

PAYDAY LENDING MARKET INVESTIGATION

Entry and expansion working paper

Summary

1. This paper discusses entry and expansion in the payday lending sector, covering the history of entry and expansion and the factors likely to affect the likelihood of entry or expansion, giving an indication of which factors may act as barriers to entry and/or expansion. We also consider the extent to which conditions for entry and/or expansion are likely to be different in the future compared with the recent past.
2. The evidence we have reviewed to date suggests the following preliminary observations.
3. First, online payday lending is a relatively new sector in the UK and many firms have entered over the past decade. In particular, payday loans have only been offered online for less than a decade. High street payday lending has been around for somewhat longer. The historic evidence suggests that the timescales that have been required to launch a payday lending business vary according to lender and business model. Some, like H&T, entered in six months, while Wonga told us that it took [redacted] from the establishment of the company to generating a sustainable level of profit after tax.
4. Second, we have identified seven main business requirements necessary to operate a payday loan company (whether as an online or high street lender), of which the following may reduce the likelihood of entry and expansion to some degree:
 - (a) *Customer acquisition*. Customer acquisition represents a significant category of costs for payday lenders, particularly online lenders. Our consideration of customer acquisition costs focuses on the costs of marketing through advertising

and acquiring customers through third parties (eg lead generators). Established lenders are likely to have an advantage over new lenders due to the retention of repeat customers who generally have lower acquisition costs. New lenders may have to match or exceed the advertising spending of existing lenders to attract sufficient customers, which could result in significant initial losses. For online lenders the cost of acquiring leads from lead generators appears to have increased in recent years, raising customer acquisition costs. Less well-established online lenders may also have disadvantages when competing to acquire customers from lead generators because they are less able to predict default behaviour accurately (see below). Customer acquisition for high street lenders appears less likely to represent a barrier to expansion since they rely to a much lesser extent on advertising and lead generators to generate new business.

(b) *Customer risk assessment.* Default costs represent the largest category of costs for payday lenders. This indicates that differences in lenders' ability to assess credit risk are likely to have a substantial impact on their ability to operate profitably in the market and compete with established lenders. When assessing whether to lend to a particular customer, lenders use their own databases and information purchased from credit reference agencies (CRAs). A new entrant is likely to face higher default rates, and therefore higher costs, than an established lender. This is because the new entrant is likely to be reliant on a greater proportion of new customers (representing a higher expected credit risk) and is likely to hold less internal information on customer repayment behaviour, so will be less able to predict default behaviour accurately.

(c) *Payment processing services.* In the past, lenders do not appear to have faced barriers in establishing commercial banking relationships. However, there is some evidence to suggest that this may be more challenging for companies entering payday lending today than it has been previously.

(d) Regulation and compliance. Regulation does not appear to have acted as a barrier to entry or expansion in the past. However, we note that the new Financial Conduct Authority (FCA) regime is likely to increase compliance costs relative to the previous regulatory regime. In addition, a number of lenders told us that the current level of regulatory change may make entry less attractive.

(e) Financing and capital requirements. Raising substantial amounts of finance to invest in entering and/or expanding in the payday lending sector could be a challenge, given the other costs and risks associated with entering the payday lending market.

5. The evidence we have reviewed so far suggests that two other business requirements are unlikely to reduce the likelihood of entry to a material extent: these were the need to invest in loan management systems and customer services and call centres.
6. Third, in relation to high street lending, the historical information on high street store openings and the responses received suggest that the barriers to expansion, through the opening of additional high street stores, are not substantial for existing payday lenders. Costs of local entry may also be lower than for de novo entry for firms with an existing high street presence in related product markets, eg pawnbroking. We note that there has, however, been a reduction in the rate of new store openings in 2013.

7. Fourth, there is evidence that the current high degree of political and media attention centred on lending practices, high APRs and social costs of payday loans may deter some firms, such as banks, from entering the payday lending sector.¹
8. Fifth, there are some indications to suggest that barriers to entry and expansion are evolving and in some cases increasing relative to the conditions that prevailed over the past decade. For example, the regulatory environment is changing, incumbent lenders have well-established consumer brands and the cost of customer acquisition, especially those acquired through lead generators, appears to be increasing.
9. We propose to explore these factors further in our ongoing analysis and in our discussions with lenders and other parties to this investigation.

Introduction

10. This paper discusses entry into the payday lending sector, covering the factors likely to affect the likelihood of entry, and gives indications on whether these are likely to act as barriers to entry. We also describe the evidence we have reviewed on the history of entry and expansion and the potential future entry and expansion.
11. The remainder of this paper is set out as follows. First, we discuss the CC guidance on barriers to entry and expansion. Second, we discuss the history of entry and expansion. Third, we discuss factors affecting the likelihood of entry, including the business requirements necessary to operate a payday loan company and the potential impact of reputational effects. Fourth, we discuss the likely time required to enter payday lending. In the final section we discuss how the factors we have identified may change and influence the likelihood of entry, expansion and exit in the future.

¹ This may also affect the willingness of comparison websites to offer payday comparison tools, with implications for customers' ability to shop around. Consistent with this, we were told by one lender ([REDACTED]) that the negative media coverage created a negative perception of all lenders, rather than encouraging customers to seek out the best offer—see the working paper on 'Shopping around' for further details.

CC guidance in relation to barriers to entry and expansion

12. In our issues statement,² we identified market power and barriers to entry as our second theory of harm, and highlighted the Office of Fair Trading's (OFT's) finding that payday lending appeared to be concentrated.³

13. As set out in our guidance,⁴ entry and expansion by firms will often stimulate competition and the prospect of entry and expansion within a short time can sometimes countervail against a prospective adverse effect on competition decision. The main focus of our assessment of the conditions for entry and expansion is on the ability and incentive of new or relatively small incumbent firms to enter into or expand in payday lending and any barriers to entry and/or expansion that may exist. However, the prospects for expansion by larger incumbent firms, which can also in some cases be an important driver of competition, may also be evaluated. In evaluating the effects on competition of these potential barriers to entry and expansion, we will typically assess the impact that the entry barriers identified have had, are having and/or may have in the future.

History of entry and expansion

14. In this section, we present the evidence we have reviewed on the history of entry and expansion in payday lending. This provides background to the discussion of potential barriers to entry and/or expansion.

15. There have been a variety of entry and expansion strategies in UK payday lending in recent years. We have identified the following principal entry strategies.
 - (a) *Privately funded start-ups*. CFO Lending Limited (CFO Lending), Global Analytics Holdings, Inc. (Global Analytics), Txt Holdings Limited (MYJAR) and Wonga

² www.competition-commission.org.uk/assets/competitioncommission/docs/2013/payday-lending/140813_payday_lendings_statement_of_issues.pdf.

³ www.of.gov.uk/OFTwork/markets-work/references/payday-lending/, consulted 22 January 2014.

⁴ *Guidelines for market investigations, CC3 (revised)*, paragraph 205.

Group Limited (Wonga) entered as start-ups and developed new Internet-based payday lending businesses from scratch using private equity investors.

(b) *Acquiring existing businesses.* CNG Financial Corp, Dollar Global Corporation (DFC), EZCORP and SRC Transatlantic (SRC) each acquired one or more Internet-based and/or store-based UK-based payday lending companies that had been founded as start-ups in the UK. Following these acquisitions, the respective parent companies, two of which are listed on North American stock exchanges, have provided the majority of funding for expansion.

(c) *Expansion from US payday lending.* Cash America International Inc. (Cash America) adapted technology systems originally developed in the USA and launched an Internet-based lender supplying UK consumers, mainly operated from its existing premises in the USA.

(d) *High-street-based entry.* The Cash Store Financial Services Inc, based in Canada, entered the UK in April 2010 and had grown to 27 branches. Speedy Cash opened its first UK branch in November 2010 and had expanded its network to 23 branches by September 2013.

(e) *Diversification strategy.* Harvey and Thompson (H&T) entered payday lending via a product diversification strategy, adding payday lending products alongside its existing pawnbroking business.

16. Table 1 summarizes company structures and when the 11 major lenders entered payday lending.

TABLE 1 Company structures and entry dates

Ultimate parent company	UK trading names	Date lending started	Date of acquisition by parent (if applicable)
DFC Global Corporation	Payday Express	Jan 1999	21/04/2009
DFC Global Corporation	The Money Shop	Feb 1999	N/A
Access Financial / CNG Financial Corporation	The Loan Store	01/01/2003	01/01/2006
Access Financial / CNG Financial Corporation	Cheque Centre		01/01/2006
DFC Global Corporation	Payday UK	Jan 2003	01/04/2011
Speedy Group Holdings Corp	WageDayAdvance	15/12/2006	08/02/2013
Wonga Group Limited	Wonga	01/01/2007	N/A
Cash America International Inc.	Quick Quid, Pounds to Pocket	01/06/2007	N/A
CFO Lending Limited	CFO Lending, Payday first	01/01/2008	N/A
TxtLoan	MYJAR	01/03/2009	N/A
Global Analytics Holdings, Inc.	Lending stream	01/08/2009	N/A
EZCORP	Cash Genie	09/10/2009	14/04/2012
The Cash Store Financials Inc	The Cash Store	01/04/2010	N/A
Speedy Group Holdings Corp	Speedy Cash	01/11/2010	N/A
H&T Group PLC	H&T	23/06/2011*	N/A

Source: Parties' responses to financial and market questionnaires.

*This is the date H&T began offering loans online. Prior to this H&T offered high street payday loans.

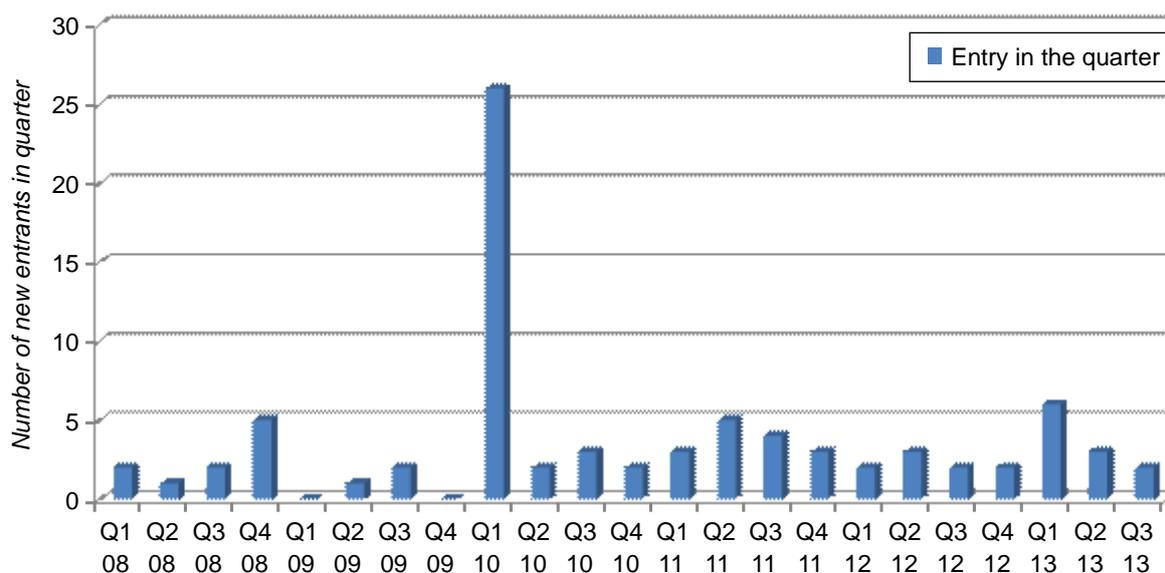
Note: N/A = not applicable.

17. In addition to the major lenders, we have information on entry by smaller lenders.

Figure 1 is based on the responses to the small company questionnaire. It shows the number of such companies that entered payday lending during this period. It suggests that there was a sharp increase in entry in 2010.

FIGURE 1

Entry by smaller lenders, 2008 to 2013



Source: Response to small company questionnaire.

Note: The small lender questionnaire responses did not cover all small lenders and therefore the results above should be seen as indicative. In particular, the results are unlikely to show firms which entered but then exited before 2013. We are investigating further the apparent surge in entry in Q1 2010.

Factors affecting likelihood of entry and expansion

18. In this section, we consider the main factors which could affect the ability of firms to enter or expand in the payday lending sector and consider whether they may act as barriers to entry and/or expansion. We cover three areas:

(a) Entry into payday lending—business requirements. We first consider the general requirements necessary to operate a payday lending business.

(b) High street entry—additional requirements. We then consider the additional requirements to enter high street lending. We also present information on the history of high street openings.

(c) Reputational effects. We discuss the potential impact of reputational effects on the likelihood of entry.

Entry into payday lending—business requirements

19. In this section, we discuss the general requirements necessary to operate a payday lending business. We cover seven topics: *(a)* regulation and compliance; *(b)* customer acquisition; *(c)* credit risk management; *(d)* loan management systems; *(e)* payment processing; *(f)* customer services and call centre; and *(g)* financing and access to capital.

Regulation and compliance

20. In this section, we describe the regulation and compliance regime that payday lenders must operate within and present the views we received on this topic.

Description

21. Currently and any time before 1 April 2014, a new entrant will require a consumer credit licence, administered by the OFT. From 1 April 2014, the licensing system will be revoked and replaced by a system of authorization under the Financial Services and Markets Act 2000, administered by the FCA. All firms which hold a consumer

credit licence issued by the OFT will only be able to carry on consumer credit activities under their existing licence until 31 March 2014; current consumer credit licences expire on that date. Current licence holders must contact the FCA in order to register for interim permission if they wish to continue carrying on consumer credit activities from 1 April 2014. The cost of the interim permission is £350 for companies and £150 for sole traders.

22. After 1 April 2014, firms will need to complete a more detailed application process for FCA authorization. There will be a phased approach to authorization, where the FCA will ask different types of firms to apply by different deadlines. Payday lending firms will be classified as carrying out 'high-risk' activities and will require full permission, whereas other firms carrying out 'lower-risk' activities will only require 'limited permission' under a less onerous authorization process. The FCA's standards are known as 'threshold conditions'. For this they consider the firm's business model, the experience and integrity of key personnel, the ownership of the firm and its financial position. Firms will still be able to carry out regulated credit activities using their interim permission while they are waiting for the outcome of their application for authorization. The FCA charges firms that are fully authorized fees when they apply to become authorized and every year they are authorized. Under the new regime, not all firms will pay the same amount. The fee payable will be proportionate to the size of the firm's business and the type of authorization. Firms with limited permission are likely to have lower fees than those of higher-risk firms.
23. There are several potential regulatory changes which could affect payday lending. In October 2013, the FCA put forward proposals, including requiring a mandatory affordability check for every loan, capping the number of rollovers to two, and limiting to two the number of times a payday lender can access the borrower's bank account

to seek payment.⁵ The FCA also has a new legislative duty to introduce a cap on the price of payday lending by 2 January 2015.^{6,7}

24. More detail on the regulatory environment is given in our working paper on 'Regulation of payday lending'.

Views of respondents

25. We received a number of views on regulation and compliance costs.
26. Ariste Holdings Limited (Ariste) said that with the FCA taking over consumer credit in April 2014, entrants would have to invest massively in compliance to receive a licence.
27. CashEuroNet said that the current OFT regime offered low barriers to entry and had reasonable compliance cost burdens. The new FCA regime was expected to add considerably to the up-front and ongoing costs and barriers. It said that the new FCA authorization regime was likely to result in significant exit, particularly by smaller players that were less able to meet the minimum requirements of the authorization regime.
28. Dollar said that over the past 24 months the profitability of the business had been negatively impacted by regulatory and self-regulatory actions (among other things). Dollar considered that current regulatory requirements were not significant hurdles or barriers to entry as evidenced by the number of new entrants over the past three to five years. Dollar considered that it was likely that a more rigorous regime proposed

⁵ FCA, [Detailed proposals for the FCA regime for consumer credit](#), 3 October 2013.

⁶ www.fca.org.uk/news/statement-on-a-cap-on-the-cost-of-payday-loans, 22 January 2014.

⁷ We also note that *Which?* has stated that it believes that default fees charged by some payday lenders are excessive and unlawful under the Unfair Terms in Consumer Contracts Regulations 1999. *Which?* has been calling for the FCA to introduce a cap on the level that firms can charge in default fees, as part of the price cap to be introduced in January 2015: <http://press.which.co.uk/whichpressreleases/which-calls-on-payday-lenders-to-cut-high-fees/>, consulted 22 January 2014.

by the FCA would increase both the requirements and the costs of regulatory compliance. Dollar said that it was too early to know for certain whether the FCA's consultation would result in higher barriers for future entry, but a determined new entrant would not be prevented from entering.

29. Global Analytics said that the main regulatory barrier to entry to the payday lending sector was uncertainty. One of the key requirements for a lender to conduct business was access to capital. Uncertainty drove an unwillingness by capital providers, as they would rather wait before committing capital to an uncertain environment.
30. H&T said that the main regulatory and compliance hurdles for a new entrant were obtaining a consumer credit licence, complying with money laundering regulations and complying with Payment Card Industry Data Security Standard requirements.
31. Speedy Cash said that 'compliance was not considered a hurdle or barrier to entry but rules to understand and work within to run a business'.
32. The Cash Store said that the UK would become more regulated particularly with a tougher new regulator on the horizon. Before a new entrant could commence trading, all the products they offered must meet strict criteria. This meant that before they could bring their product to market they had to invest a large amount of money and time on resources to meet compliance.
33. Wonga said that successful entry had been achieved by entities which, like Wonga, sought to couple strong consumer protection policies with competitive success.

34. We also note that the FCA stated that it expected, based on work done by European Economics, that its proposals to change the regulation of payday lenders could lead to between 25 and 30 per cent of lenders leaving the industry.⁸

Preliminary observations

35. Regulation does not appear to have acted as a barrier to entry or expansion in the past. However, we note that the new FCA regime is likely to increase compliance costs relative to the previous regulatory regime. In addition, a number of lenders told us that the current level of regulatory change may make entry less attractive.

Customer acquisition

36. A successful payday lender will have to acquire customers who wish to take out payday loans and have a reasonable likelihood of repaying. In this section, we describe how online lenders acquire customers and present the responses we received on this topic.

Description

37. Online lenders use a variety of strategies to acquire customers:
- (a) 'Offline' advertising, for example television, radio, sports sponsorship and outdoor advertising.
 - (b) Online advertising, through search engines such as Google. Internet lenders can place bids on keywords that are commonly used in search terms such as 'payday loans'. There is also competition between providers to achieve higher rankings in search engine results, and this requires ongoing search engine optimization work.
 - (c) Indirect acquisition, where payday lenders pay for customers introduced by third party lead generators and affiliates:

⁸ FCA, [Detailed proposals for the FCA regime for consumer credit](#), paragraph 6.95, consulted 3 October 2013.

- (i) Lead generators provide lenders with customer applications (leads) in return for a fee. A customer visiting a lead generator website will complete a form containing details on the customer's name, address, income and outgoings. Those details are then passed on to a number of lenders via a process called a 'ping tree'. Lenders who bid more will have first refusal on customer applications, and so will potentially have access to customers with higher expected profitability. More detail on this process is contained in [Annex 1](#).
 - (ii) Affiliates differ from lead generators because they do not take applications from customers. Internet affiliates are sites which have agreed to promote the products of a particular payday lender in return for a fee: these may be voucher providers (eg VoucherSteal) or other third parties (eg bloggers) which send traffic to the payday lender.
 - (d) Price comparison sites. The availability of independent 'price comparison' websites for payday loans appears undeveloped. The working paper on 'Shopping around' has more detail on this issue.
38. High street lenders use their retail outlets to attract customers. For example, The Cash Store said that its opening decisions were influenced by the visibility of the property. As it did not advertise heavily, it leant more on high street locations to capture passing trade.
39. Keynote's Consumer report Consumer Credit and Debt – Market Assessment 2012 indicates that the top three payday lenders represented approximately 80 per cent of the £33 million spent on main media advertising of all forms of unsecured loans in

2011 and 2012.⁹ Further details on the costs of acquisition are provided in our paper on 'Profitability'.

40. Table 2 shows the spending of each of the major online lenders on third party intermediaries in 2012. Five lead generators accounted for nearly 60 per cent of the spending by those lenders.

TABLE 2 Total spend on lead generators, brokers and affiliate, by lender and intermediary

Lender	Total spend 2012 £'000	Spend by intermediary 2012, £'000					Other
		T3	Ping Tree	PDB	Rev Up	9 Global	
Ariste	[X]	[X]	[X]	[X]	[X]	[X]	[X]
CashEuroNet	[X]	[X]	[X]	[X]	[X]	[X]	[X]
CFO Lending	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Express Finance	[X]	[X]	[X]	[X]	[X]	[X]	[X]
H&T	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Lending Stream	[X]	[X]	[X]	[X]	[X]	[X]	[X]
MEM	[X]	[X]	[X]	[X]	[X]	[X]	[X]
MYJAR	[X]	[X]	[X]	[X]	[X]	[X]	[X]
WageDayAdvance	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Wonga	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Total	41,541	[X]	[X]	[X]	[X]	[X]	[X]

Source: CC analysis of companies' responses to CC's data requests.

41. The balance between direct and third party sourcing differs significantly between online lenders. This is illustrated by Figure 2, which shows the proportion of new customers sourced from brokers and lead generators for each of the online lenders as a proportion of all new customers, in the year to August 2013. Some online lenders obtain more than 80 per cent of their customers from brokers and lead generators.

FIGURE 2

Proportion of new customers sourced from brokers/lead generators by lender, year to 31 August 2013

[X]

Source: CC analysis of transaction data.

Note: [X].

⁹ Nielsen/KeyNote: KeyNote Market Assessment 2012 – Consumer Credit & Debt report

Views of respondents

42. We received a number of views on customer acquisition and the role of lead generators.
43. CashEuroNet said that in 2012 it had made [REDACTED] loans via lead generators, representing [REDACTED] per cent of total new customer loans. CashEuroNet said that its main advertising channels were television/traditional advertising, pay-per-click advertising, lead generators, the QuickQuid website, affiliates and search engine optimization techniques.
44. CashEuroNet told us that [REDACTED].
45. Dollar told us that: 'Payday Express & Payday UK compete on Google and other search engine rankings. Competition for top positions on generic terms such as "payday loans" is very strong [REDACTED]'.
46. Dollar also told us that [REDACTED].
47. Dollar said that Payday UK and Payday Express used [REDACTED] to assess customer profitability. [REDACTED] Dollar said that the ping-tree model had driven up the initial costs of acquiring leads and reduced the profitability of the industry, and that Payday Express paid [REDACTED] lead and Payday UK paid [REDACTED] lead. [REDACTED] Payday UK used third party affiliates and digital display advertising, and historically it had used television advertising to build brand awareness. Payday Express and Payday UK used to market loans through comparison site moneysupermarket.com, [REDACTED]. However, moneysupermarket.com had discontinued the service [REDACTED]. There are other price comparison websites including money.co.uk, allthelenders.co.uk and whichwaytopay.com on which Payday UK may appear.

48. Dollar said that [REDACTED].
49. Global Analytics said that it assessed customers based on credit risk and expected loyalty and compared this with the fee charged by the intermediary in order to purchase profitable leads. The competition to acquire customers was intense. Significant sums were required to attract customers and acquire them from third party brokers. Global Analytics expected that intense competition would continue to drive up consumer acquisition costs until some equilibrium was reached. In the USA, for example, it cost as much as £130 (\$200) to purchase a lead from a broker, whereas in the UK the maximum cost to acquire a lead was around £70.
50. Global Analytics also told us that established brands had an advantage in acquiring customers through organic search results, as established brands were more likely to occupy the higher positions in the search engine results. Furthermore, the lack of well-developed comparison websites made it more difficult for smaller firms to compete on price.
51. H&T told us that other lenders were able to pay for high-quality leads because they charged the customer more. Therefore the customer using a lead generator would never be aware of the cheaper H&T product. This drove up the costs of leads and/or forced it to acquire riskier customers, with an associated increase in bad debt.
52. MYJAR told us that because it did not offer rollover loans, it generally had to offer a lower price for leads than competitors who did offer rollovers because the leads were correspondingly less valuable to MYJAR.
53. PDB UK (a lead generator) told us that the price of a lead had increased significantly in the period in which PDB had been active in the market. In 2008, PDB received

around £10 to £20 per accepted customer. For a customer of comparable quality, this [redacted]. This increase in prices had likely been driven by the increasing profitability of payday lending, and some of that profitability was being shared with lead generators through higher prices in the ping tree. Lenders could increase the prices they charged customers, and this might allow them to attain a higher position in the ping tree. However, higher prices might also affect the extent of repeat custom, and could therefore lower the lifetime value of a customer.

54. [redacted] Wonga said that lead generators were paid irrespective of whether or not the lead resulted in a completed loan, and higher-quality leads were paid more than lower-quality leads. In 2012, [redacted] lead generators generated [redacted] leads, of which Wonga made [redacted] loans, ie [redacted] per cent of referrals resulted in a loan. The range of commissions paid for leads was £[redacted], with an average of £[redacted], equating to £[redacted] per loan.

Preliminary observations

55. Customer acquisition represents a significant category of costs for payday lenders, particularly online lenders. Our consideration of customer acquisition costs focuses on the costs of marketing through advertising and acquiring customers through third parties (eg lead generators). Established lenders are likely to have an advantage over new lenders due to the retention of repeat customers who generally have lower acquisition costs. New lenders may have to match or exceed the advertising spending of existing lenders to attract sufficient customers, which could result in significant initial losses. For online lenders the cost of acquiring leads from lead generators appears to have increased in recent years, raising customer acquisition costs. Less well-established online lenders may also have disadvantages when competing to acquire customers from lead generators because they are less able to predict default behaviour accurately (see below). Customer acquisition for high street lenders

appears less likely to represent a barrier to expansion since they rely to a much lesser extent on advertising and lead generators to generate new business.

Credit risk assessment

56. A core capability for a payday lender is the ability to assess the credit risk of new and returning customers. As discussed in our paper on 'Profitability', default costs make up the largest category of costs for online lenders. In this section, we describe how lenders carry out credit risk assessments and present the responses we received on how default rates vary by customer type and how payday lenders use CRA data.

Description

57. To perform credit risk assessments, lenders collect information from potential customers during the loan application process (either directly or via a lead generator), use internal data about other customers and the applicant (if they are a returning customer) and purchase information about the applicant from third party CRAs. More detail on the approval procedures used by payday lenders is contained in our working paper on 'Payday loan products'; and the applications and approvals process.
58. The majority of payday lenders engage one or more CRAs to conduct a credit search on individuals who apply for loans. There are three main CRAs: Experian, Equifax and Callcredit. These CRAs hold large databases of individuals' personal information, past credit history and current credit commitments. This shared data is available on commercial terms to lenders.
59. In order to engage commercially with a CRA, a payday lender needs to agree to the information-sharing rules (known as the Principles of Reciprocity). Payday lenders can only access data when they have entered into a contractual commitment, with one or more of the CRAs, to supply data relating to their own customers within three

months of the start of any usage. The data that is accessed will be strictly at the same level as the data that is shared. If a payday lender failed to provide the necessary data in return, then access to the shared data may be restricted or suspended by the CRAs. [Annex 2](#) contains more information on the principles of reciprocity.

60. Currently, the records of the largest CRAs are updated monthly. We note that Callcredit has announced that it plans to enable real-time data sharing for payday lenders from April 2014. Callcredit stated that it was already working with nine of the top ten online short-term lenders and that:

There is a growing consensus that the availability of more frequent data sharing is required to ensure responsible lending in certain sectors. In response to this, together with feedback from our clients, trade bodies and other stakeholders we are delighted to announce that Callcredit will be implementing a real-time reporting solution. As well as addressing specific and immediate concerns in the Alternative Lending sector we believe that it is crucial to build a solution that benefits a broad spectrum of lenders.¹⁰

61. Experian has also announced the launch of a real-time data-sharing service that will give credit providers across the UK instant access to personal financial information, enabling them to make fair and accurate decisions about lending. Experian said that the service had been developed in response to an increasing demand for more short-term credit, which had also increased the challenge for all credit providers—including mainstream lenders, utilities and telecommunications companies—to understand fully the nature of a person's debt.¹¹

¹⁰ www.callcredit.co.uk/press-office/news/2014/01/callcredit-information-group-leads-the-way-with-real-time-data-sharing, consulted 28 January 2014.

¹¹ <http://press.experian.com/United-Kingdom/Press-Release/experian-to-launch-new-service.aspx>, consulted 7 Feb 2014.

62. This is consistent with MYJAR's views on the use of CRA data. MYJAR told us that historically it had found that traditional CRA data covered periods that were too long to be relevant to the behaviours exhibited by typical short-term loan users. The ability to make repayments on a long-term mortgage, loan or credit card were not good indicators of affordability to meet a loan commitment of 15/18 days.
63. The quality of the information held by payday lenders about an individual customer will be at its lowest at the time of the customer's first loan application with that lender. If the customer returns for subsequent loans, the lender has more information to help manage credit risk. Furthermore, as the lender makes more loans its data set on customers will expand, allowing it to make better lending decisions.
64. We were told that the risk of default for a new customer was higher than for an existing customer. This is consistent with our transaction data analysis. This analysis showed that 50 per cent of loans taken out by new customers were never repaid in full, or repaid in full late. For repeat customers, the figure was 33 per cent.¹² This suggests that a new entrant which has a higher proportion of new customers will typically face higher default rates than existing firms with established customer bases.

Views of respondents

65. In this section, we present the views of the respondents, first discussing how default rates vary by customer and then how they use CRA data.
- *How credit risk varies by customer type*
66. Dollar said that the write-off rates for new customers were higher than for existing customers. For Payday UK the write-off rates were [X] per cent for new customers

¹² Customers and their loans—presentation based on analysis of the transaction data, slide 33.

and [REDACTED] per cent for existing customers, and for Payday Express the rates were [REDACTED] per cent for new customers and [REDACTED] per cent for existing customers.

67. MYJAR said that the risk of default reduced as the borrower matured. First-time borrowers could result in a default rate of [REDACTED] per cent historically, whereas a borrower who had held ten or more loans exhibited a [REDACTED] per cent default rate. MYJAR told us that the business required significant investment to sustain the heavy initial bad debts associated with new customers, to build a database to learn from and improve underwriting in a young industry, and to acquire the right kind of customer.
68. WageDayAdvance said that the initial principal provision for new customers was [REDACTED] per cent, whereas for returning customers it was [REDACTED] per cent.
- *How payday lenders use CRA data*
69. We received views about the quality and value of CRA data in relation to payday lending decisions.
70. CashEuroNet said that QuickQuid imported raw data from [REDACTED] and several other specialized identity verification and prepackaged reports. Its experience in modelling sub-prime customers showed that the standard credit scores produced by CRAs were unsuited for its customer base. Accordingly it had built its own credit-scoring system using individual values for numerous [REDACTED] variables. QuickQuid used several different approval models for [REDACTED]. In each model, the [REDACTED] variables were selected and weighted according to their tested reliability in predicting defaults.
71. Dollar said that its companies used CRA data in their decision processes. Instant Cash Loans collected large amounts of personal data, [REDACTED]. Instant Cash Loans

applied an internal credit risk policy [REDACTED]. Instant Cash Loans shared information about its whole portfolio with Experian under the principles of reciprocity. This was a monthly snapshot of data. Payday UK used both Callcredit and Experian, and Payday Express used just Experian for underwriting. [REDACTED] These companies also received monthly batch updates [REDACTED]. For Payday UK these were done through Callcredit and for Payday Express they were done through Experian. In both cases, these were done through the bureau's existing customer management systems to avoid leaving any search footprints on the customer's credit file. [REDACTED] Payday UK shared information on its whole portfolio with both Experian and Callcredit and Payday Express only shared information with Experian.

72. Global Analytics said that it used CRA data to assess customers. It had also designed various algorithms and predictive models. Global Analytics used more than 1,000 variables from Teletrack and Callcredit and it sent loan performance information to these agencies. Global Analytics reported on a weekly basis to Teletrack and monthly to Callcredit.
73. H&T said that it currently used data from Experian, Equifax, Callcredit, Lending Metrics, Teletrack and Lend Protect. It said that it could cost £10 in searches to fund one loan. None of the CRAs had a complete view because not all lenders used a CRA. It considered that low-cost, real-time data with no 'value-add' services would be a benefit to the sector to avoid customers obtaining multiple loans and providing a single source of data about credit exposure.
74. MYJAR said that traditional CRA data covered periods that were too long to be relevant to the behaviour exhibited by short-term borrowers. MYJAR said that its general loan approval policy was changed in December 2012 following a logistic review of the performance of cohorts of customers at that time. In order to keep

default rates down to commercially acceptable levels, the cut-off point was determined by reference to the recovery rate of all customer cohorts. This led to the production of a list of acceptable customer profiles against which the application was matched. A further change was implemented in May 2013 which incorporated third party data, specific to affordability, into underwriting. All applications were subject to a CRA affordability assessment. Existing borrowers were subjected to an affordability check every 90 days or whenever a customer updated their details.

75. SRC said that it used data from Lexis Nexis, Experian/Teletrack and Lend Protect to verify identity, and applied an internal scoring system to make lending decisions.
76. The Cash Store told us that [✂].
77. Think Finance told us that barriers to entry in short-term lending looked low on the surface but the reality was that they were quite high. The reason for this was primarily the extensive investment required to build robust risk models.¹³ [✂]
78. Wonga said that it used CRA data and numerous other data sources to verify customer identity, verify customer bank details, satisfy age-related and similar criteria, and obtain data for some of the predictive factors in Wonga's risk assessment scorecard. Wonga worked closely with the CRAs and continuously tested new data sources and products as they came to market to assess their predictive power and ability to make more accurate and responsible lending decisions. Wonga returned data to the CRAs to enrich the data sources available to the market more generally, in accordance with the principles of reciprocity.

¹³ [Think Finance initial submission](#), p3.

Preliminary observations

79. Default costs represent the largest category of costs for payday lenders. This indicates that differences in lenders' ability to assess credit risk are likely to have a substantial impact on their ability to operate profitably in the market and compete with established lenders. When assessing whether to lend to a particular customer, lenders use their own databases and information purchased from CRAs. A new entrant is likely to face higher default rates, and therefore higher costs, than an established lender. This is because the new entrant is likely to be reliant on a greater proportion of new customers (representing a higher expected credit risk) and is likely to hold less internal information on customer repayment behaviour, so will be less able to accurately predict default behaviour.

Loan management systems

80. Technology capabilities, including the software and know-how to develop and maintain payday loan management systems represent critical building blocks for Internet-based loan businesses in particular. In this section, we describe these systems and summarize responses we received on this topic.

Description

81. New entrants are likely to employ an automated loan management system to process applications, record loans and repayments, and link to other businesses (eg banks and CRAs).
82. A new entrant could either build a system itself or obtain the system from a third party. This could involve adapting a platform in use outside the UK (eg from North America) or licensing or purchasing third party software and services. We identified a number of third party suppliers of standard components that could be used to perform various stages of the process. However, the largest lenders may choose to

invest in their own software and systems if they perceive such systems to be a source of competitive advantage.

Views of respondents

83. We received a number of views on loan management systems.

84. CashEuroNet said that current technological barriers were minimal in comparison with 2008. Commercially available credit reporting, analytics, anti-fraud and software systems for Internet payday lenders had evolved to the point that start-ups did not need to invest substantial time and capital to develop these capabilities internally. Firms like LendProtect and Welcom had well-developed software solutions that allowed lenders to assess risk. LendProtect told us that such systems particularly enabled small and medium-sized lenders to compete with larger lenders on a level playing field. These vendors provided turnkey solutions for investors who wished to enter the UK payday lending space.

85. Dollar said that a high street lender would need to invest in loan management systems/technology and collections management systems/technology to support collections activities for customers in arrears and document processing systems/technology. The scope of these investments was dependent upon the scale of a provider's operations and for small operations could be done on a manual basis with minimal investment in technology.

86. Global Analytics said that for its initial launch it selected and worked with a third party IT services partner for three years to develop, launch and scale up a system. However, during the growth phase a number of issues were encountered with the collection, underwriting and analytics systems. It decided to build its own proprietary system to overcome the challenges and support its long-term growth initiatives. Since

October 2012 all activities had used the new system. The cost of the system was approximately \$3 million, the majority of which was on software and IT group costs in India.

87. H&T said that its experience was that by using a software provider, such as Laps IT, entry to the online sector was relatively quick and low cost. H&T had invested approximately £20,000 in systems implementation.
88. MYJAR told us that it had spent around £1 million on IT systems between 2009 and 2013. It said that barriers to entry at first seemed low. However, it soon discovered that it needed to design, build and maintain a significant IT platform. The business had needed investment of £12 million to date excluding earnings generated from trading.
89. The Cash Store said that [REDACTED].
90. Wonga said that new entrants could acquire third party technology solutions instead of undertaking the development themselves. It told us that certain third party systems were very advanced, [REDACTED].

Preliminary observations

91. The evidence we have reviewed so far suggests that the need to acquire loan management systems is unlikely to reduce the likelihood of entry to a material extent.

Payment processing services

92. In this section, we describe the need for payment processing services and present the responses we received on this topic.

Description

93. Payday lenders need a commercial banking relationship in order to make bank transfers of new loans to their customers' bank accounts and recover amounts due. Online products are debit card based and lenders use continuous payment authorities (CPAs) to debit borrowers' bank accounts. Payday lenders also need a banking relationship for their day-to-day activities (eg payments for employees, goods and services, and management of working capital).

Views of respondents

94. We received a number of views on payment processing services. Global Analytics told us that a new entrant would have to establish banking relationships for the disbursement of funds as well as collections. It said that this was one of the most challenging commercial relationships as there were few banks granting accounts to this sector.
95. H&T said that it had already seen banks withdraw facilities from smaller businesses and that new businesses found it increasingly hard to obtain card-processing accounts.
96. Loaf told us that its entry into payday lending had been frustrated by the UK banking industry. Numerous banks it approached to open a standard business account had cancelled its application upon learning that it planned to offer payday loans. Loaf said that 'anti-competitive behaviour by the UK mainstream banking oligopoly was a significant barrier to small and independent new entrants providing better value payday solutions to UK consumers'.¹⁴

¹⁴ [Loaf submission](#), p1.

97. MYJAR said that the largest barrier to entry was the difficulty of obtaining commercial relationships with the banking sector because the banks considered payday lenders as competitors and were reluctant to progress banking relationships.
98. Barclays told us that, with regard to merchant acquiring services, [REDACTED].

Preliminary observations

99. In the past, lenders do not appear to have faced barriers in establishing commercial banking relationships. However, there is some evidence to suggest that this may be more challenging for companies entering payday lending today than it has been previously.

Customer services and call centres

100. In this section, we describe the need for customer services and summarize responses we received on this topic.

Description

101. The extent to which a payday lender uses call centres to interact with customers depends on its individual business strategy. Internet-based lenders generally require a call centre to service customer accounts. The use of call centres to manage inbound customer calls and loan applications can be scaled according to the business requirements. An entrant may also be able to use a third party outsourcing arrangements instead of investing in its own operations.

Views of respondents

102. We received a number of views on call centres and their costs:
- (a) Ariste told us that it spent £[REDACTED] million per year on its call centre.

- (b) Dollar told us that it operated a fully-integrated call and collections centre for its online business activities. It said that its operating expenses for collections and call centre for online activity were £[redacted] million in the year ended 30 June 2013.
- (c) Global Analytics said that its contact centre cost \$[redacted] million to operate in 2013, representing [redacted] per cent of revenue. Its workload consisted of servicing inbound telephone calls and emails and making outbound calls relating to verifying and gathering information to supplement an online application. Global Analytics received between [redacted] and [redacted] inbound calls per month in the first half of 2013.
- (d) MYJAR said that its call centre cost £[redacted] million a year and employed [redacted] people.
- (e) Wonga's primary customer contact centre was based in South Africa with additional specialist teams located in Dublin. These teams serviced the global business including UK customers. Wonga told us that annual expenditure on these facilities was £[redacted] million in 2012 and was forecast to be £[redacted] million 2013.

Preliminary observations

103. The evidence we have reviewed so far suggests that the need to acquire customer service and call centre operations is unlikely to reduce the likelihood of entry to a material extent.

Financing and access to capital

104. In this section, we describe the need for financing and present the responses we received on this topic.

Description

105. This financing for payday lending includes the capital required to invest in start-up costs or business expansion, including the costs of acquiring the business require-

ments set out above. The sources of finance may include private equity investment and retained earnings.

Views of respondents

106. We received a number of views on investment in payday lending, covering:
- (a) the scale of the investment required;
 - (b) working capital requirements; and
 - (c) the sources of finance available.
- *Scale of investment required to launch a payday lender*
107. We received a number of indications of the investment required to enter payday lending.
108. Ariste told us that it was founded in 2009 with approximately £0.5 million of internal capital. It estimated that a minimum investment of £1 million would be required to enter the sector with an ambition to be an effective competitor generating approximately £5 million per year revenue.
109. CFO Lending said that an investment of £5 million would be required to enter the payday loan sector. This would be required for an operation generating £22 million in revenue and making 250,000 loans a year.
110. Global Analytics said that the sector was maturing and very competitive, and it believed that any new entrant would have to make significant investments in marketing and acquisition strategies in order to compete effectively. This would include an initial \$2–\$3 million a year spent on television, paid search and possibly lead aggregators. It said that a new entrant needed revenues of at least \$10–\$15 million with a loan volume of around 150,000 to 200,000 per year to be an effective competitor with

at least 1 to 2 per cent market share. It would be likely to take one or two years to ramp up to this volume. Global Analytics said that it had raised approximately \$50 million (£31 million) through four separate equity raises over the past year, and had raised \$45 million debt (£28 million), of which \$30 million (£19 million) was outstanding, and the business had generated losses of \$20 million (£13 million) since it commenced UK operations in November 2008.

111. H&T estimated that the cost of entry was currently £10 million. It said that it could be assumed that an effective competitor was one that could reasonably attain a market share similar to Wonga, QuickQuid or Dollar, and this entrant would have to acquire leads in the same way that it did. H&T understood that the marketing budget to achieve that was well in excess of £10 million a year. This would enable the new entrant to be visible on television and comparison services like MoneySupermarket (where it understood it cost £250,000 per month to be listed on the payday loans page). A business generating 22,000 loans of £250 per month (outstanding loans therefore about £5.5 million) at fees of 25 per cent and incurring debt of 10 per cent of lending would generate net revenue of £9.9 million. This was the minimum business that could possibly generate sufficient revenue to pay for the marketing. Clearly in order to pay for the associated overheads (systems, management, people, bank charges etc) it would have to be bigger.

112. MYJAR told us that it had invested £12 million in the business excluding earnings from trading. It estimated that the investment now required to enter the sector would be in excess of £10 million, and a business would need to achieve revenue of £15–£20 million and an annual loan value greater than £50 million to be an effective competitor.

113. Wonga estimated that an investment of approximately £[redacted] million was required over the 14-month start-up period comprising £[redacted] million in funds to cover pre-launch and initial operating costs and £[redacted] million in cumulative loan book funding. These figures excluded bad debt costs in early months of trading and additional trading losses incurred by Quickbridge (UK) Limited.¹⁵

- *Working capital requirements for payday lenders*

114. We asked lenders how much working capital would be required to fund the operations. The responses are summarized below.

115. Ariste said that it required £[redacted] million of working capital, representing [redacted] per cent of the value of loan approvals.

116. Global Analytics said that on a monthly basis it generally required working capital equal to total expenses (approximately \$[redacted] million per month) plus total loans originated (approximately \$[redacted] million per month) less [redacted] per cent of collections (ie [redacted] per cent of \$[redacted] million, being \$[redacted] million). This currently varied between \$[redacted] million and \$[redacted] million (£[redacted]–£[redacted] million).

117. MYJAR said that it required £[redacted] million of working capital to cover its overheads, interest, tax and bank charges.

118. SRC said that WageDayAdvance's working capital requirements were £[redacted] million.

- *Sources of finance available to payday lenders*

119. We sought evidence in relation to the potential sources of finance that might be available to a new entrant or an expanding business.

¹⁵ [redacted]

120. Cheque Centre Ltd was originally founded in 1996 and was acquired by the Access/CNG Financial Corporation group, a US payday lending company, in 2006.
[REDACTED]
121. Global Analytics had carried out a series of private financings in recent years, including the issuance of various classes of equity and warrants. The shareholder base had evolved over time, and currently included a number of individuals and venture capital investors. The total amount raised through the four equity rounds in the past five years was \$50 million, and the total debt raised was \$45 million. Global Analytics estimated that its cost of equity was between [REDACTED] and [REDACTED] per cent and its cost of debt was three-month LIBOR plus [REDACTED] per cent. Global Analytics estimated that its current cost of debt was around [REDACTED] per cent, which was a slight decrease from the [REDACTED] per cent that applied in the past. The cost of equity had also reduced in subsequent equity rounds on the basis that an early investor might seek a return of 100 times on their investment, whereas a later stage investor might seek a 5 to 10 times return.
122. MYJAR told us that it was a private company that was funded through a combination of retained earnings [REDACTED], shareholder equity [REDACTED] and shareholder loans [REDACTED]. The shareholder loan balance at 28 February 2013 was [REDACTED]. This loan carried a coupon of [REDACTED] per cent a year. The shareholder [REDACTED] also received [REDACTED] per cent of the company's equity as consideration for the loan. MYJAR considered that new debt would not be available at a coupon [REDACTED] per cent plus discounted warrants for [REDACTED] per cent of the company's equity, and believed that investors would require a pre-tax return of [REDACTED] per cent. MYJAR said that it was difficult to obtain capital and banks would not provide funding of any kind. Funding for other new entrants had been provided by US listed entities engaged in servicing the under-banked or by private equity looking for returns of [REDACTED] their initial investment in [REDACTED] years.

123. SRC told us that its principal source of funding was via intercompany loans provided by its US parent company, which was a private company. SRC had intercompany debt of £7.1 million at interest rates of 2 to 4 per cent. WageDayAdvance's financial resources are all from retained earnings. Between 2008 and 2011 there was a small bank loan and a small amount of private equity investment.
124. The Cash Store told us that it was funded by its Canadian parent company, Cash Store Financial Services Inc., which had shares listed on the Toronto and New York Stock Exchanges. [✂]

Preliminary observations

125. Raising substantial amounts of finance to invest in entering and/or expanding in the payday lending sector could be a challenge, given the other costs and risks associated with entering the payday lending market.

High street entry—additional requirements

126. In this section, we consider the additional factors that may influence the likelihood of entry or expansion in high street payday lending.
127. An entrant into high street lending would need the requirements described above. The lender would also need high street locations to lend from and these will also provide the lender with a different method of customer acquisition, since the store will attract customers.
128. We focused on two potential entry and expansion strategies: first, an existing high street lender entering/expanding by opening new stores; and second, a firm which offers payday loans online could enter high street lending by opening new stores. These appeared to us to be the lowest-cost strategies since these lenders would

already have an existing payday lending infrastructure and would only need to open new high street stores.¹⁶ Consequently, in the remainder of this section we focus on those additional assets that would be required by these types of entrants.

Description

129. A high street payday lender would need to rent premises in suitable locations. This will be influenced by the need to operate in areas with high demand for payday lending and the availability of retail units with the appropriate use class (A2 Financial and professional services).¹⁷ In addition to this, high street lenders would need to fit out the locations for payday lending and hire staff.

Views of respondents

130. We considered the respondents' evidence on entry strategies and entry costs in order to understand better whether there were barriers to entry in opening new high street stores.

Entry strategies

131. Dollar told us that many factors were taken into account when it was considering opening a new store, including the proximity of other Dollar stores and competitor stores, as well as the local demographics. Dollar said that it looked for a demographic it referred to as ALICE customers (asset limited, income constrained and employed). When considering where to locate new stores, Dollar also looked at [X].
132. SRC (Speedy Cash) said that it chose its locations based on four factors: (a) where a large part of the population was credit challenged and underserved from a financial

¹⁶ A further local entry strategy could involve the expansion of the product range offered by an existing high street retailer of related products. In this context, we recognized that some firms, for example H&T, offered payday loans alongside other services from their high street premises. For these firms the incremental costs of entry and expansion (through adding payday lending services to an existing branch) could be lower than de novo entry, assuming that such a firm already had some or all of the infrastructure necessary for payday lending (eg a capability for effective credit risk assessment).

¹⁷ As set out in the Town and Country Planning (Use Classes) Order 1987 (as amended).

services perspective; (b) where there were high car/foot traffic levels; (c) where rent levels were affordable; and (d) where there were not too many competitors.

133. Speedy Cash said that the UK had proved to be a challenging market for its branches. The consumer credit market in the UK was extremely competitive at the retail level and Speedy Cash had not been able to develop a stable footing in all of its high street markets. In July 2013 it closed two branches that had been unable to develop consistent customer traffic and loan bookings. Speedy Cash did not believe that it was alone in facing these difficulties as most of its branches were located in areas where customers had many choices of credit providers, including payday lenders, instalment lenders, pawnbrokers and second-hand goods dealers. Of late, Speedy Cash had been aggressively price promoting its products and had seen better results but, taken as a whole, its branch operations were not generating acceptable returns. Given customers' seeming preference to manage financial transactions online, Speedy Cash was concerned that the high street market in the UK would be a difficult challenge for the foreseeable future and at this time it had no plans for further expansion.

134. The Cash Store said that when choosing a location, the visibility of the property was important. All 27 of its operating branches in the UK were leased. The Cash Store did not advertise heavily, so it leaned more on high street locations to capture passing trade. [REDACTED] The Cash Store said that opening a branch in a particular location was mainly dependent on the visibility of the property.

Entry costs

135. Dollar told us that costs of opening a store ranged from £[REDACTED] to £[REDACTED] per store. It said that a provider of only payday loans would incur much lower costs when opening a store because they would not need much of the safety/security equipment that

Dollar required. All except one of Dollar's retail network of 596 sites were leased.

Dollar said that competition for sites could be high. [✂]

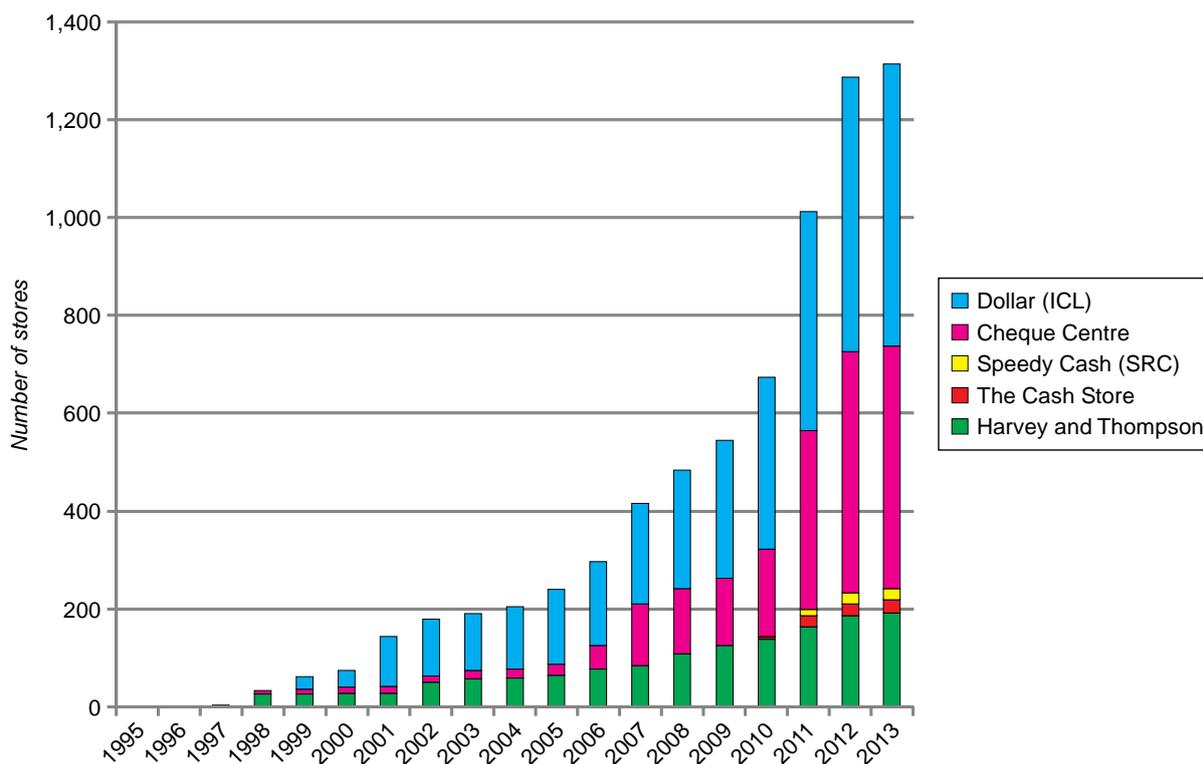
136. SRC (Speedy Cash) said that all its stores were de novo entry, with no acquisitions. Its investment per store included £250,000 for construction and approximately £150,000 to fund receivables. SRC also invested in significant advertising, promotion and recruiting efforts. It took it approximately 12 months from its decision to enter the market to the time it commenced trading.

History of high street entry

137. The responses of the major lenders allowed us to investigate the history of store openings in the UK. The evidence in Figure 3 shows that lenders have opened many stores, with large numbers of openings between 2010 and 2012. Many of these stores were opened by Cheque Centre and Dollar. More detail on the store openings of the individual companies is given in [Annex 3](#).

FIGURE 3

Number of high street lending stores over time



Source: CC analysis.

138. Figure 3 suggests there has been a reduction in the rate of store openings in 2013. Since our data only covered the period up to August 2013 we compared store opening numbers in January to August 2012 with store openings in January to August 2013. The results in Table 4 show that many of the high street lenders have slowed their store openings from 2012 to 2013.

TABLE 4 Store openings in January to August 2012 and January to August 2013

Payday lender	Openings	
	Jan–Aug 2012	Jan–Aug 2013
H&T	16	5
Speedy Cash	8	-1
Dollar	82	16
Cheque Centre	117	2
The Cash Store	2	3
Total	225	25

Source: CC analysis.

Note: Speedy Cash opened one store and closed two stores between January 2013 and August 2013.

Preliminary observations

139. The historical information on high street store openings and the responses received suggest that the barriers to expansion, through the opening of additional high street stores, are not substantial for existing payday lenders. There has, however, been a reduction in the rate of new store openings in 2013.

Reputational effects

140. An additional factor which may influence the likelihood of entry is that any firm entering either online or high street payday lending from another sector, eg a high street bank, would need to consider the reputational consequences of entry.

Views of respondents

141. Barclays and Lloyds described the potential impact of reputational effects.
142. Barclays told us that it would be concerned about entering the short-term month-end money-lending business primarily due to questions about the affordability of these products for customers, but it would also have reputational unease.
143. H&T told us that negative media coverage affected customers' responsiveness to price. H&T pointed at the negative media coverage which created a perception that 'lenders are all as bad as each other' rather than informing customers on the available alternatives in the market and the opportunity to 'save significant amounts by shopping around'.
144. Lloyds told us that it did not have any mainstream products on sale that had an APR above a pre-set level (orders of magnitude lower than current payday loan APRs) because of the potential reputational and brand damage as that was the level it

judged at which people started to question the legitimacy of the product.¹⁸ The APR was a difficult issue, particularly in relation to how it was communicated and interpreted. The APR was not appropriate for short-term lending products (and this is why it was not used for overdrafts) and presented a false impression of the cost of the product. This could lead to inappropriate comparisons being made using APRs between the cost of very short-term lending products and longer-term products such as a personal loan. However, if there was a way to overcome this issue, then it might make it more likely that Lloyds Banking Group or other mainstream lenders would consider entering payday lending or developing products designed to meet the same need. However, at present the thought of doing so would be really difficult reputationally because the very high headline APR would be likely to lead to stronger criticism of the banks than that currently experienced by payday lenders.

Preliminary observations

145. There is evidence that the current high degree of political and media attention centred on lending practices, high APRs and social costs of payday loans may deter some firms, such as banks, from entering the payday lending sector.¹⁹

Time required to achieve entry

146. In this section, we consider the likely time required to enter payday lending.

Views of respondents

147. We received a number of indications of the time needed to enter payday lending.

¹⁸ In particular, Lloyds told us that it did not have any mainstream products on the book that had an APR above [30] per cent because that was the level it judged at which people started to question the legitimacy of the product.

¹⁹ This may also affect the willingness of comparison websites to offer payday comparison tools, with implications for customers' ability to shop around—see the working paper on 'Shopping around' for details of moneysupermarket.com's withdrawal of its payday lending comparison tool. Consistent with this, we were told by one lender ([30]) that the negative media coverage created a negative perception of all lenders, rather than encouraging customers to seek out the best offers.

148. CashEuroNet told us that it started lending under the QuickQuid brand in June 2007, following a decision to enter the market in January 2007 that was made after months of due diligence. In 2008, the first year after launching, CashEuroNet generated revenue of £[redacted] million. However, initial fraud losses were substantial and impeded growth from 2007 to 2009. CashEuroNet said that QuickQuid's ramp up to competence and profitability was longer than could be expected for both native UK firms and other new start-ups from 2009 to present. The UK Internet payday loan market started to mature quickly in 2009/10.
149. CFO Lending said that it entered the payday loan sector in 2008. It slowly entered the payday market building relationships with banks and service providers and had organically grown over the initial two years and had seen significant growth with year on year increases in turnover during the five years that it operated.
150. H&T said that it estimated its own experience of six months to enter online channel as fairly reasonable and typical for an existing credit business with existing banking facilities. According to H&T's board papers, the decision to enter the online channel was made at the end of January 2011 and it started accepting applications at the end of June 2011.
151. SRC said that it took approximately 12 months from the decision to enter the market to the time it commenced trading. Speedy Cash opened its first retail branch in the UK in November 2010. It expanded gradually by opening new branches and as of 30 September 2013 it operated 23 branches. The first branches were opened in the London metropolitan area, with further expansion into Birmingham, the Midlands and the Greater Manchester area.

152. Wonga estimated that it took [REDACTED] from the establishment of the company to the point where Wonga generated a sustainable level of profit after tax.

Preliminary observations

153. The historic evidence suggests that the timescales required to launch a payday lending business vary. Some, like H&T, entered in six months, while Wonga told us that it took [REDACTED] from the establishment of the company to generating a sustainable level of profit after tax.

Potential future entry, expansion and exit

154. We considered parties' views about the scope for future entry, expansion and exit and whether the historical patterns were likely to be representative of the future evolution of the market.

155. A number of parties highlighted ways in which entry conditions might now be different from those that prevailed during the past five to ten years.

156. In terms of regulatory conditions, we note that the FCA stated that it expected, based on work done by European Economics, that its proposals to change the regulation of payday lenders could lead to between 25 and 30 per cent of lenders leaving the industry.²⁰

157. In this context, Global Analytics thought potential entrants were waiting to see what happened with the 2014 transfer of regulatory control from the OFT to the FCA before they decided whether to enter the UK market. H&T told us that the FCA and increasingly restrictive banking and merchanting (card processing) requirements would force out small businesses. H&T thought that the FCA regime would favour

²⁰ FCA, [Detailed proposals for the FCA regime for consumer credit](#), paragraph 6.95.

larger businesses which would be more able to adapt. H&T thought the market was very likely to polarize around the existing large players.

158. Think Finance, a company which was seeking to grow its payday lending business, explained its view on the future.²¹ It told us that it believed that the future of short-term lending in the UK was going to evolve rapidly away from traditional ‘payday’ loans that competed purely on speed and convenience. This was due to the media and government attention on these issues, which had highlighted a clear need to concentrate on things other than just speed and convenience. Because of these changes, Think Finance was closing down its traditional payday loan offering and introducing a new product. The new product would compete on tangible features of concern to consumers and regulators (as highlighted in the recent Bristol Report on the industry and the OFT Payday Lending Review): risk-based rates, fees, no roll-overs, payment flexibility that worked with customers’ changing circumstances, and the treatment of financial education. Think Finance thought it could compete in the rapidly-evolving short-term credit market because the increased regulatory involvement created an environment where it could succeed by focusing on fundamental consumer value drivers that affected the total cost of borrowing. Entrenched competitors would be reluctant to change due to large market shares and high profits and that left an opportunity for new entrants to establish a different type of product and brand.
159. Wonga said that it was likely that US entities would consider entering the UK payday segment, including World Acceptance Corporation, and ACE Cash Express. Beyond this, it thought there were a number of established businesses that might be interested in, and capable of, entering the UK payday loan segment, including: peer-to-peer lenders, UK and European banks, other credit providers with existing online

²¹ [Think Finance initial submission](#) , pp1–2.

products such as Provident Financial, credit card providers, large pawnbrokers, UK, European and US-based technology-oriented short-term consumer credit start-ups, international short-term credit and payday lending groups not yet active in the UK and online gaming and online payments entities, which already had in-house access to the requisite technical expertise.

Preliminary observations

160. There are some indications to suggest that barriers to entry and expansion are evolving and in some cases increasing relative to the conditions that prevailed over the past decade. For example, the regulatory environment is changing, incumbent lenders have well-established consumer brands and the cost of customer acquisition, especially those acquired through lead generators, appears to be increasing.

Lead generators

1. In this annex we provide some background information on the activities of lead generators and the ping-tree mechanism. Our focus here is on the operation of these firms. See our paper on 'Shopping around' for more information on their potential effect on customers.

What is a lead generator?

2. Lead generators are companies that contract with payday lenders to provide potential customer applications (or 'leads') in return for a fee for each lead provided. Like credit brokers more generally, lead generators are required to hold a consumer credit licence (as they 'introduce individuals seeking credit to businesses that provide credit').
3. Lead generators typically rely on a large network of sources to generate their leads. In addition to generating leads directly through their own activities (eg websites advertising payday loans, such as purplepayday.co.uk), most lead generators generate some proportion of their business through affiliates. Affiliates generate traffic using, for example, banner advertisements or a cost comparison website, and then pass these customers on to the lead generators, who will seek to collect from these individuals customer information which can be sold to a lender.
4. CashEuroNet told us that it was not uncommon for one lead provider to have 100 to 1,000 individual affiliate vendors that fed new customers to that lead provider. These affiliates could send traffic to the lead generator's site by different means, including:
 - (a) a banner advertisement affiliate could have a click-through link that routed customers to the lead provider site;
 - (b) a pay-per-click affiliate could route customers to the lead provider site;

- (c) a cost comparison or shopping site affiliate could route customers to the lead provider site; or
 - (d) an email list vendor could have links in the email text which routed customers to the lead provider site.

- 5. Despite the large number of affiliates that are often used, these may account for only a relatively small proportion of all customer applications. PDB (one of the largest lead generators) told us that its two largest websites generated the great majority of its leads.

- 6. CashEuroNet told us that lead generators had a number of advantages over lenders, which explains why lenders did not carry out all customer acquisition in-house:
 - (a) Lead providers sometimes sold multiple products or obtained volume discounts in advertising, which could provide them with a cost advantage.
 - (b) It was more efficient for a lead provider to vet and manage hundreds of affiliate vendors since the lead provider usually supplied many lenders.
 - (c) Lead providers specialized in digital marketing.
 - (d) Ping trees could be highly customized to allow a lead provider to deliver a specific customer profile (ie credit profile, income level, region, etc) that the respective lenders wanted and at certain agreed price points.

The ping-tree mechanism

- 7. Contractual and transactional interactions between lead providers and lenders vary. A common relationship between lead providers and lenders is an automated online mechanism called a ping tree.²²

²² [X]

8. The ping-tree process begins when a customer applies for a loan via a lead generator's website. In order to apply, the individual will be required to provide standard loan application details, such as name and address, contact details, income and expenses and bank details. The information collected will be primarily driven by lenders' requirements, and will reflect their own application forms.

9. Subsequent to the application being made, the ping-tree process operates as follows:
 - (a) The lead generator will send the application details to the lender who offers the highest price per lead. This position is also known as 'first look' or 'right of first refusal'. In some cases, lenders may specify filters dictating the types and volumes of leads that they want to accept, based, for example, on age, income or postcode, which will also influence whether or not they will be sent a given lead.
 - (b) The lender in first position on the ping tree usually has a short time (a matter of seconds) to carry out a risk assessment and decide whether to buy or reject the lead. This assessment is fully automated, and is based on the application details provided by the individual (checks using credit reference agency data may also be carried out at this stage). CashEuroNet told us that lenders were given only a short time to review the lead because most customers would cut short the application process if they had to wait more than 90 seconds for a lender decision.
 - (c) If the lender decides to buy the lead, the process ends for that particular customer application, and the individual is redirected to the lender's landing page to complete the loan application. Generally the information already provided by the customer will be prepopulated in the relevant fields in the lender's application form.
 - (d) If the lead is rejected by the lender in first position, that particular lead is then offered to the lender that is in second position on the ping tree (ie the lender that offers the second highest price per lead). This lender will similarly carry out an automated risk assessment and decide whether to accept or reject the lead.

(e) If the lender in second position rejects the lead, the sequence is repeated.

10. This process is summarized in Figure 1.

FIGURE 1

Summary of the ping-tree auction process

Leads acquired through online auction – “ping tree”



Source: CashEuroNet response to market questionnaire.

11. A single lender can occupy multiple positions in a ping tree. Lenders may choose to occupy multiple positions because a lead at a given credit score/initial creditworthiness assessment may be unattractive at the higher price but attractive at a lower price further down the ping tree. PDB told us that most lenders that it supplied to would occupy between three and five different pricing points in its ping tree.
12. Subsequent to a lead being purchased and a customer being delivered to the landing page, lenders will have the opportunity to carry out any further creditworthiness checks (for example, ID verification or affordability/creditworthiness checks). As such,

in many cases customers that are purchased by a lender in a ping-tree process may not ultimately be approved for a loan. PDB told us that towards the bottom of its ping tree, lenders paid per funded customer rather than per lead (ie would only pay when a lead was converted into an actual loan).

13. PDB told us that on average approximately 20 to 25 per cent of leads entering the ping tree were ultimately purchased by any lender on a cost per accepted lead basis. The top lenders generally accepted 1 to 2 per cent of the customers they were offered. These lenders were relatively stable in their activity in the ping tree. They typically operated towards the top of the tree and paid per accepted lead. [✂]
14. The bottom of the ping tree is generally occupied by small lenders, operating on a price per funded customer basis. These lenders tend to be less stable in the quantities purchased, dipping in and out of the market (for instance, some did not purchase leads at night or weekends). Funding constraints also affected the ability of some of the smaller lenders to purchase customers.

The principles of reciprocity

1. This annex describes the principles of reciprocity, as set out on the Steering Committee on Reciprocity (SCOR) website. The full rules are available on the Internet.²³
2. SCOR is a cross-industry forum made up of representatives from credit industry trade associations, credit industry bodies and credit reference agencies. It is responsible for the administration and development of the data-sharing rules known as the Principles of Reciprocity. SCOR operates on behalf of the trade associations and industry bodies that it represents and can only make recommendations on matters concerning the Principles of Reciprocity to those organizations; it has no powers of its own. Each trade association and industry body will have internal procedures for debating and agreeing their position on proposals from SCOR. Issues referred to SCOR may arise from a request by a trade association, industry body, a member or a credit reference agency. They may also arise because of legislative changes that affect the Principles.²⁴
3. SCOR representatives are nominated by their individual trade associations and industry bodies from among their member organizations. Trade associations and industry bodies represented are the British Bankers' Association, British Retail Consortium, Building Societies Association, Consumer Credit Association UK, Consumer Credit Trade Association, Council of Mortgage Lenders, Credit Services Association, Energy Retail Association, Finance & Leasing Association, Mobile Telcos and The UK Cards Association. The credit reference agencies represented on SCOR are mainstream credit reference agencies Experian, Equifax and Callcredit,

²³ [www.scoronline.co.uk/files/scor/por_version_35_\(final\)_september_2013.pdf](http://www.scoronline.co.uk/files/scor/por_version_35_(final)_september_2013.pdf).

²⁴ www.scoronline.co.uk/about_us/.

plus niche market credit reference agency CoreLogic Teletrack. The chairmanship of SCOR rotates between member trade associations and industry bodies. Trade associations and industry bodies representing members that use shared consumer data from credit reference agencies may apply to join. Membership is also available to other credit reference agencies with a consumer database, although there are rules about the volume of their database and activity.

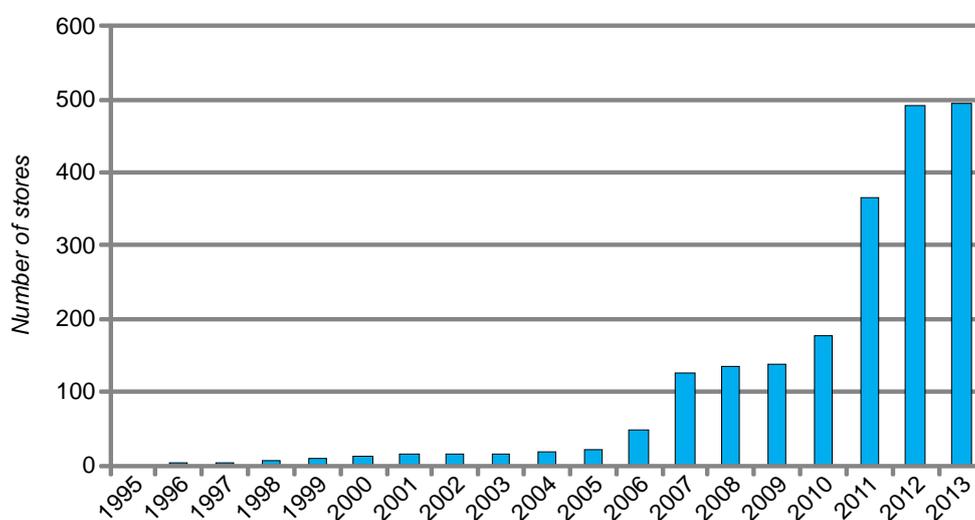
4. The Principles of Reciprocity are a set of guidelines governing the sharing of personal credit performance and related data via the closed user groups of the credit reference agencies (currently Experian, Equifax and Callcredit and niche credit reference agency CoreLogic Teletrack). They were prepared following extensive discussion among lenders, trade associations and regulatory bodies on the use of consumer information during the 1990s. The intention is to ensure that all companies which use and/or subscribe shared data undertake to abide by the Principles of Reciprocity, on the basis that 'subscribers receive the same credit performance level data that they contribute, and should contribute all such data available'.
5. The main thrust of the Principles of Reciprocity is that data are shared only for the prevention of over-commitment, bad debt, fraud and money laundering and to support debt recovery and debtor tracing, to aid responsible lending. The credit reference agencies include compliance with the Principles of Reciprocity in their client contracts and they have a responsibility to ensure that they only supply data in accordance with the Principles. Members of the credit reference agencies should ensure that compliance with the Principles of Reciprocity forms a part of their own internal audit procedures. SCOR, through the credit reference agencies, will seek confirmation of compliance with the Principles of Reciprocity from each data sharer or user.

History of store openings

1. The responses to the market questionnaire allowed us to estimate the number of store openings by lender over time. We received data for Cheque Centre, Dollar, H&T, Speedy Cash and The Cash store.
2. Figure 1 shows that Cheque Centre opened many stores between 2010 and 2012.

FIGURE 1

Cheque Centre stores

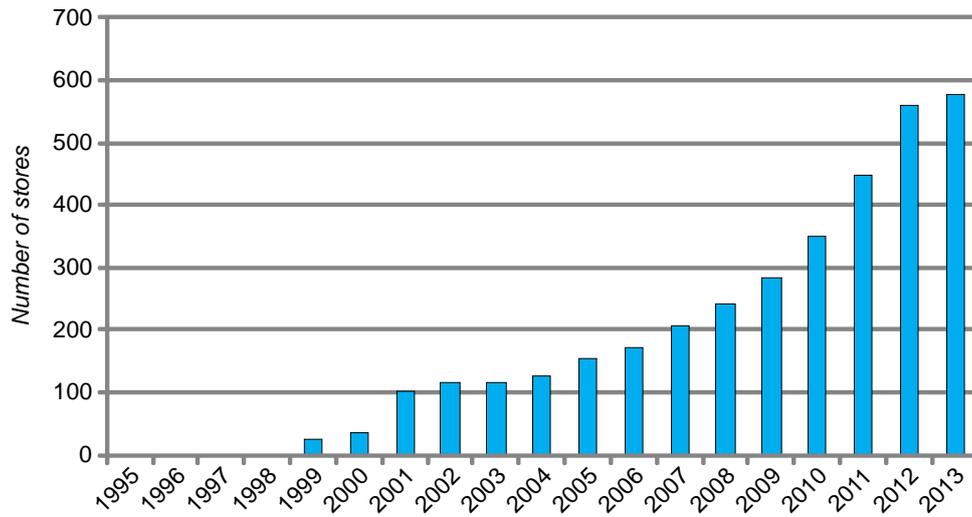


Source: CC analysis.

3. Figure 2 shows that Dollar has opened new stores in every year, with fewer stores opening in 2013.

FIGURE 2

Dollar stores

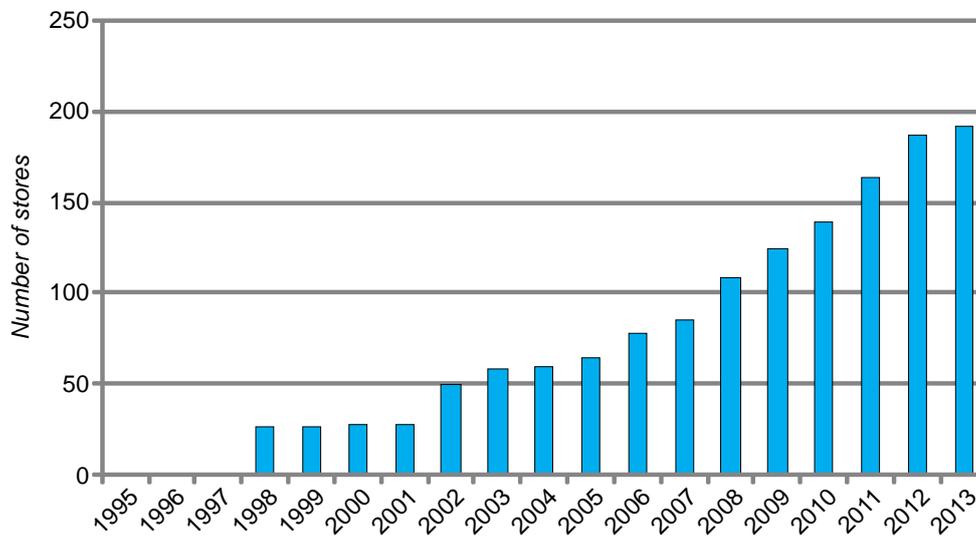


Source: CC analysis.

4. Figure 3 shows that the largest increase in H&T stores was between 2011 and 2012.

FIGURE 3

H&T stores

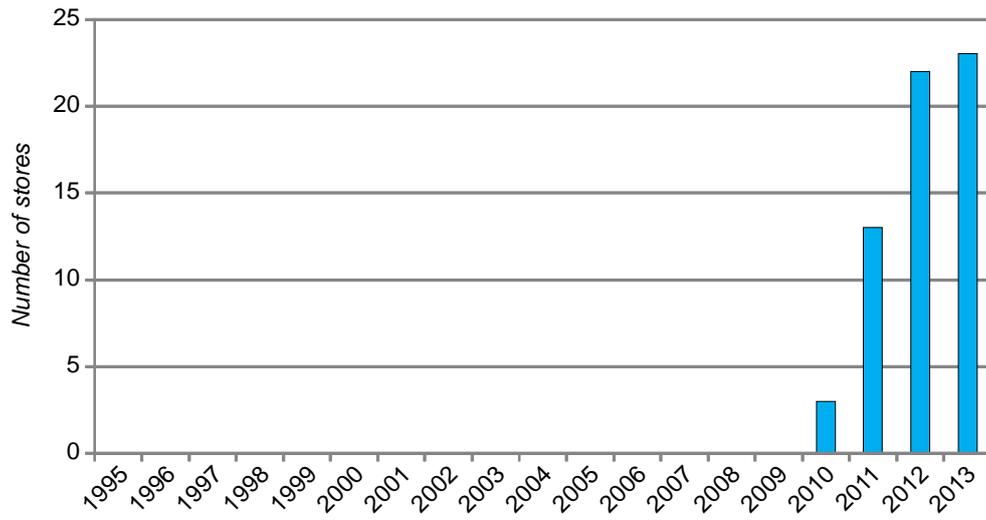


Source: CC analysis.

5. Figure 4 shows that SRC (Speedy Cash) began opening stores in 2010 and store openings flattened out in 2013.

FIGURE 4

SRC (Speedy Cash) stores

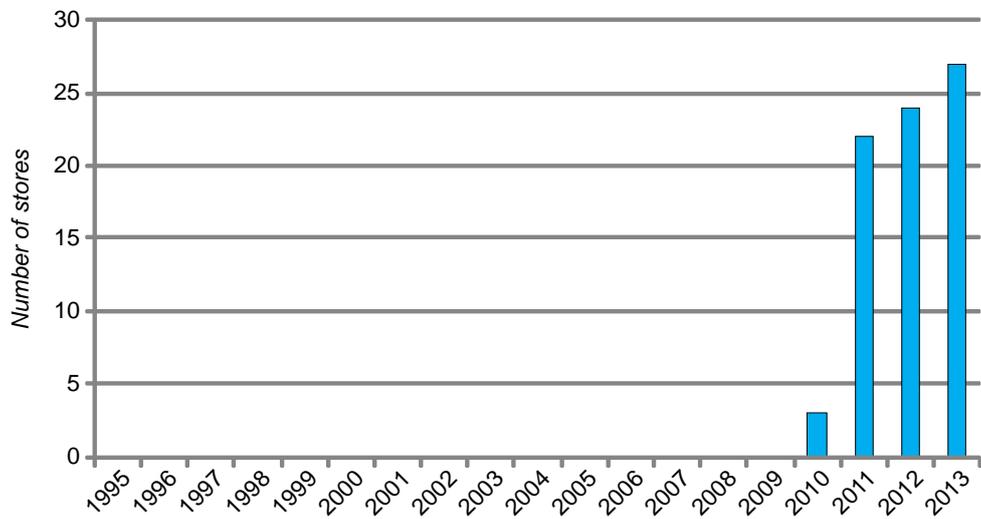


Source: CC analysis.

6. Figure 5 shows that The Cash Store opened many stores from 2010 to 2011.

FIGURE 5

The Cash Store stores



Source: CC analysis.