CASHEURONETUK, LLC:

RESPONSE TO THE ENTRY AND EXPANSION WORKING PAPER ISSUED BY THE COMPETITION COMMISSION ON 21 FEBRUARY 2014

CashEuroNetUK, LLC (**CashEuroNet**) sets out below comments on certain points raised in the Competition Commission's (**CC**'s) Entry and Expansion working paper.

1 IMPACT OF REGULATION ON PAYDAY LENDING

1.1 The CC's preliminary view is that regulation has not historically acted as a barrier to entry or expansion but that the new Financial Conduct Authority (**FCA**) regime is likely to increase compliance costs in comparison with the current OFT regime. The CC notes that a number of lenders consider that the current level of regulatory change may make entry into the payday loan sector less attractive.[1]

1.2 CashEuroNet agrees with the view expressed by other lenders and recognises that, depending on where the rate cap might be set or how it is structured, this could pose a significant threat to market entry / expansion (as explained in section 4.5 below). But assuming the cap is not set below market rates, we do not believe that the proposed regulatory regime raises significant barriers to entry to payday lending.

1.3 What concerns CashEuroNet more is the potential impact of the proposed regime on lending volumes and market exit, and what this means for consumers. Drawing on CashEuroNet's experience in the USA, it is striking how a combination of a rate cap and other regulatory measures in various States resulted in an unexpectedly large (and unintended) drop off in licensed lending such as in Colorado, Illinois, New Mexico and Florida. Figure 1 below provides an illustration of the magnitude of this drop off in Washington, when a rate cap and other restrictive regulatory measures were introduced in 2010.

Figure 1

Number of Washington payday licensees over time

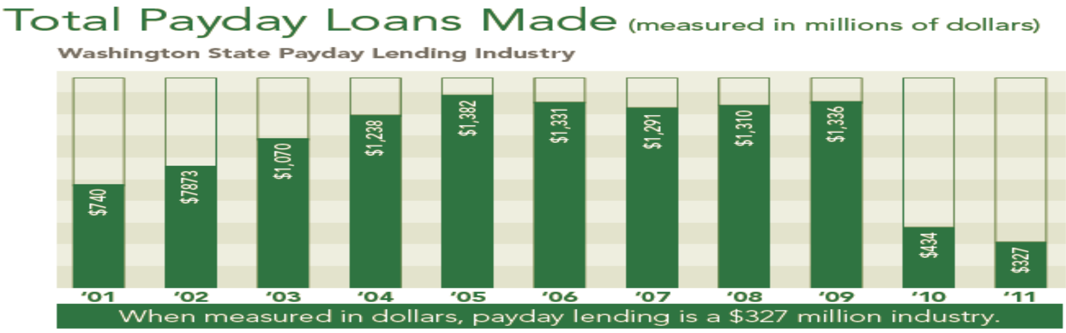
Number of Licensed Payday Lenders

Washington State Payday Lending Industry

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Companies	96	110	124	125	131	130	138	133	109	85	68
Branches	286	317	378	465	585	612	591	584	494	339	188
Total Locations	382	427	502	590	716	742	729	717	603	424	256

[1] Competition Commission, "Entry and Expansion", paragraphs 4(d) and 35.

Number of Washington payday loans over time



Source: Washington Department 2011 Payday Lending Report

1.4 It is clear that the market size and composition has been drastically altered by legislative changes that reduce the supply of legal, licensed payday lending. At the same time, consumer demand has not reduced. Whilst it is likely that some portion of demand will have been diverted to other licensed products (we return to this issue in section 6 below), the US market has seen a spike in informal and illegal lending. For example, data from the State of Oklahoma, amongst others, shows that complaints about unlicensed lending have grown to outnumber complaints about payday licensees. Furthermore, in 2013, actions were taken by the US Department of Justice, the State of New York and the US Consumer Financial Protection Bureau over 30 black and grey market lenders operating in the US without proper licensing.

1.5 This highlights the importance for the proposed regulatory regime to "strike the right balance".

2 CUSTOMER ACQUISITION

2.1 As we explained in our response to the Repeat Customer working paper, customers tend to stay with a lender for only around 12 to 18 months, and therefore every supplier in the market must continually strive to replace lost customers. Any advantage from having a stock of existing customers will last only for this period of time, [**CONFIDENTIAL**]. Consequently, CashEuroNet does not believe that lacking a stock of existing customers represents a significant barrier to entry.

2.2 CashEuroNet believes that customer acquisition costs, which represent a significant cost of payday lending, also do not represent a significant barrier to entry.

2.3 This is because most potential marketing channels have few "fixed" costs. For example:

2.3.1 Buying leads from a lead generator costs the same, per lead, for a small lender as it does for a big lender. Lenders often purchase leads at several price points on the ping tree in order to manage costs;

2.3.2 Pay-per-click costs are also similarly scalable; and

2.3.3 [**CONFIDENTIAL**]; the plethora of small TV channels now available means that the fixed cost element of TV advertising is less pronounced than in the past.

2.4 With regard to brand value, CashEuroNet believes that most of its advertising is [**CONFIDENTIAL**].

3 CREDIT RISK ASSESSMENT

3.1 Whilst effective credit risk modelling is at the heart of our business, CashEuroNet does not believe that it represents a significant barrier to entry.

3.2 The analytics behind credit risk modelling involves a great deal of "learning by doing". The advantage of payday lending is that the loan cycle is very short (typically around 30 days) which allows early and ongoing refinement of credit models in response to known default rates. In our view, a credit model can be brought to a high standard within a 6 to 12 month period, which is well within the period that a start-up can expect to break-even.

3.3 [**CONFIDENTIAL**].

3.4 As we noted above, customers tend to stay with a lender for only around 12 to 18 months, and therefore every supplier in the market must continually strive to identify new customers who are likely to be able to pay back the loan. The advantage of an existing customer base is therefore limited to this time period. Furthermore, credit risk models can be rapidly improved, given the one month loan cycle, also reducing any advantage to incumbents.

3.5 We also wish to highlight that the CC data shows a great deal of variation in default rates among lenders with a similar proportion of existing customers.[2] This also fits with the observation that the correlation between the default rate of new customers and the default rate of existing customers for each lender is rather weak.[3] This suggests that a lender cannot be sure of the future default rate of their stock of existing customers based on the default rate when they first took out a loan from the lender.

4 FINANCING AND ACCESS TO CAPITAL

4.1 CashEuroNet has set out its views on how the CC should consider the expectations for future profitability of payday lending by both new entrants and existing lenders, as well as the cost of capital, in its response to the Profitability of Payday Lending Companies working paper. These observations are relevant to the issue of financing and access to capital.

4.2 Payday lending is a risky venture, as indicated by the fact that some payday lenders have been making losses, even though the sector as a whole has grown considerably in recent years. It is primarily for this reason that payday lenders typically have low levels of gearing, and much of the debt that is held is actually inter-company funding.

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[2] Competition Commission, "Profitability of Payday Lending Companies", see figure 10.

[3] Competition Commission "Customers and Their Loans – Presentation Based on Analysis of the Transaction Data", see slide 36.

4.3 But this risk of business failure needs to be kept in context, as just about any technology-based start-up in a rapidly changing, innovative and competitive sector is going to be a risky venture. As long as the "expected" future profitability[4] is sufficient to cover the required returns to investors, then this should not pose a significant barrier to entry.

4.4 There has been considerable entry into this sector over the past five years, which emphasises the lack of barriers to entry.

4.5 CashEuroNet is concerned, however, that an inappropriately low price cap, in combination with other restrictive regulations enacted by FCA, could create a very significant barrier to entry and expansion. It could mean that investors could not expect future profitability to be sufficient to cover the cost of capital, particularly given the uncertainty around future default rates faced by any payday lender. Arguably this would not be a barrier to entry, but rather a barrier to lending, affecting new entrants and incumbents alike.

5 REPUTATIONAL RISK

5.1 CashEuroNet understands that the under-provision of financial services by banks to sub-prime customers (those with relatively low or volatile incomes or poor credit histories) has been a long running issue in the UK and the fundamental reasons for this may not change. Sub-prime customers provide very limited scope for banks to cross-sell other products and thereby spread acquisition costs, so therefore are unlikely to become a focus for mainstream lenders, even in the absence of negative political and media attention on the sector.

5.2 However, companies with experience of providing similar products may well enter the market, and there is recent evidence of this. For example:

5.2.1 Provident Financial (home credit lender) entered the ‘medium’ term online instalment loan business with Satsuma Loans, which competes directly with Pounds to Pocket; and

5.2.2 Other lenders are providing guarantor loans (e.g., Amigo loans) or loans secured on vehicles (log book loans), which are aimed at payday loan customers; some of these competitors to payday loans compare their rates to payday loans.[5]

6 IMPACT OF REGULATION ON RELATED PRODUCTS

6.1 Whilst the changing regulatory framework is likely to increase barriers to entry and expansion in payday lending and could, in particular, promote reduced lending / exit from payday lending (as described in section 1 above), it is the view of CashEuroNet that barriers to entry remain sufficiently low for relatively rapid entry and expansion to continue in this dynamic sector (assuming the cost of credit cap is not set below market rates). Entry into the market for short term loans has continued, despite the recent increased regulatory pressure.

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[4] This would be the probability-weighted average of different possible outcomes, including down-side risks of making losses.

[5] For example, Logbook Loans Direct uses the main marketing message of “Lower APRs than Payday loans!” on its website, http://logbookloansdirect.uk.com/

6.2 We also expect increased competitive pressure from products excepted from the FCA high-cost short-term credit rules. As stated in the FCA's PS14/3 detailed rules for the FCA regime for consumer credit, various competing products will be excepted from the rules for high-cost short-term credit, namely any product:[6]

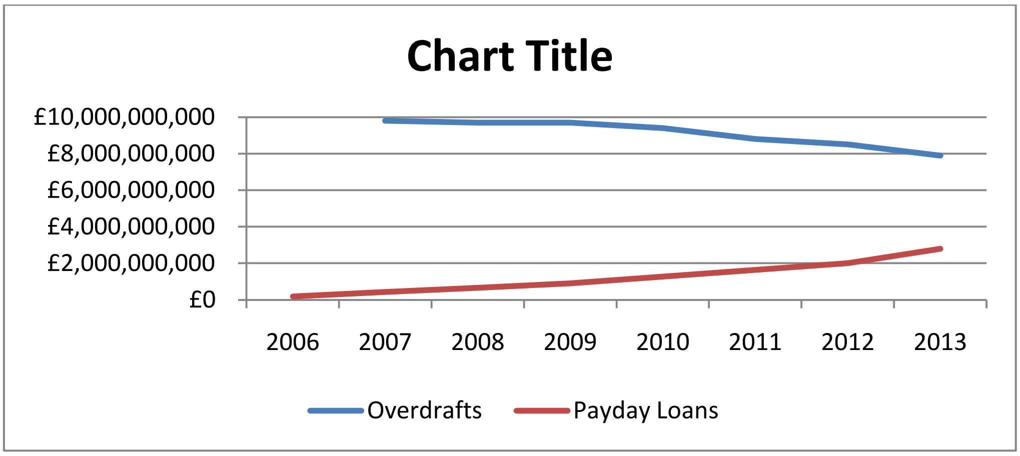
> "*which is not secured by a mortgage, charge or pledge; and which is not a home credit loan agreement, a bill of sale loan agreement or a borrower-lender agreement enabling a borrower to overdraw on a current account or arising where the holder of a current account overdraws on the account without a pre-arranged overdraft or exceeds a pre-arranged overdraft limit.*"

6.3 The FCA went further in regards to unauthorized overdrafts:[7]

> "*We have, however, clarified that the provisions on creditworthiness and affordability do not apply to overrunning (i.e. unauthorised overdrafts).*"

6.4 Unauthorised overdrafts have experienced decline in recent years, as described in Figure 2 below. In light of these regulatory advantages, we expect that bank overdrafts will reverse their decline in market share over the coming years.

Figure 2
Comparative numbers of payday loans and bank overdrafts (authorised and unauthorised) in the UK



Source: CashEuroNet[8]

6.5 Further growth can also be expected from competitors offering secured logbook loans and pawn loans. It is expected that some current payday lenders may shift products to excepted products and that payday lenders that offer pawn services may more heavily emphasise their pawn businesses (e.g. Cash Converters and Harvey & Thompson). Whilst the regulations may not create significant barriers to entry into payday lending, they do create or expand opportunities for competing products.

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[6] Section 5.3 at page 45.
[7] Section 4.10 at page 36.
[8] The chart was complied from data published by the British Bankers Association, OFT and Competition Commission hearing on Home Credit.

6.6 Finally we should like to highlight the potential negative impact on longer-term lending of the proposed regulatory regime for payday loans. [**CONFIDENTIAL**]. In this circumstance, a barrier to entry will be created in the market for longer-term loans with interest rates lower than payday loans. Consumers will miss out on attractive features not offered by more "traditional" products.

7 CONCLUSION

7.1 We would be grateful for the CC taking account of these comments and concerns in its analysis of the market.