High-cost credit

Including review of the high-cost short-term credit price cap

Feedback Statement

FS17/2

July 2017

This relates to

In this Feedback Statement we report on the main issues arising from Call for Input: High-cost credit Including review of the high-cost short-term credit price cap (published November 2016).

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1 Summary

What is this Feedback Statement about?

1.1 This Feedback Statement follows the Call for Input (CfI) that we issued in November last year. The CfI asked for views and evidence on potential areas of concern in the high-cost credit sector, including overdrafts. It also sought evidence relevant to our review of the price cap we set in 2015 on high-cost short-term credit (HCSTC).

1.2 In this paper we set out our decision to maintain the price cap on HCSTC at its current level. That decision is based on the results of our analysis which we present in this paper which indicate the cap and other regulatory measures have been a success. We also commit to review the level of the cap again in three years' time to ensure that it remains effective as the market develops.

1.3 We also set out our priorities for the next stage of our review of the high-cost credit sector. This includes an examination of both sector-wide issues and certain product-specific concerns.

1.4 Across the sector, we have seen a consistent pattern of high-cost credit consumers' credit ratings getting worse over time as they use the high-cost credit products. We will examine this to understand both why this happens and what steps we can take to protect consumers from any harm that use of high-cost credit may cause. Drawing on our experience from the credit cards market, we will also consider long-term use of high-cost credit services and what we can do to ensure that consumers are not trapped in a long-term cycle of high-cost debt.

1.5 We will also be looking at specific products in greater detail in our future work. These are rent-to-own services, home-collected credit and catalogue credit where we are aware of particular concerns.

1.6 We have different concerns about both arranged and unarranged overdrafts. We have concerns about consumers' long-term use of arranged overdrafts, at levels which are persistent, unsustainable, or both. Our concerns about unarranged overdrafts are also broader. Their use is often inadvertent, and charges appear high and complex. Based on the evidence we have to date, we believe there is a case to consider the fundamental reform of unarranged overdrafts and consider whether they should have a place in any modern banking market.

Who does this Feedback Statement apply to?

1.7 Who needs to read this whole document?

- consumer credit lenders that provide HCSTC (Section 2), other types of high-cost credit lending (Section 3) or overdrafts (Section 4)

- trade bodies representing these firms.

1.8 Who only needs to read this summary?

- other consumer credit firms and trade bodies, and
- consumer organisations.

1.9 Who doesn't need to read this Feedback Statement, but it affects them?

- consumers who take out a high-cost loan or other credit product.

The wider context for this Feedback Statement

1.10 In our CfI, published in November 2016, we gave an update on the significant changes in the HCSTC market and the improved outcomes for users of HCSTC. We asked for evidence and views on whether we should make changes to the HCSTC price cap.

1.11 We said we would look across high-cost credit products to build a full picture of how they are used, how different products may cause harm and, if so, to which consumers. This wide ranging review of high-cost credit enables us to consider whether we need to make further policy interventions and whether these should be more consistent than they currently are and applied across different markets.

1.12 We also explained that we would use the review to look at arranged and unarranged overdrafts. This was due to identified competition issues and the nature and level of charges, especially for unarranged overdrafts. The review allows us to consider the related consumer protection issues using the full range of our powers.

1.13 We have separately published a Consultation Paper which proposes changes to our rules and guidance on assessing creditworthiness (including affordability) in consumer credit, to clarify our expectations of firms.

Our conclusions and next steps

HCSTC Price cap review

1.14 We have concluded that we should keep the cap at its current level. We will review the level of the cap again in three years' time.

1.15 We have found improved outcomes for consumers since setting the cap. Consumers pay less, repay on time more often and are less likely to need help with HCSTC products from debt charities. Debt charities have also indicated that consumers are presenting themselves earlier and with lower debts, suggesting that underlying problems are being addressed sooner.

1.16 We have seen a growth in firms offering longer term multiple instalment loans. CfI respondents note that there are benefits to spreading repayments over time, but that this increases the chances of missing payments. Our analysis is in line with this view. We see a rise in the number of loans with exactly one missed payment but an overall drop in the default rate, indicating that the problems in repayment tend to be temporary and are resolved by the end of the loan period. In future monitoring of this sector we will keep a close eye on the implications for consumers of the shift to longer-term instalment loans.

1.17 We found no evidence that consumers who have not been able to get HCSTC products since the cap have generally had negative consequences as a result. The majority (63%) of consumers turned down for HCSTC products since the cap was introduced believe that they are better off as a result. We have not seen a significant 'waterbed effect' with consumers increasing their use of other high cost credit products after failing to get a HCSTC loan. We also found no evidence that consumers who have been turned down for HCSTC are more likely to have subsequently used illegal money lenders.

1.18 The market has got much smaller since 2014 and we expect further changes. However, many firms have been able to continue operating under the cap. There has been a slight increase in the number and value of HCSTC loans issued since its low point in 2015 and we see some evidence of stronger competition within the market.

1.19 We do not consider that the price cap is currently too tight. This is because firms are continuing to operate under the cap, and consumers who are declined for HCSTC do not generally appear to be harmed as a result. Additionally, HCSTC consumers have had improved outcomes which indicate that our interventions, including the price cap, have been of benefit.

1.20 Many industry CfI respondents called for a period of regulatory stability. They also said that other areas of high cost credit had a greater risk of harm to consumers and should be higher priorities for any further work from us now.

High cost credit review

1.21 We have considered a wide array of products, including arranged and unarranged overdrafts and other high-cost credit services. For clarity, while we have considered overdrafts together with other high-cost credit services, we discuss our concerns about overdrafts separately in Chapter 4.

1.22 We have identified a number of issues which could cause consumer harm. We will investigate these further with the aim of issuing a Consultation Paper on proposed solutions to our concerns in Spring 2018. We are particularly concerned about rent-to-own, home-collected credit and catalogue credit, as well as wider concerns about consumers' long-term indebtedness.

Rent-to-own (RTO)

1.23 Our initial findings highlight concerns about the high costs of RTO borrowing for this particularly vulnerable consumer group, and the consequences of that borrowing.

1.24 We will look in more depth at why consumers use RTO to obtain goods and whether more affordable alternatives are available. We will take a leading role in supporting collaboration to share best practice and foster innovative thinking and will convene a forum to encourage cross-agency public policy solutions, for example, how provision in this market could be enhanced through such schemes as social housing providers supplying essential goods.

1.25 We will also carry out a market-based analysis to understand and where possible address constraints that may currently prevent new entrants or other credit providers from increasing their supply of potentially cheaper credit to this vulnerable consumer group. This will include considering whether this may be of broader application in other high-cost credit areas.

Home-collected credit

1.26 We have similar concerns to RTO about the potential for high levels of financial distress experienced by longer-term borrowers. We will focus on particular features of the business model which may incentivise consumers' long-term indebtedness and where we identify that this causes harm, explore options for potential action to protect consumers. These could include, for example, introducing restrictions on refinancing and rollovers, imposing time gaps between borrowing or time limits on the total duration of borrowing.

Catalogue Credit

1.27 Our analysis raises concerns about the high level of arrears experienced by borrowers, with the fees and charges that are triggered by arrears, and the associated risk of financial distress. In addition we have observed high levels of interest charged outside interest-free periods and will look in more depth at the impact on borrowers and the transparency around interest-free periods.

Wider consideration of high-cost credit products

1.28 Across our high-cost credit work we see a market where certain products do not work well for a minority of consumers. Yet many of those consumers may benefit from some access to credit. We are aware that measures we take to protect consumers in these markets may deny a section of consumers any access to credit. Accordingly, we consider that it is important to make sure that we have the evidence to make the right judgements about where and how to intervene.

1.29 To this end we will analyse in depth the worsening of high-cost credit consumers' credit ratings to understand what is causing these deteriorations.

1.30 We will analyse multiple and repeat use of products and patterns of longer term indebtedness and whether this harms consumers.

1.31 We will incorporate the insights from this analysis into any regulatory measures we consult on in Spring 2018.

Overdrafts

1.32 There are longstanding concerns about overdrafts. When we took over the regulation of consumer credit in 2014, our research showed that overdraft charges were high, complex, confusing and poorly understood.

Unarranged overdrafts

1.33 The evidence in this review reinforces these concerns, particularly for unarranged overdrafts, and points to further problems. Unarranged overdrafts are high-cost products. In many cases their costs are significantly higher than HCSTC loans, which present risks that consumers could suffer financial harm because of the level of charges. In addition, many consumers do not know about the cost implications of using unarranged overdrafts or even that they actually have used one. Banks can make unarranged overdrafts available to consumers without carrying out any assessment of affordability. Patterns of use show that a minority of consumers incur the majority of fees. This raises concerns about whether these charges are incurred by potentially vulnerable consumers, and whether those consumers are trapped in a cycle of overdraft debt.

1.34 Based on the evidence we have to date, we believe there is a case to consider the fundamental reform of unarranged overdrafts and whether they should have a place in any modern banking market. We have significant doubts about whether unarranged overdrafts in their current form can continue in a well-functioning market for consumer credit.

1.35 As part of our overall review of retail banking we will focus on how we can address these fundamental concerns about the way these services operate to ensure that consumers are appropriately protected and that the market functions well for consumers.

1.36 We will also ensure that, when necessary, we coordinate with other related FCA work, particularly on how to improve prompts and alerts to ensure any intervention meets consumers' needs.

Arranged overdrafts

1.37 Arranged overdrafts raise a distinct set of issues. Our concerns about these services involve the long-term debt accumulation to levels which are either persistent, unsustainable or both. These are similar to the harm to consumers that we identified in our Credit Card Market Study, and which are central to our proposed interventions to address persistent debt in that market.

1.38 The next stages of our work on arranged overdrafts will assess whether and how much consumers suffer harm from persistently using overdrafts and how far firms' incentives are aligned to ensuring borrowing remains affordable.

Next steps

1.39 We will investigate the issues outlined above further, and where intervention is needed and justified we aim to consult in Spring 2018 on proposals concerning both overdrafts and other forms of high-cost credit.

2 Review of the HCSTC price cap

Summary
We have carried out a review of the HCSTC market to evaluate whether there is a case for changing the price cap. We find that:

- Current consumers pay less for loans and are more able to repay them on time than before we took over regulation of the market and set the cap. Fewer consumers are seeking help from debt advice charities because of HCSTC products, though some consumers continue to face problems with their loans.
- Consumers who have been turned down for HCSTC products have not generally turned to other forms of high-cost credit or illegal money lending. With hindsight, these consumers largely report that they consider it to be positive that were not able to get a loan.
- The size of the market reduced substantially during 2014 in terms of the number and value of loans issued and the number of consumers using HCSTC. However, there has been a slight recovery since 2015. HCSTC firms show a mixed picture of profitability. With several firms currently trying to sell their business we expect to see changes in the composition of firms in the market.

We have decided to maintain the cap at the current level and to conduct another review of the price cap in three years.

Introduction

2.1 The FCA was given a statutory duty in December 2013 to cap the price of HCSTC loans in order to protect borrowers of HCSTC from excessive charges.

2.2 HCSTC is broadly defined in our Handbook[1] as an unsecured regulated credit agreement which has an annual percentage rate of charge (APR) of at least 100% and is due to be repaid (or substantially repaid) within one year. The definition specifically excludes loans by community finance organisations, home-collected loans, bill of sale loans and arranged or unarranged overdrafts.

1 The definition can be found in the Glossary section of the FCA Handbook

2.3 The following box sets out the structure of the price cap:

0.8% per day

When loans are taken out or rolled over, the interest and fees charged must not exceed 0.8% per day of the amount borrowed.

£15 default fees

If borrowers default, fees must not exceed £15. Firms can continue to charge interest after default but not above the initial rate.

TOTAL COST CAP

100% of amount borrowed

(applying to all interest, fees and charges)

Borrowers must never have to pay more in fees and interest than 100% of what they borrowed.

2.4 The price cap came into force on 2 January 2015. We committed to reviewing the cap after two years to see whether it was working in the way which we expected and to check for any distortions of the market. We have now completed this review. This chapter sets out the reasons why we have decided to keep the cap at its current level and structure.

2.5 When we took over the regulation of consumer credit from the Office of Fair Trading (OFT) in 2014, we introduced a package of measures which impacted on the HCSTC market. Our focus on regulating the HCSTC market has been to ensure that firms only lend to borrowers who can afford it and fair treatment of these customers. For example, we placed limits on the number of rollovers (refinancing) and limits on the number of attempts to collect payments using continuous payment authorities (CPAs). Our interventions have aimed to make it difficult for firms to base their business models on unaffordable borrowing by reducing their incentives to lend to borrowers who cannot afford the loan. Following their investigation into the HCSTC market, the Competition and Markets Authority (CMA) introduced further requirements on HCSTC lenders in 2015. The CMA obliged online lenders to list on at least one price comparison website and all lenders were required to provide borrowers with a summary of the final costs of their loans.

2.6 We have also held firms to account where we see that they have not met our standards or those of the OFT. We have used our supervisory and enforcement powers, alongside actions from the Financial Ombudsman Service, to ensure that past misconduct has been identified and appropriate changes made at these firms. There have been several significant redress schemes, with large amounts being repaid to consumers, often resulting from poor affordability assessments by firms. HCSTC lenders, along with all other consumer credit firms, have also been subject to a rigorous authorisation process to ensure that they meet our Threshold Conditions.

2.7 The price cap builds on this work by protecting borrowers with HCSTC loans from excessive charges, including default charges and interest. As the cap reduces the revenues to HCSTC firms, it has the effect of making some consumers unprofitable to serve and it was expected that firms would tighten their lending criteria and that these consumers would lose access to HCSTC.

2.8 When we made our decision on the level and structure of the price cap, our research showed that the consumers who would no longer be able to access the market were likely to be better off as a result, as the loan would have made their financial position worse. We expected that 89% of consumers who could get HCSTC credit in 2014 would still be able to do so and that the cost of credit would be significantly reduced for these consumers. We also expected the cap to lead to a significant reduction of the number of firms in the market.

2.9 During this review we have assessed how the market has developed against these expectations. We have not attempted to separate the specific effects of the price cap from the other interventions affecting the HCSTC market. Instead, we have looked at the current HCSTC market to see if there is any evidence that it would be beneficial to change the cap level or structure.

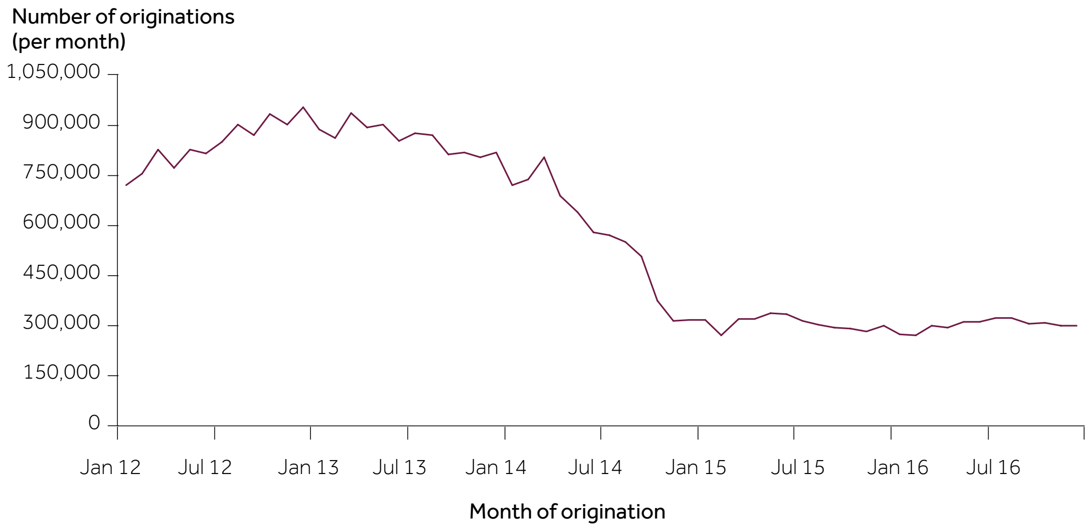
2.10 As we set out in the CfI, the review looked at the following:

- consumers' experience of using HCSTC after the cap was introduced
- consequences for consumers who can no longer access HCSTC post-cap
- the current state of the HCSTC market and how it has changed since we started regulating it, and
- the scope of the cap and the impact it has had on other high-cost credit products.

2.11 Before publishing the CfI in November 2016, we analysed the HCSTC market using data collected from Credit Reference Agencies (CRA) and from both successful and unsuccessful applications submitted to us by HCSTC firms applying for authorisation. This research gave us a picture of how the market had changed between January 2014 and June 2015. These findings, given in the CfI, included:

- the market got much smaller during 2014, with a significant decline in revenues, the volume of loans issued and the number of consumers applying and accepted for HCSTC. Figure 2.1 shows how many loans were made during 2012-2016;
- Current HCSTC consumers are less likely to default than before we became the consumer credit regulator and introduced our rules for this market, including the price cap. There was also a decrease in rates of arrears between January 2014 and June 2015. However, HCSTC consumers continued to be more likely to have arrears on other credit products after taking out a HCSTC loan.
- We had been concerned that a 'waterbed effect' may mean that our interventions had created distortions in the market or that problems from the HCSTC market had simply moved to other markets. However, we found no evidence that declined applicants were generally taking out other high cost products. We also found no robust evidence of declined applicants increasingly turning to illegal money lenders, and
- We have not seen evidence of widespread attempts by firms to avoid the cap by structuring products so that they fall outside of the HCSTC definition.

Figure 2.1: Number of HCSTC originations 2012-2016[2]



2.12 In the CfI, we invited comments on these findings and asked for more information to help us to understand the drivers of these changes. As well as considering the CfI responses, we have carried out further research. In particular, we commissioned a consumer survey of 1,800 people to understand three groups of consumers: those recently accepted for a HCSTC product, those recently declined and those who previously used HCSTC but no longer do. This survey gave us a fuller picture of the socio-economic situation of HCSTC users and allowed us to investigate their experience of being accepted or declined for HCSTC. We also gathered additional CRA data to get an accurate picture of the HCSTC sector.[3]

Summary of findings

2.13 The findings of the review are largely in line with those we set out in the CfI.

- **Current consumers:** We see considerable evidence that consumers are generally getting better outcomes than in 2014, when we were considering the price cap proposal. In particular, the cost of borrowing has fallen significantly and the considerable reduction in default rates shows consumers are more likely to repay their loans on time. While most firms continue to offer single instalment loans for a period of around one month, many are increasingly offering instalment loans for longer periods. Linked to this we see a rise in the number of loans with missed payments. This increase is driven by people missing one payment and then going on to repay the loan in full, indicating that the problems in repayment tend to be temporary and are resolved by the end of the loan period. The number of people seeking debt advice due to HCSTC has also fallen substantially since 2014. However, we note that when compared to the outcomes of people who do not take out HCSTC products, HCSTC consumers appear to have a higher risk of a bad credit 'event', such as missing a loan payment, in the 3-12 months after taking out a HCSTC product than would have been expected, taking into account their credit history.

2 The sources for this chart are the research we conducted ahead of setting the price cap, the data from the CfI and data from more recent CRA analysis. See the Technical Annex for more information on this.

3 See the Technical Annex to this Feedback Statement for more information about this analysis. In particular, Chapter 8 sets out the findings for the HCSTC market.

- **Declined consumers:** We had been concerned that consumers who were declined HCSTC might instead turn to other forms of high-cost credit or to illegal money lenders. In line with the CfI findings, we find limited evidence of consumers replacing HCSTC with other forms of formal credit. Around 15% of declined consumers take out an alternative credit product after being declined HCSTC, while around 25% turn to informal forms of credit such as friends or family. We do not find robust evidence that people are increasingly turning to illegal money lenders as a direct result of being declined for HCSTC products. We do see evidence that, for many consumers, being declined access to HCSTC had a positive effect, with 63% stating that they thought it was 'for the best'.

- **Viability of the market:** There are more HCSTC firms currently in the market than we expected when we set the cap. Following a significant decline in the size of the market in 2014, there has since been slight increase in levels of lending. We also see signs that that competition is strengthening with significant changes in market shares during 2015-16. Accordingly, we conclude that a viable market has remained under the cap. We note that at present many firms are unprofitable and several are trying to sell their businesses. As a result we expect that there may be significant changes in the market in the future, particularly on the high street.[4]

- **Scope of the cap:** We have not found evidence of widespread attempts by firms to evade the cap. Because consumers do not appear to substitute HCSTC with other forms of credit there is not a clear case for extending the scope of the cap to other areas to eliminate a distortion of the market or firms finding loopholes in the regulation. We will instead consider whether price caps could be appropriate for other high-cost credit products as part of the wider review. We discuss this later in this publication.

Outcome of the review

2.14 The main finding to support a tightening of the cap is that current consumers are at a higher risk of their financial situation worsening in the 3-12 months after taking out a HCSTC product when compared with people not taking out such loans. This point, together with the observation that there are a larger number of firms in the market than we expected, could suggest that the cap is currently set too high.

2.15 When we set the price cap we said that we expected that an impact of the cap would be that HCSTC lenders would stop lending to people who were at a high risk of harm from taking out HCSTC. We were clear, however, that it would not completely eliminate the risk as it applied even to consumers with relatively good credit scores. We see that the risks have remained roughly the same before and after the cap and so do not consider that a change in the price cap would eliminate the risk. We also know that, while there are more firms in the market than expected, many are unprofitable and we expect further changes in the composition of the market. On balance, we do not think that tightening the price cap is necessary. We discuss this issue in more detail below. We will continue to monitor the outcomes for consumers in this market.

2.16 We do not find sufficient evidence to suggest that the cap is currently set too low. A viable market appears to be operating under the cap. Although there are signs of fragility, we consider that the appropriate response is to keep the cap at the current level. This will give firms a degree of regulatory stability in which to clearly assess the effects of the changes which have been made to products and business models.

4 By 'high street' we mean firms which have a physical store presence rather than being online only.

2.17 We were concerned that those who were turned down for HCSTC could see their financial situation get worse or those consumers may substitute HCSTC with other high cost or illegal forms of borrowing. We have not seen that this is typically the case and so do not see a case for raising the cap.

2.18 We have therefore decided to keep the cap at its present level. We will continue to monitor the market and also commit to carrying out another review of the price cap in three years.

Outcomes for current and declined consumers

Current consumers of HCSTC

2.19 Consumers of HCSTC products tend to be in a deteriorating financial position before taking out a loan. In the 12 months before first applying for a HCSTC loan, consumers have usually seen an increase in their overall debt levels. On average, 43% have missed at least one payment on a credit product, rising to 53% in the month they apply. Similar patterns apply to the proportion of debts in default and the likelihood of exceeding their overdraft limit.

2.20 Our consumer survey, together with CRA data, gave us a picture of current HCSTC consumers.

- **Age and gender:** HCSTC consumers are, on average, 35 years old and tend to be male (62%).
- **Income:** Current users have lower incomes than the national average (£20,400 versus £26,370 a year), with 88% having earned income and 23% receiving benefits.[5] 76% are employed full time and 81% have regular income.
- **Savings:** At the time of applying for their last loan, 76% of accepted consumers have no money in accessible savings. Those with savings have, on average, around £177.
- **Debts and bills:** At the time of the survey, 14% of HCSTC consumers say they are falling behind on their bills, with 68% struggling to pay their bills at least from time to time. On average, borrowers have non-mortgage debts of £4,700 and half owe more than £2,000. Around one in ten HCSTC consumers have a mortgage.

2.21 When compared with our research ahead of setting the price cap we see that there does not appear to have been a significant change in the profile of consumers currently using HCSTC and those who took out such loans in 2014. This indicates that HCSTC remains a sub-prime, rather than mainstream or near-prime, credit product.

2.22 As well as looking at consumers' socio-economic characteristics, we also used the survey and CRA analysis to understand why consumers take out HCSTC loans and their experiences of these products.

- **Reason for taking out the loan:** The main reason given for taking out a HCSTC loan was to pay for living expenses, followed by paying a bill. Borrowers tended to give the

5 Note that some individuals will receive income though both earnings and benefits.

speed and ease of getting money as the reason for choosing HCSTC rather than another form of credit.

- **Number of loans taken out:** 60% of HCSTC consumers took out 3 or fewer loans in 2016, 10% took out 12 or more. The average was just under 5.

- **Experience of the loan:** 61% of current consumers are happy with their decision to have taken out a HCSTC loan with 30% stating they regretted the decision. Levels of regret were higher where individuals reported financial difficulties[6], with fewer than 40% of these consumers saying they were happy with their decision.

2.23 We find that there have been significant improvements in the cost of credit and borrowers' ability to repay their HCSTC loans. There has also been a substantial fall in the number of people turning to debt advice bodies for help with HCSTC, with Citizens Advice reporting a 60% drop in the number of HCSTC-related issues and a 30% drop in issues related to other high-cost credit areas. Debt charities have also indicated that consumers are presenting themselves earlier and with lower debts suggesting that underlying problems are being addressed sooner. However, we remain concerned that some consumers' use of HCSTC could possibly be due to an increase in their risk of having arrears on other credit products.

2.24 **Lower costs of borrowing.** The principal aim of the price cap was to protect HCSTC consumers from excessive charges associated with these products. The cap has, by design, meant that the cost of borrowing has decreased substantially. Before the price cap was introduced, HCSTC loans typically cost consumers over £100 per loan. After the cap this dropped to around £60.[7] This has generated significant benefits for those consumers who continue to take out these loans: leading to total savings of approximately £150 million for the 760,000 individuals using HCSTC each year.[8]

2.25 **Significantly reduced default rates.** The high risk of borrowers being unable to repay HCSTC on time or at all was a key factor when we assessed the harms and benefits of using HCSTC when we set the cap. In the CfI we presented the findings from our analysis of CRA data between January 2014 and June 2015 which indicated that there had been a decline in default and arrears rates. In the CfI we asked for feedback on whether this finding was accurate and any other evidence of risks for consumers post-cap.

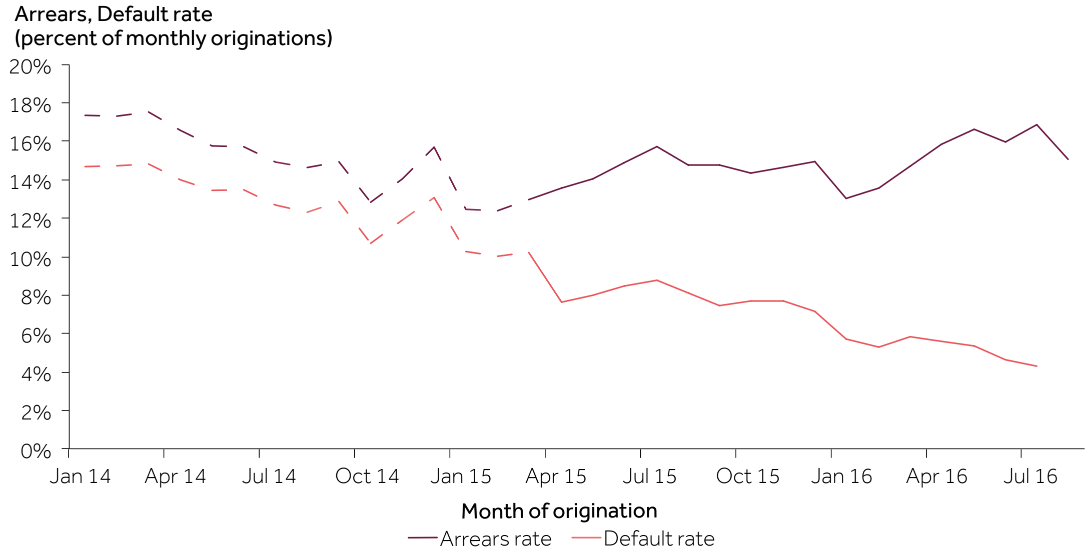
2.26 Figure 2.2 shows arrears and default rates since 2014. This shows that default rates on new HCSTC loans have decreased considerably since we introduced regulation and the price cap. This significant fall indicates that firms are increasingly lending to individuals able to repay the loan. This is in marked difference to the situation before to the price cap where firms were generating around half of their revenues from charges for late payment and default. As discussed in more detail below, we do not find evidence of a 'waterbed effect': consumers who can no longer get HCSTC products do not typically take out other credit products as a replacement. As such, we do not see that the fall in the default rate is due to the underlying issues moving to other credit products.

6 Defined in our survey as falling behind on some or many of their bills and financial commitments.

7 We obtained this figure through our own analysis of CRA data and it is corroborated by a joint report by the Consumer Finance Association and Oxera. See page 11 CFA/Oxera (2017), *'Impact of regulation on High Cost Short Term Credit: How the functioning of the HCSTC market has evolved'*

8 This figure is based on an average saving of around £40 per loan and an average (mean) of five loans taken out per consumer per year.

Figure 2.2: Arrears and default rates on HCSTC loans by date of origination[9]



2.27 There has been an increase in arrears rates on HCSTC loans issued in 2016 compared to 2015. Our analysis of the data indicates that this rise is largely because HCSTC loans are increasingly structured as instalment loans with multiple payments. As these loans have more payments and are spread over a longer period of time than a single instalment loan, there is a higher risk of a borrower missing at least one payment. We find that the rise is mainly caused by consumers missing exactly one payment and then going on to repay the loan within the loan period. This does not appear to indicate greater overall financial distress as the arrears are temporary.

2.28 This finding is in line with CfI responses which highlighted research[10] showing that, before the price cap, around half of the HCSTC lenders' revenue came from interest and charges for late payment or default. Respondents pointed out that this figure has reduced to 20-25% and suggested that borrowers are now more likely to repay their loans on time.

2.29 **Increase in complaints to the Financial Ombudsman Service, but a decrease in HCSTC cases to debt charities.** The Financial Ombudsman Service's 2016 annual report[11] reported a 227% increase in the number of complaints about 'payday loans' in 2016 compared to 2015. They upheld a relatively high number of these - 59% - compared with an average of 43% across all complaints. However, this may not reflect current behaviour. The Financial Ombudsman Service notes, 'the FCA's tougher rules for high-cost short-term credit are having an impact. Most of the payday loan complaints we're now getting involve loans that were taken out some time ago'[12]. Since 2014 we have undertaken significant regulatory interventions in the sector, including several significant redress schemes. It is likely that increased public awareness of our expectations and some firms' past misconduct contributed to the increase in complaints made about historical loans. We will continue to monitor complaint levels

9 This chart combines data from the CfI analysis (dotted line) and the analysis of recent CRA data (solid line) which use slightly different definitions of default and arrears due to differences in the data used. For the CfI we take arrears as being over 7 days late in payment and default as over 30 days. For the recent CRA data, we take any missed payment in a loan as representing that it is in arrears and for defaults we measure the loans which are marked as in default in credit records. For further discussion of arrears and defaults using more recent CRA data see chapter 8 of the Technical Annex to this Feedback Statement.

10 See, for example, page 12 of Oxera/CFA (2017).

11 Financial Ombudsman Service Annual Report 2016/17: 'Fairness in a changing world'

12 Financial Ombudsman Service Annual Review 2016/2017, page 19

and to liaise closely with the Financial Ombudsman Service and others, including HCSTC lenders, to ensure that complaints are dealt with appropriately.

2.30 Responses from debt advice bodies are consistent with this picture. Citizens Advice reported a 60% reduction in HCSTC cases since 2014, and that the number of cases had stabilised since the start of 2015. Similarly, Stepchange reported a 30% drop in clients with HCSTC debts from 23.4% in 2013 to 16.3% in 2016.

2.31 Despite this, debt advice and consumer groups told us that there are still issues in the HCSTC market. These include problems with leniency procedures, the adequacy of affordability checks and transparency around default fees and early repayment. We see the fall in HCSTC cases by debt advice groups as evidence that our interventions have had a positive impact in this market. Where we see evidence of continued poor practice we will take the appropriate actions.

2.32 **Continuing risk of arrears on other credit products.** Our original analysis looked at a range of financial indicators to find out if HCSTC users tended to be better or worse off after taking the loan. We found evidence that consumers with the lowest credit scores were generally better off in the short term. However, they were also much more likely to become worse off within 3-12 months of taking out the loan. We also saw that while this risk was lower for consumers with better credit ratings, a significant proportion of them still showed signs of harm after taking out their loan.

2.33 Our more recent analysis of CRA data shows that these risks remained after the cap was introduced. We used CRA data from January 2014 to June 2015 which covered the period both before and after the cap's introduction. We found that, compared to those who did not take out a HCSTC loan, first time HCSTC consumers remain more at risk of harm than we would have expected from their previous 12 month's credit history. This harm includes any bad credit event, the level of their non-HCSTC balances in default or going over their overdraft limit.

2.34 We found a particularly increased risk of a bad credit event being noted on a consumer's credit file. This risk increased during 2014, despite our interventions in the market. Borrowers in Q1 2014 were around 3% more likely to have a bad credit event than we would have expected from their previous credit history, had they not taken out the loan. This rises to around 6-8% in Q4 2014. Our analysis does not explain what drove this growth during 2014 and the price cap does not appear to have had an effect. In the months after the cap, first time borrowers had the same increased risk of bad credit events in the 3-6 months after borrowing as those who borrowed before the cap. The price cap does not appear to have reduced the risk which suggests that the price of the loan is not the main reason for this increased risk.

2.35 We found that the 5% of HCSTC consumers with the lowest credit scores have a significantly increased risk of harm. However, we also found evidence that the increased risk of financial distress occurs across a wider group of consumers. This is in line with our original analysis when setting the cap. We explained that, while it would not remove these risks, it would lower the cost of borrowing for HCSTC consumers. This in turn would reduce the risk that borrowers' debt grows due to excessive fees and interest. The price cap has achieved this.

2.36 The continued risk of harm for some HCSTC customers was a key consideration when deciding whether it would be appropriate to tighten the cap. Given that the cap did not reduce this risk in early 2015, we do not have sufficient evidence that this would tackle the causes behind these outcomes now.

2.37 We would expect that tightening the cap would reduce the supply of HCSTC to the highest-risk consumers. However, it would also reduce firms' profit from all loans. This would significantly affect HCSTC firms' overall profitability and could severely reduce the number of firms and the availability of credit in this sector.

2.38 As a result of these findings, we do not consider that tightening the cap would be effective or proportionate. Our analysis of the wider high cost credit sector shows that many consumers have lower credit scores in the year after taking out a high cost product. We think that the risks of harm identified are common across the high cost credit sector. We will investigate this further as part of our wider review.

Declined applicants

2.39 When setting the price cap we knew that an impact would be that firms would stop lending to some consumers as they would no longer be profitable to serve. We judged that these consumers would be, on balance, better off as a result of not receiving the loan. Despite this, we noted that there were legitimate concerns that the loss of access to HCSTC may lead to their financial situation becoming worse and that they may turn to other high-cost products or to illegal money lenders. In this review, we have looked at the outcomes for those denied access to HCSTC to see whether they would have been better off with the loan, which could suggest a benefit in raising the level of the cap, and whether they have substituted HCSTC with other forms of high-cost credit. This could indicate that the remedies applied to HCSTC may need to be applied more widely.

2.40 We used a range of tools to examine the outcomes for this group. This included analysis of CRA data to look at what formal credit products were taken out and how their financial situation changed in the period after they were turned down for HCSTC. We supplemented this analysis with information from our consumer survey which had a particular focus on this group, allowing us to look into areas not visible from CRA data, such as borrowing from friends or family.

2.41 We conducted similar research on declined applicants for HCSTC products as we did for successful applicants which we set out earlier. In particular, our research found:

- **Age and gender:** With an average age of 33, individuals declined HCSTC are slightly younger than those accepted (who had an average age of 35) and have a more even gender split (44% female rather than 38%).

- **Income:** Declined individuals have an average annual income of £15,900 which is lower than those accepted (£20,400), are more likely to be in households receiving income from benefits and less likely to be in full time employment.

- **Savings:** The share of declined applicants with no savings at the time of requesting a HCSTC loan is similar to that of accepted applicants. However, as a whole, the declined group has less money in savings. Those with savings have, on average, around £117, which is a third less than the average for the accepted group.

- **Debts and bills:** 22% of the declined group are falling behind on their bills, with 74% finding their bills to be a struggle at least from time to time. As a group, those declined HCSTC have lower levels of debt than those accepted, with an average of £3,700.

2.42 Overall, we find that our predictions around declined applicants when setting the price cap were accurate. The analysis of CRA data we presented in the CfI showed that while declined applicants were on a trajectory of increasing debt, this trend was not accelerated after their applications were declined. Many individuals' accumulation of debt slowed down. The majority (63%) of declined consumers responding to our survey said it was for the best that their application had been unsuccessful.

2.43 **Declined applicants are not generally turning to other high cost products.** In the CfI we presented analysis of CRA data which investigated which new credit products were taken out by individuals in the 30 days following being turned down for HCSTC. That analysis found that between 8% and 13% took out new products, which were most likely to be revolving credit (store and credit cards) and personal loans. Other forms of high-cost credit, including home-collected credit, RTO or catalogue credit were taken out less frequently than personal loans or revolving credit following a declined HCSTC application. Our analysis also showed that current account overdrafts did not appear to be regularly used as an alternative to HCSTC when applications were declined. We stated in the CfI that, on the basis of this initial analysis, we did not find evidence of declined applicants turning to other high-cost credit products. We invited comments on this while stating that we would also carry out further research in this area.

2.44 Many CfI respondents disagreed with the idea that declined consumers were not turning to other forms of high-cost credit, giving examples of individuals who hold both HCSTC and other high cost credit products. Several responses from HCSTC lenders – including those that disagreed with our findings - said the markets were distinctly different and that few consumers who apply for HCSTC also hold other high cost credit products.

2.45 While we agree that there will be some movement between HCSTC and other credit products when they are turned down for HCSTC, we do not find that this is typically the case: there has not been a simple transfer of demand from one product to another. As part of our consumer survey we focused on declined applicants and their subsequent actions. Our survey showed that the majority (60%) do not go on to borrow from other sources. 37% take no further action (including 'going without') and 7% state that they cut expenditure as a result. While 20% of declined individuals reported that they needed the loan to pay a bill, only 1% state that they missed a bill payment as a result of not receiving credit. The 40% who turn to other sources of borrowing mainly go to friends or family. In total, 15% of the declined group go on to use other forms of formal credit. This figure is in line with our analysis of CRA data set out in the CfI and provides more evidence for our initial findings.[13]

2.46 Having considered all the evidence, we conclude that other forms of high-cost credit are only limited substitutes for HCSTC and that the cap has not led to a significant shift of demand to different products with potentially similar risks. If we had found that other high cost credit products were more readily be substituted for HCSTC, this could have indicated that our interventions should be extended to these other products. In considering these products as part of our wider review into high-cost credit, we recognise that each product potentially has a different set of consumers and risks. Thus we will need to identify any harm and the most effective remedy on the basis of an analysis of each product, rather than applying a direct read across from our work on HCSTC.

13 Our survey findings around this point are in line with a report from the Social Market Foundation (2016), 'A *modern credit revolution: an analysis of the short-term credit market*'. See, in particular, page 25.

2.47 **We do not see strong evidence of a rise in illegal money lending because of the price cap**. A key part of our judgement of the cap's risks and benefits was that being excluded from HCSTC due to the impact of the cap was unlikely to mean those consumers turned to illegal money lenders. At the time, our analysis suggested that less than 5% of declined applicants would consider turning to these sources and the results from our recent survey do not show any change in this. Where declined individuals in our survey had subsequently used informal sources, 3% said that the person they approached lends as a way of earning money. This is in line with our previous analysis. For those who were aware that the person that they would go to would charge, the expected costs were substantial - an average expected interest of £167 on a £250 loan.

2.48 Illegal money lending is a complex and long standing problem driven by a range of social and economic factors. The individuals who use illegal money lenders are difficult to reach and reluctant to talk, though we have discussed the issue with a range of frontline staff dealing with illegal money lending, including regional Illegal Money Lending Teams, social services and community groups. We have not seen any clear indication that declined or former users of HCSTC are increasingly turning to illegal money lenders as a result of the price cap.

Current state of the HCSTC market

Number of firms in the market

2.49 One of our key considerations when setting the price cap was the impact it would have on the supply of HCSTC. We chose the level of the cap to allow a viable market to continue, both through online and high street distribution channels. At the time, our analysis suggested it was possible that only a handful of firms would continue to exist in the market, although we stated that we did not take 'dynamic' effects, such as changes in products or business models, into account.

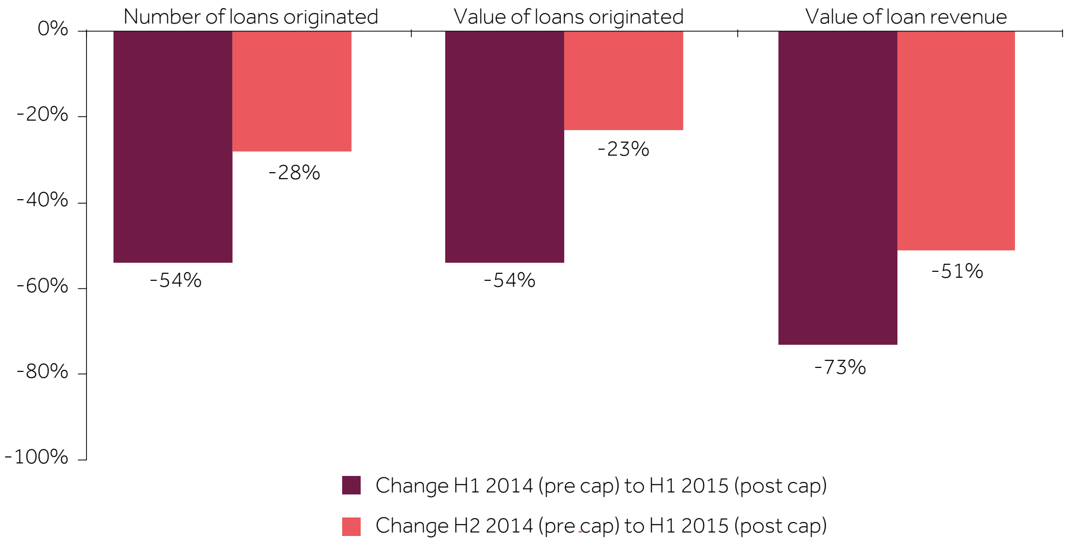
2.50 There has been a significant reduction in the number of firms in the sector since 2014. 188 firms that initially applied for FCA authorisation to engage in HCSTC activities subsequently withdrew their applications, often where it was clear they were unlikely to meet our standards. Despite this, the number of firms in the market is considerably higher than we predicted in 2014. 144 firms have the relevant permissions to conduct HCSTC business, of which around 30 were actively lending in December 2016.

2.51 More firms have stayed on the high street than we expected. However, several CfI respondents representing the HCSTC industry suggested that these firms are in a fragile position due to their higher fixed costs (e.g. store rental costs). The number of high street stores offering HCSTC loans has significantly reduced since 2013 and those that remain typically offer a diverse range of credit services as well as HCSTC. We continue to expect to see significant changes in high street HCSTC firms and note that several high street lenders are in the process of selling or winding down their business.

Levels of lending and revenues

2.52 Our data show that the size of the market contracted sharply during 2014, compared with 2012-13, followed by a slight recovery and stabilisation during 2015-16. When setting the cap we also expected significant reduction in firms' revenues and profits. At the time, our model indicated that revenues would fall by 42% as a result of the cap. Figure 2.3 shows the difference in revenues made in the first six months after the price cap was introduced compared with the first and second half of the previous year. In particular, we see that there was a 51% reduction in revenues when compared with the period immediately preceding the cap. While this is not all entirely due to the price cap, it is in line with expectations.

Figure 2.3: Change in number and value of loans originated and revenues earned during H1 2015 (post-cap) compared to H1 and H2 2014 (both pre-cap)



2.53 In their responses, HCSTC firms and trade associations said they considered a viable market has been able to exist under the price cap, despite the lower levels of revenues. However, many stated that the high street was under particular pressure due to the high fixed costs. The industry generally agreed that the cap was at the right level, with only one firm suggesting that it should be raised.

2.54 Despite this, we see signs of fragility in the market. Many firms are currently unprofitable and we expect to see many leave the market if this does not change. The levels of profitability suggest that the market may not be able to sustain the number of firms currently active in this sector.

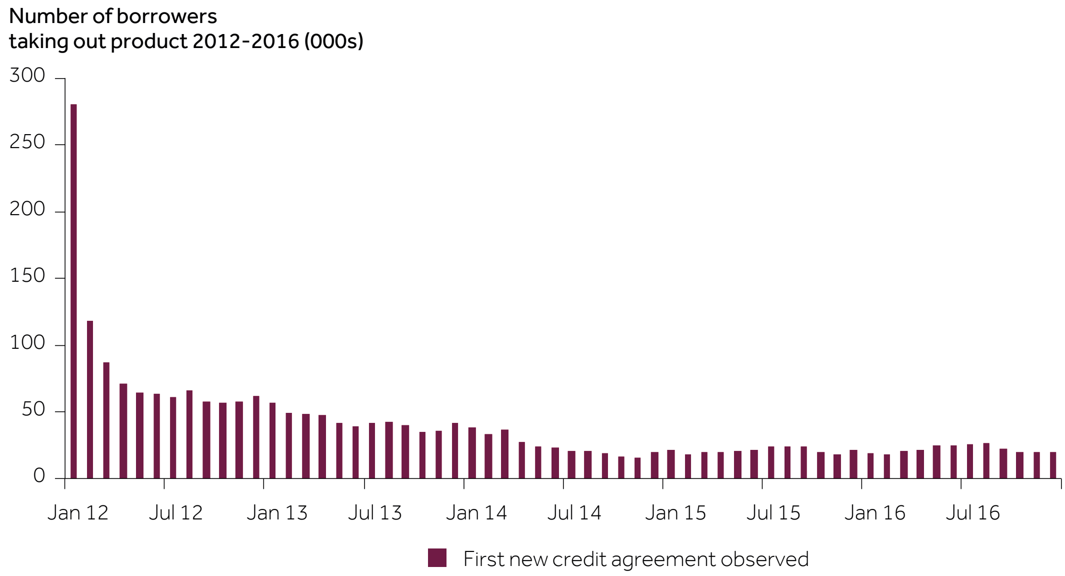
Number of HCSTC consumers

2.55 The research we undertook ahead of the CfI also showed a drop in the number of consumers applying for HCSTC over the course of 2014. Our CfI itself said the biggest factor in decreased lending volumes was the significant drop in applications, rather than a reduction in supply. We looked at this to assess the on-going viability of the HCSTC market.

2.56 In 2013, 1.7m people took out a total of 10.3m HCSTC loans worth £2.5bn. In 2016, 760,000 people took out a total of 3.6m loans worth slightly over £1bn. Figure 2.4 shows the number of new consumers taking out HCSTC loans each month between 2012 and 2016. This also shows a drop during 2014, although the trend of declining numbers of new consumers started in 2013.[14]

14 This is based on the timing where HCSTC loans are first observed in these CRA data. Not all HCSTC loans appear in these data before the start of 2015 which means we do not expect to observe the first time all HCSTC borrowers take out a HCSTC loan'

Figure 2.4 – Number of new consumers taking out a HCSTC loan 2012-2016



2.57 The drop in the numbers is only partially explained by firms tightening their lending standards. Our analysis shows that, since 2014, there has been a substantial drop in the number of individuals applying for HCSTC loans. In the CfI we said that we would look further at the reasons for this drop in applications as part of the review.

2.58 Respondents highlighted a number of potential reasons for the drop in applications involving changes in both firms' and consumers' behaviours. Several HCSTC lenders and trade bodies said the authorisation process and adapting to the new regulatory environment had meant firms reduced their focus on marketing and getting new consumers. Some respondents indicated that they expected to see the number of applicants rising when firms had adapted to the new regulation and started to increase their focus on marketing.

2.59 Figure 2.4 shows that the number of new consumers applying for HCSTC since January 2015 has remained fairly constant at around 20,000 a month. However, the volume and value of loans has increased slightly since January 2015. This suggests that the recent growth has come from lending to people who have taken out HCSTC loans in the past, rather than attracting a greater number of new consumers.

2.60 Our consumer survey had a particular focus on individuals who had previously used HCSTC ('former users') but had not reapplied for at least 6 months. We found that this group tended to be slightly older (average age 36) than current consumers and more likely to own their own property, either outright or with a mortgage. Current consumers and former users had fairly comparable income and debt levels, although around 60% of former users said their financial situation had improved in the previous 12 months, compared with 48% of current consumers. This difference may be relevant since 61% of former users stated that the reason for not continuing to use HCSTC was that their financial circumstances had improved. Following this, 12% said that they were put off by the high cost of credit, 8% that they were attempting to stay out of debt and a further 8% gave the main reason as negative impressions of loans.

2.61 At least 89% of former users appear to have stopped applying for HCSTC because they do not need or want the product. Only 4% stated that they stopped applying for HCSTC because they their last application for a HCSTC loan had been declined.

2.62 Responses from HCSTC firms, academics and consumer groups stated that consumer demand was firm-led and so the decline in marketing was a reason that applications fell. We find some evidence for this. When asked their main reason for choosing a HCSTC lender, the most common answer consumers gave was that they had been attracted by the firm's advertising, with 27% of the group giving this response. This is notably higher than for current HCSTC consumers where only 16% said advertising was their main reason for choosing a lender. This suggests it is plausible that the reduction in marketing has contributed to a decline in applications.

2.63 Many respondents also pointed to changes in consumer attitudes as a key reason for the drop in demand. They suggested that consumers were not applying for loans because they expected to be declined, were concerned about the impact of a HCSTC loan on their credit rating or had low trust in the sector. We used our survey to investigate levels of trust in the HCSTC industry's ability to follow the rules. As a whole, former users had lower levels of trust than current or declined consumers. Former users also show lower levels of trust among those who had avoided borrowing altogether, indicating that this may be a contributing factor.

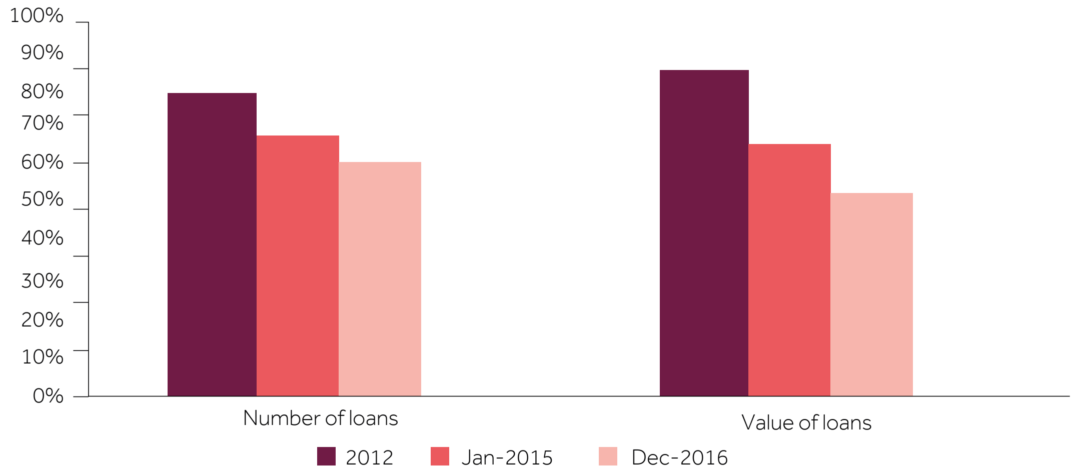
Competition

2.64 The CMA report into competition in the HCSTC market[15] found that the market was fairly concentrated in 2012. The top three lenders had over 65% of the market share in terms of the number of loans issued and over 70% of the value of loans.

2.65 There are signs that competition between firms may have strengthened during 2015-16. Figure 2.5 compares the market share of the three largest lenders and shows that concentration of the market in the top three lenders decreased between 2012 and the price cap's introduction in January 2015. These changes have continued across 2015-16 and our analysis indicates that several smaller lenders have grown, including new entrants to the market. This provides further evidence that the HCSTC market is viable and that the current cap is not set too low.

15 CMA (2015), *'Payday lending market investigation: Final Report'*

Figure 2.5. Combined market share of three largest[16] lenders by number and volumes of loans



2.66 The CMA report also noted that there was very little price competition within the market. This was partly because consumer demand was less affected by prices and more influenced by other features, such as how soon the money would be available. Some CfI respondents said that there has been pricing under the initial cost cap of 0.8% a day and suggested that this is evidence of price competition. However, there are alternative explanations for this pricing. In particular, the 100% total cost element of the cap means that a loan priced at 0.8% per day cannot have a term longer than 125 days. So it is likely that pricing of loans below the daily cap is driven more by lenders offering a different range of products rather than price competition. Our consumer survey findings support this: only around 9-12% of people who wanted HCSTC chose firms on the basis that they are the cheapest, had good interest rates or were the best offer on a price comparison website.

Changes to products

2.67 We noted in the CfI that there had been a move by HCSTC firms towards offering longer term instalment loans. The CfI asked for views on the implications of increasingly longer term loans for consumers.

2.68 Many respondents, including those from industry and consumers bodies, said the longer term of the loan meant that the cost would typically be higher than a shorter term loan, but that each individual repayment would be more affordable. As such, the respondents said some consumers may find this type of loan is more suitable for their situation but this may not be the case for all consumers. In line with this, several consumer groups stated that firms needed to ensure that they carried out suitability assessments to ensure that the structure of the loan is appropriate to the borrower.

2.69 Several debt advice bodies noted that they had observed that people coming to them for advice were more able to repay instalment loans, compared with the larger one-off payments for single instalment HCSTC loans. On the other hand, HCSTC lenders who said the longer duration of the loans led to increased credit risk and a higher chance of a borrower experiencing a change in their circumstances. Our analysis of CRA data bears this out. Arrears rates have increased, corresponding to consumers missing one payment on an instalment loan, but there has been an overall decline in default rates.

16 We take the three largest lenders at each time (2012, January 2015, December 2016) and for each measure (number and volume of loans). The lenders are therefore not necessarily the same.

Several HCSTC firms and trade bodies highlighted that longer term instalment loans also offer increased flexibility as consumers can repay the loans early. They also quoted research[17] which found that while contractual lengths of loans have been increasing, the actual duration has decreased, which shows that borrowers are generally repaying their loans early.

2.70 Responses from the HCSTC firms and their representatives tended to highlight consumer choice as a key benefit of the move to longer term loans. Other responses raised concerns that reducing the availability of shorter term loans would disadvantage some consumers who preferred them. Following the CfI we analysed product sales data for the largest HCSTC firms, which firms send to us as part of their regulatory requirements. This shows that during 2016 there was a marked increase in the number of loans issued for longer than 30 days. We are particularly interested in the finding that, while average loan term is increasing, many firms are still offering products which cluster into two distinct groups: shorter term loans of fewer than 30 days and longer term instalment products.

2.71 We recognise that the price cap, together with the limit on rollovers, have been key drivers of the move to longer term loans. Overall, based on the responses to the CfI and our own analysis, we do not see the increase in loan duration as a concern. A range of products still exist and the fall in default rates indicates that borrowers are increasingly able to pay off their loans.

Scope of the cap

2.72 We have examined whether there is evidence of widespread 'gaming' of the cap. We are aware of a few products priced just under the 100% APR definition for HCSTC. However, these are generally for longer duration loans than HCSTC and we have not seen an increase in the number of these products since the price cap was introduced. For clarity, while many HCSTC firms are also providing longer term instalment loans, these are typically 3-4 months in duration and, therefore, well within the HCSTC definition. We do not consider that there has been any significant attempt by firms to avoid the cap and so do not propose to alter the definition of HCSTC. Responses to the CfI were positive around the APR and duration in the definition of HCSTC.

2.73 In the CfI, we asked for evidence of whether the cap had had an impact on other high-cost products. Unsurprisingly, the responses were similar to those around whether other high cost products are substituted for HCSTC which we discuss earlier in this chapter. We do not find evidence that consumers are being shifted from HCSTC to other high-cost products as a result of the cap so consider that these products should be considered separately as part of the wider review. We do not consider that the rules which apply to HCSTC should also apply to other products in order to ensure that there are not distortions in the market. We note that several responses did call for us to take such an approach on grounds of consistency. We do not rule out extending these rules if we see evidence of harm in other products in the future where this extension would be an appropriate remedy. However, without evidence of harm we do not consider that this would be a necessary or proportionate step.

17 See, for example, page 17 of Social Market Foundation (2016)

3 High Cost Credit Review

Summary
We have considered a wide array of high-cost services and have identified a number of issues which could cause consumer harm. We will investigate these further with the aim of issuing a Consultation Paper on proposed solutions to our concerns in Spring 2018. We are particularly concerned about Rent-to-Own, Home-Collected Credit and Catalogue Credit, as well as wider concerns about consumers' long-term indebtedness.

- Rent-to-Own – we will look at why consumers use RTO to obtain goods and whether more affordable alternatives are available. We will convene a forum to encourage cross-agency public policy solutions. We will also carry out a market-based analysis to understand and where possible address constraints that may currently prevent new entrants or other credit providers from increasing their supply of potentially cheaper credit to this vulnerable consumer group. This will include considering whether this may be of broader application in other high cost credit areas.
- Home-Collected Credit – we will focus on particular features of the business model which may incentivise consumers' long-term indebtedness and where we identify harm, explore options for potential action to protect consumers.
- Catalogue Credit – Our analysis raises concerns about the high level of arrears experienced by borrowers, with the fees and charges that are triggered by arrears, and the associated risk of financial distress. In addition we have observed high levels of interest charged outside interest-free periods and will further investigate the impact on borrowers and the transparency around interest-free periods.
- Wider consideration of high-cost credit products – We will analyse in depth the worsening of high-cost credit consumers' credit ratings to understand whether the use of high-cost credit is causing these reductions. We will also examine multiple and repeat use of products, patterns of longer term indebtedness and whether that harms consumers.

Introduction

3.1 In our November 2016 CfI we announced our intention to review the high-cost credit sector as a whole. We wanted to build a full picture of how particular products are used and how they may cause harm and, if so, to which consumers. This would enable us to consider whether we need to make further policy interventions and whether these should apply across different markets more consistently than at present.

3.2 We also explained that we would use the high-cost credit review to look at arranged and unarranged overdrafts from a consumer protection perspective. We discuss overdrafts in more detail in Chapter 4, but we have also considered the relationship between overdraft use and other high-cost credit products as part of our analysis.

3.3 The CfI asked for views on issues including what products to include in the review, the extent and causes of harm from high-cost credit products, the feasibility and desirability of a more consistent approach and the types of intervention we should consider. We received nearly 100 responses and held a series of meetings with trade associations, consumer organisations and academics to discuss their views.

3.4 We have also carried out detailed quantitative research on a large representative sample of credit reference agency records[18] and used evidence gathered through our authorisations process and supervision work. This has given us further insights into consumers' use of high-cost credit. It has enabled us to identify areas of concern, both for immediate action and further consideration, so we can improve outcomes for consumers.

3.5 In this chapter we set out our overall approach to the review, the main themes from CfI feedback, findings from our analysis and the key areas of focus for the next phase of the review that will be completed in 2018. We look at these issues on a product-by-product basis.

Overview of high-cost credit markets

3.6 Outside the large, mainstream consumer credit products – credit cards, unsecured personal loans, overdrafts and motor finance – there are a variety of other products. As Table 3.1 shows, the largest markets by number of consumers are catalogue credit and retail finance, with around 2 million consumers taking out these type of credit in 2016. HCSTC and home-collected credit are smaller, with around 800,000. Rent-to-own, guarantor lending and logbook lending have much smaller consumer numbers, ranging from less than 100,000 to 200,000.

18 See the Technical Annex to this Feedback Statement for more information about this analysis.

Table 3.1: Comparison of market sizes of non-mainstream products (2016)

	Number of consumers with outstanding debt (million) [percent of UK adults]	Annual number of consumers taking out product (million)	Annual number of originations (million)	Annual value of originations (billion)	Value of outstanding debt (billion)
Catalogue credit	7.6 [14.7%]	1.9	2.5	£0.8	£4.0
Retail finance	5.3 [10.2%]	2.3	2.6	£4.4	£6.0
Store card	1.9 [3.7%]	0.4	0.4	£0.2	£0.7
HCSTC	1.6 [3.1%]	0.8	3.6	£1.1	£1.1
Home credit	1.6 [3.1%]	0.7	1.7	£1.3	£1.1
Rent-to-own	0.4 [0.8%]	0.2	0.6	£0.6	£0.5
Other running account[19]	0.3 [0.6%]	0.2	0.2	£0.2	£1.0
Guarantor	0.1 [0.2%]	0.1	0.1	£0.2	£0.3
Logbook	<0.1 [<0.1%]	<0.1	<0.1	<£0.1	<£0.1

The risk profile of consumers using high-cost credit

3.7 We analysed the credit risk profile of people who used high-cost credit products in 2016 and how their risk profile changed between 2015 and 2017. Figure 3.1 shows that consumers using home-collected credit, HCSTC, guarantor loans and rent-to-own products had a broadly similar risk profile. They had a much lower credit score in 2015 (higher credit risk) than consumers with consumer credit debt in general. Catalogue credit users are noticeably different. While they have lower credit scores than the population as a whole, their scores are not as low as users of other high-cost products.

3.8 We also found that the credit scores of people who used high-cost credit products, including HCSTC, worsened significantly between 2015 (Figure 3.1) and 2017 (Figure 3.2). This does not necessarily mean that high-cost credit is the cause of this deterioration. There are likely to be a variety of factors, such as rising living costs or life events which happened either at the time or after consumers applied for these loans. However, it does confirm that users of high-cost credit are often in a difficult and deteriorating financial situation.[20] We will investigate the causes of this deterioration further in the next stage of the review.

19 These are running account products that offer revolving credit facilities that are not a current account, credit card, catalogue or store card.

20 Credit scoring orders consumers ranging from 0 to 100 based on likelihood of repaying debt, with a lower score indicating higher credit risk. These figures show the credit scores of consumers in January 2015 and January 2017 who had taken out a high-cost credit product in 2016. See Technical Annex for further analysis.

Figure 3.1: January 2015 credit score profile of consumers taking out less mainstream consumer credit products during 2016

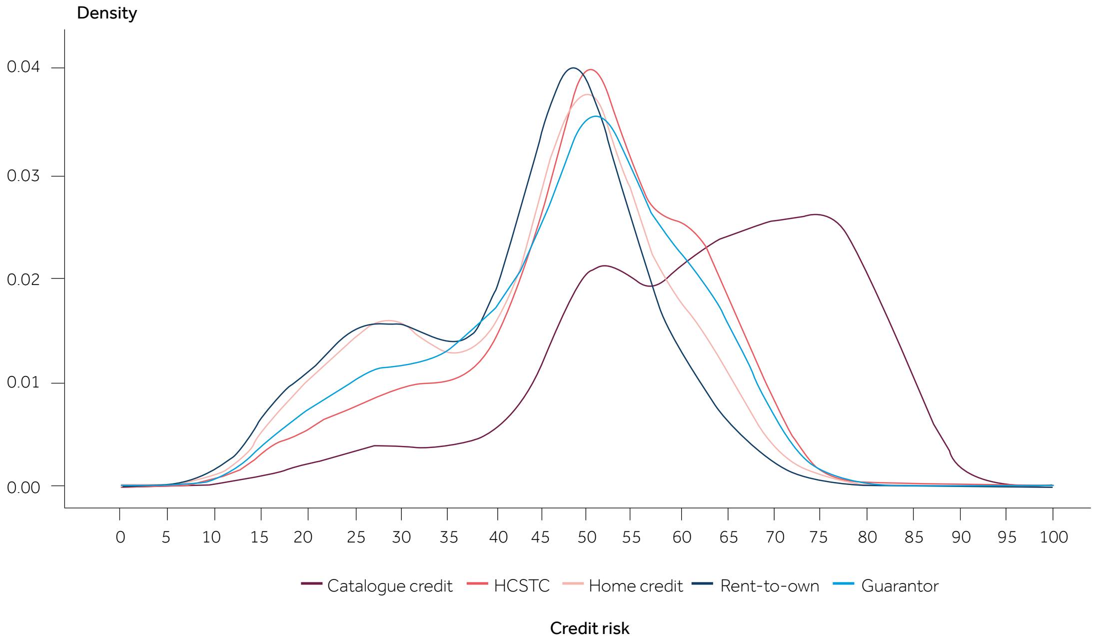
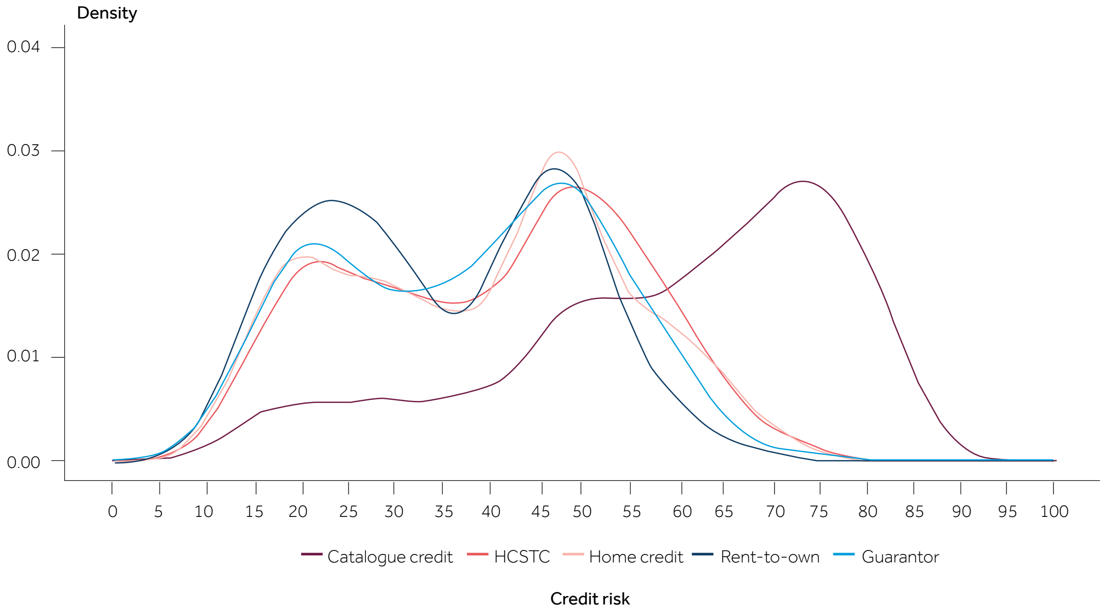


Figure 3.2: January 2017 credit score profile of consumers taking out less mainstream consumer credit products during 2016



3.9 Table 3.2 provides a comparison of the socio-economic profiles of consumers taking out high-cost credit products in 2016. This shows how the users of these different products have different characteristics. Home-collected credit and rent-to-own have the lowest median annual net incomes. Logbook loan and rent-to-own consumers have the lowest credit scores and hold the highest median number of products with outstanding personal debt. Retail finance, catalogue credit and store card consumers have relatively high credit scores.

Table 3.2: Comparison of consumer circumstances of median 2016 users of less mainstream credit products (January 2017 statistics)

	Median age	Median credit score (0-100)	Median outstanding personal debt	Median estimated annual, net income	Median DTI ratio	Median number of products with outstanding personal debt
Catalogue credit	45	63	£1,300	£17,700	28%	2
Retail finance	41	69	£4,300	£24,700	19%	3
Store card	36	65	£1,100	£17,500	8%	2
HCSTC	32	42	£3,600	£20,000	18%	5
Home credit	42	41	£2,800	£15,500	22%	5
Rent-to-own	36	35	£4,300	£16,100	29%	8
Other running account	34	54	£4,300	£21,900	21%	4
Guarantor	33	40	£7,400	£20,800	32%	6
Logbook	38	32	£7,600	£23,300	26%	7

The pricing of high-cost credit products

3.10 We analysed how different consumer credit products varied in their pricing structures.[21] We looked at two metrics: 'cost of credit'[22] and 'daily rate'[23], based on firms' advertised prices. These do not include penalty or late payment charges, which we will assess in the next part of our review.

3.11 Figure 3.3 below shows that the majority of consumer credit products have a cost of credit below 100% and a daily rate under 0.2%. HCSTC are the products with the highest 'daily rate', along with unarranged overdrafts, other revolving products (such as store cards) and home-collected credit.[24]

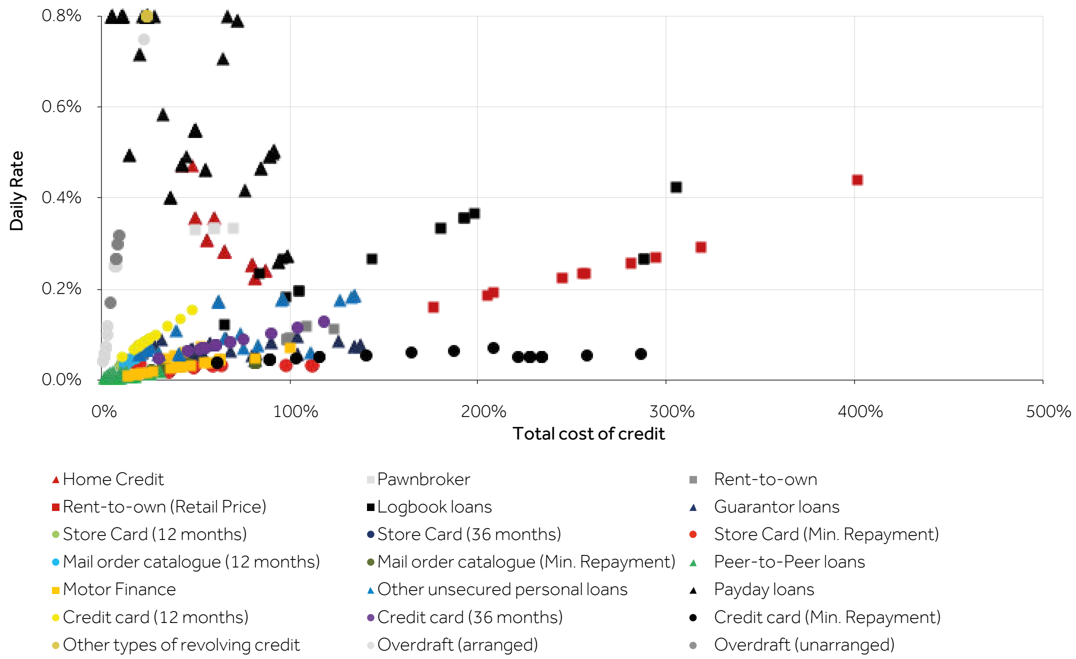
21 For revolving credit facilities repayment scenarios for only paying the contractual minimum and repaying debt in 1, 2 and 3 years are displayed. We note some important limitations to these metrics (to address these would require more granular, non-public data):
- These do not account for the amortization schedule – this can mean the amount of principal outstanding upon which interest is accruing on will differ between product offerings.
- These do not show actual costs incurred by consumers – in particular it does not show additional contingent charges (e.g. refinancing and default interest and charges) or conversely if charges are reduced for early repayment.

22 e.g. The overall cost (interest and charges) of borrowing over the course of a credit agreement (if repaid in line with contractual agreement) as a percentage of the amount of credit provided. A 'cost of credit' of 100% displays that the credit costs as much in interest and charges as it does in repaying the amount borrowed.

23 'Daily rate' - The 'cost of credit' as a percentage of the number of days the credit agreement is scheduled to last for and amount of credit provided. For example, a 'daily rate' of 1% (or alternatively £1 per £100 borrowed) displays that the credit agreement is expected to cost (in interest and charges) 1% of the amount borrowed each day the agreement lasts for.

24 Analysis conducted in Q1 2017

Figure 3.3: Cost of consumer credit product offerings



3.12 The products with the highest 'cost of credit' are rent-to-own (red squares – where the cost is assessed against the retail price of the product), logbook loans (black squares) and high APR credit cards[25] (black circles - assuming the consumer only makes minimum repayments).

Use of multiple high-cost products

3.13 Table 3.3 below gives a broad overview of which combined debts consumers hold. This shows how likely a borrower with a particular type of product is to hold high-cost and other products.

3.14 For instance, RTO consumers are less likely to have a mortgage and are relatively less likely to have credit card borrowing. However, they are more likely to hold other household bill debts and other high cost products than any other category of high cost credit user. The picture is similar for home-collected credit users.

3.15 We also see that many consumers taking out high-cost products were also holding credit card and overdraft debts. In the next phase of the review we will look more closely at the relationship between these debts to assess whether consumers took out high-cost credit products to help manage such debts, or whether they grew as a result of use of high-cost credit products.

3.16 We look at which other products high-cost credit users hold in further detail in the Technical Annex.

25 We issued a consultation in April 2017 on new rules for credit card firms to help consumers who are in persistent debt. Accordingly, we are not intending to consider credit cards as part of this review and outside of that consultation.

Table 3.3: Debts held by high-cost credit borrowers as of Nov 2016

	Consumers taking out product (Dec 2015 – Nov 2016)								
In November 2016, percent of consumers with outstandin debts on…	Catalogue credit	Retail finance	Store card	HCSTC	Home credit	Rent-to-own	Other running account	Guarantor	Logbook
Catalogue credit	57%	16%	22%	32%	40%	46%	28%	38%	31%
Retail finance	12%	88%	16%	8%	5%	4%	16%	10%	4%
Store card	7%	7%	47%	7%	5%	4%	7%	7%	2%
HCSTC	7%	1%	4%	73%	19%	30%	38%	43%	54%
Home credit	8%	1%	3%	15%	94%	52%	10%	18%	46%
Rent-to-own	2%	<1%	1%	4%	12%	86%	3%	5%	4%
Other running account	1%	1%	1%	9%	3%	3%	55%	11%	21%
Guarantor loan	1%	<1%	1%	4%	2%	2%	5%	85%	2%
Logbook loan	<1%	<1%	<1%	<1%	<1%	<1%	1%	<1%	90%
Mortgage	20%	46%	20%	9%	5%	2%	21%	10%	8%
Credit card	40%	45%	38%	57%	37%	37%	56%	65%	67%
Overdraft	22%	19%	23%	50%	33%	40%	40%	54%	60%
Charge card	<1%	<1%	<1%	<1%	<1%	<1%	<1%	<1%	<1%
Unsecured personal loan	18%	28%	22%	29%	17%	20%	33%	29%	29%
Motor finance	9%	19%	11%	12%	6%	8%	15%	15%	15%
Telecommunications	20%	13%	16%	41%	40%	61%	31%	45%	50%
Other household bills	8%	5%	4%	10%	16%	21%	9%	13%	8%

Arrears rates and financial distress

3.17 We also analysed the arrears and default rates of high-cost credit products (Figures 3.4 and 3.5 respectively). Arrears rates are an important indicator of financial distress. For consumers of some, but not all, of these products, getting in to arrears will also have cost implications, as charges may be applied at that point. Notably, arrears charges do not apply to most home-collected credit products.

3.18 Home-collected credit products show the highest arrears rates for much of the period of this analysis. However, these rates have fallen since the start of 2014, after consumer credit regulation was transferred to the FCA. Since 2015, they have stabilised at around 30%, a similar level to catalogue credit. Guarantor loans show the next highest arrears rates.[26]

3.19 The relatively lower arrears rates for rent-to own products may reflect consumers' ability to end the agreements at any point. We look at this further in the discussion of rent-to own below.

26 For guarantor loans arrears rates data refers to arrears where the borrower missed a payment.

Figure 3.4: Arrears rate by origination date (January 2013 – March 2016)

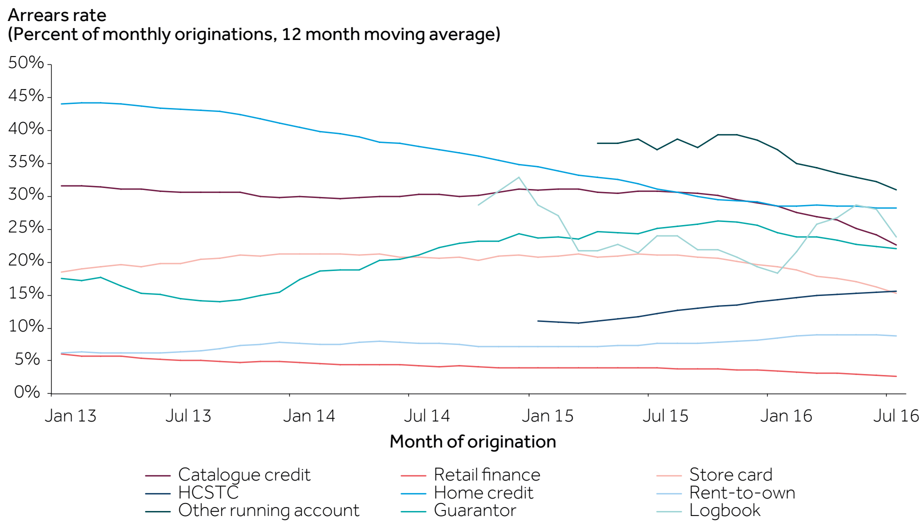
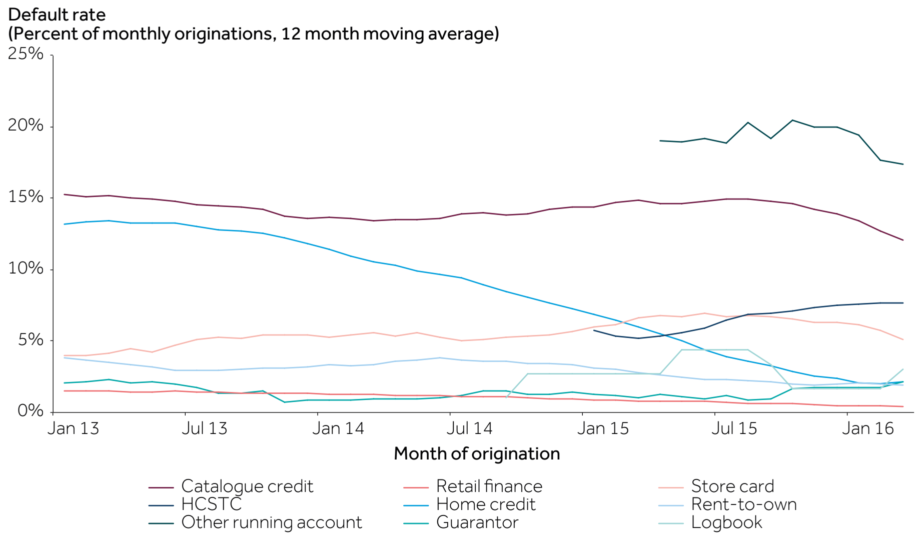


Figure 3.5: Default rate by origination date (January 2013 – March 2016)



Feedback

Scope of the review

3.20 In the CfI we identified the main types of high-cost credit. These are HCSTC (including payday loans), home-collected credit, catalogue credit, some rent-to-own products, pawnbroking, guarantor and logbook loans. Other credit products – such as motor finance, credit cards and overdrafts – may be high-cost, particularly for less creditworthy consumers or depending on how they are used.

3.21 Several CfI respondents pointed out similarities between high-cost credit products, such as consumers that are more likely to be vulnerable than most other financial services users. However, others stressed the differences in product features, business models and in how consumers use each product and why. This suggests that different high-cost products may not be close substitutes for each other.

3.22 We believe that taking an overall view of the consumer's experience of high cost credit products gives an important base to develop our thinking on possible interventions. We also recognise that the often distinct features of products and how consumers use them means it may not generally be appropriate for us to take a uniform approach across all high cost products.

3.23 While we will continue to consider the impact on consumers of their overall use of high cost credit, we have identified rent-to-own, home-collected credit and catalogue credit, in addition to overdrafts as areas where we want to focus the review. We set out further details on the product-specific issues we have identified below.

Creditworthiness

3.24 Some respondents felt that pre-contractual creditworthiness and affordability assessments for high-cost credit products are poor or inadequate. As a result, consumers take out products which are not suitable for their needs and circumstances.

Creditworthiness

- Appropriate creditworthiness assessments can prevent unaffordable borrowing and reduce the risk of harm to consumers. Robust assessments for high-cost products may also encourage firms to focus their business models on sustainable lending, rather than profiting from the fees and charges for missed payments and default.
- In CP17/27 we clarify our expectations of firms when assessing creditworthiness (including affordability). We consider these changes will also facilitate more effective monitoring and supervision, as firms will be required to demonstrate how their policies and procedures comply with our rules and deliver good outcomes for consumers.

Illegal Money Lending

3.25 Some respondents were concerned that consumers would turn to illegal money lending because they could not access legitimate credit services. In our review we will continue to take into account the risks that our interventions could remove the supply lines of credit for consumers.

Illegal Money Lending

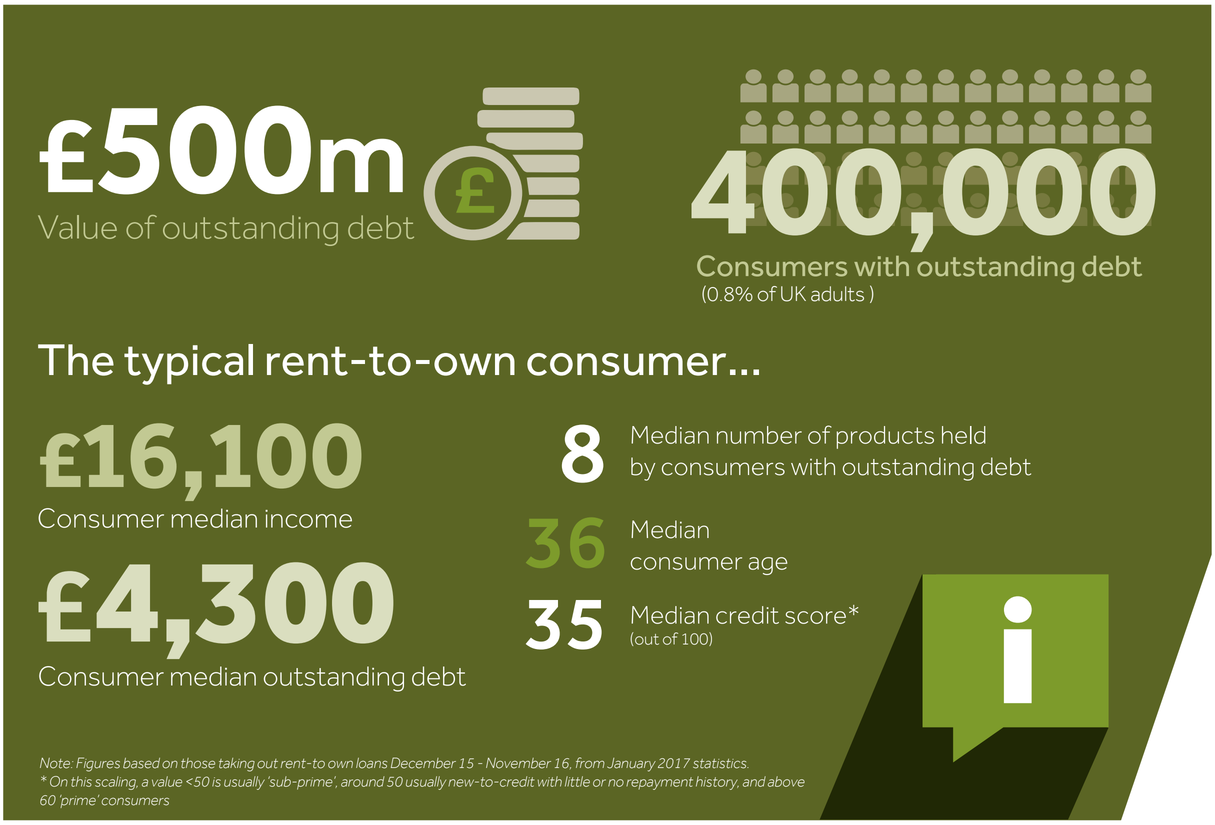
- Illegal Money Lending (IML) can take many forms, ranging from staff working for authorised lenders providing credit illegally, or criminal operations such as loan sharks.
- We work alongside external agencies, such as Local Authority IML teams, and with firms to tackle unauthorised lending and protect consumers.
- Illegal money lending is a complex and long standing problem driven by a range of social and economic factors. The individuals who use illegal money lenders are difficult to reach and reluctant to talk, though we have discussed the issue with a range of frontline staff dealing with illegal money lending, including regional Illegal Money Lending Teams, social services and community groups. We have not seen any clear indication that declined or former users of HCSTC are increasingly turning to illegal money lenders as a result of the price cap.

Preliminary findings by product

3.26 In this section, we set out the feedback from our Call for Input on a product-by-product basis, give findings from our own research. We explain how we will take these forward as part of the high-cost credit review in the following section.

Rent-to-Own

3.27 RTO retailers sell household items, such as washing machines and televisions, in-store and on-line. Consumers pay on a weekly or monthly basis and can choose to have ownership of the goods transferred to them when all the payments have been made.



3.28 Table 3.4 illustrates the size of the rent-to-own market since 2012. In 2016, 200,000 people took out an RTO loan. 400,000 people had outstanding debt at the end of 2016, with a value of £0.5 billion. Overall, the picture is of a decline in the market. By the end of 2016, the number of loans fell by 26% and the value of loans fell by 28%, compared to 2015. The average loan value remained near £1,100.[27]

Table 3.4: Size of rent-to-own market (2013 – 2016)[28]

	Number of consumers taking out product (millions)	Average (mean) value of originations	Number of originations (millions)	Value of originations (billions)	Value of outstanding debt (billions)
2013	0.2	£1,120	0.8	£0.9	£0.6
2014	0.2	£1,190	0.8	£0.9	£0.6
2015	0.2	£1,130	0.7	£0.9	£0.7
2016	0.2	£1,090	0.6	£0.6	£0.5

Responses to the Call for Input

Consumer group responses highlighted the high cost of RTO products and the increased risk that high costs may have for people who are already financially vulnerable. They suggested that RTO firms inflate the prices of consumer goods and further increase costs with compulsory add-ons, such as insurance.

Some debt advice organisations reported that consumers had taken out other debts to service their RTO debt or had to prioritise RTO payments over essential everyday spending. Some respondents highlighted what they considered to be a relatively high repossession rate. They also said that, because goods lose value or incur repair costs before all repayments have been made, this can lead to further borrowing.

However, many respondents noted that RTO was currently the only way that some consumers can afford to buy essential household goods. In particular, industry responses argued that RTO fills a critical gap in the market to provide low-income households with essential household goods and helps people build their credit profile.

Some respondents called for price-capping of RTO products, either by extending the HCSTC price cap or introducing a bespoke cap. Industry respondents cautioned that price capping could restrict access to RTO, driving consumers to the black market. They considered that prices reflect the risks and costs of providing credit to a high risk group. One respondent said that RTO firms are small and medium enterprises which do not have the buying power of large retailers.

Some respondents said there is a lack of transparency around costs. Prices for goods are typically higher than retail prices available elsewhere, and obscured further by the compulsory sale of ancillary services and products such as warranties and insurance.

27 FCA analysis of representative sample of CRA records 2013 to 2016.
28 Data started in 2013 due to low coverage of the market in 2012.

An industry respondent said the rigorous FCA authorisations process, which is currently ongoing, was sufficient to deal with any consumer protection concerns. They argued that further consideration should wait until firms have adjusted their businesses in line with our authorisation requirements.

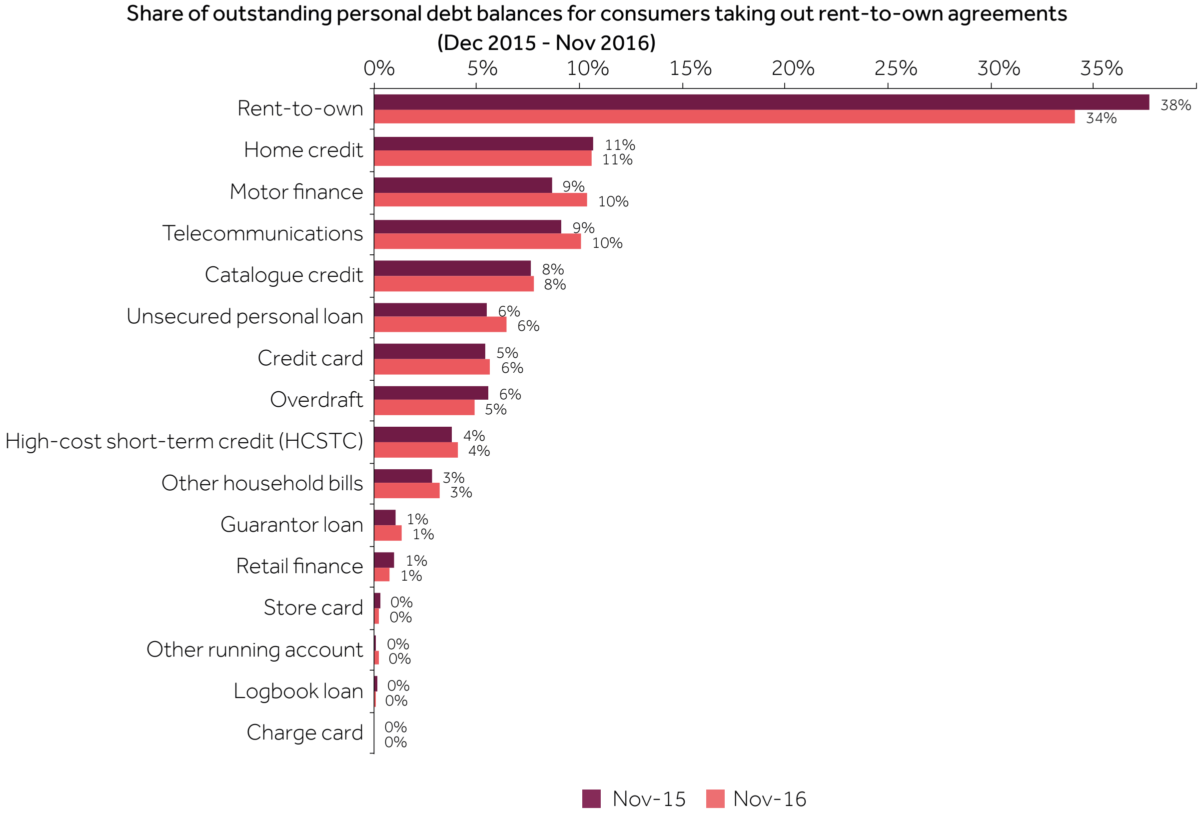
Our response

We agree with many of the concerns raised about RTO products and have been driving improvements in firm conduct through our authorisations and supervision work. In July 2016, we announced that our interventions have led to the three largest RTO firms, covering 91% of the market, agreeing to make major improvements in their product affordability, arrears handling and price transparency. Following our work in this area, the largest firms no longer require consumers to take out the firm's own insurance products. We intend to make further announcements on our authorisation and supervision work in this area in the near future and will continue our focus on individual firm conduct.

However, our initial findings from the first stage of our review support taking a broader look at the RTO sector in the next stage.

Our analysis confirms that RTO consumers are a particularly vulnerable group, with the median annual income for an RTO consumer being £16,100 in 2016. It also confirms that, despite the recent decline in the market, consumers' debts are increasing. The median amount of debt has more than doubled from £2,000 to £4,300 from November 2014 to November 2016. RTO borrowers were also relatively likely to hold other high cost credit products, particularly home-collected credit. In addition Figure 3.6 illustrates that RTO debts make up a significant share of RTO consumers' overall personal debt.

Figure 3.6: Share of outstanding personal debt of rent-to-own borrowers (December 2015 – November 2016) as of November 2015 and November 2016



We are particularly concerned with the increase in the median ratio of outstanding personal debt to estimated annual net individual income (DTI ratio) for RTO consumers , which has increased from 14% to 29%. Previous research indicates that individuals with higher DTI ratios with most of their debts in higher cost products are much more likely to suffer financial distress than other users of consumer credit[29].

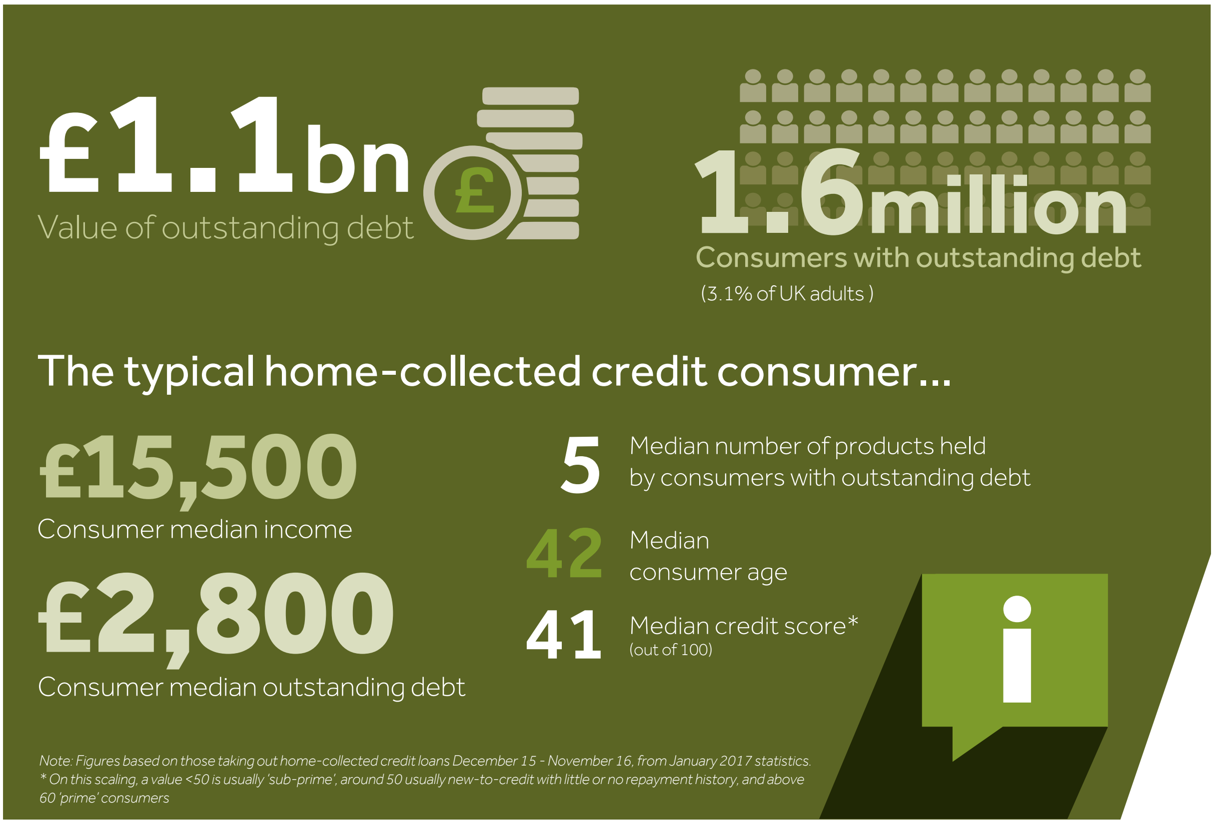
We remain concerned about the high costs of RTO borrowing on this particularly vulnerable group. While we accept that RTO provides a service that enables people to purchase essential goods, we are also concerned that there are harmful consequences of this high cost borrowing for a significant number of consumers.

We are not yet considering new rules for RTO products. However, we consider that price-capping would be a very difficult tool to use in this market, given that the goods linked to the loans can be marked-up independently of the interest rate.

29 FCA Occasional Paper 20, p.7.

Home-collected Credit

3.29 Home-collected credit (home credit or doorstep lending) involves relatively small sums paid in cash. Most are repaid in under a year by weekly instalments which the lender or their agent collects from the consumer's home.



3.30 Table 3.5 illustrates the size of the home-collected credit market. In 2016, just under 700,000 people took out a home-collected credit loan. 1.6 million people had outstanding debt at the end of 2016, with a value of £1.1 billion. There was particularly strong year-on-year growth by the end of 2016 compared to the end of 2015 – over 12% and 21% growth in the number and value of lending respectively. The value of the average loan value also increased from £710 to £770. Despite this, the market is still below its peak in 2012 in terms of the number of consumers and number of loans made.

Table 3.5: Size of home credit market (2012 – 2016)

	Number of consumers taking out product (millions)	Average (mean) value of originations	Number of originations (millions)	Value of originations (billions)	Value of outstanding debt (billions)
2012	0.9	£680	2.1	£1.4	£1.0
2013	0.8	£700	1.8	£1.2	£1.0
2014	0.7	£670	1.6	£1.1	£0.9
2015	0.6	£710	1.5	£1.1	£0.9
2016	0.7	£770	1.7	£1.3	£1.1

Responses to the Call for Input

Consumer group responses were concerned about how adequate affordability checks are. In particular they highlighted that poor checks can worsen financial difficulties for consumers already struggling with repayments if they lead to poor lending decisions on taking out further loans.

Some debt advice organisations reported that lending agents may contribute to this practice by pressurising consumers to take out a new loan to refinance their existing debt, rather than offering repayment plans. They also reported that there may be financial incentives for firms to encourage borrowers to rollover loans. Some respondents suggested that the result of these practices can effectively trap consumers into repeat borrowing and make it very difficult for them to escape the cycle of debt.

Many respondents acknowledged that features of home-collected credit provided benefits to consumers – including no default fees and some payment flexibility. In particular, industry responses argued that the home-collected credit model gives consumers face-to-face contact. Consumers can explain the reasons for non-payment and the collector can reduce or suspend payments for consumers who cannot pay.

Some respondents asked for the review to look further at the nature of the product. This included how the offer of an immediate cash loan at their doorstep can lead some consumers to make poor financial decisions. Some respondents suggested that the relationship between the lending agent and consumer should be examined, including how the agent might influence how the borrower behaves. They also asked that the review consider collection practices. Some consumer bodies said that they had evidence of intimidating collection practices which might make consumers prioritise these debts over other essential debts.

Our response

We agree with many of the concerns raised in the CfI. We have been actively working with firms to drive improvements in conduct as part of our authorisations process.

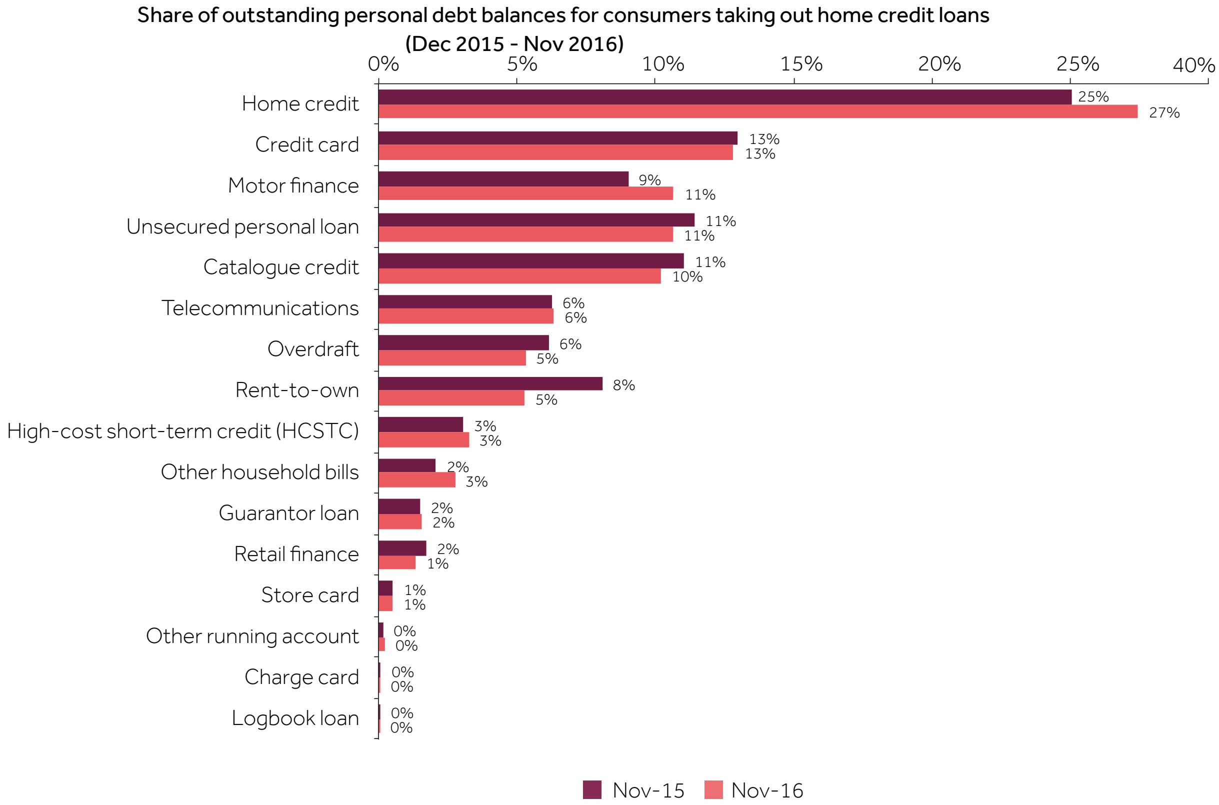
Our initial findings from the first stage of our review confirm we should further examine the home-collected credit sector in the next stage of our review.

Our analysis confirms that home-collected credit consumers are a particularly vulnerable group, with the median annual consumer income being £17,300 in 2016. Despite an overall decline in the number of loans and value of lending since 2012, the median amount of outstanding debt more than doubled from £1,200 to £2,800 between November 2014 and November 2016. Ranked by outstanding debt, the top 25%

of borrowers had a minimum of £3,100 in this type of debt in November 2014 compared to at least £5,700 in November 2016.

We are also particularly concerned with the increase in the median ratio of outstanding personal debt to estimated annual, net individual incomes (DTI ratio) from 10% to 22% January 2015 to January 2017. This indicates a greater proportion of consumers are likely to be suffering financial distress. In addition Figure 3.7 below shows that home-collected credit is making up an increasing share of home-collected credit users' total debt balances.

Figure 3.7: Share of outstanding personal debt of home credit borrowers (December 2015 – November 2016) as of November 2015 and November 2016

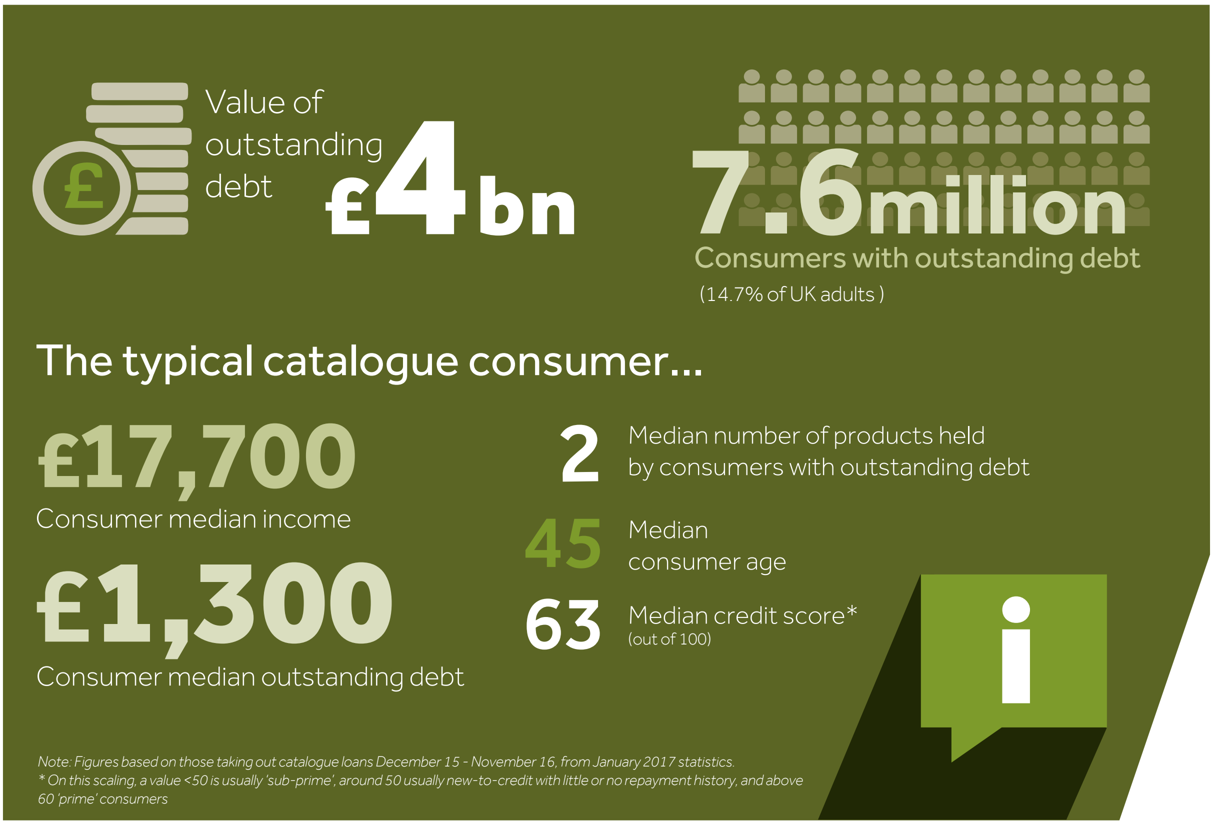


In our creditworthiness CP we provide greater clarity on our expectations on firms to undertake adequate affordability assessments. Our Thematic Review on Staff Incentives, Remuneration and Performance Management CP17/20, where we are consulting on a new rule and guidance, clarifies our expectations that firms effectively manage risks to consumers from how they reward sales and collections staff.

As with RTO, we recognise that home-collected credit may be the only way that some consumers can get credit. However, we remain concerned about lending practices to this particularly vulnerable group. We are particularly concerned that a combination of poor lending decisions, including subsequent rollovers and refinancing, and sales and collection practices may cause increasing financial distress.

Catalogue credit

3.31 Catalogue credit (also known as mail order or home shopping catalogues) involves retailers and suppliers providing online and hard-copy catalogues, which give consumers the option to purchase goods by making weekly or monthly repayments on credit.



3.32 Table 3.6 below illustrates the size of the catalogue credit market. Catalogue credit has a significantly larger consumer base than other high-cost credit markets. In 2016, 1.9 million people took out catalogue credit. This is still a significantly smaller number than in 2013, where over 2.7 million people took out these products. There was £4 billion value of total outstanding catalogue credit debt at the end of 2016. This is a significant increase on 2014 and 2015, where the figures were £2.9 billion and £3.4 billion respectively. As the number and value of new lending has changed little, this means that the increase is mainly due to consumers increasing their use of existing catalogue credit facilities[30]. The revolving nature of catalogue credit means the outstanding debt will be higher because, unlike loans, the balance will not necessarily reduce if the consumer keeps spending on it.

30 Ibid

Table 3.6: Size of catalogue credit market (2012 – 2016)

	Number of consumers taking out product (millions)	Average (mean) value of credit limit at origination	Number of originations (millions)	Value of credit limit at origination (billions)	Value of outstanding debt (billions)
2012	2.8	£280	3.6	£1.0	£1.8
2013	2.7	£280	3.4	£0.9	£2.5
2014	2.0	£310	2.5	£0.8	£2.9
2015	1.8	£320	2.3	£0.7	£3.4
2016	1.9	£320	2.5	£0.8	£4.0

3.33 Between 2012 to the start of 2015 there was little change in the proportion of catalogue credit agreements which went into arrears – around 30%. The proportion of new catalogue credit agreements entering default stayed at around 15% between 2012 and 2015.

Responses to the Call for Input

Some debt charities reported that catalogue credit accounts for a third of their clients.

Consumer group responses reflected concerns about the relatively expensive interest rates which can apply after an introductory period of interest-free credit. One respondent stated that often consumers may not fully understand the 'buy now pay later' deal which normally back-dates interest on the full-cost of the item even if most repayments have been made.

One debt advice organisation referred to research by Which? This found some companies will add high interest charges to the whole original balance of the credit if consumers fail to make payments on time, and backdate these charges to the time of the order. They also reported concerns that some catalogue firms may increase the price of goods so that even if these are paid back using interest-free credit periods, this ends up costing much more than on the high street.

One respondent reported potential issues with expensive add-on insurance, payment protection or extended warranties. There was also concern about the adequacy of affordability assessments and also that catalogue companies did not appear to be agreeing to temporarily postpone repayments when dealing with borrowers in financial difficulties.

Our response

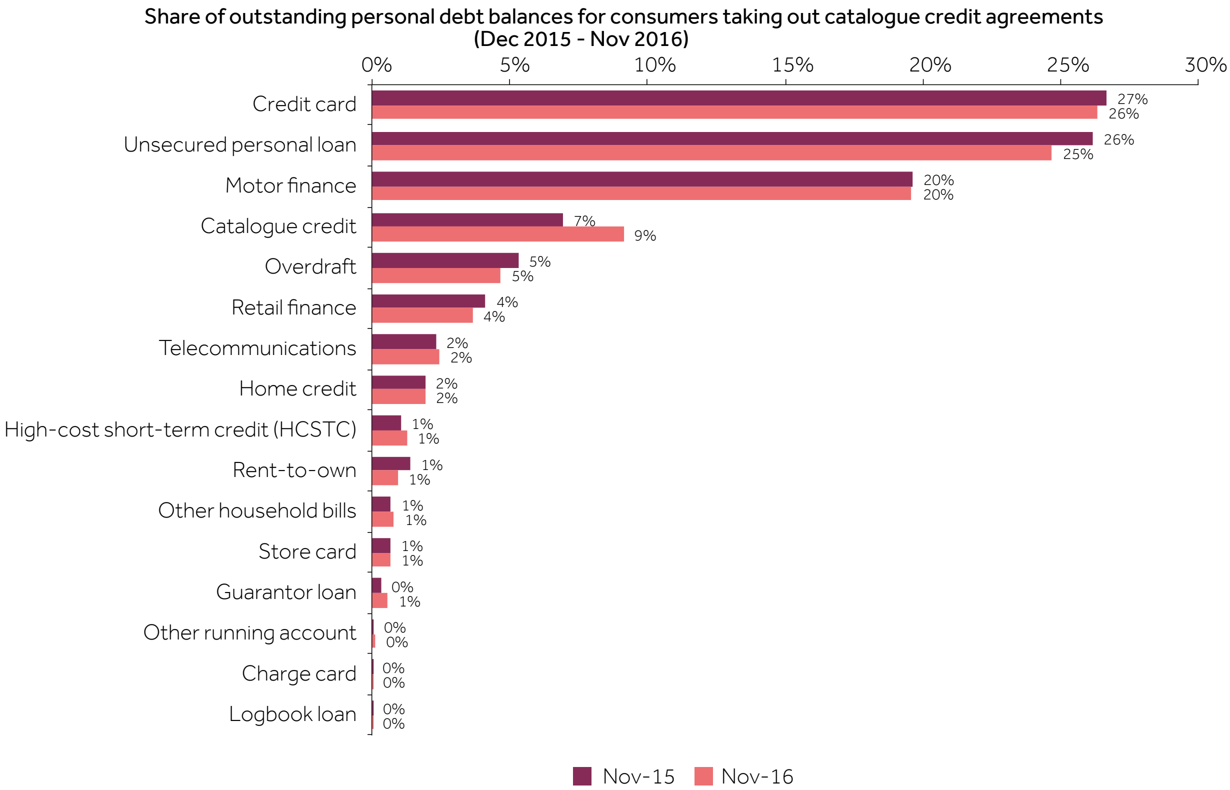
Our initial findings from the first stage of our review support us taking a broader look at the catalogue credit sector in the next stage.

Our analysis confirms that catalogue credit consumers are a potentially vulnerable group, with the median annual income for a catalogue consumer being £17,700 in 2016. The median amount of debt has increased substantially from £300 in November 2014 to £1,300 in November 2016. When ranked by their outstanding debts, the top 25% of borrowers had at least £2,900 in debt in November 2014 compared to at least £5,600 by November 2016.

We are concerned with the high arrears and default rates experienced by catalogue credit consumers, which are among the highest we see across high-cost credit (see Figure 3.3 and 3.4). This is despite the consumer base having substantially better credit scores than other high-cost products.

Figure 3.8 below also indicates catalogue credit is making up an increasing share of catalogue credit users' overall debt, with credit cards representing the largest share.

Figure 3.8: Share of outstanding personal debt of catalogue credit borrowers (December 2015 – November 2016) as of November 2015 and November 2016



We remain concerned about the costs of borrowing for this potentially vulnerable group. We are concerned about the charging structure and transparency for consumers. This includes the high levels of interest that are charged outside the interest-free period, whether consumers get enough notice at the point when the interest-free period will end and the implications that this has on the overall cost of the product due to fees and charges.

Other products

3.34 Motor finance is now outside our high-cost credit review. This is because, as we announced in our Business Plan 2017/18, we are looking at this market to develop our understanding of these products and how they are sold, and to assess whether the products cause harm to consumers. We are taking forward a range of work to help us answer these questions, and to decide what further interventions may be necessary. This includes supervisory work with FCA authorised lenders, detailed analysis of millions of anonymised credit reference agency records, and careful scrutiny of firms' sales practices and processes. We are also working closely with the Bank of England and the Prudential Regulatory Authority, who are considering the risks raised by the expansion of motor finance that fall within their regulatory remit. We will publish an update on this work in Q1 2018.

3.35 Credit cards are also out of scope of our review given changes planned following our Credit Card Market Study, whose final findings we published last year. It found that many cardholders were in arrears, default or had persistent levels of credit card debt. We set out proposals for a set of remedies. As part of this we are currently consulting on proposed new rules designed to help consumers take control of their finances and avoid persistent debt and avoidable charges. Once the remedies have been implemented, we will review how effective they are and assess if we need to intervene further. We will also continue to work closely with consumer groups and industry to deliver changes to help consumers gain more control over their finances.

3.36 We are not proposing to do further policy work on logbook lending, pawnbroking and guarantor lending at this time, although we will continue to deal with firms in these markets through our authorisations and supervision work. We will also consider the overall set of a consumer's debts and how consumers use and view them as we develop our thinking on individual products. We set out a brief summary of the CfI responses below and our response.

Logbook loans

3.37 Logbook loans are a form of credit secured against a vehicle. Ownership of the vehicle is transferred to the lender while the consumer makes repayments and if a borrower falls into arrears the lender may seize the vehicle.

Responses to the Call for Input

We received relatively little feedback on logbook loans. A few respondents referred to the 'extremely high' APRs, and suggested that firms are more concerned with the value of the vehicle than making a rigorous assessment of affordability.

Some respondents raised concerns about the measures firms might take to repossess vehicles in the event of non-payment, and whether consumers are aware of the risks of repossession from the start.

Much of the feedback reflected issues examined by the Law Commission study into the Bill of Sale Acts, which are part of the legislative framework for logbook lending. Some felt that the antiquated nature of the legislation was driving up the cost of borrowing, leading to a lack of transparency for consumers and failing to adequately protect consumers in areas including repossession and third party purchasers.

Analysis and Next Steps

3.38 In considering the feedback on logbook lending we have taken account of the low relative complaints levels for logbook loans, reinforced by feedback from debt advisory groups highlighting low volumes of client issues. We have also taken account of the recommendations made by the Law Commission as a result of their recent review.

3.39 In September 2016, following consultation with firms and consumer bodies, the Law Commission recommended repealing the entirety of the Bill of Sale Acts and replacing them with a new Good Mortgages Act. This would allow for improved protection for borrowers, including around forbearance and risk warnings, protect third party purchasers of vehicles subject to a Bill of Sale, save costs caused by unnecessary registration and bureaucracy, and remove unnecessary restrictions on secured lending to smaller businesses.

3.40 The Government has announced it will act on Law Commission recommendations to introduce the Good Mortgages Act, and the Law Commission has recently consulted on a draft bill. We consider that this would address a number of the known issues in the market. As a result, we are not proposing to take any further measures on logbook lending at this time. Instead, we will maintain a watching brief and work with firms during the interim period to ensure consumers are protected.

Pawnbroking

3.41 Pawnbroking loans are secured lending where an individual provides an asset (known as the pledge) to a pawnbroker, against which the pawnbroker provides finance up to the asset's agreed value.

Responses to the Call for Input

We received very little evidence of harm from pawnbroking in the CfI. Pawnbrokers pointed to the relatively low complaints levels compared with other sectors. This was supported by data from debt charities which showed that pawnbroking accounted for the fewest issues among high-cost credit clients.

Some respondents suggested that information for consumers on the consequences of non-payment were fairly limited, but this was not substantiated by evidence from debt charities or consumer bodies. Our analysis suggests that, because loans are secured against the pledge, the price of the credit is comparatively low and consumers may decide in some cases not to redeem an item if they are unable to repay.

Our response

In light of this we do not consider pawnbroking to be a priority area of the review in terms of potential risk. We will maintain a watching brief on the sector through our ongoing supervision and authorisations in case issues arise. We have recently contacted pawnbroking firms to get more information about this market and to assess any potential risks.

As part of the creditworthiness CP, we propose to clarify the requirements applicable to certain pawnbroking agreements where the consumer's liability is limited to the market value of the pledge. Such agreements will be subject to an exclusion from the requirement to assess creditworthiness.

Guarantor loans

3.42 Guarantor loans are secured lending where an individual provides security against the risk of not making repayments by getting someone else, typically a friend or family member, acting to guarantee loan repayment.[31]

Responses to the Call for Input

Responses from consumer groups reflected concerns that guarantors often do not know about their liability and responsibilities. One respondent suggested that a guarantor can take on liability for a loan and the firm transfers the balance to the borrower so quickly that, as well as difficulties in understanding the complexity of the product and what they are agreeing to, guarantors do not have a cooling off period.

One consumer body said one of the most frequent problems reported to them was a lack of forbearance shown to borrowers or guarantors. This meant that guarantors were asked to make payments with little notice and a lack of flexibility. One debt advice organisation recommended that we should look further at the relationship between the guarantor and borrower. For example, whether the guarantor was vulnerable and how potential coercion, financial abuse and undue influence could affect their agreement to act as guarantor.

Our response

We agree with many of the concerns raised by CfI respondents and have been driving improvements in firm conduct through our authorisations and supervision work. This has included engagement with the largest firm carrying out guarantor lending.

Our authorisations process has not so far identified any issues from current applications that indicate wider sector issues. We have dealt with individual issues on a case by case basis by working with specific firms. For example, we know that smaller firms do not always understand that

31 See FCA CP15/6 and PS15/23
www.fca.org.uk/publication/consultation/cp-15-06.pdf & www.fca.org.uk/publication/policy/ps15-23.pdf

they have an ongoing obligation to both the consumer and guarantor throughout the lifetime of a loan.

We will continue to maintain a watching brief on key risks in this sector and continue to work with firms to ensure consumers are protected.

We consider that most of the remaining areas of concern identified in the CfI are already addressed in our rules and guidance. For example, we published guidance clarifying that firms should give guarantors notice and a reasonable period to make payment.[32]

We recognise this is a relatively new market which is growing rapidly and needs ongoing monitoring. For example, there were less than 60,000 people holding guarantor-loan debts in 2014 compared with over 135,000 people in 2016. This growth is mirrored in the number and value of initial guarantor loans which, in 2016, reached a new high of 90,000 loans worth £29.8 million.

Other running account credit

3.43 As part of our analysis we identified a small number of other running account business models that offered overdraft-type revolving credit facilities that were not a current account, credit card, catalogue or store card. These business models are varied and account for 200,000 consumers and the average (mean) value per loan is £1,100. This amounts to £1 billion in outstanding debt.

3.44 Our examination of the performance of these agreements shows high arrears and default rates. Outstanding balances in arrears are 9% and in default, 26%.

3.45 We will consider the high arrears and defaults rates for other running account credit and engage with other running account credit firms in our ongoing supervisory work. We will also consider this as part of our wider consideration of consumers' high-cost credit debts.

Store Cards

3.46 Store cards are similar to credit cards except they can only be used at particular retailers.

Responses to the Call for Input

We received very little feedback regarding store cards, except to note that these sometimes formed part of a borrower's overall debt portfolio.

32 www.fca.org.uk/publications/finalised-guidance/guarantor-loans

Our Response

Our analysis indicates that store card users have lower median outstanding personal debt than all other categories of high cost credit users, higher median credit scores than most other high cost credit users and lower median debt-to-income ratios.

To this end we do not consider store cards a priority area of the review in terms of potential risk. We will maintain a watching brief on the sector through our ongoing supervision work, and consider store cards as part of our wider consideration of consumers' high cost credit use.

Next steps

3.47 We have identified a number of issues which could cause consumer harm. We will investigate these further with the aim of issuing a Consultation Paper on proposed solutions in Spring 2018. We are particularly concerned about rent-to-own, Home-collected credit and catalogue credit, as well as wider concerns about consumers' long-term indebtedness.

RTO

3.48 We will look at why consumers use RTO and the current alternative options. Many organisations and agencies are exploring different ways of helping people avoid borrowing for essential household goods. Some housing associations and local governments, for example, provide tenants with white goods and other basics. We will take a leading role to support collaboration to share best practice and fostering innovative thinking in this area and will convene a forum to encourage cross-agency public policy solutions.

3.49 We will also undertake a market-based analysis to better understand what limitations may prevent alternative credit options being developed or used in the RTO market. We will examine if there are regulatory barriers that we could address which would support the growth of alternatives. We will also consider whether this may be of broader application in other high-cost credit areas.

3.50 In addition, we will carry out further research to better understand the impact of the costs of RTO on consumers, balanced against the benefits of accessing credit to buy household goods.

Home-Collected Credit

3.51 We will focus in particular on features of the business model which may be encouraging consumers' long-term indebtedness. If we find evidence of harm from persistent indebtedness, we will consider potential remedies. These could include, for example, introducing restrictions on refinancing and rollovers, time gaps between borrowing or time limits on the total duration of borrowing. As with any rule changes in this area, we would consider carefully the potential impact on consumers' ability to access credit.

Catalogue Credit

3.52 We will consider why consumers tend to use catalogue credit including the numbers and type of consumers who do not repay within the interest free-period and the notification and explanations that consumers receive on when this period will end. We will undertake further analysis on whether the high levels of arrears, high incidence of charges and backdating of interest may indicate incentives that lead to poor consumer outcomes.

Wider consideration of high-cost credit products

3.53 Across our high-cost credit work we see a market where certain products do not work well for a minority of consumers. Yet many of those consumers may benefit from some access to credit. We are aware that measures we take to protect consumers in these markets may deny a section of consumers any access to credit. Accordingly, we consider that it is important to make sure that we have the evidence to make the right judgements about where and how to intervene.

3.54 To this end we will analyse in depth the worsening of high-cost credit consumers' credit ratings to understand what is causing these deteriorations.

3.55 We will analyse multiple and repeat use of products and patterns of longer term indebtedness and whether this harms consumers.

3.56 We will incorporate the insights from this analysis into any regulatory measures we consult on in Spring 2018.

4 Overdrafts

Summary

- We have significant concerns about how unarranged overdrafts operate. Charges are high, complex and potentially harmful. Based on the evidence we have to date, we believe there is a case to consider fundamental reform of unarranged overdrafts and consider whether they should have a place in any modern banking market.
- Our concerns in relation to arranged overdrafts are about consumers' long-term use of arranged overdrafts, at levels which are persistent, unsustainable or both. We will now consider whether and to what extent consumers suffer harm from persistent use of overdrafts and whether we should intervene as we are doing in the credit cards market to reduce persistent debt.

Overview

4.1 Concerns over overdrafts are long-standing. The research we undertook when we took over the regulation of consumer credit in 2014 showed that overdraft prices were high, complex, confusing and poorly understood.[33]

4.2 We put further work on overdrafts on hold during the CMA's retail banking market investigation, but committed to examine them in 2016 once that investigation was complete. Our focus in this review is to examine both arranged and unarranged overdrafts through our consumer protection lens, as the CMA has already examined the competition issues in its Retail Banking market investigation. This has given us a different, and broader, perspective than previous reviews.

4.3 Our current review has reinforced the concerns we set out in 2014, in particular about unarranged overdrafts. Our analysis to date has also raised additional issues about the way unarranged overdrafts are designed and operate.

Unarranged overdrafts – summary

4.4 Not only are unarranged overdrafts expensive, but in many cases they cost significantly more than HCSTC loans. Many consumers are also unaware either that they have used an unarranged overdraft or of the cost implications even if they do.

4.5 Under European law, a current account provider is not required to carry out a creditworthiness assessment before permitting the consumer to borrow under an unarranged overdraft.[34] Patterns of use show that a minority of consumers incur the majority of fees, and that a significant minority of those who use unarranged overdrafts use them time and again. The use of extra, expensive credit may negatively

33 www.fca.org.uk/publication/research/consumer-credit-insights-overdrafts.pdf
34 The Consumer Credit Directive (CCD) sets out requirements for creditworthiness assessments, which are transposed into UK law by our responsible lending rules in CONC 5.2. The CCD sets out that these rules apply to arranged overdrafts but contains an exemption for unarranged overdrafts. As the CCD is maximum harmonising, the UK cannot, in general, require a creditworthiness assessment before lending to a consumer under an unarranged overdraft. The CCD does not apply to lending under €200 and in this space we note that the UK is not constrained by the CCD.

affect their wellbeing - leading to greater financial difficulties. As well as the financial cost, this could also come at a personal cost, for example through increased mental ill-health and stress. Taken together, these raise concerns about whether unarranged overdrafts are available to borrowers who would not meet the affordability requirements of other lenders. We also have concerns about whether the costs of the facility and banking more generally fall on those who are vulnerable or in financial difficulties.

4.6 Based on the evidence we have to date, we believe there is a case to consider fundamental reform of unarranged overdrafts and consider whether they should have a place in any modern banking market.

4.7 The next stage of our review will focus on assessing the existence and extent of these suspected harms to consumers and how we might address those. We will also consider recent technological changes including changes to payments and alerts. We note recent developments involving Lloyds Banking Group and we will take into account if firms move away from the problems identified in this report to a clearer and alternative charging structure for short-term credit. We also need to better understand how banking business models have evolved in order to avoid unintended consequences, and we will seek to develop solutions that preserve useful parts of the market while addressing identified harm.

Arranged overdrafts - summary

4.8 Arranged overdrafts can provide a convenient way to help consumers manage day-to-day finances. Our main concerns are about consumers' long-term use of arranged overdrafts, at levels which are persistent, unsustainable or both. These are similar to the harm to consumers that we identified in our Credit Card Market Study, and which lie at the centre of our proposed interventions to address persistent debt in that market.

4.9 Our next stages of work on arranged overdrafts will focus on establishing whether and to what extent consumers suffer harm and if we need to make changes to reduce persistent use of arranged overdrafts.

Introduction

4.10 Overdrafts play a unique role in the credit market. When we consider whether consumers suffer harm from using them it is important to recognise the difference between arranged and unarranged overdrafts.

4.11 Overdrafts allow an account holder to take money from their account when there is no money in it. This can be up to an agreed limit (for an arranged overdraft) or beyond the agreed limit at the bank's discretion (for an unarranged overdraft). Arranged overdrafts can provide a convenient way to help consumers manage day-to-day finances, and can play a role in managing income and expenditure flows over longer periods of time.

4.12 The CMA reviewed overdrafts as part of their investigation into Retail Banking. They considered that overdraft users would have the most to gain from increased switching between banks, but are the least likely to switch[35]. As well as broader measures to

35 CMA, *Retail banking market investigation*, https://assets.publishing.service.gov.uk/media/57ac9667e5274a0f6c00007a/retail-banking-market-investigation-full-final-report.pdf , p.xv

make it easier to switch between retail banks, the CMA introduced specific measures for overdrafts[36] as follows:

- requiring banks to enrol consumers automatically into an unarranged overdraft alert
- requiring banks to introduce grace periods to reduce charges
- recommending that the FCA identifies and implements measures, if appropriate, to increase consumers' engagement with their overdraft use and charges
- an obligation for banks to set and publicise a Monthly Maximum Charge - the maximum amount that the provider will charge a consumer during any given month for an unarranged overdraft

4.13 In our response to the CMA on 3 November 2016, we said we would look at overdrafts through a broader perspective – including the consumer protection lens. We subsequently included a number of questions on overdrafts in our CfI on high-cost credit.[37] These focused on the relationship between overdrafts and other high-cost credit products, the key issues we should consider and what measures we could take to address those issues.

Responses to the Call for Input

We summarise the responses we received in the box below, before providing feedback on the comments we received and our analysis of the issues. Given the significant differences between arranged and unarranged overdrafts, we have presented our analysis on these separately.

36 Ibid., p.xxxvi, xlii
37 www.fca.org.uk/publications/corporate-documents/our-response-cma-investigation-competition-retail-banking-market

Responses to our Call for Input on Overdrafts

Relationship with other high-cost credit services:

- Most banks that responded felt overdrafts are not a substitute for other high-cost credit products.
- High-cost credit firms and trade bodies felt overdrafts, particularly unarranged overdrafts, are a substitute for high-cost products because they provide easy, short-term access to credit but can be much more expensive.
- Most debt advice respondents felt consumers were using a combination of credit cards, loans, overdrafts and payday loans to meet their needs, often using one to pay off another. Which? argued that the terms on which unarranged overdrafts are provided should be judged as alternative sources of emergency funds such as HCSTC loans.

The key issues the FCA should consider:

- Many banks suggested that better engagement and competition were the key issues and we should judge the effectiveness of the CMA Remedies before taking any action on overdrafts ourselves.
- Other respondents identified transparency of charges as a key issue that needed improving, particularly on unarranged overdrafts. Many in the consumer or debt sector and also other high-cost lenders suggested the charges were complex and confusing. Some from the high-cost sector called for a requirement for firms to disclose the APR for an overdraft.
- Many argued unarranged overdraft charges are disproportionate to the amount borrowed and it was not clear if they reflected the costs to the firm.

Measures we could consider:

- Some respondents said we should explore the level of charges, whether there should be a cap and require transparency on what the charges will be and when they will be applied.
- On arranged overdrafts many respondents felt we should focus on the issue of financial difficulty. We should establish good practice on how firms should approach persistent users to restructure their debt.

Analysis and next steps on Unarranged Overdrafts

4.14 We have significant concerns about the harm that consumers suffer from unarranged overdrafts. Our concerns are based on previous investigations into how the current account market operates[38], the CfI responses, our analysis in the course of this review and our knowledge of recent developments in the market. Based on the evidence we have to date, we believe there is a case to consider fundamental reform of unarranged overdrafts and consider whether they should have a place in any modern banking market.

38 These include the Cruickshank report (1998-2000), Office for Fair Trading and Competition Commission reports (2005-2013) and Competition and Markets Authority reports (2014-present)

4.15 We consider the most significant potential harm from unarranged overdrafts is a result of the following factors:

a. Unanticipated charges and lack of transparency – Pricing structures are highly complex. Consumers' understanding and awareness of their use of unarranged overdrafts and the charges they face remains low.

b. High charges – The charges for consumers who borrow with an unarranged overdraft are high compared to the charges for other high-cost credit services and, particularly, to those allowed under the price cap for HCSTC.

c. Repeated use – Many consumers use unarranged overdrafts month after month. They incur high charges which may contribute to their repeat use because for consumers in vulnerable situations, such repeat use is unlikely to be their best option.

d. Distribution of charges – We are also concerned about whether a small cohort, who may be vulnerable or in financial difficulties may be paying a disproportional amount for the provision of current accounts.

4.16 We expand on these below.

Unanticipated charges and lack of transparency

4.17 Without clear and predictable prices it can be difficult for a consumer to understand how much their borrowing has, or is likely to, cost. This can make it hard for consumers to decide what type of borrowing best suits their needs. As consumers are not making active purchases they are not responding to high prices. Firms may exploit this inertia by pricing the credit at unreasonable levels and importantly higher than similar products based on term and risk.

4.18 Before examining our current body of evidence on transparency, we first examine the charging structures for unarranged overdrafts.

Banks' charging structures

4.19 Most major retail banks include a number of different elements in their charging structure. These may include a fee for a consumer payment that takes them into unarranged overdraft (or beyond a buffer zone), a monthly charge, daily charges for remaining in unarranged overdraft and interest on the overdrawn amount. On 12 July 2017, Lloyds Banking Group announced it was moving to a new structure for overdrafts. Table 4.1 summarises which banks include which elements in their charging structures.

Table 4.1: Banks' charging structures[39]

	Daily charge (£)	Un/paid item (£)	Debit interest EAR (%)	Cap (monthly) on daily charges (£)	Cap on un/paid items
Range	**5 - 10**	**6 - 15**	**16 - 19**	**35 – 100**	**8 - 75**
LBG (old)	√	√	√	√	√
RBSG	√	√		√	√
Barclays	√	√		√	√
HSBCG	√	√	√	√	√
Santander	√	√		√	√
Nationwide		√	√		√

Source: Tables 2 & 3 of Appendix 6.3 of the CMA Retail Banking Market Investigation Final Report

4.20 Banks may charge if there is an attempt to take a Direct Debit from a consumer who has no funds available. They may charge where they do allow the payment – so called Paid Item charges - or charge so-called Unpaid Item fees if they do not allow it. At the six providers of current accounts included in Table 4.1 above, these charges range from £6 - £15 and daily fees from £5-£10.

4.21 Several Personal Current Account (PCA) providers also cap the amount of fees or charges they can charge per monthly charging period. For some, this is an absolute cap, for others, it relates to the number of daily charges that could be charged. Following the CMA's market investigation, banks will have to establish a Monthly Maximum Charge, to cover all charges and fees that consumers may face when they use an unarranged overdraft facility.

4.22 Some banks' unarranged products resemble the charging structure for their arranged overdrafts. Nationwide for example does not charge a daily fee. The recently announced Lloyds Banking Group charging structure does not charge any interest or fees if they use unarranged facilities.

Technological developments and real-time information

4.23 Historically, unarranged overdraft charging was partly a by-product of payment methods and processing that took days to clear. As the impact on consumers and their ability to manage their own liquidity was more marked, unarranged overdrafts helped mitigate this.

4.24 Cheques could take several days to clear and the array of differing payments systems - all of which had their own timings - meant that a bank was asked to accept payments from a customer even if they had not authorised or arranged any such funding.

4.25 However, over time due to regulation and technological changes, not least in the payments system and usage, these instances are now less frequent. Firms have the capacity to make instantaneous decisions based on near real-time data about whether to lend to a customer. There are exemptions, not least around contactless payments, where payments of up to £30 are allowed without pre-authorisation.

4.26 Consequently, it does not appear that unarranged lending is not authorised or consented to by firms, which means that the firm is making a commercial decision to

39 Barclays is a slight outlier as it is of the view that it does not offer an unarranged overdraft facility at all, but offers an 'Emergency Borrowing' product which is offered to new consumers as an extension of their arranged overdraft facility. This is offered on an opt-in basis, up to an arranged and pre-agreed limit, and is therefore an additional tier of an arranged overdraft.

lend as it does through arranged overdrafts. This could weaken any justification for the pricing differentials that exist between arranged and unarranged overdrafts.

Transparency about overdraft use

4.27 Given the charging structures for unarranged overdrafts, a consumer's small mistakes, such as forgetting about an upcoming direct debit, can lead to significant charges. Evidence shows that consumers' awareness of their use of unarranged overdrafts is low. Both our investigation in 2014 and the CMA's research found that many consumers are simply unaware they are in unarranged overdraft.

4.28 Our research from 2014 shows people are confused by unarranged overdrafts and that banks can earn revenue from consumers' lack of understanding, confusion and limited attention'.[40]

4.29 The CMA's evidence shows half of the people that used unarranged overdrafts were not even aware that they had done so. The CMA concluded[41]:

> 72. (b) Overdraft users generally have limited awareness of and engagement with their overdraft usage. For example, over half of overdraft users we surveyed underestimated their usage by two or more months in a year and over a third were not aware that they had gone into overdraft. Moreover, around half of unarranged overdraft users did not believe they had gone into unarranged overdraft.
>
> […]
>
> 73. […] Low engagement by unarranged overdraft users is of particular concern because unarranged overdraft usage is not pre-agreed with the bank and in many cases may be inadvertent. Such usage also involves a significant increase in charges. Some customers may therefore not want to use unarranged overdrafts and would avoid doing so if they had greater awareness of their overdraft usage.

4.30 Consumers cannot avoid harm from using a service if they do not know that they are using it.

Regulatory steps to promote transparency

4.31 Since 2008 there has been significant regulatory pressure on the major providers of current accounts to improve the transparency around pricing and to encourage the dissemination of control mechanisms. Banks have been encouraged to make greater use of apps and alerts to help consumers avoid charges.

4.32 Our Occasional Paper (OP10) showed the impact that alerts, together with mobile banking, can have. That research found that signing up to text alerts or mobile banking apps reduces the amount of unarranged overdraft charges a consumer incurs by 5% to 8%. Signing up to both services has an additional effect, resulting in a total reduction of 24%.[42] The additional impact of combining both services shows the benefit of

40 www.fca.org.uk/publication/research/consumer-credit-insights-overdrafts.pdf, p1
41 CMA, Retail banking market investigation Final report, paras 72-73.
42 www.fca.org.uk/publications/occasional-papers/occasional-paper-no-10-message-received-impact-annual-summaries-text

receiving information that is automatically triggered, without the consumer actively having to seek it, as well as being able to act quickly when they have received it.

4.33 To deal with their concerns about the lack of transparency over overdraft charges, the CMA's package of remedies proposed steps to give consumers much greater control over their overdraft charges. Their aim is to ensure consumers are clearly told when they are about to incur these charges and have the opportunity to avoid them. In particular, they recommended that the FCA carry out further work, including behavioural research and testing, on specific proposed prompts and alerts. We are currently developing this testing.

Assessment

4.34 Current overdraft charging models are complex. The charges that consumers will actually face will depend on the relation between their usage and the specific charging structure for their current account. Given that half of consumers do not even realise that they have used an unarranged overdraft, and others may not know how much or for how long they will borrow, it will be difficult for many consumers to determine the costs and assess their value.

4.35 Our focus in this review is to assess whether consumers need additional protection to prevent them suffering harm. To make this assessment, we will need to examine whether particular groups of consumers are less likely than others to benefit from the CMA's measures that we are currently developing. So we will consider whether, even if consumers were significantly more engaged with their unarranged overdraft usage and charges, there would still be a significant number of consumers who remain exposed to high charges.

4.36 What we currently know about the charges consumers incur shows that large revenues are generated from a small minority of consumers: those who repeatedly use unarranged overdrafts (see paragraph 4.57 below). Further analysis will explore whether even if this group of consumers have much greater awareness they will still not be able to avoid such charges. If our further analysis shows this is the case, then we may need to introduce further measures to protect those consumers.

High charges

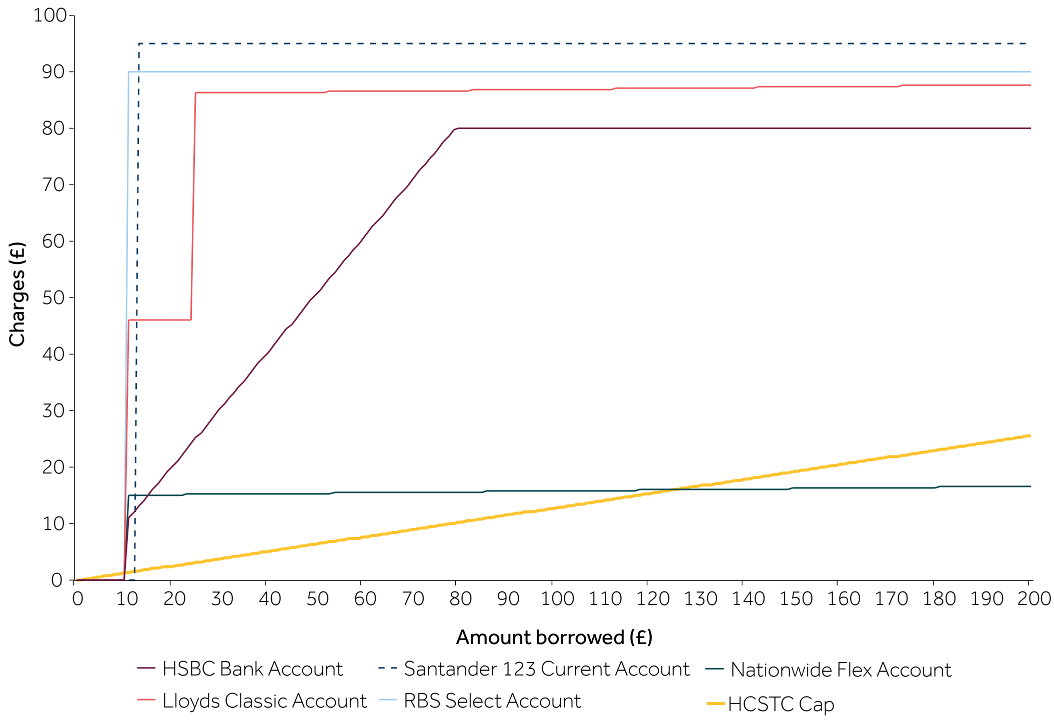
4.37 From a consumer protection perspective, high prices for credit services can cause direct harm to consumers. In particular, consumers may stay in debt longer, have difficulty meeting their other financial obligations, or take out further credit to cover the costs when they would otherwise not have to.

4.38 As consumers using high-cost credit services may have lower than average, or precarious, income flows, the use of extra, expensive credit may negatively affect their wellbeing - leading to greater financial difficulties. As well as the financial cost, this could also come at a personal cost, for example through increased mental ill-health and stress.

4.39 In looking at charging levels, we have compared the charging structures of a number of banks, to allow us to compare charges with other services, particularly HCSTC. We have analysed how much consumers could pay when borrowing different amounts for a different number of days. We present the results of this analysis in Figure 4.1.

4.40 As these show, the daily charges dominate the interest charges. Whether a consumer borrows £30 or £200 makes little difference to the charges they could face. These calculations are based on the simplifying assumption that the consumers make a single payment that takes them overdrawn, with no further payments. This may not reflect actual patterns of usage and further payments either made or refused could add to the charges incurred. Under LBG's recently announced overdraft charging structure, customers would pay no additional fees or interest for unarranged borrowing in this example.

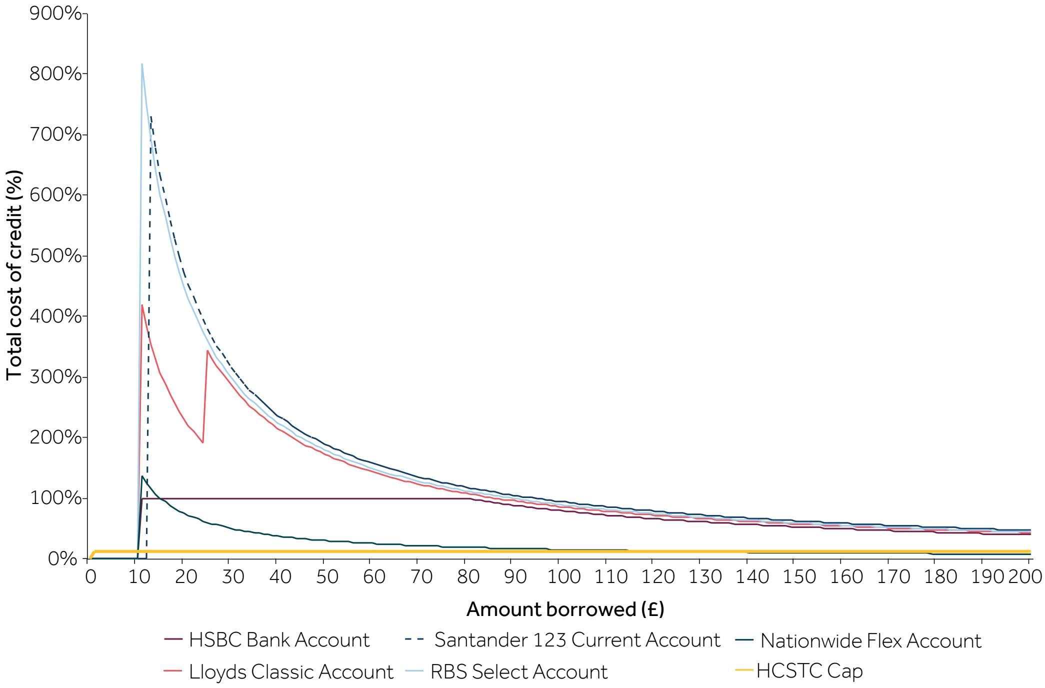
Figure 4.1: Total monthly charges for unarranged overdrafts held for 16 days, charging structure effective June 2017[43]



4.41 We then extended this analysis to calculate what these charges would be as a percentage of the amounts borrowed, to calculate a simplified 'total cost of credit'. We give the results of this analysis in Figure 4.2 below. The HCSTC line represents the amount that could be charged were these amounts to be borrowed using a HCSTC loan for 16 days.

43 Sources: https://www.lloydsbank.com/current-accounts/personal-overdrafts/rates.asp#tab-row-2; https://www.hsbc.co.uk/1/PA_esf-ca-app-content/content/uk/pdfs/en/47590_Personal_Banking_TCs_WEB.pdf; http://www.santander.co.uk/uk/current-accounts/understanding-overdrafts; http://personal.rbs.co.uk/personal/current-accounts/overdrafts/overdraft-details.html; http://www.nationwide.co.uk/products/current-accounts/flexaccount/rates-fees-overdrafts; all accessed June 2017
Note: The calculations assume that the borrowing occurs within a single billing period. Nationwide's calculation is based on a single paid item charge being incurred.

Figure 4.2 Total Cost of Credit in % for a 16 day Unarranged Overdraft



4.42 While these are relatively simplified calculations, the magnitude of the 'total cost of credit' is striking, and significantly more than the amounts that would be permitted under the price cap for HCSTC.

4.43 Analysis published by Which? in 2016 concluded that, when comparing the cost of borrowing £100 for 30 days using HCSTC and using an unarranged overdraft to borrow the same amount, unarranged overdraft charges at some high street banks were as much as 7.5 times higher than the maximum charge of £24 on a HCSTC loan[44].

4.44 We have also completed provisional analysis of current account data from six major retail banks over a two year period covering 2015 and 2016. This shows that most unarranged overdrafts are small, with under half of the unarranged overdrafts which charged a fee involving borrowing of less than £50. Notably, these are borrowing levels for which the 'total cost of credit' that we calculated above are the highest.

Relationship between prices and costs

4.45 To fully understand prices, it is also necessary to assess the underlying costs of providing unarranged overdraft facilities. That analysis would need to consider the relationship between charges and the credit risk or costs of lending.

4.46 In that context, the information available to banks should enable them to have a detailed understanding of the credit risk of their account holders. Additionally, the ability of banks to access funds paid into that account would reduce the risks of lending by a current account provider compared to the risks faced by a third party lender.

4.47 In the strategic review of retail banking we will carry out detailed financial analysis of PCAs. The analysis from this work will inform our understanding of the role of overdraft charges in the business model. We will consider these findings in any assessment we

44 https://press.which.co.uk/whichpressreleases/overdraft-charges-could-cost-156-more-than-payday-loans/

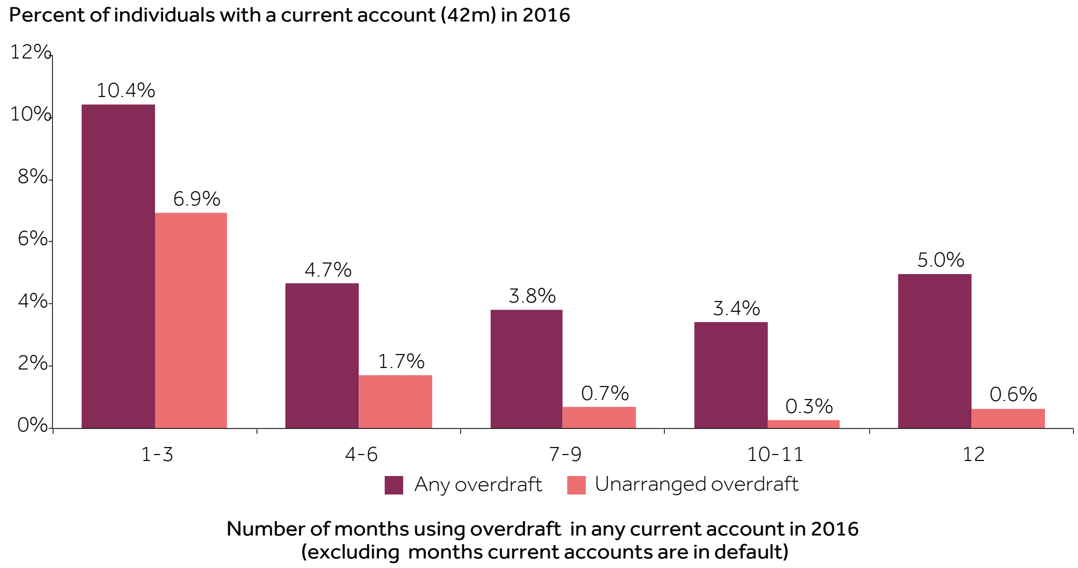
make to assess the benefits and costs of intervening to tackle consumer harm from high prices for unarranged overdrafts.

Repeated use of unarranged overdrafts

4.48 Unarranged overdraft charges may cause particular harm when consumers repeatedly incur them. This is because the net costs are much higher, and likely to cause a much greater cost to the individual on an ongoing basis, especially where lending reflects underlying financial difficulties. Indeed, financial difficulties may be created or worsened by the charges themselves.

4.49 Figure 4.3 presents analysis of the proportion of current account holders that use unarranged overdrafts at all within the month, and the number of months in 2016 that they did so.

Figure 4.3 Frequency of unarranged overdraft usage, 2016[45]



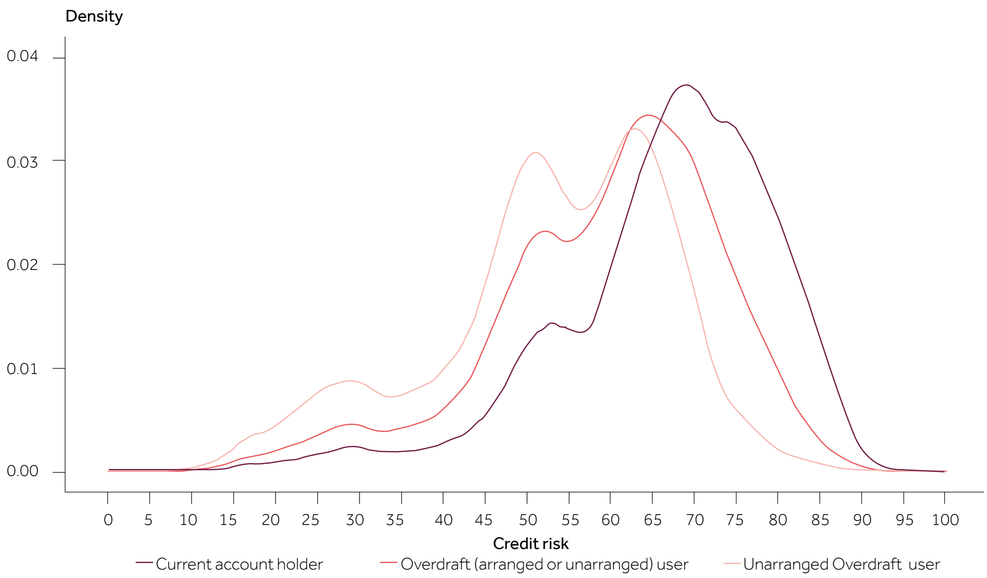
4.50 This analysis shows that a quarter of people that used unarranged overdrafts used them in four or more months during 2016. Nearly 10% of unarranged overdraft consumers used them for 10 or more months. We are concerned that consumers who repeatedly using unarranged overdrafts are being given access to a service that seems unsuitable for them, and which may be contributing to potential financial distress.

4.51 It is also relevant that unarranged overdrafts are not subject to creditworthiness requirements.[46] This may allow for lending practices for unarranged overdrafts that would not meet the standards that we expect in relation to other products.

4.52 The potential importance of creditworthiness assessments can be shown by examining the credit risk of overdraft users. Figure 4.4 presents our analysis of the credit score profile of overdraft users. This shows that overdraft users typically have lower credit scores than consumers with current accounts. Furthermore, consumers using unarranged overdrafts have noticeably lower credit scores than the overall population of current account and overdraft users.

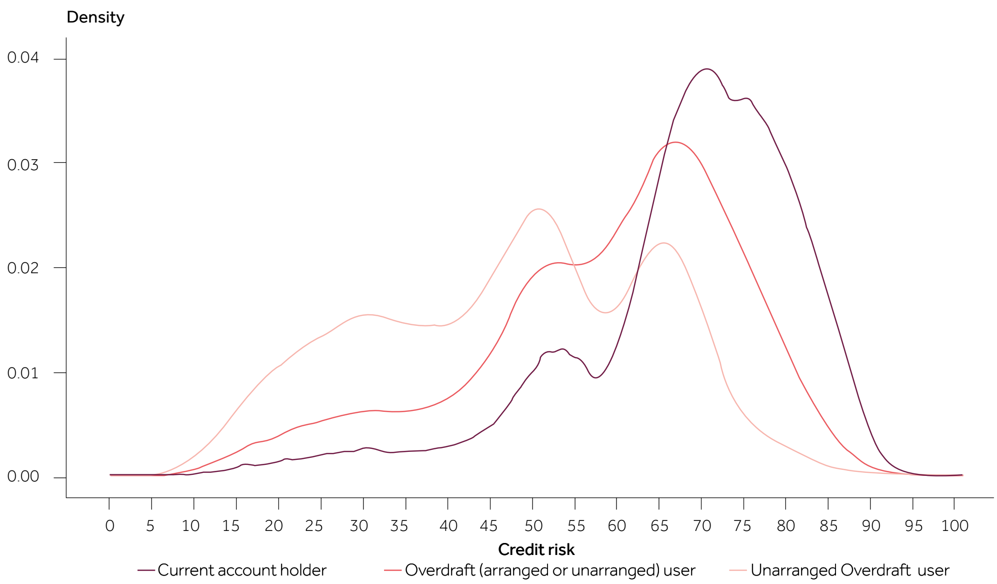
45 FCA analysis of CRA data
46 The Consumer Credit Directive requires a creditworthiness assessment for arranged overdrafts, but not unarranged overdrafts, and CCD harmonisation precludes member states from requiring one.

Figure 4.4: Distribution of January 2015 credit score of consumers with current accounts in November 2016 compared to the subset of those with any overdraft or unarranged overdraft outstanding, non-defaulted debt



4.53 We also observe worsening credit scores for unarranged overdraft users between 2015 and 2017, similar to the changes we showed for consumers of other high-cost credit users in Chapter 3 above. A comparison of Figures 4.4 and 4.5 shows that the credit scores of people using overdrafts in November 2016 have worsened between January 2015 and January 2017.

Figure 4.5: Distribution of January 2017 credit score of consumers with current accounts in November 2016 compared to the subset of those with any overdraft or unarranged overdraft outstanding, non-defaulted debt



4.54 In their responses to the CfI, firms said they are able to identify and exclude those on very low incomes or who are vulnerable from unarranged overdrafts. They can do this either by moving them to Basic Bank Accounts or by putting other protections in place. In June 2016, HM Treasury figures indicated that there were 7.89 million Basic Bank Accounts open across nine of the largest UK banks.

4.55 Moving potentially vulnerable consumers into Basic Bank Accounts can have a positive impact by ensuring that they are not harmed by unarranged overdrafts. However, as we set out in an Occasional Paper in 2015, vulnerability can be a difficult issue to predict or identify.[47] It may also be a fluid concept and it may not always be easy to identify individuals affected due to short term crises, or where problems have become too large to manage.

4.56 In the next stage of this review, we will examine the existence and extent of harm to consumers from repeat use of unarranged overdrafts and if necessary, whether regulatory intervention is needed.

Distribution of charges

4.57 Because of the charging structures and patterns of use, charges for unarranged overdraft usage are highly concentrated on a minority of consumers who may suffer harm as a result. We are concerned about the distributional effects of this, in particular who pays for the costs of providing current accounts.

4.58 The data we hold on current accounts from six major banks during 2015-16 shows:

- In one bank, less than 5% of consumers pay over £250 per year in unarranged overdraft charges, and in aggregate pay 50-60 % of all unarranged overdraft fees. At the same time, nearly three-quarters of this bank's consumers pay no unarranged overdraft charges at all.
- At another bank, 85-90% of unarranged charges are paid by 10-15% of consumers and less than 5% of consumers account for 60% of charges.

4.59 The fact that less than 5% of consumers contribute over half of all unarranged overdraft revenue suggests there may be an inappropriate concentration of charges on a very small group. Those consumers may be experiencing difficulties and the charges themselves could compound underlying problems.

4.60 We are aware that the charges and revenues for unarranged overdrafts are elements of the current account product. Other revenue sources such as arranged overdrafts, packaged bank accounts, foreign exchange and interest foregone make up the revenues for the accounts for banks. Any regulatory intervention that reduces one revenue stream is likely to have an impact elsewhere.

4.61 In the Strategic Review of Retail Banking Business Models we will look at the business models of firms to identify, amongst other things, how free-if-in-credit banking is paid for. In particular, we will assess whether it leads to any concerns about how charges are distributed between different types of consumers.

Next steps

4.62 Unarranged overdrafts have undergone significant changes since the original 2008 Market Investigation by the OFT. At the same time, changes to the payments system and technology around consumer control have all radically transformed the context in which unarranged overdrafts occur, meaning far fewer transactions are unauthorised

47 www.fca.org.uk/publication/occasional-papers/occasional-paper-8.pdf

by firms and are instead agreed. Some firms have started to price unarranged overdrafts as another form of credit.

4.63 Nevertheless, we remain concerned about the way unarranged overdrafts are designed and operate. We intend to explore how firms make available and charge for overdrafts and how consumers' behaviour and circumstances interact with product features and charges. We may pursue fundamental changes in the way that unarranged overdrafts are provided.

4.64 We recognise the potential benefits of consumers having some flexibility to borrow above agreed levels, both in providing credit within the day (intraday smoothing) and access to small, very short term emergency funds. We will aim to develop solutions that preserve useful parts of the market while addressing the harm we observe.

4.65 We could explore a cap on charges, as many respondents asked us to do in the CfI. However, this would address just one of the symptoms and would not tackle our concerns about how appropriate it is to offer this service for repetitive use by consumers, without creditworthiness considerations, and in a way that may make consumers worse off as a result.

4.66 If further analysis shows we need to intervene, we recognise the need to exercise caution in designing those interventions. If PCA providers were unable to provide unarranged overdrafts and were unwilling to provide arranged overdrafts to certain consumers:

- This could cause harm to consumers if important transactions are declined (incurring charges or penalties) and consumers did not have a ready source of alternative liquidity.
- Any interventions to address harm from high unarranged overdraft fees may simply be shifted to unpaid item fees.
- PCA providers could change the pricing of arranged overdrafts to partly or wholly replicate the pricing of unarranged overdrafts. In particular, they could charge higher prices to consumers whom they judge to pose a higher credit risk.

4.67 As noted above, there is concurrent work underway to develop remedies to address the CMA recommendations, notably those on prompts and alerts, to review any impact of the Monthly Maximum Charge put in place by the CMA and our strategic review of retail banking business models.

4.68 Our work on alerts includes analysis of the impacts of alerts that banks already use, as well as field trials on additional types of alerts, especially alerts for unarranged overdrafts. The work on prompts will provide information about the potential for prompts to encourage greater competition in the PCA market, with the aim of reducing the price of overdrafts.

4.69 The Strategic Review of Retail Banking Business Models will allow us to better understand how overdraft prices relate to the cost of providing PCAs. It will also be crucial to understanding the extent to which the costs fall disproportionately on vulnerable consumers.

Analysis and Next Steps on Arranged Overdrafts

4.70 Many respondents called for us to introduce measures to address persistent debt, affordability or to make firms apply forbearance measures for those in financial difficulty. We also received responses proposing to give consumers more control.

4.71 Some banks thought we should review the impact of current efforts to improve competition such as Open Banking, before taking action.

4.72 Arranged overdrafts offer the ability to borrow far larger sums, over a longer period and are generally priced in different ways to unarranged overdrafts. They are far more prevalent and at some time or another most consumers use them to deal with temporary funding shortfalls.

4.73 We are concerned about the harm to consumers in this market, but it is of a different nature to unarranged overdrafts. Consequently, the analysis and the potential remedies are also likely to be different. The main strands of our investigation are:

a. **Long-term indebtedness** – arranged overdraft facilities may encourage consumers to carry a long-term balance.

b. **High levels of indebtedness masking financial difficulties** – The above may also be associated with very heavy overdraft use which reflects underlying financial difficulties.

c. **Unanticipated charges** – Several PCA providers have introduced monthly fees that are triggered immediately when a consumer enters into arranged overdraft. While these fees are only charged on the first overdraft of the month, and so are effectively lower on a per-transaction basis than unarranged overdraft fees, they still raise concerns about consumers being charged disproportionately for small amounts.

4.74 We will now undertake more work to understand better how consumers use arranged overdraft facilities and whether our concerns set out above merit intervention to protect consumers. In particular, we will consider how can we ensure firms' incentives are aligned with those of consumers to minimise the risk that an arranged overdraft is unsuitable or harmful. In our work we are mindful of the broader potentially positive role arranged overdrafts play in consumers' lives.

Long term indebtedness

4.75 Our concerns about long-term indebtedness in arranged overdrafts are similar to those which prompted the persistent debt remedy in our credit card market study. This addressed concerns about a flexible revolving credit facility being used for longer term borrowing in a way that the product is not designed for and which is more expensive than alternatives such as personal loans.[48] We are concerned with how far firms' incentives are aligned to prevent the mis-use of arranged overdrafts in this way, how far they ensure customers are on the most suitable product for their needs or whether they promote or encourage persistent indebtedness.

4.76 Our preliminary analysis of a representative sample of data from a CRA shows consumers' use of overdrafts over time. Figure 4.3 above shows that a substantial

48 A personal loan of £5000 over 3 years can be obtained at below 5% APR. Most overdrafts are around 16-19% APR.

minority of consumers use arranged overdrafts repeatedly or persistently over the course of a year. Approximately 5% of consumers were in overdraft every month in 2016. This is likely to under-estimate the actual proportion as reporting to credit reference agencies is based on a specific point in time in the month and so does not include individuals who used an overdraft at other points in a month.

4.77 There are also features of arranged overdrafts that may raise unique concerns. Arranged overdraft lines are typically included in the 'available funds' information given to consumers, which may have the effect of normalising the use of overdrafts. Consumers may not see an overdraft as borrowing, and so may not consider altering their spending or considering more suitable alternative credit options.

4.78 The current account provider sets overdraft limits when the account is opened and may extend these limits without an explicit affordability check if the increases are relatively small. We are concerned about the risk of the cumulative effect of a series of small increases over time. These could increase the possibility of an overdraft reaching unaffordable levels and creating harm for consumers as a result. This can mean that what is initially a useful tool to manage money flows soon becomes a form of dependency that is too large to manage. As this all happens slowly it is hard for the consumer to define when and how things changed.

4.79 We are also concerned that firms increase overdraft limits in response to a consumer's changing life circumstances, but appear less likely to reduce them. This may generate a ratchet effect contributing to a greater risk of harm to consumers.

4.80 All the above factors of the product design, firms' practices and underlying incentives may encourage consumers to take on more debt than they are comfortable with, over a longer period and paying more interest than is available elsewhere.

Masking financial difficulties

4.81 We are concerned that these factors may also increase the risk that consumers borrow more than is affordable because the credit limit is inappropriately set. As we highlighted in our consultation on credit cards, large borrowing may be due to underlying financial difficulties which mean the consumers can no longer repay within a reasonable period. Where this happens, being given access to further debt and the resulting charges may cause consumers further harm. We are concerned about whether firms' incentives and processes adequately consider these risks.

4.82 We will undertake analysis of how much overdraft levels are related to financial difficulties. Our current data show that, as with unarranged overdrafts, there are a small number of consumers with very heavy overdraft use who generate a significant proportion of banks' revenues from arranged overdrafts.

- in one bank, less than 5% of consumers pay over £400 a year, which is 50-60% of the total of all arranged overdraft revenue
- in another bank, less than 2.5% of consumers pay over £400, but make up 25-35% of all arranged overdraft revenue.

4.83 We will explore whether there are ways in which we could intervene to reduce any harm to consumers paying these high charges. For example, if our further analysis identifies harm, we may consider whether we should oblige banks to offer these consumers personal loans instead, if they offer better value to consumers.

Unanticipated charges

4.84 We are also concerned about some banks' practice of adding fixed monthly charges to arranged overdraft facilities as well as interest. Some consumers in persistent debt may have no choice but to use this facility and it may make the unaffordability trap worse for them. It may also be unreasonably expensive for those who are very light users of arranged overdrafts. This could include, for example, consumers who face a cash shortage for only a few days or need very small amounts of credit for a short period. Finally, as with unarranged overdrafts it makes prices more complex and behaviour dependent and ultimately more complex to understand, compare or switch. Given the lack of ability to compare and perceived difficulty of switching, this becomes more important.

4.85 As we take both this review and the Strategic Review of Retail Banking Business Models forward, we will further examine the link between charges and credit risk. Unlike credit card issuers, banks offering arranged overdrafts have first claim on funds in a consumer's account. While this substantially reduces the credit risk banks face, it also stops consumers choosing which debt repayments to prioritise.

4.86 Collectively, this leaves us concerned with how banks normalise debt, how they assess affordability, and how far firms' incentives are aligned to those of consumers in longer term or 'persistent debt'.

Next steps

4.87 We will carry out additional analysis specifically to diagnose the harms from arranged overdrafts and to evaluate the impact of potential remedies. This includes analysis of persistent borrowing on arranged overdrafts. We will also take into account the impact of the work from the CMA's review to encourage switching and take control of overdraft costs, including FCA work on prompts and alerts.

4.88 If we identify harm to consumers that needs to be addressed, we may look at interventions to both improve consumers' control over their limits and to identify and help those in persistent debt. In this case, we would use a similar framework to that we proposed in the Credit Card remedies.

4.89 If needed, we could also consider what controls banks need to put in place to ensure they do not exploit persistent debt. Instead, we could look at ways to ensure banks are incentivised to provide a flexible overdraft facility for urgent short-term need.

Annex 1
List of non-confidential respondents

118 Money [Madison CF UK Limited]

ABCUL [Association of British Credit Unions Limited]

Abdul Dambha

Adam Afriyie MP

All Party Parliamentary Group on Alternative Lending

All Party Parliamentary Group on Debt and Personal Finance

Amigo Loans Limited

Association of Business Recovery Professionals (R3)

Association of Professional Compliance Consultants (APPC)

Barclays Bank

BCCA Ltd (BCCA)

British Bankers' Association (BBA)

British Retail Consortium (BRC)

Buy As You View [Duraven Finance Limited]

Capital Credit Union Limited

Capital One (Europe) plc (COEP)

Carnegie UK Trust

Centre on Household Assets and Savings Management (CHASM)

Chartered Institute on Credit Management (CICM)

Christians Against Poverty (CAP)

Citizens Advice

Citizens Advice Merton and Lambeth

Consumer Credit Association (CCA)

Consumer Credit Trade Association (CCTA)

Consumer Finance Association UK (CFA UK)

CreditAbility Ltd

Dr J. Byrne

Dr John Gathergood

DR Law

Elevate Credit

Experian

Fair for You

FCA Practitioner and Small Business Practitioner Panels

Finance and Leasing Association (FLA)

Financial Services Consumer Panel

Gary Urquhart

HSBC

John Lamidey

Jon Wilkinson

Law Society of Scotland

Leeds City Council

Leeds City Credit Union

Lending Metrics

Lending Standard Board (LSB)

Lloyds

London Borough of Newham

Lynn Story

Mew Economic Foundation

Miltons Pawnbrokers

Money Advice Scotland

Money Advice Trust

Money and Mental Health

Money.co.uk

Mr Robert E Rutkowski

Mutual Clothing

National Pawnbrokers Association (NPA)

Nationwide Building Society

Neil Forrester

NI Consumer Council

Non-Standard Finance plc

Paul Hare

Peter Lamb

Provident

Rachel Reeves MP

Responsible Finance

SA Compliance

Samantha Baker

SCOTSS

Shop Direct (SDFC)

Step Change

Stephen Canton

Susan Walker

Tesco Bank

Toynbee Hall

UK Cards Association

Virgin Money

Wage Me

Which?

Young Foundation

Annex 2
Abbreviations used in this paper

APR	Annual percentage rate of charge
CCA	Consumer Credit Act 1974
CfI	Call for Input
CMA	Competition and Markets Authority
CONC	Consumer Credit Sourcebook
COND	Threshold Conditions
CP	Consultation Paper
CPA	Continuous payment authority
CRA	Credit reference agency
FCA	Financial Conduct Authority
FSMA	Financial Services and Markets Authority
HCSTC	High-cost short-term credit
MMC	Monthly Maximum Charge
OFT	Office of Fair Trading
OP	Occasional Paper
PCA	Personal current account
PCW	Price comparison website
PRIN	Principles for Businesses
PSD	Product Sales Data
RTO	Rent-to-Own
SYSC	Senior Management Arrangements, Systems and Controls

We have developed this Feedback Statement in the context of the existing UK and EU regulatory framework. The Government has made clear that it will continue to implement and apply EU law until the UK has left the EU. We will keep the proposals under review to assess whether any amendments may be required in the event of changes in the UK regulatory framework in the future.

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