OFFICE OF FAIR TRADING

Payday Lending

Consultation on a market investigation reference

March 2013

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Any enquiries regarding this publication should be sent to us at: Marketing, Office of Fair Trading, Fleetbank House, 2-6 Salisbury Square, London EC4Y 8JX, or email: marketing@oft.gsi.gov.uk.

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CONTENTS

1 INTRODUCTION

1.1 The OFT has provisionally decided to make a market investigation reference (MIR) to the Competition Commission (CC) of the market for payday lending in the United Kingdom. This consultation document is published in order that interested parties can respond to the provisional decision. Comments should be sent by 1 May 2013 to:

Payday Lending Consultation
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1.2 Payday lending consists of the provision of small sum unsecured cash loans on a short term basis, typically repayable on the consumer's next payday or at the end of the month, but specifically excluding home credit (where repayments are collected in the consumer's home). Some payday lending providers also engage in wider activities such as pawnbroking, medium-term loans, cheque cashing, gold buying, foreign currency exchange, international money transfers or buying and selling of second-hand goods.

1.3 This provisional decision follows the OFT's review of compliance in the payday lending sector with the Consumer Credit Act 1974 (CCA),[1] wider relevant legislation and OFT guidance, in particular the Irresponsible Lending Guidance (ILG). We have also drawn on evidence from research commissioned by the Department for Business, Innovation and Skills (BIS) from the Personal Finance

[1] The OFT's final report on its review of compliance in the payday lending sector, March 2013

Centre of Bristol University into the UK Payday Lending industry[2] (the Bristol Research).

1.4 The evidence paints a concerning picture of the UK payday lending market. It suggests that irresponsible lending is not a problem confined to a few rogue traders, but may have its roots in the way competition works in this market. The evidence suggests that many payday lending consumers are in a weak bargaining position, and face firms that compete on speed of approval rather than on price. Current guidance requires payday lending firms to check whether potential borrowers can meet repayments in a sustainable way. However, given widespread non-compliance, those firms that carry out such checks adequately risk losing out in the marketplace to competitors. Payday lending firms describe and market their product to consumers as one-off short term loans but in practice around half of their revenue appears to come from loans which last longer and cost a lot more because they are rolled over or refinanced. Lenders may not need to compete hard for revenue from rolled over loans because by that stage in the process the borrower may feel they have no alternative.

1.5 As a result of the evidence gathered in the course of this Compliance Review, the OFT believes that the problems in the payday lending sector go further than can be addressed solely through securing improved compliance with relevant laws and guidance by individual firms. It suspects that there are market features that prevent, restrict or distort competition in the market for the supply of payday lending in the UK.

1.6 Features of the payday market that appear to be causing or contributing to this prevention, restriction or distortion of competition include:

a) endemic poor compliance with relevant law and guidance, in particular in relation to affordability assessments, which risks bad lenders driving out good ones

b) business practices which obscure the full cost of payday lending particularly when repayments are late or missed

[2] The Impact on business and consumers of a cap on the total cost of credit: Personal Finance Centre, Bristol University, March 2013

c) a significant proportion of payday lending customers having poor credit histories, limited access to other forms of credit and pressing needs and therefore being less price sensitive

d) high switching costs for customers post-loan which dampen competition for rollover loans from which payday lending firms derive around half their revenue

e) market concentration may be exacerbating the effect of these features.

2 THE REFERENCE TEST

2.1 Under section 131 of the Enterprise Act 2002 (the Act), the OFT may make a market investigation reference to the CC where it has reasonable grounds for suspecting that any feature, or combination of features, of a market in the UK for goods or services prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the UK or a part of the UK.

2.2 In its published guidance,[3] the OFT has said that it will make references to the CC only when the reference test set out in section 131 of the Act is met and, in its view, each of the following criteria, have been met:

- It would not be more appropriate to deal with the competition issues identified by applying the Competition Act 1998 (CA98) or using other powers available to the OFT or, where appropriate, to sectoral regulators.
- It would not be more appropriate to address the problem identified by means of undertakings in lieu of a reference.
- The scale of the suspected problem, in terms of its adverse effect on competition, is such that a reference would be an appropriate response to it.
- There is a reasonable chance that appropriate remedies will be available.

2.3 The OFT believes that the test for a reference set out in section 131 of the Act is satisfied and that each of the additional criteria set out in its guidance is also met. Set out below are the features of the market that, in the OFT's view, prevent, restrict or distort competition and discuss how we believe the criteria set out in our guidance have been met.

2.4 OFT guidance states that in consulting on a reference the OFT should normally express a view as to the possible definition of the

[3] www.oft.gov.uk/shared_oft/business_leaflets/enterprise_act/oft511.pdf

market (or markets) affected. The OFT's view on this is set out below at Annexe A. Draft Terms of Reference for the investigation are also set out at Annexe B.

3 FEATURES OF THE MARKET WHICH PREVENT, RESTRICT OR DISTORT COMPETITION

3.1 The OFT's provisional view is that it has reasonable grounds for suspecting that there are particular features that prevent, restrict or distort competition in the market for the supply of payday lending and, therefore, that the section131 test is met. These features are summarised in paragraph 1.6 above, and discussed in detail in turn below.

Endemic poor compliance with regulation

3.2 Lenders must, by law, assess creditworthiness before issuing a loan, and OFT Guidance[4] makes clear that they should also assess affordability – that is, each borrower's ability to repay in a sustainable manner. All assessments should include consideration of the potential for that specific credit commitment to impact adversely on the individual borrower's financial situation. We found endemic non-compliance within the sector with this requirement.

3.3 It appears to the OFT that the way this market operates may create strong incentives for non-compliance with this requirement. In particular, there is evidence that firms compete primarily on speed and ease of loan approval. A common theme across payday lending websites reviewed as part of the OFT's Compliance Review was to talk up the easy availability of loans and speed of arrangement rather than give equal billing to the costs or risks. Statements on websites included 'borrow up to £750 instantly', 'instant cash', 'simple, fast, easy', 'funds can be transferred to your bank account within as little as 15 minutes'.

3.4 Furthermore, the Bristol research found that customers reported using payday lending for the following main reasons: it was quick and convenient (90 per cent of online payday lending customers), it makes it easier to manage when money is tight (81 per cent of

[4] Irresponsible lending – OFT guidance for creditors, February 2011

payday lending customers) and because they could not borrow from elsewhere (50 per cent of online payday lending customers). The top three reasons for expressing satisfaction with online payday lending were speed of loan decision (36 per cent), convenience (35 per cent) and customer service (27 per cent).

3.5 The risk in this environment is that those lenders prepared to comply with the law and guidance, for example by investing time and money in establishing affordability more accurately, are driven out of the market by those lenders who are aware that many customers are focused on access to credit and speed of decision.

3.6 A further concern relates to the use of Continuous Payment Authority (CPA). In the course of the Compliance Review the OFT found some lenders misusing this facility, for example by taking multiple payments over a number of days when repayments have been missed without consumers' informed consent, by failing to explain how CPA works and how CPAs may be cancelled, and by refusing to cancel them where this is requested. This misuse may have two impacts in the market. First, by ensuring that payday lending firms are paid back ahead of other creditors it may shield them from the consequences of poor lending decisions, thus reducing the incentives for payday lending firms to avoid making irresponsible loans in the first place and thereby further distorting competition within the market. Second, misuse of CPA also creates the risk that borrowers in financial difficulties will not schedule repayments to creditors so as to deal with their debts in the right order.

Lack of transparency of the costs of payday loans

3.7 The above evidence suggests that factors such as the amount a lender is willing to lend and rapid availability of the loan may take precedence in the eyes of the customer over the loan's overall cost. Evidence gathered during the Compliance Review also suggests that it is difficult for customers to get a clear idea of the costs of particular payday loans for comparison purposes in advance of making an actual application, particularly when applications are made over the phone or online. Mystery shopping conducted on the OFT's behalf by Ipsos MORI[5] found that in most cases transparency was lacking in the level of information payday lenders were willing to give, especially around the provision of information on Annual Percentage Rates (APRs), the total cost of credit, affordability assessments and the potential impact of the use of CPA.

3.8 Transparency may not be much better online. An assessment of payday lenders websites as part of the Compliance Review found that frequently the total cost of the loan is not apparent until late in the application process. The OFT Market Study into the Advertising of Prices[6] found that customers could be misled into making purchases they subsequently regret when the final price is not revealed until late in the transaction and that such 'drip pricing' practices can have adverse effects on competition.

3.9 We have found limited evidence of the extent to which consumers assess the price information that is available in the payday lending market. APRs are intended to facilitate consumer comparison of the cost of finance but it is doubtful whether the average consumer actively compares prices on this basis. In its 2006 review of the Home Credit market the Competition Commission found that 'in practice, home credit customers appear to pay most attention first to the availability, and then to the affordability, of the credit, that is, to the level of the weekly payment, and less to measures of value of the loan they are taking out (such as the APR or total cost of credit (TCC)). In practice, we found that customers appeared largely insensitive to changes or differences in the price of home credit loans expressed in these terms'. The OFT believes evidence that such a pattern of behaviour is also to be found in the payday lending market. This can be seen in the Bristol research where only 46 per cent of retail payday lending

[5] Annexe G Mystery Shopping: The OFT's final report on its review of compliance in the payday lending sector, March 2013

[6] Advertising of Prices Office of Fair Trading October 2009

and 49 per cent of online payday lending customers claimed to consider the APR when they took out their loan.[7]

3.10 Customers could use the total amount payable to compare the prices of different payday loans. This may be easier for most customers to understand than an APR, but it becomes complicated if the amount borrowed and the terms of repayment of the loans being compared are not identical. At present, payday loans may not be sufficiently standardised to allow such comparisons to be made easily.

3.11 This lack of transparency may result in a tendency for customers to make decisions on any particular loan they are offered according to whether they have a pressing need rather than whether it represents good value in comparison with other loans. This in turn risks undermining competition on price within the payday lending industry. In other words, poor transparency about prices means that consumers as a whole are less effective at constraining prices in this market.

Price Insensitive Consumers

3.12 The Bristol research found that, according to OFT definitions of vulnerability,[8] 60 per cent of retail payday loan customers and 37 per cent of online payday loan customers were vulnerable. The OFT believes customers in the market for payday loans may be in a poor bargaining position due to the high perceived risk that they will default on payments, the shortage of alternative sources of small sum credit and pressing need for a loan. A significant proportion of payday loan customers do not appear to be active in comparing the prices and other terms on which credit is supplied by different lenders. The Bristol research found that only 26 per cent of retail payday borrowers and 46 per cent of online payday borrowers said they compared the costs of borrowing before taking out their loan.

[7] The Impact on business and consumers of a cap on the total cost of credit: Personal Finance Centre, Bristol University, March 2013

[8] Vulnerable consumer groups: quantification and analysis OFT 219 April 1998

3.13 Where customers are not focused on price and/or cannot get clear, comparable price information, price competition is likely to be weak. In this situation there is a risk that high default costs (associated with inadequate affordability assessments alongside advertisements designed to attract customers with poorer credit records) can be passed back to customers in the form of higher prices.

High switching costs particularly when payday loans are rolled over

3.14 There is a particular concern that a substantial minority of payday loan customers ‘roll over’ their initial loan. 'Rollover' loans, whereby customers repay the interest charges owed but postpone repayment of the remainder of the outstanding debt for another loan period (typically a month) are common in the payday lending market. Rollovers and refinancing (experienced as the same by the borrower, but where a new loan is issued to repay the amount outstanding on an existing loan) can also involve an element of 'selling up', where there is an extension of further capital. Likewise, a number of firms offer partial rollovers, whereby the consumer repays an element of the capital owed as well as the interest when extending the loan period.

3.15 Evidence supplied to the OFT as part of the Compliance Review suggests that a significant proportion of payday lenders’ revenues are drawn from these customers. 28 per cent of all loans in our survey of 21 payday loan providers were rolled over or refinanced at least once and these loans accounted for nearly 50 per cent of payday lending firms’ revenue. Furthermore 5 per cent of payday loans were rolled over or refinanced four or more times and, although only a small part of the market, these loans accounted for 19 per cent of payday lending firms’ revenues. The Compliance Review found that 30 per cent of the firms visited appeared to actively market rollovers to customers in advance of the payday loan becoming repayable.

3.16 The OFT has seen very little evidence of competition between lenders at the point the ‘rollover’ is agreed with the borrower. The original lender has a very significant advantage in the market as only they know which borrowers have taken payday loans from them and only the original borrower knows at what date the loan is due to be repaid. There is also a lack of clarity about whether payday loan rollovers are treated as modifications of an existing agreement, the creation of a new agreement or a unilateral concession on the part of the lender. The Compliance Review found evidence which suggested that in many cases what is happening when a loan is rolled over is not clear to customers. This uncertainty creates the risk of further reducing the incentive for customers to shop around for competitive rates at the point of rollover.

3.17 If customers who are finding it difficult to meet the scheduled repayment date or have other reasons to wish to postpone repayment find it easier to accept new loans or roll over existing loans with the same lender than go elsewhere, and are likely to do so, this entrenches borrowing from the current lender. This mitigates against the consumer getting a better deal by shopping around for a lower rate which would reduce the cost of servicing his/her debt.

Market concentration and barriers to entry

3.18 The payday lending market shows relatively high concentration which may be likely to reduce intra-market rivalry between payday lending firms. A survey conducted as part of the Compliance Review suggested that the three largest companies have a combined market share by value of loans of 57 per cent. On the other hand, over the last three years there has been a very significant increase in the volume of payday loans and their value and we have been told by payday lenders that the market is characterised by significant new entry.

3.19 Payday lenders regard themselves as operating in a very competitive environment. There are a significant number of payday lending firms operating in the UK. The OFT's survey identified 190 firms that issued payday loans in 2011/12. Of those, only 136 were operating in the previous year and 96 were operating in 2009/10. Regulatory barriers – the requirement to be licensed under the Consumer Credit Act 1974 (CCA) – are perceived to be low. However full compliance with the conduct requirements which are set out in the law and guidance may be seen as more onerous than current industry standards. The proposed transfer of consumer credit regulation to the Financial

Conduct Authority (FCA) from April 2014 and the subsequent introduction of a new authorizations regime in April 2016 is likely to increase regulatory costs and make entry to the payday lending market more difficult.

3.20 Websites and major advertising campaigns appear to be important in attracting new customers and this could make it harder for a new entrant to win customers. In addition, the larger lenders' investment in brand awareness is significant and it would take an entrant time to replicate this. Any entrant would also have a higher bad debt risk than an existing market player with an established customer base.

3.21 In the OFT's view the existence of a very large number of firms engaged in payday lending cannot be assumed to constrain the behaviour in the market of the biggest lenders. Some of the firms making payday loans will have very small market shares. We estimate that three firms account for 57 per cent of the market by value of loans, with upwards of 187 firms accounting for the remaining 43 per cent or on average 0.2 per cent of the market each. Furthermore while there is significant evidence of new entry, we do not assume that entry barriers will continue to be low, as sunk costs by incumbents in advertising and new regulation may act as a barrier to entry in the future. In the OFT's view further research would be needed before coming to any definitive view on the impact concentration and barriers to entry in this market are having on consumers.

Conclusion on features

3.22 For these reasons, it is the OFT’s view that the section 131 test for making an MIR to the CC is met and, therefore, the decision on whether or not to make an MIR rests on the exercise of the OFT’s discretion. As explained in paragraph 2.2 above, the OFT considers four criteria in making this assessment. These are discussed in turn below.

4 APPROPRIATENESS OF A REFERENCE

4.1 The OFT has found no evidence of any agreements or conduct that could be addressed by CA98 action (under either the Chapter I or Chapter II prohibition) or action in respect of Articles 101 or 102 of the Treaty of the Functioning of the European Union (TFEU).[9]

4.2 The OFT consider that other powers available to it or other sectoral regulators would not adequately address the competition issues identified. Other possible OFT action includes an OFT market study, enforcement action under consumer protection legislation, business education and consumer education.

4.3 Market studies enable the OFT to examine the causes of why particular markets are not working well for consumers, leading to proposals as to how they might be made to work better. A market study is not appropriate in this case given the evidence of restrictions and distortions of competition in this market which has already come to light as a result of the OFT's Compliance Review.

4.4 The OFT is progressing enforcement and compliance action in the sector as a priority. However, enforcement action must proceed on a firm by firm basis and can be time-consuming. Furthermore, the OFT considers that the problems in this market are more deep-rooted than can be adequately addressed through a programme of enforcement action against individual firms.

4.5 The Government has determined that from April 2014 the FCA should take on responsibility for the regulation of consumer credit, including payday lending. The FCA will have significant powers and resources which go beyond those available to the OFT under the CCA, including explicit powers to cap interest rates and to impose a ban or a limit on the number of rollovers payday lenders may offer. However the FCA has no formal remit in this sector at present. The OFT provisionally considers that an authoritative and

[9] Formerly Articles 81 and 82 of the EC Treaty, the Treaty establishing the European Community.

expert analysis of the way competition works in this market works is needed now, and believes the CC is well placed to do this. Should an MIR be made and the CC find one or more adverse effects on competition, it will be open to the CC to work closely with the FCA to identify lasting solutions for this market..

Undertakings in lieu of a reference

4.6 The OFT has power under section 154 of the Act to accept undertakings instead of making a reference to the CC. Given the features which are suspected of having an adverse effect on competition, the industry-wide nature of these features, and the number of parties involved, the OFT is not currently able to judge with any certainty whether particular undertakings would effectively address all the problems that may exist and achieve as comprehensive a solution as is reasonable and practicable. The OFT will, however, consider any proposals for undertakings made in the course of this consultation.

Proportionality

4.7 OFT guidance identifies three factors as relevant to whether an adverse effect on competition is significant, and thus whether a reference to the CC is appropriate: the size of the market, the extent of the problems within the market and the likely duration of these problems. In the OFT's view, all three criteria are met in the market for payday lending. First, the size of the market is significant, estimated at approximately £2-2.2bn in 2011/12 in outstanding balances. Second, a significant proportion of the market is affected by the features that prevent, restrict or distort competition, which appear to be prevalent throughout the UK, as is evidenced by the Compliance Review and the Bristol research. Third, the features identified as adversely affecting competition are unlikely to be short-lived given that the payday lending market has grown in recent years, some of the lenders appear to be making sustained profits and there is adequate evidence of market entry.

4.8 The OFT has considered the possibility that the concerns considered in this consultation might be mitigated as a consequence of changes in the market which might be brought about as a result of the Compliance Review or further changes to industry codes of practice or the transfer of regulation of consumer credit to the FCA, thus making the kind of remedies which might follow a CC investigation unnecessary. The OFT takes the view, however, that notwithstanding such changes there will remain sufficient and significant features in the market which merit investigation and, if it subsequently finds one or more adverse effects on competition, remedy by the CC.

Availability of remedies

4.9 If the CC decides that there is one or more adverse effects on competition it must take action to 'remedy, mitigate or prevent' the adverse effect on competition and to 'remedy, mitigate or prevent any detrimental effects on customers' so far as those effects have resulted from the adverse effect (section 138 of the Act). In order to achieve that, the CC may accept undertakings from appropriate persons or may make an Order under section 161 of the Act. Such an Order may contain anything permitted under Schedule 8 of the Act, as well as supplemental provisions. Schedule 8 provides the CC with wide-ranging powers falling within the following general areas: general restrictions on conduct, general obligations to be performed, acquisitions and divisions, and the supply and publication of information.

4.10 The OFT believes that there is a reasonable chance that the CC would be able to identify appropriate remedies to the spread of concerns raised, should it find one or more adverse effects on competition. These could include for example direct action on loan pricing (for example interest rate caps), on rollovers, or on the use of CPA. As noted above, it would be open to the CC to work closely with the FCA to identify lasting solutions to the problems in this market.

5 CONCLUSION

5.1 Having considered the above criteria, the OFT has provisionally decided to make a MIR to the CC of the market for the supply of Payday Loans in the United Kingdom.

5.2 This consultation document is published in order that interested parties can respond to the provisional decision. Comments should be sent by 1 May 2013 to

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Office of Fair Trading
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ANNEXES

A A POSSIBLE MARKET DEFINITION

Product market

Demand side substitution

A.1 Some payday loan customers also use a number of other credit products to provide small sum credit. For these products to be in the same market as payday lending there must be a possibility of demand side substitution by borrowers between other forms of unsecured small sum credit influencing the conduct of existing payday loan suppliers.

A.2 The OFT sets out a list of distinctive product characteristics which we consider consumers look for in payday loans:

- trust in and familiarity with the providers, products and procedures
- simple, straightforward and speedy access
- small amounts borrowed for short terms
- lack of requirement for security.

A.3 A range of other small sum credit products are available. These include:

- agency mail order
- pawnbroking
- sale and buy-back shops
- retail credit
- home credit
- credit cards (including sub-prime cards)
- store cards
- personal loans (including log book loans)
- overdrafts.

A.4 Data presented to the OFT in responses from payday lenders indicate that at any one time some consumers of payday loans may use one or more of these other products. It has been put to us that the data indicates that all 'small sum credit products' are to varying degrees substitutes and hence may be regarded as competing in the same consumer market. However, a key issue will be the extent to which these alternative sources of credit are open to payday borrowers at the point in time at which they take on a payday loan.

A.5 While it is an issue for further empirical research on customer behaviour, we observe that while superficially alternative sources of unsecured small-sum credit may be available to customers (for example home credit), payday lending is distinguished by the speed with which decisions on loans are made.

A.6 Many consumers of payday loans will not have access to the full range of alternative credit products listed in paragraph A3. Some will have exhausted their entitlement and have borrowed as much on, say, overdrafts and credit/store cards as their credit rating will support.

A.7 The OFT understands, based on evidence from comments made in meetings with lenders, that consumers of payday loans tend to regard these other credit products as complementary to payday loans and use a variety of them to maximise their access to credit rather than as substitutable for payday loans.

A.8 Overall the OFT doubts that there is sufficient functional similarity between payday loans and the other small-sum credit products available to many payday loan customers such that payday lenders will be constrained in terms of price (the cost of credit) by substitution to other small-sum credit products. More comprehensive evidence from consumer surveys, particularly in relation to the degree of substitution between payday lending and other forms of credit, would be needed to reach a firmer conclusion.

Supply side substitution

A.9 The question here is whether suppliers of the other products can switch to supplying payday loans. The timeframe for this is the short run (for example, within one year).

A.10 The OFT is aware that some firms have diversified from pawnbroking into providing payday loans from fixed premises. However, significant entry by firms with a business model in which consumers interface through a website has also characterised recent growth in this industry. The most significant barrier these firms face is establishing brand recognition and generating internet site 'hits' by potential customers.

A.11 The scope for supply side substitution suggests that some firms currently not engaged in payday lending ought to be included as potential payday loan suppliers but a definitive conclusion would require significant consumer research.

Geographic market

A.12 The OFT has not drawn any firm conclusions as to the relevant geographic market for payday lending. Payday lending is essentially nationally based for companies using the internet model but more locally based for companies operating out of high street offices and serving walk-in customers. Some business is reported to come from word of mouth recommendations in the case of high street based payday lenders. A few large lenders operate nationally or over several regions. Some payday lenders have back office functions based outside of the UK.

A.13 The OFT found no evidence of significant price differentiation either by region or in relation to the degree of competition locally. This might suggest that the relevant geographic market is the UK. It would also be relevant whether for example the speed of access to loans varied geographically. The OFT's analysis of the features of the market suggest that they are prevalent throughout the UK, whether the relevant geographic market is defined narrowly (local markets) or widely (the whole of the UK).

B DRAFT TERMS OF REFERENCE

B.1 The OFT, in exercise of its powers under sections 131 and 133 of the Enterprise Act 2002 (the Act), hereby makes a reference to the Competition Commission for an investigation into the supply of payday lending in the United Kingdom.

B.2 The OFT has reasonable grounds for suspecting that a feature or a combination of features of the market or markets for the supply of payday loans in the UK prevents, restricts or distorts competition in this market.

B.3 For the purposes of this reference: payday lending consists of the provision of small sum unsecured cash loans on a short term basis, typically repayable on the consumer's next payday or at the end of the month, but specifically excluding home credit (where repayments are collected from the consumer's home).