PAYDAY LENDING MARKET INVESTIGATION

Summary of hearing with the Financial Conduct Authority held on 6 March 2014

Background

1. From 1 April 2014, the Financial Conduct Authority (FCA) would become the sector regulator for consumer credit, including the payday lending industry, having assumed responsibility from the Office of Fair Trading (OFT).

2. Companies would be subject to supervision from the date of interim permission (1 April); the FCA would not wait for their full authorisation. Consumer credit firms were to be subject to the same supervisory process as other financial services firms. Where the OFT's approach was largely intelligence-led, the FCA approach would be proactive and include a regular programme of engagement with firms in proportion to their size and the risk that they pose to consumers.

3. Following an announcement in November 2013, Parliament passed legislation which placed a duty on the FCA to impose a price cap on the cost of payday loans by 2 January 2015.

The consumer credit regime

4. The OFT undertook a review of compliance by payday lenders, publishing an Interim Report in November 2012 and a final report in March 2013. This highlighted a significant degree of non-compliance with consumer credit legislation and OFT regulatory requirements.

5. The FCA published a policy statement and rules specific to consumer credit on 28 February 2014. The evidence from the OFT compliance review of poor lending practices and consumer harm provided an important part of the background for some of these initial rules, including those relating to high-cost short-term credit (HCSTC).

6. Consumer credit providers would need to be authorised by the FCA to carry out consumer credit activities beyond the interim permission period. Authorisation under the Financial Services and Markets Act 2000 replaced the OFT licensing system, and consumer credit firms would have to follow a similar process to other financial services when applying for full authorisation.

If firms had an OFT licence and had registered for interim permission, they could continue to carry out consumer credit activities until their application for authorisation had been determined (if they applied within the timescale set by the FCA) or until the deadline to apply had expired. It had been possible for OFT licensed firms to obtain interim permission since October 2013. The FCA did not expect the full authorisation process until later in 2014.

7. On full authorisation, firms would fall into four risk categories for supervision purposes, Categories 1 to 4. The FCA intended to look at firms' business models when determining which category they fell into. Category 1 firms were those with the most complex business models, such as large retail banks, while Category 4 firms had simpler business models and were typically smaller. The parameters for consumer credit firms were still under development, but the expectation was that most payday lenders would fall into categories 3 and 4.

8. The regime would be underpinned by requiring regular reporting to identify key risk indicators, for example rapid growth, increasing arrears levels or inadequate capital provision. The level of reporting required of firms would vary according to whether they required full or limited permission. This would be determined by their revenue and the regulated activity they participated in.

9. All HCSTC firms would require 'full permission'. HCSTC lenders would be expected to report every six months or on an annual basis, depending on the size of the firm. They would be required to provide both regular reporting at the firm level – for example, their gross loan volumes, key financials – as well as product sales data and details of individual loans at the point of sale which would be reported quarterly.

10. As current expectations were that they were most likely to fall into Categories 3 and 4, HCSTC firms would not be relationship-managed. Instead, the FCA's proactive supervision of firms would involve peer group analysis of business models and strategies, a periodic assessment roughly every four years and thematic reviews of priority risks. There would also be reactive supervision when things go wrong. Reactive supervision would be intelligence led.

11. Through two specialist teams, the FCA would also be able to conduct supervision of consumer contracts and financial promotions with a view to tackling misleading or unfair practices. Regular thematic reviews of the consumer credit sector would be conducted, working with a cross section of firms, including smaller firms. The FCA would supervise and collect evidence on all types of consumer credit, including credit card lending.

Views on the CMA's annotated issues statement

12. The FCA had regard to the OFT's definition in their reference to the CMA and the CMA's definition for payday loans in deciding on the definition it considered appropriate in the context of FCA rules.

13. The FCA agreed that one of the problems with transparency and the availability of information in the market was the shortage of ways to compare different products.

14. Some evidence suggested that customers were clear about the initial cost when they took out a payday loan but often overestimated their ability to repay.

15. The risk warning introduced as part of the FCA consumer credit rules was intended to make those consumers who might roll over more aware of the risk and consequences of doing so and to signpost help for those in financial difficulties. The FCA understood that it would not address the information problems in the market. There was a question over customers' ability to compare the products on offer. It was not clear whether customers understood all the different costs involved with different products. Charges and fees that did not form part of the headline price contributed to this.

16. Following on from the issue of transparency, the FCA noted that where lead generators were credit broking they were regulated as credit brokers for the purposes of the consumer credit regime. They would be expected to go through authorisation like any other credit provider. The FCA also noted that the financial promotion rules applied and should capture any lead generators passing themselves off as something they were not. The FCA continued to conduct work on how the interest rate cap would affect the dynamic of lead generators in relation to HCSTC providers.

17. [✂].

Impact of the consumer credit rules

18. The rules had two main objectives. The first was that firms only lend to borrowers who could afford it, and the second was to increase borrowers' awareness of both the costs and risks of borrowing unaffordably, and also signposting them to sources of help if they had financial difficulties. The FCA did not view repeated use of CPAs as an appropriate method of collecting overdue debts, however useful it might be as a payment method in other circumstances. It might also be the only realistic payment method for certain business models. However, where a customer had been unable to repay their loan on a previously agreed repayment date, or at an agreed time, it was

inappropriate to continue to use CPA's repeatedly and this was reflected in the final rules. If a CPA failed at one of those times, the FCA would expect to see lenders contacting customers.

19. In looking at the adequacy of firms' assessments of affordability and a customer's ability to repay, the FCA rules were intended to be appropriate and proportionate. They should not prevent innovation in lenders' business models. This would be prioritised at authorisation and firms would be judged on outcomes. The FCA remained open-minded about different ways in which firms decided to conduct affordability assessments. The restriction on rollovers and CPAs was intended to ensure lenders made certain their affordability assessments were robust.

20. The FCA was also focused on the development of real-time data-sharing initiatives. Again, work in this area would be outcome focused. Access to this data was particularly important because it opened up important sources of data for firms carrying out affordability assessments.

21. In developing rules the FCA had chosen the most competitive options available to it. To that end, it was embedding an understanding of competition into its organisation. The FCA expected increased regulation to cause some exit from the tail of the HCSTC market as set out in the Cost Benefit Analysis published in October 2013. This should not signify less competition but more effective competition. In the end, there should not be any conflict between effective competition and consumer protection.

Proposed price cap

22. Early stages of the FCA's work on a price cap had looked at international experience. The introduction and structure of caps in other countries was generally based on a political judgement. The FCA had instead decided to follow an analysis-based approach.

23. [✂].

24. In coming to a judgement on the price cap going forward, the FCA would carry out rigorous analysis on the current state of the market. It intended to rely on three planks of analysis: a supply-side model, a demand-side model and dynamic analysis of competition in the market.

25. On the supply side, lenders used risk models to assess the distribution of the risk and, therefore, the cost pertaining to particular individuals. By looking at risk models, the FCA would be able to determine who might be pushed out of the market. This could be done by checking if particular types of individuals or loans were likely to remain profitable under a proposed price cap.

26. On the demand side, the FCA would use two data sources. Credit reference agency data would show the financial situation of particular customers before they attempted to take out a loan. At the margin, customers who were refused loans did not (before taking out the loan) look that much different to customers who were able to take out loans. This would allow for an estimate of what happened to customers who were excluded. The FCA would then use survey data to look at informal substitute markets.

27. Finally, the FCA would analyse how competition might be expected to change as a result of the price cap. This analysis would require an element of judgement but it would be based on modelling likely competitive scenarios resulting from different types of price caps.