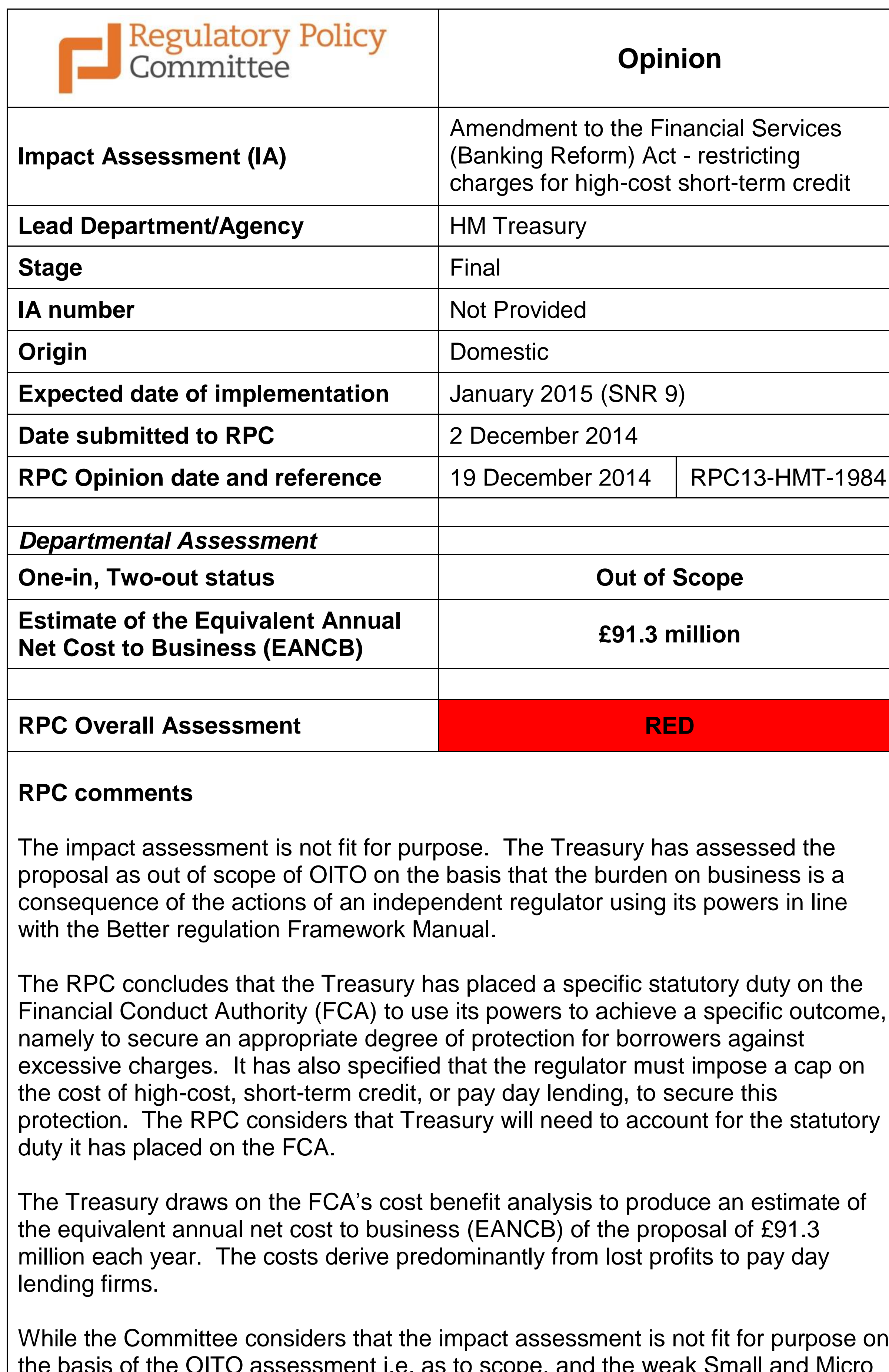


Regulatory Policy Committee	Opinion	
Impact Assessment (IA)	Amendment to the Financial Services (Banking Reform) Act - restricting charges for high-cost short-term credit	
Lead Department/Agency	HM Treasury	
Stage	Final	
IA number	Not Provided	
Origin	Domestic	
Expected date of implementation	January 2015 (SNR 9)	
Date submitted to RPC	2 December 2014	
RPC Opinion date and reference	19 December 2014	RPC13-HMT-1984
Departmental Assessment		
One-in, Two-out status	**Out of Scope**	
Estimate of the Equivalent Annual Net Cost to Business (EANCB)	**£91.3 million**	
RPC Overall Assessment	**RED**	

RPC comments

The impact assessment is not fit for purpose. The Treasury has assessed the proposal as out of scope of OITO on the basis that the burden on business is a consequence of the actions of an independent regulator using its powers in line with the Better regulation Framework Manual.

The RPC concludes that the Treasury has placed a specific statutory duty on the Financial Conduct Authority (FCA) to use its powers to achieve a specific outcome, namely to secure an appropriate degree of protection for borrowers against excessive charges. It has also specified that the regulator must impose a cap on the cost of high-cost, short-term credit, or pay day lending, to secure this protection. The RPC considers that Treasury will need to account for the statutory duty it has placed on the FCA.

The Treasury draws on the FCA's cost benefit analysis to produce an estimate of the equivalent annual net cost to business (EANCB) of the proposal of £91.3 million each year. The costs derive predominantly from lost profits to pay day lending firms.

While the Committee considers that the impact assessment is not fit for purpose on the basis of the OITO assessment i.e. as to scope, and the weak Small and Micro

Business Assessment (SaMBA), it can validate the net cost to business as a reasonable assessment of the impact of the proposal on business.

Background (extracts from IA)

What is the problem under consideration? Why is government intervention necessary?

"Serious flaws have been identified in the functioning of the market for high-cost short-term credit (HCSTC). On the demand side, evidence suggests that borrowers are not price-sensitive, due largely to the fact many face a lack of alternative options or are prioritising other factors over price in borrowing decisions. On the supply side, firms are incentivised to take advantage of borrowers' lack of choice and price insensitivity, by imposing high, upfront and hidden costs, and continuing with other practices that cause detriment to consumers."

What are the policy objectives and the intended effects?

"A cap on the total cost of borrowing for short-term high cost-lending is intended to better serve consumers and reduce the likelihood and scale of detrimental debt difficulties:

i. removing the incentive for firms to lend to – and make disproportionate profits from – people who cannot afford such loans and are likely to suffer greater financial difficulties if offered them;

ii. better protecting borrowers who do continue to participate in this market, including by ensuring fairer and more transparent pricing structures, meaning consumers can better understand and compare what different providers are offering them, and can better control their borrowing."

Comments on the robustness of the OITO assessment

The Treasury explains in its impact assessment that the Government is proposing to implement the preferred option (option 2), that *"…does not of itself add any regulatory burden, rather any costs stem from how the independent regulator uses its existing powers to satisfy the statutory duty. The FCA's rules are not subject to OITO. To the extent there is an impact on other firms in the industry, the FCA will need to demonstrate in its cost-benefit analysis that any costs are proportionate to the benefits.*

"There is an exemption for measures that do not impact on business or civil society organisations from the Better Regulation Executive's One-in-One-out Rule, so the measure in this IA is therefore out of scope of the rule."

The Treasury explains in its impact assessment that the intention of the legislation is to require the FCA to *"…use its powers to set a cap on total costs of borrowing for pay day loans…"* (paragraph 6). However, in order to satisfy the Committee

that the Treasury is justified in assessing the proposal as ‘out of scope’ of OITO, it would have to demonstrate that:

- it was inevitable that the regulator would use its existing powers in the same way as the Treasury has legislated for the regulator to curb excessive payment charges by pay day lenders;
- the regulator would have opted specifically to impose a cap on pay day lending charges, rather than any other intervention; and
- under these circumstances the regulator would have set the cap within twelve months of the time frame set by the Treasury in legislation (January 2015).

On the basis of the evidence presented in the impact assessment, the Treasury has not satisfied the Committee that the proposal is ‘out of scope’ of OITO and will therefore need to account for the statutory duty placed on the FCA to cap the cost of pay day lending. The Treasury has drawn on the FCA’s cost benefit analysis to produce an estimate of the cost to business.

The RPC considers that this legislative change is regulatory and ‘in scope’ of OITO, consistent with the Better Regulation Framework Manual (paragraph 1.9.10). It imposes a net cost on business (an ‘IN’) of £91.3 million each year.

Comments on the robustness of the Small & Micro Business Assessment (SaMBA)

The proposals increase the scope of regulation on business. A SaMBA is, therefore, required.

The SaMBA is not sufficient. The Treasury has not provided adequate evidence in its impact assessment that it has fully considered the impact of the proposal on small and micro businesses. While the Treasury explains that the proposal is aimed at addressing the activities of pay day lending firms, of which many are likely to be small and micro businesses, it does not believe that exempting them from the proposals will be proportionate.

The Treasury explains that these businesses operate to the detriment of consumers. However, the Treasury must provide more information and analysis on the size of the market serviced by small and micro business lenders, what proportion are likely to exit the market, and what mitigating factors, if any, have been considered and subsequently discounted. The Treasury also explains that certain types of small business may also use the services of pay day lending firms, although this is expected to be low.

Quality of the analysis and evidence presented in the IA

The Treasury proposes to place a duty on the FCA to cap the cost of high-cost, short-term credit. It is requiring the FCA to design and implement the cap with the

specific outcome of securing an appropriate degree of protection for borrowers against excessive charges. The Treasury explains that there is considerable evidence that a cap could mitigate the effect of market failures that cause detriment to consumers at risk of being exploited.

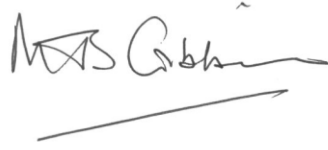
The Treasury has provided a qualitative explanation of the costs of the proposal on society, including business. It explains that most of the cost on business would fall on pay day lending firms, many of which are likely to be small or micro businesses. The Treasury explains that it is likely that a number of firms will exit the market altogether. The Treasury must improve its impact assessment to provide more detail on the number of firms likely to be affected by the proposal and how many may exit as a consequence of the proposal. The Treasury explains that consumers will benefit from the proposal as it will curb unfair and excessive costs of accessing short term funding.

The Treasury states that it was not possible to model the impact of any cap given the uncertainty of the level and structure of such a cap at the time the statutory duty was imposed. It has drawn on the cost benefit analysis prepared by the FCA as part of its obligation to set a price cap on pay day lending.

The FCA explains in its policy statement (PS14/16, November 2014) that it does not have a single estimate of the number of authorised firms that are active in the pay day lending market. Its best estimate is that there are approximately 400 firms offering these types of loans, or planning to do so in the future. Many of these firms are franchises. The FCA used these data from 83% of the market to assess the impact of the lending decisions of pay day firms lending. The FCA analysed current and past lending decisions on an individual, firm-by-firm basis to establish a baseline. It used this analysis to assess the effect of different cap options on future lending decisions, including how revenue and profit would change as a result of the proposal.

The FCA's policy statement, based on its final cost benefit analysis, estimates that setting a cap of 0.8% per day of the amount borrowed (interest and fees), and a total cost cap of 100% of amount borrowed, would reduce the value of loans by 4% or around £60 million each year. In turn, this would reduce revenues for pay day lending firms by 39% or £220 million each year. The FCA estimates that the reduction in revenue is due to reduced charges that firms can impose on customers who remain in the market, for example lower interest rates on the initial loan and reduced fees on loans that are rolled over. Pay day lending firms will also lose revenue as a consequence of loans that will now not be made available because of the cap. Overall, the FCA expects the proposed cap to reduce profits to pay day lending firms by 43% or £120 million each year. The Treasury has estimated the equivalent net cost to business to be £91.3 million each year.

The FCA's final estimate of the loss of profits to pay day lending firms of £120 million contrasts with its initial estimate of £190 million set out in its published consultation document. The FCA explains that it reduced its initial estimate on the basis of consultation responses, discussions with lenders and revised assumptions underpinning the profitability model used in the analysis. In particular, the cap has a lower impact on pay day lending firms because they have already responded to the tightening of lending criteria as a consequence of concerns over consumer

affordability. The effect of the change in criteria resulted in a significant reduction in lending volumes.		
Signed		**Michael Gibbons,** Chairman