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Competition Commission: Payday lending market investigation Statement of Issues

Which? welcomes the publication of the Competition Commission's proposed investigation into the short-term loan market, following the Office of Fair Trading's market referral under s131 and s133 of the Enterprise Act 2002.

However, by concentrating primarily on price, margins and market share, Which? believes that the Competition Commission's (CC) theories of harm risk missing or underplaying a number of key anti-competitive elements of the short-term loan market. We therefore encourage the CC to specifically address the following additional areas in its investigation, as well as possible behavioural remedies:

- Lenders' emphasis on convenience and speed of payment, rather than price.
- Excessive default fees that exploit borrowers' over-confidence in their ability to repay in full and on time and which distort price competition.
- The use of rollovers and increases in loan amounts to deter switching.
- Some lenders' non-compliance with relevant laws and guidance giving those firms an unfair competitive advantage.
- Payment collection practices which incentivise lenders to repeatedly resubmit requests, meaning that short-term loans are effectively secured on the borrower's bank account.

We have explained in detail below the areas we believe the CC should focus on in its investigation. In addition, the evidence Which? submitted to the OFT on 1 May 2013 explains

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the ways in which we believe the payday loan market is uncompetitive. We have attached a copy of our submission to this response, along with the appendices.

Theories of harm

Theory of harm 1: impediments to customers' ability to search and identify the best value product, and switch supplier

The CC Statement of Issues argues that 'to drive effective competition customers need to be both willing and able to: access information about the various offers available in the market; assess these offers to identify the good or service that provides the best value for them; and act on this assessment by switching to purchasing the service from their preferred supplier.'

We agree that the pricing of payday loans is not straightforward, often involving daily or monthly interest, fixed fees and charges for late payments. However, we believe the CC's current approach is overly focused on transparency and information remedies. There are problems in the short-term loan market that will not be solved by giving consumers additional information, such as high default charges and an emphasis on speed and convenience rather than price.

Convenience and speed

As noted in the University of Bristol study[1], payday loan users choose a lender primarily on delivery (such as convenience and speed of application and payment), not on price. Lenders compete for business on this basis, which can exploit the desperation of consumers unable to access mainstream credit. 34% of payday loan users in our August 2012 survey of credit users[2] used the loan to pay for emergencies and unexpected expenses, while 32% used it for household bills.

Behavioural economics suggests that consumers heavily discount the future cost of credit. For example, it is likely that a consumer in financial distress would choose a lender that promises to pay out in 30 minutes, compared with another lender that takes 24 hours, even if the latter offers significantly lower interest charges.

High default fees

The Statement of Issues states that consumers may underestimate 'the importance that they will later attach to the charges they incur'. And yet, many consumers will not even consider default charges when considering a loan as they do not believe they will incur such penalties.

In our August 2012 survey, while a third (29%) of payday loan users had taken out credit they *knew* they couldn't repay, half (48%) of payday loan users had taken out credit in the past that it *turned out* they couldn't afford to repay. Even with greater transparency over penalty charges, many consumers are over-optimistic about their ability to repay and will therefore not factor them into their calculations. Transparency will not lead to reduced default charges.

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[1] http://www.bristol.ac.uk/geography/research/pfrc/themes/credit-debt/pfrc1302.pdf [pdf]

[2] Credit Britain report, www.which.co.uk/creditbritain [pdf]

Our survey also found that one in five users of payday loans were hit by 'unexpected' charges and that, in the last 12 months, more than half of payday loan users had incurred charges because of missed or bounced repayments. The business model of some lenders appears to be based on the unsustainable default charges incurred by borrowers. As many consumers don't take these charges into account when comparing and taking out loans, we believe the profit structure of the market is inherently anti-competitive. The CC should therefore look at both the level of default charges and the circumstances in which they are imposed.

Irresponsible lending practices

The CC Statement of Issues states: 'The task customers face may be further complicated by the need to forecast future income and expenses in order to choose correctly. We will investigate how easy it is to evaluate payday loan products […].'

While we agree that consumers must be able to easily compare deals from different lenders, one of the biggest problems in the payday sector is that consumers don't shop around on price. Lenders shift the emphasis away from cost and towards the speed of application and the likelihood of a successful application, with some lenders making a virtue of their lack of credit checks. We therefore welcome the CC's intention to consider the relative weight consumers attach to the speed, availability and cost of borrowing, as well as examining lenders' behaviour, but believe this aspect should be given much greater prominence in the CC's investigation.

More important than the provision of consumer information about rollovers and the lack of credit- and affordability checks is a clampdown on the irresponsible lending practices themselves. Irresponsible lenders, such as those that fail to conduct sufficient affordability- and credit checks and those that actively encourage borrowers to roll over or increase their loan, would not be affected by a move towards greater transparency as their non-compliance with relevant laws and guidance currently gives these firms a competitive advantage. It is the practices themselves that need to be stamped out, not how firms raise potential borrowers' awareness of them.

Regardless of the level of transparency around rollovers, it is important to consider the actual behaviour of consumers. Given the choice between (i) repaying £125 at the end of the month on a loan of £100 and (ii) repaying just the £25 interest, with the capital rolled over for a further month, it is likely that many vulnerable consumers will choose the latter option, in spite of the higher longer-term cost. Also, if someone is allowed to roll over a loan four times, the lender will have received £125 in interest, meaning it can turn a profit even where the borrower ultimately defaults on the whole capital amount. Given the cost to the borrower and the damage defaulting does to the borrower's credit file when shared with a credit reference agency, the needs and priorities of the lender and the borrower are severely misaligned.

The CC intends to conduct primary research into how responsive customers are to changes in prices and how much shopping around or switching is observed. However, this will not get to the root causes of a lack of competition, namely the anti-competitive practices by lenders detailed above. Excluding these practices from the CC's primary research would be a missed opportunity to explore how real consumers view and use high-cost credit products.

Theory of harm 2: Market power and barriers to entry

We agree that the CC should examine the constitution of the high-cost credit market to assess the level of competition and any barriers to entry. We would reiterate here that market power does not revolve solely around market share and advertising budgets, but should also look at the behaviours detailed above that distort competition, particularly where lenders defend or increase their market share by lowering their lending standards and their compliance with regulatory requirements.

The fact that, according to the OFT, between 36% and 41% of payday revenue derives from sources other than interest on initial loans, such as revenue from rolling over or refinancing and other fees and charges, suggests a market that is not functioning effectively or competitively.

Given the widespread poor practice in this market, there is little competitive pressure on firms to behave responsibly. Indeed, the business model of some firms appears to be based on making unaffordable loans which borrowers struggle to repay on time.

Scope of CC investigation

While we note that the current CC investigation is only looking at short-term loans and that the detailed structure of other credit markets are outside the scope of the referral, Which? agrees that the CC investigation should assess the extent to which there are effective alternatives for payday loan customers, including bank overdrafts and other types of unsecured credit.

Logbook loans

One specific product we believe should be included in the CC's investigation, however, is the logbook loan market, whereby a short-term loan is secured against the borrower's vehicle. Logbook loans are effectively a variation of payday loans and, given the risk of the borrower losing their car, are arguably higher risk than 'unsecured' payday loans.

Payday loans secured on the customer's payment account

Although marketed as unsecured credit, in reality payday loans are secured on collateral, the customer's payment account. The lender knows when salary or benefits will be paid into the borrower's current account, so any loan is effectively secured against salary. Payday lenders can clean out a borrower's current account as soon as funds are paid in, leaving the individual with little or no money for other essential bills.

Consumers are required to have a bank account to receive wages and government benefits. Widespread misuse of continuous payment authorities (CPA) by payday lenders[3] means CPAs are often presented repeatedly, or in gradually smaller amounts until the payment is successful.

[3] See p4 of Which? submission to the OFT, 1 May 2013: http://www.staticwhich.co.uk/documents/pdf/which-response-oft-payday-lending-consultation-319869.pdf

FCA and OFT compliance work

We note the other work on high-cost credit that is being conducted by the OFT and the Financial Conduct Authority (FCA). It is imperative that the CC investigation does not delay or reduce the scope of the current and future regulators' work. In particular, the OFT and FCA must ensure that both the payday sector and alternatives to payday loans function effectively, and the regulators must clamp down on poor behaviour. This must include home credit loan agreements, 12-month loans, guarantor loans, credit cards and overdrafts.

The CC must ensure that the data it gathers enables the FCA to take early action when it takes over the regulation of consumer credit in April 2014. The CC should consult the FCA to determine what information the latter needs.

Definition of short-term loans

The Statement of Issues defines short-term loans as being generally below £1,000. We would draw the CC's attention to the fact that a lack of sufficient affordability- and credit checks by some lenders can lead to borrowers taking out a series of loans with different lenders, far in excess of £1,000. It is therefore important that the CC investigation bears in mind both individual loans and also the collective impact on an individual consumer of multiple loans.

It is also important to differentiate between advertised maximum loan amounts and those loans offered to existing customers. As noted in our submission to the OFT, in one case in Which?'s October 2011 investigation, having borrowed just £100, our researcher was then offered up to £1,200 the next time he enquired about a loan. Two other researchers received letters from their lender stating 'When you have paid back your outstanding loan, you will be eligible to borrow more – you are already pre-approved'.