.80 In trying to assess whether there are problems with responsible lending and how serious they are, we were hampered by difficulties in obtaining company data, particularly data relating specifically to debt consolidation.⁶⁸

5.81 The OFT has limited information-gathering powers under both the EA and the CCA. In relation to the CCA, we can only require information from traders when they apply for a new credit licence or to renew an existing one and only in order to assess fitness to hold such a licence. This restricts our ability to investigate traders during the currency of their licence.

5.82 We have, however, identified some practices which, at least potentially, raise concerns about the responsibility of lending decisions. In relation to some of these, our consumer survey and complaints analysis appear to show real problems. Most of the potential areas of concern are relevant to credit provision generally. The review of the CCA offers an opportunity to address many of these issues.

⁶⁸ Some respondents sent in very helpful information. On the whole, however, access to detailed information was problematic.

AFFORDABILITY

- 5.83 The key criterion for judging whether lending is responsible (in the context of long-term debt consolidation) is whether the lender's decision is based on a good assessment of the potential borrower's ability to repay the loan on a regular basis, taking due regard of their income and expenditure. The larger the loan, and the greater the risk to the consumer, the more important it is that the lender makes appropriate checks. We acknowledge that borrowers too have a responsibility to be honest and realistic. Without the details of individual cases it is very difficult to say whether any given lending decision is responsible or not.
- 5.84 Borrowers who are not in regular employment and who do not have accounts may be able to self-declare their income. In such cases lenders should be in no doubt as to the affordability of repayments before granting credit. Some lenders allow those who are in regular employment to self-declare, and even advertise to this effect. This has the potential to lead to both irresponsible lending and irresponsible borrowing. Normally, those in regular employment would have documentary evidence of their income and would not need to self-declare.
- 5.85 Some lenders have argued that the decline in the rate of mortgage repossessions⁶⁹ in recent years indicates that lending decisions are not being made irresponsibly, on the basis of equity, but that proper account is being taken of ability pay. However, in the current economic climate of low unemployment, low interest rates and increasing house prices, the level of repossessions would, in any case, be expected to be relatively low, so that it cannot be seen in itself as a strong indicator of responsible lending.
- 5.86 Consumer groups have questioned the responsibility of high LTV debt consolidations. As has been referred to in the section on advertising, high LTVs are apparently available only to those with a very clean credit record. At one level this might indicate responsible lending. Lenders offering up to 125 per cent LTV would need to assess affordability carefully because they know that there is little or no equity available as security. However, while borrowers with equity can switch to a lower cost remortgage, borrowers with high LTV loans are vulnerable to property prices falling and could be locked into a loan, unable to remortgage because of insufficient equity.

⁶⁹ Statistics from the CML indicate that mortgage repossessions have declined in recent years and stood at 11,970 in 2002.

- 5.87 In assessing affordability, lenders should be able to satisfy themselves that they have sufficient evidence of the borrower's circumstances. Just under half of the respondents in our consumer survey said that they did not have to provide proof of income, and just over half said that they did not have to provide proof of address when applying for their debt consolidation product. Slightly more than half of respondents said that they were not asked to provide details of existing debts. Where there is an existing relationship between lender and borrower, providing fresh proof of income or address may not be necessary. We would expect, however, that the extent of existing debts would be taken into account in any significant lending decision.
- 5.88 Some lenders share information on credit limits, balances, payment profiles and current monthly payments through credit reference agencies. Only these lenders have access to all the information held by the agencies, including details of missed payments and defaults. However, this information does not normally include data showing that only the minimum payments are being made on credit cards and store cards. This may be an indicator of current or future payment difficulties, as balances are likely to increase and debts can potentially remain outstanding indefinitely. Recently, one of the credit reference agencies has developed a Consumer Indebtedness Index to identify those borrowers who are currently servicing their debt but for whom a change in circumstances or further borrowing could present problems. This index obviously provides useful information but it is not used by all lenders.
- 5.89 Other lenders can only access a database of publicly available information, such as CCJs and electoral registers. Unless a lender shares its data and pays the higher fee for full access it may have difficulty in verifying information provided by borrowers. There is clearly a delicate balance to be struck between sharing excessive amounts of data about borrowers, and lenders having sufficient information to make good decisions. The DTI task force on over-indebtedness encouraged lenders to share a wider range of data on borrowers and to use the data available more fully.⁷⁰
- 5.90 Responses to our consultation indicated a variety of approaches by brokers and lenders to the verification of information provided by borrowers. There was no clear and consistent distinction between the information required in relation to secured and unsecured borrowing. Some lenders would require as much proof for unsecured borrowing as for secured. Many lenders relied on checks with credit reference agencies rather than asking for documentary proof.

⁷⁰ *DTI Task Force on Tackling Over-indebtedness*, July 2001, recommended that shared data should include outstanding credit balances, credit limits, history of repayments and amounts borrowed.

- 5.91 Banks lending money to their own current account holders typically required less documentary information from applicants for credit, instead relying largely on the evidence already available to them, for example, from the conduct of their accounts. Several lenders mentioned that the documentary evidence sought depended on an assessment of risk. Sometimes lenders would only ask for documentary evidence when they could not establish proof of residency through a credit search. When lending to non-status borrowers, some providers wanted documentary verification of income, while others relied on the customer's word or used a reasonability test (what a customer is likely to be earning). Self-employed borrowers could often self-declare for loans of less than £25,000. Larger loans typically required some kind of supporting documentation, though this varied from business cards, to an accountant's letter, to a self-assessment tax form, to three years' audited accounts. Employees could be asked for payslips, a P60 tax notice, employers' letters, proof of length of employment and previous employment, or anticipated income. Other evidence cited included bank statements, mortgage references, existing credit commitments and outgoings for household bills.
- 5.92 Lenders told us that credit card applicants are required to state their income and employment details on the application but documentary evidence is not required. Lenders rely on checks with credit reference agencies and customers are asked fewer questions when applying for a credit card than when applying for a loan.
- 5.93 Credit cards (and credit card cheques⁷¹) are regarded by consumer groups and many in the industry as easily available and – subject to credit limits – offering open-ended credit. The in-depth interviewees were using credit cards as a core part of their financial coping strategy. They were used for the monthly balancing of day-to-day expenses and/or as a method of spreading payments on other loans.
- 5.94 Advertisements for credit card balance transfers often include debt consolidation as a possible purpose. Whether a balance transfer to another credit card is a better or worse way of refinancing or consolidating credit card debt than taking out a fixed term unsecured or secured loan will depend on the terms of the balance transfer offer and the consumer's own circumstances. Where the balance transfer is on the basis of a low interest rate and the cardholder expects to be able to settle the balance before the offer ends the

⁷¹ Credit card cheques can be used where the credit card itself is not accepted, for example, when paying road tax or utility bills. The amount is charged to the credit card account and interest is usually payable from when the cheque is written (with no interest-free grace period), and there may also be a handling fee.

flexibility of a credit card will generally allow this without any additional cost. By contrast a lender has a right to impose early settlement charges on a fixed term consolidation loan when it is settled early. On the other hand if the consumer does not expect to be able to clear the debt quickly, the APR on a credit card is likely to be higher than on a fixed term loan.

- 5.95 US consumer groups believe that credit card companies in the United States (many of which are also major providers in the UK) target low-income individuals and consumers with tarnished credit records with deceptive sales pitches. It is claimed that the new cards on offer will help consumers repair their damaged credit ratings. Consumer groups say, however, that the cards carry exorbitant fees and other hidden costs that worsen consumers' financial problems. Recently, we have seen the launch of credit cards in the UK aimed at credit-impaired borrowers. Given the tendency for some practices in the US credit market to be replicated in the UK this is a part of the market which will need to be monitored particularly carefully.
- 5.96 We found some instances of borrowers saying that they had been offered more than they asked for:

'I was encouraged to take out a loan for more than I needed, so my loan is part consolidation and part for home improvements.'

If true, such practices might raise issues of affordability, particularly for those who are seeking to consolidate their debts because they are already over-extended. One lender was aware of some brokers who tried to encourage borrowers to apply for larger loans so that they would exceed £25,000 and thus would not be regulated under the CCA. Insofar as this practice does exist, it would be eliminated by the proposal in the DTI White Paper to abolish the £25,000 upper limit on credit agreements covered by the CCA.

SPEED OF DECISION-MAKING

- 5.97 Many advertisements emphasise the speed with which decisions in principle and confirmed decisions can be made and the speed with which money can be obtained. (The consumer survey showed that 73 per cent received their money within one week of the contract being signed by them.) For the consumer, speed and efficiency is important, but it is also important that sufficient time is taken to make a responsible lending decision. Of the three stages listed above, the speed with which confirmed decisions are made is the crucial one with regard to responsible lending. This is the period when, where appropriate, checks should be made on proof of income, identity, other debts and so forth.

- 5.98 Results from our consumer survey would suggest that these checks are often performed very quickly. Almost a third of respondents said that the time taken from deciding to consolidate debts in the first place to receiving a confirmed offer was just one day. It should be noted that the period did vary considerably between types of product, with secured products generally taking longer than unsecured ones. However, even with remortgages, around a third (17 of 47) said that they received a confirmed decision in one week or less and with second charge mortgages this rose slightly to around a half (18 of 39). Around a fifth (8 of 39) of the second charge sample said that they received a confirmed offer within one day.
- 5.99 Consumers' perception conflicts to some extent with what we were told by many brokers and lenders, who were adamant that making confirmed offers was not a quick process, unless it involved no more than a check with a credit reference agency which could be carried out automatically. Where borrowers were required to post documents to the lender and where clarification of information given to brokers was needed, the process could take weeks.

FURTHER BORROWING

- 5.100 The consumer survey showed that 38 per cent of those who had consolidated debts in the last two years had done so before. The figure was slightly lower among those who had remortgaged (28 per cent versus 40 per cent who had used other consolidation methods). Of the 96 people who had consolidated debts before, almost two-thirds had done so on two or more occasions previously. This rose to 74 per cent among those who had transferred a credit card balance. For almost half of the respondents who had consolidated debts before (45 per cent), there was a gap of two years between each time they had consolidated debt. Of the 96 consumers who had consolidated their debt before, 44 per cent took out their most recent debt consolidation product to pay off previously consolidated debts.
- 5.101 Lenders and brokers offering debt consolidation through second charge mortgages have reported that they frequently ensure that outstanding debts are paid by writing cheques in the names of the creditors. This seems to be less common with providers of unsecured loans, it being less likely that unsecured debt would be paid directly (except credit card balance transfers). Sixty per cent of the borrowers in our consumer survey said that they were given the money to pay their debts off themselves. Obviously, direct payment ensures that the new credit is used for the debt consolidation and does not increase the need for further borrowing to cover these debts.

- 5.102 Some brokers said that they suggest that over-extended borrowers taking out debt consolidation loans should cut up their credit cards or store cards. Of course, they cannot insist on this. After consolidating their debts, 24 per cent of respondents to our consumer survey borrowed further, including obtaining new credit cards. Two of those interviewed in our in-depth study said that their bank asked them to cut up their credit and debit cards, only to have the bank send them replacement cards soon afterwards.
- 5.103 Six months after a loan is agreed, many brokers start marketing to the borrower with further credit opportunities. Our consumer survey found that a quarter of borrowers have been offered unsolicited additional credit (most likely on credit card balance transfers and least likely on remortgages).
- 5.104 Interviewees from the in-depth survey spoke of being 'bombed' with information about different loan offers through the internet, television, newspapers, direct mail and through their banks. Those who had previously taken out loans also received frequent cold-calls from loan providers. The FSA will be limiting cold-calling for regulated mortgage products unless there is an established customer relationship and the consumer has indicated that they want such approaches. The OFT has recommended to the DTI's CCA Review that it should consider equivalent protection for all second charge mortgages and unsecured credit.

6 WHAT THE OFT IS DOING

- 6.1 The use of consumer credit is growing. The provision of credit generally, and credit for debt consolidation in particular, is characterised by vigorous product development and marketing. Whether consumers are considering debt consolidation simply to improve the terms on which they are borrowing or to relieve a position of distress, they are faced with a number of complex decisions. Consumers need to understand what debt consolidation involves and what alternatives, such as debt management or in extreme cases insolvency, may be open to them. For some financially distressed consumers, free debt counselling may be more appropriate, simply because of the cost of commercial services. There may be insufficient awareness of the existence and availability of free services.
- 6.2 Debt consolidation can be helpful to many consumers but if this part of the market is to work well, action is needed at a number of levels:
- financial literacy and numeracy
 - enforcement and regulatory action
 - improving regulation and the law.

FINANCIAL LITERACY AND NUMERACY

- The OFT produces consumer leaflets giving advice about credit and debt. This includes advice on borrowing, budget planning, comparing credit cards, top ten credit tips and what to do to get out of debt.
- A new OFT consumer education team has been set up to improve consumer knowledge and awareness of credit and debt issues. As part of its work, it will aim to give consumers the skills they need to make the best decisions when buying credit and to handle their debt effectively. In the autumn of 2004 an information campaign will be launched about different forms of credit and credit cards.
- A consumer education strategy is being developed by a national group of public and private sector members, chaired by the OFT's Executive Director. It will bring together and coordinate consumer education in the UK to avoid gaps or duplication. For example, the OFT will be mapping research about consumer behaviour to share the findings more widely. The OFT strategy will mesh with the FSA financial capability strategy. We will lead on consumer education dealing with debt and credit issues.

- The OFT will feed information on matters relating to debt consolidation into the FSA's consumer financial capability strategy.

ENFORCEMENT AND REGULATORY ACTION

- Where this study has identified practices in the market which may be regarded as unfair – for example lenders requiring existing customers to take out consolidation loans as a way of tackling a debt problem – they will be further investigated and action taken as appropriate.
- The OFT will consider the scope for tackling the problems relating to transparency and responsible lending through its guidance on fitness to hold a consumer credit licence and through trade association codes of practice.
- The study identified a number of apparent breaches of credit advertising rules. These are being pursued by the OFT. We will be undertaking a further monitoring and compliance review of credit advertising later this year.

IMPROVING REGULATION AND THE LAW

- The CCA and associated secondary legislation including the Advertisements Regulations are currently being reviewed by the Government. In addition to its ongoing enforcement of the Act and Regulations, the OFT will be advising the DTI on the amendments which it believes to be necessary in the interests of consumers. The findings of this study will inform the OFT's advice, particularly in relation to clarity about the services and products on offer.
- The NSLG already discourage the use of volume overrides and the FSA regulation of first charge mortgages will prohibit their payment. The OFT will consult on the approach taken towards volume overrides as a part of a general review of the NSLG. This review will look at the content and scope of the guidelines including whether there is a need to extend parts of the guidelines to all borrowers and unsecured forms of lending.
- The FSA is consulting on proposals for regulating the sale and administration of general insurance, including PPI. We are informing them of our findings and we will work with them to ensure that consumers' interests are protected.

ANNEXES

A LIST OF RESPONDENTS

Businesses

Alfa Mortgages Ltd
Baines and Ernst Ltd
Barclays Bank Plc
Black Horse Ltd
Blemain Group Plc
Britannia Capital Securities
Central Trust Plc
Debtfreedirect Plc
Dial-4-a-Loan Plc
Direct Line Financial Services Ltd
Equifax Plc
Experian Ltd
FIRSTPLUS Plc
Freedom Finance Ltd
HFC Bank Plc
HSBC Bank Plc
Impact Plus Plc
Independent Finance Corporation Ltd
KRM Ltd
Lloyds TSB Bank Plc
Loans.co.uk Ltd
Lombard Direct Ltd
Nationwide Building Society
NatWest Bank Plc
Norton Finance Ltd
Ocean Finance
Prestige Finance Ltd
Royal Bank of Scotland Plc
Southern Pacific Mortgages Ltd
Swift Advances Plc

Tesco Personal Finance
The Finance House
Ulster Bank Ltd

Government departments / Regulatory organisations

Department for Constitutional Affairs
Department of Trade and Industry
Financial Services Authority
Her Majesty's Treasury
The Commission for Racial Equality

Trade associations

Association of British Credit Unions Ltd
Association of Independent Financial
Advisers
Association for Payment Clearing
Services
British Bankers' Association
Consumer Credit Trade Association
Council of Mortgage Lenders
Finance and Leasing Association
Finance Industry Standards Association
National Pawnbrokers Association

Consumer organisations

Advice UK
Advice Northern Ireland
Citizens Advice
Citizens Advice Scotland
Consumer Credit Counselling Service
General Consumer Council for Northern Ireland
Local Authorities Coordinators of Regulatory Services
Money Advice Trust
Money Advice Trust (Scotland)
National Debtline
Welsh Consumer Council

United States

American Association of Retired Persons
Butera & Andrews: Attorneys at Law

Center for Responsible Lending - Self Help
Congressman Ney's Office
Consumer Federation of America
Credit Research Center, Georgetown University
Department of Housing and Urban Development
Federal Trade Commission
Federal Reserve Board
Lotstein Buckman: Attorneys at Law
Mortgage Bankers Association of America
National Association of Consumer Advocates
National Consumer Law Center
National Home Equity Mortgage Association
US Treasury Department
- Office of the Comptroller of the Currency
- Office of Thrift Supervision

B METHODOLOGY

CONSULTATION

- B.1 During the study views were sought from a wide variety and large number of stakeholders including lenders, brokers, consumer organisations, trade organisations and other government departments.

We would like to thank all those who contributed to the study.

MFS OMNIBUS DATA

- B.2 Data from 48,000 back-dated interviews was purchased from MORI Financial Services (MFS) showing representative figures for the use of debt consolidation in the UK.
- B.3 Extra questions were also added to two waves of the MFS omnibus survey conducted every two weeks comprising 2,000 face-to-face interviews of the general public aged 16 and over.

CONSUMER SURVEY

- B.4 Following a competitive tendering process, the OFT commissioned Wirthlin Europe Ltd to conduct research among consumers in order to understand the nature of debt consolidation, the relationship between consumers and the providers of debt consolidation products, and how well consumers were being served.
- B.5 The objectives of the survey were to determine:
- the types of consumers who used debt consolidation
 - the way in which consumers used debt consolidation
 - why consumers consolidated debts
 - how consumers chose providers and products
 - what consumers' expectations were
 - how much was borrowed and how much was offered
 - how much debt consolidation cost
 - the extent to which consumers understood the implications of the agreement they had entered into
 - whether consumers were aware of the total costs
 - what selling methods were used

- the transparency and effects of marketing and advertising techniques
- the level of satisfaction consumers gained from debt consolidation.

B.6 The research was undertaken in two stages:

- i) 250 telephone interviews with customers who had consolidated debt in the last two years. The sample was selected from a data set supplied by Experian Ltd of consumers who had indicated in a previous survey that they had a personal loan and would consider debt consolidation. Although quotas were not imposed, a comparison with the large-scale MFS data set indicates that the sample is broadly representative of the population in terms of sex, age and household income. We believe therefore that, although this is only a small-scale survey, the results are broadly indicative of the experience of consumers who consolidate their debt as a whole. However, less emphasis can be placed on the results from subsets of the data because the sample size is often much smaller.
- ii) 14 in-depth interviews with consumers who had experienced problems with debt consolidation. The sample used was sourced from respondents to the telephone interviews and complainants from CABx.

All of the consumer survey work was conducted on an anonymous basis.

COMPLAINTS DATA

B.7 The OFT received examples of specific complaints data concerning debt consolidation from CABx, Citizens Advice Scotland, the Consumer Credit Counselling Service and Money Advice Scotland. These organisations also assisted by providing names of consumers willing to discuss their experiences.

The OFT would like to thank these organisations and those consumers who volunteered to be contacted for their assistance.

MEDIA ANALYSIS

B.8 The OFT commissioned TNS Media Intelligence to collect credit advertising from national and regional newspapers and from television. This was supplemented by internal research of businesses that advertise over the internet and through mailshots.

INTERNATIONAL RESEARCH

B.9 Research was conducted in order to gain an insight into debt consolidation in the United States. This involved meeting consumer, trade and regulatory bodies to discuss issues such as:

- market trends
- consumer purchasing behaviour
- consumer problems and concerns
- initiatives adopted by relevant trade and government bodies to remedy problems.

B.10 We would like to thank all of the US consultees but with particular thanks to the Federal Trade Commission (Bureau of Consumer Protection) and the US Department of Housing and Urban Development for assisting us in organising the research visit.

C GLOSSARY OF TERMS

Administration Order	An order made in the county court to administer the payment of debts by an individual. It deals either with the insolvent estate of a deceased debtor, or with an individual with small debts (usually under £5,000) to pay. A debtor's payments to creditors are made directly to a court as a single payment, which is then shared out.
APR	The annual percentage rate of a loan. It expresses the total charge for credit as a standard measure which borrowers can use to compare the credit charges under one deal with another, whatever rate or method of charge is used.
Charging Order	An order which is obtained by the creditor and imposed/reinforced by the court, to collect outstanding unsecured debt. It gives the creditor priority over assets should the property be sold, and when made absolute can be used to force sale.
Debt Arrangement Scheme	The Scottish equivalent of an Administration Order.
Debt management	Debt managers do not usually give consumers access to more credit but manage existing debts for a fee.
Insolvency practitioner	An authorised person who specialises in insolvency, usually an accountant or solicitor. They are authorised either by the Secretary of State for Trade and Industry or by one of a number of recognised professional bodies.
Individual Voluntary Arrangement	A negotiated settlement between a debtor and their creditors which allows the debtor to repay their debt in affordable monthly instalments over a fixed period of time, usually five years. The terms of the IVA will depend on personal circumstances but can ultimately allow for a proportion of the debt to be written off. If the debtor owns a property, they will

normally have to offer creditors a sum of money in place of their equity. It is also possible to offer creditors a lump sum to settle debts through an IVA.

Loan to value	The ratio of the loan amount to the valuation of the property.
Non-status borrower	A borrower with an impaired or low credit rating who would find it difficult generally to obtain finance from traditional sources on normal terms and conditions.
Non-status Lending Guidelines	Guidelines issued by the OFT, for lenders and brokers in the non-status lending market. They highlight potential areas for concern, and offer examples of good practice. Breach of them may be taken into account by the OFT in assessing the fitness of a lender or broker to continue to hold a consumer credit licence under s25 CCA.
Rule of 78	A formula used by lenders to calculate an early settlement figure for instalment loans; for a loan paid back in 12 monthly instalments, since $1 + 2 + 3 \text{ etc} + 11 + 12 = 78$, $12/78$ ths of the interest is owed after the first month, $11/78$ ths after the second month, and so on until $1/78$ th of the interest is owed at the end of the 12th month.
Second charge mortgage	A loan borrowed against the equity in the borrower's property. It is so called because it is in addition to the first mortgage.
Secured loan	A loan secured against property.
Total charge for credit	The total charge for credit includes interest and other charges payable under the credit agreement and linked transactions.
Volume override	An additional payment made by a lender to a broker on the basis of business volume and profitability.

D HOW DEBT CONSOLIDATION LOANS AND AGREEMENTS ARE REGULATED

Regulation under the Consumer Credit Act

- D.1 Consumer credit up to the value of £25,000 is regulated by the Consumer Credit Act 1974 (CCA). The CCA regulates the credit market in two ways, by licensing traders and by setting rules and regulations. Traders must be fit to hold a consumer credit licence and those traders who are deemed unfit by the OFT, for example because they have convictions or breach consumer legislation, will either be refused a licence or have their licence revoked. A licence will normally be granted in the absence of evidence of lack of fitness.
- D.2 The licensing regime is run by the OFT. The OFT has issued guidance on how it enforces its licensing regime. The Non-status Lending Guidelines (NSLG) set out in some detail practices that should be followed by lenders serving borrowers who are unable to obtain loans on normal high street terms. Written specifically to counter problems in the unregulated, secured credit industry, they also have relevance across the whole market. They are to be reviewed during 2004.

ADVERTISING

- D.3 All credit advertisements aimed at consumers are regulated by sections 43 to 47 of the CCA. Section 46 of the CCA imposes a requirement that information must not be false or misleading in a material respect. More detailed regulation is imposed by the Consumer Credit (Advertisements) Regulations 1989. The Regulations classify advertisements as simple, intermediate or full depending on the amount of information they contain. The Regulations set out specific information requirements for each category of advertisement. Breaches of the advertising requirements are criminal offences and may also be enforced under Part 8 of the Enterprise Act 2002 (EA).

AGREEMENTS

- D.4 Agreements made under the CCA must comply with the Consumer Credit (Agreements) Regulations 1983. These ensure that all agreements contain key financial information, such as the APR, amount of credit and instalments due. They also require a description of any security. It is important that lenders draw up their agreements correctly, as otherwise they may only be enforceable by

court order, and in some situations the court will not be permitted to enforce the order.

WITHDRAWAL FROM PROSPECTIVE SECURED AGREEMENTS

- D.5 Lenders offering secured loans regulated by the CCA to consumers have to send the consumer a non-executable copy of the loan agreement seven days in advance of sending or presenting the executable copy for the consumer to sign. During the seven days, the lender or broker is not permitted to contact the consumer at all. This measure is intended to give the consumer enough time to consider the loan in an unpressured environment or to take independent advice.

EARLY SETTLEMENT

- D.6 Section 94 of the CCA gives consumers the right to complete any payments due under a regulated loan ahead of time. Section 95 allows the consumer to claim a rebate of some of the interest payable under the loan that is yet to fall due. The Consumer Credit (Rebate on Early Settlement) Regulations 1983 set down a statutory formula for calculating the minimum rebate a lender must grant. Lenders are free to offer better settlement terms if they wish.

Loans not regulated by the CCA

- D.7 There are some exceptions from the CCA, one of which includes first charge mortgages used for domestic land and house purchases which are regulated by the Financial Services Authority (FSA).

Proposed changes to the regulatory regime

GOVERNMENT PROPOSALS TO UPDATE THE CCA

- D.8 The Department of Trade and Industry (DTI) published the White Paper, *Fair, Clear and Competitive: the Consumer Credit Market in the 21st Century* on 8 December 2003. The White Paper sets out the Government's proposals to create a more transparent regime so that consumers can make better-informed decisions and get a fairer deal. Implementation is intended to take place between October 2004 and April 2006. The Government intends to:
- change the Advertisement Regulations to make credit advertisements clearer and simpler for consumers and traders to understand, and the regulations easier for authorities to enforce

- provide consumers with clearer information, before and after agreements are signed
- enable consumers to enter and conclude credit agreements online, speeding up application procedures and reducing burdensome paperwork
- raise awareness of early settlement charges and change the law to prevent those who repay early from being penalised.

D.9 The Government's stated desire is for a modern framework that encourages and rewards vigorous competition, innovation, choice and enterprise, while stamping out irresponsible and unfair lending practices.

D.10 To this end, the Government is proposing:

- strengthening of the credit licensing regime to target rogue and unfair trading practices and provide enforcers with the powers they need to supervise a fair and effective credit market
- changes to the law to end unfair selling practices – replacing a limited 'extortionate' test with a wider 'unfairness' test – as well as providing an effective dispute resolution mechanism
- removal of the £25,000 financial limit and most of the exemptions. This would have a significant effect in widening the scope of credit regulated by the CCA. The CCA would then regulate all consumer loans for whatever value, as long as they are not for business purposes or a first charge mortgage. The FSA will be regulating the latter – see below.

INTRODUCTION BY FSA OF RULES ON MORTGAGE LENDING

D.11 On 31 October 2004 the FSA will introduce rules that will regulate some debt consolidation activity that occurs through remortgages and advances on existing mortgages.

D.12 The proposals will mean that all those who carry on mortgage business will need to be authorised by the FSA or be exempt from authorisation. Businesses may be exempt if, for example, they are an appointed representative of an authorised firm or are an exempt professional firm. Authorised businesses can carry out one or more of the following:

- advising on mortgages

- arranging mortgages
- mortgage lending
- administering mortgages.

D.13 Additionally, the Financial Services and Markets Act 2000 imposes controls by way of rules.

D.14 Of most importance to this study are the rules on advertising that will come into effect in October 2004. The FSA has recognised that debt consolidation products carry particular risks and as such have proposed that all debt consolidation advertisements (covered by their regime) that replace unsecured lending with secured lending include the warning statement:

'Think carefully before securing other debts against your home. Your home may be repossessed if you do not keep up repayments on your mortgage.'

D.15 Additionally, any advertisements that are aimed at impaired credit consumers will also have to state the APR, and there will be a requirement that any claim about a product will have to be balanced by the possible disadvantages, where this is applicable. For example, a debt consolidation advertisement that claims to reduce monthly repayments substantially will also have to state with no less prominence that the length and overall cost of the loan will increase.

European controls

D.16 Consumer credit is regulated across the European Community by Directive 87/102/EEC. This, as a minimum harmonisation Directive, seeks to ensure a common lowest level of regulation and consistency in the use of terms, particularly the APR. In almost every part of its functions, the CCA exceeds the benchmark set by the Directive.

CHANGES PROPOSED BY THE EU

D.17 Currently, the European Union is considering a new draft Directive on consumer credit. This seeks to create a single market in financial services across the EU by imposing a common set of rules for all consumer credit. As such, the proposal is for a maximum harmonisation Directive. This means that member states could not have national rules that provided for greater consumer protection. If passed this could have a significant impact on current UK consumer credit law. A copy of the draft Directive can be found at http://europa.eu.int/eur-lex/en/com/pdf/2002/com2002_0443en01.pdf

D.18 The Government wants a properly functioning single European marketplace for credit, with the potential to boost competition, generate better deals and ensure consumers have enough protection to shop confidently across borders.

D.19 To this end, the Government will press for:

- cross-border data access on an equal and fair basis
- a common approach to advertising and information regulation, unfair practices, rules on the calculation of the APR, and debt recovery and collection practices
- high level consumer rights and redress mechanisms
- an effective passport regime for lenders wanting to market and sell credit products cross-border.

E DEBT CONSOLIDATION IN THE UNITED STATES

Introduction

- E.1 The US credit market is highly developed and provides credit across a broad spectrum of risk, that is, from the very low-risk 'status'⁷² to the 'near status' to the very high-risk 'non-status'.⁷³ It is generally accepted that the status market is very competitive while at the same time subject to intense federal supervision. The non-status sector, where independent finance companies dominate and which lie outside the direct scrutiny of federal regulators, is of greater cause for concern to consumer groups. Complaints involving debt consolidation activity have, however, been received in both the status and non-status sectors.
- E.2 Federal laws have been designed to ensure that all borrowers benefit from increased disclosure and thus greater transparency in their credit transactions as well as protecting the more vulnerable borrowers. Companies marketing debt consolidation loans have been the subject of a number of enforcement actions brought by the Federal Trade Commission (FTC), Department of Housing and Urban Development (HUD), Office of the Comptroller of the Currency (OCC) and the Federal Reserve Board (FRB).

Debt consolidation products

- E.3 Credit for debt consolidation purposes in the US can be accessed through a number of channels. However, secured lending, in the form of remortgaging and home equity loans, has become more attractive to consumers than unsecured loans. There are a number of reasons for this, the most important of which is the tax incentive associated with secured borrowing. The 1986 tax reforms phased out federal income tax deductions for interest paid on non-mortgage consumer debt, making secured debt relatively more attractive. Consequently, there has been a sizeable shift towards secured lending. Surveys sponsored by the FRB show that the proportion of homeowners with home equity debt expanded from around 7 per cent in 1983 to around 11 per cent in 1988 following the tax reforms, and to 13 per cent in 1997.⁷⁴

⁷² 'Status' borrowers are known as 'prime' borrowers in the US.

⁷³ *Mortgage Refinancing in Early 2001 and Early 2002*. Federal Reserve Bulletin December 2002.

⁷⁴ *Recent Developments in Home Equity Lending*, Federal Reserve Bulletin April 1998.

- E.4 A combination of declining interest rates⁷⁵ and strong house prices has led many consumers to 'cash-out' while refinancing their mortgages.⁷⁶ The FRB has estimated that US households in 2002 cashed-out almost \$200 billion in home equity (or around 3 per cent of the total home equity available). Of these cashed-out funds, approximately \$70 billion was used to repay (in part or in full) home equity loans. The FRB believes a significant part was used to reduce higher cost credit card debt.⁷⁷
- E.5 From its monthly surveying of consumers⁷⁸ in the first half of 2002, the FRB found that 45 per cent of homeowners who refinanced did so with the intention of cashing-out their home's equity. The most common use of these cash-out funds was to repay other debts.
- E.6 US borrowers wanting to unlock the equity in their homes by using home equity loans can do so in two ways. A traditional home equity loan is a 'closed-end' loan extended for a specific period, requiring repayment of the principal and interest in monthly instalments. It can be a second charge or junior charge⁷⁹ mortgage. Home equity loans are equivalent to secured loans in the UK. They are typically second mortgages. However, borrowers may also unlock equity via a home equity 'line of credit' or HELOC. This is a revolving account that permits borrowing from time to time at the account holder's discretion up to the amount of the credit line. The majority of credit lines are also of second mortgage status but can be first charge for homeowners with no other mortgage debt outstanding.

Providers of debt consolidation

LENDERS

- E.7 A large number and variety of lenders currently extend credit for debt consolidation purposes. These deposit and non-deposit taking institutions are involved in both secured and unsecured loans and include:

⁷⁵ The Federal Reserve has cut its Federal Funds rate 13 times since the start of 2001.

⁷⁶ This increased demand for refinancing in the US is heavily cyclical. Other non-economic factors explain the strength of refinancing in the US, including the widespread adoption of new technology such as automated underwriting systems (AUS) which has eased the process of refinancing making it faster, cheaper and easier for borrowers.

⁷⁷ Chairman Alan Greenspan at the annual convention of the Independent Community Bankers of America, Orlando, Florida, 4 March 2003.

⁷⁸ FRB – Michigan Survey. The FRB found that respondents who had refinanced their mortgages did so either in 2001 or in first half of 2002.

⁷⁹ Any loan secured on a property which is not the first mortgage.

- commercial banks
- independent financial companies
- credit unions
- thrift institutions (savings banks and loan institutions).

BROKERS

- E.8 Brokers have become the dominant originators of refinancing and secured lending. The HUD says that brokers have increased their share of the origination market from practically zero in 1980 to 55 per cent in 2000.⁸⁰ It increased further to around 65 per cent during the recent refinancing wave in 2001, accounting for \$1.3 trillion of the \$2 trillion mortgages originated during 2001.
- E.9 The typical brokerage firm in the US, often referred to as a 'mom and pop shop', is a small operation usually consisting of about five workers and the owner.⁸¹ This model contrasts with the broker model that dominates loan origination in the UK. While there are numerous smaller broker firms that interface directly with the wholesale lender or act as introducers to other brokerage firms, the larger national brokers' firms account for much of the secured loan business in the UK.

Debt consolidation problems

SECURED LENDING

- E.10 Many of the problems associated with secured lending have involved companies making debt consolidation loans mainly to non-status borrowers. A number of government⁸² and independent studies have raised concerns about lending practices in this segment of the market. Practices that have arisen in relation to debt consolidation and which have prompted regulators into action include loan churning, excessive rates and fees, equity lending⁸³ and targeting of vulnerable groups. While concern has also been expressed about converting unsecured debt into secured debt, there does not appear to be a particular problem in terms of borrowers not realising the general implications of this. In a recent FRB

⁸⁰ The HUD cites research carried out by academic David Olson who has conducted several surveys of the brokerage industry.

⁸¹ Department of Housing and Urban Development.

⁸² See for example *Curbing Predatory Lending 2000*, a joint study by HUD and Treasury Department.

⁸³ Lenders basing their decision to lend on the equity in borrowers' property rather than their ability to repay the loan.

monthly *Survey of Consumers*,⁸⁴ consumers were asked a number of questions related to mortgages and were specifically questioned on the consequences of using their home for collateral; 91 per cent answered correctly.

UNSECURED LENDING

- E.11 Problems with unsecured lending have frequently related to credit cards provided by status lenders.
- E.12 The FRB⁸⁵ has found that card companies will typically charge 3 per cent of the balance for transferring the debt onto one card. For many borrowers, transferring credit card balances on to one card has proved more costly than they initially thought. Initially, borrowers are attracted by the 'teaser rate' which many balance transfer programs offer, but they are then quickly locked into a much higher, long-term rate which applies to all debt that has been consolidated. Similarly, borrowers wishing to transfer debt on to one card are attracted by other terms on the cards such as low finance charges and processing costs. However borrowers have found that once the card has been approved they are not given these favourable terms. These practices are generally known as 'bait and switch.'

Enforcement action relating to debt consolidation products

- E.13 A number of federal laws have been used in relation to debt consolidation loans. The 1968 Truth in Lending Act (TILA) applies to both secured and unsecured lending and governs credit advertising as well as requiring adequate disclosure. TILA's subsequent 1994 amendment, the Home Ownership and Equity Protection Act (HOEPA), is primarily designed to deal with 'high-cost' secured lending. HOEPA loans are identified through a combination of rate and fee based triggers and are subject to greater federal supervision. The Real Estate Settlement Protection Act (RESPA) requires, among other things, that consumers receive disclosures at various times in the transaction services. The Equal Credit Opportunity Act (ECOA) prohibits discrimination in lending, as well as including a general prohibition against unfair and deceptive practices. The 1914 Federal Trade Commission Act (FTCA) has also been used against businesses extending credit that has been used for consolidation purposes. Some record amounts have been negotiated by the OCC and the FTC in legal settlements concerning debt consolidation cases.

⁸⁴ University of Michigan's monthly *Survey of Consumer Finances* conducted in November and December 2001.

⁸⁵ Federal Reserve Bank of Philadelphia System, January 2003: *Credit Card Pricing Developments and their Disclosure*.

RECENT OCC ENFORCEMENT ACTIONS AGAINST STATUS LENDERS⁸⁶

- E.14 The FTCA, the Federal Deposit Insurance Act (FDIA)⁸⁷ and the Fair Credit Reporting Act⁸⁸ were used by the OCC to address issues of deceiving and unfairly charging customers by misleading them, among other things, about balance transfer programmes, credit protection plans, and annual fees.
- E.15 The FTCA, FDIA, and TILA were used in relation to bait and switch schemes. In these schemes consumers were allegedly marketed pre-approved credit card offers with attractive terms, but apparently received considerably less favourable credit card accounts with undisclosed processing fees.

RECENT FTC ENFORCEMENT ACTION AGAINST NON-STATUS LENDERS⁸⁹

- E.16 Since 1998 the FTC has brought 17 law enforcement actions against non-status lenders allegedly engaged in predatory lending behaviour. Many of these cases involved debt consolidation loans and highlighted a number of abusive practices ranging from loan churning to equity-based lending, to illegal use of insurance packing.⁹⁰
- E.17 The FTC has alleged violations of the FTCA through deceptive marketing practices that induced consumers to refinance existing debts into home loans with high interest rates, costs, and fees, and to purchase high-cost credit insurance. The FTC has also made charges of violations of several other federal laws, including TILA, FCRA and ECOA, regarding unfair tactics in collecting consumers' payments on loans.
- E.18 These issues involved asserting falsely that borrowers would save money when consolidating existing debt into a single home equity loan when the promotion material did not take into account the loan fees and closing costs. They also involved concealing balloon payments, charging substantial fees, costs and

⁸⁶ Case information has been obtained from the OCC website.

⁸⁷ The Federal Deposit Insurance Act is enforced by the Federal Deposit Insurance Corporation. It preserves and promotes public confidence in the US financial system by insuring deposits in banks and thrift institutions for up to \$100,000; by identifying, monitoring and addressing risks to the deposit insurance funds; and by limiting the effect on the economy and the financial system when a bank or thrift institution fails.

⁸⁸ The Fair Credit Reporting Act (FCRA), enforced by the Federal Trade Commission, is designed to promote accuracy and ensure the privacy of the information used in consumer reports.

⁸⁹ Case information has been obtained from the FTC website.

⁹⁰ Bundling optional insurance products on top of the loan amount, sometimes without the borrower's prior knowledge.

credit insurance premiums. Sometimes the optional insurance products were packed into the loan without the borrower's consent and violated the TILA.

Improving information provision and financial literacy

- E.19 The HUD has taken the view that too much information may overwhelm borrowers and actually hinder the shopping around process. In an effort to clarify the amount and type of information a borrower must assimilate when closing a refinance or secured loan, the HUD is proposing to reform the current rules and HUD1 form.⁹¹ The aim is to simplify the information borrowers are confronted with and to alert consumers only to key information which will allow them to make more informed choices and comparisons.
- E.20 Federal regulators have, both independently and in partnership with each other, introduced programmes designed to improve financial literacy. For example, in spring 2003 the FRB launched its Financial Education Initiative designed to stimulate US households to learn more about their financial management.⁹²
- E.21 The Department of the Treasury established the Office of Financial Education (OFE) in May 2002. Its aim is to ensure that consumers have access to financial education programmes that will give them practical skills to make informed financial choices.
- E.22 Surveys and research have been carried out to find out more about what information consumers use to make financial decisions and where they get that information from. The FRB⁹³ has devoted resources to analysing the behaviour of consumers during the financial purchasing process by examining the ways in which households gain knowledge about personal finances, their preferred sources of information and the effectiveness of learning strategies.

⁹¹ HUD1 or Real Estate Settlement Statement, required under section 4 of RESPA and Regulation X, enforced by the Department of Housing and Urban Development. The form is used as a statement of actual charges to parties in connection with the settlement.

⁹² There may be lessons to be learnt from similar projects in the United States.

Researchers there looked at where consumers got their information from and found significant variations between different ethnic groups. Asians mainly found information about financial products from newspapers; Afro-Americans used television, job fairs and church events; whereas Hispanics relied on recommendations from friends and family. Accordingly, consumer education needs to be targeted specifically through the relevant channel for any given group.

⁹³ *Federal Reserve Bulletin* July 2003. *Household Financial Management: The Connection Between Knowledge and Behaviour*. (Data was taken from the Michigan Survey of Consumers and the Survey of Consumer Finances.)