COMPETITION COMMISSION

PAYDAY LENDING MARKET INVESTIGATION

RESPONSE OF WONGA GROUP

TO ANNOTATED ISSUES STATEMENT

28 FEBRUARY 2014

TABLE OF CONTENTS

1. EXECUTIVE SUMMARY

1.1 This submission sets out Wonga Group Limited's (**"Wonga"**) response to the Competition Commission's (**"CC"**) Annotated Issues Statement (**"AIS"**) and the working papers as published on 31 January 2014. Wonga reserves its position to make further representations on working papers received since 31 January 2014. To the extent that Wonga makes subsequent representations on issues raised in those working papers, this paper should be read in conjunction with those further submissions.

The short-term credit market is dynamic and constantly evolving and exhibits vigorous competition through product innovation as well as on price

1.2 A variety of short-term credit products have emerged to form a continuous chain across loan duration and loan amount which "fills the gap" between traditional payday loans and longer-term, higher value, credit products. Customers can (and do) choose between a wide range of products which are capable of providing small sum cash loans to cover unexpected costs including products offered by banks, credit card providers, home credit providers, credit unions, high street lenders and online lenders.

1.3 There is compelling evidence of competitive interaction between providers of these products. Wonga has taken significant risks to transform an untested online product (supported by a novel technology platform) into a challenger to more established short-term credit providers. These providers have been forced to respond by developing new, more flexible products or adapting existing products. For example, Provident Financial plc (a home credit provider) has launched an online loan product, peer-to-peer lenders are offering smaller value loans for shorter durations (which are also online) and banks are improving transparency, accessibility and ease of use (including through "sliders" and mobile phone applications), as well as launching small sum, shorter-term personal loan products.

1.4 This, in turn, is forcing Wonga and others (including new entrants) to respond. The rate of growth in the payday segment is slowing (as acknowledged by the CC) and payday lenders must compete vigorously for a share of a decreasing population of new payday customers, which they must then work hard to retain given high rates of churn. This reflects a number of factors including customers finding alternative forms of credit, customers switching to new products, such as instalment loans, as well as customers switching to rival payday lenders.

1.5 Gross revenues for the three largest entities in the last 12 months have either decreased or remained flat. There is also evidence of market share instability amongst online lenders. Dispersion in returns across the sector is clearly consistent with a competitive market that has been in its growth phase, as well as with variations in the efficiency of different business models.

1.6 Non-price competition has been acknowledged by the CC, although the evidence indicates that there has been significantly more than the "some" described by the CC. A number of innovations have revolutionised the short-term credit market and many are being incorporated into a variety of short-term credit products, including the online customer interface (for example, upfront transparency and loan self-management tools), mobile accessibility and the faster repayment service.

1.7 Wonga has made significant improvements to its Little Loans product [CONFIDENTIAL] in order to improve its competitiveness to customers seeking more flexible, and [CONFIDENTIAL], arrangements providing compelling evidence of a wider market definition encompassing a range of short-term credit products.

1.8 Wonga's pricing model offers increasingly competitive prices over progressively shorter loan terms and customers choose Wonga over rivals for shorter-term loans (i.e. for loans of 15-18 days as compared to an industry average of 22 days). More generally, lenders seek to gain competitive advantage through their charging structures and customers respond to this by self-selecting the product which best serves their needs. The simplicity and transparency of Wonga's prices has also been a distinguishing feature which is valued by customers.

1.9 Whilst this pricing strategy has been successful historically, Wonga is [CONFIDENTIAL] strong competitive threat [CONFIDENTIAL]. In particular, existing and emerging rival products are more competitive than Wonga's product for loans of longer duration (i.e. more than 15-16 days). Wonga faces strong competition from products such as [CONFIDENTIAL] which has adopted the same charging structure as Wonga (albeit at lower prices) and offers repayment flexibility including over longer durations.[1] [CONFIDENTIAL].

1.10 In light of this continued product innovation and competitive leap-frogging, the CC must ensure that its analysis properly reflects the full range of competing products within the short-term credit market, otherwise its analysis will be based on models of lending which are rapidly becoming outdated and less relevant. Further, in dynamic and evolving markets where product boundaries are blurred, there are significant risks that any remedies will dampen existing competitive constraints, distort competition (both between existing players and between incumbents and new entrants) and undermine incentives to invest. Moreover, the CC has yet to consider specifically the vast body of evidence which points to high levels of satisfaction amongst payday customers, which provides a direct clear indication that customers' requirements and demands are being met.

The characteristics of online payday customers do not indicate vulnerability or dependence and shopping around actively takes place

1.11 Wonga's research, and that of Bristol University,[2] has identified that online customers tend to be younger, have higher incomes, have access to other mainstream credit options and are less likely to be in financial difficulties. The CC's own survey finds that certain customer types have a much higher propensity to (only or mainly) use online lenders: those on middle and higher incomes; those educated to degree level or higher; full time workers and younger customers. There is also evidence of stronger engagement by online customers as regards, for example, higher levels of shopping around and more pro-active management of loans, for example, through early repayment.

1.12 A credible body of evidence supports the existence of shopping around by a significant proportion of customers. Moreover, Wonga considers that this level of shopping around at this level is consistent with effective competitive constraints given that the behaviour of customers that actively shop around is an important factor driving Wonga's business strategy to the benefit of less active customers. In this regard, Wonga does not price discriminate (promotions affect only a small proportion of loans and are not limited to particular customer types).

1.13 As regards short-term loans and repeat borrowing, customers have multiple opportunities to switch and gain experience of different lenders. Accordingly, payday loans are very different from longer-term and more complex financial products such as pensions and mortgages, where decisions are made infrequently.

1.14 The evidence does not support the hypothesis that customers may be less inclined to shop around due to the importance attributed to speed or a lack of perceived benefits from

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1 Other instalment loan and open ended credit agreement products include: Zebit short-term cash loan (Lending Stream), Zebit's instalment loan (Lending Stream), Genie 3 month loan (Ariste), Speedy Cash Flex Loan (SRC), Speedy Cash Flex Account (SRC), Pounds to Pocket (CashEuroNet), and Harvey and Thompson's Kwikloan.

2 The impact on business and consumers of a cap on the total cost of credit, Personal Finance Research Centre University of Bristol, 2013 ("**Bristol University Research**").

shopping around. Speed is important to some but not all customers and even where it is valued, online searching does not introduce any material delay, and any delay will be weighed against the advantages of getting the best deal in any event.

1.15 The availability of, and ease of access to, key information on lenders' websites is acknowledged by the CC, as is the relatively straightforward nature of the product. Customers have also confirmed that they have access to clear information. As regards any difficulties in comparing charges, Wonga notes that comparison sites already exist and it would be straightforward to ensure that standard measures of the cost of borrowing can be readily compared across a range of short-term credit products including other forms of credit.

1.16 Customer engagement is further illustrated by Wonga's research which indicates that [CONFIDENTIAL] of its inactive customers are switching to payday rivals ([CONFIDENTIAL] per cent), with [CONFIDENTIAL] per cent using some other form of lending product. There is therefore little support for the CC's hypotheses regarding barriers to switching. Where customers choose not to switch, this is likely to be due to satisfaction with their existing lender (with lenders competing hard to secure this loyalty). The CC's own survey indicates that 61 per cent of respondents who had not considered going to a different lender indicated that this was because they are happy with the service provided by the current lender. Further, Wonga does not see incentives offered by lenders to repeat customers as creating material barriers for rivals.

The evidence does not support a theory of harm based on the existence of barriers to entry or expansion

1.17 A review of the recent pattern of substantial entry and expansion clearly demonstrates that barriers to entry and expansion are low. In this regard, the CC itself has identified a large number of both "*major*" and "*smaller*" lenders that have entered the payday lending segment. This level of entry (at least 11 major lenders since Wonga's entry and approximately 43 instances of smaller entry recorded between Quarter 2 2010 and Quarter 3 2013) is extraordinary on any measure but particularly in relation to financial services, where entry has generally been limited. Wonga notes that entry can (and does) occur in a sufficiently small timeframe to constrain incumbents (i.e. less than one year). The CC's analysis also underestimates the extent of new entry to date as a significant number of other instances of entry and expansion have not been captured in the CC's data.

1.18 The evidence collated by the CC does not support a finding that relevant business characteristics constitute barriers to entry. Further, the CC has failed to acknowledge a range of developments and associated factors which assist new entry and expansion compared to the situation facing first movers such as Wonga (including, recent developments in the quality and specificity of CRA data, and the availability of off-the-shelf software packages to support a loans business).

Conclusion

1.19 Unlike other, more mature, financial services markets reviewed by the CC, the market for short-term credit is dynamic and rapidly evolving with the emergence of many new competitors, a range of new products, the refinement and evolution of existing products, and technological change. There has also been innovation in pricing structures, for example, QuickQuid's risk-based pricing model.

1.20 Wonga expects to see stricter enforcement of current regulatory standards enshrined in consumer credit and consumer protection legislation in light of the Financial Conduct Authority's (**"FCA"**) new role in relation to consumer credit. This tougher regime will make it harder for entities which have adopted business models which are non-compliant with the regulatory framework to operate sustainably (although Wonga does not consider that tougher regulatory measures will raise barriers for credible entrants). New entrants will succeed where they stay ahead of the regulatory curve by designing high quality products which are both compliant and consumer-focused.

1.21 In dynamic markets, however, there are significant risks associated with over-regulation, in particular where regulation seeks to control outcomes (such as capping prices). Whilst Wonga appreciates that the FCA now has a legislative duty to introduce a cap on the cost of credit for high-cost short-term credit agreements, the risks that competition will be distorted and/or muted are significant. There are also significant specification risks associated with such remedies, particularly given the blurring of product boundaries outlined above. Wonga, therefore, welcomes the CC's intention to scrutinise the regulatory proposals which have been announced in order to ensure that the risks of adverse impacts on competition and the loss of customer benefits are minimised.

1.22 Wonga notes that the CC has powers to make recommendations to other public bodies and Wonga envisages that the CC would use this power to challenge any proposal which the CC considers will "strengthen" a market feature considered to lead to an adverse effect on competition (for example, barriers to entry).

2. SCOPE OF THE CC INVESTIGATION: DEFINING A PAYDAY LOAN

2.1 In the AIS, the CC seeks to "define" a payday loan. In this connection, Wonga notes that:

(a) the CC's definition of payday loans is broader than that used in the Issues Statement. The CC explains this change as follows: "*The revised definition is to capture products at the edge of what might be considered a payday loan, such as 12-month loans or loans where the amount borrowed may in many instances be £1,000 or more…but which nonetheless are similar in concept to other payday products within our terms of reference*".[3] Wonga notes that the CC includes within its scope the Pounds to Pocket instalment product which allows customers to take a loan of up to £2,000; and

(b) the CC intends to consider: (i) any variation in competition between lenders of payday products (e.g. between shorter- and longer-term products); and (ii) "*the competitive constraint presented by lenders offering products that fall outside of this definition, (for instance other types of credit)*."[4]

2.2 In this section, Wonga addresses two points:

(a) Wonga welcomes the CC's intention to adopt a more flexible definition which allows it to explore the impact of recent trends but is concerned that despite the broader definition: (i) relevant longer-term products have been largely excluded from the CC's analysis; (ii) certain products which fall within the CC's parameters have not been considered in any detail; and (iii) certain products which fall outside of the CC's parameters are nevertheless providing important competitive constraints on payday loans providers because their repayment terms allow them to be used for short-term borrowing, and therefore should form part of the CC's assessment; and

(b) in a market which is evolving rapidly, attempting to draw “bright lines” in relation to product market boundaries is very difficult, and there are significant risks that any remedies adopted on such a basis will undermine incentives to innovate and will themselves distort competition.

A. The CC's limited consideration of existing and emerging innovative products

2.3 Wonga welcomes the CC's intention to adopt a more flexible definition which allows it to explore the impact of recent trends. Wonga considers that, increasingly, the distinctions between credit products based on product characteristics are blurring as the market evolves. More specifically, many products have emerged to "fill the gap" between short-term payday loans (of a month or less) and longer-term products offered by other non-standard credit providers (e.g. home credit) as well as mainstream credit providers (e.g. credit cards and personal loans).

2.4 [CONFIDENTIAL]

Figure 1: [CONFIDENTIAL]

2.5 It is clear that these products are establishing a continuous chain across loan duration and loan amount. There is some acknowledgement of this trend in the AIS and certain of the working papers. For example:

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[3] *Payday loan products* working paper, paragraph 9. The definition is *"short-term unsecured credit products which are generally taken out for 12 months or less, and where the amount borrowed is generally £1,000 or less. Home credit loans agreements, credit cards, overdrafts, credit union loans and retail credit are all excluded"* (paragraph 8).

[4] *Payday loan products* working paper, paragraph 11.

(a) the CC acknowledges the emergence of products that allow an individual to borrow for longer periods and to make repayments in instalments;[5] and

(b) the AIS reaches the view that there has been "*some competition between lenders on non-price loan attributes in the period since 2008*"[6] in part due to evidence on product innovation namely "*a number of lenders have introduced the facility for customers to draw down further funds during the term of a loan; although they remain only a small proportion of the loans offered by the lenders we considered, instalment loans are becoming increasingly available and a number of lenders have introduced either loans specifically designed to be repaid in instalments or the option to do so*"[7] (emphasis added).

2.6 Wonga is concerned, however, that despite the broader definition adopted by the CC and the intention to investigate products with instalment repayment or credit line flexibility:

(a) the longer-term products which the CC has identified as falling within its definition are largely excluded from its analysis of transaction data and its analysis of pricing.[8] As discussed further in the sections below, the CC excludes long-term products from its analysis of repeat borrowing because it would "*skew the results*".[9] As regards the analysis of prices over time, the CC has identified borrowers using relatively longer-term instalment products for borrowing needs of less than one month (by agreeing to a long-term loan but repaying early) but has not, however, included instalment products in its analysis;[10]

(b) certain short-term credit products which fall within CC's parameters of "generally" 12 month or less and "generally" £1,000 or less have not been examined in any detail, including a peer-to-peer lending product (RateSetter), a guarantor loan (Amigo Loans), an online product recently launched by home credit provider Provident Financial (Satsuma) and further online loan products (Everyday Loans and Peachy). These products are described in the table at Annex 1; and

(c) certain longer-term products which offer loan terms and loan amounts beyond the CC's revised definition have not been examined in any detail despite the fact that many of these have early repayment terms allowing them to be used for shorter-term borrowing requirements (for example, instalment loans such as Peachy and 118 118 Money, peer-to-peer loans such as Zopa and AvantCredit's SpringCoin). These products are described in the table at Annex 1. These are highly relevant given that the CC has observed early repayment of longer-term loans in relation to the products it has chosen to include.

2.7 [CONFIDENTIAL]

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5 *Payday loan products* working paper, paragraph 23.

6 AIS, paragraph 64.

7 AIS, paragraph 62, first and second bullet points.

8 Wonga is also unclear whether the CC has correctly measured the overall loan value attributable to longer term products. For the sample of loans analysed by the CC, the value of loans attributable to longer term products in 2012 is indicated as £59 million (*Customer and their loans - presentation based on analysis of the transaction data*, slide 6). Cash America states in its filing to the Securities Exchange Commission that it lent approximately £84 million in relation to its longer term products, which Wonga believes is entirely attributable to the UK because, outside the US, Cash America is understood to only offer instalment products in the UK (see Cash American FORM 10-K SEC filing for the fiscal year ended 31 December 2012, page 68, www.cashamerica.com/Files/Annual%20reports/Cash_America_2012_Annual_Report.pdf).

9 *Repeat customers – presentation based on analysis of the transaction data,* slide 16.

10 *Payday lending price over time* working paper, slide 4.

B. The risks associated with remedies in markets which are evolving rapidly

2.8 In dynamic and rapidly evolving markets where product boundaries are blurred, there are significant risks that any remedies that are adopted will undermine incentives to innovate and will themselves distort competition. This is because the appropriate scope of any remedies will be unclear and there will be a risk of creating an unlevel playing field not only between existing competitors but also between incumbents and new entrants. In particular, there is a risk that any remedy which undermines the incentives of payday lenders to offer loans and evolve their products will dampen the competitive constraint exerted by payday lenders on a wide range of other short-term credit products.

2.9 The CC acknowledges specification risks relating to remedies designed to control outcomes in its market investigation guidelines. It states: "*Defining appropriate parameters for the control measure—for example, the level of a price cap—may be complex and, in some cases impractical, and the measure may therefore be vulnerable to specification risks. This is especially likely where any of the following conditions apply:… Products or services are differentiated rather than homogeneous; this may increase the complexity of any control in order to capture adequately the diversity of products offer…Supply arrangements and products are subject to significant ongoing change, which require the control measure to change to reflect new developments*"[11] (emphasis added).

[11] CC3 (Revised) — Guidelines for market investigations: Their role, procedures, assessment and remedies, April 2013, paragraph 88 of Annex B: Remedial Action.

3. MARKET DEFINITION

3.1 In this section, Wonga:

(a) outlines the range of products which provide customers with small sum cash loans;

(b) summarises the evidence which Wonga has provided to the CC on the competitive interaction between these products and further evidence of competitive interactions in situations of "natural experiments"; and

(c) addresses the evidence relied upon by the CC in reaching its preliminary views on market definition. Wonga considers that this evidence is deficient in numerous respects. A full response to the CC's preliminary position is provided at Annex 2.

A. Products which provide small sum cash loans

3.2 Wonga summarises in Table 1 below the products which are capable of providing small sum cash loans to cover unexpected costs (those which are highlighted fall within the CC's current definition of a payday loan). Notwithstanding the slightly broader definition of a payday loan now adopted by the CC, it is still focusing on an overly narrow set of products defined by characteristics which are evolving as dynamic competition forces existing products to change and new products to emerge. The wider set of products outlined in this table must form part of the CC's competition assessment. Figure 2 below provides an indication of the variety of brands which exist within the unsecured lending market.

Table 1: Small sum cash loan products

Banks	Authorised overdrafts
	Unauthorised overdrafts
	Short-term unsecured loans (e.g. HSBC Flexiloan)
Credit card providers	Range of products which allow deferral of payment from month to month
Home credit	Cash to the door
	Online products (e.g. Provident Financial's Satsuma product)
Credit unions	Offline lending (underwriting in a brick and mortar location)
	Online lending (e.g. 6 Towns Credit Union)[12]
High street lenders	Pawn brokers
	Unsecured loans
Online short-term lender	Unsecured payday lenders
	Instalment loans with early repayment option (e.g. Pounds to Pocket, Peachy, 118 118 Money, Avant)
	Line of credit (e.g. FlexCredit, Sunny)
	Guarantor loans (e.g. Amigo Loans)
	Peer-to-peer loans (e.g. Rate setter, Zopa, AgreeIt)
	ClearAccount directly addresses the excessive overdraft fees by linking to customers' bank current accounts and lending money as a line of credit when balance falls below authorised level.
Friends and family	Loans
	Acting as guarantors
Hybrid loan products	Loan products which mix characteristics of short-term loans and guarantor loans (e.g. mymate.co.uk)

Figure 2: [CONFIDENTIAL]

12 6 Towns Credit Union offers "payday loans" through online application at https://sixtowns.securecu.co.uk/d1db78c186/secure.asp? The union explicitly mentions Wonga as a competitor and compares its own loan offering in terms of APR and total amount repayable to Wonga's: http://www.sixtowns.co.uk/content.asp?section=116

B. Evidence on competitive interaction provides a strong indicator of wider competitive constraints

3.3 Wonga has taken significant risks to transform an untested online product (supported by a novel technology platform) into a challenger to a range of short-term credit providers (including mainstream products). These providers have been forced to respond, in turn forcing Wonga and others (including new entrants) to respond. Wonga considers that this provides compelling evidence supporting a wider market definition encompassing a wide range of short-term credit products. Wonga notes, in this regard:

(a) the CC's own third party evidence provides a number of important indicators of competitive interaction;

(b) the CC has failed to give sufficient weight to evidence provided by Wonga showing how providers within the short-term credit market have developed new, more flexible products or adapted existing products to offer greater flexibility and accessibility in response to the success of certain payday lenders (in particular Wonga);

(c) the CC has failed to consider wider evidence of competitive interactions in situations of "natural experiments"; and

(d) the CC has given insufficient consideration to evidence that Wonga's commercial behaviour is influenced by the actions of other credit providers.

Indicators of competitive interactions in third party evidence provided to the CC

3.4 There are a number of indications in the third party evidence provided to the CC that there are competitive interactions between payday loans and a wide range of products, for example:

(a) Provident Financial (a home credit provider) told the CC that it had updated and modernised its home credit offer "*in response to the general trend in customer behaviour and preferences for greater convenience, speed and online interaction*";[13]

(b) Capital One (a credit card provider) told the CC that it had tested two credit card products "*as potential alternatives to, and partly in response to, the growth of payday lending*";[14]

(c) Lloyds Banking Group told the CC that "*it had reacted to the growth of payday lending by undertaking research into why customers made use of payday loans and was giving consideration to what this might mean for its product suite*";[15]

(d) Mobilemoney (a logbook loan provider which provides credit secured against a customer's car) indicated that "*the growth of payday lending was adversely affecting its business for loans of £200-£1,000*";[16] and

(e) Leeds City Credit Union indicated to the CC that "*it was trying to win customers from payday lenders, working with local partners and media to raise its profile*". It

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13 *Competition between payday lenders and other credit providers* working paper, paragraph 51. Wonga presumes that Provident Financial is referring to the launch of its online product (Satsuma) which offers unsecured loans for 13 or 26 weeks with weekly repayments.

14 *Competition between payday lenders and other credit providers* working paper, paragraph 49.

15 *Competition between payday lenders and other credit providers* working paper, paragraph 48.

16 *Competition between payday lenders and other credit providers* working paper, paragraph 49.

also noted that "*speed was important to payday loan customers and it was under pressure to change its approach*".[17]

The CC has failed to give sufficient weight to evidence provided by Wonga showing competitively driven innovation across the product spectrum

3.5 Wonga has provided a range of evidence to the CC to show how distinctions between payday loan products and other credit products are blurring and how products across this wider spectrum are adapting to incorporate the successful features of the short-term loan products pioneered by Wonga, for example, in relation to online access (including on mobile devices) and use of online tools to increase transparency and improve customer service. For example:

(a) Banks. Banks are improving their products by introducing (or improving) product and service features which are popular and which drive demand in the payday segment, for example:

(i) improvements to transparency and ease of use by allowing customers to select loan amount and loan duration using "sliders". All the leading UK retail banks (including Lloyds Bank, Barclays Bank, RBS Group/NatWest, Santander, Nationwide, Co-Op Bank and TSB) now use almost identical "sliders" on their websites to those pioneered by Wonga to allow their customers to choose loan duration and loan amount for their personal loan products.[18]

(ii) improvements to online and mobile accessibility for customers. The major banks have developed their own mobile phone applications. This began with Barclays' Pingit in 2012 (an application available on Android, Blackberry and iPhone devices which allows users to check balances and instantly send and receive funds using their mobile phones), but the other leading banks have since followed with their own mobile banking applications;[19]

(iii) banks have unique access to vast amounts of customer data and also use analytics to refine their lending rules and assess post-lending performance. The evidence submitted to the CC by the banks[20] indicates that banks can and do perform analysis of those among their customer base which use payday loans and are therefore well placed to offer products which appropriately reflect these customers' requirements. The willingness of HBOS to lend to payday customers is acknowledged by the CC and Barclays has indicated to the CC that it will also provide credit (subject to, at present, manual checks);[21] and

(iv) certain banks, such as HSBC, are now offering products which compete even more directly with payday loans. For example, HSBC's Flexiloan product offers HSBC current account customers loans of between £500 and £5,000 (in increments of just £10) for a minimum of one month, subject to the bank's assessment of the customer's personal financial circumstances. Customers apply via phone or in branch.

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17 *Competition between payday lenders and other credit providers* working paper, paragraph 50.

18 Examples of such sliders used by Lloyds Bank and Barclays Bank were provided at paragraph 4.24 of Wonga's Response to the Issues Statement.

19 The following banks, for example, have introduced mobile banking applications for multiple operating systems: Barclays, NatWest/RBS, HSBC, Lloyds Bank, TSB, First Direct, Santander and Halifax.

20 *Competition between payday lenders and other credit providers* working paper, Annex 3.

21 *Competition between payday lenders and other credit providers* working paper, Annex 3, paragraphs 1 and 5.

(b) Credit card providers. These companies are deploying big-data and credit adjudication solutions to improve their customer risk assessment process. In addition, these entities are also adapting their products to meet the needs of payday customers. For example, Capital One told the CC that it had tested two credit card products "*as potential alternatives to, and partly in response to, the growth of payday lending*".[22] Vanquis now offers (for a monthly fee) a repayment option plan which provides a degree of flexibility to help its customers meet short-term unexpected borrowing requirements, for example, by allowing them to take a payment holiday in a month of their choosing (once a year), and to miss a payment without adverse credit reference consequences (once a year).[23]

(c) Home Credit. As noted above, Provident Financial (a home credit provider) launched in the first half of 2013 an online cash loans product called "Satsuma", which offers short-term loans which must be repaid over 13 to 26 weeks in weekly repayments. Provident has told the CC that "*its home credit offer did compete at the margins with payday lending*".[24]

(d) Peer-to-peer lenders. The peer-to-peer lending model is rapidly evolving including by offering smaller value loans for shorter durations. RateSetter, for example, has a minimum loan amount of £1,000 and a maximum of £25,000 and customers may borrow for a minimum of 6 months to a maximum of 60 months (and therefore it offers loans within the CC's duration specification and at the edge of the loan amount specification). Peer-to-peer lending has grown rapidly and this is expected to continue. Some high profile commentators (in particular David Haldane, director of financial stability at the Bank of England) have highlighted the disintermediation threat which peer-to-peer lending poses for banks through the use of digital technology to bridge the information gap between lenders and borrowers. The segment has seen strong recent growth and this is expected to continue. According to a recent Mintel report, the peer-to-peer lending market has grown and accounted for loans worth £200 million in 2012.[25] Elaine Moore at the Financial Times reported that "*the market will be worth £1bn by 2016 if it continues to grow at its current speed, research by the Open Data Institute and supported by the Bank of England predicts*."[26]

(e) Credit unions. As noted above, credit unions are increasing their efforts to offer an alternative to payday loans. For example:

(i) FutureGov, a social innovation and technology company, has embarked on developing Popcash - a "*secure mobile product that enables people to access low interest loans from responsible lenders, such as credit unions, to rival high-interest payday lenders*";[27]

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22 *Competition between payday lenders and other credit providers* working paper, paragraph 49.

23 See http://www.vanquis.co.uk/credit-cards/vanquis-repayment-option-plan

24 *Competition between payday lenders and other credit providers* working paper, paragraph 51.

25 Mintel, "Personal Loans - UK, January 2013", page 45. *"P2P lending has shown more than enough promise to ensure that its longevity and expected market growth are assured. According to the CEO of Zopa, the number of customers using peer-to-peer lending is set to double in 2013. Peer-to-business lending is also taking off and in December 2012 the government awarded £10 million to Zopa as part of a scheme to promote lending to small businesses. Diversification of the industry involves an element of risk, however it should help the market to grow further."*

26 Financial Times, "Digital finance lending set to hit £1bn" (July 15, 2013). *"Although the peer-to-peer market accounts for a fraction of consumer credit and will not be regulated until 2014, it has attracted powerful champions in recent years including Vince Cable, business secretary and Andy Haldane, executive director of financial stability at the Bank of England."*

27 See http://wearefuturegov.com/2013/10/introducing-popcash-a-simple-app-for-complicated-personal-finances/

(ii) London Mutual Credit Union has recently launched a product which allows online application.[28] The website features sliders and includes a comparison of the cost of borrowing from CUOK and from a typical payday lender;[29]

(iii) 6 Towns Credit Union,[30] West Sussex Credit Union[31] and HertSavers Credit Union[32] are some of the credit unions which already offer payday loans through online application;

(iv) My Community Bank, an online platform recently established by Brent Shrine Credit Union, will soon allow customers across the country to manage their account online for both saving and borrowing needs;[33] and

(v) Partners Credit Union[34] and Coastal Credit Union[35] make their application forms available online, so that customers can apply for payday loans by post.

(f) Guarantor loans. Entities such as Amigo Loans and GBP Loans have emerged in recent years to offer unsecured loans where a third party acts as a guarantor. These are online entities with similar customer interfaces to online payday lenders (for example, Amigo Loans uses sliders) with funds paid directly into customers' accounts (following credit checks performed in relation to the guarantor).

The CC has failed to consider wider evidence of competitive interactions in situations of "natural experiments"

3.6 The CC has failed to consider the evidence of competitive interactions in situations of "natural experiments", for example, where the impact on customer demand can be examined in circumstances where the supply of payday lending is constrained. Such experiments are possible in the USA because some States have prohibited payday lending.

3.7 Economic research published by the Federal Reserve Bank of New York[36] seeks to understand the nature of the interaction between payday loans and overdrafts by examining the effects of: (i) changes in the availability of payday loans (i.e. decisions by states to prohibit, or to allow, having previously prohibited, payday lending); and (ii) the effects of variation in banks' proximity to areas where payday loans are available. The study found that:

(a) payday loans are cheaper than overdrafts for at least half of depositors;[37]

(b) overdrafts and payday loans are "at least partial substitutes"[38]; and

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28 The loan facility is exclusively for people who live or work in Southwark, Lambeth, Westminster or Camden.

29 See https://www.cuonline.org.uk/PDL/Default.aspx?CU=LMCU

30 See footnote 12 above.

31 See https://www.westsussexcreditunion.org.uk/apply

32 See https://hertsavers.securecu.co.uk/a2f4155556/secure.asp?section=17

33 See https://www.mycommunitybank.co.uk/home/

34 See http://www.partnerscreditunion.co.uk/content.asp?section=61

35 See http://www.coastalcreditunion.co.uk/wp-content/uploads/DRAFT-Loan-Application-Form-Nov-20111.pdf

36 *Competition and Adverse Selection in the Small-Dollar Loan Market: Overdraft versus Payday Credit*, Federal Reserve Bank of New York Staff Reports, Staff Report no. 391, September 2009 (Revised December 2009) (the **"Federal Reserve Bank Research"**), provided at Annex 5.

37 Federal Reserve Bank Research, page 1..

38 Federal Reserve Bank Research, page 4.

(c) increased availability of payday loans affects overdraft fees and average loan size, due to the adverse selection that banks face as consumers of smaller overdrafts switch to payday loans.

3.8 This evidence is consistent with there being competitive interaction between overdrafts and payday loan products. In particular, an identifiable change in the conditions for overdraft borrowing is noted in areas where payday loans are permitted or accessible, compared with other areas. The banks' competitive response, which is to raise overdraft fees in areas where payday loans take some of their business, might on the face of it appear counterintuitive. This is, however, consistent with the close degree of substitution between payday loans and overdrafts for at least a proportion of customers (those with shorter duration borrowing requirements). The banks suffer a fall in shorter/smaller overdraft loans, and therefore the proportion of larger/longer overdrafts rises. This reduces the profitability of bank overdrafts at the original price, given the fixed fee structure for overdrafts, leading them to raise fees to residual customers to reflect the increased costs associated with overdraft borrowing.

Wonga's commercial behaviour is influenced by the actions of other credit providers

3.9 Wonga's entry was motivated by the desire to challenge existing credit providers by providing a better offer to customers who were poorly served, in particular, by offering a more transparent and flexible product which suits the need of customers. This objective remains central to Wonga's strategy and Wonga therefore monitors developments amongst the traditional lending institutions which might improve their relative attractiveness, and seeks to highlight its own competitiveness relative to other products. In this regard:

(a) Wonga has provided details to the CC of the comparisons it undertakes with other credit products to ensure that its product is considered to deliver value for money (taking into account all product characteristics) relative to rivals. [CONFIDENTIAL];[39] and

(b) [CONFIDENTIAL].[40]

C. The evidence relied upon by the CC to support its preliminary views on market definition is deficient in numerous respects

3.10 In the AIS, the CC sets out its preliminary thoughts on product market definition as follows: "*we are not presently minded to define the product market as being wider than the definition of payday loans we have adopted…the evidence that we have seen suggests that other types of credit are likely to offer little competitive constraint on payday lenders*".[41]

3.11 Prior to addressing the CC's preliminary views and evidence, Wonga outlines a number of market definition considerations which are of particular importance given that: (i) it is clear from the CC's analysis of product characteristics that products within the short-term credit market are differentiated; (ii) the range of alternative sources of credit is wide; and (iii) product innovation is a key feature of the market. These considerations are as follows:

(a) it is inappropriate to focus unduly on differences in products' characteristics as delineating market boundaries. The relevant question is whether the relative attractiveness of these characteristics to marginal customers is such that other

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[39] Wonga's Response to the Market Questionnaire, paragraphs 13.8 to 13.10 and Annexes 13B, 13C and 13E.

[40] Wonga's Response to the Market Questionnaire, paragraph 28.1 and Annex 13E.

[41] AIS, paragraph 68.

products may be considered sufficiently close substitutes that switching to these products would constrain price increases;

(b) in considering the demand-side constraints faced by suppliers, emphasis should be placed on the preferences of marginal consumers. To date, the CC's analysis has not indicated any consideration of how the preferences of marginal customers might differ from average customers;[42]

(c) it is important to consider the aggregate constraint provided by all potential substitutes, particularly in circumstances where diversion might be dispersed such that switching to any single potential substitute may not satisfy the standard market definition tests. The CC appears to consider the substitutability of each credit product in isolation, rather than assessing their combined effect on payday lenders;

(d) an analysis which focuses only on direct substitution between certain products and payday loans will not capture the possible transmission of competitive constraints across overlapping product segments through switching at segment boundaries (with these boundaries becoming less distinct due to the developments described above);[43]

(e) treating particular products as being "in" or "out" of the market is over-simplistic. Whatever the final view reached by the CC on the scope of the relevant product market, it is very important that the CC continues to consider the competitive constraints imposed by other credit products as a key part of the CC's competition analysis; and

(f) it is also important to consider the possibility of competitive constraints becoming stronger as new products (which may have a relatively limited direct impact on demand for payday loans at present) become more established and further innovations, resulting in additional product launches, take place. Wonga observes in this regard, that the CC was able to reach such a conclusion in relation to the emergence of innovative and relatively untested over-the-top (**"OTT"**) services and their likely constraint on bundled packages of traditional pay TV in the *Movies on pay TV* market investigation.[44] The CC also considered that Sky's decision (in the course of the investigation) to launch its own innovative OTT offering was seen by

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42 There are examples of regulators seeking to explore this issue through empirical analysis. For example, Ofcom responded to criticism that it was not adequately focused on marginal customers in its definition of pay TV markets by extending its analysis of substitutability to consider the specific preferences of groups of subscribers who were identified as more likely – other things being equal – to be marginal consumers (although Ofcom noted that whether a consumer is marginal depends on a range of factors, including the current price of the service). See Ofcom's Pay TV Statement (31 March 2010) at paragraph 5.122.

43 For instance, the CC should specifically consider the competitive constraint between instalment loans and the range of other products (including home credit, peer-to-peer loans, guarantor loans and personal loans) which tend to have higher minimum loan duration and loan amounts as compared to payday loans and which overlap with instalment loans. It is well established that substitution across overlapping product segments can result in constraints being exercised indirectly. The European Commission Guidelines on market definition state that "[i]*n certain cases, the existence of chains of substitution might lead to the definition of a relevant market where products or areas at the extreme of the market are not directly substitutable*." (EU Commission *"Notice on the definition of relevant market for the purposes of Community competition law"* (97/C 372/03), paragraph 57.)

44 "*We then discuss in more detail the implications of the launch of the OTT services of LOVEFiLM, Netflix and Sky (Now TV) on the competitiveness of the pay-TV retail market. In our assessment we took account of the fact that, at the time of our report, there had been only a short period since the launch of the OTT services of LOVEFiLM, Netflix and Sky (Now TV), and as such there was necessarily little measurable evidence of their impact. Nevertheless, we exercised our judgement and considered their likely implications in the light of the information available. We found that, although these services had had a limited impact on demand for traditional pay-TV services to date, we expected this constraint to increase over time*" (Final report in the Movies on pay TV market investigation, paragraph 5.7).

the CC as a competitive response.[45] There are strong parallels in this case given the recent and continuing emergence of new products, and the decision by established players [CONFIDENTIAL] to launch new products in response. A forward-looking assessment of competitive constraints, therefore, and the exercise of judgement in the face of uncertainty, is essential.

3.12 The CC's preliminary view on market definition is based on the following evidence:

(a) a comparison of the functional characteristics of payday loans with those of other credit products;

(b) evidence on hypothetical switching from the CC's survey, in particular, what payday customers would have done had they not been able to take out a payday loan;

(c) evidence on access to other forms of credit;

(d) evidence of competitive interaction between payday lenders and providers of other credit products; and

(e) comparisons of prices between payday loans and other forms of credit.

3.13 Wonga considers that the CC's use of the evidence available to date is deficient in numerous respects, for the reasons set out below and in more detail in Annex 2.

The CC's comparison of products is over-simplistic and the CC has wrongly excluded borrowing from friends and family as a relevant constraint

3.14 The CC's comparison of products is over-simplistic and does not consider the preferences of marginal customers. Products with very different characteristics can constrain each other depending on how characteristics are valued and traded-off when customers make decisions (in this case borrowing decisions). For example, customers might value more highly a product which offers greater speed, convenience and control at a particular cost of borrowing but would switch to a product with different features if the differential in the cost of borrowing exceeded the value attributed to these quality and service features. Without this evidence the CC cannot draw reliable conclusions on what drives customer choices between differentiated credit products, and the nature of the trade-offs which are made between different product features.

3.15 Wonga considers that borrowing from friends and family should be considered as a relevant competitive constraint for the following reasons:

(a) borrowing from friends and family occurs within the same choice framework as for commercial products. It involves weighing up product characteristics against associated costs. Although the costs of borrowing from friends and family will be largely non-financial, switching may still be expected if the advantages of payday loans are no longer perceived to outweigh these costs;

(b) informal arrangements have been identified as exerting competitive constraints in other consumer contexts, for example, the European Commission found in *Universal Music Group/EMI Music* that digital retailers were constrained in their ability to raise prices by the threat of piracy; and

(c) this form of borrowing is evolving (like all other forms of borrowing in the short-term credit market) towards a more commercialised arrangement which is

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45 "*It appeared to us that Sky's launch of Sky Movies as an unbundled OTT product on Now TV before any other content was offered on the service was, at least in part, a response to the competitive threat from LOVEFiLM and Netflix*" (Final report in the Movies on pay TV market investigation, paragraph 5.81).

facilitated by using social network tools (for example, the "Agree It" Facebook application whereby Facebook friends can request loans from each other, for personal or business use, at mutually agreeable rates).

3.16 The CC's functional comparisons are also limited because they are backward-looking and static and therefore do not reflect key product innovations which seek to incorporate the successful and popular features of payday loans described above.

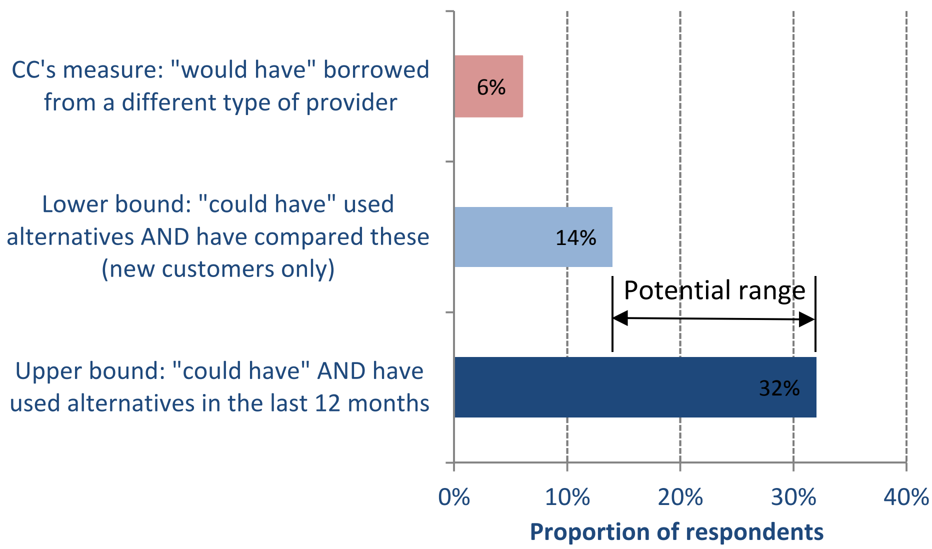
The CC places undue weight on responses to a hypothetical switching question

3.17 The CC places undue weight on responses to a hypothetical switching question which asks what payday loan customers would have done had they not been able to take out a payday loan. The responses to this question cannot be relied upon as an indicator of substitution because: (i) the question was not framed correctly; (ii) respondents were not prompted; and (iii) there are inconsistencies with other survey responses. Wonga's research indicates that many customers consider alternative sources of credit to be relevant options. [CONFIDENTIAL].[46]

3.18 The CC's survey provides indicative evidence that the proportion of marginal customers who may potentially switch to alternative credit sources could range between around 14 per cent to 32 per cent. The lower bound reflects the proportion of new customers who indicated having access to alternatives <u>and</u> who compared payday loans with at least one other credit source. The upper end of the range captures the proportion of customers who have access to, and have chosen to use, alternatives sources of credit.

3.19 These estimates of marginal customers are illustrated in the figure below.

Figure 3: Estimates of switching by marginal customers derived from TNS BMRG Survey



Sources: AIS, analysis of TNS BMRG survey

There is evidence indicating that borrowers' access to other credit products is not an issue

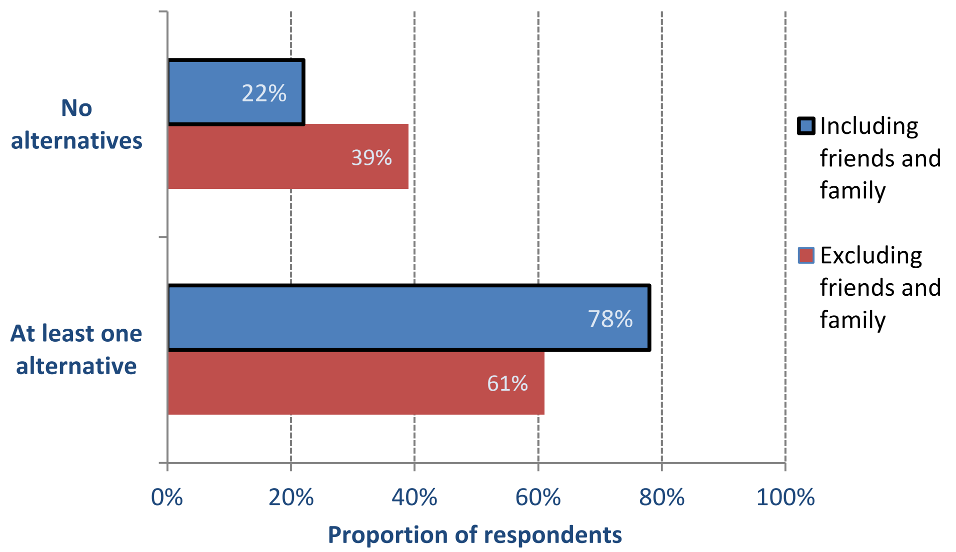
3.20 There is no suggestion in the evidence provided by non-payday loan lenders to the CC that these entities would not explore opportunities to lend to payday customers where

46 Populus Customer Survey, March 2013, slide 20 at Annex 3 of Wonga's Initial Submission.

there were commercial and profitable opportunities to do so. Indeed, they already lend by way of overdrafts, credit cards and other mainstream forms of credit.

3.21 The CC's own survey indicates that eight in ten (78 per cent) of respondents could have used at least one alternative source of credit (61 per cent if borrowing from friends and family is excluded) as shown in the figure below.[47]

Figure 4: Proportion of respondents to TNS BMRG Survey indicating use of alternative sources of credit



Source: TNS BMRG Survey

3.22 This is consistent with a range of other evidence:

(a) [CONFIDENTIAL];[48]

(b) the Bristol University Research found that: (i) 49 per cent of online customers <u>disagreed</u> that they used an online payday loan because they could not borrow from anywhere else; and (ii) 30 per cent of online customers indicated that they had used a specific form of borrowing because they could not borrow from anywhere else;[49]

(c) a Consumer Finance Association study indicates that 43 per cent of payday loan customers have access to £200 through other sources had they not taken out their payday loan;[50]and

(d) a Friends Provident, JMU and Policis report indicates that a significant majority (77 per cent) of credit users have access to other credit options.

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47 TNS BMRG Survey, page 78.

48 Populus Customer Survey, March 2013, slide 21 at Annex 3 of Wonga's Initial Submission.

49 Bristol University Research, figures 4.2, 4.3 and 4.5.

50 See http://www.cfa-uk.co.uk/information-centre/payday-facts-and-research/payday-facts-and-research/the-payday-lending-market.html

The CC's comparison of prices between payday loans and other forms of credit is of limited evidential value

3.23 Static price comparisons are limited as an indicator of substitutability in differentiated markets because, as noted above, switching between high and low price products can occur depending on how customers (in particular marginal customers) value specific product features.

3.24 In any event, the CC's price comparison methodology is limited because a number of longer-term products (e.g. peer-to-peer loans and guarantor loans) have not been considered. Moreover, for certain products which have been considered (e.g. Provident Personal Credit, a home credit product), the CC has not attempted to calculate the costs of borrowing if customers took advantage of early repayment options.[51][52]

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51 Wonga is aware, in this regard, that early repayment is an option for Provident's online "Satsuma" product (subject to approval by an agent).

52 Finally, Wonga considers that the CC has not collected enough data on certain credit options in order to ensure that its analysis reflects average market prices. Credit union, home credit and pawnbroker pricing, for example, is based on samples of one which is insufficient.

4. DEMAND AND SUPPLY CHARACTERISTICS

4.1 In this section, Wonga provides its observations in relation to the CC's description of certain aspects of the demand and supply of payday lending, namely:

(a) customer characteristics and use of payday loans; and

(b) costs and profitability.

4.2 Wonga comments on the CC's findings in respect of the size and structure of the payday sector as part of its discussion of competition in section 5 below.

A. Customer characteristics and use of payday loans

The CC has not highlighted certain key characteristics of payday loan borrowers

4.3 The CC has reported in the AIS most, but not all, of the key characteristics of payday loan borrowers which are highlighted by the TNS BMRG Survey. Important characteristics which are missing are as follows:

(a) payday loan customers are more likely to be in work than the population as a whole;[53] and

(b) payday loan customers have similar levels of education as compared to the population as a whole.[54]

4.4 Wonga also notes the finding of the TNS BMRG Survey that whilst eight in ten customers used online lenders overall, this was significantly higher among certain types of customers. In particular, a higher proportion of the following groups were found to only ever, or mainly use online lenders: those on middle income (83 per cent) and higher income (90 per cent); those educated to degree level or higher (84 per cent); full time workers (84 per cent) and younger customers between 18 and 24 (88 per cent) and 25 to 34 (86 per cent).[55]

4.5 As regards the characteristics of Wonga's customer base, Wonga has developed a customer base in the UK of just over [CONFIDENTIAL] online borrowers, all with bank accounts, debit cards and mobile phones, i.e. a customer base with characteristics which are notably different from the characteristics typically associated with vulnerable consumers. Customers using Wonga and other online providers are younger, have higher incomes, have access to other mainstream credit options and are less likely to find themselves in financial difficulties.[56]

4.6 Wonga considers that its customers, and online customers more generally, are more representative of a generation of people who have grown up with the Internet and are familiar, and comfortable, with real-time online interactions (for example, from Amazon purchases, online banking and online grocery shopping). They are comfortable using the Internet to help identify the right product and the right deal by using, for example, price

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53 TNS BMRG Survey, page 19.

54 TNS BMRG Survey, page 21.

55 TNS BMRG Survey, page 48.

56 See slide 3 of the Populus Customer Survey, March 2013 at Annex 3 of Wonga's Initial Submission. The Bristol University Research also identified online payday customers as being *"quite a different group"* compared to retail payday customers (i.e. the high street segment) in terms of demographics. More specifically, online payday customers were found to be younger (85 per cent under 50) with a high proportion working (90 per cent) and the majority were not on a low income (69 per cent). The study also found that only 13 per cent of online customers did not repay their most recent loan on the due date (i.e. half of the 26 per cent of retail customers who did not repay on time). See sections 3.2.4, 14.5.3 and 14.5.4 of the Bristol University Research.

comparison websites (which are heavily advertised), or through self-navigation using search tools such as Google.

4.7 The availability of short-term loans online has allowed these customers to use the power of the Internet to identify suitable loan products and then manage their loans online resulting in significant customer engagement and demand-side pressure to which providers have been forced to respond. There is a variety of evidence suggesting stronger engagement by online customers, in particular:

(a) online customers are significantly more likely to shop around than high street customers;[57]

(b) the proportion of the value of repayments which are made early online is higher (24 per cent) as compared to the high street (9 per cent), suggesting that this flexibility is valued by online customers and facilitated by the online medium;[58] and

(c) the proportion of loans which are rolled over online is significantly lower (16 per cent) as compared to the high street (26 per cent).[59]

Use of payday loans

4.8 Wonga notes the CC's comments on repeat use of payday loans and would make the following observations:

(a) the CC's analysis of repeat borrowing is based on models of lending which are rapidly becoming less relevant, which may lead the CC to reach misleading conclusions and may fail to adequately assess the impact of flexible products which, although currently small, are likely to have a significant impact; and

(b) the CC's analysis of repeat customers and rollovers provides a number of indicators which are consistent with responsible lending.

The CC's analysis of repeat borrowing is based on models of lending which are rapidly becoming less relevant

4.9 In relation to repeat borrowing, the AIS points out that "*around 60 per cent of new customers go on to take at least one further loan with the same lender within a year of the first loan. On average, our estimates suggest that a payday customer will take out between 3 and 4 additional loans with the same lender within a year of their first loan from that lender*".[60] This result arises from analysis of repeat business with the same lender, where the CC is focusing on "entirely new loans" when thinking about repeat business (as distinct from "rollovers").[61]

4.10 Wonga notes that the CC treats top-ups (i.e. additional credit taken before the end of the loan term) as separate loans in its measure of repeat borrowing.[62] It is not at all clear, however, that top-ups should be treated as if they were "entirely new loans". For many of Wonga's customers, top-ups provide additional (and valued) flexibility in meeting a specific credit requirement (particularly in circumstances where the amount required might be uncertain, and an informed customer might wish to limit what they borrow until the need arises in order to minimise interest costs). Using top-ups in this way is very

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57 TNS BMRG Survey, page 97.

58 *Customers and their loans – presentation based on analysis of the transaction data,* slide 39.

59 *Customers and their loans – presentation based on analysis of the transaction data,* slide 42.

60 AIS, paragraph 38.

61 *Repeat customers – presentation based on analysis of the transaction data,* slide 2.

62 *Repeat customers – presentation based on analysis of the transaction data,* slide 16.

different from a situation where an "entirely new loan" is taken to meet a new borrowing requirement.

4.11 As noted above, flexible repayment products which have emerged recently are making any such distinction meaningless because they generally allow customers to dip in and out of credit when required (through revolving credit facilities) with variable repayment which can be changed at any time (e.g. QuickQuid's FlexCredit product). In other words, the concept of a loan for a discrete requirement (which may be repeated through further loans to meet subsequent requirements) is being replaced by longer-term arrangements which allow customers greater flexibility to meet borrowing requirements as and when they arise. Wonga's top-up arrangements are consistent with this flexibility (albeit they are only available within the original loan term).

4.12 The CC's analysis, which focuses on counting discrete loans within a specific period, cannot accommodate these new models of lending, more specifically:

(a) it wrongly treats top-ups as if they were discrete loans whereas they are simply an example of the wider trend which allows customers to take and manage credit flexibly; and

(b) it excludes longer-term products whose typical duration is longer than that of a "standard" payday loan.[63]

4.13 Wonga is concerned that the CC's analysis of repeat borrowing is based on models of lending which will rapidly become outdated, and therefore the CC may draw misleading conclusions and may fail to assess the impact of flexible products which, although currently small, are likely to have a significant impact.

The CC's analysis of repeat customers provides a number of indicators which are consistent with responsible lending

4.14 There are several indicators that lending to repeat customers is undertaken responsibly and that customers for whom a repeat loan would not be appropriate because they would struggle to repay are "filtered out" through effective affordability assessments, in particular:

(a) the CC's analysis indicates that: (i) progressively fewer customers take additional loans; (ii) there is a decline in the proportion of customers that pay late or never repay in relation to subsequent loans; (iii) there is a decline in the share of loans which are rolled over for later loans;[64] and (iv) there are lower rates of late/non-repayment for repeat customers as compared to new customers.[65] This is consistent with tighter affordability checks and "filtering" of higher risk customers as the number of payday loans and/or rollovers taken increases. This points to effective affordability assessments (particularly in relation to the online segment which has a better repayment profile than the high street in general);[66] and

(b) the CC's analysis compares the repayment profile of an "average last loan" with an "average not-last loan" and finds the proportion of non-repayment for last loans to be significantly higher (64 per cent) as compared to 6 per cent of loans that are

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63 *Repeat customers – presentation based on analysis of the transaction data,* slide 16. "*For comparison: the average duration of products we classified as "standard" is 22 days (median 21 days); average duration of "long term" products in our dataset is 181 day (median 166 days). Because we analyse additional borrowing from the same lender in a given period of time, inclusion of long term products would skew the results. These longer term products represent 3.4% of all the loans in our dataset*".

64 *Repeat customers – presentation based on analysis of the transaction data,* slides 30 and 34.

65 *Customers and their loans – presentation based on analysis of the transaction data,* slide 33.

66 *Customers and their loans – presentation based on analysis of the transaction data,* slide 39.

not last which are never repaid.[67] This result is unsurprising as lenders will typically rule out loans to customers with outstanding debts. The CC's presentation states "*last loans are less likely to be repaid*". A more appropriate interpretation of the result, however, would be that loans which are not repaid are very likely to be the last loan, as this better reflects the causality arising from responsible lending decisions.

The benefits to customers of some flexibility in relation to loan duration should not be under-estimated

4.15 The CC notes that "*there are potential advantages to the borrower from rolling over a loan because he or she does not have to repay the principal at the end of the first loan period*".[68] Wonga considers that an appreciation of these benefits is important as part of any consideration of rollovers. Wonga has moved from a position where it previously declined to offer any extensions to a position where a limited number of extensions are available (subject to creditworthiness/affordability checks at the point of each extension). Wonga changed its position because it believes that it is in the interests of customers to be able to apply for a short extension at particular times. The alternatives (namely default after one loan or borrowing from less responsible/reputable sources) impose significant costs on customers which can be avoided.

4.16 Wonga considers that a responsible approach to extension can avoid the risk of customers getting into financial difficulties. In this regard, Wonga limits rollovers to a maximum of three and was the first in the industry to adopt this limit to help ensure that extensions are not provided in circumstances which are likely to result in a customer experiencing financial difficulties. Wonga has a range of other policies which are also designed to meet this objective.[69] These policies are effective; the CC's analysis indicates that Wonga has the [CONFIDENTIAL] lowest rate of rollover of the lenders considered by the CC ([CONFIDENTIAL] of loans issued in 2012).[70]

B. Costs and profitability

4.1 Wonga notes that the CC has referred to a number of important issues relating to the interpretation of profitability on which it does not yet appear to have formed even preliminary views.[71] Wonga's observations on the interpretation of measures of profitability are as follows:

(a) *How to take account of the relative immaturity of the market*. Wonga has previously noted that a simple assessment of historical performance is not appropriate in the context of a dynamic sector characterised by innovation, the introduction of disruptive technology, and high levels of entry. (These trends are seen within the payday segment but also in relation to products which compete with payday loans.) In this context, Wonga observes that any "high" profits are

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67 By number of loans for customers who started borrowing in 2012, and whose last loan was in 2012. See *Repeat customers – presentation based on analysis of the transaction data* at slide 36.

68 AIS, footnote 26.

69 Where customers apply for an extension, acceptance is subject to a rigorous affordability assessment which is undertaken before any extension request is agreed and which Wonga has strong incentives to perform in order to avoid a significant rise in default losses. Wonga will only ever extend the length of a loan when requested to do so by a customer. The term of a loan is never extended by default without the request of a customer, i.e. by "default rollover"; customers can choose the duration for the loan extension (other lenders insist on a 30 day rollover period); customers must significantly reduce the outstanding balance by paying off all fees and interest on the original loan; Wonga does not proactively encourage extensions; creditworthiness and affordability are re-assessed at the point of extension; the additional cost of extending the loan is clearly explained to customers; and this has previously been acknowledged by the CC.

70 *Customers and their loans – presentation based on analysis of the transaction data,* slide 43.

71 *Profitability of payday lending companies* working paper, paragraphs 15 and 16.

neither systematic across the industry nor persistent (indeed, they are forecast to decline significantly in response to competition from new products and increased costs following regulatory intervention). Wonga considers that the CC should consider in detail the likely future trend in profitability in the sector given the significant slowdown (or even a negative trend) in the rate of growth, increasing competitive pressure, and the effects of regulatory changes which are due to be introduced.

(b) *What conclusions to draw from the disparity in returns across the sector*. The CC's analysis demonstrates that there has been a wide disparity in financial performance over time and across the sector. This reflects, among other factors, the sensitivity of profits to efficiency and performance in reducing default rates. Wonga has achieved a low principal loss rate of [CONFIDENTIAL] (in 2012) which significantly outperforms many of its peers. Wonga considers that the evidence of dispersion in financial performance across the sector is a strong indicator of effective competition. Companies that have innovated and developed attractive products that are easy to use, transparent, and meet consumers' needs have performed well, and strong performers such as Wonga are compelled to innovate further to ensure that they remain competitive and are not "leapfrogged" by the development of new products. [CONFIDENTIAL].[72]

(c) *The appropriate benchmark*. The CC makes reference to both evidence of the cost of capital for consumer lending (using the Capital Asset Pricing Model) and evidence on required returns for venture capital. Wonga considers that the start-up nature of its business should be taken into account when identifying an appropriate benchmark against which to compare returns. In this regard, the CC must explicitly recognise the impact of survivorship bias given that many of the firms within the remit of the inquiry are start-ups (and, in the case of online operators, are similar in risk profile to technology start-ups).

(d) *Economic measure of profitability*. The CC acknowledges that it typically makes adjustments to take account of factors which may lead to the economic return deviating from an accounting return. It notes that various respondents have identified relevant adjustments to make, although it notes that it has not received specific evidence to allow it to make such adjustments at this stage. Wonga considers that it would be reasonable to take account of a range of approaches to determining asset values, such as price-earnings multiples (as adopted by the CC in the *Classified Directory Services* inquiry); premiums paid over book values (as adopted by the CC in *Store Cards*); precedent from other CC financial services inquiries (with differences in capital intensity controlled for); and market to book ratios for publicly listed payday lenders. Wonga will follow up its AIS response with a more detailed memorandum on profitability, in which it will identify potential relevant adjustments to make.

4.2 Wonga considers that the implications of the above issues are clear: irrespective of the precise way in which profitability may be measured, the features described above clearly indicate that the market is operating in a competitive manner. Wonga will be commenting in detail on the CC's *Profitability of payday lending companies* working paper within the specified time frame for responses.

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72 See paragraph 2.7 for further information on these initiatives.

5. **COMPETITION IN THE PAYDAY SEGMENT**

5.1 Wonga addresses in this section features of the payday segment which are consistent with vigorous competition, namely:

(a) market share instability;

(b) evidence of increasing pressure on prices;

(c) the material body of evidence indicating vigorous and ongoing non-price competition; and

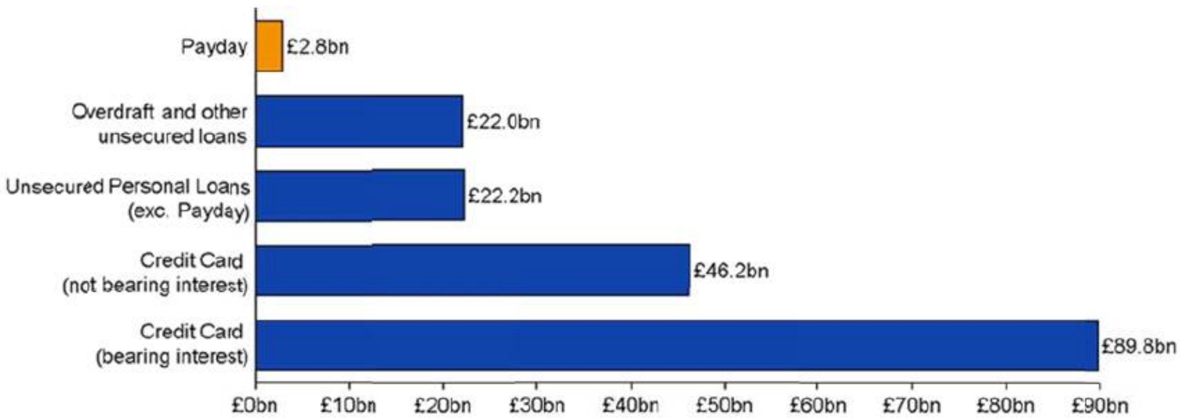
(d) high levels of customer satisfaction. In particular, Wonga considers that the CC should acknowledge the body of evidence which supports the high levels of customer satisfaction amongst payday customers.

5.2 Wonga considers that the CC has ample evidence that the UK short-term credit market is delivering considerable innovation, unrivalled choice of credit products, high levels of customer satisfaction, and competitive pricing.

A. Size and structure of the payday segment

5.3 The CC rightly points out that, despite recent growth, payday lending remains a relatively small proportion of overall unsecured debt.[73] Wonga considers this to be an important observation in the context of the evidence (discussed above) of competitive interaction between many of the products within the overall measure of unsecured debt. Wonga estimates that the payday segment represents less than 2 per cent of the overall unsecured lending market, while credit cards and overdrafts represent approximately 86 per cent (as indicated in Figure 5 below). While payday lenders have filled a gap in the availability of short-term credit during the financial crisis, the easing of liquidity pressures on the banks is likely to contribute to increased competition from the traditional lenders going forward.

Figure 5: Breakdown of the 2012 UK unsecured lending market



Source: Mintel, "Personal Loans - UK, January 2013". BBA "Credit Card Monthly Release Tables – May 2013" for ratio to split credit card balance data between those bearing and not bearing interest. AIS, paragraph 45 for payday loan data.

5.4 Wonga also notes that the CC has found evidence of a slowing in the rate of growth of the payday segment between 2011 and 2012, with the rate of growth slowing still further

[73] AIS, paragraph 45, first bullet and footnote 36.

between 2012 and 2013.[74] Wonga agrees that the CC's analysis provides a number of indicators of a declining rate of growth, for example:

(a) the CC compares the number of loans issued in each month from January to July in 2013 compared to the number of loans issued in the corresponding month the year before. Whilst loan value and volume in 2013 exceeds the amounts in the corresponding month in 2012, the difference is decreasing over time and reaches an "inflection point" in August 2013 (the CC's last month of data) where loan volumes and values in August 2013 are lower than August 2012;[75]and

(b) the proportion of new loans is lower for 2013 (January to August) than 2012 (for online and high street, and for loan number and value). This is also consistent with slower payday segment growth;[76]and

(c) the CC finds a reduction in operating profit growth relative to prior years reflecting *"both a slowdown in revenue growth… and an increase in costs relative to revenue compared with prior periods"*.[77]

5.5 Although Wonga does not agree that the payday segment is the appropriate frame of reference for a competition assessment, this finding is consistent with Wonga's experience in relation to the payday segment. [CONFIDENTIAL]. Looking forward, Wonga forecasts this trend to continue, driven by regulatory uncertainty, a more mature market phase, and strong competition between payday lenders themselves, as well as between payday lenders and alternative providers of credit.

5.6 The CC refers in the AIS to snapshot measures of concentration in particular "[o]f *newly-issued loans in 2012: the largest three lenders accounted for nearly 70 per cent of loans and 75 per cent of loan value; and the largest ten lenders accounted for just under 90 per cent of loans and value*".[78] Snapshots of segment concentration are generally uninformative and therefore the CC typically looks for evidence of stability in market shares over time as a more relevant indicator of the level and nature of competition.[79] Wonga has estimated the market shares of "pure play" payday lenders between 2006 and 2012. Not only does this show the proliferation of providers in recent years, but there is also evidence that entities are increasing their share at the expense of other entities, and that smaller players are able to gain share and grow.

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74 AIS, paragraph 45, third bullet.

75 *Customers and their loans – presentation based on analysis of the transaction data,* slides 15 and 16.

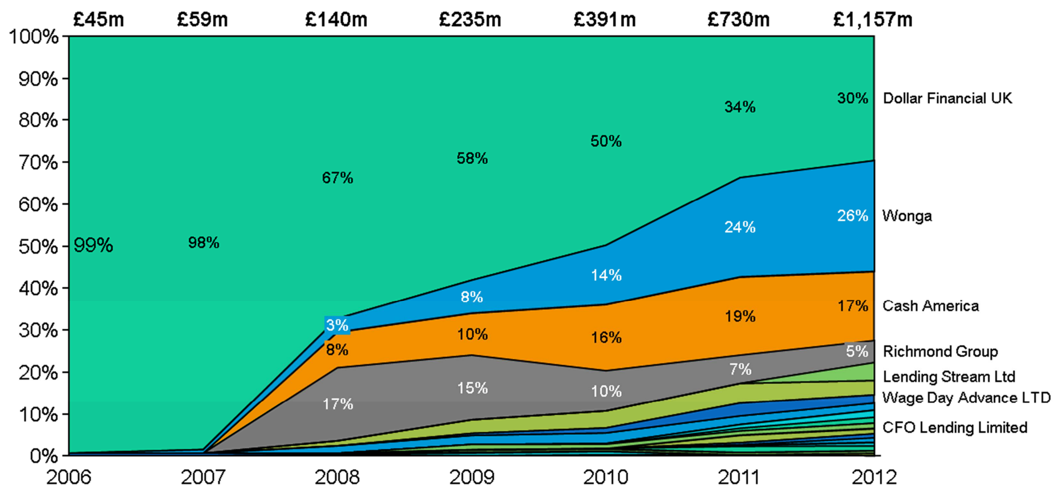
76 *Repeat customers – presentation based on analysis of transaction data*, slide 5.

77 *Profitability of payday lending companies* working paper, paragraph 60.

78 AIS, paragraph 45, fifth bullet.

79 Wonga notes, in this regard, that the CC has only considered percentage point changes in the ten largest lenders' shares of total payday loan revenue between <u>two</u> years (namely 2011 and 2012). See *The size and concentration of the payday lending sector* working paper at figure 2 (redacted).

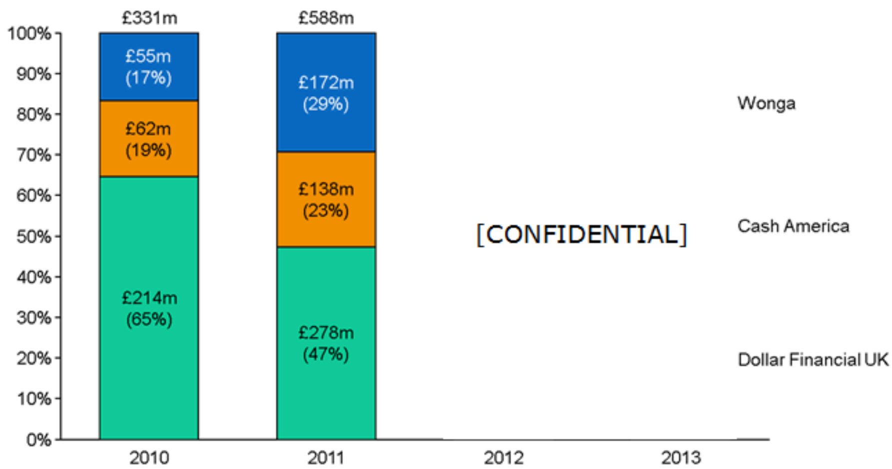
Figure 6: Evolution of market shares (net revenues) of "pure play" payday lenders 2006 - 2012 (net revenues, £m)



Source: Illustrative analysis based on annual reports from Companies House and SEC filings for the public companies (as of 21 February 2014). Note: This analysis excludes all Cheque Centres, but excludes entities such as Harvey & Thompson which offer other products in addition to payday loans.

5.7 Focusing on the position of the three largest players, there is further evidence of share instability with Wonga and Cash America able to take away share from (mainly bricks and mortar) Dollar Financial due to the successful entry and growth of their online payday loan product offerings (as shown in Figure 7 below). Wonga achieved the second highest share of the three at [CONFIDENTIAL] in 2013. Cash America, however, has steadily taken share from both Wonga and Dollar Financial.

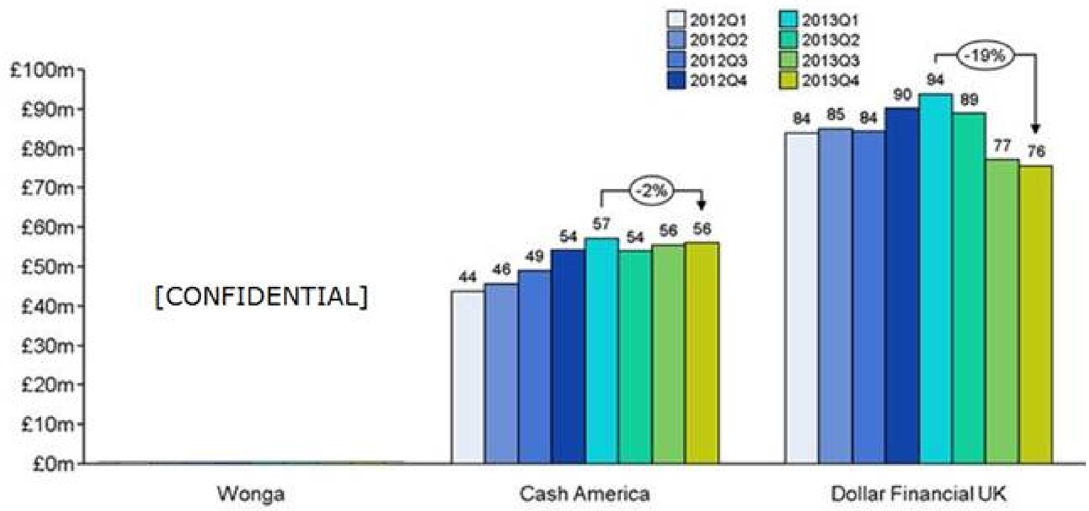
Figure 7: Evolution of net revenue of top 3 <u>online</u> lenders (2006 - Q3 2013)



Source: Illustrative analysis based on annual reports from Companies House and SEC filings for the public companies (as of 21 February 2014)

5.8 Over the course of the last 12 months, revenues for the three largest entities have either decreased or remained flat. As noted above, [CONFIDENTIAL] and expects this trend to continue, driven by increased competition, quality and innovation in the market.

Figure 8: Last 24 months quarterly net revenues of top 3 short-term lenders



Source: Illustrative analysis based on published accounts from Companies House and SEC filings for the public companies adjusted to normalise for use of different accounting standards and policy. UK revenues for Cash America are estimates. All figures relate to UK net revenues.

B. Price competition

5.9 The CC has undertaken: (i) a comparison of payday lenders' current prices; and (ii) an analysis of how prices have changed over time. These analyses inform the CC's emerging views on the degree to which lenders compete on price. The AIS indicates that "*the evidence that we have seen to date suggests that the extent to which lenders compete on prices is limited.*"[80]

5.10 Wonga has identified a number of significant shortcomings in the CC's approach to its pricing analysis which are explained in more detail in Annex 3. In summary, Wonga has the following concerns:

(a) the CC's analysis does not sufficiently reflect recent market developments which are likely to have a significant impact on the evolution of the market, in particular, the emergence of longer-term products with flexible repayment structures; and

(b) the CC has assessed price variation between lenders across repayment scenarios which are considered by the CC to be representative of typical customer behaviour. Wonga does not agree that the scenarios chosen by the CC accurately describe typical customer behaviour, nor are the CC's assumptions reasonable in a number of respects.

5.11 Wonga explains below why the CC's preliminary interpretation of the evidence on pricing and, in particular, the suggestion that it points to "limited" price competition is incorrect.

The evidence available to the CC does not support the preliminary view that price competition is "limited"

5.12 The AIS indicates that "*the evidence that we have seen to date suggests that the extent to which lenders compete on prices is limited.*"[81] Wonga does not agree with this interpretation for the following reasons:

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80 AIS, paragraph 60.

81 AIS, paragraph 60.

(a) there is clear evidence that lenders seek to gain competitive advantage through their charges and charging structures and that customers are exercising choice and identifying the product which best serves their needs;

(b) product development allowing greater repayment flexibility (which can reduce the total cost of borrowing to the benefit of customers) has been a central element of price competition but this has not been given sufficient weight by the CC because of its focus on headline prices;

(c) the CC has yet to reach any robust conclusions on prices in the context of costs; and

(d) the evidence on promotions is consistent with pro-competitive behaviour by lenders designed to win market share.

Lenders seek to gain competitive advantage including through their charges and charging structures and customers respond to this

5.13 The differentiation in charges (and, in particular, charging structures) which the CC has identified should not be interpreted as evidence of a lack of demand-side pressure or price sensitivity, but rather as lenders seeking to gain competitive advantage. For example, Wonga has sought to differentiate itself and gain competitive advantage through transparency, simplicity and daily interest charges which (when coupled with early repayment) allows customers to limit the cost of borrowing to the time period over which funds are needed. More specifically, Wonga's pricing model offers increasingly competitive prices over progressively shorter loan terms.

5.14 Customers are exercising choice and identifying the product which best serves their needs. In Wonga's case, this means that its customers tend to take loans which are shorter [CONFIDENTIAL] than the industry average (22 days)[82] where Wonga's product is less expensive than most other competing offers (as confirmed by the CC's analysis of scenario 1: £100 loan repaid on time after 14 days). [CONFIDENTIAL]. The fact that Wonga's market share for shorter duration loans is higher than for longer duration loans is entirely consistent with customers exercising choice in the marketplace.[83]

5.15 Wonga faces [CONFIDENTIAL] competition from (amongst others) [CONFIDENTIAL] product which has adopted the same pricing structure which will appeal to customers seeking shorter-term loans. The [CONFIDENTIAL] product charges on the basis of daily interest rates and therefore competes head to head with Wonga for loans with shorter duration where Wonga has tended to be more competitive relative to fixed price products. It prices consistently below Wonga.[84] [CONFIDENTIAL].

5.16 [CONFIDENTIAL].[85] [CONFIDENTIAL].

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82 *"If we exclude the longer term products, the average duration of a payday loan made by the 11 major lenders in our sample is 22 days*" (*Customer and their loans – presentation based on analysis of the transaction data,* slide 26).

83 Wonga notes that the CC has calculated Wonga's share of supply of loans of duration 12 to 16 days within the range 30 to 40 per cent and Wonga's share of supply of loans of duration of 26 to 30 days within the same range (*Customers and their loans* working paper, slide 29). Wonga does not believe that these estimates are correct given Wonga's internal data on the proportion of its loans at different loan duration. Wonga also notes that MYJAR's share of supply of loans of duration 12 to 16 days is indicated as falling within the range 20 to 30 per cent but MYJAR only offer loans of duration 18 days (*Payday loan products* working paper, Table 3).

84 [CONFIDENTIAL]

85 Inactive Customer Survey at Annex 13A of Wonga's Response to the Market Questionnaire.

Product development allowing greater repayment flexibility is a central element of price competition but this is not captured by an analysis which focuses on headline prices

5.17 The CC's analysis of price trends over time focuses on headline rates and therefore misses the trends in product development which have had and will continue to have a significant impact on the total cost of borrowing to the benefit of customers. This is a central element of price competition and will be increasingly important going forward.

5.18 For example, the CC highlights, in its description of price trends for Wonga, the introduction by Wonga of its transmission fee in 2008 and subsequent increase from £3.50 to £5.00. On its face, this might be considered consistent with the CC's observation that "*headline interest rates and fees increase intermittently over time, with these increases rarely reversed*".[86] This fee, however, was introduced by Wonga in order to allow it to earn a reasonable return on loans with short durations. As a consequence, Wonga was able to reduce its minimum loan duration, in due course, to one day, thereby improving repayment flexibility (an improvement which the CC has noted in its working paper on competition in product innovation).[87] As noted above, most of Wonga's customers take loans of shorter duration than the industry average and therefore are benefitting from this flexibility.

5.19 Headline prices, therefore, are limited as an indicator of the nature of competition. Wonga reviews the competitiveness of its offer to customers by looking at aspects such as simplicity, flexibility, responsibility and transparency as well as aspects relating to price, all of which affect the value of the product to the customer. The total cost of credit is what matters to customers (as evidenced by their informed choice of Wonga for shorter loans) and this depends on loan duration and the structure of the pricing offer.

The CC has yet to reach any robust conclusions on prices in the context of costs

5.20 Wonga notes that the CC is continuing to consider its observations on pricing in the context of changes in the costs to lenders.[88] In this regard, the CC observes that Wonga's prices do not appear to have responded to cost shocks.[89] Wonga considers whether, and how, to adjust for cost shocks as part of its holistic review of its product offer. Revenue from interest rates and other charges must cover operating costs, default losses and provide a reasonable return on investment but, at the same time, prices must be competitive relative to other short-term credit options (which Wonga monitors by reviewing the offers of rivals). In practice, [CONFIDENTIAL]. In other cases, Wonga has increased prices, for example in August 2013, Wonga increased its default fee to align Wonga's arrears charge with the [CONFIDENTIAL] incurred by Wonga. In general, cost recovery and price competitiveness must be balanced, and Wonga must consider its longer term positioning as well as the need for its pricing to be readily understood and transparent to customers.

The evidence on promotions is consistent with pro-competitive behaviour by lenders designed to win market share

5.21 As regards the CC's evidence on price promotions offered by payday lenders, Wonga considers that the various promotional activities employed by payday lenders are pro-competitive. In particular, Wonga's waiver of the transmission fee, Dollar's use of promotional discount codes and SpeedyCash's free £200 loan promotion are typical of devices which aim to win market share and that tend to enhance competition. Moreover,

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86 *Payday lending prices over time,* slide 6.

87 *Competition in product innovation* working paper, paragraph 34.

88 AIS, paragraph 60.

89 *Payday lending prices over time,* slide 19.

price competition through discounts and promotional activities rather than reductions in standard prices are commonly observed in other industries, particularly in sectors such as financial services, energy and retail.

C. Non-price competition

5.22 In the section on "Non-price competition", the AIS concludes that "*the evidence suggests that there has been* <u>*some*</u> *competition between lenders on non-price loan attributes in the period since 2008*"[90] (emphasis added). Wonga considers that this statement materially understates the level of competitively driven innovation that has occurred in recent years.

5.23 Wonga considers that the CC has understated the degree of non-price competition in the payday sector as well as between payday lenders and other credit providers, and should acknowledge the significant level of innovation which has occurred in recent years. In this regard, Wonga observes that:

(a) the *Competition in product innovation* working paper refers to a <u>very</u> large volume of the innovations implemented by numerous market participants. The working paper acknowledges that the innovations that it refers to are not an exhaustive list of all the innovations introduced by lenders, but a list of examples.[91] The actual body of evidence supporting the finding of non-price competition is, therefore, greater than that which has been summarised by the CC, pointing to a much more significant trend than has been acknowledged in the AIS;[92]

(b) the CC has not taken into account innovation over the same period in respect of non-payday lending products which is also of central importance in assessing the extent of non-price competition between lenders (consistent with Wonga's view that the relevant market encompasses a range of short-term lending products). Examples of such innovations have been provided in Wonga's Response to the CC's Issues Statement[93] and are outlined in paragraph 3.5 above;

(c) the innovations which the CC considers to be the "most significant" are briefly summarised in the AIS at paragraph 62 within the following three categories: (i) facilities for customers to draw down further funds during the term of a loan; (ii) instalment loans; and (iii) faster payment services. This short list significantly understates the variety and volume of innovations in the payday segment (as summarised in the *Competition in product innovation* working paper). At the very least this list of significant innovations should also include:

(i) the improvement in access to lending services through the introduction of mobile phone applications (Wonga was the first to fully roll out such an application in 2010). Customers' use of Wonga's mobile application has been very high since launch – approximately [CONFIDENTIAL] of Wonga's Little Loan volumes originate from use of the mobile phone application. Other payday lenders have (or will soon) launch similar mobile phone applications confirming the popularity of this feature. Indeed Wonga recognises that in order to continue to serve its customers, it needs to continue innovating in this regard; and

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90 AIS, paragraph 64.

91 See the response to Question 6 of the Market Questionnaire for a more thorough list of product innovations introduced by Wonga since 2008.

92 The vast majority of innovations outlined in the AIS and the relevant working paper have been implemented by Wonga. [CONFIDENTIAL]. The success of Wonga's innovations is demonstrated by Wonga's significant growth since entry. From a start-up just six years ago, Wonga has become a leading digital financial service business.

93 See, in particular, banks' development of mobile banking applications (see paragraph 4.23(d)) and banks' introduction of "sliders" (see paragraph 4.24) similar to those used by Wonga and other payday lenders.

(ii) improvements to the loan approvals process, given that such improvements result in widening customers access to credit whilst also ensuring that Wonga continues to lend responsibly. Wonga's risk management system is continually developing as it learns from the behaviour and performance of existing customers. In addition to this on-going development, [CONFIDENTIAL]. This continual refinement ensures that Wonga can make the most accurate and responsible lending decisions possible;[94]

(d) the payday lending sector has seen much higher levels of innovation as compared, for example, with the significantly lower levels of innovation found by the CC in the home credit market (in relation to which the CC also found there to have been "*some innovation*"[95] (emphasis added).

D. Rivalry benefits customers

5.24 Wonga considers that the evidence and outcomes described above in relation to the short-term credit market are far more consistent with a view that the market is competitive than the CC's emerging contention that there exists a series of narrow markets in which a small number of suppliers have powerful positions. An important further outcome in this regard is direct evidence that customers' requirements and demands are being met to their satisfaction (a factor which the CC has yet to address directly).

5.25 There is a vast body of evidence pointing to high levels of satisfaction amongst payday customers, namely:

(a) Wonga recorded a world-class net promoter score of [CONFIDENTIAL][96] (with [CONFIDENTIAL] of customers rating Wonga's services as 9 or 10 out of 10);[97]

(b) 90 per cent of customers would recommend Wonga's services;[98]

(c) an even more impressive 96 per cent of respondents said that they find the Wonga service easy to use;[99]

(d) a Consumer Finance Association survey finds that 93 per cent of payday customers are satisfied with the overall experience, 74 per cent are satisfied with the value and 90 per cent are satisfied with the clarity of the terms and conditions for their loan;[100]

(e) the Bristol University research suggests that 94 per cent of online payday customers where satisfied overall with the service they had received from the short-term lender they had used;[101] and

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94 See the response to Question 23 of the Market Questionnaire, in particular, paragraphs 23.9 to 23.12, for a detailed outline of how Wonga's loan approval process has been, and is being continually improved.

95 See, for example, paragraph 3.182 of the CC's 2004 Home Credit Final Report.

96 Customers are asked to rate how likely they are to recommend the company to someone else, using a scale of 0-10. Those answering 9 or 10 are classed as "promoters", 7 or 8s are "passives" and anything below that are "detractors". The score is then calculated by subtracting the percentage of detractors from the percentage of promoters (ignoring passives).

97 See slide 5 of the Populus Customer Survey, March 2013 at Annex 3 of Wonga's Initial Submission.

98 See slide 8 of the Populus Customer Survey, March 2013 at Annex 3 of Wonga's Initial Submission.

99 See slide 10 of the Populus Customer Survey, March 2013 at Annex 3 of Wonga's Initial Submission.

100 See www.cfa-uk.co.uk/information-centre/payday-facts-and-research/payday-facts-and-research/the-payday-lending-market.html

101 Bristol University Research, table 10.1.

(f) the TNS BMRG Survey data also indicates high levels of customer satisfaction across all short-term credit lenders: 61 per cent of "multiple borrowers" who have stayed with the same lender stated that the reason for not changing was because they were "happy with the service provided by the current lender".[102]

5.26 This is important and consistent evidence that payday customers are served well.

[102] TNS BMRG Survey, page 136.

6. THEORY OF HARM 1

6.1 In this section, Wonga addresses a number of issues raised by the CC as regards its assessment of shopping around by customers, in particular, whether there are costs into doing so and any barriers to identifying the best loan. In this regard Wonga considers that:

(a) a significant proportion of customers do shop around at a level consistent with effective constraints on lenders;

(b) incentives to shop around are not unduly influenced by the importance attributed by customers to speed;

(c) the availability and clarity of information is not a significant barrier to shopping around; and

(d) there is no strong evidence that customers may be over-optimistic about their ability to repay.[103]

6.2 Wonga also addresses the CC's consideration of three potential barriers to switching and shows that:

(a) there is no compelling evidence indicating that perceived inconvenience is a significant barrier to switching;

(b) there is no compelling evidence that customers are disinclined to switch because they perceive a greater likelihood of loan approval by their existing lender; and

(c) incentives offered by lenders to repeat customers do not create material barriers for rivals.

SHOPPING AROUND

A. A significant minority of customers <u>do</u> shop around at a level consistent with effective constraints on lenders

6.3 The CC has chosen to focus on the results of the TNS BMRG Survey which indicate that "*a large proportion of payday loan customers do not shop around prior to taking out a loan*".[104] Wonga considers that the CC should not place undue weight on this survey finding for the following reasons:

(a) there are inconsistencies between the TNS BMRG Survey responses about how important payday loans are to customers;

(b) there is a credible body of evidence which supports shopping around by a significant proportion of customers;

(c) the CC's comments lack any insights as to the level of shopping around the CC would consider consistent with an effective constraint on lenders;[105] and

(d) as regards short-term loans and repeat borrowing, customers have multiple chances to switch and gain experience of different lenders. Accordingly, payday loans are very different from longer-term and more complex financial products

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103 The points raised below with regard to the effectiveness of shopping around are made in addition to the points submitted by Wonga on this subject in its response of 23 September 2013 to the CC's Issues Statement.

104 AIS, paragraph 83.

105 The examples provided in this response are in addition to the points submitted by Wonga on this subject in its response of 23 September 2013 to the CC's Issues Statement. See, in particular, paragraphs 5.4 to 5.45.

such as pensions and mortgages, where there are few opportunities to sample different products.

There are inconsistencies between survey responses about how important payday loans are to customers

6.4 In order to highlight the importance of shopping around, the CC states that nearly 60 per cent of respondents to the TNS BMRG Survey indicated that the expenditure was something that they definitely could not have gone without.[106] There are, however, inconsistencies in the responses to different survey questions as regards the ability of respondents to go without (as discussed in Annex 2, section B).

There is a credible body of evidence indicating that a significant proportion of customers do shop around

6.5 The TNS BMRG Survey indicates that a significant proportion of customers <u>do</u> shop around prior to taking out a loan:

(a) three in ten customers (27 per cent) in the quantitative TNS BMRG Survey (almost one third) shopped around for their sampled loan (the specific loan they were asked about in the interview) (see Figure 9 below);[107]

(b) four in ten customers (40 per cent) had shopped around for a payday loan (i.e. taking into account loans not specifically asked about in the interview) (see Figure 9 below);[108]

(c) based only on the sampled loan, 24 per cent of new payday loan customers shopped around, with this proportion increasing to 28 per cent for repeat customers;[109] and

(d) 31 per cent of all online customers shopped around, compared to 13 per cent of all high street customers (see Figure 10 below).[110]

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106 *Shopping around* working paper, paragraph 24.

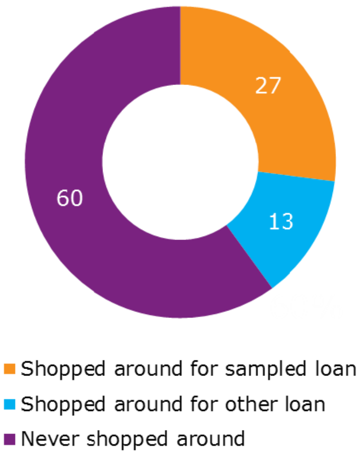
107 Page 96, TNS BMRG Survey.

108 Page 96, TNS BMRG Survey.

109 Page 96, TNS BMRG Survey.

110 Page 97, TNS BMRG Survey.

Figure 9: Customers who shopped around for sample loan (%)



Source: Page 96, TNS BMRG Survey

Figure 10: Customers who shopped around for sample loan, by channel (%)

Source: Page 97, TNS BMRG Survey

6.6 Other sources also suggest that a material proportion of customers shop around:

(a) the Bristol University Research suggests that around half (46 per cent) of online payday customers compared the cost of their loan with similar or other types of lenders before taking out their loan;[111] and

(b) Wonga's own customer research has found that a total of [CONFIDENTIAL] of Wonga customers "looked at and considered" other cash advance websites when shopping around (see Figure 11 below).[112]

Figure 11: [CONFIDENTIAL]

The level of shopping around identified in various surveys is consistent with an effective constraint on payday lenders

6.7 If the CC is to use the TNS BMRG Survey to indicate a lack of shopping around in support of its theory of harm, it needs to explain why the level of shopping around shown in its survey, as well as in the third party research referred to above, is not sufficient to constrain the activities of payday lenders. This is particularly the case as the CC makes no reference to what proportion of respondents it considers would constitute a "sufficient" rate of shopping around.

6.8 Wonga submits that the indicated levels of shopping around are material because active customers (i.e. customers that actively shop around) are one of the key drivers of Wonga's business strategy, to the benefit of less active customers. This is because:

(a) Wonga does not price discriminate. Its prices are therefore constrained, inter alia, by those customers that do shop around; and

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111 Bristol University Research, page 29.

112 See slide 16 of the Populus Customer Survey, March 2013 at Annex 3 of Wonga's Initial Submission. The CC highlights certain methodological differences between the Populus Customer Survey and the TNS BMRG Survey. Wonga does not consider that any such methodological considerations justify placing less weight on Wonga's research given that: (a) the Populus Customer Survey covered a total of over [CONFIDENTIAL] respondents (all online customers), compared to TNS BMRG Survey's combined sample of only 1,061 online customers; and (b) [CONFIDENTIAL].

(b) Wonga seeks to ensure that its product remains attractive (in a holistic sense) in order to attract and retain active customers.

Payday customers also learn about, and are able to compare lenders, by borrowing with multiple lenders

6.9 The FCA highlights the frequency of purchasing as a relevant consideration in assessing the ability of customers to learn from past experiences. It states (in an occasional paper on behavioural economics), "*It can be difficult to learn about financial products. Some financial decisions, such as taking out a mortgage or planning a pension – are made infrequently and with consequences revealed only after a long delay*".[113] In contrast, the repeat borrowing identified by the CC in relation to payday loan,[114] and the short duration of these loans provides an opportunity for customers to learn from past experiences on a much more frequent basis as compared to the examples given by the FCA (namely mortgages and pensions).

B. Incentives to shop around are not unduly influenced by the importance attributed by customers to speed or a lack of perceived benefits from shopping around

The importance attributed by customers to speed

6.10 The CC is considering whether customers have weak incentives to shop around in circumstances where there is a perceived, or real, urgency to obtaining credit.[115] In this regard, Wonga observes that speed is important to some but not all customers and even where it is valued, online searching does not introduce any material delay, and any delay will be weighed against the advantages of getting the best deal in any event.

Speed is important for some but not all customers

6.11 A minority (21 per cent) of customers who did not shop around indicated that this was because they needed the loan quickly or did not have time. Others reasons, however, were given in similar proportions, for example: "*happy with the first one I looked at*" (20 per cent); and "*have used lender before*" (18 per cent).[116] This suggest that there are several factors which explain inactivity some potentially reflecting customer satisfaction and/or the perception that shopping around is less necessary due to knowledge accrued from previous use.

6.12 Although the TNS BMRG Survey results indicated "*speed of getting the money*" as the most important factor cited by respondents (74 per cent citing it as extremely or very important),[117] there are a number of additional material factors which are also highly ranked by customers. More specifically, a number of non-speed related factors such as ease of the application process are highly ranked by customers in terms of importance after speed (see Figure 12).

6.13 [CONFIDENTIAL].

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113 FCA, Applying behavioural economics at the Financial Conduct Authority, April 2013, Occasional Paper No. 1, page 16.

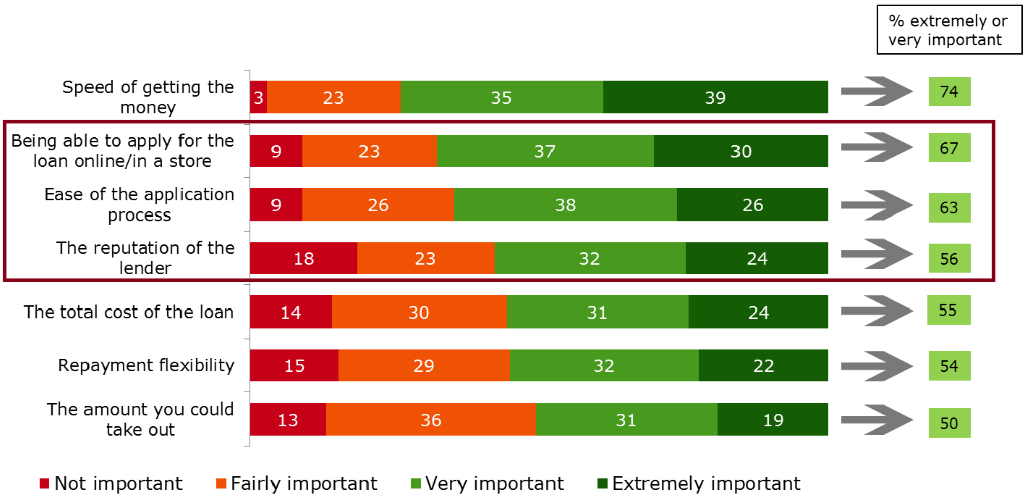
114 The TNS BMRG Survey, at page 132, indicates that a majority (57 per cent) of those with two or more loans have experience of more than one lender. The TNS BMRG Survey's qualitative results, at page 66, also highlight the information benefits which accrue to repeat borrowers. It states "*Serial borrowers or 'heavy users' have knowledge of multiple lenders, maximising their access to credit*".

115 See the AIS at paragraph 86 and the *Shopping around* working paper at paragraphs 70 to 77.

116 TNS BMRG Survey, page 103.

117 TNS BMRG Survey, page 91.

Figure 12: Range of factors cited as important in choice of payday loan



Source: Page 91, TNS BMRG Survey

Figure 13: [CONFIDENTIAL]

Even where speed is valued by customers online searching does not introduce a material delay

6.14 Given that the payday loan product is relatively straightforward and information is available and transparent (as acknowledged by the CC), Wonga considers that customers can get a reasonable overview of alternative offers within a short space of time. More specifically, Wonga rejects:

(a) the suggestion of TNS BMRG based on certain (un-specified) qualitative survey findings that "*the experience of shopping around was a very cursory experience for some customers, with often only a small amount of time spent comparing lenders or loans*";[118] and

(b) the suggestion in the Shopping around working paper that "*qualitative research suggests that in some cases the shopping around behaviour of online customers may not be particularly thorough*".[119]

6.15 These are subjective judgements which may reflect a lack of understanding of the nature of payday loans. As noted in section 4, Wonga considers that the online environment facilitates effective searching and comparisons between lenders, and online customers are comfortable using the Internet in particular, to help them identify the right product and the right deal by using. This is supported by the TNS BMRG Survey which states "*it is in theory much quicker and easier to compare lenders online*".[120]

6.16 For many customers a brief search may be sufficient where information is clear and the product is straightforward. Wonga notes that the vast majority (73 per cent) of

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118 TNS BMRG Survey, page 100.

119 *Shopping around* working paper, paragraph 50.

120 TNS BMRG Survey, page 97. Independent Mintel research conducted in October 2012 also indicates that consumers actively use the Internet to research loans (including personal loans, secured loans, payday loans) – 39 per cent of loan holders used a search engine and 29 per cent used a price comparison tool (Mintel, "Personal Loans – UK", January 2013, page 83).

respondents to the TNS BMRG Survey indicated that they felt they had spent the right amount of time on shopping around to compare payday loans.[121]

6.17 Moreover, any delay will be weighed against advantages of getting the right deal.

Limited evidence to suggest a lack of perceived benefits from shopping around

6.18 The CC states that "*some* [TNS BMRG Survey] *responses suggested a lack of motivation for shopping around among a minority of customers*"[122] (emphasis added). In fact, the TNS BMRG Survey indicates that only 5 per cent of the customers indicated "*lenders are all much the same*" as a reason for not shopping, which is a de minimis proportion. Further, an even smaller minority reported a lack of any interest in comparing offers: only 2 per cent said that they "*couldn't be bothered*" and only 2 per cent said that "*they did not even think to compare other offers*".[123]

6.19 The CC then notes that around 20 per cent of the customers who did not shop around (and had never done so) claimed that they were happy with the first loan that they looked at.[124] In this regard, the CC states that "*it is unclear what made customers think that the first loan they looked at was offering a good deal given that they did not shop around and/or collect information on any other loans available*".[125] However, as explained in paragraph 6.14, a judgment on the amount of time a customer may need to shop around is a subjective one and there is evidence that the vast majority of respondents (73 per cent[126]) felt that they had spent the right amount of time shopping around.

C. The availability and clarity of information cannot be regarded as a significant barrier to shopping around

6.20 As stated in its response of 23 September 2013 to the CC's Issues Statement,[127] Wonga considers that being able to compare and contrast different forms of credit is vital for consumer choice and facilitates competition. It is for this reason that Wonga provides easy access to product information and associated costs in a clear and transparent manner to all current and potential customers, which has been confirmed by the CC's *Review of the websites of payday lenders and lead generators* working paper.

6.21 The CC is considering the information available to borrowers and the extent to which restrictions may exist on the availability of, or ease of access to, the information required to shop around effectively. In this regard, Wonga makes the following observations, which are set out in further detail in Annex 4:

(a) the availability, and ease of access to, key information on lenders' websites is acknowledged by the CC.[128] There is a body of further evidence which points to information being readily available and readily understood, in particular:

(i) the TNS BMRG Survey evidence that when shopping around, customers are able to find information on the factors they consider to be of most importance in choosing a payday loan;

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121 TNS BMRG Survey, page 150.

122 *Shopping around* working paper, paragraph 78.

123 *Shopping around* working paper, paragraph 79 and TNS BMRG Survey, page 103.

124 *Shopping around* working paper, paragraph 79 and TNS BMRG Survey, page 103.

125 *Shopping around* working paper, paragraph 79.

126 TNS BMRG Survey, page 150.

127 See, in particular, paragraph 5.5.

128 AIS, paragraph 87.

(ii) the TNS BMRG Survey evidence that the vast majority of customers make comparisons across a number of lenders;

(iii) the CC's analysis (in particular the *Review of the websites of payday lenders and lead generators* working paper) which finds that lenders websites play a key part in providing information to customers;

(iv) evidence from the TNS BMRG survey and Wonga's research that customers consider themselves to have access to clear information.

(b) Wonga does not consider that customers face material difficulties in comparing loan attributes with regard to additional charges, where lenders have different pricing structures. In this regard, Wonga notes that:

(i) while there is some product differentiation reflecting different pricing structures, the CC has observed that traditional payday loans are relatively straightforward compared to other financial products;[129]

(ii) to the extent there is differentiation this is pro-consumer and pro-competitive because it reflects innovation by lenders to offer more flexible, short-term credit products which allow customers greater control (for example, by charging daily fees rather than fixed charges and allowing fee-free early repayment);

(iii) the CC's review of payday lenders' websites found that information in relation to default charges and late payment fees is generally accessible and clearly laid out on payday lenders' websites; and

(c) Wonga notes that the TNS BMRG Survey evidence does not support the hypothesis that customers will choose between lenders based on their perceived likelihood of loan approval rather than the merits of different loans.[130] The survey indicates that the main reason customers did not look elsewhere was because they were happy with the service previously provided. Only 10 per cent indicated that it was because they perceived a greater chance of being approved for a loan as a repeat customer.[131]

D. There is no compelling evidence that customers may be over-optimistic about their ability to repay

6.22 The CC is considering whether some borrowers may be over-optimistic about their ability to repay and, if so, whether they are likely to pay insufficient attention to the fees and charges associated with repaying late. Wonga considers that there is no compelling evidence to support this hypothesis, and other evidence indicates that customers seek to inform themselves about fees and charges associated with repaying a loan late, or otherwise become more informed after direct experiences of paying them resulting in greater awareness thereafter. More specifically:

(a) as noted above, most respondents to the TNS BMRG Survey claimed to have a good understanding of what they would need to repay with 94 per cent indicating that they understood this very or fairly well.[132] Moreover for customers who do shop around, 64 per cent collected information on late payment fees;

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[129] AIS, paragraph 88.

[130] AIS, paragraphs 89 to 91.

[131] TNS BMRG, page 103.

[132] TNS BMRG Survey, page 110.

(b) the qualitative TNS BMRG Survey indicates that customers might only become aware of late payment/roll over fees if they have to pay them, but this prompts them to consider them more closely and compare them across lenders should they take another loan;[133] and

(c) confidence in ability to repay amongst respondents to the TNS BMRG Survey relates closely to the reality of whether customers actually repaid on time. The TNS BMRG Survey report states "*confidence in ability to repay relates closely to the reality of whether customers actually repaid on time, with 87% of those who said they were confident of repaying actually repaying on time, compared with 33% of those who were not very or not at all confident of repaying on time*".[134]

CUSTOMER SWITCHING

6.23 The CC is considering three potential barriers to switching, namely:[135]

(a) perceived inconvenience associated with switching (for example, complexities in transferring funds to pay outstanding debt);

(b) customer uncertainty about whether or not they will be approved for a loan by an alternative lender who will take different factors into account and will generally not have access to detailed information on that customer's repayment history; and

(c) incentives offered by lenders to repeat customers (e.g. greater availability of credit) which rivals cannot match without access to credit history.

A. There is no compelling evidence indicating that perceived inconvenience is a significant barrier to switching

6.24 Wonga observes that perceived inconvenience and complexities in transferring funds are not reasons which are specifically identified by the TNS BMRG Survey. In fact, the majority (61 per cent) of borrowers who have not considered going to a different lender for a loan indicate that this is because they are happy with the service provided by the current lender.

B. There is no compelling evidence that customers are disinclined to switch because they perceive a greater likelihood of loan approval by their existing lender

6.25 The TNS BMRG Survey results do not indicate that this as a particular concern:

(a) only 4 per cent of borrowers who have not considered going to a different lender for a loan indicate that this is because the current lender is regarded as more likely to approve their application; and

(b) only 9 per cent of borrowers who had considered switching but had not actually done so indicated that this was because the current lender was considered to be more likely to approve their application.[136]

133 TNS BMRG Survey, page 113.

134 TNS BMRG Survey, page 118.

135 AIS, paragraph 94.

136 TNS BMRG Survey, page 136.

C. Incentives offered by lenders to repeat customers do not create material barriers for rivals

6.26 Wonga agrees that repeat customers will be offered terms consistent with their credit history, but Wonga does not see this as a barrier for new entrants seeking to attract a customer base for the following reasons:

(a) entrants (including Wonga) have started from scratch and have been able to build up their customer bases (including through switching) and acquire, over time, information on credit histories for their repeat customers; and

(b) the data used by Wonga and others to perform appropriate affordability assessment and credit vetting is readily available (including data on exposure to short-term debt) and has become an even richer and more informative market-wide resource as the payday segment of this information has developed and as more lenders enter reciprocal arrangements with the credit rating agencies ("**CRAs**"). [CONFIDENTIAL]. This information is also available to smaller rivals and provides them with the same insights on an applicant's exposure to short-term credit products. In this regard, these entities benefit due to the increased availability of richer data from CRAs and other and data sources.

6.27 With regard to switching more generally, [CONFIDENTIAL]: see paragraph 5.16 above for further details.

7. THEORY OF HARM 2

7.1 The CC's second theory of harm relates to market power and barriers to entry; in particular, the CC is considering "*whether barriers exist which make it difficult for new and smaller lenders to exert a competitive constraint on larger, established lenders.*"[137]

7.2 In this section, Wonga submits:

(a) the recent pattern of entry and expansion unequivocally demonstrates that, in fact, there are no material barriers to entry and expansion;

(b) the CC's analysis on factors affecting the likelihood of entry overstates the extent to which these factors amount to barriers to entry and expansion;

(c) the evidence on the time required to achieve entry supports a finding that entry can occur in a remarkably short timeframe; and

(d) the CC's analysis on the scope for future entry, expansion and exit fails to take account of a range of developments which have made entry easier for second movers, and will continue to do so in the future.

A. Recent pattern of entry and expansion

7.3 The recent pattern of entry and expansion clearly demonstrates that barriers to entry and expansion are not material. Wonga submits that, in assessing the extent to which barriers to entry and expansion give rise to an adverse effect on competition, the CC should place considerable weight on this evidence of <u>observed actual behaviour.</u>

7.4 First, the CC's own analysis identifies a variety of entry and expansion strategies[138] and instances of entry by both "*major lenders*" and "*smaller lenders*"[139]. In particular, the CC identifies eight instances of entry by "*major lenders*" since Wonga's entry (i.e. in less than 7 years),[140] which include:

(a) Cash America (QuickQuid, Pounds to Pocket);

(b) CFO Lending (CFO Lending, Payday First);

(c) Txtloan (MYJAR);

(d) Global Analytics (Lending Stream);

(e) EXCORP (Cash Genie);

(f) The Cash Store;

(g) Speedy Cash; and

(h) H&T.

7.5 This high level of entry by major players over such a short period of time has been accompanied by a steady stream of entry by smaller lenders (with approximately 43

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137 AIS, paragraph 96.

138 *Entry and expansion* working paper, paragraph 15.

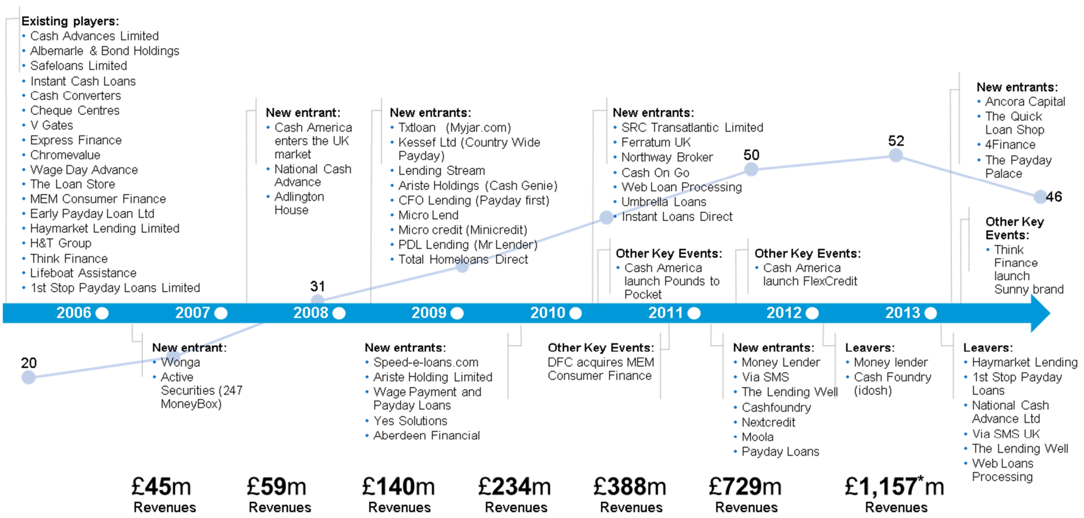
139 *Entry and expansion* working paper, paragraphs 16 to 17.

140 *Entry and expansion* working paper, table 1.

instances recorded between Quarter 2 2010 and Quarter 3 2013).[141] On any measure, and especially so when compared to other financial services markets (such as traditional personal banking services including personal current accounts[142]), this represents very significant new entry.

7.6 Secondly, this strong history of entry is supported by Wonga's own internal analysis. Figure 14 below shows that there has been consistent new entry of firms offering payday loans since 2006. More specifically, Wonga estimates that there were more than 50 firms offering payday loans at the peak in 2013 (although this has now declined due to exits during 2013). In addition, entry has occurred by both small players as well as more established and well capitalised brands, including Cash America (trading as QuickQuid), Think Finance (trading as Sunny) and 4Finance (trading as Vivus).

Figure 14: Lenders providing a payday product, and pure players estimated revenues (£m, # of firms)[143]



* Estimate – two competitors, The Loan Store Limited and Lending Stream, haven't yet reported results for 2012, so figures are based on 2011 revenues

7.7 Thirdly, it would be incorrect for the CC to discount the pattern of strong entry on the basis that it includes a number of smaller players which might not constrain the larger incumbents. This is because:

(a) as the CC itself has stated, 11 of the entrants over the period surveyed can be characterised as "*major*"; and

(b) a number of these entrants are large international financial service firms with deep pockets which have demonstrated a strong commitment to the UK payday lending sector through their significant investments to date, including:

(i) Cash America International, Inc. (QuickQuid and Pounds to Pocket), which is listed on the New York Stock Exchange, has a total of 969 worldwide

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141 *Entry and expansion* working paper, figure 1. In this regard, the CC notes that these results may not have captured the full extent of new entry by smaller lenders, i.e. entry by smaller lenders may have been underestimated by the CC's analysis.

142 For example, the CC only identified five new entrants between 1995 and 2006 in its *Personal Current Counts Northern Ireland* market investigation and eight instances of entry from 1979 in its *Store Cards* market investigation. Similarly, the OFT only identified five new entrants since 2000 in its 2013 *Personal Current Accounts UK* market study.

143 Source: Annual reports from Companies House, SEC filings for the public companies and press releases (as at 12 December 2013)

locations offering specialty financial services to consumers (including pawnshops) and generated revenue (in 2012) of $1.8 billion;

(ii) DFC Global Corporation (The Money Shop, PaydayUK, and Payday Express), which is a NASDAQ-listed company with more than 1,500 retail storefront locations worldwide, and generated revenue (in 2013) of $1.1 billion;

(iii) EZCORP (Cash Genie), which is a NASDAQ listed company which operates more than 1200 pawn and financial services locations worldwide and generated total revenues of $1.01 billion for the fiscal year ended September 30, 2013; and

(iv) The Cash Store Financial Services Inc (The Cash Store), which is listed on both the New York Stock Exchange and Toronto Stock Exchange, operates from across 510 branches in Canada and 27 branches in the UK, and generated revenue of $190.8 million for the year ended September 30, 2013.

7.8 Fourthly, the summary of entry and expansion set out above under-estimates total entry and expansion in relevant markets as it focuses only on a narrowly defined sub-set of the relevant short-term credit products relevant to the CC's analysis and does not capture other recent entry. In this connection, the CC has failed to identify the following (non-exhaustive) examples of entry:

(a) PDL Finance Limited (Mr Lender), a privately-held UK company that generated a total revenue of £17.5 million in 2012 with net profit of £2.4 million;

(b) Oakam Limited (The Bonus Loan and The Big Plus Loan), a privately-held UK company, which entered the short-term loan market in 2007 and offers payday loans both online and through high street stores. It has opened 20 stores across the UK since 2007, and generated total revenue of £19.9 million in 2012 with net profit of £2 million;

(c) Think Finance, Inc (Sunny), which entered the UK short-term loan market in 2011. It offers credit products in both the U.S. and the UK, and generated revenue of $502 million in 2012;

(d) Provident Financial plc, which has generated total revenue of £980 million in 2013. Provident's online cash loan products (Satsuma) was launched on 7 November 2013 and offers its customers short-term loans of either 13 or 26 week durations delivered directly into their bank accounts; and

(e) a range of other short-term unsecured credit products which fall within the CC's current definition of payday lending, including certain peer-to-peer products, instalment loans and other general unsecured loan products including by lenders such as 118118 Money (see Section 2 and Annex 1).

B. Factors affecting the likelihood of entry

7.9 The CC is considering a range of factors which could affect the ability of firms to enter or expand within the payday lending sector, including: business requirements such as regulation and compliance; customer acquisition; credit risk management; loan management systems; payment processing; customer services and call centre; financial and access to capital; certain additional requirements for high street lenders; as well as reputational effects.

7.10 The CC's emerging view is that the need to acquire loan management systems and customer call service and call centre operations is unlikely to reduce the likelihood of entry to a material extent,[144] and that barriers to expansion in relation to high street lending are not substantial for existing payday lenders.[145] Wonga agrees with the CC's preliminary observations in this regard and therefore makes no further comment on these points in this response.

7.11 However, Wonga considers that the CC's preliminary observations on the following factors affecting the likelihood of entry do not accurately reflect the current market conditions:

(a) regulation and compliance;

(b) customer acquisition;

(c) credit risk management;

(d) payment processing;

(e) financial and access to capital; and

(f) reputational effects.

7.12 Wonga sets out its views on each of these in turn below, but as a general observation, it is clear from the very significant entry that has occurred since 2007 that these business requirements are surmountable for new entrants.

Regulation and compliance

7.13 The CC has observed that *"[r]egulation does not appear to have acted as a barrier to entry or expansion in the past. However…the new FCA regime is likely to increase compliance costs relative to the previous regulation regimes…[and this] may make entry less attractive."*[146] In this regard, the CC cites the FCA which has stated that its proposals could lead to between 25 and 30 per cent of lenders leaving the industry.

7.14 Wonga observes that it is difficult to comment meaningfully on the extent to which regulation and compliance will make entry less attractive given that the breadth and detail of that regulation remains to be determined. Wonga would, however, observe, that:

(a) the history of entry and expansion strongly indicates that, to date, regulation and compliance have not impeded entry, particularly by entities such as Wonga and those identified by the CC in the *Entry and expansion* working paper;

(b) if reasonable and even-handed regulatory measures are successful in improving reputation, then the sector will become more attractive to new entrants; and

(c) the adoption of regulatory proposals will end uncertainty, and any new entrants will know exactly what the requirements are that they will need to fulfil in order to enter and compete within the market; and

(d) unnecessary or overly restrictive regulation, however, can distort markets, not least by dampening incentives to enter and expand, and it is for this reason that the FCA and the CC must exercise due caution when considering any regulation, particularly in relation to nascent products, which are characterised by high levels of growth and innovation (see section 8 below).

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144 *Entry and expansion* working paper, paragraph 103.

145 *Entry and expansion* working paper, paragraph 139.

146 *Entry and expansion* working paper, paragraph 35.

Customer acquisition

7.15 The CC's analysis of customer acquisition costs focusses on: (i) building a brand via marketing and advertising expenditure; and (ii) acquiring leads from lead generators.

7.16 Although brand awareness is a relevant factor in driving any online business (short-term credit, or otherwise), Wonga does not consider that this gives rise to material entry barriers. [CONFIDENTIAL]

(a) [CONFIDENTIAL];

(b) [CONFIDENTIAL]; and

(c) [CONFIDENTIAL][147] [CONFIDENTIAL].[148]

7.17 [CONFIDENTIAL].[149] [CONFIDENTIAL].

Credit risk management

7.18 The CC observes that a "*new entrant is likely to face higher default rates, and therefore higher costs, than an established lender….because the new entrant is likely to be reliant on a greater proportion of new customers (representing a higher expected credit risk) and is likely to hold less internal information on customer repayment behaviour, so will be less able to accurately predict default behaviour.*"[150]

7.19 It is of course the case that for any short-term credit lender (both new entrants and established providers), default rates for new customers will tend to exceed those for customers with whom the lender has an established relationship and who have demonstrated an ability to repay their loans in the past. It is also likely to be the case that a new entrant, by virtue of starting out with few existing customer relationships (the exception being entrants in related segments of the short-term credit market), will initially have a higher proportion of "new customers" and hence be likely to experience higher defaults for an initial period of time. However, Wonga does not consider that this amounts to a barrier to entry or expansion.

7.20 First, new entrants can, and have, overcome this issue (as is demonstrated by the high levels of entry described in detail in paragraphs 7.3 to 7.8 above). Indeed, Wonga experienced these high rates of default when it entered the market [CONFIDENTIAL]. Over time, and with investment in, and improvements to, credit assessment models, Wonga has managed to bring its principal default rate down from [CONFIDENTIAL] in 2008 to [CONFIDENTIAL] in 2012 (as a percentage of principal lent).

7.21 Secondly, the improved quality of CRA data currently available (and to be made available in the near future) ameliorates the risk of new and recent entrants potentially incurring higher default rates. These players benefit from the rich source of data that has been created by the larger, established lenders (because they gain insight form the payment histories of the customers of these large lenders when their own contribution will be small). When Wonga started offering loans in the UK, the available CRA data was not as rich as was not tailored to payday loans and therefore did not include many of the metrics which would assist a lender in assessing an applicant's exposure to short-term debt.

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147 [CONFIDENTIAL].

148 TNS BMRG Survey, page 101.

149 Although, Wonga would comment that the comparison with the cost of lead generators in the US (see *Entry and expansion* working paper, paragraph 49) is not necessarily informative as restriction on advertising by payday lending in the US may have distorted the market by driving up the costs of leads from lead generators.

150 *Entry and expansion* working paper, paragraph 79.

7.22 Since 2007, CRAs have improved their data products and have tailored them to suit the particular needs of lenders making short-term loans such as payday loans (in collaboration with payday lenders which are obliged to share their data under the principles of reciprocity). As a result, a new entrant today would have access to a much richer and more specific data set from CRAs than that which was available to Wonga in 2007. Relevant developments (and developments currently in the pipeline) include:

(a) the continued improvement in all relevant CRA existing products as a result of the increase in the size of the datasets over time;

(b) [CONFIDENTIAL];

(c) [CONFIDENTIAL];

(d) [CONFIDENTIAL];

(e) CoreLogic Teletrack UK, the largest real-time reporting solution serving non-traditional credit markets in the UK, already provides access to proprietary, non-traditional consumer credit data in real-time;[151] and

(f) Experian announced on 5 February 2014 that it would launch its own real-time data sharing service for lenders, including payday lenders, in the third quarter of 2014. The service will see Experian providing updates several times over a 24-hour period on short-term loans to its Credit Account Information Scheme, which is one of the largest sources of information about the credit commitments held by people in the UK.

7.23 These developments will enable new entrants and smaller lenders to minimise risk associated with default rates. Wonga considers that, in particular, the move to real-time data sharing will have a marked effect of the ability of all lenders (including new entrants) to accurately assess credit risk and reduce default rates (subject to lenders using that data to make responsible lending decisions). This is because:

(a) reciprocal sharing of real-time data across the payday lending sector means that the rich data provided to the CRAs by incumbents in relation to their customers loan activity, will also be available to new entrants;

(b) all lenders, including new entrants, will be able to improve their affordability and credit risk checks by being able to see whether a potential customer has recently taken out a loan with another provider, and whether or not that loan has been repaid;

(c) real-time data will allow short-term lenders to perform better affordability assessments than existing frameworks because the data will be more current; and

(d) the likelihood of fraud and identity fraud will decrease with real-time data available to verify identity of existing payday customers.

7.24 Thirdly, notwithstanding the above, a potential inverse relationship between default rates and number of loans, far from representing a barrier to effective competition, merely represents a path that all successful entrants to the industry (including Wonga) may have to traverse. Different firms may adopt different models of business acquisition, and these models may have an impact on default rates irrespective of any possible relationship between the total volume of loans and the ability of credit risk models to accurately assess ability to repay.

151 See http://www.corelogic.com/landing-pages/corelogic-teletrack-uk.aspx.

7.25 Some businesses (such as Wonga) have emphasised building a long-term brand. Others may have adopted a policy of gaining customers in the early phase of development by carrying out credit checks to a less extensive degree (i.e. lowering the hurdle for giving loans) in order to build a book. This would likely lead to higher default rates than a model in which applications are generated through brand-building, but approvals are subject to high credit ratings. Both models can allow for growth, and the structure of costs would be different (in one case, higher customer acquisition costs; in the other, higher loan loss costs).

Payment processing

7.26 The CC makes the preliminary observation that lenders to date do not appear to have faced barriers in establishing commercial banking relationships but that there is some evidence to suggest this may be changing.

7.27 Wonga agrees that lenders to date do not appear to have faced such barriers (especially given the large number of entrants, in particular smaller lenders to whom this may be more of a concern). Further, Wonga has not seen any evidence of the availability of such commercial banking services being restricted.

Financial and access to capital

7.28 The CC makes the preliminary observation that raising substantial amounts of finance to invest in entering and/or expanding in the payday lending sector could be a challenge.[152] The CC focuses on the scale of investment, working capital requirements and sources of finance.

7.29 In relation to the scale of investment, Wonga notes that the range of business models available means that the scale of investment can vary considerably and that there is no requirement for an entrant to "enter big" in order to be successful. Further, recent developments (for example, in relation to the quality of CRA data and the availability of loan management software[153]) also serve to reduce certain entry and expansion costs compared with 2007 when Wonga entered (and the subsequent period of significant growth).

7.30 The CC's discussion on access to working capital is very cursory and is insufficient on which to base any view that access to working capital requirements may restrict entry.

7.31 In relation to sources of funding, Wonga believes that potential entrants with sound business models will be able to source funding. Indeed, Wonga notes that there have been a large number of entrants with a variety of funding arrangements which clearly demonstrates that adequate financing and capital is not a factor inhibiting entry. In this regard, as the sector is now more developed and business models have been market tested, there will be more sources of funding than were available to Wonga when it created its new and untested business model and entered the sector in 2007.

Reputational effects

7.32 The CC makes a preliminary observation that the *"current high degree of political and media attention centred on lending practices, high APRs and social costs of payday loans may deter some firms, such as banks, from entering the payday sector."*[154]

7.33 In relation to this potential barrier to entry, Wonga notes that there have been a large number of entrants suggesting that, where there is profit to be made, firms will enter.

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152 *Entry and expansion* working paper, paragraph 125.

153 See paragraphs 7.21 to 7.23 and Wonga's Response to the Market Questionnaire at paragraph 42(c)(i).

154 *Entry and expansion* working paper, paragraph 145.

C. The time required to achieve entry

7.34 The CC makes the preliminary observation that the timescales required to launch a payday lending business vary, highlighting that H&T took 6 months, whereas Wonga took [CONFIDENTIAL] months. Although there are some variations, timescales of between 6 and [CONFIDENTIAL] months are short and indicate that entry is possible within a short timeframe.

7.35 In this regard, when the [CONFIDENTIAL] months it took Wonga to enter are considered in the appropriate context, it is clear that Wonga's entry occurred within a very short timeframe:

(a) Wonga was a new start-up launching an entirely new product aimed at disrupting the existing short-term, unsecured credit market. It is obvious that such an ambitious product launch and market entry would take longer than a new entrant to a more developed sector which can take advantage of a wide range of off-the-shelf products (such as loan management software and CRA data) which reduce the risk, cost and time associated with having to develop bespoke, untested systems.[155] CashEuroNet has stated, for example "*Our launch into the United Kingdom in 2007 and Australia and Canada in 2009 demonstrate that we can quickly and efficiently enter new markets*." CashEuroNet also states "*The scalability and flexibility of our technology platform allows us to enter new markets and launch new products quickly, often within three to six months from conception to launch*";[156] and

(b) the [CONFIDENTIAL] month period ran from the establishment of the company to the point when Wonga generated a sustainable level of profit after tax, and it therefore over-estimates the time taken for Wonga to enter the market.

D. Future entry and expansion

7.36 In considering whether the historical patterns of entry are likely to be representative of the future evolution of the sector, the CC appears to focus its preliminary analysis on the extent to which changes to regulatory conditions might make entry and expansion more difficult and/or less likely. Wonga's views on this are set out in paragraphs 7.13 and 7.14 above and section 8 below.

7.37 The CC has, however, failed to consider adequately the extent to which sector developments may have reduced entry costs and risks and therefore made entry and expansion easier and more likely. In this regard, as set out in Wonga's MQ response,[157] many of the costs [CONFIDENTIAL] have been significantly reduced, due to the following factors:

(a) the increased availability of richer data from CRAs and other and data sources (see paragraphs 7.21 to 7.23 above);

(b) technological developments (i.e. the evolution of technology, the reduction in the costs of hardware and software development and the availability of off-the-shelf loan management systems, software and providers). In this regard, Wonga's original platform, while suitable at the time of launch, quickly became unsustainable as a result of its significant growth. The range of products now available in the market for new entrants give such entrants the ability to pick a

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155 See paragraphs 7.21 to **Error! Reference source not found.**, 7.36 to 7.38, and Wonga's Response to the Market Questionnaire at paragraph 42(c)(i).

156 www.nasdaq.com/markets/ipos/filing.ashx?filingid=7785977#D228493DS1_HTM_ROM228493_4, page 93.

157 Wonga's Response to the Market Questionnaire, paragraphs 48.2 to 48.4.

product suitable for both their existing and potential future needs (thus avoiding the significant IT costs incurred by Wonga);[158]

(c) the availability of skilled and experienced personnel with consumer credit experience;

(d) the availability of brand management, brand creation, and marketing agencies with deep experience of the consumer credit sector; and

(e) the scalable costs of advertising and marketing expense.

7.38 In addition, new entrants gain valuable insights by observing customer acceptance and traction of innovative products and service features developed by early movers such as Wonga.

E. Conclusion

7.39 In light of the evidence set out above, it is clear that, on any measure, barriers to entry and expansion are low.

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158 For further detail, Wonga refers to its Response to the Market Questionnaire at paragraph 42.3(c).

8. THE REGULATION OF PAYDAY LENDING

8.1 The CC has rightly highlighted in the AIS the potential impact on competition of forthcoming changes to the way payday lending is regulated. In particular, in relation to the FCA's new legislative duty to impose a cap on the cost of payday loans, the CC comments:

> "*Depending on its level and the way in which it is implemented, a price cap in particular may significantly affect the incentives of companies to enter the market or the incentives of those within the market to remain in or supply certain groups of customers. It might also affect the way in which firms compete and, in particular the way that lenders compete on prices in order to win and retain customers. Proposals for how the cap will be set will not be published by the FCA before our provisional findings*."[159]

8.2 Wonga also notes that the CC is considering the impact of regulatory changes in the context of its assessment of entry and expansion. The AIS states:

> "*We will take into account the potential implications of greater regulation which is intended to drive out some of the lending practices which have been highlighted in the media. We are also considering the extent to which any other factors might impeded lenders' ability to enter or expand in the payday sector, including whether there are any restrictions on lenders' ability to access finance, and the effect of the FCA's proposed changes to the regulatory regime on the regulatory uncertainty facing lenders and their costs of compliance*."[160]

8.3 Wonga considers that an assessment by the CC of the impact on competition of proposed regulatory changes is essential. The CC indicates that it will consider whether any regulatory changes are likely to "*strengthen or weaken*" any market features considered by the CC to lead to an adverse effect on competition (**"AEC"**).[161] In Wonga's view, the CC must also have regard to the effect of any regulatory action on any relevant customer benefits of the feature or features of the market concerned. In this regard, Wonga notes that relevant customer benefits include lower prices, higher quality or greater choice as well as greater innovation in relation to payday loans (which, as described in section 5 above, is a key feature of the market for short-term credit).

8.4 Wonga has outlined above the significant risks[162] associated with remedies which seek to control outcomes (such as a price caps), as well as other types of remedy. More specifically there are risks that competition will be distorted and/or muted (including through any reduction in the constraint exerted by payday lenders on other short-term credit providers in the event that payday lending is marginalised) and that regulatory uncertainty will "chill" incentives to invest (both by incumbents in new product development and by new entrants which are unlikely to incur significant sunk costs when returns are uncertain). This problem is particularly acute in markets which are rapidly evolving and where products are differentiated as noted at paragraphs 2.8 and 2.9 above.

8.5 Other risks relating more specifically to the price cap include reduced consumer choice due to price convergence, gaming to avoid the price cap (for example, the flight of lenders to the nearest non-regulated short-term credit product), and quality reductions to allow lenders to sustain profitability under the price cap regime (including through constraints on access to credit). Both the OFT (as part of its review of high cost credit in 2010) and

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[159] AIS, paragraph 17.

[160] AIS, paragraphs 103 to 104.

[161] AIS, paragraph 18.

[162] See paragraphs 2.8 and 2.9.

Bristol University questioned the suitability of price controls after a consideration of these risks.

8.6 In light of these risks, Wonga considers that the CC should scrutinise the regulatory proposals which have already been announced in order to ensure that the risks of adverse impacts on competition and the loss of relevant customer benefits is minimised. Wonga notes in this regard that the CC has powers to make recommendations to other public bodies and Wonga envisages that the CC could use this power to challenge any proposal which the CC considers will "strengthen" a market feature considered to lead to an AEC (for example, by raising barriers to entry).

ANNEX 1: CREDIT PRODUCTS WHICH SHOULD FORM PART OF THE CC'S COMPETITION ASSESSMENT

Product[1]	Details and features	Minimum / Maximum loan amount and term	Early repayment
Credit products which fall within the CC's parameters of "generally" 12 month or less and "generally" £1,000 or less			
Everyday Loans (Everyday Loans Limited)	Unsecured personal loans Following an initial online application and receiving a conditional decision within minutes, the customers visits an Everyday Loans branch to confirm details of the loan and collect the cheque.	£500 to £10,000	
Satsuma Loans (Provident Personal Credit Limited)	Provident Financial performs credit checks on customers and uses CPAs to collect repayments from the customer's debit card. There are no penalties for missed or late repayments.	£100 to £300 (or £800 for existing customers) 13 to 26 weeks	Customers can repay early May be entitled to rebate
Amigo Loans (Amigo Loans Limited, part of The Richmond Group)	Customers only pay interest for the period during which they have the loan.	£500 to £5,000 12 to 36 months	Loans may be paid off early
RateSetter (Retail Money Market Limited)	RateSetter was the first to introduce a "Provision Fund" to peer-to-peer lending to protect lenders against late payments or defaults. It claims that no RateSetter lender has "*ever lost a penny*".[2]	£1,000 to £25,000 6 to 60 months	No early repayment fees
Peachy (Cash On Go Limited)	Offers short-term loans which can be repaid in up to five instalments.	£50 to £500 5 days to 5 months	Loans may be repaid early
Credit products which offer loan terms and loan amounts beyond the CC's revised definition but which have early repayment terms, and can therefore be repaid within 12 months			
Zopa (Zopa Limited)	Leading peer-to-peer lender, which *"rewards savers and borrowers who are good with their money by providing lower rate loans and higher interest on savings".*	£1,000 to £20,000 24 to 60 months	Loans can be repaid early with no early repayment fees
SpringCoin (AvantCredit)	Online lender which offers "*affordable, personal loans to responsible people who should not have to settle for an expensive option or take hours out of their busy day to travel to a loan store or bank*."[3] It "*custom fits*" each loan based on the needs and qualifications of each individual borrower (i.e. the actual eligible loan amount, APR, and length of loan will depend on credit worthiness and repayment history).	£1,000 to £20,000 12 to 36 months	Customers can pay off their loan at any time to save on future interest payments No early repayment fees
118 118 Money (Madison CF UK Limited)	It is the financial services arm of 118 118 (a directory enquiries provider) and offers unsecured personal loans to consumers through its website. Serves customers who have been turned down by banks for loans.	£1,000 to £5,000 12 to 24 months	Advises customers to call its specified lines

[1] The Consumer Credit Licences for these products are held by the corporate entities specified in brackets.

[2] See http://www.ratesetter.com/lending/provision_fund.aspx.

[3] See https://www.avantcredit.com/about_us.

ANNEX 2: THE CC'S ANALYSIS OF MARKET DEFINITION

2.1 In the AIS, the CC sets out its preliminary thoughts on product market definition as follows: *"we are not presently minded to define the product market as being wider than the definition of payday loans we have adopted…the evidence that we have seen suggests that other types of credit are likely to offer little competitive constraint on payday lenders"*.[4]

2.2 This preliminary view is based on the following evidence:

(a) Functional characteristics. Despite identifying that credit cards and overdrafts share a number of characteristics and that "*these two credit products are likely to be the closest non-payday commercial substitutes to payday loans for most customers*",[5] the CC highlights evidence from its qualitative research as to the reasons why customers may not be inclined to switch to these products;[6]

(b) Evidence on hypothetical switching. The CC cites the responses to one survey question (namely, what payday customers would have done had they not been able to take out a payday loan) as evidence that customers are willing to switch to other credit products only to a very limited extent;[7]

(c) Evidence on access to other forms of credit. The CC suggests that a possible reason for limited switching is a lack of access to other forms of credit. The CC also cites survey evidence that many borrowers had experienced problems using other types of credit in the past;[8]

(d) Evidence on customer comparisons of payday loans against other forms of credit. The CC explores whether the apparent lack of substitution between payday loans and other forms of credit might be explained by a lack of awareness of other products. In this regard, the CC notes a TNS BMRG Survey finding that "*only the minority of customers who had alternatives available to them got as far as comparing the pros and cons of payday loans against other credit products*";[9]

(e) Evidence of competitive interaction. The CC has identified little evidence of payday lenders taking the actions of providers of other credit products into account when setting their own offering, or of other credit providers changing their own behaviour to compete directly with payday lenders;[10] and

(f) Analysis of price comparisons between payday loans and other forms of credit. The CC concludes that "[p]*ayday loans are generally substantially more expensive than the other forms of credit considered in this* [the CC's] *analysis*".[11]

2.3 Wonga considers that the CC's use of the evidence available to date is deficient in numerous respects, for the reasons set out below. Wonga also sets out further evidence which supports its view that a wider market definition encompassing all short-term credit products is more appropriate.

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4 AIS, paragraph 68.

5 *Competition between payday lenders and other credit providers* working paper, paragraph 4.

6 AIS, paragraph 53.

7 AIS, paragraph 53.

8 AIS, Paragraph 53.

9 *Competition between payday lenders and other credit providers* working paper, paragraph 40.

10 AIS, paragraph 53.

11 *Price comparison method* working paper, paragraph 8.

A. Functional characteristics

The CC's comparison of products is over-simplistic and does not consider the preferences of marginal customers

2.4 The CC has considered whether other credit products have similar characteristics to payday loans. The CC states "*The more similarities that potential alternatives share with payday loans, the more likely customers will be to switch to these products if payday lenders were to worsen their offering*".[12] This is over-simplistic. In multi-dimensional differentiated markets, such as short-term credit, the likelihood of switching between products is not just a function of similarities in product features but also the relative valuation of different features by customers and, in particular, by marginal customers.

2.5 Customers might value more highly a product which offers greater speed, convenience and control at a particular cost of borrowing but would switch to a product with different features if the differential in the cost of borrowing exceeded the value attributed to these quality and service features.

2.6 In other market investigations involving differentiated products, the CC has used conjoint (or trade-off) analysis to investigate customer preferences between different profiles of product characteristics and thereby identify perceived values of specific product or service features. For example, the CC used this technique to investigate the relative utilities of different aspects of private healthcare in driving decisions on which private healthcare facilities to access. It was also considered as part of the CC's investigation into payment protection insurance to assess the value of the convenience to customers of purchasing this product at the point of credit sale. Ofcom has also used conjoint analysis to understand the motivations behind the decision to purchase a bundle containing premium sports channels.

2.7 Wonga considers that without this kind of evidence it is difficult for the CC to draw reliable conclusions as to what drives customer choices between differentiated credit products and the nature of the trade-offs which are made between different product features. In this regard, the reference by the CC to the findings of the qualitative research suggesting customer concerns about using other credit products (e.g. "*lack of discipline associated with borrowing on a credit card, the high cost of borrowing using an unauthorized overdraft, and a dislike of hidden charges*")[13] is not informative for market definition purposes. This is because the CC has not assessed the value attributed to customer control, transparency, and other features (such as speed and convenience) and the degree to which switching would occur if any price differentials were no longer considered to be justified by product feature advantages.

The CC does not have sufficient evidence to dismiss borrowing from friends and family as relevant constraints

2.8 The CC finds it difficult to see a basis on which it could be concluded that loans from friends and family would be a significant competitive constraint on payday lending because it considers this to be an inherently different form of borrowing based on personal rather than commercial relationships, where the availability of this option and the factors involved are likely to vary considerably.[14]

2.9 Wonga considers that borrowing from friends and family should be considered as a relevant competitive constraint for the following reasons:

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12 AIS, paragraph 52.

13 AIS, paragraph 53.

14 *Competition between payday lenders and other credit providers* working paper, paragraphs 21 to 22.

(a) borrowing from friends and family occurs within the same choice framework as for commercial products;

(b) informal provisioning is established as a competitive constraint in other consumer contexts; and

(c) this form of borrowing is evolving (like all other forms of borrowing in the short-term credit market) towards a more commercialised arrangement which is facilitated by using social network tools (for example, the "Agree It" Facebook application).

Borrowing from friends and family occurs within the same choice framework as for commercial products

2.10 A decision to borrow from friends and family, instead of using alternative sources of credit, involves weighing up product characteristics against associated costs within the same choice framework as that which applies to choices between commercial products. The cost which is traded-off may not be a direct cash price but rather the non-financial costs associated with a variety of negative risk factors, for example, the social stigma associated with borrowing from friends and family, or the burden which might be placed on family and friends as a consequence.[15] This does not mean, however, that these choices are invalid as a competitive constraint on credit products involving commercial relationships such as payday lending. If the cost of payday lending were to increase such that its advantage were no longer perceived to outweigh the non-financial costs associated with borrowing from friends and family, then switching may be expected.

Informal provisioning is established as a competitive constraint in other consumer contexts

2.11 An intuitive example of informal provisioning as a competitive constraint on prices negotiated in a commercial relationship is personal domestic services such as cleaning, where prices are constrained by the opportunity cost of members of the household doing the cleaning themselves.

2.12 A further example relates to music downloads, and the extent to which prices are constrained by informal/illegal file-sharing. In *Universal Music Group / EMI Music*, the notifying parties submitted that piracy should be considered as part of the relevant market definition. Although the European Commission did not agree that piracy is relevant from a wholesaler's point of view (since its customers are music retailers, who are unlikely to substitute away in favour of piracy), it does state that:

> "*the Commission shares the view of the Notifying Party, supported by the market investigation, that piracy has an adverse impact on retail prices and volumes and that digital retailers are constrained in their ability to raise retail prices by the threat of piracy*".[16]

2.13 It goes on to note that "[p]*irated sources of recorded music, by the mere fact that they are illegal and not only free, entail significant risks for the consumer.*"[17]

2.14 Accordingly, *Universal Music Group / EMI Music* supports a consideration of "friends and family" in assessing competitive constraints because it acknowledges that informal / non-commercial substitutes can still act as a competitive constraint on price (or other aspects of competition).

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15 Some of the negative factors associated with this form of borrowing which might be weighed up as non-financial costs are outlined in the TNS BMRG Survey at page 87.

16 *COMP/M.6458 - Universal Music Group/EMI Music*, paragraph 213.

17 *COMP/M.6458 - Universal Music Group/EMI Music*, footnote 146.

This form of borrowing is evolving to incorporate more commercialised arrangements

2.15 Consistent with the dynamic evolution of the short-term credit market, the boundary between commercial and non-commercial borrowing arrangements is becoming blurred through innovations, in particular, web-based solutions which use social networking to match borrowers and lenders and reduce borrowing risk. For example, "Agree It" is a new free-to-use Internet application which seeks to facilitate borrowing between friends and family on Facebook as an alternative to payday loans.[18] Through the application, Facebook friends can request loans from each other, for personal or business use, at mutually agreeable rates. The borrower gets "a cheaper loan closer to home" while the lender gets "better returns" investing in people they "know and trust".

The functional comparison is backward looking and static

2.16 The CC's functional comparisons are also limited because they are backward-looking and static and therefore do not reflect key product innovations which seek to incorporate the successful and popular features of payday loans as described in further below.

B. Evidence on hypothetical switching

The CC places undue weight on responses to a hypothetical switching question which is flawed

2.17 The CC has no evidence on actual switching between payday loan products and other credit products and therefore its preliminary findings rely heavily on the results of a single survey question which asks what payday loan customers would have done had they not been able to take out a payday loan.[19] 6 per cent of respondents indicated that they would have borrowed from a different type of provider with most individuals indicating that they would have gone without the loan (29 per cent), or borrowed from friends and family (31 per cent). Wonga does not consider that this result can be relied upon as an indicator of substitution for the following reasons:

(a) <u>The question was not framed correctly</u>.[20] Respondents were asked to consider their response in the context of a specific borrowing occasion where the respondents used a payday loan (Qpdsb1). The responses will not, therefore, capture views on the products which are generally considered to be substitutable for payday loans, encompassing both occasions where payday loans are chosen (but other credit products were considered) as well as occasions where other credit products were chosen (but payday loans considered). A better way to have framed this question would have been to ask respondents to consider their last credit requirement.

(b) <u>Potential substitution was not investigated using prompted questions (in addition to an unprompted question)</u>. Respondents were not prompted in relation to Qpdsb1 (which asks what respondents would have done instead of getting a payday loan). The question assesses diversion, which is typically assessed by asking respondents

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18 See https://apps.facebook.com/agree-it/

19 *Competition between payday lenders and other credit providers* working paper, paragraph 24. TNS BMRG Survey, page 72.

20 The CC highlights in its own guidance the need to frame hypothetical questions very carefully to avoid bias. It highlights as a potential source of bias and measurement error "*question framing affecting the way in which consumers consider the hypothetical situation… When using hypothetical questions, care should be taken to minimise the effects of these sources of bias and error in the consumer survey design. The responses to such questions should always be assessed in the context of other evidence about the respondent and a general understanding of consumer behaviour*" (CC and OFT, "*Good practice in the design and presentation of consumer survey evidence in merger inquiries*", March 2011, paragraphs 3.33 and 3.34).

to consider specific prompted alternatives.[21] Wonga considers that the CC should have investigated this critical issue both through unprompted and prompted questions. Wonga also notes that the surveyor could only code one unprompted answer. Although this is typical for questions designed to assess diversion, the weakness of this approach is that it cannot capture the degree to which that potential alternatives are relatively close in their attractiveness. For example, a respondent might indicate friends and family as the most likely choice in the absence of the payday loan taken on a specific occasion; the fact that use of a credit card was a very close second choice is not, however, captured.

(c) Potential substitution was not investigated by considering other hypothetical scenarios. Respondents were not, for example, asked to consider how a 5-10 per cent increase in the total cost of borrowing might have affected their choice of credit. It is unclear why the CC has not chosen to assess substitution using this approach in this case. Wonga notes that the Bristol University research suggests that a majority of payday customers (55 per cent) would not have been likely to take out their loans in the event that the price was higher suggesting a high degree of price sensitivity.[22]

(d) There are inconsistencies between the responses to Qpdsb1 and other survey responses which is indicative of a poorly framed question. For example:

(i) a relatively high proportion (31 per cent) of respondents indicate that they would have borrowed from friends and family but customers interviewed in the qualitative survey were either unable to borrow from friends and family or unwilling to do so, with social stigma being cited as the primary reason to avoid this kind of borrowing;[23]

(ii) a relatively high proportion (29 per cent) of respondents indicate that they would have gone without the loan if the payday loan had not been available. In response to another survey question, however, 59 per cent of respondents indicated that they definitely couldn't have gone without whatever they needed the loan for (Qpdsa4).[24] TNS BMRG notes this inconsistency and highlights that 24 per cent of this respondent group responded to Qpdsb1 that they would most likely have gone without in the absence of the payday loan that they were asked to consider (indicating that a significant proportion of respondents have given an inconsistent response to two similar questions);[25] and

(iii) a further question (Qpdsb3) which asked respondents a more general question on what they "could have" used as an alternative source of credit (and which suggests a much higher potential use of alternative source of credit), is not given significant weight by the CC in the context of potential substitution, even though TNS BMRG indicates that the responses to this question might also have reflected what would have been used.

2.18 For the reasons outlined above, Wonga does not consider that the response to Qpdsb1 can be relied on to provide any meaningful evidence on demand substitutes for payday

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21 See, for example, Box 3.17 *"Good practice in asking a diversion ratio question"*, in the CC and OFT document entitled *"Good practice in the design and presentation of consumer survey evidence in merger inquiries"* of March 2011, which shows a prompted question designed to assess diversion in the event a specific supermarket were to close.

22 Bristol University Research, figure 5.1. Customers were asked "*If the cost of taking out a loan from this lender on this occasion had been higher, how likely are you still to have taken the loan out?*"

23 TNS BMRG Survey, page 87.

24 TNS BMRG Survey, page 68.

25 TNS BMRG Survey, page 72.

customers. Wonga is also doubtful about the reliability of the responses to this question because Wonga's research indicates a different picture as regards customer preferences for different sources of credit. When Wonga's customers were asked to rank their preferences for different sources of credit (without being constrained by any specific borrowing occasion, and with prompting to allow clear identification of preferences between the key alternatives), [CONFIDENTIAL].[26]

Other evidence from the CC's survey provides indicative evidence of higher rates of switching by marginal customers

2.19 A number of alternative estimates of marginal switching can be inferred from the survey responses, including the proportion of respondents who stated that they have access to:

(a) alternative credit sources <u>and</u> have compared payday loans with these alternatives.[27] The TNS BMRG Survey found that, of all <u>new</u> customers, 14 per cent had indicated having access to alternatives <u>and</u> compared payday loans with at least one other credit source. It should be noted that this result is based on new customers only (i.e. those for whom the sampled loan was their first payday loan), rather than all customers.[28] Moreover, the reliability of the result is unclear given potential framing issues[29] and indications of inconsistency, in particular, a proportion of respondents who stated they did not "shop around" have nonetheless switched payday lenders at least once of their own volition; and

(b) alternative credit sources <u>and</u> have used an alternative in the last 12 months. This is a wider estimate of potential switching which captures the proportion of customers who have access to, and have chosen to use, alternatives sources of credit, and which avoids some of the framing issues which limit the reliability of other responses. Based on a cross-tabulation in the TNS BMRG annex of tables,[30] around 32 per cent (489 respondents out of a base of 1,523) of respondents had access to alternatives and had used at least one alternative in the last 12 months.

2.20 These estimates indicate that the proportion of marginal customers who may potentially switch to alternative credit sources could range between 14 per cent to 30 per cent.

C. Evidence on borrowers' use of, and access to, other credit products

2.21 The CC states "[i]f *payday loan customers are unable to access other forms of credit, perhaps because of poor credit ratings, they will not be able to switch to these alternatives*".[31] In this regard, the CC cites the following evidence, which Wonga discusses below:

(a) views expressed by non-payday lenders on the proportion of their customer base that take payday loans, highlighting the higher credit risk for these customers, the monitoring of these customers undertaken by lenders and the use of information on payday lending as part of the credit checking process;[32] and

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26 Populus Customer Survey, March 2013, Slide 20 at Annex 3 of Wonga's Initial Submission.

27 Respondents who have stated alternatives in question Qpdsb3 (*"Could you have used…[*alternative source of credit]*?"*) <u>and</u> answered *"yes"* to question Qpdsb7 (*"Did you get as far as finding out information to compare the pros and cons of the alternative(s) against the pros and cons of a payday loan?"*).

28 TNS BMRG Survey, page 83.

29 Qpdsb7 on comparing credit alternatives with payday loans is phrased *"did you get <u>as far as</u>"* (emphasis added), appearing to make the effort/hurdle of what qualifies as "comparing pros and cons" quite high.

30 See http://www.competition-commission.org.uk/assets/competitioncommission/docs/2013/payday-lending/140131_payday_lending_tns_survey_tables.pdf at table 328 on page 2028.

31 AIS, paragraph 52.

32 *Competition between payday lenders and other credit providers* working paper, paragraphs 29 to 30 and Annex 3.

(b) results from the TNS BMRG Survey on the use of alternative forms of credit, experience of problems using credit products in the past, and access to other forms of credit. Other survey evidence is also cited in respect of access.[33]

Views of lenders do not suggest any unwillingness to lend to payday loan customers

2.22 There is no suggestion in the evidence provided by non-payday loan lenders to the CC that these entities would not explore opportunities to lend to payday customers where there were commercial and profitable opportunities to do so. Indeed, they already lend by way of overdrafts, credit cards and other mainstream forms of credit. [CONFIDENTIAL].[34] These entities highlight credit risks in relation to payday customers but it is entirely unsurprising that this should inform their lending decisions.

The CC's findings based on TNS BMRG Survey evidence are unreliable

2.23 The CC has selectively reported the survey results pertaining to the use of alternative forms of credit. The CC states "[w]*hen asked about their existing use of credit products, our survey showed that 49 per cent of payday loan customers had used an alternative form of credit in the last 12 months*".[35] This TNS BMRG Survey result, however, excludes the use of overdrafts which are clearly relevant to the analysis (the CC accepts, for example, that overdrafts share many characteristics with payday loans and are likely to be amongst the closest commercial substitutes to payday loans for most customers).[36]

2.24 The proportion of payday loan customers who had used some other form of non-payday loan credit in the last 12 months when overdrafts are included increases from 49 per cent to 74 per cent.[37] It is notable that a high proportion of customers indicated using a credit card in the last year (31 per cent) and an even higher proportion had made use of an overdraft (73 per cent).[38]

2.25 The survey also asked respondents to consider all other options that they had instead of taking out a payday loan (Qpdsb3). A sizeable proportion indicated that they could have used a pawnbroker loan (27 per cent); overdraft (20 per cent); bank or building society loan (20 per cent); credit card (18 per cent); and home credit (17 per cent) amongst other products. Wonga notes, however, that TNS BMRG expressed reservations about these results and considered that they "*may tend to under-estimate availability of other sources of credit*".[39]

2.26 Wonga notes that the CC refrains from reporting in the AIS the cumulative position which is implied by these survey results (notwithstanding the potential under-estimation highlighted by TNS BMRG). As indicated in the TNS BMRG Survey report, eight in ten (78

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33 *Competition between payday lenders and other credit providers* working paper, paragraphs 28 to 39 and Annex 3.

34 *Customers and their loans – presentation based on analysis of the transaction data*, slide 32. Banks can use similar tools to manage credit and have unique access to vast amounts of customer data in order to do this.

35 *Competition between payday lenders and other credit providers* working paper, paragraph 31.

36 *Competition between payday lenders and other credit providers* working paper, paragraph 4.

37 TNS BMRG Survey, page 27.

38 *Competition between payday lenders and other credit providers* working paper, table 3.

39 TNS BMRG Survey, page 78. In light of this potential under-estimation, it is inappropriate to calculate the respondents who said they could use a particular form of credit as a proportion of those respondents who had used it in the last 12 months as the CC has done at table 3 of the AIS. Wonga notes that their cross tabulation does not form part of the TNS BMRG Survey report, perhaps due to concerns as to the reliability of the underlying survey data.

per cent) of respondents could have used at least one alternative source of credit (61 per cent if borrowing from friends and family is excluded).[40]

2.27 Based on the figure which excludes borrowing from friends and family, the CC highlights the TNS BMRG Survey finding that 39 per cent of respondents indicated that they had no other alternative sources of credit.[41] Again, however, the CC does not acknowledge other survey findings which indicate a higher degree of choice. In particular, when respondents were asked to judge whether taking out a payday loan was their first choice or last resort for providing the money they needed (on a scale from 1 (first choice) to 5 (last resort)), only two in ten (23 per cent) said that a payday loan was their last resort. To the extent that respondents indicating a 4 or lower may be regarded as having some degree of choice as to how they source the credit required, then this survey result suggests that 77 per cent of respondents were able to exercise some degree of choice.[42]

2.28 [CONFIDENTIAL].[43]

2.29 Of the other survey evidence cited by the CC, Wonga notes the following:

(a) the Bristol University Research estimates that mainstream credit is a feasible alternative to short-term credit for 24 per cent of online payday loan customers. When asked directly, however, 49 per cent of online customers <u>disagreed</u> that they used an online payday loan because they could not borrow from anywhere else. Furthermore, when asked why they had used this form on borrowing on a specific occasion, only 30 per cent of online customers indicated that it was because they could not borrow from anywhere else.[44] The CC does not report this latter survey result;[45]

(b) the CC highlights a finding from a Consumer Finance Association study indicating that 57 per cent of payday loan customers would not have had access to £200 through other sources had they not taken out their payday loan. This implies that 43 per cent may be expected to have such access (which is a significant proportion). Moreover, the survey also indicates high rates of credit use by low income customers, which the CC has chosen not to report: credit cards (41 per cent); overdrafts (37 per cent); home credit (22 per cent); store cards (17 per cent); and bank loans (26 per cent);[46]and

(c) the CC highlights a finding from a Friends Provident, JMU and Policis report that 23 per cent of payday loan users had no other credit option. A very significant majority (77 per cent), therefore, do have other credit options. Indeed, the report states "*many credit users borrow across product categories and relatively few borrowers from non-standard lenders have no other credit options. Where borrowers tend to borrow primarily within a single product category, <u>this is more often a function of affinity with the lending model rather than a lack of options</u>*"[47] (emphasis added).

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40 TNS BMRG Survey, page 78.

41 AIS, paragraph 53, third bullet and *Competition between payday lenders and other credit providers* working paper, paragraph 34.

42 TNS BMRG Survey, page 71.

43 Populus Customer Survey, March 2013, slide 21 at Annex 3 of Wonga's Initial Submission.

44 Bristol University Research, figures 4.2, 4.3 and 4.5.

45 *Competition between payday lenders and other credit providers* working paper, paragraphs 35 and 36.

46 See http://www.cfa-uk.co.uk/information-centre/payday-facts-and-research/payday-facts-and-research/the-payday-lending-market.html

47 "Credit and low-income consumer A demand-side perspective on the issues for consumer protection", Friends Provident, JMU and Policis, page 81.

2.30 The CC has selectively reported survey findings and has presented these findings in a manner which points towards potential limitations in access to other forms of credit. In fact, a range of survey evidence, including the CC's own survey, suggests that access is not an issue and that a very significant proportion of customers have access to, and use, other forms of credit. As suggested by Friends Provident, JMU and Policis, preferences (or product "affinity") will undoubtedly influence the choice of product. As noted above, however, the CC has not performed a robust analysis of choice and preference in this multi-dimensional product context, and is not, therefore, in a position to reach any conclusions on market definition on the basis of the evidence gathered to date.

D. Evidence on customer comparisons of payday loans against other forms of credit

2.31 The CC explores whether the apparent lack of substitution between payday loans and other forms of credit might be explained by a lack of awareness of other products. In this regard, the CC notes a TNS BMRG Survey finding that "*only the minority of customers who had alternatives available to them got as far as comparing the pros and cons of payday loans against other credit products*".[48]

2.32 This question has not been framed appropriately because the phrase *"did you get as far as"* gives the impression of a high hurdle or effort required in order to compare the pros and cons of different products. Wonga also notes that this question was only put to new customers (with a base of 323 respondents) and that, when the results are presented as a proportion of new customers who indicated they had access to alternative sources of credit (which is likely to be under-estimated), the sample sizes are too low to derive meaningful conclusions.[49]

2.33 More generally, Wonga notes that the detailed questions in the TNS BMRG Survey relating to shopping around (e.g. section 2e) were confined to shopping around amongst payday lenders. The survey design has significantly limited the extent to which the CC can investigate the behaviour of customers in searching between, and identifying the best value product amongst, the wider set of alternative sources of credit.

2.34 Other evidence available to the CC suggests that a significant proportion of payday loan customers compare the costs of loans against other forms of credit. For example, the Bristol University Research found that 18 per cent of online payday loan customers had compared the cost of loans from non-payday providers before choosing to take out their loan.[50] If anything, these proportions understate the extent of potential switching that would be relevant for a market definition exercise. A 5-10 per cent price rise would be expected to induce further switching by some customers who indicated that they would not find it worthwhile comparing costs against potential substitutes at current prices.[51]

E. Analysis of price comparisons between payday loans and other forms of credit

2.35 The CC has compared the pricing of different credit options under different repayment scenarios. Whilst the CC identifies that payday loans are typically cheaper than using unauthorised overdrafts, and typically cheaper than using home credit (in scenarios where customers repay on time), it observes that "[p]*ayday loans are generally substantially more expensive than the other forms of credit*" considered in the analysis.[52]

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48 *Competition between payday lenders and other credit providers* working paper, paragraph 40.

49 TNS BMRG Survey, page 83.

50 Bristol University Research, table 5.1.

51 5-10 per cent being the relevant range for considering the extent of substitution under the standard approach to market definition.

52 *Price comparison method* working paper, paragraph 8.

2.36 Wonga considers that price comparisons are limited as an indicator of substitutability in differentiated markets, and that switching between high and low price products can occur depending on how customers (in particular marginal customers) value specific product features. As noted above, the CC has not investigated customers' valuations of product features and how this influences their willingness to trade-off price against these features (particularly in circumstances where relative prices change). A static comparison of prices is of limited evidential value in this context.

2.37 In any event, Wonga considers that the CC's price comparison methodology is limited and does not allow the CC to fully explore the range of alternative credit sources which might be used by payday customers, nor the manner in which these products might be used to meet short-term borrowing requirements. In particular, Wonga notes that a number of longer-term products (e.g. peer-to-peer loans and guarantor loans) have not been considered. Wonga is aware that many of these allow for early repayment at no cost and therefore might be used for short-term borrowing.[53] Equally, although the CC does include prices for Provident Personal Credit (a home credit product), it has not attempted to calculate the costs of borrowing if a customer took advantage of early repayment options. Wonga is aware, in this regard, that early repayment is an option for Provident's online "Satsuma" product (subject to approval by an agent).[54]

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53 Wonga notes that the CC has acknowledged use of longer-term instalment products by payday loan customers for short-term borrowing. The CC states "*Our analysis suggests that, in some cases, borrowers use relatively long-term instalment products for borrowing needs of less than one month by agreeing to a long-term loan but repaying early*" (*Prices over time* working paper, slide 4).

54 Finally, Wonga considers that the CC has not collected enough data on certain credit options in order to ensure that its analysis reflects average market prices. Credit union, home credit and pawnbroker pricing, for example, is based on samples of one which is insufficient.

ANNEX 3: THE CC'S ANALYSIS OF PRICES

A. The CC's analysis of prices is backward looking and largely excludes emerging products which are challenging incumbents, particularly on price

3.1 Wonga considers that a key recent market development is the emergence of products which offer customers greater flexibility, in particular, instalment loans and open credit agreements. These products are within the CC's scope of reference.[55] Wonga considers, however, that these products have not been sufficiently considered by the CC as part of its pricing analysis. More specifically, only certain products have been included in the CC's price comparisons (and only for certain repayment scenarios), and the analysis of prices over time excludes all but two of the products in question. Wonga is concerned that by largely excluding these products from its pricing analysis, the CC will miss the opportunity to assess the potential effects of products which are anticipated to have a significant impact.

3.2 The CC's price comparison includes certain longer-term products in its analysis for the following reason:

> "*In some cases, longer-term instalment products can be agreed for relatively long durations but may nevertheless be 'prepaid' by the borrower, who thus incurs no interest or finance charges relating to the remainder of the originally agreed loan period. Our analysis suggests that some longer-term instalment loans are indeed used for short-term borrowing, and on this basis we have included a number of longer-term products in our analysis*."[56]

3.3 The CC has included the following instalment loan and open-ended credit agreement products: QuickQuid FlexCredit (CashEuroNet); Zebit short-term cash loan (Lending Stream); Genie 3 month loan (Ariste); Speedy Cash Flex Loan (SRC) and Speedy Cash Flex Account (SRC). It does not, however, include Pounds to Pocket (CashEuroNet),[57] Zebit's instalment loan, and Harvey and Thompson's Kwikloan nor the instalment products outlined in Annex 1. Moreover, the CC has yet to include instalment loans and other longer-term products in its price comparison scenario 3 (which considers the total cost of borrowing when a loan is rolled over).[58]

3.4 Where the CC has included flexible, longer-term products in its price comparisons, it is striking that these products are consistently at the bottom of the pricing range. In particular, in scenario 1 (repayment of £100 on time after 14 days) and scenario 2 (repayment of £100 on time after 28 days) as reproduced below in Figure 3.1 and Figure 3.2 respectively, the four products with the lowest total cost of borrowing are: Zebit short-term cash loan (Lending Stream) paid on a weekly basis; QuickQuid FlexCredit, Speedy Cash Flex Loan (SRC) and Speedy Cash Flex Account (SRC).

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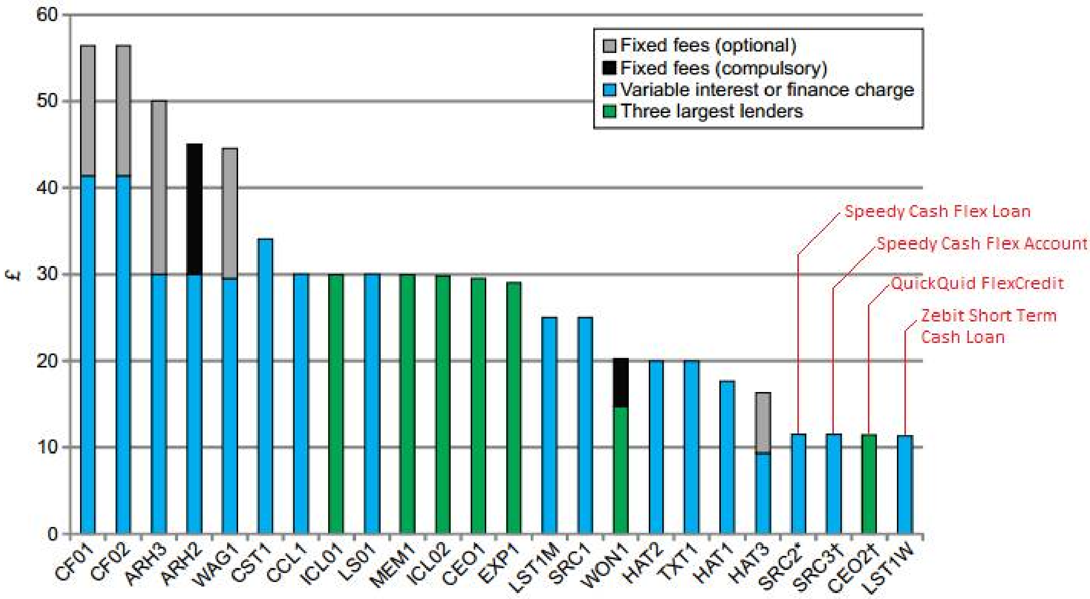
55 *Payday loans products* working paper, paragraph 9. Indeed the CC slightly broadened its working definition of a payday loan in order to incorporate these products and allow the CC to *"take into account ongoing product innovation, the trend of which appears to be towards products which allow borrowers increased flexibility over loan term and amount."*

56 *Payday lender pricing* working paper, paragraph 47.

57 The CC states "*we do not have price information or transaction data for this product*" but the CC can presumably request that such information is provided by CashEuroNet (*Payday lender pricing* working paper, paragraph 5(d)).

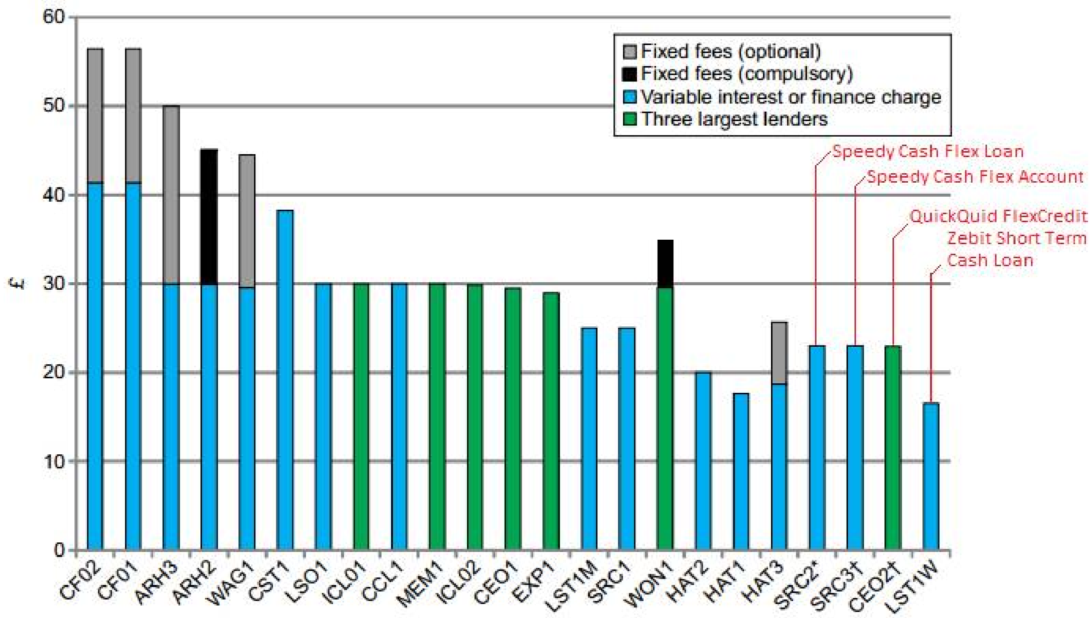
58 The CC outlines the issue it faces in modelling an extension in the context of a longer-term product which is repaid early as follows *"where borrowers use longer-term products to finance short-term borrowing (ie by 'prepaying' their loan before the agreed date as described in paragraph 47), the originally planned loan duration could be 'extended' by the borrower by delaying prepayment. We do not currently include the prices of any products of this type in the analysis of this scenario (including SRC's Speedy Cash Flex Loan)"* (*Payday lender pricing* working paper, paragraph 64). Wonga is unsure why these products have been excluded from this scenario given the suggestion that this might be modelled by assuming that early repayment would occur later than has been modelled under the other scenarios.

Figure 3.1: Total cost of credit for a £100 loan over 14 days (Scenario 1)



Source: *Payday lender pricing* working paper

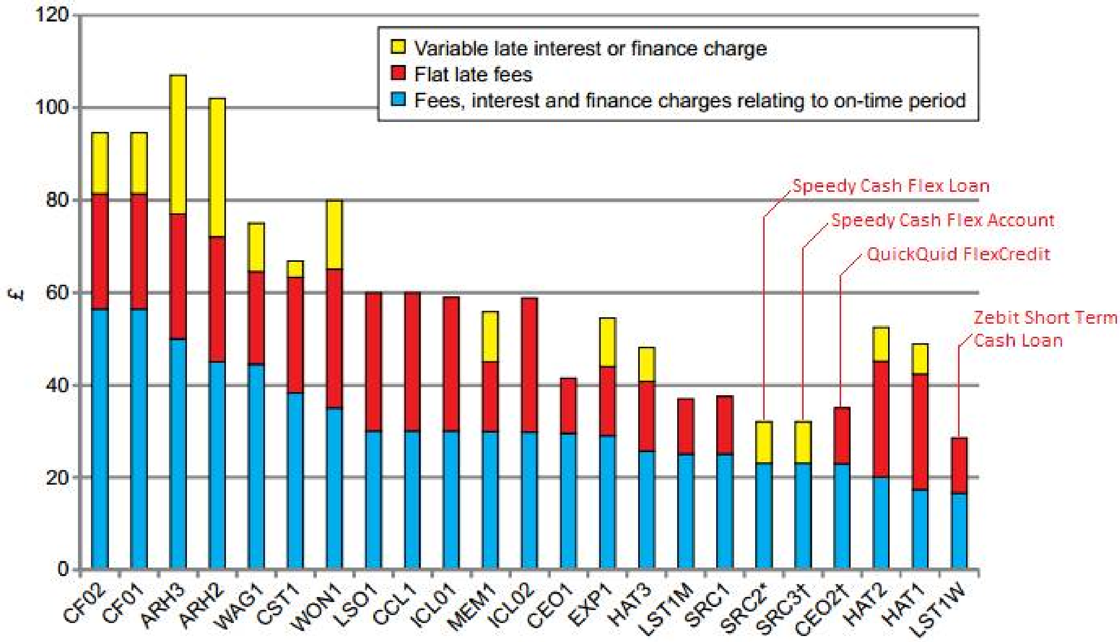
Figure 3.2: Total cost of credit for a £100 loan over 28 days (Scenario 2)



Source: *Payday lender pricing* working paper

3.5 In scenario 4 (repayment of £100 late after 11 days) as reproduced below in Figure 3.3, these same products are amongst the six products with the lowest total cost of borrowing.

Figure 3.3: Total cost of credit for a 28-day loan: repaid on time versus 11 days late (Scenario 4)



Source: *Payday lender pricing* working paper

3.6 The CC indicates that some products are not included in its analysis of price over time. It states:

> "*Our analysis suggests that, in some cases, borrowers use relatively long-term instalment products for borrowing needs of less than one month by agreeing to a long-term loan but repaying early. While we continue to examine the extent to which this occurs, these products are not included in this piece of analysis*".[59]

3.7 This is a serious omission which limits very significantly the ability of this analysis to accurately represent key pricing trends. For example, one of the "main observations" arising from the analysis is "*An increasing number of products have TCCs close to £30 per £100 when repaid on time*".[60] Wonga considers that this reflects the CC's narrow focus on single repayment products. The limited analysis that the CC has done on flexible products (limited to CashEuroNet's FlexCredit and SRC's Speedy Cash Flex Loan and Flex Account products) suggests they are "*relatively cheap*".[61] Wonga considers that a comprehensive analysis of these products would not indicate price convergence in recent months but rather aggressive pricing at the lower ends of the pricing spectrum. Figure 3.4 below shows that FlexCredit is priced consistently and significantly lower than Wonga's Little Loan products over all loan durations .

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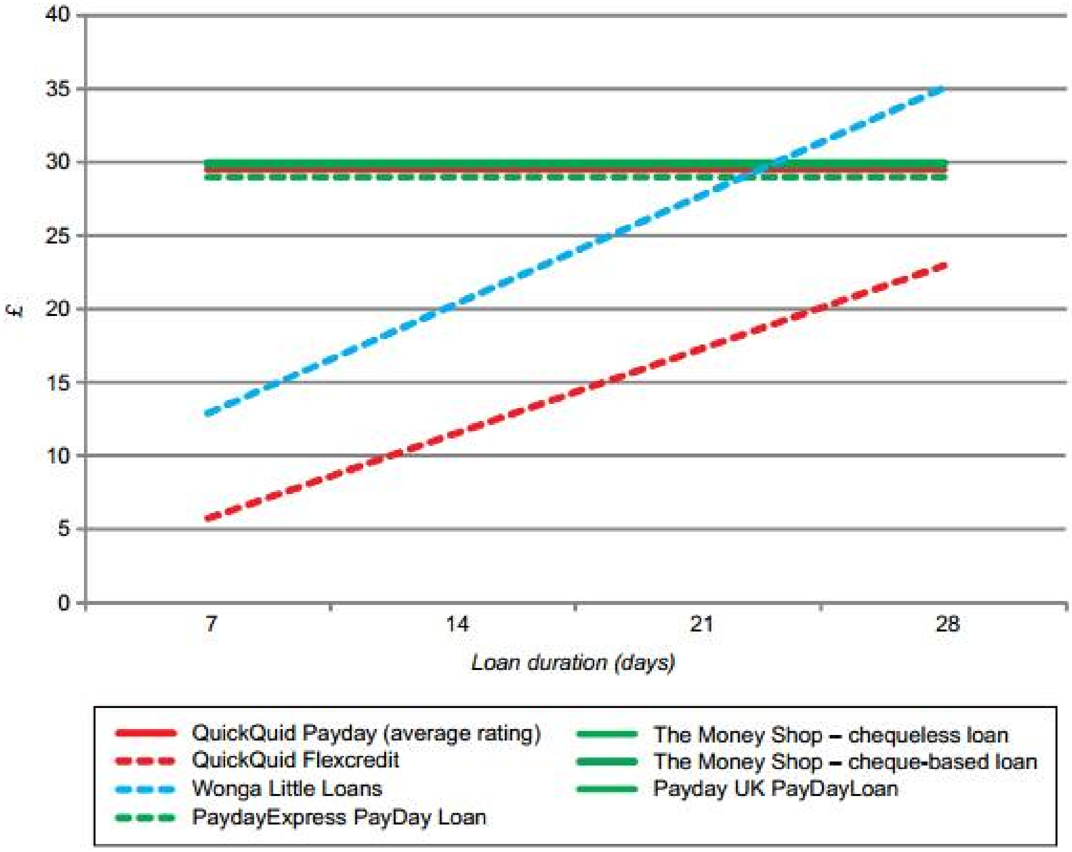
59 *Payday lending prices over time,* slide 4.

60 *Payday lending prices over time,* slide 6.

61 *Payday lending prices over time,* slides 53 to 54.

Figure 3.4: Total cost of credit for a £100 loan at different durations—the three largest lenders only



Source: *Payday lender pricing* working paper

3.8 Given their significance as pricing mavericks, the CC must ensure that its pricing analysis properly incorporates longer-term products and open-ended credit agreements so that their impact can be assessed both now, but more importantly, as they grow in significance.

B. The repayment scenarios considered by the CC are not sufficiently representative of typical customer behaviour

3.9 The CC emphasises the importance of comparing prices in scenarios which "*accurately describe typical customer behaviour*."[62] Wonga has the following concerns in this regard:

(a) Wonga notes that the CC has selected £100 as the loan amount for each scenario on the basis of its "*modal frequency and reasonable proximity to the bulk of the distribution of loan values*."[63] It is not self-evident, however, that this is the most appropriate measure of central tendency for comparing prices. The average value of payday loans made by the 11 major lenders is £260 (for the 12 months to August 2013).[64] Products which charge a flat fee (e.g. Wonga's transmission fee) will be relatively more expensive where the cost of borrowing is calculated in

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62 *Payday lender pricing* working paper, paragraph 42.

63 *Payday lending pricing* working paper, Annex 2, paragraph 2. The CC's presentation "*Customers and their loans*" indicates that *"the modal (most common) loan amount is £100 (around 13 percent of all loans) – we also see peaks at £200 (8%), £150 (7%), £300 (5%), £50 (5%)*" (slide 21). Wonga notes, however, that this narrative is not consistent with the chart at slide 22 which appears to show that the proportion of loans between £100 and £150 is between 15 and 20 per cent.

64 *Customers and their loans,* slide 21.

relation to £100 as compared to £200 because the larger the loan amount the larger the base over which the flat fee is spread; and

(b) Wonga notes the CC's assumption (for each scenario) that customers do not choose to top-up their loans.[65] Wonga considers that this feature is a key benefit to customers (and a factor which differentiates Wonga's offer) which allows customers to lower their interest costs by topping up funds when needed rather than taking funds up-front as one lump-sum. Wonga may appear more expensive if this feature is not incorporated.

3.10 Further, Wonga observes that the calculation of the total cost of borrowing across lenders in each scenario is based on headline prices and therefore does not reflect the actual cost of borrowing, given the existence of promotional activities that are available to a wide spectrum of customers (for example, Speedy Cash's free £200 loan which applies to 90 per cent of loans to new customers).[66]

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65 *Payday lending pricing* working paper, paragraph 44(b).

66 *Payday lending prices over time,* slide 12.

ANNEX 4: INFORMATION AVAILABLE TO BORROWERS AND SHOPPING AROUND

4.1 The CC is considering the information available to borrowers and the extent to which restrictions may exist on the availability of, or ease of access to, the information required to shop around effectively. In this regard, Wonga makes observations on the following:

(a) both the CC and customers acknowledge the availability of, and ease of access to, key information on lenders' websites;

(b) the CC notes that traditional payday loans are relatively straightforward compared to other financial products.[67] This is also considered in the context of comparing payday loan additional charges, which the CC is also investigating;[68]

(c) the CC is investigating the possibility that customers will choose between lenders based on their perceived likelihood of loan approval rather than the merits of different loans;[69] and

(d) the role of lead generators.

A. The availability of, and ease of access to, key information on lenders' websites is acknowledged by the CC

4.2 As regards the availability of, and ease of access to, the information required to effectively shop around, Wonga considers that a range of evidence (including the CC's desktop research into lenders' websites, customer views and third party evidence) points to information being readily available and readily understood:

(a) When shopping around, customers are able to find information on the factors they consider to be of most importance in choosing a payday loan. The TNS BMRG Survey outlines the range of attributes "found out" by those customers who compared lenders.[70] In Table 4.1 below, Wonga compares these attributes with the range of factors cited as important in the choice of payday loan.[71] Five of the seven factors cited as most important to respondents when taking out a payday loan are listed in the top seven types of information discovered by a majority of customers who shopped around. In other words, shopping around <u>does</u> provide customers with the opportunity to gather a large proportion of the information they consider most important in choosing a payday loan.[72]

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67 AIS, paragraph 87.

68 AIS, paragraph 88.

69 AIS, paragraphs 89 to 91.

70 TNS BMRG Survey, page 100.

71 TNS BMRG Survey, page 92.

72 The two exceptions are: (i) "*being able to apply for the loan online/in a store*" - it is unsurprising that this is not cited amongst the information that customers found out when shopping around because these customers will tend to assume that online application is possible for online providers of loans; and (ii) "*the reputation of the lender*" - customers are unlikely to determine the reputation of a lender purely from its own website as customers will tend to look to perceived independent sources in order to reach a view on this.

Table 4.1: Comparison of (a) attributes customers that shopped around said they found; with (b) factors cited as important in choice of payday loan

Attributes customers that shopped around said they found out when comparing lenders, page 100 TNS BMRG Survey (Percentage of customers that found this information)	Equivalent factors cited as important in choice of payday loan, page 91 TNS BMRG Survey (Percentage of customers that considered this "extremely" or "very important" information)
"How much it would cost to borrow the amount needed" (91 per cent) "The cost if you didn't pay back on time" (64 per cent)	"The total cost of the loan" (55 per cent)[73]
"How quickly the other loan would be granted" (84 per cent)	"Speed of getting the money" (74 per cent)
"How long you could take out the other loan for" (80 per cent)	"Repayment flexibility" (54 per cent)
"Repayment options (e.g. instalments)" (75 per cent)	"Repayment flexibility" (54 per cent)
"The amount you could take out" (79 per cent)	"The amount you could take out" (50 per cent)
"How long it would take to apply for the other loan" (66 per cent)	"Ease of the application process" (67 per cent)

(b) Customers make comparisons across a number of lenders (in particular Wonga's website). Shopping around can only be effective if customers can, and do, make comparisons across a number of lenders. It is, therefore, highly significant that the TNS BMRG Survey identifies that over three quarters (77 per cent) of online customers who shopped around said that they viewed at least three websites, and just under half (48 per cent) looked at four or more – both material levels of shopping around.[74]

(c) Lenders websites play a key part in providing information, and the CC has found that relevant information is easily found on these websites. The TNS BMRG Survey outlines the most common methods used to compare payday loans. Overall, the most common methods used were visiting websites of lenders (89 per cent) and seeing advertising (57 per cent),[75] which suggests that lenders themselves play a significant role in providing the information customers need for the purposes of effective shopping around.

The AIS,[76] the *Review of the websites of payday lenders and lead generators* working paper and the *Shopping around* working paper all observe that key information regarding the features of a particular loan can generally be found easily on lenders' websites. The CC finds that:

(i) the large online lenders' websites typically contain the key information about loan terms, the total cost of credit, default and late charges, speed of the process, loan duration and maximum and minimum loan amount;

(ii) in general, this information can be easily found on the website; and

(iii) in general, this information is clearly presented (using font of normal size and weight). Wonga scores highly in all these aspects.

73 This is consistent with Wonga's own customer research which also confirmed that the total cost of repayment was the most useful piece of information customers considered when taking out a loan from Wonga and elsewhere. Knowing the total cost of repayment was rated the most useful piece of information by [CONFIDENTIAL] of respondents. See slide 25 of the Populus Customer Survey, March 2013 at Annex 3 of Wonga's Initial Submission.

74 TNS BMRG Survey, page 102.

75 TNS BMRG Survey, page 101.

76 See, in particular, paragraph 87 of the AIS.

Wonga considers that customers can readily compare quotes where lenders such as Wonga provide up-front transparent information on the cost of borrowing and key products' features (which the CC has confirmed is largely the case), allowing online customers to take a quote and click to another website to compare with the quotes of other providers.

(d) Customers have also confirmed that they have access to clear information. A body of evidence indicates that customers consider themselves to have access to clear information required to shop around effectively. For example:

(i) 86 per cent of respondents to the TNS BMRG Survey said that it was easy to find the information to compare lenders and 82 per cent said that the information was clear;[77]

(ii) an overwhelming 94 per cent of respondents stated that, at the point they took out their loan, they understood very or fairly well what they needed to repay, including 78 per cent who said they understood very well.[78] In addition, customers involved in the qualitative research said they felt that information on repayment charges was generally clear and transparent - especially where a "slider approach" is used, as Wonga does;[79] and

(iii) these results are consistent with Wonga's own customer research which found that: [CONFIDENTIAL] of Wonga's customers considered that they had access to enough information from Wonga regarding Wonga's services and that it was conveyed "well" or "very well";[80] and 96 per cent of Wonga's customers said that they find Wonga's service easy to use (76 per cent "very easy" and 20 per cent "easy").[81]

4.3 The above, coupled with the CC's finding that overall the most common method for finding information was visiting websites of lenders (89 per cent), suggests that lenders play a significant role in providing the information that customers need to shop around effectively, and that customers find the information to be clear.

B. Straightforward nature of payday loan features and comparing loan attributes with regard to additional charges

4.4 As regards the CC's suggestion that there may be difficulties in comparing loan attributes with regard to additional charges, where lenders have different pricing structures, Wonga makes the following observations:

(a) as a general comment, whilst there is some product differentiation amongst lenders (for example, between loans where interest is charged per day and those where fixed interest charges are levied irrespective of the duration of the loan), payday loans are still relatively simple and transparent compared to many other products (for example, utility products where customers may be faced with multiple tariff structures and uncertainty as to their consumption profile), and this is acknowledged by the CC.[82] Moreover, product innovation by lenders such as Wonga and others to offer more flexible, short-term credit products which allow customers greater control (for example, by charging daily fees rather than fixed charges and allowing fee-free early repayment) is pro-consumer and pro-

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77 TNS BMRG Survey, page 108.

78 TNS BMRG Survey, page 110.

79 TNS BMRG Survey, page 112.

80 See slide 11 of the Populus Customer Survey, March 2013 at Annex 3 of Wonga's Initial Submission.

81 See slide 10 of the Populus Customer Survey, March 2013 at Annex 3 of Wonga's Initial Submission.

82 AIS, paragraph 88.

competitive. The ability of customers to compare prices is also pro-competitive and should be encouraged, but this should not come at the expense of innovation;

(b) more specifically in relation to additional charges, Wonga notes certain findings from the CC's qualitative interviews suggesting that "*customers were not generally clear about the penalties that they might have to pay, especially where it was the first time they had taken out a loan*".[83] This finding, however, is not consistent with the following CC findings: (i) the quantitative TNS BMRG Survey data (which indicated that 94 per cent of customers understood how much they needed to repay either very well or fairly well) or other qualitative results;[84] (ii) the CC's *Review of the websites of payday lenders and lead generators* working paper observes that information in relation to default charges and late payment fees is both generally accessible and clearly laid out on payday lenders' websites and that Wonga's website scores particularly highly in this regard (Wonga's flat £30 late payment fee is outlined clearly on the "What does it cost" part of its website, one click away from its homepage); and (iii) the TNS BMRG Survey quantitative finding that of the customers that did shop around, a significant 64 per cent found out the cost of not repaying on time; and

(c) Wonga notes that the CC is considering the role of comparison websites in facilitating comparisons.[85] The quantitative TNS BMRG Survey finds that 42 per cent of respondents indicated that the most common method used to compare lenders was to visit comparison websites. Wonga considers that this high rate of usage is indicative of the value offered by these sites (customers would be unlikely to use these sites if they were difficult to use or unhelpful).[86] Wonga considers that price comparison sites have emerged as an increasingly important tool in the consumer lending market. Wonga notes the limitations some of these comparison sites might have but welcomes the fact that many price comparison companies are innovating in order to provide better services to the customer. For example: money.co.uk provides information to enable comparisons across a range of financial products, including credit cards, current accounts, personal loans, prepaid cards and mortgages. Many price comparison sites use sliders like those used by Wonga, enabling customers to choose a loan amount and loan duration. In addition, there are an increasing number of independent sources of online information on payday loans and alternative short-term credit options, and more than the "limited" amount referred to in the *Shopping around* working paper.[87] In this connection, Table 4.2 at the end of this Annex outlines a number of additional price comparison sites available to payday loan customers and provides details on how loans are compared on those sites.

C. Customers choosing on the basis of likelihood of loan approval

4.5 As regards the suggestion that customers will choose between lenders based on their perceived likelihood of loan approval rather than the merits of different loans, the TNS BMRG Survey evidence does not support this hypothesis. Among customers who did not shop around due to having previously used the same lender, the main reason for not looking elsewhere was being happy with the service previously provided (58 per cent).

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83 TNS BMRG Survey, page 112.

84 The TNS BMRG Survey, page 112, notes that "*Customers in the qualitative research said they felt repayment charges were generally clear and transparent - especially where a 'slider approach' is used*".

85 AIS, paragraph 89.

86 For this reason, Wonga considers that less weight should be placed on the qualitative findings suggesting that where comparison sites were used by customers, they were not found to be helpful because they did not compare like with like loans (TNS BMRG Survey, page 95).

87 *Shopping around* working paper, paragraph 106.

Only 10 per cent indicated that it was because they perceived a greater chance of being approved for a loan as a repeat customer.[88]

D. The role of lead generators

4.6 The AIS[89], the *Review of the websites of payday lenders and lead generators* working paper and the *Shopping around* working papers identify a number of potential issues arising from the use of lead generators by customers. In Wonga's view, these issues warrant further investigation by the CC, given that the transaction data analysed by the CC suggests that over a third (35 per cent) of all new customers that apply for payday loans do so via a lead generator. The issues that the CC has identified with which Wonga has particular concerns include the following:

(a) [CONFIDENTIAL].[90] [CONFIDENTIAL].

(b) [CONFIDENTIAL].[91]

(c) [CONFIDENTIAL],[92] [CONFIDENTIAL].

(d) [CONFIDENTIAL][93] [CONFIDENTIAL].

4.7 [CONFIDENTIAL].

Table 4.2: Additional Payday Loan Price Comparison Sites Identified By Wonga

This table comprises payday comparison websites found from the first seven pages of a Google search conducted on 21 February 2014. Excluded from this table are websites which require the customer to fill in personal details to obtain payday comparison results as such websites generally tend to be lead generators.

Payday comparison websites	How many loans compared?	Comparison features
Random Money Available at http://randommoney.co.uk/compare	Variable – a loan amount of £100 for a term of 20 days returned 49 results (as of 21 February 2013).	• Uses sliders like those used by Wonga enabling customers to choose a loan amount and a loan duration. • Quotes are instantaneously provided for the selected loan amount and duration for a number of lenders including APR, transfer fee, interest charges, total cost of borrowing, payment time and in some cases the extension fee.
Readies Available at https://www.readies.com/	Variable – a loan amount of £100 for a term of 20 days returned 30 results (as of 21 February 2013).	• Uses sliders like those used by Wonga enabling customers to choose a loan amount and a loan duration. • Quotes are instantaneously provided for the selected loan amount and duration for a number of lenders including APR, representative example, interest charges, total cost of borrowing, user reviews and whether the lender is a signatory of the "Good Practice Charter".
Compareandpaydayloans.com Available at http://www.compareandpaydayloa	A direct comparison of seven lenders.	• Users are able to compare loans to the amounts of £100, £200 and £300. • Quotes are provided for the amounts of £100, £200 and £300 for a number of lenders including APR, total cost of borrowing based on 30 day

88 TNS BMRG Survey, page 103.

89 See, in particular, paragraph 87 of the AIS.

90 [CONFIDENTIAL]

91 [CONFIDENTIAL]

92 [CONFIDENTIAL]

93 [CONFIDENTIAL]

Payday comparison websites	How many loans compared?	Comparison features
ns.com/compare-payday-loans-200		term, and whether a credit check is needed.
Instant Compare Available at http://instantcompare.co.uk/compare-loans/payday-loans/	Variable – a loan amount of £100 for a term of 20 days returned 8 results (as of 21 February 2013).	• Uses sliders like those used by Wonga enabling customers to choose a loan amount and a loan duration. • Quotes are instantaneously provided for the selected loan amount and duration for a number of lenders including APR, total cost of borrowing, payment time and whether early repayment is allowed.
Loan Lounge Available at https://www.loanlounge.co.uk/payday-loans?gclid=CLqI0PHb3bwCFYMfwwod0zMACQ	Variable - a loan amount of £100 returned 5 results (as of 21 February 2013).	• Uses sliders like those used by Wonga enabling customers to choose a loan amount. • Quotes are instantaneously provided for the selected loan amount for a number of lenders including the APR, the maximum and minimum loan amount available and the maximum length of the repayment term.
Payday Choice Available at http://www.payday-choice.com/list-of-direct-lenders/compare-direct-lenders	A direct comparison of seven lenders.	• For each lender, information is provided on the maximum and minimum loan amount available, the maximum and minimum loan term available, the total amount repayable, whether or not a credit check is required, what restrictions apply in case of each individual lender and the website's own "star" rating for each lender.
Dosh Daddy Available at http://www.doshdaddy.com/	Variable.	• Users are able to compare loans of the amounts of £100, £200, £300, £400 and £500 pounds for a loan term of either 7, 14, 21 or 28 days. • Quotes are instantaneously provided for the selected loan amount and duration for a number of lenders including APR, total cost of borrowing, total amount repayable, representative example, transfer time and whether early repayment is allowed.
Which Payday Lender Available at http://www.whichpaydaylender.co.uk/	A direct comparison of five lenders.	• For each lender, information is provided on APR, amount repayable for a £100 loan for 30 days, representative example, whether credit checks are performed and whether same day transfer is possible. • User may click on more information to access in-depth profiles for each lender.
Payday Pedro Available at https://www.paydaypedro.co.uk/money/payday-lenders/	A direct comparison of forty four lenders.	• For each lender, information is provided on maximum loan size, maximum loan term and the representative APR. • Payday Pedro keeps a list of payday loan lenders along with in-depth profiles for each of them – available at https://www.paydaypedro.co.uk/money/list-payday-loan-lenders/

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Abstract

We find that competition from payday lenders leads depository institutions to raise overdraft fees and reduce the availability of "free" checking accounts. We attribute this rise in prices partly to adverse selection created by banks' practice of charging a flat fee regardless of the overdraft amount—pricing that favors depositors prone to large overdrafts. Payday credit is priced per dollar borrowed, so when that option is available, depositors prone to small overdrafts switch. That selection works against banks; large overdrafts cost more to supply and, if depositors default, banks lose more, so prices rise. Consistent with this adverse selection hypothesis, we document that the average dollar amount per returned check at banks and other depository institutions increases when depositors have access to payday credit. Our findings illuminate competition and pricing frictions in the large, yet largely unstudied, small-dollar loan market.

Key words: payday credit, overdraft credit, competition, adverse selection

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Melzer: Northwestern University (e-mail: b-melzer@kellogg.northwestern.edu.)
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I. Introduction

The small-dollar consumer loan market we study pits two very different competitors against one another. On the one side are mainstream banks and credit unions that supply overdraft credit whenever they cover check, ATM, or debit card transactions that would have overdrawn depositors' account otherwise. On the other side are payday lenders who cash and hold customers' personal checks for about two weeks, providing the check-writer with $50 to $500 of credit in the interim.

Although much maligned for its high prices, payday credit can be cheaper than overdraft credit. The median price for overdraft credit in 2006 was a flat $27 per overdraft (FDIC 2008). The typical price for payday credit is $15 *per $*100 of credit. Given two weeks of credit at those prices, payday credit is cheaper than overdraft credit for overdrafts below $180.[1] According to the FDIC (2008), the median overdraft at POS, ATM, and check transactions was $20, $60, and $66 in 2006 implying payday credit would be the cheaper substitute for at least half of depositors.

Our paper investigates how the availability of payday credit affects overdraft fees and the supply of "free" checking accounts, the base good with which overdraft services are bundled. We estimate the effect of payday credit using two different identification schemes. The first, following Morgan and Strain (2008), compares how outcomes change as states switch from allowing to prohibiting payday credit, or vice versa. The second, following Melzer (2009), focuses on states that prohibit payday credit, and compares outcomes at institutions located near the border of a state that allows payday credit with outcomes at institutions located further from

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[1] $27/$180 = $15/$100. Sheila Bair (2005), now head of the Federal Deposit Insurance Corp., observed that depositories earned "enormous" fees on overdraft protection and that customers were turning to payday credit for their "cheaper product."

such a border. The identifying assumption for the first scheme is that legal changes within states are independent of overdraft outcomes, a plausible, if arguable, assumption. The identifying assumption for the second scheme is that the payday laws and location of intermediaries in one state are independent of laws in neighboring states, a less arguable assumption it strikes us. Importantly, the identifying assumptions of these two models are independent, which strengthens the overall research design.

Except perhaps in the most concentrated deposit markets, we find that banks and other depository institutions raise fees on overdraft credit and reduce the supply "free" checking accounts when payday credit is available. The changes are similar in both models, and are economically meaningful; the price of overdraft credit increases by $1, or 4 percent, and the likelihood of "free" checking falls by 5 percent.

Although we entertain other explanations for our findings, we attribute them partly to adverse selection created by the curious flat-fee pricing of overdraft credit. According to the FDIC 2008 (Table IV.2 p. 14), 98.4 percent of depository institutions charge *per* overdraft. White (2007) contends that banks eschew charging explicit interest to avoid regulation as credit and hence, usury limits. Banks may also want to avoid the adverse publicity that quadruple digit interest rates might incite.[2] Flat fee ("buffet-style") pricing of overdraft credit disadvantages depositors prone to small overdrafts, and so exposes overdraft providers to adverse selection. Once payday credit priced *ala* carte becomes available, depositors prone to smaller overdrafts switch, saddling banks and credit unions with proportionately more depositors prone to large overdrafts. That adverse selection increases costs to overdraft providers in two ways; funding

[2] Bair (2005) notes the attitude of some bank officials toward payday loans: "most bank officials we interviewed perceived the product as too high risk to offer profitably except at extremely high interest rates, thus inviting criticism from media, public policy officials, and consumer advocates."

large overdrafts costs more, and if the credit is not repaid, lenders lose more. Higher costs imply higher prices.

The adverse selection hypothesis implies that overdraft attempts should fall in number, but rise in average dollar amount when payday credit is available. Using data from Federal Reserve check processing centers, we confirm these predictions for a subset of overdraft attempts: returned checks, which are overdraft attempts that depositories refuse to pay. We extend and confirm Morgan and Strain's (2008) finding that returned checks are fewer when payday loans are allowed. In addition, we find that average amount of a returned check increases by 15% when payday loans are available. In combination, we believe that these facts are compelling evidence in favor of the adverse selection hypothesis.

A final, auxiliary finding provides indirect support for the adverse selection hypothesis: when payday credit is available, depositories reduce the availability of "free" checking accounts only for accounts *without* direct deposit. That selective tightening may represent risk management; expecting that customers who demand "free" checking without direct deposit may be anticipating large, unpaid overdrafts, depositories limit the supply of free checking without direct deposit.[3]

The interactions between overdraft providers and payday lenders may be a case where a competing class of firms educates myopic consumers about the hidden fees ("shrouded attributes") associated with another firms' product, an issue studied by Gabaix and Laibson

[3] The credit model in Riordan (1993) predicts competition in banking *per se* can increase risk and lead banks to tighten underwriting for two reasons. First, competition may degrade the quality of information banks use to screen borrowers, so more bad loans are made. Second, concerns about the winners' curse—the fact that banks may overbid (underprice) credit---will lead them to tighten underwriting standards.

(2006).[4] Whereas depository institutions may have no incentive to reveal the hidden overdraft fees associated with "free" checking, payday lenders might.[5] On that point, it is interesting to note how aggressively payday lenders have publicized the results of the FDIC (2008) study of the costs and usage of overdraft credit.[6]

As a complement to the growing literature about payday credit and consumer outcomes (Morse (2008), Morgan and Strain (2008), Melzer (2009), Skiba and Tobacman (2008), Carrell and Zinman 2008)), our work studies the effect of payday credit on the price of other types of credit. Fusaro (2008) also studies the cost of overdraft credit, but does not investigate its determinants. Hannan (2006) and Deyoung and Phillips (2009) analyze price competition for short-term credit within the banking and payday markets, respectively, but do not look at competition across the two industries. Finally, our work also bears some relation to an emerging industrial organization literature on price-increasing competition. Chen and Riordan (2008) show that competition between two differentiated products can increase each product's price in "non-exceptional" theoretical circumstances and cite evidence of price-increasing competition in two markets, food and drugs.[7] Our paper finds price-increasing competition in a third market.

Section II compares overdraft and payday credit and makes the case, based on prices and usage patterns, that they are at least partial substitutes. Section III describes the exit and entry of payday lenders that constitute the "experiments" we use to study overdraft and deposit outcomes. Section IV presents the main result—price-increasing competition—revealed by those

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[4] Indeed, they use "free" bank accounts and overdraft fees as leading examples of shrouded attributes. See footnote 22 in Gabaix and Laibson (2006).

[5] Within the "shrouded attributes" model, banks can earn more by keeping overdraft terms hidden, because informed customers will avoid the add-on or switch to another bank. Payday lenders offer only the checking account add-on, or credit in this case, so they are not subject to the same customer loss when they inform their customers about overdraft terms.

[6] For example: http://www.approvedcashadvance.com/images/highlights_fdic_bank_overdraft_programs.pdf

[7] Perloff, Suslow, and Seguin 2005; Ward et al. 2002; Thomadsen 2005

experiments. Section V presents auxiliary findings suggesting that adverse selection created by crudely (flat) priced overdraft is partly responsible the price-increasing competition we find. Section VI concludes by discussing implications for consumer welfare, policy, and future research.

II. Overdraft and Payday Credit

This section describes the two main players in the small-dollar loan market and compares the pricing and usage of their services. The key points are: overdraft and payday credit are partial substitutes; payday credit may be cheaper than overdraft credit; and both payday lenders and overdraft credit providers depend on revenues from repeat borrowing by core customers.

II.1 Overdraft Credit

Sometime in the 1990s financial advisory firms began marketing trade-marked, computer algorithms designed to automate and optimize depository institutions' (DI) traditionally *ad hoc* overdraft decisions.[8] The FDIC's (Federal Deposit Insurance Corporation) recent landmark study of bank overdraft programs reveals how ubiquitous overdraft credit programs have now become (FDIC 2008).[9] Forty percent of all banks surveyed operated automated overdraft programs. Over three-fourths of large banks (asset > $ 5 billion) had automated overdraft of one sort or another. The study shows that depository institutions offer a full "suite" of overdraft credit, ranging from lines of credit (LOC), arguably the top-of-the line, to automated discretionary overdraft protection, more familiarly known as bounce "protection," the variety we study.[10]

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[8] In a testimonial on the website of Strunk and Associates, purveyor of "Overdraft Privilege, a banker recalls "… I believe …we were the first institution in Georgia to implement the service. That was in 1998 or 1999" http://www.strunklp.com/custom.asp?id=128274&page=13. Accessed March 30, 2009.

[9] Starting with the population of banks scheduled for examination between May and December 2007, the FDIC surveyed a stratified, random sample of 462 institutions about their automated overdraft programs. Of those, a non-random sample of 39 banks were asked to provide transaction-level data.

[10] LOC are opt-in services charging interest comparable to credit card rates. "Bounce protection," by contrast, is the opt-*out* (default) choice charging flat fee rates that often imply implicit interest rates at three digit levels.

Depending on the amount of the overdraft, overdraft credit can be more expensive than payday credit. The median NSF (insufficient funds) fee charged by depository institutions *per* overdraft was $27 in 2007 (FDIC 2008, p.III, bullet 5). At that fee, the implicit annual percentage interest (APR) on a hypothetical, two week overdraft of $60 is about 1,173 percent, more than the typical APR for payday credit.[11] Repeated overdrafts are common for a subset of users (Table 1). About nine percent of depositors studied by the FDIC (2008) overdrew ten or more time *per* year, resulting in average fees incurred of $451 to $1610 *per* year. That fact is notable, as repeat ("chronic") usage of payday credit is also common and is commonly used as a critique against the industry.

Supplying overdraft credit seems profitable for depository institutions by any number of measures. The 1157 banks studied in FDIC (2008) claimed $2 billion in NSF-related fees in 2006, or $1.7 million *per* bank.[12] For the median bank, NSF fee income accounted for 43 percent of noninterest income and 21 percent of net operating income.[13] Banks and credit unions, particularly the latter, are surprisingly reliant on revenue from overdraft credit (Table 2). By Moebs' estimates, overdraft revenue accounted for 60.4 percent of credit union net operating income in 2005.

Supplying overdraft credit is not without risks or costs, however. Depository institutions involuntarily closed 30 million accounts between 2001and 2005 for "recidivist" check bouncing,

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[11] The implicit annual percentage rate is ($27/$60)*26*100. Using actual overdraft transactions on 1339 accounts at a small Midwestern depository institution, Fusaro (2008) reckons the median APR exceeded 4,000%, with "chronic" overdrafters paying $3,440 annually in fees.
[12] FDIC (2008) Table VIII-1, p. 57.
[13] FDIC (2008) Table VIII-2, p. 58.

and the trend is upward (Campbell, Jerez-Martinez, and Tufano 2008, p.1). The average loss *per* bad account in 2007 was $310 (FDIC 2008, Table VIII-5).[14]

II.2 Payday Credit

In 2007 roughly 19 million households demanded credit from about 24,000 payday lenders (Stephens 2008). As with overdraft, payday borrowers demand the credit repeatedly; many customers take out four or five loans *per* year, and a sizable fraction demand ten or twelve loans *per* year (Elliehausen and Lawrence 2001, Caskey 2002). The distribution of credit demand bears uncanny resemblance to the distribution of overdraft credit demand in Table 1.

Payday credit underwriting is minimal; applicants must prove that they have a checking account and a job. The checking account pre-requisite makes checking accounts and payday credit partial complements, implying positive correlation in the individual demand for each. Given a deposit account, however, payday credit and overdraft credit are substitutes, implying negative correlation in their individual demand. As we discuss later, that asymmetric technological relationship might help account for some of our findings.

III. Entry and Exit by Payday Lenders as "Experiments"

Because of the controversy surrounding payday credit, the state laws governing it have been in flux. Following Melzer (2009) and Morgan and Strain (2008), we use those fluctuations to identify plausibly, or at least arguably, exogenous variation in payday credit supply. We identify fluctuations or differences in regulation in 13 states. The appendix documents the regulatory differences in detail.

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[14] Charged-off deposit losses are counted in "residual charge-offs not elsewhere classified" (FDIC 2008 p. 62) Losses on charged-off deposits accounted for 12.6 percent of total gross loan and lease charge-offs in the FDIC study.

With a few exceptions, New England states have barred entry of payday lenders by strict enforcement of usury limits. Other states have closed markets outright or indirectly, *via* prohibitive usury limits, while a few have sanctioned and safe harbored the practice. Using those differences, we define two distinct indicators of DD credit availability: *Allowed* and *Access*.

$Allowed_{sy}$ equals one for institutions located in a state *s* where payday credit is allowed in year *y,* and zero otherwise. Because our regressions include state fixed effects, the variation that identifies the effect of *Allowed* comes from states that switch from prohibiting to allowing payday credit, and vice-versa. One state, New Hamphshire, switched from prohibiting to allowing in 2000. D.C. and six states switched from allowing to prohibiting payday credit between 2002 and 2008: MD, GA, NC, WV, PA, and OR.

Our identifying assumption is that political-economy decisions driving changes in *Allowed* are exogenous with respect to outcomes. While that assumption may be arguable, we find it plausible given the absence of any evidence to the contrary.

The 2nd availability measure is actually a sequence of distance-based indicators. $Access\_X\_Y_{cy}$, is a county-year level indicator equal to one if an institution is located in a county whose center is within X and Y miles of a state that allows payday lending (zero if not).[15] For example, *Access_0_10* equals one if an institution is in a county located 10 miles or less from a state that allows payday loans, and zero otherwise. *Access_10_20* and *Access_20_30* are defined analogously. The omitted category is *Access_30_plus*.

Note that *Access* varies only in states that prohibit payday lending.[16] Its effect is identified by comparing outcomes at institutions relatively near states that allow payday credit to

[15] We use the county center because we do not know the exact location of institution within the county.
[16] The 13 states that prohibit payday lending for some time during the sample period are: CT, DC, GA, MA, MD, NC, NH, NJ, NY, OR, PA, VT, WV.

outcomes at more remote institutions. The identifying assumption is that the distance between institution *i* and a state where payday credit is allowed is exogenous with respect to overdraft terms at institution *i*, a weaker assumption than needed for *Allowed*.[17]

The institutional and county characteristics defined by *Allowed* and *Access* differ in a few ways (Table 3). States with changes in *Allowed* have higher proportions of Hispanics and blacks, and relatively more savings banks (versus commercial banks). Savings banks are also over-represented (relative to commercial banks) in counties without access to payday credit (*Access_0_10 =1).* Unemployment rates are significantly lower in those counties as well. Importantly, our regression analysis controls for those differences by including institution and county-level controls.

IV. Data and Results

IV.1. Data

The data on overdraft prices and "free" checking were provided to us by Moebs $ervices of Lake Bluff, Illinois which collected the data through a telephone survey.[18] Moebs draws a random sample of institutions – stratified by region, asset size and institution type – and calls each institution's main branch to assess fees charged to customers at that specific location.[19]

[17] Our identifying assumption requires, firstly, that payday credit regulations in bordering states are uncorrelated with characteristics of the overdraft market across the border, and secondly, that depositories do not locate based on payday credit availability in some way that alters the composition of depositories near the border. To weaken the latter assumption, we control for the institution type, institution size (log assets), and the concentration of the local deposit market. Also reassuring is that Moebs almost always surveys the main branch, a location that was typically determined long before payday lenders arrived on the scene.

[18] Moebs $ervices is an economic research firm focused on the financial services market. Their survey of fees and services at depository institutions was initiated to collect data for the Federal Reserve's Annual Report to the Congress on Retail Fees and Services of Depository Institutions (1989 to 2002), and has continued annually thereafter.

[19] Many banks with regional or national branch networks are chartered separately in each state. Moebs samples from the population of chartered institutions, so a single bank holding company might be sampled multiple times in a given year, across separately chartered subsidiaries.

The full space of data spans roughly 20,000 branch-year observations, half on commercial banks, 40 percent on credit unions, and 10 percent on savings banks. The two variables of interest are *Fee,* the fee charged per overdraft event, and *Free Checking*, a binary variable indicating whether an institution offers free checking accounts. *Fee*, measured in constant (2008) dollars, is observed at banks from 1995 to 2008, and at credit unions from 1999 to 2008.[20] *Free Checking* is observed from 2003 to 2008.

Sample statistics for the dependent variables are in Table 4. Average *Fee* is $25, but some institutions charged above $50. Although free lunches are said not to exist, "free" checking is ubiquitous; about 75 percent of depository institutions offered it.[21] Overdraft fees and the availability of "free" checking differ across types of institution. Credit unions and savings banks charge significantly lower fees, and were more likely to supply "free" checking, especially on accounts without direct deposit.

We match the Moebs survey data with balance sheet and income statement data filed by each institution with the FDIC (Federal Depository Insurance Corporation) and NCUA (National Credit Union Administration).[22] We also use the FDIC's Summary of Deposits database to calculate the HHI (Hirshman-Herfindahl index) of bank deposit market concentration for each county and year.[23] County characteristics including median income, racial composition, home ownership, population and percent urban population, are from the 2000 Census. Unemployment rates, by county and year, are from the Bureau of Labor Statistics' Local Area Unemployment Statistics.

[20] Nominal prices are converted to real prices, in 2008 dollars, using the level of the June CPI from 1995 to 2008.
[21] "Free" checking, as distinct from free *checks,* means fees are not levied until the account balance is negative, in which case NSF or OD prices apply.
[22] These databases are populated through regulatory filings – bank and credit union Call Reports, and Thrift Financial Reports.
[23] NCUA does not collect the equivalent data for credit unions so credit union market shares cannot be calculated.

IV.2. Findings with *Allowed*

We estimate the impact of payday credit availability on *Fee* and *Free Checking* using difference-in-difference regressions of the form:

(A) $Y_{icsy} = \alpha + a_s + a_y + \beta Allowed_{sy} + \theta HHI_{cy} + \vec{\gamma} Cnty_{cy} + \vec{\pi} Inst_{iy} + \varepsilon_{icsy.}$

Y_{icsy} represents *Fee* or *Free checking* at institution *i* in county c*,* state *s,* at year *y*. The fixed effects (a_s and a_y) control for differences in the mean of *Y* across states and years. Some versions of (A) include a Census division-year effect to control for regional-specific trends. *HHI* (Herfindahl-Hirschman Index) measures bank deposit market concentration in each county-year. In some specifications we include an interaction, *Allowed**HHI,* to see if the payday credit effects depend on deposit market concentration. *Cnty* is a vector of eight county-level control variables, including the unemployment rate, which varies across years.[24] *Inst* controls for the natural log of assets and institution type (with dummy variables): saving bank, credit union, or commercial bank (the omitted category). The regressions are estimated by ordinary least squares, but we report probit estimates of *Free Checking* in robustness tests. Observations are grouped by state in calculating Huber-White robust standard errors.[25]

The key coefficient, β, measures how F*ee* or *Free Checking* varies with *Allowed*. Textbook theory implies β < 0, but given our adverse selection hypothesis, we reserve the possibility of β > 0.

Table 6 reports estimates of the regression model. Before considering β, note some of the other results. Credit unions and savings banks charge lower fees for overdraft than commercial

[24] The county-level Census controls are cubics in median income, population and percent urban population; percent black, white, Hispanic and Asian; percent home hownership and percent foreign born.
[25] Clustering by state addresses the Bertrand et al. (2004) concern that serially correlated outcomes bias standard error estimates in differences-in-differences regressions.

banks and are more likely to offer free checking. *LogAssets* has a significant, positive coefficient in every model, implying larger institutions charge higher overdraft fees and are more likely to offer "free" checking. By contrast, *HHI* is insignificant in every model implying *Fee* and *Free Checking* are uncorrelated with local deposit market concentration.

Now consider *β*. The results suggest access to payday credit is associated with higher overdraft fees in all but the most concentrated deposit markets. *Allowed* is positive in all four *Fee* regressions and is significantly different from zero in three of four specifications. The exception is specification (3), where we include census division-year fixed effects, but even in that case we find no evidence of price-decreasing competition. The estimate in column (2), the model with the maximal set of controls, implies overdraft fees increase by $1.31 when payday credit is available, a 5 percent increase relative to average overall the sample. Model (4), where we include the interaction *Allowed*HHI,* indicates that access to payday credit increases overdraft fees the most in competitive deposit markets. Based on the point estimates, payday availability decreases overdraft fees in concentrated markets, with an HHI above 0.6, a level three times the average HHI for overall the sample.

The *Free Checking* regressions indicate depository institutions are less likely to offer free checking accounts when depositors have access to payday credit. *Allowed* is negative and significant in models (5) – (6) which includes the model with census division-year fixed effects. The smallest estimate on *Allowed,* in model (5), implies depositories in states that allow payday lending are five percentage points less likely to supply free checking.[26]

Before discussing the results, we confirm that they hold using an entirely different measure of payday credit availability.

[26] Since *Free Checking* is binary, this model assumes linear probability; we relax that assumption in a robustness exercise.

IV.3. Findings with Access

A potential concern with *Allowed* is that states endogenously liberalize their payday lending laws as OD fees increase, leading to a biased estimate. Using *Access* reduces those concerns; the identifying variation in *Access* does not depend on law changes in the institution's home state.

The regression model is:

(B) $Y_{icsy} = \alpha + a_{st} + \vec{\beta}\boldsymbol{ACCESS}_{cy} + \vec{\gamma}\boldsymbol{CNTY}_{c} + \delta BORDER_{c} + \theta HHI_{cy} + \vec{\pi}\boldsymbol{INST}_{icsy} + \varepsilon_{icsy}.$

Apart from replacing *Allowed* with *Access,* model (B) differs from (A) in two ways. First, (B) includes a state-year effect (instead of state and year effects) to isolate variation in *Access* that is unrelated to the state-level changes payday availability captured by (A). Second, some specifications of (B) include *Border*, a dummy indicating whether an institution is located in a county within 25 miles of a state border. *Border* controls for general differences between institutions located near a state border and more interior counties. To improve precision of the estimates we include all observations in the regression sample, but the identifying variation in *Access* comes from institutions in the thirteen states that prohibit payday lending at some time during the sample.

Table 6 reports regression estimates. We observe the same significant differences across types of institutions and size of institution as with regression model (A). Market concentration (HHI) is insignificant, as before.

The main results with *Access* are very similar to those with *Allowed.* Given county characteristics and type of institution, depository institutions are about 9 percentage points less likely to offer free checking if payday credit is accessible within 10 miles, with no discernible effect at greater distances. Overdraft fees are significantly higher when payday credit is accessible. These estimates are very close to the earlier estimates; given the type and size of institutions and other controls, overdraft fees are $1.48 higher when payday credit is available within 10 miles. Access beyond ten miles does not significantly affect overdraft prices. As with *Allowed*, *Access* seems to have a larger effect on OD fees in low-HHI deposit markets, but the estimated coefficient on the HHI interaction term is quite imprecise.

IV.4. Robustness

Table 7 shows that the main findings are robust to several alternative functional forms. Estimating a probit model for *Free Checking* (panel A) yields marginal effects very similar to the linear probability estimates in the main results. A log-linear model, with *Log(Fee)* as the dependent variable, also yields an estimated effect of *Allowed* and *Access* of between four percent and six percent. This analysis confirms that the nominal to real price adjustment does not change the results. Results for model (A) are also stable when county dummy variables are used in place of the *Cnty* vector.[27]

Table 8 confirms the results of model (B) using a continuous measure, *LogDistance*, instead of *Access*. A one percent increase in the distance to a state that allows payday credit increases the probability that *Free Checking* is available by four percentage points and decreases OD fees about 50 cents.

V.1. Adverse Selection and Other Possible Explanations

How do we explain our finding of price-increasing competition? One might wonder if we are confusing cause and effect; perhaps rising overdraft prices within a state (endogenously) motivate legislators to permit payday credit? However, our second identification is less subject

[27] Results are available upon request.

to that objection. It seems implausible that the regulatory decisions in one state are driven by the overdraft conditions in counties in neighboring states, and, at that, only by those counties within 10 miles of the border, as we find.

Could access to payday credit drive up prices by increasing *demand* for overdraft credit? That prediction follows from the “debt trap” hypothesis against payday credit, the proposition that prohibitively expensive payday loans aggravate their users already strained financial condition and drives them to demand still more credit, including, perhaps, overdraft credit.[28] However, Morgan and Strain (2008) document that returned checks rates fall when payday credit is available. That finding, which we confirm and extend below, suggests access to payday credit *reduces* demand for overdraft credit, at least by some account holders.

Our findings could reflect the theoretical counter-effects of competition predicted by Chen and Riordan (2008). Analyzing a monopoly-duopoly model where consumers make discrete choices between differentiated products, they show that the customary downward pressure on prices from entry (as firms “defend” lost market share) may be offset by upward pressure arising because the duopolist’s remaining customers are less price-elastic. While those effects could be operating here, we do not have any direct evidence for them.

Where we can provide direct evidence is for the adverse selection hypothesis. That hypothesis, again, is that the flat-fee pricing of overdraft credit discriminates against depositors prone to small overdrafts so they switch to payday credit when available while depositors prone to large overdrafts stick with banks and credit unions. That adverse selection hypothesis implies

[28] Melzer (2009) finds that households with geographic access to payday loan stores are more likely to report difficulty paying bills, and Skiba and Tobacman (2008) find higher rates of Chapter 13 bankruptcy filings among payday borrowers.

that the average amount *per* overdraft should increase when payday credit is available.[29] We test this prediction using data on returned checks, a subset of overdraft attempts, from Federal Reserve Regional Check Processing Centers (CPC).[30]

Some limitations of the data require discussion. Fed CPCs operate regionally; a CPC might process checks drawn on depository institutions from other states (which introduces some error in variables) and some states do not have a Fed CPC (which limits the events we can study). New Hampshire and Rhode Island have never had a CPC within their borders so we omit the changes in regulation in those states from our set of "experiments." That leaves six events, all bans, in five states (GA, NC, MD, WV, OR, and PA) with which we identify the effect of payday credit access on rates and amounts of returned checks.

With electronic payments supplanting checks, the Federal Reserve in 2004 began consolidating its check processing operations by closing some CPCs and transferring their operations to others. To maintain continuous series for those CPCs, we create *pro forma* series by combining the data for those CPCs at the beginning of the observation period. For example, the Columbia, SC CPC was closed and its operations were transferred to the Charlotte, NC in August, 2004. Combining their data at the beginning of the observation period creates a pro *forma* "Charlotte-Columbia" CPC that reflects joint activity at the CPC. Having to use *pro forma* series tends to attenuate the impact of payday lending bans on the outcomes.

To see how returned check patterns vary with access to payday credit we estimate difference-in-difference regressions of the form:

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[29] To clarify our terminology: overdraft attempts can be divided into two mutually exclusive and exhaustive categories, returned (bounced) checks and paid (protected) overdrafts.

[30] The Federal Reserve clears checks for banks, credit unions, and other depository institutions. The 45 Fed CPC operating in 2003 cleared about 38 percent of the estimated 36.6 billion checks written on all types of U.S. depository institutions that year, including credit unions and savings banks. Federal Reserve 2005 Check Restructuring Factsheet. http://www.federalreserve.gov/boarddocs/press/other/2004/20040802/attachment2.pdf.

$$\text{(C)}\ Y_{csdt} = \alpha + a_c + a_t + \beta Allowed_{st} + \gamma Unemployment_{dt} + \kappa \text{Controls}_{\text{st}} + \varepsilon_{ct}.$$

The dependent variable, Y_{csdt}, denotes either 1) the *rate* of returned checks or 2) the average dollar amount *per* returned check at CPC c in state s in Federal Reserve District *d* at time (year-quarter) *t*. The rate of returned checks is measured in two ways: 1) number of returned checks *per* number of checks processed; and 2) dollar value of returned checks *per* dollar value of checks processed. The former seems more pertinent here because payday credit users, having lower than average income, are likely to write (and bounce) checks of smaller than average value, and the effect of these on the latter (dollar) measure will be muted. The regressions include a fixed effect for each CPC (a_c) and each date (a_t). *Allowed* is defined as before, except the NH and RI events are excluded. $Unemployment_{dt}$ denotes the unemployment rate in the Federal Reserve District wher CPC *c* is located at *t*. $\text{Controls}_{\text{st}}$ is a vector of controls measured at the state level: unemployment, log income, and income growth.

Summary statistics are reported in Table 9. The average rate of returned checks *per* number processed is 1.26 percent. The mean dollar amount *per* returned item is \$872 and the median amount is \$758. Those amounts are larger by an order of magnitude than the means and medians in FDIC (2008), presumably because the FDIC counted all overdrafts, protected or not, while our data only cover unprotected overdrafts; risk-averse banks may hesitate to cover \$800 overdrafts.

The returned check regression results are reported in Table 10. Model (1) indicates that the returned check rate *per* checks processed, the measure more closely associated with small dollar check writers, declines when payday lending is allowed. Returned checks *per* dollar processed tends downward (Model 2), but the decline is not statistically significant. Those results confirm Morgan and Strain (2008). Model (3) indicates that the amount *per* returned check rises when payday lending is permitted (significant at the ten percent level). The average amount *per* return increases by $130 dollar when payday lending is permitted, an increase of 15 percent relative to average.

The returned check regressions seem consistent with the adverse selection hypothesis.[31] When payday credit is available, depositors prone to frequently bouncing small checks may switch to less expensive payday loans. The depositors that do not switch are prone to bouncing larger checks, where overdraft is not such a bad deal.

V.2. Free Checking With Direct Deposit & Without

Recall that "free" checking is less available when payday credit is available. That finding might partly reflect that a checking account is a complement, pre-requisite actually, for payday credit, so their demand is positively correlated. While granting that possibility, we conjecture it also has to do with the possibility that "free" checking is less profitable to depository institutions when payday credit is available to depositors. Depository institutions may use "free" checking as loss leader that is compensated for by expected revenue from overdrafts. If payday credit helps depositors avoid overdrafts, the loss leader becomes a money loser. That logic predicts the decline in "free" checking will be more pronounced for deposits without direct deposit.

Consistent with that prediction, the results in Table 11 show that payday credit availability affects only the supply of "free" checking accounts without direct deposit. Also observe that institutional differences in the main results—the greater propensity for credit unions and savings banks to supply "free" checking-- is significant only for accounts without direct

[31] In addition to changing the distribution of overdraft attempts, payday credit availability might also influence banks' policy of whether or not to cover an overdraft attempt. Changes in bank policy do not seem able to explain our findings that the average amount of returned checks increases when payday credit is available, however. To the extent banks are saddled with a riskier pool of overdrafters when payday loans are available, they would likely tighten standards and reduce the proportion of overdrafts paid, contrary to our results.

deposit. Credit unions and savings banks may rely more on overdrafts on accounts without direct deposit to compensate for providing "free" checking services.

V. Conclusion

Faced with competition from payday lenders, mainstream depository institutions charge higher overdraft fees and are less likely to offer "free" checking accounts without direct deposit. We attribute this price-increasing competition at least partly to adverse selection. When payday credit price *ala carte* is available, the small dollar overdrafters disadvantaged by the buffet pricing of overdraft credit switch, saddling banks and other depositories with proportionately more higher cost, possibly riskier large-dollar overdrafts. Depository institutions raise prices and manage the extra risk by reducing the supply of free accounts without direct deposit.

How does the competition we study affect consumer and producer welfare? Banks, credit unions, and other depository institutions appear to lose when faced with competition from payday lenders as some of their core customers—depositors prone to small, perhaps repeated overdrafts—switch to payday lending and their remaining customers overdraw, and perhaps default, in larger amounts. The depositors who switch to payday lenders would also appear to gain, assuming they are making rational, informed choices. The losers, of course, are the customers who stick with bank overdraft at the new higher price.[32] Without a model, we cannot calibrate the net welfare effect. However, Gabaix and Laibson (2006) use overdraft credit as the leading example of a "shrouded attribute," an expensive, overpriced feature of a good or service

[32] Our findings might reconcile the salutary effects of payday access in Morgan and Strain (2007) with the inimical effects in Melzer (2009); perhaps Melzer (2009) is detecting the households which stick with (now higher priced) overdraft, while Morgan and Strain (2007) are picking up the households who select away from overdraft.

that is hidden from consumers. "Debiasing," that is, educating consumers by unshrouding hidden attributes, is welfare increasing.[33]

[33]There is also a competing effect in shrouded attributes model. Shrouding only occurs when sophisticates can avoid the "add-on" at sufficiently low cost ("e"). The introduction of the substitute lowers "e" for sophisticates, making shrouding more likely, all else the same. In the context of overdraft, that implies banks are more likely to lower the price of the base good (the deposit), but charge higher add-on prices. We are finding higher add-on prices, but also higher base good prices.

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Table 1: The Distribution of Deposit Overdrafts and Fees Paid to Banks in 2006

# of overdrafts per year	*% of depositors*	*Annual fees paid ($)*
0	75.0	0
1 – 4	12.0	64
4 – 9	5.0	215
10 – 19	4.0	451
20 or more	4.9	1610

Source: FDIC (2008, p. IV, Executive Summary points 2,3,4)

Table 2: Importance of Overdraft Revenues to Depository Institutions

	Overdraft (OD) Revenue ($ billions)	*Net Operating Income (NOI) ($ billions)*	*OD Revenue/NOI (percent)*
Banks	26.1	$145.8	17.9
Savings Banks	3.5	21.9	16.0
Credit Unions	3.5	5.8	60.4
Total	33.1	173.7	19.1

Source: Moebs $ervices (http://www.moebs.com/Default.aspx?tabid=125) using FDIC and NCUA 2003 Call Reports and 5300 Reports

Table 3: Average Institution and County Characteristics, by Change in *Allowed* and *Access_0_10*.

Reported are means and number of observations (N). *Allowed* =1 for states in institutions allowing payday lending , 0 otherwise. *Access_0_10* indicates whether payday loans are available within ten miles of center of county where institution is located.

	No Change *Allowed*	Change in *Allowed*	Diff. significant at 5%	*Access_0_10 = 0*	*Access_0_10 = 1*	Diff. significant at 5% level
Institution	(17,837)	(2375)		(2,830)	(391)	
Credit Union	0.41	0.41		0.44	0.49	
Commercial Bank	0.47	0.45	*	0.30	0.36	*
Savings Bank	0.12	0.14	*	0.26	0.15	*
Total Assets†	2,409,000	2,738,000		3,875,000	1,824,000	
County	(1,750)	(264)		(199)	(38)	
Median Income	36,900	37,400		42,800	42,700	
Population	126,500	132,600		283,400	198,700	
Percent urban	0.49	0.51		0.64	0.60	
Home ownership	0.73	0.72		0.69	0.71	
Percent white	0.82	0.81		0.83	0.84	
Percent black	0.07	0.13	*	0.08	0.09	
Percent hispanic	0.07	0.03	*	0.05	0.03	
Percent foreign born	0.04	0.03		0.06	0.05	
County-Year						
Unemployment Rate	0.052	0.052		0.050	0.046	*
(N)	(7,764)	(234)		(931)	(155)	
HHI	0.21	0.21		0.17	0.18	
(N)	(7,675)	(1,114)		(931)	(155)	

† N = 17,763 for no Change in *Allowed*, N= 2,374 for change in Allowed, N = 2802 for *PaydayAccess_0_10 = 0*

Table 4: Summary Statistics for Overdraft Fees and Availability of Free Checking Accounts by Type of Institution

	Panel A: All Institutions				Panel B: Banks				Panel C: Credit Unions			
	obs	mean	std dev	median	obs	mean	std dev	median	obs	mean	std dev	median
Overdraft Fee	15,089	24.98	7.32	25.95	10,345	25.73	7.33	26.80	4,744	23.34	7.00	24.59
Free Checking	10,542	0.73	0.44	1	5,253	0.66	0.47	1	5,289	0.81	0.39	1
Free Checking w/o Direct Deposit	9,626	0.62	0.48	1	4,339	0.52	0.50	1	5,287	0.71	0.46	1
Free Checking w/ Direct Deposit	9,626	0.11	0.31	0	4,339	0.12	0.33	0	5,287	0.10	0.30	0

Table 5: How Payday Credit Access Affects Overdraft Fees and Availablity of Free Checking Accounts

Reported are OLS regression estimates (robust standard errors clustered by state). *Allowed* =1 for institutions located in states allowing payday credit, zero otherwise.

	Dependent Variable (mean):							
	Overdraft Fee (24.98)				*Free Checking (0.73)*			
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Allowed	1.09*	1.31**	0.40	1.92***	-0.051**	-0.049**	-0.069***	-0.054
	(0.62)	(0.52)	(0.78)	(0.60)	(0.024)	(0.022)	(0.025)	(0.037)
*Allowed*HHI*				-3.27*				0.03
				(1.77)				(0.15)
HHI		-0.33	0.13	2.63		0.04	0.05	0.01
		(0.99)	(0.95)	(1.60)		(0.05)	(0.06)	(0.14)
CreditUnion		-2.38***	-2.42***	-2.38***		0.24***	0.24***	0.24***
		(0.38)	(0.38)	(0.38)		(0.03)	(0.03)	(0.03)
SavingsBank		-1.22***	-1.17***	-1.21***		0.08**	0.09**	0.08**
		(0.24)	(0.24)	(0.25)		(0.03)	(0.03)	(0.03)
LogAssets		0.96***	0.95***	0.95***		0.04***	0.04***	0.04***
		(0.09)	(0.09)	(0.09)		(0.01)	(0.01)	(0.01)
State and Year FEs?	Y	Y	Y	Y	Y	Y	Y	Y
County Controls?	N	Y	Y	Y	N	Y	Y	Y
Division-Year Trends?	N	N	Y	N	N	N	Y	N
Observations	15,072	15,041	15,041	15,041	10,524	10,505	10,505	10,505
R^2	0.19	0.32	0.34	0.32	0.04	0.10	0.11	0.10

* significant at 10%; ** significant at 5%; *** significant at 1%

Table 6:

Effects of County-Level Payday Credit Access on Overdraft Fees and Free Checking Availability

Reported are OLS estimates (robust standard errors clustered by county). *Access_X_Y* equals 1 if institution is located in county whose center is within Y and X miles of a state that allows payday lending.

Dependent Variable (Mean):	*Overdraft Fee (24.98)*			*Free Checking (0.73)*		
	(1)	(2)	(3)	(4)	(5)	(3)
Access_0_10	1.20**	1.48***	1.68***	-0.051	-0.088**	-0.09**
	(0.56)	(0.55)	(0.60)	(0.04)	(0.04)	(0.04)
Access_10_20	0.14	0.22		-0.05	-0.05	
	(0.60)	(0.66)		(0.04)	(0.04)	
Access_20_30	-0.18	-0.08		0.01	0.02	
	(0.70)	(0.58)		(0.03)	(0.03)	
*Access_0_10*HHI*			-1.59			0.07
			(2.11)			(0.14)
HHI		-0.067	1.38		0.058	0.00
		(0.67)	(2.04)		(0.06)	(0.13)
CreditUnion		-2.39**	-2.39***		0.24***	0.24***
		(0.21)	(0.21)		(0.02)	(0.02)
SavingsBank		-1.10**	-1.10***		0.09***	0.09***
		(0.21)	(0.21)		(0.02)	(0.02)
LogAssets		0.95***	0.95***		0.04***	0.04***
		(0.05)	(0.05)		(0.00)	(0.00)
Border		-0.32*	-0.30*		0.04***	0.03**
		(0.18)	(0.18)		(0.01)	(0.01)
State-Year FEs?	Y	Y	Y	Y	Y	Y
County Controls?	N	Y	Y	N	Y	Y
Observations	15,072	14,996	14,996	10,524	10,490	10,490
R^2	0.24	0.37	0.37	0.07	0.12	0.12

* significant at 10%; ** significant at 5%; *** significant at 1%

Table 7: Robustness Relative to Functional Form

Results are provided for the following variations on the basic empirical models in Tables 5 and 6. Regressions in Panel B assume a probit functional form for Free Checking as opposed to a linear probability model. Regressions in Panels A use the log of OD as the dependent variable. Robust standard errors grouped by state are reported in parenthesis.

	Panel A		**Panel B**	
Estimation Method:	OLS		OLS	
Dependent Variable (Mean):	*Log Fee (3.19)*		*Free Checking (0.73)*	
	(1)	(2)	(1)	(2)
Allowed	0.061**		-0.063**	
	(0.026)		(0.030)	
Access_0_10		0.042*		-0.10***
		(0.024)		(0.04)
Access_10_20		-0.01		-0.06
		(0.03)		(0.05)
Access_20_30		0.00		0.02
		(0.02)		(0.04)
CreditUnion	-0.09***	-0.09***	0.25***	0.26***
	(0.02)	(0.01)	(0.02)	(0.02)
SavingsBank	-0.04***	-0.04***	0.07**	0.08***
	(0.01)	(0.01)	(0.03)	(0.02)
LogAssets	0.04***	0.04***	0.04***	0.05***
	(0.004)	(0.002)	(0.005)	(0.004)
HHI	0.03	0.04	0.06	0.08
	(0.04)	(0.03)	(0.06)	(0.07)
Border		-0.01		0.04***
		(0.01)		(0.02)
State-Year FEs?	N	Y	N	Y
State and Year FEs?	Y	NA	Y	NA
County Controls?	Y	Y	Y	Y
Observations	14,828	14,784	10,484	10,269
R^2/Pseudo-R^2	0.25	0.30	0.09	0.10

* significant at 10%; ** significant at 5%; *** significant at 1%

Table 8: Robustness Relative to Access

Reported are regression coefficients (robust, clustered standard errors) for models use LogDistance, the natual logarithm of the distance to the nearest allowing state) instead of *Access_X_Y.*

	(1)	(2)
Dependent Variable (Mean)	*Overdraft Fee (24.98)*	*Free Checking (0.73)*
LogDistance	-0.48*	0.04*
	(0.26)	(0.02)
CreditUnion	-2.39***	0.24***
	(0.21)	(0.02)
SavingsBank	-1.12***	0.09***
	(0.22)	(0.02)
LogAssets	0.95***	0.04***
	(0.05)	(0.003)
HHI	-0.06	0.05
	(0.67)	(0.07)
Border	-0.31*	0.04***
	(0.19)	(0.01)
State-Year FEs?	Y	Y
County Controls?	Y	Y
Observations	14,903	10,390
R^2/Pseudo-R^2	0.37	0.12

* significant at 10%; ** significant at 5%; *** significant at 1%

Table 9: Returned Check Descriptive Statistics

Monthly unemployment rates (quarterly averages) by state and by Federal Reserve district comes from BLS and the St.Louis Fed's FRED database, respectively. Quarterly Personal income per capita is from BEA. Check data come from Federal Reserve Check Processing Centers (CPC). Complaints data are monthly and come from FTC. Bankruptcy data is by state and extends from 1998:Q1 to 2008:Q4. Bounced checks data is by Federal Reserve CPC and extends from 1998:Q1 to 2008:Q3.

Variable	Obs	Mean	Median	Std. Dev.	Min	Max
# returned/# processed (%)	1325	1.29	1.17	0.65	0.34	6.01
$ returned/$ processed (%)	1325	1.21	1.10	0.62	0.11	6.16
$ returned/# returned ($ thousands)	1325	0.869	0.774	0.344	0.347	2.830
State Unemployment Rate (%)	1763	4.85	4.80	1.04	2.10	8.70
District Unemployment Rate (%)	1763	4.91	4.92	0.93	2.35	7.07
State Personal Income per Capita ($)	1763	32126	31170	6060	19953	56274
State Personal Income per Capita Growth (Q/Q, %)	1763	1.00	1.03	0.91	-2.66	5.16
Payday Permitted?	1763	0.95	1.00	0.21	0.00	1.00

Table 10: Fewer, but Larger, Returned Checks When Payday Credit is Permitted

Reported are coefficients (st. errors) estimated via OLS using returned check rates at Federal Reserve Regional Check Processing Centers (CPC) over 1998Q1-2008Q3. *Alloweed* equals one if state permitted payday lending, zero if not. *Allowed* is identified by bans over sample in six states: GA, NC, MD, WV, OR and PA. Regressions include fixed CPC and date effect. Standard errors are clustered by CPC .

Dependent variable:	#Returned/#Processed	$Returned/$Processed	$Returned/#Returned
(mean)	(1.29%)	(1.21%)	(0.869 thousand)
	(1)	(3)	(5)
Allowed	-0.33**	-0.18	0.130*
	(0.16)	(0.13)	(0.07)
State Unemployment	0.012	-0.006	0.003
	(0.06)	(0.06)	(0.02)
District Unemployment	0.026	0.029	-0.064***
	(0.09)	(0.08)	(0.02)
Log Income	-0.359	0.262	-0.531
	(1.83)	(1.52)	(0.79)
Income Growth	-0.018	-0.016	0.007
	(0.01)	(0.01)	(0.01)
Constant	5.02	-1.15	6.96
	(19.10)	(15.80)	(8.25)
Observations	1325	1325	1325
Adjusted R-squared	0.64	0.64	0.81

Robust standard errors in brackets. *** p<0.01, ** p<0.05, * p<0.1

Table 11: Differential Effects on Free Checking by Direct Deposit

Reported are regression coefficients (robust, clustered standard errors) indicating if effect of deferred deposit availability or access on free checking differs for deposits without (panel A) or with (panel B) direct deposit.

Dependent Variable: (Mean)	**Panel A** *Free Checking w/o Direct Deposit* (0.62)		**Panel B** *Free Checking w/Direct Deposit* (0.11)	
	(1)	(2)	(1)	(2)
Allowed	-0.039*		-0.0003	
	(0.020)		(0.023)	
Access_0_10		-0.10**		-0.01
		(0.05)		(0.02)
Access_10_20		-0.12**		0.04
		(0.05)		(0.03)
Access_20_30		-0.05		0.05*
		(0.04)		(0.03)
CreditUnion	0.26***	0.25***	-0.001	0.002
	(0.03)	(0.02)	(0.02)	(0.01)
SavingsBank	0.05	0.05*	0.02	0.02
	(0.04)	(0.03)	(0.01)	(0.02)
LogAssets	0.03***	0.03***	0.01***	0.01***
	(0.006)	(0.004)	(0.002)	(0.003)
HHI	0.004	0.01	0.02	0.03
	(0.06)	(0.08)	(0.03)	(0.05)
Border		0.06***		-0.03**
		(0.02)		(0.01)
State-Year FEs?	N	Y	N	Y
State and Year FEs?	Y	NA	Y	NA
County Controls?	Y	Y	Y	Y
Observations	9,589	9,576	9,589	9,576
R^2	0.11	0.13	0.03	0.05

* significant at 10%; ** significant at 5%; *** significant at 1%

APPENDIX A: PAYDAY LOAN REGULATIONS

Summary of Coding for *Allowed*:

The Moebs survey of checking account fees and services was conducted in December of 2006, and in June for every other year. Five states prohibited loans throughout the sample period (*Allowed = 0*): CT, MA, NJ, NY and VT. Seven states changed from allowing to prohibiting payday lending between 1995 and 2008 (*Allowed* = 0 beginning in the year given in parentheses): MD (2002), GA(2004), NC (2006), WV (2006), DC (2008), OR (2008) and PA (2008). One state changed from prohibiting to allowing payday lending between 1995 and 2008 (*Allowed* = 1 beginning in the year given in parentheses): NH (2000). The remaining states allowed loans throughout the sample period (*Allowed* = 1).

States that prohibited payday lending throughout 1995-2008

New Jersey and New York forbid payday loans *via* check cashing laws that prohibit advancing money on post-dated checks (N.J. Stat. 17:15A-47 and NY CLS Bank 373) and usury limits (N.J. Stat. 2C:21-19 and NY CLS Penal 190.42). Massachusetts banned payday loans through a usury limit on small loans made or brokered in the state (ALM G.L.c.140 §96 and CMR 209 26.01). Connecticut prohibited lending *via* a cap on check cashing fees (Conn. Agencies Reg. § 36a-585-1) and small loan interest rates (Conn. Gen. Stat. 36a-563). Vermont prohibited payday lending through a usury limit (8 V.S.A. § 2230 and 9 V.S.A. § 41a).

We confirmed by reading 10-K filings and company websites that the largest multistate payday store operators – Ace Cash Express, Advanced America, Cash America, Check into Cash, Check 'N Go, Money Mart and Valued Services – did not operate payday loan stores in these five states.

States that experienced a change in payday loan availability between 1995 and 2008[34]

Maryland banned payday lending through restrictions on fees charged by check cashers (MD Financial Institutions Code § 12-120) and small loan interest rates (MD Commercial Law Code § 12-306), and finally passed anti-loan brokering legislation (MD Commercial Law Code § 14-1902), effective June, 2002 to eliminate the agency payday lending model, whereby payday lenders operated as agents, arranging loans for out-of-state banks.

Georgia banned payday lending with a law that took effect in May, 2004 (O.C.G.A. § 16-17-1).

Payday lenders operated under the agent model in North Carolina and West Virginia until 2006. All remaining lenders agreed to exit North Carolina in March, 2006, after facing a series of suits filed by the state Attorney General (see NC Department of Justice press release). First American Cash Advance, the last payday lender in West Virginia, operated under the agent model until July, 2006 (see press release from WV Attorney General). North Carolina prohibits payday lending through a 36% interest rate cap on small loans (N.C. Gen. Stat. § 53-173). West Virginia prohibits payday lending by limiting fees on check cashing, prohibiting payday check cashing (W. Va. Code § 32A-3-1) and imposing a usury limit on small loans (W. Va. Code § 47-6-5b).

The District of Columbia prohibited payday lending in November, 2007, by limiting fees on check cashing and prohibiting post-dated check cashing (D.C. Code § 26-317 and 26-319).

Oregon placed a *de facto* ban on payday lending in July, 2007, by imposing a 36% interest rate cap as well as restrictions on loan renewals (ORS § 725.622).

Payday lending was ostensibly banned throughout the sample period in Pennsylvania via a cap on small loan interest rates (P.A. 7 P.S. § 6201-6219), but the agent model was permitted through a law that sanctioned loan brokering (P.A. 73 P.S. § 2181-2192). Some lenders ceased operations in the state in mid-2006, after the FDIC placed restrictions on their bank lenders (Sabatini, 2006). However, Advance America, the largest national payday lender, did not stop lending and close its Pennsylvania stores until December, 2007 (See Advance America 9/07 press release).

New Hampshire's small loan interest rate ceiling acted as a *de facto* ban on payday loans until it was removed in January, 2000 (1999 NH ALS 248), and payday lenders entered thereafter.

[34] We have not captured every law change with *Allowed*. We include those that were binding, as confirmed through press releases, news stories and the public filings of the largest payday loan operators. In the case of one law sanctioning DD credit in Rhode Island (R.I. P.L. 2001, Ch. 371, § 4), we could not confirm the date DD lenders entered; according to a supervisor in the Division of Banking, check cashers began offering payday on transactions prior to the July 2001 law change. We do not count Rhode Island as a state with a change in *Allowed*.