PAYDAY LENDING MARKET INVESTIGATION

Summary of hearing with Lloyds Banking Group held on 7 November 2013

Background

1. Lloyds Banking Group (LBG) believed that payday loans fulfilled a genuine customer need. Many of its customers used payday lenders. LBG had reacted to the growth of the payday lending sector by undertaking research into why its customers used payday loans instead of other products which could meet a similar need such as overdrafts. LBG had given consideration as to what this growth might mean for its products and for the assistance given to help its customers to budget.

The market

2. LBG thought while that the growth in the payday lending market was due mainly to economic circumstances it was also partly linked to consumer misperceptions in relation to the application process and the pricing of overdrafts. An overdraft could be applied for online and the process took as little time as that required to submit an application for a payday loan (around 2 minutes). Some consumers also preferred a payday loan to an overdraft because it had a fixed repayment date whereas an overdraft was an open-ended commitment. Anecdotal evidence indicated that some customers preferred to keep their lending separate from their bank, managing their finances separately from their day-to-day current account.

3. Although there was some overlap between bank products which provided short-term bridging finance, such as overdrafts and payday loans, LBG's focus was different. LBG looked to develop long-term relationships with its customers by providing advice, help with money management, budgeting and help for customers in financial difficulties. These considerations were more appropriate for its customers rather than simply the provision of finance. However, there were some customers it was unable to help with short-term finance such as those who had basic bank accounts (LBG estimated that there were around 8 million adults in this sector of the market) and who did not have overdraft facilities. Around half of LBG's customers who were using payday lenders did not have an overdraft facility. LBG estimated that the number of its customers using payday loans was 25 per cent higher for those with basic accounts than those with full banking facilities.

4. LBG used data it obtained from credit bureaus, banks and other financial organizations, in addition to its own highly developed systems to inform its customer assessments. Many online providers used similar processes. LBG used its Lending Pathways to help determine the most appropriate option for the customer (i.e. overdraft, credit card or a loan). LBG had recently initiated a pilot project in Leeds with the local credit union, the Citizens Advice Bureau and a local debt charity to help such customers understand the range of options available to them over and above simply going to the pawnbroker or payday lender.

5. LBG did not treat those of its customers who took out payday loans differently to those of its customers using overdrafts or credit cards. If a potential customer had a payday loan it would not have any impact on an application although LBG noted that there was a clear correlation between payday lenders and consumers who were a poor credit risk. LBG segmented its customer base on the basis of risk and

indebtedness. Payday loan customers were typically male, had below-average incomes and were above the typical levels of indebtedness. However, the population of payday lending customers also included consumers, for example, who were relatively well off and over 50 years of age. LBG was not aware that payday lenders were targeting any specific geographical areas.

6. Planned overdrafts that had a pre-agreed facility were cheaper than payday loans. However, unauthorized overdrafts could be more expensive and reflected the fact that these typically had low recovery rates. [✂]. LBG's two brands had different overdraft charging structures. Halifax had a simple rate of £1 a day (reflecting research that Halifax customers found interest rates and monthly fees confusing) whereas Lloyds charged a 19 per cent interest rate and a £6 per month usage fee. Although the Halifax overdraft could potentially become expensive to use it was not designed to be used every day of the month. The Lloyds product could be cheaper than payday loans depending on the way it was used. LBG had introduced buffer zones and grace periods to overdraft facilities which meant a customer did not pay charges provided they returned to below their limit at the end of the day. LBG had also introduced an add-on to current accounts called 'Control' which prevented customers from exceeding their overdraft facility as transactions which would take customers over their limit would automatically be rejected. However, this had the disadvantage that customers could incur late payment fees from providers of certain services in the event that a direct debit was unpaid and so customers had to decide whether it might be better to temporarily have an unauthorized limit. LBG noted that the payday lenders had brought innovation to the market notably by introducing the sliding scale which LBG had adopted.

7. During the economic downturn LBG continued to lend across all its credit products. Credit cards and payday loans had different product characteristics and were used for different types of purchase.

8. LBG was concerned about the conduct of payday lenders which could cause difficulties for its customers and LBG consequent operational issues. Some of LBG's concerns were being addressed by the Financial Conduct Authority (FCA) in the FCA's recent consultation document. Other concerns were being addressed by the industry such as the introduction of the Visa Europe Stop scheme. Others remained, notably identity theft which arose from insufficient 'know-your-customer' checks by payday lenders. LBG also expressed concern that there did not appear to be a relationship between the representative APRs being advertised by payday lenders and the actual cost of the loans. The key concern for LBG, however, was whether customers were repeatedly taking out payday loans and relying on them as a source of income. The key difference between the banks and the payday lenders was that if a product was being used inappropriately by a customer the bank would initiate contact and try to find a way of consolidating the debt and helping the customer budget.

9. The credit risks, conduct risks and reputational risks associated with entering the payday lending market combined with APRs that had to be used by the payday lenders were a deterrent to entry. Customers found the APRs of payday lenders, which were misleadingly advertised and which did not represent what the customer paid, confusing and unhelpful. LBG thought that the display of more useful, comparable information by comparison websites could potentially improve customers understanding of their choices in what was largely an online market.

10. LBG had enhanced its digital capabilities in response to the increased use of digital technology across its customer base and particularly among its newer, younger customers. It ensured that the products available in its branches were available

online. The application process was just as fast and efficient as for any of the payday lenders. It took around 2 minutes to apply for an overdraft or loan and the money was instantly available to the customer but there was a time lag for credit cards which had to be sent to the customer. LBG had seen a migration of customers, some of which had used high street branches for many years, to digital.

11. LBG provided transaction services to some short term lenders but took the decision to lend on a case-by-case basis, measured in relation to credit risk, conduct risk and reputational risk. As a result of the Banking Reform Bill banks might be prohibited from lending to other financial institutions.

12. Some payday lenders had left the market while some of the larger organizations had, through competing vigorously, consolidated their position. Some of the changes that would be enforced through the FCA in terms of lending would be a challenge and might potentially separate the organizations further. Given the economic climate the demand for payday loans would continue in the foreseeable future.

Continuous payment authority

13. LBG identified the use and abuse of continuous payment authority (CPA) by payday lenders and identify theft (and the consequent removal of funds from a customer's account) as the main causes for concern in the payday lending market. The introduction of VISA's new Europe Stop system (VISA accounted for around 95 per cent of all debit transactions) would prevent payday lenders from trying to take payments from a customer's account after that customer had cancelled a CPA but noted that the system would need monitoring to ensure it worked. The FCA's proposals would address the issue of payday lenders repeatedly trying to access money from a customer's account but noted that these would not come into effect for around a year or so. Identity fraud had an impact on LBG as it had to devote a lot of its operational resources to resolve the problem. Around 2 per cent by volume of all transactions payday lenders were processing through LBG customer accounts were fraudulent. The new payment regulator which would be able to focus on the payment systems would provide some added comfort.

Financial Conduct Authority

14. LBG was unable to comment on the affordability calculation used by the payday lenders as this information was internal. If the payday lenders subscribed to credit bureaus and invested in credit management systems then they would have the opportunity to make good affordability decisions. However, the challenge would be determining whether what the customer declared was truthful. If a customer had a current account with LBG, LBG could review the customer's income and outgoings. If LBG was unsure of the financial status of a customer it would refer the customer to its personal lending (manual underwriting) department.

15. The move from the current compliance-based regulatory system operated by the Office of Fair Trading to the new conduct-based regime to be operated by the FCA, which would be more expensive, would have a big impact on the cost base of all the companies in the market and could have an impact on new entry.