

Payday Lending

Final decision on making a market investigation
reference

June 2013

OFT1492

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CONTENTS

<u>Chapter/Annexe</u>	<u>Page</u>
1 Introduction	4
2 The reference test	10
3 Features of the market which the OFT has reasonable grounds for suspecting prevent, restrict or distort competition	12
4 Appropriateness of a reference	45
5 Conclusion	61
Annexe A: Terms of Reference	63
Annexe B: A possible market definition	64

1 INTRODUCTION

- 1.1 Following a consultation (the Consultation) on a provisional decision to refer the market which was published on 6 March 2013 (the Consultation document),¹ the OFT has decided to make a market investigation reference (MIR) to the Competition Commission (CC) of the market for payday lending in the United Kingdom. This report sets out the OFT's reasons for this decision.
- 1.2 Payday lending for these purposes consists of the provision of small-sum cash loans marketed on a short-term basis, not secured against collateral, including (but not limited to) loans repayable on the consumer's next payday or at the end of the month and specifically excluding home credit loan agreements,² credit cards,³ credit unions and overdrafts.⁴ Some payday lenders 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. However, for the purposes of this reference these are outside the scope of the Terms of Reference (found at Annexe A).
- 1.3 The provisional decision followed the OFT's review of compliance by the UK payday lending sector with the Consumer Credit Act 1974 (CCA) and other relevant legislation and OFT guidance including the Irresponsible Lending Guidance (the Compliance Review).⁵ The Compliance Review included the inspections of 50 firms (accounting for 90 per cent of the market), questionnaires, complaint data and a web sweep.⁶ The Compliance Review also included a detailed data request to 21 firms and a short data request to all other known payday

¹ 'Payday Lending: Consultation on a market investigation reference', OFT, March 2013 (OFT1482).

² As defined in the CC's Home Credit Market Investigation Order 2007.

³ Credit-token agreements as defined in the Consumer Credit Act 1974.

⁴ Authorised overdrafts within section 74(1) (b) and overdrawn within section 74A of the Consumer Credit Act 1974.

⁵ 'Payday Lending Compliance Review Final Report', OFT, March 2013 (OFT1481).

⁶ The web sweep was also of 50 firms, but not all of these were among the 50 firms visited as part of the inspections.

lenders. The OFT also drew on evidence from research commissioned by the Department for Business, Innovation and Skills from the Personal Finance Research Centre at Bristol University into the high-cost credit market and the potential impact of a cap on the cost of credit (the Bristol Research).⁷

- 1.4 The OFT invited views and evidence in response to the Consultation document. The Consultation period ended on 1 May 2013. The OFT has carefully considered all the responses received and has as part of the Consultation process met with a number of stakeholders including payday lenders and trade bodies. In total, the OFT received formal responses from 22 organisations consisting of consumer groups and debt charities, payday lenders and their trade associations, think-tanks, an alternative credit provider, a government body and a professional body.
- 1.5 Of these responses, six did not support the proposed reference, 13 were supportive of a reference and a further three provided comments on issues discussed in the Consultation document but did not express an explicit view on whether the market should be referred to the CC. The OFT also received a number of letters from individual consumers all of which cited a range of poor experiences with payday loans.
- 1.6 In addition to the evidence base available at the time of the provisional decision and the responses to the Consultation on that decision, the OFT has considered evidence that has been published and become publicly available since the consultation closed on 1 May - independent surveys published by Citizens Advice (the Citizens Advice survey),⁸ YouGov SixthSense (the YouGov SixthSense survey)⁹ and the

⁷ 'The impact on business and consumers of a cap on the total cost of credit, Personal Finance Research Centre', University of Bristol, March 2013.

⁸ The Citizens Advice survey was initiated on 26 November 2012, the date by which four major payday lending trade associations (the Consumer Finance Association (CFA), the Consumer Credit Trade Association, the BCCA and the Finance & Leasing Association) had implemented the Good Practice Customer Charter (the Payday Lending Charter). At the time of the most recent results publication, the survey had seen 2,000 responses although some responses may relate to borrower experiences predating the Payday Lending Charter. See Press Release 'Citizens Advice exposes payday lenders' failings as OFT closes in on unscrupulous lenders', Citizens Advice, 28 May 2013, available at www.citizensadvice.org.uk/index/pressoffice/press_index/press_20130528.htm and 'Holding payday lenders to account: early results from the Citizens Advice payday loan survey', Citizens Advice, May 2013, available at www.citizensadvice.org.uk/eb-payday-loan-briefing-may2013.pdf.

⁹ YouGov SixthSense commissioned two surveys in early March 2013; the first on a nationally representative sample of 1,397 UK adults, and the second a booster survey of 757 people who had taken out a loan.

Consumer Finance Association (the CFA survey),¹⁰ as well as those responses so far received to letters issued in follow-up to the Compliance Review. Citizens Advice also provided the OFT with anonymised raw data from its own survey.

- 1.7 The OFT has considered the views and evidence submitted during the Consultation. While this has not changed the OFT's view that the statutory test for an MIR and the OFT's discretion criteria are met, it has refined its views set out in the Provisional Decision document about the market features and the application of the OFT's criteria.
- 1.8 The OFT has concluded that it has reasonable grounds for suspecting that features of the payday lending sector prevent, restrict or distort competition and that an MIR to the CC is an appropriate and proportionate response. A thorough investigation of whether there is indeed an adverse effect on competition in the market and whether this has a detrimental effect on customers will complement the OFT's ongoing enforcement work in the sector and will provide a solid evidential and analytical foundation to support the introduction of FCA regulation in this sector.
- 1.9 Chapter 2 sets out the nature of the test that must be satisfied in order for the OFT to have the power to make an MIR of this market to the CC.
- 1.10 Chapter 3 sets out the features of this market that the OFT has reasonable grounds for suspecting may be preventing, restricting or distorting competition.
- 1.11 Chapter 4 sets out the OFT's reasoning for exercising its discretion to make an MIR.

Collectively, both surveys identified 451 users of 'non-standard lending products' in the past two years, 95 of whom had taken out a payday loan. See 'Non-Standard Lending 2013', YouGov/Sixthsense, 2013, available at <http://sixthsense.yougov.com/finance-reports/non-standard-lending/non-standard-lending.aspx>.

¹⁰ Results from the CFA's survey were published in its 'Credit Crunched' report. The survey, conducted by Harris Interactive, sampled 1,105 customers of six Payday lenders who are members of the CFA. It was conducted in September and October 2012, before the implementation of the Payday Lending Charter. See 'Credit Crunched', Consumer Finance Association, 2013, available at www.cfa-uk.co.uk/Credit%20Crunch_full%20report.pdf

1.12 The Annexes set out the Terms of Reference and a possible market definition to frame the MIR.

1.13 The remainder of this section summarises the concerns OFT has based on the evidence available and its reasons for making this reference.

Summary

1.14 The OFT's analysis of the UK payday market has identified a number of features which the OFT suspects are preventing, restricting or distorting competition in the market:

- The Compliance Review found varying levels of non-compliance with relevant law and guidance by payday lenders. The OFT suspects that those firms which invest more time and effort in complying may be placed at a competitive disadvantage to those which invest less.
- The OFT has identified practices which make it difficult for consumers to identify or compare the full cost of payday loans effectively at the point when loans are taken out. The OFT suspects that these practices undermine price competition by rendering consumers as a whole less effective at constraining prices.
- A significant proportion of payday borrowers have poor credit histories, limited access to other forms of credit and/or pressing needs. This may make them less price sensitive which, the OFT suspects, weakens price competition between payday lenders.
- There are barriers to switching between payday lenders or to alternative products or options at the point of rollover.¹¹ The OFT

¹¹ Once a payday loan has been made, the borrower will have to repay the full amount borrowed, together with the interest and charges for the credit, at the end of the loan period (typically 30 days or less.) Where a lender agrees to effectively extend the duration of the loan period (whether by the exercise of a term in the original agreement or by refinancing), this is commonly (and hereafter in this document) referred to as 'rolling over' the loan, or a 'rollover'.

suspects that these barriers benefit incumbent lenders and prevent, restrict or distort competition from possible alternative lenders at the point of rollover.

- The OFT suspects that high concentration and barriers to entry and expansion exacerbate the prevention, restriction or distortion of competition arising from the features identified above.

1.15 The OFT is concerned that, as a result of these features and the adverse effect on competition to which they give rise, a significant proportion of borrowers are exposed to the risk of serious detriment in taking out loans which they cannot afford to repay on time. Borrowers may not realise the financial implications of not paying back the amount due in full or on time (defaulting), and the inherent difficulty in paying back the entire credit, plus interest and charges, in a single payment after a relatively short period.

1.16 Moreover borrowers do not appear to understand how rollovers operate, or what effect they may have. The speed with which rollovers are granted, and the lack of a proper explanation about their costs, may deter consumers from shopping around or realising that they have a choice, and so may inhibit competition at this stage. The taking out of loans which they cannot afford to repay on time has the potential for significant ongoing harm to borrowers (in terms of both economic detriment and psychological distress), many of whom may be vulnerable.

1.17 The OFT has concluded that an MIR is an appropriate and proportionate response to these concerns. While the OFT is proceeding to take enforcement action against the most serious behaviour in the market, it does not consider that the drivers of such behaviour can be addressed through enforcement alone. None of the payday lenders surveyed in the review were fully compliant with the relevant laws and guidance. The widespread nature of this non-compliance suggests that it has its roots in the market dynamics in the industry, rather than in the behaviour of isolated companies. There are a number of elements to this:

- Competition appears to be primarily about availability and speed of loan approval, rather than price. Potential borrowers often need money quickly, may be unable to access alternative sources of credit, and may be reluctant to spend time shopping around. This competitive pressure to approve loans quickly may give firms an incentive to skimp on the affordability assessment required by regulation – particularly if they know that they can recover the debt through use of continuous payment authority (CPA),¹² or can impose charges associated with defaulting (default charges) if the consumer is unable to repay on time.
- The OFT is concerned that the business model – at least in some parts of the industry – appears to be predicated on making unaffordable loans which borrowers struggle to repay on time and which can lead them to pay far more than they expected through rollovers, additional interest and other charges through which many lenders appear to derive up to 50 per cent of their revenue.
- Rollovers appear to be key to the business model for many lenders. Firms that depend on borrowers not paying off loans first time are likely to have less incentive to be rigorous in assessing affordability. The evidence suggests that there are few (if any) affordability checks at the rollover stage.

1.18 A range of other remedies have been put forward by various parties, for example interest rate caps or bans on rollovers. Such measures cannot be implemented using the OFT's powers under the CCA and other legislation. In April 2014, the Financial Conduct Authority (FCA) will take on responsibility for credit regulation and will be in a position to consider and implement fundamental changes to the regulatory regime. A thorough investigation by the CC now will provide a sound evidential and analytical platform for FCA to build an effective system of regulation which underpins rigorous competition and which protects the interests of consumers in this market.

¹² CPA allows a business such as a payday lender to withdraw sums from an individual's bank account through a payment card without having to seek repeat authorisation for each withdrawal.

2 THE REFERENCE TEST

2.1 Under section 131 of the Enterprise Act 2002 (the Act), the OFT may make an MIR 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,¹³ 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. The OFT has reasonable grounds for suspecting that the features of the market set out below prevent,

¹³ 'Market Investigation References', OFT, March 2006 (OFT511).

restrict or distort competition. This document also sets out how the the criteria set out in the OFT's guidance have been met.

2.4 The Terms of Reference for the MIR are set out at Annexe A.

3 FEATURES OF THE MARKET WHICH THE OFT HAS REASONABLE GROUNDS FOR SUSPECTING PREVENT, RESTRICT OR DISTORT COMPETITION

3.1 The OFT 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 section 131 test is met. These features are:

- A. Competition to approve loans quickly leads to widespread but variable non-compliance with regulatory requirements.
- B. Practices which make it difficult to identify or compare the full cost of payday loans, particularly when repayments are late or missed.
- C. A significant proportion of payday borrowers have poor credit histories, limited access to other forms of credit and pressing needs and therefore may be less price-sensitive.
- D. Barriers to switching at the point of rollover.
- E. Market concentration and barriers to entry and expansion.

3.2 The subsections below set out the evidence the OFT has received and the conclusions it has drawn on each of the five features.

A. Competition to approve loans quickly leads to widespread but variable non-compliance with regulatory requirements

Summary

3.3 Payday lenders compete for customers primarily on the basis of availability of loans and speed and ease of loan approval, rather than price. Speed of loan approval is important to many customers and is thus an important parameter on which firms compete. In addition the

revenue streams of payday lenders rely heavily on rolling over or refinancing. These features of the market create incentives for non-compliance with relevant law and guidance by payday lenders.

- 3.4 There is widespread non-compliance with the law and guidance relating to affordability assessments. The majority of lenders are not conducting adequate affordability assessments. Levels of non-compliance do, however, vary with some lenders conducting more adequate assessments than others.
- 3.5 There are other factors which may make it commercially viable for firms not to assess affordability thoroughly. These include the recoument of costs through rollovers even when a significant proportion of their borrowers struggle to repay; the use of CPA (discussed below); and weak price competition (discussed under features B to E).
- 3.6 Assessing affordability adequately takes time and effort. Since payday lenders compete primarily on availability of loans and speed and ease of loan approval, the OFT suspects that those firms which invest more time and effort in conducting affordability assessments may be placed at a competitive disadvantage to those which invest less. There is therefore a risk that bad practices drive out good practices.

Widespread and variable levels of non-compliance

- 3.7 The OFT considers that the basis on which payday lenders compete, together with the importance of rollovers to their revenue streams, create incentives for non-compliance with relevant law and guidance. Further the Compliance Review evidence suggests that irresponsible lending was not confined to a few traders, but applied across the sector.
- 3.8 The areas and extent of non-compliance with the CCA and other relevant regulations varied across the market, as did the likely impact on consumers, and the OFT had differing concerns about all 50 firms inspected – in particular, around advertising, pre-contractual

explanations, affordability assessments, rollovers and CPA, and also debt collection and forbearance.¹⁴

3.9 In particular, there was evidence that the majority of lenders were not conducting adequate affordability assessments. There was also evidence that 26 per cent did not conduct any affordability assessment for new customers and 33 per cent did not do so in respect of new loans.¹⁵

3.10 The Compliance Review found that payday lenders competed for customers on the basis of availability and speed/ease of loan approval, rather than price. A common theme across websites reviewed as part of the Compliance Review was that they emphasised the easy availability of loans and speed of arrangement rather than give equal weighting to potential costs or risks.¹⁶ Statements included 'borrow up to £750 instantly', 'instant cash', 'simple, fast, easy' and 'funds can be transferred to your bank account within as little as 15 minutes'.

3.11 The Compliance Review found evidence that the revenue streams of payday lenders relied heavily on rolling over or refinancing loans. 28 per cent of loans were rolled over at least once, providing 50 per cent of payday revenues, and 19 per cent of revenues came from the five per cent of loans that were rolled over four or more times. In addition, around a third of loans were repaid late or not repaid at all.

3.12 While the OFT understands that the use of statistics relating solely to firms' revenues is only of limited value in assessing competition concerns,¹⁷ no responses were received which questioned the evidence that revenue derived from payday loans not repaid on time is a significant competitive driver of the payday lending market as a whole.

¹⁴ Compliance Review, page 2, Annex D and Annex H.

¹⁵ See Compliance Review, pp12-14 (and Annex D paragraphs 18-22 and 77-119).

¹⁶ As noted in the Compliance Review, 30 of the 50 websites inspected emphasised the speed and simplicity of loan applications

¹⁷ Market Investigation References, OFT, March 2006 (OFT511), paragraph 4.6.

- 3.13 The Compliance Review found that 44 of the 50 lenders inspected allowed rollovers. Of these, 17 actively promoted rollovers in marketing material or at the point of sale as a 'feature' of the loan, and 15 lenders proactively alerted borrowers to the rollover option prior to the loan due date. Some lenders specifically encouraged borrowers to roll the loan over rather than repay, and a number would agree to roll over even after the borrower had already missed a repayment. In the case of one lender, OFT inspection officers noted that 'rollovers' appeared to be treated as an integral profit driver in its business model, and that there was a common understanding by staff that rollovers were a key fee generation opportunity.
- 3.14 In response to a specific request for information following concerns that arose during the Compliance Review inspections, one lender provided evidence to the OFT that confirmed that its profitability from rollover loans was much higher than for loans which are repaid on time.
- 3.15 Only 14 of the 44 lenders which allowed rollovers said they conducted an affordability assessment on all rollovers, and only 23 per cent of all lenders responding to the OFT questionnaire said that they assess affordability each time a loan is rolled over. Inspecting officers saw examples of loans that had been rolled over repeatedly, sometimes more than 12 times. There was also evidence from the Compliance Review that lenders were using rollovers as a substitute for forbearance towards borrowers in financial difficulty and also as a substitute for proper affordability checking.
- 3.16 The OFT also has particular concerns around the use of CPA, whereby borrowers essentially give payday lenders access to their current account. The Compliance Review found evidence of misuse of CPA, for example by taking payments without borrowers' informed consent, by making repeated and excessive attempts at payment even when it was clear that the borrower was in financial difficulty, and by misleading borrowers over their right to cancel a CPA.
- 3.17 By using CPA the payday lender can ensure that it is paid back ahead of other creditors (and in preference to borrowers meeting direct debits and essential living expenses). As such, it may shield such lenders from the consequences of poor lending decisions, thus reducing the

incentives for payday lenders to avoid lending irresponsibly in the first place or to use CPA and rollovers responsibly.

3.18 The use of CPA may result in lenders not carrying out thorough affordability checks, because having the card details effectively allows the lender instant access to any and all money paid into the account, which increases their chances of being repaid possibly ahead of other creditors.

3.19 Complaints from consumers received by the OFT included that borrowers not being aware that they had signed up to a CPA, or how it would work, and that lenders took frequent part payments over a lengthy period, often leaving the borrower facing significant hardship.¹⁸

3.20 Evidence on developments in the payday loan market since the results of the Compliance Review were published is provided both by the continuing pattern of complaints to the OFT as well as a survey conducted by Citizens Advice covering the period from 26 November 2012 onwards. Significantly only 36 per cent of the 2,000 survey respondents reported that they were asked questions to establish whether they could afford to pay back the loan.¹⁹

3.21 Citizens Advice has also noted that, despite industry initiatives and the OFT's revised guidance, misuse of CPAs continues to be commonplace.²⁰ It concluded that many lenders appeared to be continuing to use CPAs to ensure their loans are repaid, regardless of the financial position of the borrower and the impact the use of CPA may have on their personal and financial circumstances.

3.22 The Citizens Advice survey data, to which the OFT was given anonymised access, also showed a pattern of varying levels of non-

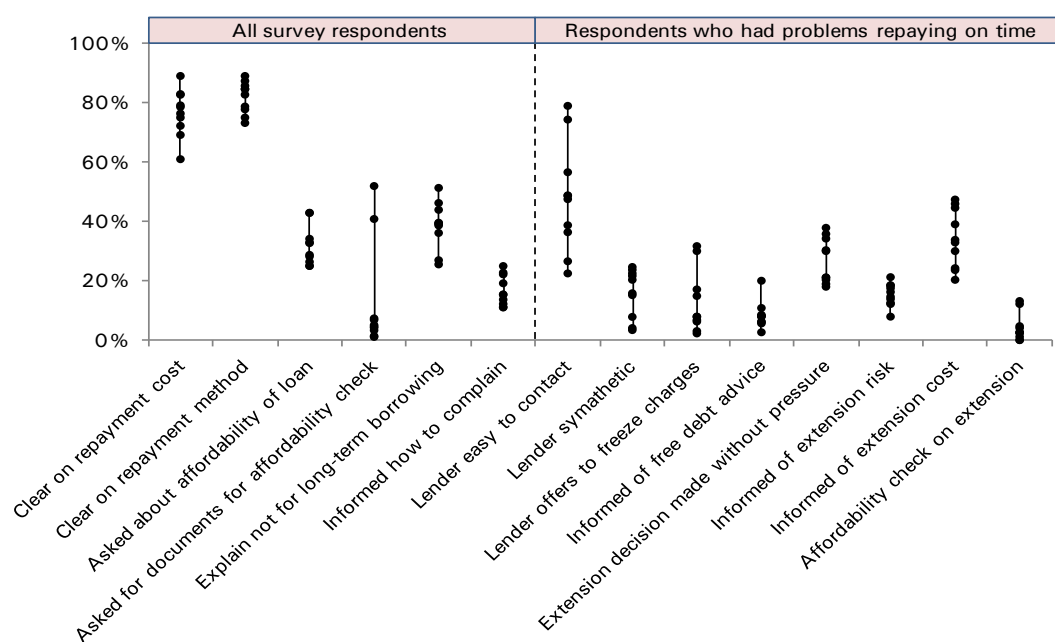
¹⁸ Compliance Review, paragraphs H.26-H.30. These were based on the 686 complaints received by the OFT during a six-month period from February to August 2012.

¹⁹ Press Release 'Citizens Advice exposes payday lenders' failings as OFT closes in on unscrupulous lenders', Citizens Advice, 28 May 2013, p2.

²⁰ See 'Holding payday lenders to account: early results from the Citizens Advice payday loan survey', Citizens Advice, May 2013, p4.

compliance among payday lenders. The diagram below shows the average positive response rate of respondents to each of the questions posed in the survey, grouped by lender.²¹ The responses suggest widely varying degrees of non-compliance between individual lenders: the average difference between the highest and lowest scoring lenders for each question is 25 percentage points. For example, 32 per cent of one lender's borrowers who had trouble paying their loan back on time reported having been offered a freeze on interest and charges (the highest score), whilst the lender with the lowest score for this question had only offered to freeze interest or charges to such customers in two per cent of cases.²²

Figure 1: Responses to Citizens Advice survey questions: average values by lender with 40 or more survey responses (higher percentage means more compliant)



Source: Citizens Advice survey data

²¹ Each column corresponds to a question asked in the survey, while each marker in a given column represents a different lender. Marker positions are calculated as the average positive response to the specified question by borrowers who reported borrowing from that particular lender. For each question, the same group of lenders (those with over 40 responses) is covered.

²² This represents a 30 percentage point difference.

3.23 All of the above leads the OFT to conclude that irresponsible lending is not a problem confined to a few lenders, but appears to have its roots in the way competition works in this market – in particular, through lenders’ reliance on speed of approval, excessive use of CPA, and reliance on revenue from rollovers – and as such goes deeper than a poor compliance culture. The evidence also shows that, although non-compliance by lenders with the relevant laws and guidance is widespread, levels of non-compliance vary substantially between lenders.

Effect on competition

3.24 Evidence from the Compliance Review suggested that firms that invest time and effort in proper affordability checks may lose out to those that do not. There are a number of ways in which this could occur. One way would be, that if a business is more likely to decline applications, this would result in a smaller customer base, with fewer borrowers going on to roll over or default (because they are more likely to be able to afford to repay on time). This in turn will reduce revenue from rollovers and default charges, on which – as noted above – many lenders appear to rely on heavily.

3.25 More rigorous affordability checks are also likely to delay a decision on an application, and hence the availability of funds. As noted above, firms compete primarily on speed and easy access to credit, and many individuals may be in urgent need of a loan, so may go elsewhere if they feel the process may take too long. This may deter lenders from contacting employers or asking for and validating documentary evidence.

3.26 Inspections undertaken as part of the Compliance Review suggested that lenders are deterred from making adequate affordability checks by the risk of losing business if they delay. A number of lenders inspected emphasised the need to approve applications quickly, to avoid potential borrowers going elsewhere. This was seen as being particularly problematic where applications were made on a Friday evening, or over the weekend, as it would not be possible to undertake manual verification checks, such as contacting the employer to verify employment, until the Monday.

3.27 Furthermore, in the context of the follow-up letters sent to the 50 lenders inspected during the Compliance Review, the OFT received some complaints suggesting that if some lenders were required to address their compliance issues earlier than others (as the letters were sent out in a rolling programme over a two month period) then those lenders would be placed at a competitive disadvantage in becoming fully compliant before their competitors.

3.28 The OFT considers that there are significant but varying levels of non-compliance in the UK payday loan market with relevant law and guidance which are designed to protect borrowers. As set out in paragraphs 4.25 to 4.26, industry initiatives have not, so far, improved compliance.

3.29 The endemic nature of this feature suggests that many lenders view full compliance as a competitive disadvantage which increases their costs and risks losing business to those who are less compliant. Consequently, competition in the market is restricted, prevented or distorted. This leads to a situation in which consumers are exposed to the risk of serious detriment in taking out loans which they cannot afford to repay on time and exposes them to the risk that they need to rollover with consequent default charges.

Points raised during the consultation

3.30 In response to the Consultation, some payday lenders contended that they, individually, were fully compliant with current regulations but that steps should be taken by the OFT as regulator to enforce better compliance by others. Some payday lenders also pointed to the Business Survey in the Bristol Research in which online lenders said they routinely declined about nine in 10 loan applications.²³

3.31 However as set out above the Compliance Review found evidence of widespread non-compliance with the CCA and other legislation, and with OFT guidance. The problem of irresponsible lending was not confined to a few traders, but applied across the sector.

²³ Bristol Research, p44.

- 3.32 During the Consultation, a number of payday lenders and trade associations also questioned how a Compliance Review could in itself provide evidence of competition concerns as its main focus was on whether individual firms were carrying out the necessary processes to demonstrate compliance. These stakeholders also submitted that the OFT had failed to present adequate evidence to support how non-compliance with regulations and guidance impacted competition. One lender in particular claimed that it had a very good record of compliance and yet had been able to grow market share.
- 3.33 The OFT has set out the effect on competition in paragraphs 3.24 to 3.29 above.
- 3.34 Several payday lenders claimed that the OFT had failed to take into account recent evidence and developments in the market, such as the Payday Lending Charter and the OFT's revised Debt Collection Guidance (both of which were implemented in November 2012). The evidence that the OFT has seen to date both from complaints received by consumers during 2013 and the results of the Citizens Advice survey both suggest that the Payday Lending Charter and the OFT's revised Debt Collection Guidance have had very limited impact on the extent of non-compliance in this market.
- 3.35 In response to the Consultation, two lenders stated that in their view many other payday lenders did little in regard to affordability assessments and this put their own businesses at a disadvantage. Another lender said: 'it is quite normal for firms to be able to gain a competitive advantage from non compliance if they can get away with it'. As set out above the OFT suspects that those firms which invest more time and effort in conducting affordability assessments may be placed at a competitive disadvantage to those which invest less. There is therefore a risk that the bad practices appear to drive out good practices.
- 3.36 Some payday lenders queried the OFT's original emphasis on price in the Consultation document. These lenders submitted that factors such as convenience and speed of approval, aside from being compatible with regulatory compliance, represented important aspects of their offering and thus valid bases on which to compete for customers.

3.37 In the OFT's view, while competition among payday lenders to deliver better service levels is to be welcomed, 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 accurately establishing affordability and limiting use of CPA, may lose business to those lenders prepared to make unaffordable loans on the basis that they can recover debts through CPA and increase their revenue through rollovers and default charges.

3.38 Furthermore, the incentives for businesses to earn a high proportion of their revenues from rollovers appear to restrict competition to provide loans that best meet consumers' needs, and may encourage poor business practices that impact detrimentally on borrowers.

B. Practices which make it difficult to identify or compare the full cost of payday loans, particularly when repayments are late or missed

Summary

3.39 The OFT has identified practices which make it difficult for consumers to compare the full cost of loans effectively at the point when loans are taken out. The full cost includes costs that arise when repayments are late or missed. Price transparency is often lacking, at least until an individual has applied for the loan, and there is insufficient emphasis at the advertising and pre-contract phase on rollover costs and other risks associated with the credit.

3.40 The OFT suspects that these practices, which make it difficult for consumers effectively to compare the full cost of loans, undermine price competition by rendering consumers as a whole less effective at constraining prices.

Practices which make it difficult to compare

3.41 The OFT suspects that there are a range of business practices in this market which obstruct shopping around by potential borrowers for best value. In particular, the OFT remains concerned that:

- The full costs of a loan may not be revealed until the borrower is some way through the approval process thus hindering comparison and distorting decision making.
- Variation in the manner that costs are stated by different lenders make comparisons between lenders difficult.
- Costs that are incurred when a loan is not paid on schedule may not be clear and comparable to borrowers when taking out the loan. This could particularly affect borrowers who may be prone to overestimating their ability to repay the loan on time.

3.42 Evidence gathered during the Compliance Review suggests that it can be difficult for potential borrowers to get a clear idea of the costs of payday loans for comparison purposes in advance of making an application, particularly when this is made over the phone or online.²⁴ Mystery shopping conducted on the OFT's behalf by Ipsos MORI 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 and the use of CPA.²⁵ As the Ipsos MORI report stated:

'Many lenders were reluctant to answer shoppers' questions or to provide more than basic information without the borrower themselves first signing up (or providing personal details such as bank statements or agreeing to undertake a credit check)'.²⁶

3.43 An assessment of payday lenders' websites as part of the Compliance Review found that frequently the cost of credit was not apparent until late in the application process. For instance, 12 of the 50 sites

²⁴ OFT analysis of data gathered during the Compliance Review suggests that payday lenders that accept only online, phone or SMS applications represent at least three quarters of the market by turnover.

²⁵ See Compliance Review, Annexe G.

²⁶ Compliance Review Annexe J: Mystery Shopping, paragraph 1.8.

reviewed failed to show a representative example where triggered,²⁷ and in a further 12 cases where an example was included, this example was insufficiently prominent or difficult to find.²⁸ As a representative example is designed to illustrate the likely cost of a loan, its omission is likely to make shopping around more difficult for consumers.

3.44 The Compliance Review also found evidence of potentially misleading advertising and limited availability of pre-contractual information (PCI) prior to the point of application. For instance, 43 of the 50 lenders inspected did not explain all the matters required by the CCA (such as the total amount payable and the consequences of failure to repay on time), and 15 lenders made it possible for individuals to enter into agreements online without having first been clearly presented with the required PCI and an adequate explanation of the key features and risks.²⁹ The Review also found that many websites failed to include detailed cost information, or that this was hidden away or difficult to find.

3.45 At present, payday loans may not be sufficiently standardised to allow price comparisons to be made easily. The Ipsos MORI mystery shopping report found that:

‘the different ways in which the interest rate or amount payable was quoted could make it more difficult for less numerate consumers to compare the loan options between lenders. Less than half of the 50 lenders who were willing to provide information gave the total cost of the loan’.³⁰

²⁷ If an advertisement includes a rate of interest or an amount relating to the cost of the credit, this triggers the requirement to display a representative example (including the representative APR).

²⁸ Compliance Review, Annexe E, paragraph E.8.

²⁹ Compliance Review, paragraphs D.15 and D.16.

³⁰ Compliance Review, Annexe J, paragraph 1.26.

3.46 The Bristol Research shows that just 46 per cent of retail payday borrowers and 49 per cent of online payday borrowers claimed to consider the APR when they took out their loan.³¹

3.47 The Bristol Research also shows, this may be particularly problematic amongst online lenders given that 'it was difficult to compare prices, as some charged per day, others for 28 or 30 day loan terms'.³² As a result of these differing calculation methods³³ and the way they are presented on lenders' websites, borrowers may find it difficult to compare loans from different providers, even where the APR is given, with a resultant detrimental effect on competition.

3.48 Such concerns over calculation methodologies were also reflected in a submission to the Consultation from a consumer group which stated that:

'Some lenders calculate the interest charge based on the number of days you borrow for, and allow potential customers to calculate the cost of a loan by using sliders on their website. Other lenders have a fixed charge for borrowing up to your next payday, so the actual daily cost will differ depending on when you take out the loan.'

3.49 Other consumer groups also cited numerous examples of where borrowers had found it difficult to work out the real cost of payday loans, for instance, one group stated that:

'some of the costs of the payday loans are unclear from the outset and customers who are in financial difficulty

³¹ Bristol Research, Table 5.3.

³² Bristol Research, p28.

³³ For example, two different lenders might both state in their advertising that it costs £30 to borrow £100 for 30 days. Some lenders, however, will calculate the amount of interest to be charged on a daily basis – meaning the consumer would pay the equivalent of £1 a day interest per £100 borrowed and so if they only borrowed £100 for 10 days would pay only £10 in interest. This makes the loan cheaper the shorter the duration of the loan. Other lenders, however, charge the interest as a fixed fee so that whether the money is borrowed for 10 days or 30 days, the amount of interest charged would still be £30 per £100 borrowed. This method of calculation makes the loan relatively more expensive the shorter the period the money is borrowed for.

often find themselves hit with additional charges, causing the debt to spiral.’³⁴

3.50 The OFT is also concerned that there is often a lack of clarity about the costs and risks associated with rollovers and that consumer awareness of the full cost of rolling over a payday loan may be impaired when the initial loan application is made. According to the Bristol Research, only 42 per cent of retail payday borrowers and 52 per cent of online payday borrowers said they knew of ‘other fees or charges, such as early resettlement or penalty charges’.³⁵ Given the relatively high rate of payday loans not repaid on time, the level of default charges represents important information for borrowers to consider from the outset. However, as the Bristol Research indicates, only around half of borrowers consider these forms of cost information.³⁶

3.51 The OFT notes that 79 per cent of respondents to the Citizens Advice survey felt they were ‘clear’ on the total repayment cost of their individual loan(s).³⁷ However, several submissions from consumer groups and debt charities in response to the Consultation provided anecdotal evidence showing that borrowers did not appreciate the full cost of their loans including in relation to rollovers and late repayment. In considering the behaviour of payday borrowers, one consumer group told the OFT that they tended to overestimate their ability to pay off loans:

‘We see on a daily basis the significant payday loan debts that clients have amassed simply because they were unaware of the impact of fees and high interest rates. Many of these clients were already in a vulnerable position and unlikely to take the time or effort involved

³⁴ Citizens Advice Submission page 3.

³⁵ Bristol Research, Table 5.3.

³⁶ Lack of information over the cost of rollover or refinancing was also observed in the Ipsos MORI report where in well over half (22 of 38) of assessments the lender did not provide information on the risks of this, even when prompted.

³⁷ See Press Release ‘Citizens Advice exposes payday lenders’ failings as OFT closes in on unscrupulous lenders’, Citizens Advice, 28 May 2013, p1

to even begin to understand the complexities and implications of what they were taking on.'

3.52 The consumer group Which? submitted that consumers were often over-optimistic about their ability to repay their debts, particularly when under financial pressure. Which? highlighted the results of its 2012 survey which found that while 29 per cent of payday borrowers had taken out credit they knew they couldn't repay, another 48 per cent took out credit in the past that it turned out they couldn't afford to repay.³⁸ Overconfidence amongst consumers may produce behavioural errors that can be exploited by firms in a manner which adversely affects competition.³⁹

Effect on competition

3.53 The lack of transparency that the OFT has identified makes it difficult for consumers to assess and compare the full cost of loans effectively at the point when loans are taken out. This may lead consumers to make decisions on any particular loan according to whether they have a pressing need rather than whether it represents good value in comparison with other loans.

3.54 Where it is difficult for consumers to compare prices between lenders, they are likely to be less effective as a whole at constraining prices. As the OFT notes in its guidance on market investigation references:

'Where customers are well informed, they can make efficient choices and their purchases will provide useful information to sellers about customers' preferences. Sellers then have the incentive to provide the goods and services that customers most value. Without such information, the incentives to compete on price, quality and other terms are likely to be diminished. In short,

³⁸ See 'Credit Britain: Making lending work for consumers', Which? Credit Britain, May 2013, available at www.staticwhich.co.uk/documents/pdf/which-report-credit-britain-making-lending-work-for-consumers-319871.pdf.

³⁹ See 'Applying behavioural economics at the Financial Conduct Authority', Occasional Paper No.1, Financial Conduct Authority, April 2013, pp 6-7 and 56-57.

adequate information available to customers is one of the pre-requisites for markets to work well.’⁴⁰

3.55 Moreover the OFT Market Study into the Advertising of Prices⁴¹ found that customers can be misled into making purchases they subsequently regret when the final price is not revealed until late in the transaction. It also found that such practises can have adverse effects on competition.

3.56 Consequently the OFT suspects that competition in the payday lending market is restricted, prevented or distorted by a lack of transparency as to the full cost of payday loans.

Points raised during the consultation

3.57 In response to the Consultation, several payday lenders stated that they complied with existing regulations regarding transparency and that the cost of their loans was clear to borrowers. A number of these submissions also stated that the Bristol Research indicated that borrowers understood both the cost of their payday loans and how this form of borrowing was expensive. In particular, they pointed to the finding that 80 per cent of retail payday borrowers and 89 per cent of online payday borrowers said they considered the total amount they had to repay (the original amount borrowed plus interest).⁴² Several payday lenders and one trade association told the OFT that payday loan costs were more transparent than other credit products such as home credit, pawnbroking and overdrafts.

3.58 Furthermore, submissions by payday lenders in response to the Consultation also queried the usefulness of APR as a measure of cost. These submissions stated that the short duration of payday loans made APR a distorted and inappropriate measure with which to illustrate and compare the costs of these loans.

⁴⁰ See ‘Market Investigation References: Guidance on the making of references under Part 4 of the Enterprise Act’, OFT, March 2006, paragraph 5.21.

⁴¹ ‘Advertising of Prices’, OFT, December 2010 (OFT1291).

⁴² In relation to expense, 79 per cent of online payday borrowers and 71 per cent of retail payday borrowers agreed that these forms of credit represented ‘an expensive way of borrowing’. See Bristol Research, p38.

3.59 The OFT recognises that the Payday Lending Charter seeks to address some of these issues by committing lenders who sign up to inform borrowers about the total cost of the loan including fees and charges.⁴³ However, the OFT is concerned that the available evidence still suggests that transparency issues continue to adversely affect competition in this market by limiting the ability of consumers to compare loans effectively on price at the point of taking out the loan. In particular:

- A further OFT review of payday lenders' websites and advertising subsequent to the publication of the Compliance Review found ongoing issues regarding cost transparency and compliance with the law and guidance.⁴⁴
- Submissions received by the OFT from several consumer groups and debt charities indicated insufficient awareness of cost amongst borrowers – especially in regard to the cost of rollovers. None of these submissions reported any improvement since the Payday Lending Charter was adopted.

C. A significant proportion of payday borrowers have poor credit histories, limited access to other forms of credit and pressing needs and therefore may be less price-sensitive

Summary

3.60 A significant proportion of payday borrowers have poor credit histories, limited access to other forms of credit and/or a pressing need of money at the point of taking out a loan. As such they may be

⁴³ The Payday Lending Charter includes a commitment to 'Tell you how the loan works and the total cost of the loan (including an example of the price for each £100 borrowed, together with fees and charges) before you apply'.

⁴⁴ These websweeps were made as part of the OFT's ongoing compliance work since publishing the Compliance Review www.of.gov.uk/OFTwork/credit/payday-lenders-compliance-review/

focused on the speed and convenience of the loan rather than its price.

3.61 Price insensitivity among consumers is likely to weaken price competition, thereby enabling lenders to raise their prices without losing business.

Price insensitivity

3.62 A significant proportion of payday borrowers have poor credit histories, limited access to other forms of credit and pressing needs at the point of taking out their payday loan. In such an environment, many borrowers are likely to be focused on speed and convenience of the loan rather than price. This lack of focus on price may be exacerbated by price information that is incomplete or difficult to compare (as discussed under Feature B above), but would be likely to persist even if cost information was more transparent and comparable between different lenders.

3.63 Using an OFT measure of vulnerability,⁴⁵ the Bristol Research found that 60 per cent of retail payday borrowers and 37 per cent of online payday borrowers were 'vulnerable'. Furthermore, when examining access to mainstream forms of credit,⁴⁶ the Bristol Research found that only a minority of payday borrowers possessed a viable mainstream credit alternative when taking out their loan.⁴⁷

3.64 Evidence from the YouGov Sixthsense survey suggests that over half of all payday borrowers are likely to consider themselves in some form of financial trouble, with around one quarter of borrowers in 'serious financial trouble'.⁴⁸ Furthermore, 39 per cent of respondents who had taken out a payday loan in the past two years considered themselves

⁴⁵ 'Vulnerable consumer groups: quantification and analysis', OFT, April 1998 (OFT219).

⁴⁶ Defined as unsecured credit such as credit cards, overdrafts and personal loans but excluding student loans, home credit, pawnbroking and payday loans. See Bristol Research, p3.

⁴⁷ 24 per cent for online payday lenders and 14 per cent for retail payday lenders.

⁴⁸ OFT analysis of the YouGov Sixthsense survey. Out of 95 borrowers, 23 reported being in 'serious financial trouble' (defined as a situation where they 'have missed loans repayments or can't pay basic bills') whilst a further 32 reported being in 'slight financial trouble'.

to be 'very dependent' or 'fairly dependent' on non-standard lending products, and 66 per cent had been rejected for at least one mainstream credit product in the past two years.

3.65 In addition, a number of debt advice charities submitted that borrowers were vulnerable and often unable to get credit elsewhere and that many borrowers followed a similar path: exhausting their credit options before turning to a payday lender. Overall, the OFT suspects that a significant number of 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 payment and the shortage of alternative sources of small-sum credit.

3.66 The OFT notes that the Bristol Research contains indicators suggesting that a significant proportion of payday borrowers may be in urgent need of money when taking the loan. These include:

- Borrowers tended to use their loans either to meet everyday expenses (43 per cent retail, 35 per cent online) or to pay other household bills such as utility bills (36 per cent retail, 28 per cent online).⁴⁹
- Borrowers were unlikely to consider using savings rather than borrow money (just 12 per cent of retail borrowers and 13 per cent of online borrowers considered this option).⁵⁰
- A significant proportion of borrowers believed that they couldn't borrow via another form of credit when taking out their loan (57 per cent retail, 50 per cent online).⁵¹

⁴⁹ Bristol Research, p19.

⁵⁰ Bristol Research, p26.

⁵¹ Bristol Research, Table 4.2. This compares with a figure of 66 per cent of borrowers responding to the YouGov Sixthsense survey who reported that they had been rejected for at least one mainstream credit product in the previous two years.

3.67 Evidence from the CFA survey also suggests that payday borrowers may be in urgent need of money at the time they borrow. 25 to 34 year olds were found to borrow mainly for 'food' and 'child essentials', as well as 'vehicle expenses' and 'utility bills'; and 35 to 44 year olds were found to borrow mainly for 'food', 'emergency needs', to 'pay off loans and credit cards' and 'utility bills'.

3.68 The Bristol research indicated that borrowers focused on speed and convenience when deciding to take out their loan. For instance, nine out of 10 payday borrowers agreed that payday loans represented 'a good way to raise cash quickly' and the most common reason cited by borrowers for taking out a payday loan rather than borrowing in some other way was 'convenience'.⁵²

3.69 The pressing needs of borrowers when taking out their loan and consequent focus on speed and convenience may underlie the Bristol research's other finding 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.⁵³

Effect on competition

3.70 Price insensitivity amongst significant numbers of borrowers may result in lenders facing lower levels of competitive constraint on interest rates and charges associated with loans. This weakens price competition.

3.71 In this situation, there is a risk that firms can raise prices without losing customers and that the cost of high rates of default (associated with inadequate affordability assessments alongside advertisement designed to attract borrowers with poorer credit records) can be passed back to borrowers in the form of higher prices. This shields lenders from the effects of poor lending decisions (Feature A above)

⁵² 61 per cent of online and 54 per cent of retail gave this as their reason for taking their most recent loan rather than alternatives.

⁵³ Bristol Research, Table 5.1. Even fewer borrowers stated that they had compared the cost of their loans amongst other lenders of the same type (42 per cent online and 20 per cent retail)

because obtaining high returns from those who do repay on time enables firms to sustain high rates of default.

Points raised during the consultation

3.72 During the Consultation, some payday lenders submitted research which suggested their customers were not vulnerable or that, when considering the current economic climate, their customers were no more vulnerable than users of other types of credit. Some lenders also presented survey evidence which indicated that their customers did shop around for loans and had access to other forms of credit (including forms that would be defined as 'mainstream credit' such as overdrafts or credit cards). The OFT accepts that the profile of borrowers may vary significantly between firms. However, while differences may exist between retail and online payday borrowers on measures of vulnerability and shopping around,⁵⁴ nonetheless, the OFT remains of the view that overall the evidence suggests that a significant proportion of borrowers are likely to display low price sensitivity.

3.73 One Consultation response from a payday lending trade association submitted that even if only a minority of borrowers compared prices, their actions would still act as a constraint on lenders' prices. This could be true if payday loan prices (including all relevant charges and schedules) were fully transparent and easily comparable, and the OFT is aware of analysis of utility and other markets suggesting the potential for the 'marginal consumer' to drive down prices across a market.

3.74 However, the OFT's view is that a lack of transparency in this market – as identified under feature B – combined with many consumers having few alternative forms of credit, as outlined above, points to an inability of consumers, even at the margin, to drive down prices. Furthermore, the existence of barriers to switching at the point of rollover – as identified under feature D below – suggests little evidence of market searching at this point, and this further weakens the ability of consumers to constrain lenders' prices.

⁵⁴ Bristol Research, paragraphs 14.5.3 and 14.5.4.

D. Barriers to switching at the point of rollover

Summary

3.75 There are barriers to individuals switching between payday lenders or to alternative products or options at the point of rollover:

- The incumbent lender has a significant point of sale advantage over other lenders at the point of rollover. Given its knowledge of its borrowers' repayment schedules, the incumbent lender is able to identify borrowers before or on their repayment dates, and offer or promote rollovers to those who indicate an inability to repay, or even those that do not.
- There is evidence to indicate that incumbent lenders actively encourage or pressurise their borrowers to roll over debt, and do not direct them to seek independent debt advice. A number of lenders roll over loans automatically unless the borrower repays in full on the due date.
- This may restrict the ability, or perceived ability, of borrowers to switch to alternative and perhaps more appropriate lenders if they are unable to repay their loans. Borrowers may also be unclear as to the availability of alternative ways to resolve their debt at this point in the process.

3.76 The OFT suspects that these barriers benefit incumbent lenders and prevent, restrict or distort competition from possible alternative lenders at the point of rollover.

Barriers to switching

3.77 At the time when a payday loan is due to be repaid, the initial lender has a major point of sale advantage in securing additional revenue. Given their knowledge of borrowers' repayment schedules, lenders will be able to identify borrowers before or on their repayment dates, and to offer or promote rollovers to those who indicate an inability to pay,

or even those who do not. Furthermore, borrowers may be unclear as to their options at this point and may also face pressure from their existing lender to rollover their loan. These factors may combine to make the rollover segment of the market less competitive and potentially more profitable.

3.78 As identified above, lenders appear to rely to a significant extent on revenue from loans which are rolled over: the Compliance Review found that 50 per cent of lenders' revenues in 2011/12 were derived from the 28 per cent of payday loans that were rolled over.⁵⁵ In addition, the OFT's inspections identified that some payday lenders encourage borrowers to pay back their existing loan and immediately re-borrow. While not being classified as a rollover, this could have a similar effect, as the borrower's initial capital liability would not be paid off, and charges may be levied. It may therefore lead to similar competition concerns. In an environment where borrowers are actively encouraged or pressured to extend their existing loan, and not directed to seek independent debt advice, borrowers may be unaware of alternative choices as to how to resolve their unpaid debt.

3.79 The Compliance Review uncovered widespread evidence of payday lenders proactively advertising rollovers or new loans to their customers, both before repayment of the original loan was due, and before the borrower had indicated an inability to repay the loan. Seventeen of the 50 lenders inspected (including some of the largest lenders) were found to actively promote rollovers in marketing material or at the point of sale as a 'feature' of the loan, whilst 15 used emails, SMS messages and/or telephone calls to proactively alert borrowers to the rollover option up to 10 days in advance of the loan becoming repayable.⁵⁶ In most cases, there appeared to be little or no attempt to discuss the implications of rolling over with the borrower, to facilitate an informed decision and encourage borrowers to consider alternative options.

3.80 Inspections undertaken as part of the Compliance Review also identified that a number of lenders appeared to roll over loans

⁵⁵ Compliance Review, p9.

⁵⁶ Compliance Review, pp 14-15 and Annexe D.

automatically in all or most cases, unless the borrower repaid in full on the due date.

3.81 Results from the Citizens Advice survey show that between 26 November 2012 and 17 May 2013, amongst the 75 per cent of respondents who had problems repaying their loan, only 28 per cent reported that they extended their loan without feeling pressurised by their lender.⁵⁷ In addition, only 16 per cent said they were offered a repayment plan which included freezing interest and charges. Only 17 per cent and 35 per cent of these respondents felt their lender made clear the risks, and costs, of extending their loans, respectively.

3.82 According to Citizens Advice, evidence gathered from the survey has also uncovered that '[some] lenders appear to actively encourage [borrowers] to rollover or extend loans'.⁵⁸

3.83 The survey results also indicate that vulnerable borrowers are not being informed of the availability of independent debt advice, despite the Payday Lending Charter committing lenders to 'tell [borrowers having problems repaying a loan] about free and independent debt counselling organisations who can...help': only eight per cent of borrowers who reported having trouble paying back their initial loan on time reported that their lender fulfilled this commitment. Citizens Advice reports that in some cases 'lenders were actively discouraging borrowers from getting the advice they need, for example by adding more charges if an adviser got involved'.⁵⁹

3.84 The Compliance Review found that borrowers who sought help or advice from debt advisers had on average rolled over their payday loans at least four times before seeking this help, and that some lenders' customers had rolled over loans in excess of 12 times.⁶⁰

⁵⁷ See Press Release 'Citizens Advice exposes payday lenders' failings as OFT closes in on unscrupulous lenders', Citizens Advice, 28 May 2013, p2.

⁵⁸ See 'Holding payday lenders to account: early results from the Citizens Advice payday loan survey', Citizens Advice, May 2013, p3.

⁵⁹ See 'Holding payday lenders to account: early results from the Citizens Advice payday loan survey, Citizens Advice', May 2013, p3.

⁶⁰ Compliance Review, p11.

3.85 More than 50 per cent of respondents to the YouGov Sixthsense survey who had taken out a payday loan in the past two years had rolled over with the original lender at least once. However, the evidence on how many borrowers actually switch lenders at this stage is unclear. Whilst the Compliance Review found evidence that some borrowers take out multiple loans,⁶¹ one major payday lender shared an internal customer survey which suggested that 23 per cent of its customers felt that at the point they took out their loan, they were unable to borrow from any other lender (including other payday lenders).

3.86 In response to the Consultation, one charity referred to 'the huge pressure and harassment [from lenders] that many of our clients report receiving once they have defaulted on a payday loan', and noted that this would encourage excessive rolling over of loans.

3.87 Some consumer groups submitted that in situations where borrowers find themselves in severe financial difficulties, lenders should consider rescheduling repayments, but that in their experience most payday lenders did not facilitate this or cooperate appropriately with independent debt advisors.

3.88 One respondent noted that payday lenders may be incentivised to encourage rollovers even if it is not in the best interest of borrowers:

'If someone is allowed to roll over a loan four times, assuming interest of £25 per £100 borrowed the lender will have received £125 in interest, meaning it can turn a profit even where the borrower ultimately defaults on the whole capital amount. Given the cost to the borrower and the damage defaulting does to the borrower's credit file when shared with a credit reference agency, the needs and priorities of the lender and the borrower are severely misaligned'.

⁶¹ Debt advisers told the OFT that their average client had six separate payday loans. See Compliance Review, p2.

3.89 A charity also noted its concern that there has been a 'worrying trend' towards some lenders rolling over loans automatically if they are not repaid in full and on time.

Effect on competition

3.90 The OFT suspects that barriers to switching at the point of rollover are a feature of the market that may restrict, prevent or distort competition in the payday lending market.

3.91 Considering the evidence in the round, it appears that payday lenders hold a significant point of sale advantage when borrowers near the end of their loan period, creating a barrier to switching. This is reflected in the fact that half of all UK payday lenders' revenue (on a market wide basis) arises from loans that are rolled over at least once, with lenders seemingly able to actively encourage or pressurise existing borrowers to roll over debt; evidence from the Citizens Advice survey suggests this behaviour is ongoing despite industry commitments in the Payday Lending Charter and other industry codes of practice.

3.92 This combination of the point of sale advantage and lenders' behaviour and actions may be restricting the ability, or perceived ability, of payday borrowers to switch to alternative and perhaps more appropriate options, if they are unable to repay their loan in full and on time. Borrowers may be unaware of alternative choices as to how to resolve their unpaid debt. These factors may limit borrowers' ability to constrain fees and charges at rollover.

3.93 The OFT suspects that these barriers benefit incumbent lenders and prevent, restrict or distort competition from possible alternative lenders, or alternative products or options, at this point.

Points raised during the consultation

3.94 In response to the Consultation, some payday lenders submitted that switching at the time the original loan is due is relatively easy and simply involves taking out a new payday loan with another provider to pay off an existing loan. They suggested that this is a quick process, with no early repayment charges and no additional cost to the

borrower. It was asserted that, contrary to borrowers being confused about their situation, this option should be obvious to them.

3.95 For example, one submission states:

‘at the point their short-term loan is due... [borrowers] may apply for loans from alternative suppliers (whether payday loans, or alternative sources of credit), comparing the costs of credit from each, and in the event of a successful application they may use the proceeds to settle their initial loan... [these borrowers] could effectively transfer their balance to any of a wide number of existing lenders. They would face very low switching costs. The time and effort involved in applying for a short-term credit product compares favourably with other credit products such as credit cards (which may require more detailed application for balance switching) because of innovations such as real-time automated affordability checking’.

3.96 Some lenders pointed out their low rollover rates, and the fact that they would only roll over a loan at the request of the borrower. One such lender noted its concern that this leaves them at a competitive disadvantage. One of the larger lenders suggested that it was not in its commercial interests to allow loans to be rolled over if this is likely to leave borrowers in financial difficulty. Submissions received from individual payday lenders also asserted that their policies were intended to restrict the availability and number of rollovers.

3.97 It was also noted that some trade association codes of practice now limit rollovers to a maximum of three (and that some lenders do not roll over at all), and particular reference was made to the commitments made in the recent Payday Lending Charter.

3.98 The OFT considers that the evidence it has seen from the Citizens Advice survey, the Compliance Review and some consultation responses suggests that, whilst some individual lenders do not allow rollovers, revenues from loans that are rolled over appear to be a major revenue driver for many payday lenders, and whilst switching to

alternative providers may be a realistic possibility for some borrowers, there nonetheless appear to be substantial barriers to switching at the point of rollover as well as a lack of awareness about alternative courses of action. As noted above, the Citizens Advice survey results also suggest that there is widespread non-compliance with certain industry codes of practice.

E. Market concentration and barriers to entry and expansion

Summary

3.99 Market concentration in the payday lending market is high. While over 240 licences were held by businesses in 2012 offering payday loans, three companies account for over 70 per cent of the UK payday market, measured by turnover. Major increases in advertising spending by leading brands and new regulatory initiatives may have the effect of creating significant barriers to entry and expansion. A combination of high market concentration and barriers to entry and expansion may exacerbate the prevention, restriction or distortion of competition in the payday lending market and the resulting risk of harm to consumers arising from the features identified above, as it could indicate that the leading firms in the market have the ability to unilaterally exercise market power.

Market concentration and barriers to entry and expansion

3.100 A quantitative analysis of data collected as part of the Compliance Review suggests that the three largest UK payday lending companies have a combined market share of 70 per cent, measured by turnover from payday lending,⁶² and that the market's Herfindahl-Hirschmann index value is around 1,900.⁶³

⁶² The 57 per cent figure quoted in the Compliance Review and Consultation document includes all separate credit licence holders, whilst the 70 per cent figure accounts for common parent company ownership of certain payday lenders.

⁶³ The Herfindahl-Hirschmann index value calculates the sum of squared market shares of all market participants, and is typically used as a measure of market concentration.

3.101 Measured this way, the payday lending market meets the OFT's definition of a 'concentrated' market and is close to the point at which the OFT would regard the market as 'highly concentrated'.⁶⁴

3.102 Over the last three years there has been a very large increase in the volume and value of payday loans in the UK. Data collected by the OFT as part of the Compliance Review identified up to 131 firms that issued payday loans in 2011/12.⁶⁵ Of these, only 106 were operating in the previous year and 77 were operating in 2009/10. However, it is not clear that new entry has reduced concentration. The OFT is aware, for example, of some recent major acquisitions in the market.

3.103 Current present regulatory barriers (the requirement to be licensed under the CCA) are perceived to be low. However the proposed transfer of consumer credit regulation to the FCA from April 2014, and the subsequent introduction of a new authorisations regime (which will be earlier for 'high-risk' businesses, potentially including payday lenders), may increase regulatory costs, making entry to the payday lending market more difficult.

3.104 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 and expand. Keynote, a leading market research company, notes that in the two years between 2009/10 and 2011/12, one established payday lender increased its advertising spend by around 1500 per cent, from £0.9 million to £15.1 million, accounting for over 40 per cent of the total advertising in the high-cost credit sector. Three other leading lending brands which were operating in 2009/10 increased their aggregate advertising spend by 340 per cent over the same period.⁶⁶

3.105 Established lenders have built up databases of borrowers, which would enable them to identify those who have taken out a payday

⁶⁴ The OFT and CC consider any market with a Herfindahl-Hirschmann index value of greater than 1,000 and 2,000 as being 'concentrated' and 'highly concentrated' respectively, when undertaking merger assessments. See 'Merger Assessment Guidelines', OFT, September 2010 (OFT1254), paragraph 5.3.5.

⁶⁵ The Compliance Review referred to 190 individual credit licence holders in 2011/12, whilst the 131 figure accounts for common parent company ownership of certain payday lenders.

⁶⁶ 'Consumer Credit and Debt: Market Assessment 2012', Keynote, November 2012, p114.

loan, and repaid or defaulted in the past. Any new entrant would face costs acquiring and assessing risk in its customer base.

3.106 During the Consultation process, the OFT saw evidence that brand loyalty may be an important feature of the payday lending market. One of the leading lenders shared evidence from a survey of its customers which showed that whilst more than half of its new customers reported shopping around before choosing that lender, the vast majority of its existing customers did not shop around before borrowing again from that lender. This may pose a barrier to firms wishing to attract new customers.

Effect on competition

3.107 In the OFT's view, the high degree of concentration and the current (and potential heightening of) barriers to entry and expansion, means it is possible that the leading firms in the market have the ability to unilaterally exercise market power. This could exacerbate the prevention, restriction or distortion of competition arising from the features identified above and could result in higher costs to borrowers.⁶⁷

3.108 The OFT believes that more work is required to identify the full impact that concentration and barriers to entry and expansion in the payday lending market may be having on consumers, and that the CC is well placed to undertake this work.

Points raised during the consultation

3.109 On market concentration, two Consultation respondents suggested that other short-term credit products should be considered in the same market as payday loans, which could imply a less concentrated market. Several respondents also suggested that despite the market share of the three largest lenders, there was no immediate link to concentration or competition concerns.

⁶⁷ See 'Guidelines for market investigations', Competition Commission, 2013, paragraph 14.

- 3.110 On barriers to entry and expansion, several respondents suggested that there are significant barriers to expansion following recent large-scale advertising campaigns, and that any new entrants would struggle to expand to the levels of the three large incumbent lenders. One trade association also noted that while initial regulatory costs for new entrants are low, total setup costs are much higher, and it is unlikely that new entrants will be able to secure banking facilities, for instance merchant facilities for the processing of debit cards.
- 3.111 A number of submissions from payday lenders and trade associations stated that they regarded themselves as operating in a very competitive environment and that there are a significant number of payday lending firms operating in the UK. They suggested that barriers to entry and expansion are commensurately low and surmountable, that the many small lenders in the market exert competitive pressure on larger lenders, and that some of these could be set to expand in the near future.
- 3.112 Another response commented that while entry may be relatively easy, established lenders will have built up databases of individual borrowers which enable them to lower their bad debt costs, and will leave new entrants to lend to riskier-than-average borrowers, creating a barrier to expansion. A payday lender noted that new entrants would initially face higher bad debt risks, but disagreed that this represents a barrier to entry and expansion, instead submitting that this is an inevitable feature in the market and that companies with effective business models would be able to expand.
- 3.113 With reference to payday lenders' submissions that the market should be defined more widely, the OFT continues to believe that its possible market definition to support a separate payday lending market, set out in Annexe B, is appropriate for the concentration calculations presented above.
- 3.114 Whilst the evidence on barriers to entry and expansion in the payday lending market is not conclusive, in the OFT's view the combination of this evidence with evidence of the high degree of market concentration gives reasonable grounds to suspect that these could be exacerbating the prevention, restriction or distortion of competition arising from the features identified above.

Other possible issues

- 3.115 The Bristol Research identified reported concerns expressed by a number of lenders in the Business Survey about the practices of lead generators and brokers. In particular concerns were raised about instances of borrowers acquired through lead generators who had ended up with multiple payday loans or on a debt management plan.⁶⁸
- 3.116 A number of submissions to the Consultation also raised that the role of lead generation companies in selling leads to payday lenders should be investigated further by the OFT. One submission by a think-tank suggested that the manner in which payday lenders bid for these leads encouraged the subsequent promotion of rollovers to borrowers (so that the successful lender could recoup the initial cost of buying the lead). Another submission from a payday lender stated that concerns over transparency may result from the behaviour of lead generators and their initial interaction with borrowers.
- 3.117 The evidence relied upon by the OFT does not itself indicate that the features identified above relate to the activities of lead generators and the OFT has not thought it appropriate to conduct research into those activities.
- 3.118 However, should the CC, in the course of gathering evidence during its detailed investigation, consider that the role of lead generators should be within the scope of their investigation, then it may request that the OFT expands the terms of reference. It is likely that the OFT would need to reconsult on doing so at that stage.
- 3.119 One payday loan association raised a number of other issues during the consultation. These included:
- Smaller payday loan lenders not joining a relevant trade association and thus hindering the ability of trade associations to encourage best practice in the industry.

⁶⁸ Bristol Research, p41.

- A possible tightening of rules around the use of CPAs by payment service providers, in response to changes in the relevant scheme rules limiting use of 'recurring transactions'.

3.120 It would be open to the CC to consider these issues as part of its market investigation.

Conclusion on features

3.121 For these reasons, it is the OFT's view that the section 131 test for making an MIR to the CC is met.

4 APPROPRIATENESS OF A REFERENCE

4.1 The OFT's MIR guidance⁶⁹ sets out four criteria to guide the OFT in exercising its discretion to make a reference to the CC:

- **Alternative powers:** it would not be more appropriate to deal with the competition issues identified by applying the CA98 or using other powers available to the OFT or, where appropriate, to sectoral regulators.
- **Undertakings in lieu of a reference:** it would not be more appropriate to address the problem identified by means of undertakings in lieu of a reference.
- **Proportionality:** the scale of the suspected problem, in terms of adverse effect on competition, is such that a reference would be an appropriate response to it.
- **Availability of remedies:** there is a reasonable chance that appropriate remedies will be available.

4.2 The OFT's assessment of each of these four factors follows.

Alternative powers

4.3 The OFT has considered whether some or all of the possible concerns identified could be addressed more appropriately through alternative powers available to it or to others.

4.4 The OFT considers 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,

⁶⁹ 'Market Investigation References – Guidance about the making of references under Part 4 of the Enterprise Act', OFT, March 2006 (OFT 511).

enforcement action (under the CCA and/or other consumer protection legislation, or CA98), business education and consumer education.

- 4.5 Powers available to other regulators include the powers available to FCA under FSMA from April 2014.

Enforcement action

Action by the OFT

- 4.6 Following publication of the Compliance Review in March 2013, the OFT wrote to the 50 leading lenders it inspected, requiring them to take immediate steps to address areas of non-compliance and prove to the OFT that they had adequately done so. The first audit reports of changes made by lenders have started to come in, and are being analysed, and all of the audits are due by the end of July.
- 4.7 In response to the Consultation, some payday lenders, trade associations, and think-tanks submitted that the problems identified in respect of features A to D relate to non-compliance resulting from a lack of sufficient OFT enforcement action.
- 4.8 One payday lender in particular submitted that 'it is typical for non-compliance to provide competitive advantages in many sectors of the economy'. In its submission it further stated that 'there is nothing special about this feature of the payday lending sector and it does not indicate a competition concern'. In addition, it pointed out that the FCA will be given powers to tackle these issues. One payday lender also claimed that effective enforcement had achieved high levels of compliance in other countries, such as the USA, and that this could similarly be achieved in the UK.
- 4.9 However, the OFT does not consider that enforcement action alone will adequately address the features it has identified, or that it will do so on an ongoing basis, sufficient to ameliorate the OFT's concerns about those features or the adverse effects on competition to which they give rise:
- Feature A: the non-compliance identified by the OFT appears to result from incentives created by the fact that payday lending firms

earn a high proportion of their revenues from rollovers, and compete primarily on the basis of availability of loans and speed and ease of approval. These factors reduce competitive pressures to ensure loans are granted on the basis of adequate affordability checks to the detriment of consumers. While enforcement action can tackle the symptoms (varying non-compliance with existing regulations) a CC inquiry can investigate the causes (how competition works) and propose remedies that addresses the root causes of problems observed.

- Feature B: the difficulty that consumers have in assessing and comparing the full cost of payday loans, cannot be addressed by enforcing compliance with existing legislation and guidance because existing provisions do not cover all aspects of charging and do not ensure comparability. In particular, the Consumer Credit (Advertisements) Regulations require a representative example but this does not include information on default charges or the cost of rollovers and products are often structured in different ways (in terms of loan duration, interest, and charges).
- Feature C: enforcing compliance with current legislation and guidance will not of itself make borrowers more price sensitive so as to impose a competitive constraint on interest rates and charges associated with loans. Whilst measures that increase transparency may affect levels of price awareness, as indicated above, existing legislation and guidance does not address all our concerns in this regards.
- Feature D: the barriers to switching at the point of rollover - for example, the point of sale advantage cannot be addressed through enforcing compliance with existing guidance and legislation.
- Feature E: the effect of high market concentration and barriers to entry and expansion, in combination with the features set out above, cannot be dealt with through improved compliance.

4.10 A market investigation will look at the market as a whole. If the CC finds that there is one or more than one adverse effects on competition, it will be required to take such action as it considers to be reasonable and practicable, to remedy, mitigate or prevent the adverse effect on competition and any detrimental effects on customers that result from, or may be expected to result from, the same.⁷⁰ Action taken by the CC following a market investigation could go to the heart of the features that the OFT has identified, whereas enforcement action will not.

Action by the FCA

4.11 From April 2014, the FCA will have significant powers which go considerably beyond those available to the OFT under the CCA, including the ability to cap the cost of credit and to ban or limit the number of rollovers lenders may offer. The FCA will look at identifying any gaps in the rules that need to be filled. It will also apply its authorisation scheme to payday lending (possibly at an earlier stage than other consumer credit firms), thereby raising the threshold for participation in the market.

4.12 Several lenders in response to the Consultation highlighted their understanding that the FCA would codify OFT guidance and industry codes into FCA rules, and identify and rectify any gaps in regulation.

4.13 For example, an association of payday lenders highlighted that in its consultation document on the FCA regime for consumer credit the FSA states that in April 2014 the FCA intends to codify industry codes of conduct (which emphasise the importance of affordability checks), and that the FSA has also stated that the FCA will implement a stringent 'gateway' for licensing which is intended to ensure that those payday lenders that are non-compliant will have their licence applications refused.

4.14 However, the FCA has no formal remit in this sector at present. The FCA intends to consult in the autumn on draft rules for consumer credit, to be implemented from April 2014. These are likely to

⁷⁰ Enterprise Act 2002, Section 138.

incorporate aspects of existing OFT guidance, including the Irresponsible Lending Guidance (and Debt Collection Guidance), and possibly also elements of industry codes. However, it seems unlikely that the FCA will be in a position to go beyond that initially, given its statutory responsibilities,⁷¹ and the lack of an established evidence base covering market dynamics and competition drivers in this sector. It would be required to consult, and undertake a full cost-benefit analysis (CBA), before introducing any new rules, and it may be reasonable to assume that it will want time to assess the market and any recent developments before introducing additional measures.

4.15 If the FCA were to initiate a more in-depth analysis of the market soon after acquiring responsibility for consumer credit regulation in April 2014, this could take several months to complete, possibly up to a year. The FCA would then need to consult on draft rules and a draft CBA, and consider responses. It would be reasonable to expect, therefore, that any interventions necessary to address competition issues might not be implemented until October 2016 at the earliest.

4.16 The OFT considers that an independent, authoritative and expert analysis of the way competition in this market works is needed now, so that if one or more adverse effects on competition is found, any necessary and appropriate remedies can be put in place by the CC and/or the FCA can have timely access to the expert analysis of the CC in order to help it frame its own intervention in the market. The FCA has confirmed that it would support an OFT decision to refer the payday lending market to the CC, and indicated an analysis by the CC would be a useful input to its work on this market in future.

4.17 Should 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. An MIR therefore has the potential to add to the FCA's future regulatory action in the market, and the relative timescales should allow for effective working together, having regard to wider developments.

⁷¹ The FCA can introduce new rules only following consultation and a cost-benefit analysis. It will be consulting in September on transposing existing OFT guidance into FCA rules, but that will require only a limited CBA given that the guidance already applies to licensees (so turning it into rules should not add to the costs of compliance). It would need an adequate evidence base to support new rules beyond this.

4.18 Unless and until solutions are found to the features that the OFT suspects prevent, restrict, or distort competition in this market, there is a considerable risk of significant, and potentially increasing, consumer harm. It is therefore important, in the OFT's view, that an independent, authoritative and expert analysis of the market begins now because of the growing scale of this market and the severity of detriment (both economic and psychological) to borrowers. The OFT suspects that the scale of consumer detriment in this market may actually be increasing. In the Compliance Review the OFT found that in the first quarter of 2009/10 only one per cent of Citizens Advice Bureaux debt casework clients had one or more payday loans. In the same quarter of 2012, 10 per cent had at least one payday loan. In November 2012 Step Change Debt Charity reported that the proportion of their clients with payday loan debts had increased from 3.7 per cent in 2009 to 17 per cent in 2012. The consumer base for payday lending continues to grow. Continuous growth of this sector was confirmed in submissions obtained in the consultation.

4.19 Furthermore there is evidence that the misuse of CPAs is leaving borrowers with insufficient funds to deal with basic needs and cases of unsuitable loans being made to consumers with very low incomes and significant credit commitments.⁷²

4.20 The Compliance Review found evidence of misuse of CPA for example by taking payments without consumers' informed consent, by making repeated and excessive attempts at payment even when it was clear that the borrower was in financial difficulty, and by misleading borrowers over their right to cancel a CPA.

4.21 Consumer complaints included that the borrower was not aware that they had signed up to a CPA, or how it would work, and that lenders took frequent part payments over a lengthy period, often leaving the consumer facing significant hardship.

4.22 According to OFT definitions of vulnerability, the Bristol Research found that 60 per cent of retail borrowers and 37 per cent of online borrowers were 'vulnerable'. Borrowers tended to use their loans

⁷² Compliance Report, pp10-13, and Annexes D and H.

either to meet everyday expenses (43 per cent retail, 35 per cent online) or to pay other household bills such as utility bills (36 per cent retail, 28 per cent online).⁷³ Upwards of four in 10 borrowers agreed that this type of credit trapped them into a cycle of borrowing. This ranged from 42 per cent of online borrowers, rising to 64 per cent of retail borrowers. 63 per cent and 60 per cent of retail and online payday borrowers, respectively, felt that it is 'too easy to borrow this way'.

4.23 According to a recent CFA report,⁷⁴ payday borrowers may be in urgent need of money at the time they borrow. 25 to 34 year olds were found to borrow mainly for 'food' and 'child essentials', as well as 'vehicle expenses' and 'utility bills'; and 35 to 44 year olds were found to borrow mainly for 'food', 'emergency needs', to 'pay off loans and credit cards' and 'utility bills'.

4.24 Market research company ComRes conducted a study in September 2012 of 627 individuals who had taken out a payday loan.⁷⁵ It found that 42 per cent (266) had prioritised paying back their payday loan over paying for one of the following:

- buying food (24 per cent of all payday loan borrowers)
- buying clothes for myself/my family (18 per cent)
- paying a utility bill (18 per cent)
- transport costs (12 per cent), and
- paying a bank loan or credit card bill (12 per cent).

⁷³ Bristol Research, p19.

⁷⁴ 'Credit Crunched', Consumer Finance Association, 2013.

⁷⁵ See 'Personal Debt Survey', ComRes, September 2012, available at www.comres.co.uk/polls/Personal_Debt_Snapshot_results_1st_Oct_12_Sig.pdf.

Industry Initiatives

4.25 Industry initiatives have not, so far, improved compliance to a sufficient degree. The Citizens Advice survey, carried out between 26 November 2012 and 17 May 2013 (that is, after the introduction of the self-regulatory Payday Lending Charter), has found evidence of:

- ‘Irresponsible lending’: including lending to people who may or do lack capacity at the time of taking out the loan, such as under 18s, people with mental health issues or people who may have consumed excessive amounts of alcohol
- ‘Inadequate checks on borrowers’: chasing people for debts when the loan had actually been taken out by someone else using their identity
- ‘Taking more than owed’: lenders taking more than they are owed then refusing to refund it
- ‘Draining bank accounts’: misuse of CPA by persistently raiding bank accounts without any warning leaving no money to live on
- ‘Harassment’: pestering people who are in debt and also hounding others at the same address in a bid to shame the borrower, and
- ‘Refusal to agree to repayment plans’: not helping people who are struggling to repay by agreeing a reasonable repayment plan.

4.26 In addition, the report found that:

- During the same six month period 24,575 people sought online advice about payday loans from Citizens Advice.
- 84 per cent of survey respondents who reported having repayment problems were not offered the chance to freeze interest and charges when they were struggling to repay.

- ‘Some of the most worrying issues for consumers, such as misuse of continuous payment authorities (CPAs) seem to be continuing, and may even be increasing’.⁷⁶
- ‘Many lenders appear to be continuing to use CPAs to ensure their loans are repaid, regardless of the financial position of the borrower and the impact the use of the CPA to recover the debt will have on their personal and financial circumstances’.⁷⁷

Action by the OFT under Competition Enforcement Powers

4.27 The OFT has found no evidence of 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 on the Functioning of the European Union.

Market study

4.28 One payday lender and a think-tank suggested that the OFT should carry out a market study before deciding whether to make a reference. Market studies enable the OFT to examine the causes of why particular markets are not working well for consumers and can lead to proposals as to how they might be made to work better.

4.29 The OFT remains of the view that a market study is not appropriate in this case, given that there is significant evidence already available from other sources (see Chapter 3 above).

4.30 The OFT is required by section 131 of the Act to have reasonable grounds for suspecting that any feature, or combination of features, of a market in the United Kingdom 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. If

⁷⁶ See ‘Holding payday lenders to account: early results from the Citizens Advice payday loan survey’, Citizens Advice, May 2013, p4.

⁷⁷ See ‘Holding payday lenders to account: early results from the Citizens Advice payday loan survey’, Citizens Advice, May 2013, p4.

the OFT is satisfied that this threshold is met and that an MIR is appropriate, there is no need for the OFT, nor there is a legal obligation, to carry out a market study. A market study would be unnecessarily duplicatory, and an unnecessary burden on both public resources and on business.

Undertakings in lieu of a reference

4.31 The OFT has power under section 154 of the Act to accept undertakings instead of making a reference to the CC.

4.32 During the Consultation period only one payday lender suggested that undertakings could be an alternative means of addressing the concerns identified by the OFT. In particular, it was suggested that the Payday Lending Charter could be made binding and enforceable as formal undertakings in lieu of a reference.

4.33 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 such an approach would effectively address all the problems that may exist and achieve as comprehensive a solution as is reasonable and practicable, but its preliminary view is that it appears unlikely that the terms of the Payday Lending Charter adequately address its fundamental concerns with competition in this market.

4.34 To that extent, as set out in the OFT MIR guidance, it is worth noting that:

'Undertakings in lieu of a reference are unlikely to be common. In many cases the OFT will not have done a sufficiently detailed investigation of a competition problem, prior to making a reference to the CC, to be able to judge with any certainty whether particular undertakings will achieve as comprehensive a solution as is reasonable and practicable. This is particularly likely to be the case when the adverse effects on competition arise from market features involving several firms or industry-wide practices. Moreover, trying to negotiate

undertakings with several parties, in circumstances in which possible adverse effects on competition have not been comprehensively analysed, is likely to pose serious practical difficulties. By contrast, where an adverse effect on competition arises from the conduct of a very few firms there may be more scope for accepting undertakings in lieu, provided that the OFT is confident that they will achieve a comprehensive solution'.⁷⁸

- 4.35 The payday lending market has grown in recent years and there is evidence of market entry. New entrants would not be bound by any undertakings given now, and this is an additional factor indicating undertakings would not, in this case, be appropriate.
- 4.36 The OFT considers that this concern remains despite the possibility that barriers to entry may rise in future due to increasing advertising spend by some incumbents and likely future FCA action on the 'gateway' to the market.
- 4.37 In the same submission it was suggested that the remedies adopted by the CC in its previous inquiry into home credit would provide a useful benchmark against which to assess and identify remedies that could work in the payday lending sector.
- 4.38 Although the features of the payday lending market that may be preventing, restricting, or distorting competition may to some extent be similar to those applicable at the time of the home credit MIR, the home credit market is very different from the payday lending market, characterised by different products and potentially different market dynamics (as highlighted, for example, in the Bristol Research). Thus, it cannot be assumed that the remedies identified in the home credit market would be suitable

⁷⁸ 'Market Investigation References – Guidance about the making of references under Part 4 of the Enterprise Act', OFT, March 2006 (OFT 511), p12.

Proportionality

4.39 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.

4.40 First, the size of the market is significant, estimated at approximately £2-2.2bn in 2011/12 in outstanding balances.

4.41 Second, a significant proportion of the market is affected by the features that the OFT has reasonable grounds for suspecting may prevent, restrict or distort competition, which appear to be prevalent throughout the UK, as is evidenced by the Compliance Review and the Bristol Research.

4.42 Third, the features identified are unlikely to be short-lived given that:

- the payday lending market has grown rapidly in recent years
- the underlying incentives driving competition in this market, highlighted above, are unlikely to change absent appropriate action, and
- consumer characteristics and behaviour are unlikely to be short lived.

4.43 The OFT has considered the possibility that the concerns identified might be mitigated as a consequence of changes in the market which might be brought about as a result of the Compliance Review and follow-up audits, 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 and an MIR disproportionate.

4.44 In response to the Consultation, several payday lenders and trade associations highlighted in particular the Payday Lending Charter, the additional changes to the codes of individual trade associations, and the establishment by the CFA of a Short-term Lending Compliance Board to promote compliance with its code. Respondents also pointed to the OFT's revised Debt Collection Guidance, on the misuse of CPA, and argued that most lenders would have delayed amending their policies and procedures pending publication of the Compliance Review, to avoid the risk of having to make further (costly) systems changes within a short period.

4.45 More generally, respondents argued that the market has been in a state of flux since the instigation of the Compliance Review in February 2012, and that lenders should be allowed time to respond to the various initiatives. It is argued that the audits required by the OFT, following publication of the Compliance Review, will be the catalyst for wide-ranging changes within the industry, and that the OFT should allow time for these to bed in and be assessed before making a reference. One payday lender suggested that these changes represent much more significant developments than cited in relation to the Personal Current Accounts (PCA) market, which the OFT has not referred to the CC.⁷⁹

4.46 However, the OFT considers that these initiatives are not sufficient reason to merit delaying an MIR in order to wait to see if they have sufficient impact, nor to lead it to think that any remedies possibly identified by the CC at the end of its inquiry would have a short life.

4.47 The OFT's conclusion in this respect is based on the following considerations:

1. The evidence to date, in particular the Citizens Advice survey and continued complaints from consumers and debt advice organisations, together with an examination of relevant websites, suggests that the voluntary initiatives have, so far, not been adequately implemented. In addition, as highlighted in the paragraph below, it is unlikely that, even if fully implemented, these

⁷⁹ www.oft.gov.uk/OFTwork/markets-work/othermarketstwork/pca-review/

initiatives would significantly address the features identified and do not have the same potential to do so as the changes noted in the PCA decision.

2. Without an in-depth investigation of the market it is not possible to reach a definitive view on the extent to which these measures might, if successfully adhered to, address the concerns that the OFT has identified. Nor could it be excluded that these initiatives may, in fact, place unnecessary burdens on the industry, to the ultimate detriment of competition, and of consumers. Taking the example of rollovers, the Bristol Research indicates that the industry itself was not clear about the best way to deal with them and states that:

‘At the time of the Business Survey in early 2012, payday lenders had mixed views about whether or not rollover loans should be limited or even banned. A few thought that industry practices could be improved, for example to ensure that customers were not encouraged to rollover loans or were not faced with high charges if they did. Several mentioned the work of their trade associations in this respect. Others considered that rollover loans served a useful purpose for some customers. Moreover, if rollover loans were limited or banned, should the same not apply to minimum credit card repayments?’⁸⁰

4.48 Among the reasons put forward to argue that an MIR would be inappropriate at this time, one major payday lending trade association indicated that Citizens Advice is in the process of conducting a year-long review of the success of the Payday Lending Charter, and that the OFT should wait for the outcome of this review before considering an MIR. In this regard, and as noted above, Citizens Advice has recently published interim survey results which indicate that there are significant levels of non-compliance with the Payday Lending Charter,

⁸⁰ Bristol Research, p50.

particularly in relation to affordability checks and use of CPA. In addition, the survey indicates that significant concerns still remain in relation to, barriers to switching, and competition incentives at the point of roll-over.⁸¹

4.49 The OFT takes the view that, notwithstanding the measures identified by the respondents, there will remain sufficient and significant features in the market which merit investigation now by the CC, because the proposals are not sufficient to deal with a concern, and/or the proposals are unlikely to be implemented.

Availability of remedies

4.50 If the CC decides that there is one or more adverse effects on competition it must take such action as it considers reasonable and practicable 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).

4.51 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.

4.52 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, measures promoting transparency (for example obligations relating to advertising or the provision of price information to potential borrowers), or direct action controlling behaviour/prices (for example interest rate caps) or prohibiting conduct

⁸¹ See 'Holding payday lenders to account: early results from the Citizens Advice payday loan survey', Citizens Advice, May 2013.

(for example 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 identified in this market.

4.53 In response to the Consultation one payday lender submitted that, in so far as the feature concerning borrowers not shopping around is concerned, this is a social or behavioural issue, and not a problem with competition on the market. As such, in its submission, this perceived problem could not be adequately addressed by any remedies the CC could impose.

4.54 The OFT disagrees with this view. Lack of switching and shopping around is a common feature in competition assessments, and the CC has in the past put in place remedies which have sought to deal with this feature and to increase transparency.⁸² Should the CC determine that transparency remedies would, in this case, be insufficient, it would remain open to the CC to consider other remedies dealing with the consequences of customers not shopping around or switching, such as caps on rollovers and/or the cost of credit.

4.55 No stakeholders raised concerns in relation to the possible availability of remedies in so far as the other features are concerned.

⁸² See for example the CC's investigation into payment protection insurance www.competition-commission.org.uk/our-work/directory-of-all-inquiries/ppi-market-investigation-and-remittal/final-report-and-appendices-glossary

5 CONCLUSION

- 5.1 Having considered the above criteria, the OFT has decided to make an MIR to the CC of the market for the supply of payday lending and closely related markets in the United Kingdom.

ANNEXES

ANNEXE A: TERMS OF REFERENCE

- A1 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.
- A2 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.
- A3 For the purposes of this reference, payday lending consists of the provision of small-sum cash loans marketed on a short-term basis, not secured against collateral, including (but not limited to) loans repayable on the consumer's next payday or at the end of the month and specifically excluding home credit loan agreements,⁸³ credit cards,⁸⁴ credit unions and overdrafts.⁸⁵

⁸³ As defined in the CC's Home Credit Market Investigation Order 2007.

⁸⁴ Credit-token agreements as defined in the Consumer Credit Act 1974.

⁸⁵ Authorised overdrafts within section 74(1) (b) and overdrawing within section 74A of the Consumer Credit Act 1974.

ANNEXE B: A POSSIBLE MARKET DEFINITION

B1 OFT guidance states that in consulting on a reference the OFT should normally express a view as to the possible definition of the market (or markets) affected. However, the OFT is not obliged to make a full assessment of market definition:

‘In making a market investigation reference to the CC, the OFT must specify the goods or services for whose supply or acquisition competition is adversely affected. This will require some consideration of the definition of the relevant market. Market definition...need not always be a necessary step’.⁸⁶

B2 Below the OFT sets out its view on a possible market definition, given consideration of the likely demand-side and supply-side substitutability with alternative products. It is also used in support of its concentration analysis in Chapter 3.

Product market

Demand-side substitution

B3 Some borrowers 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.

B4 In the OFT’s view, consumers generally look for the following distinctive product characteristics in payday loans:

- trust in and familiarity with the providers, products and procedures

- simple, straightforward and speedy access

⁸⁶ ‘Market Investigation References: Guidance about the making of references under Part 4 of the Enterprise Act’, OFT, March 2006 (OFT511), paragraph 4.8.

- small, fixed amounts borrowed for short, fixed terms
- lack of requirement for security or collateral.

B5 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
- log book loans
- other personal loans
- overdrafts

B6 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 suggested 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. Two Consultation responses received by the OFT suggested that other small-sum credit products, in particular

unauthorised overdrafts, perform a similar function to payday loans and could be considered to be in the same market.

- B7 However, in the OFT's view the evidence suggests that alternative sources of credit may not be sufficiently constraining the price of payday loans for them to be part of the same relevant product market. Key issues will be (i) 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, and (ii) customer preferences for these alternative sources of credit.
- B8 The Bristol Research suggests that a substantial proportion of borrowers are unable to borrow elsewhere at the time of applying (30 per cent of online borrowers and 35 per cent of retail borrowers), and that for three quarters of online borrowers, other sources of mainstream credit were inaccessible.⁸⁷ Additionally, only around 17 per cent of borrowers compare prices with 'other types of lenders'.⁸⁸
- B9 Evidence from a Policis study also suggests that customers often do not view overdrafts as comparable products to payday loans:
- 'Payday borrowers...often chose payday in the knowledge that it is a high-cost way to borrow. They valued ready access to small-sum cash, but could also see the short timescale for repayment as less high risk than borrowing on an open-ended overdraft or revolving credit facility'.⁸⁹
- B10 Further evidence published since the OFT's preliminary decision suggests that mainstream credit products may not be available to a large proportion of borrowers. A recent report by the CFA notes that 'traditional credit is either not available or unappealing for younger people',⁹⁰ and the YouGov Sixthsense survey found that 66 per cent

⁸⁷ Bristol Research, p21.

⁸⁸ Specifically, 16 per cent of 'traditional' and 18 per cent of online borrowers.

⁸⁹ 'Credit and low-income consumers: A demand-side perspective on the issues for consumer protection', Friends Provident Foundation, Liverpool John Moores University, Policis, 2011, p52.

⁹⁰ Credit Crunched, CFA, 2013, p25.

of borrowers had been turned down for at least one mainstream credit product in the past two years.

- B11 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. It also generally involves smaller amounts of credit, over shorter periods, and with a more automated process for provision and collection of credit.
- B12 Many consumers of payday loans will not have access to the full range of alternative credit products listed above. Some will have exhausted their entitlement and have borrowed as much on, say, overdrafts and credit/store cards as their credit rating will support.
- B13 The OFT understands, based on evidence from comments made in meetings with payday lenders, that consumers of payday loans tend to regard these other credit products alongside payday loans and use a variety of them to maximise their access to credit rather than as substitutable for payday loans.
- B14 Overall, the OFT doubts that there is sufficient functional similarity between payday loans and the other small-sum credit products available to many borrowers 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

- B15 Markets can also be defined from the supply side, specifically if there is sufficient potential supply-side substitution. The relevant question is whether suppliers of other products, most likely those listed above, can switch to supplying payday loans within a short timeframe (for example, within one year) to such an extent as to influence prices of payday loans.

- B16 The OFT's market definition guidelines note that: 'Analysing supply side substitution raises similar issues to the analysis of barriers to entry... Supply side substitution can be thought of as a special case of entry – entry that occurs quickly (for example, less than one year), effectively (for example, on a scale large enough to affect prices), and without the need for substantial sunk investments'.
- B17 The OFT is aware that some firms have diversified from pawnbroking into providing payday loans from fixed premises. However, entry by firms with a business model in which consumers interface through a website has also characterised recent growth in this industry, and lenders which do not lend from fixed premises account for more than 75 per cent of the market by turnover. The most significant barrier these firms face in entering what is primarily an online-based industry is establishing brand recognition and generating internet site 'hits' from potential customers. This barrier has potentially heightened in the past few years as the largest payday lenders have substantially increased their advertising expenditure (see paragraph 3.104). Barriers to entry and expansion are discussed in further detail in Chapter 3.
- B18 Given the availability of relevant digital technology and sufficient finance to support a marketing campaign, there would appear to be scope for supply-side substitution by firms currently not engaged in payday lending. However, a definitive conclusion would require significant market research, which the CC is in a suitable position to undertake.

Geographic market

- B19 The OFT has not drawn any firm conclusions as to the relevant geographic market for payday lending.
- B20 Payday lending is essentially nationally-based for companies using the internet model but more locally-based for those operating out of high-street offices and serving walk-in customers. In the case of high-street payday lenders, some business is reported to come from word-of-mouth recommendations. A few large lenders operate nationally or over several regions. Some payday lenders have back office functions based outside of the UK.

B21 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.

B22 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).