PAYDAY LENDING MARKET INVESTIGATION

Summary of a response hearing with DFC Global Corp held on Tuesday 5 August 2014

Background

1. DFC Global Corp (DFC) told us that it had been acquired by Lone Star. Lone Star understood that the payday lending industry was currently in transition, was subject to regulatory activity and that there was likely to be disruption as a result. [✀].

2. The new Financial and Conduct Authority (FCA) regulatory regime, which had been in place since 1 April 2014, was already having an impact on the industry with the cost of compliance and regulation having increased substantially. The need for payday lenders to adapt and change existing business models over the last few months had been constant and further changes would be required as a result of the price cap to be introduced in 2015.

3. Some operators had already stopped their lending activities completely in anticipation of FCA supervision. Numerous lenders were currently subject to skilled person reviews under section 166 of the Financial Services and Markets Act 2000. All operators were currently subject to an in-depth, thematic review into debt collection and DFC believed that the inevitable consequence of the new regulatory framework was that many payday lenders, which were currently operating under interim provision permission, would not successfully meet the requirements for full authorisation and/or would make the decision not to apply for full authorisation. DFC expected that the transition to the new regime would continue to have a serious and negative impact on the industry and DFC for some time to come.

4. In the FCA's report on its proposals for a price cap on high-cost, short-term credit, the FCA acknowledged that there was a high risk that lenders would exit the market either due to low profitability, or operating losses in the current market place resulting in reduced levels of competition. The FCA's modelling also suggested that the 0.8% cap would mean that only the three largest online lenders would be able to continue to offer high-cost, short-term credit and that it was possible, although not certain, that one high street firm might be able to operate. This would not provide a competitive market place for

providers or consumers. DFC thought that there would be fewer providers than there were today but that the assumption that there would only be three or four lenders in the market was unrealistic and that changes to product design would allow other companies to enter the market.

5. The FCA also indicated that a substantial number of customers, estimated at around 160,000 a year would lose access to the high-cost, short-term credit market entirely. DFC thought this number could be much higher than that. While the FCA concluded that its research suggested that it was unlikely that these customers would turn to illegal or unregulated money lending, there was a risk that those customers would have no choice but to resort to unregulated or illegal lending. The FCA also acknowledged that consumers might be reluctant to report using such illegal lenders and that there was a general lack of evidence on the impact of price caps on illegal money lending, with the exception of the emergence of unlicensed online companies in the US. Research in the UK in 2010 regarding illegal lending suggested that the total cost of such illegal credit was three and a half times the cost of the highest cost of legal credit.[1]

6. DFC had experienced a [✂]% [✂] in the volume of loans (on the high street and online) from June 2013 to June 2014. DFC attributed this to the changes it had made to [✂].

7. As a result of these challenges, DFC's profits for its three UK business units in the quarter ended June 2013 had been £[✂] in the same period in 2014.

8. DFC had not been able to adequately measure how much of that [✂] related to customer demand. Its applications were [✂] but could be attributed to DFC's changes [✂]. The [✂] in lending volumes had resulted in a [✂] in revenues [✂]. DFC had not yet seen any decrease in the prices charged by lead generators in order to win business, but there had been definite changes in lead generator behaviour, and [✂].

9. DFC's average acquisition cost per customer loan ranged from about £[✂]. It did not think it would be able to continue incurring this cost because [✂].

10. The FCA was very focussed on affordability as well as a key performance indicator type measurement for on time repayment, whether it was for single or multiple repayments. So, whereas the industry used to have the ability to work with customers who would not repay on time, it no longer had the ability or luxury of working with customers in the same way because the prime goal was to underwrite a customer and provide them with credit, which that customer could repay on the stated terms. As a result underwriting would be

[1] BIS Interim Evaluation of the National Illegal Money Lending Project – October 2010

tighter which should reduce bad debt. DFC thought that its level of bad debt would fall.

11. Payday lending accounted for around [✄] the revenue of DFC's high street stores and 100% of its online business. Although DFC's high street portfolio had high fixed costs it had the ability to cover these by offering multiple products including non-payday loan products. DFC believed that all its products were valued by its customers who knew they could visit DFC for more than just an unsecured payday loan.

12. DFC told us that [✄]. However, DFC was not sure whether [✄] could be introduced under the existing price cap proposals and if not whether there would be the opportunity [✄].

Remedies

13. DFC considered that it would be very important to consider any remedies in the context of an industry in which a high degree of market exit was predicted to take place, with the few remaining lenders being subject to a price cap while at the same time faced with an increasing cost base. The costs and benefits of any remedies would have to be carefully weighed so that any additional cost was not unnecessarily imposed on the remaining operators, otherwise there would be a real risk that there would be further exit from the market leading to an even greater reduction in the access to credit. While DFC was supportive of the overall objectives of the Competition & Markets Authority's (CMA's) proposed remedies primarily that of increasing the availability of information to the consumer to enable them to shop around more effectively, it did have concerns about the necessity, cost, proportionality and effectiveness of some aspects of these remedies particularly in light of recent developments in the sector.

14. The FCA had not conducted any modelling on the impact of the price cap on its business. Although the FCA had modelled the caps on two rollovers and two continuous payment authorities (CPA) it had not modelled other things, for example, the interpretation of the Consumer Credit sourcebook (CONC) rules DFC was currently having to implement, the very things that had [✄]. The FCA's modelling also did not take DFC's [✄] into account. There was a need for increased compliance under the new regime but DFC noted that the FCA had also not modelled the regulatory cost to business. DFC noted that the FCA data was based on a survey of 2,000 customers from 2012/2013. Since that time DFC had under gone [✄] and DFC no longer lent, for example, [✄].

15. DFC suggested a potential remedy which it believed would enable customers to understand whether or not they were dealing with licensed lenders. DFC believed that there would be an influx of unregulated, offshore, unlicensed lenders in the market place and so it would be beneficial for customers if there was a link on the provider's website linking their final authorisation number to the FCA's website. This would not be an accreditation check or an FCA seal of approval but it would provide clarity for a customer that at least they were dealing with a licensed provider.

The impact of the price cap

16. The price cap as presently configured would stifle product innovation in the market place because the design of the products would have to fit within the price cap regime. DFC believed that the price cap would effectively reduce the average duration of a loan. There would not be any impact on a 30 day loan but with 100% total cost of credit and a 0.8% day rate it was unlikely that there would be products in the market place longer than six months. However, there would still be opportunities for customers to search for differences in price, fees and products despite the price cap. DFC also thought it was unlikely that lenders offering a very short term loan would, at 0.8%, be able to recover their fixed origination costs.

17. DFC believed that pricing would concentrate around the price cap. It had seen this in the US with state mandated caps and where a state had implemented or changed a cap. This had also occurred in Canada where provincial regulation in late 2008 through 2009 resulted in a cap being set at the midpoint of market rates which, over a relatively short period, saw lenders above the cap reduce their prices and companies beneath the cap increase theirs to the cap.

Price comparison website

18. DFC was very supportive of any measures that would enable it, as well as other payday lenders, to participate in existing commercial price comparison websites (PCWs). A PCW would benefit customers by providing additional transparency and information. A well-publicised, well-articulated PCW would also benefit new entrants by providing customer acquisition and marketing opportunities. DFC thought the site would assist in lowering the costs of customer acquisition. However, it was too early to tell just how effective the PCW would be when prices were capped. The PCW would also not be operating under optimal conditions in an industry with only three or four lenders all of which would be subject to a price cap. DFC thought that a customer should be able to compare products, prices, features, benefits and availability on the site but make their application through the lenders website.

19. DFC wanted the customer to have choice and so thought that online and store based products should be included on the site. All lenders should be required to appear on at least two PCWs. There would be limited effectiveness and economies of scale of having four, five or six PCWs. Two PCWs would accomplish the same goal. Bearing in mind the FCA would have regulatory oversight for the industry it would be logical for the FCA to be the body to accredit any PCW active in this sector.

20. Customers should have the ability to determine the ranking criteria on the PCW. Some customers might want to rank lenders based on name, some on APR, while others might want to rank on minimum/maximum loan size or duration. DFC did not see any risk to the consumer in letting a lender pay to appear at the top of a list provided that the list was based on the criteria selected by the customer and not the criteria established by the PCW and the process was transparent. Lenders should not have the ability to game the site and mislead consumers about the outcome of their application simply by jumping to the top of the list. However, if all the lenders were offering the same cost per £100, DFC did not see a problem with a lender paying to appear at the top of a customer list providing it had not supplied any information different to that requested by the customer. Some of the lead generators DFC was working with were starting to create mini PCWs as such. Lenders were charged a fixed cost for appearing on the site and the position of lenders was rotated on the site. An advert on the right hand side showed all the lenders the same number of times.

21. Participation in a commercial PCW was the most proportionate and effective way forward. However, this remedy would only be effective if measures were also taken to ensure search engines such as Google did not penalise PCWs for enabling payday lenders to participate on those sites. DFC thought this was good for the consumer and competition and helped policing because all the lenders on it would be checking to make sure everyone else was interpreting the categories in the same way.

22. DFC would hope that high street lenders could participate on a PCW.

Fees and charges

23. DFC fully supported any recommendation to the industry on how to increase customers' awareness of fees and charges through improved disclosure. DFC thought that the FCA should look at the customer's journey, reviewing the information borrowers received and whether it was effective or not, right through to either repayment or default. DFC already provided information on its charges and fees to its customers in a timely manner and believed that all lenders should provide similar levels of information.

24. DFC was looking at its default fees in light of the proposals in the FCA consultation document. The £15 cap covered the duration of a loan so if a customer defaulted on repayments more than once a lender might have to consider [✂].

Creditworthiness

25. DFC used [✂] of the three large CRAs for its credit information, and used ‘application searches’ which it considered to be standard industry practice.

26. DFC considered that its first and foremost responsibility to a borrower was to provide them with a robust affordability assessment and would be concerned that providing an indication of creditworthiness to customers on the basis of incomplete information would give rise to “false” positives and negatives thus inadvertently misleading the customer. It supported some aspects of the remedy proposal relating to customers’ creditworthiness insofar as it would help customers manage their credit activities more effectively.

27. DFC already provided information to its customers about the credit checks it undertook and DFC supported any measures that would mean that all payday operators adopted a similar transparent approach. DFC advised potential online and retail customers that it conducted credit searches. This was indicated on the application form it used in its high street stores, and staff were also required to inform customers (being prompted by a pop up box). Online DFC flagged up the fact that it would be conducting a credit search above the submit button. Reference was also included in DFC’s frequently asked questions.

28. DFC’s approach to verifying and checking an application was to use a combination of internal and external data in a cost efficient manner. DFC considered credit searches to be a relatively expensive piece of data. DFC’s process began by [✂].

29. The full credit search, which was the final stage in the process, left a footprint on the customer’s credit file. DFC estimated that its “dup” check eliminated around [✂]% of applications from the process and that additional checks such as affordability and other verification prior to the performance of a credit search (which filtered further applications) meant that only a small percentage of applications reached the credit search stage.

30. The results of credit searches proved useful showing when a customer had sought credit from a lender, or lenders. DFC considered the ability to see that a borrower had applied for credit with another lender as a useful indicator of credit hungriness which correlated closely with credit risk. DFC accepted that it was not possible to distinguish between a customer being declined credit or

deciding not to go ahead with an application for a loan. The provision of real time data makes no difference on this specific issue. [✂]. DFC said that a quotation search would give identical information as an application search, but that both would be supplemented with other datasets.

31. DFC told us that any indication of eligibility could not be based solely on a quotation search. A credit search provided [✂] of a lending decision and so [✂] would be needed. DFC was concerned if there was any requirement that it should provide an indication of the qualification for credit prior to the appropriate affordability assessments being undertaken. DFC considered that such a requirement would conflict with its regulatory obligation to undertake appropriate affordability assessments and, at the same time, risk misleading and confusing its customers.

32. DFC also used other CRA and third party products to conduct fraud checks such as verification of a customer's identity, their address, bank details and debit card. In its high street stores DFC was able to obtain verification through documentation provided by a customer.

33. DFC thought that a PCW should not incorporate any indication of the likelihood of credit being issued or the ability for credit to be issued through the PCW. DFC considered that developing such a website would be disproportionately and prohibitively expensive given the uncertainty of any benefits which would accrue. Similarly DFC were uncertain whether implementing proprietary pre-application screening technologies would offer significant benefits.

Data sharing

34. Prior to the FCA price cap proposal The Money Shop had been working with [✂] and Payday UK had been working with [✂]. Payday UK was already sharing real time data ([✂]) with [✂] and The Money Shop was intending to implement [✂] product by the end of 2014. It cost DFC [✂] pence per credit search with [✂] and [✂] for searches from [✂] though [✂] made additional charges to access their real time systems.

35. DFC believed that more up to date information would enable it to make better credit decisions which is why it supported real time data sharing, but considered that daily updates were sufficient. DFC said it would consider using [✂] CRA if it had a substantial, growing population of customers but this option would be subject to a cost benefit analysis. DFC was not sure whether access to real time data would assist new entrants. It believed that the main hurdle for new entrants was establishing a book of business.

Periodic statements

36. DFC did not think its customers would find a periodic statement of borrowing costs helpful, particularly if they were receiving similar documents from other lenders on a monthly, quarterly or annual basis. DFC believed that there were potential significant costs attached to such a remedy, in particular for retail operations, and that it would be ineffective and disproportionate. However, it noted that if these statements were issued by email the overall cost (including development costs and some marginal maintenance costs) would be lower than for a mail delivery.

37. DFC had an online account management facility which showed the status of a borrower's current loan but could easily be expanded to show any previous borrowing.

38. If DFC's high street business had to issue statements it would need to do so by post as, although DFC was increasingly collecting email addresses for its high street customers at present it had email addresses for around only [✂]% of customers. This coverage compared to [✂]% of customers for whom DFC held mobile phone numbers. However, DFC said that their customer base was often transient with respect of their contact details with customers potentially changing telephone number every two to three months.

39. DFC were concerned that any statement would be seen by customers as an unwanted push, particularly if customers were sent multiple statements from multiple lenders at the same time.

Lead generators

40. DFC used around [✂] lead generators, with a core of [✂] lead generators.

41. DFC supported the role that lead generators played in the market but believed that consumers would benefit from greater transparency in this area. DFC had no objection to lead generators being required to indicate that they were not lenders and to be specific in how they disclosed how they placed their leads.

42. When DFC had operated with PCWs such as [✂], the leads it received were of a [✂] quality than those referred by other lead generators.

43. Some lead generators were moving towards greater transparency already. DFC considered that this was principally being driven by the FCA regulatory regime and the FCA's requirement (under principle 6) that customers were treated fairly and received the product they wanted was driving this process.

44. Some companies such as [✂] were now more clearly indicating their status and activity as a lead generator on their websites. [✂] operated two models of lead generation. In addition to displaying a panel of lenders with an “apply now” button which took a customer straight to the website of the lender concerned it also operated the ping tree model and so gave borrowers the option of completing an application form and [✂] would submit the form through the pingtree.

45. Many lead generators were changing their systems so that they could ask a customer what features and functions they were looking for and then send those to the highest bidder meeting those functions. DFC had stopped trading with those lead generators that would not adapt to what DFC considered was important from an affordability perspective. There were signs that DFC’s [✂] lead generators were adjusting their systems and trying to change their models.

46. Around [✂]% of all offers of credit made by DFC in response to applications made through lead generators were not converted into loans. DFC thought the reason for this was that some borrowers might want to borrow more that DFC’s scorecard allowed while others might not want to proceed with the remainder of the process (i.e. inserting their debit card details or signing for the loan. DFC’s affordability assessments which might result in it offering a customer a lower amount than they requested was also a factor. DFC noted that its drop off rate was similar for customers visiting its website directly where the equivalent ‘conversion rate’ was around [✂]%.

47. DFC told us that credit searches that it undertook on the leads it was offered from the pingtree and which passed its basic criteria checks, left a foot print on a customer’s credit file, irrespective of whether the loan was declined or the customer decided not to proceed with the loan. Real time data would indicate whether or not the customer had taken out a loan.

CMA’s provisional findings

48. DFC welcomed the CMA’s acknowledgement in its provisional findings that there was a demand for short-term, small sum credit which was being met by payday loans. DFC also welcomed the CMA’s recognition of innovation in the industry as well as high levels of customer satisfaction. Nevertheless, as DFC indicated in its written response to the CMA, DFC did not accept the CMA’s provisional findings or conclusions that there were features of the market that gave rise to an adverse effect on competition. In particular, DFC did not accept that its profit levels had been, or were, consistent with a lack of competitive pressure. In addition it did not accept that the CMA’s calculation

that consumers were being overcharged between £5 and £10 per loan was accurate or had been substantiated by the evidence.

49. In light of the substantial changes that already taken place in the market and the further changes that were inevitably going to take place in the coming months, DFC believed that many of the CMA's findings and conclusions were likely to be of historical interest only.