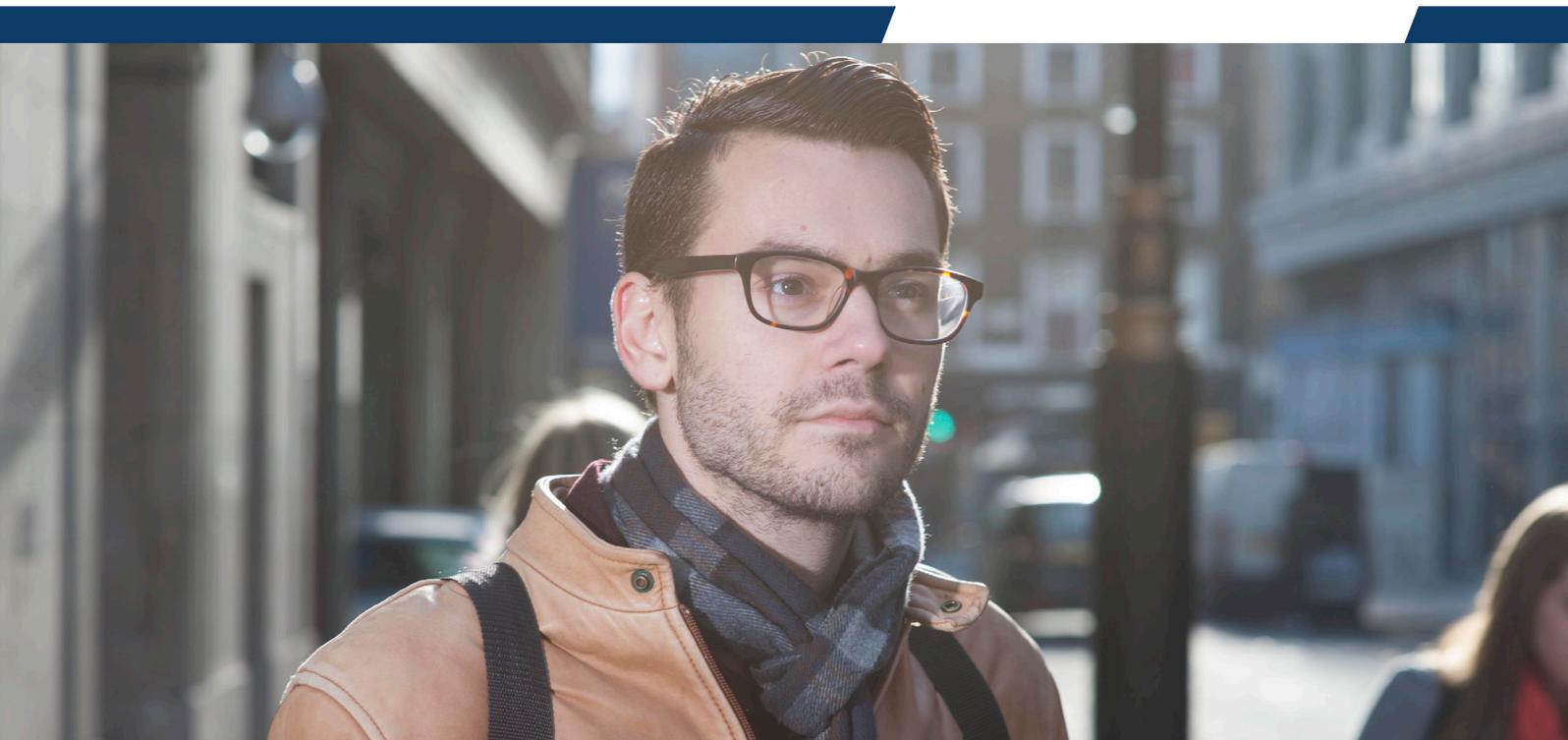


Proposals for a price cap on high-cost short-term credit

July 2014



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We are asking for comments on this Consultation Paper by **1 September 2014**.

You can send them to us using the form on our website at:
<http://fca.org.uk/your-fca/documents/consultation-papers/cp14-10-response-form>.

Or in writing to: Dr Diana Tlupova
Consumer Credit Policy Team
Financial Conduct Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

Telephone: 020 7066 1000
Email: cp14-10@fca.org.uk

We make all responses to formal consultation available for public inspection unless the respondent requests otherwise. We will not regard a standard confidentiality statement in an email message as a request for non-disclosure.

Despite this, we may be asked to disclose a confidential response under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Rights Tribunal.

You can download this Consultation Paper from our website: www.fca.org.uk.

Abbreviations used in this document

APR	Annual percentage rate of charge
BIS	Department for Business, Innovation & Skills
BMSA	Business model and strategy analysis
CBA	Cost benefit analysis
CC	Competition Commission
CCA	Consumer Credit Act
CCD	Consumer Credit Directive
CDFI	Community development finance institution
CEO	Chief Executive Officer
CMA	Competition and Markets Authority
CONC	Consumer Credit Sourcebook
CP	Consultation paper
CPA	Continuous payment authority
CRA	Credit reference agency
EEA	European Economic Area
ECD	E-Commerce Directive
EIA	Equality impact assessment
EAR	Effective annual rate of interest
EU	European Union
FCA	Financial Conduct Authority
FSA	Financial Services Authority

FSMA	Financial Services and Markets Act
HCSTC	High-cost short-term credit
ISS	Information Society Services
MAS	Money Advice Service
MFA	Market Failure Analysis
OFT	Office of Fair Trading
P2P	Peer-to-peer
PRA	Prudential Regulation Authority
PS	Policy Statement
PSD	Product sales data
RD	Regression discontinuity
SCOR	Steering Committee on Reciprocity
SECCI	Standard European Consumer Credit Information
TAR	Total amount repayable
TCC	Total cost of credit
UTCCD	Unfair Terms in Consumer Contracts Directive

1

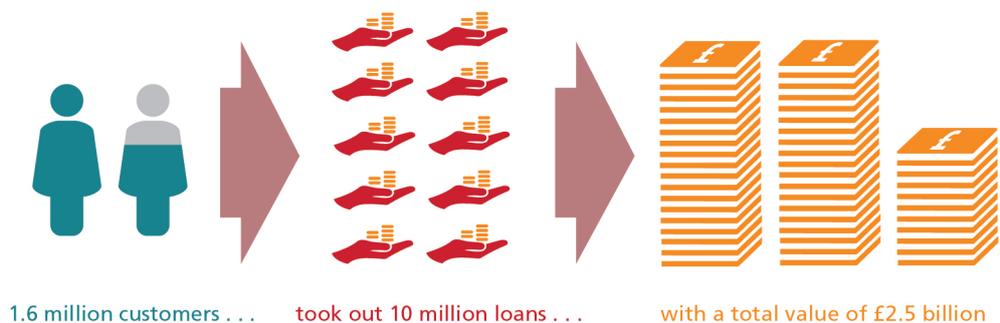
Executive summary

Introduction

- 1.1** The high-cost short-term credit industry (including payday lending) has grown rapidly in recent years, as many consumers look for quick and easy borrowing to manage their finances. We began regulating these firms on 1 April 2014, with a strong commitment and clear remit to tackle poor conduct in the market and ensure that there is an appropriate degree of protection for consumers.
- 1.2** In February 2014 we published our final rules for consumer credit firms, setting out the standards they have to meet to continue doing business, including rules reflecting the Office of Fair Trading (OFT)'s previous guidance, for example on assessing if loans are affordable. These also included new requirements for risk warnings on financial promotions, restricting the use of continuous payment authorities, and limiting the number of times a loan can be rolled over to twice. Firms must also give customers information on how to get debt advice if they are struggling to repay their loans.
- 1.3** In January 2015, we will introduce a price cap on what high-cost short-term credit lenders can charge. We are doing this to meet a duty to make rules about agreements that appear to us to involve high-cost short-term credit, with a view to securing an appropriate degree of protection for borrowers against excessive charges.
- 1.4** We have carried out extensive research to understand this market and the consumers that use it, which has helped us plan our proposals.

Key facts about the market

In 2013 . . .



The average loan per customer was £260.

The average number of loans per year taken out by a customer from any firm is estimated to be 6.



- 1.5** Now we want to hear your views. Please send us your responses to our consultation questions by 1 September 2014 using the online response form on our website, or by writing to us at the address on page 2 of the consultation paper.

How we approached designing a price cap

- 1.6** Over the past six months we have gathered a significant amount of evidence to support our proposals. We have:
- reviewed existing research and liaised with overseas regulators that use a cap
 - had discussions with the industry and consumer groups
 - used data collected using our statutory information-gathering powers to build models of eight firms and 16 million loans, to see which loans would not be made after the cap is introduced and to estimate customer savings and the impact on firms; and
 - analysed credit records for 4.6 million people (obtained using statutory powers), and carried out a survey of 2,000 consumers, to understand what would be likely to happen to consumers who would no longer get loans
- 1.7** We set out our findings in our consultation paper and you can see our research in detail in the Technical Annexes.
- 1.8** We have found that excessive charges for high-cost short-term credit are harming significant numbers of consumers. Many borrowers pay a high price for a loan that is of limited net benefit, or makes their already difficult financial situation worse. Borrowers who have problems

repaying can end up owing significantly more than they originally borrowed. For those who only just get loans, these make them worse off in the medium-term compared with those who fail to get loans.

- 1.9** We explored how introducing a price cap would affect firms and their lending decisions, what effect there would be on consumers who would no longer have access to high-cost short-term credit, and whether as a result consumers would be better or worse off.
- 1.10** We also talked to regulators in other countries about how they set their price caps and the impact on their markets, gathered input from a panel of academic advisers, and liaised closely with the Competition and Markets Authority, which is undertaking an investigation of the payday lending market.

Our proposed price cap

- 1.11** Our price cap ensures that consumers will never need to pay back more than twice what they have borrowed, and someone taking out a typical loan over 30 days and repaying on time will not pay more than £24 per £100 borrowed.
- 1.12** Our proposed cap is based on analysis of the impact it has on firms, consumers and competition. We believe it will:
- protect those whose financial position would become worse if they took out high-cost short-term credit
 - protect those who struggle to repay because of escalating costs
 - reduce costs for most borrowers; and
 - give 89% of consumers who would otherwise be served¹ access to high-cost short-term credit

¹ After taking into account the impact of our rules in PS14/3.

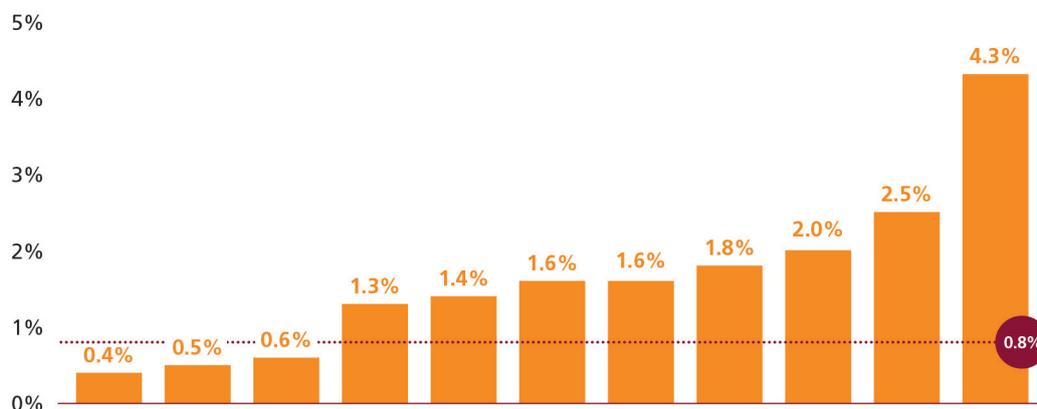
FCA price cap for HCSTC lenders

 <p>0.8% per day</p> <p>When loans are taken out or rolled over, the interest and fees charged must not exceed 0.8% per day of the amount borrowed.</p>	<p>TOTAL COST CAP 100% of amount borrowed</p> <p>(applying to all interest, fees and charges)</p> <p>Borrowers must never have to pay back more in fees and interest than 100% of what they borrowed.</p>
 <p>£15 default fees</p> <p>If borrowers default, fees must not exceed £15. Firms can continue to charge interest after default, but not above the initial rate.</p>	

Initial cost cap

- 1.13** We found that current revenue per loan ranges from 0.4% to above 4% per day. We tested a range of initial cost caps between 0.4% and 1% per day. The proposed initial cost cap of 0.8% per day lowers prices for borrowers who pay back their loans on time. This is calculated as a daily rate, which means the cost of the loan is directly proportionate to its duration.
- 1.14** Calculating the initial cost cap according to a percentage of the loan also means that pricing is proportionate to the size of the loan, so consumers only pay higher prices if they borrow more. This is fair for firms too, as the majority of their costs increase with the size of the loan. It also means they still have some flexibility to choose their own pricing structures.
- 1.15** We decided not to specify our proposed cap in terms of APR (the annual percentage rate of charge) as, while it is useful for comparing the basic cost of loans of the same size and duration that are paid back on time, it is not easy to compare loans of different size and length – for example, a shorter loan that costs the same as a longer one would have a much larger APR. (This is illustrated in Chapter 5 of the consultation paper.)

The majority of the firms we surveyed currently charge above 0.8%



The graph shows all interest and charges per loan per day.

Caps on default fee and default interest

- 1.16** It is reasonable not to prevent firms making a charge as they incur costs when a borrower fails to repay on time, so long as they are not excessive and they treat borrowers in default or arrears difficulties with forbearance and due consideration. We think that a £15 cap on default charges reflects the need to provide consumers with an incentive to pay back on time, whilst also providing the right incentive to firms by not rewarding failure to properly assess affordability.

Total cost cap

- 1.17** The total cost cap protects borrowers from escalating fees and charges on longer loans.
- 1.18** We tested a range of total caps from 50% to 200%. We concluded that 50% would have a disproportionate impact on the length of loans and access to high-cost short-term credit, and 200% would not offer enough protection against spiraling costs for those who struggle to repay.
- 1.19** The lower the cap, the more the length of loans could be restricted, and some longer loans may be more manageable and easier to repay on time. We believe 100% balances protecting consumers and allowing firms to continue offering loans for different lengths of time. Taking into account behavioural factors, we also think a 100% total cost cap would be easy for consumers to understand and help them to identify any lenders that attempt to charge more.

What does the price cap cover?

- 1.20** The price cap covers high-cost short-term credit as defined in our Handbook of Rules and Guidance.

a regulated credit agreement :

- (a) which is a borrower-lender agreement or a P2P agreement;
- (b) in relation to which the APR is equal to or exceeds 100%;
- (c) either:
 - (i) in relation to which a financial promotion indicates (by express words or otherwise) that the credit is to be provided for any period up to a maximum of 12 months or otherwise indicates (by express words or otherwise) that the credit is to be provided for a short term; or
 - (ii) under which the credit is due to be repaid or substantially repaid within a maximum of 12 months of the date on which the credit is advanced;
- (d) which is not secured by a mortgage, charge or pledge; and
- (e) which is not:
 - (i) a credit agreement in relation to which the lender is a community finance organisation; or
 - (ii) a home credit loan agreement, a bill of sale loan agreement or a borrower-lender agreement enabling a borrower to overdraw on a current account or arising where the holder of a current account overdraws on the account without a pre-arranged overdraft or exceeds a pre-arranged overdraft limit.

- 1.21** We have considered whether to widen the scope of the price cap to include other forms of high-cost short-term credit that are currently excluded in the definition above as these products could also cause harm to consumers. We have decided not to propose widening our definition at present.
- 1.22** Nevertheless, we are taking proactive steps to address potential consumer harm. For example, we are starting a comprehensive credit card market study in autumn 2014 and we have recently visited the largest home-collected credit firms to get a better understanding of the risks in this market.
- 1.23** We are also working with the Competition and Markets Authority on the personal current account market, including overdrafts.
- 1.24** As this work develops, we will consult on new rules if we believe they are needed.

How will the price cap affect consumers?

- 1.25** We believe there will be two main groups affected by the cap: consumers who will still be eligible for high-cost short-term credit and those who will no longer get loans.
- 1.26** Consumers who are still eligible for high-cost short-term credit will benefit from lower prices. We estimate their median saving per loan to be £14 and the median annual saving £76. The average annual saving would be £193. Total savings for consumers would be approximately £250 million per year.²
- 1.27** We estimate that 11% of individuals who would otherwise get high-cost short-term credit (about 160,000 people a year) would no longer get loans. However, we believe that for most of these people, a payday loan or other form of high-cost short-term credit is not the best outcome for them due to the high cost, particularly if they are unable to pay back on time. The effect of our cap will prompt more people in financial difficulty to seek other ways of handling their situation, such as by seeking debt advice. Apart from a short initial period we believe these customers will be better off not having taken out a loan.
- 1.28** Our research indicates it is unlikely that these customers will turn to illegal money lending. Fewer than 5% of customers who had been turned down for a loan told us they had considered going to an illegal money lender, while 2% reported having used one since July 2013. (We recognise, however, that people may be reluctant to report using illegal lenders so the results of our survey may be underestimated.)

How will this affect firms?

- 1.29** Introducing any price cap that delivers an appropriate degree of consumer protection will lead to a reduction in profits for firms, as most of their revenue is generated through interest charges and the number of loans they make will fall. However, only the largest lenders currently make significant profits – most are only marginally profitable, and some make no profit at all. (For some firms, this is not their core business.)
- 1.30** Our modelling shows that reducing the initial charge element of the cap increases the risk of firm exit, and hence the risk that very few firms remain in the market. The modelling suggests that at 0.8% the three largest online firms will be able to continue to offer high-cost short-term credit, and that it is possible that one high-street firm may be able to operate. Importantly, these impacts do not reflect firm responses to the cap, which would be expected to limit them. Looking at how price caps have affected other countries, it is difficult to predict how firms may respond. The firms that remain in the market will have some flexibility to choose their pricing structure, and we expect that they will continue to compete on non-price factors, including speed and convenience.
- 1.31** We will monitor the impact of the cap and review it in two years' time.
- 1.32** As high-cost short-term credit firms start to apply for authorisation from 1 December 2014, we will look at their business models to ensure they are treating consumers fairly and following our rules. We will pay particular attention to whether they are trying to avoid the price cap.

² These savings are to consumers who pay back on time, those who pay later than they expected and those who do not pay back (reducing their debts).

Improving how firms share data about consumers

- 1.33** We have strongly encouraged market participants to improve the way they share information about consumers, so firms lending on a short-term basis can be sure that the information being used in their affordability assessments is up-to-date and accurate. The more accurate the assessment, the less risk there is of a firm lending to a consumer who may experience difficulty in repaying the loan. It would also reduce consumers' ability to take out a number of different loans with different lenders.
- 1.34** Market participants are already responding to these challenges in a number of ways. Some credit reference agencies are developing and launching their own products that update information daily or in real-time, and some of the largest lenders have indicated that they will use these when they become available.
- 1.35** We expect to see more than 90% of current market participants participating in real-time data sharing by November, and more than 90% of loans being reported in real-time. Firms must also share data more widely to improve the coverage of the real-time databases. If we do not see sufficient progress by November, we will consult on the introduction of data sharing requirements.

Next steps

- 1.36** We seek responses to this consultation by 1 September 2014.
- 1.37** We plan to publish our final rules in early November to give firms time to prepare for the introduction of the price cap on 2 January 2015.
- 1.38** All high-cost short-term credit lenders that were part of the OFT regime and now have 'interim permission' will need to apply for authorisation from 1 December 2014. Any new market entrants must apply for authorisation before they can start lending. We will not authorise a firm if they cannot demonstrate compliance with the price cap.

2

Overview

Structure of this paper

- 2.1** The following chapters discuss our proposals in detail:
- Chapter 3 – Background
 - Chapter 4 – Our approach to developing proposals for a price cap
 - Chapter 5 – Our proposals
 - Chapter 6 – Supervising the price cap
 - Chapter 7 – Data sharing
 - Chapter 8 – Next steps
 - Annex 1 – Cost benefit analysis
 - Annex 2 – Compatibility statement
 - Annex 3 – List of questions
 - Annex 4 – International case studies
 - Annex 5 – Equality impact assessment

Key issues on which we are consulting

- 2.2** There is a full list of our consultation questions in Annex 3.
- 2.3** Key issues that we are asking about are:
- The methodology we used to develop our proposals.
 - Whether we have struck the right balance between their impact on consumers, firms and competition.
 - The structure and level of our price cap.
 - Our analysis of the impact of our proposals on firms and on the market.

- Our analysis of the impact of our proposals on consumers who will no longer be able to obtain high-cost short-term credit.
- Our cost benefit analysis.

Who should read this paper?

2.4 This paper will be of interest to:

- FCA-authorized firms involved in HCSTC, as lenders, operators of peer-to-peer platforms or brokers (most of whom will have interim permissions).
- Firms that are considering applying for FCA authorisation to carry out these activities.
- Trade bodies representing consumer credit firms.
- Consumer organisations.
- Groups that represent those with protected characteristics (age, gender, disability, race, pregnancy and maternity, religion and belief, sexual orientation and transgender) as they may wish to comment on our equality impact assessment (Annex 5).

This paper will also interest consumers

2.5 Anyone who has taken out, is considering taking out, or has been refused a high-cost short-term loan, or had difficulties paying back such loans, may want to comment on our proposals for a price cap.

3

Background

The high-cost short-term credit (HCSTC)³ market has grown significantly in recent years. It now generates revenue of over £1 billion, with approximately 10 million loans issued in 2013. This chapter summarises some key provisional findings from the Competition and Markets Authority (CMA) investigation into the payday lending market in the UK and the consumers that use it and findings from our own research on HCSTC use.

We also summarise the requirements currently in place to protect consumers.

The HCSTC market

- 3.1** The Competition and Markets Authority (CMA) published its provisional findings in its Payday Lending Market Investigation⁴ on 11 June 2014. These include a comprehensive description of the HCSTC market.
- 3.2** In its provisional findings the CMA has found that there is an adverse effect on competition arising out of the features it describes. In particular, price competition is weak, and consumers do not generally shop around to find a good-value loan. This is aggravated by consumers' perceived urgency of their need and uncertainty of access to credit, and it can also be difficult for consumers to identify the best-value product on offer. Consumers are particularly insensitive to fees and charges for default or late payment when taking out a loan.
- 3.3** The CMA has also expressed concern about the role of lead generators and a lack of transparency regarding their role and how they operate.
- 3.4** These provisional findings are broadly consistent with the Bristol report⁵ and the Office of Fair Trading (OFT)'s compliance review of payday lending.⁶
- 3.5** The CMA found that total payday loan revenue in 2012/13 was £1.1 billion, with 10.2 million loans issued, worth £2.8 billion. This was a significant increase on the previous year although the rate of growth has since reduced substantially. There were 1.8 million payday loan customers in 2012/13, and the average customer took out six loans in a 12-month period (with 40% of customers using more than one lender in the year).
- 3.6** According to the CMA's figures, 83% of payday customers have taken out a loan online and 29% on the high street (with 12% having used both channels). The average loan was £260 (but £290 online and £180 on the high street).

³ Our definition of HCSTC is included in the Executive Summary of this consultation paper.

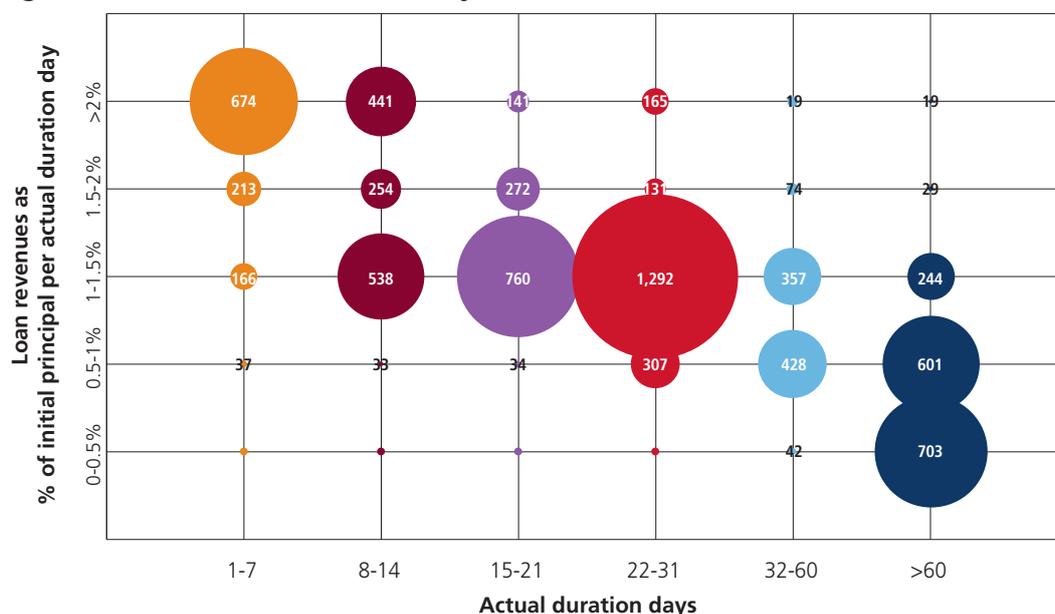
⁴ <https://www.gov.uk/cma-cases/payday-lending-market-investigation>

⁵ <https://www.gov.uk/government/publications/the-impact-on-business-and-consumers-of-a-cap-on-the-total-cost-of-credit>

⁶ www.offt.gov.uk/shared_offt/credit/oft1481.pdf

- 3.7** Our own findings on the market are broadly consistent with the CMA's, but with some differences reflecting different sources of data and the different focus of our research. In addition, our analysis is based on data for both 2012 and 2013, though we focus quoted figures on 2013. In the remainder of this paper, we make clear whether data derives from our analysis or the CMA's.
- 3.8** We estimate that in 2013, 1.6 million customers took out around 10 million loans, with a total value of £2.5 billion.⁷ The average loan has a principal of around £260 lent over an initial duration of 30 days. The average number of HCSTC loans per year taken out by a customer from any firm is estimated to be six.⁸
- 3.9** The HCSTC market is quite concentrated. The three largest lenders, operating under five brand names, have a combined market share of 72% by revenue. This is consistent with the CMA's finding that the three largest lenders account for 70% of total revenue, with the ten largest lenders accounting for more than 90%.
- 3.10** Most firms' revenue is generated through interest charges. We found that revenue per loan ranges from 0.4% to above 4% per day. Only the three largest lenders have had high returns above the cost of capital, and the operating margin of the high street is much lower than online.⁹

Figure 3.1: Number of loans issued by revenue and duration band



- 3.11** There is also a significant degree of intermediation in this market, with lenders paying significant sums to acquire customers from lead generators and other credit brokers. The CMA found that 40% of online borrowers take out their first loan with a lender via a lead generator.

⁷ Data from 33 firms covering approximately 99% of the market.

⁸ Data from 33 firms, as above.

⁹ The CMA's findings are broadly consistent. They found that the three largest lenders have had high and in some cases exceptional returns over much of the last five years, and significant variation in the profitability of smaller lenders, with some making losses.

The borrowers who use this market

3.12 Our research broadly confirmed what previous surveys have shown – that, when they apply for HCSTC loans, many customers are in a difficult, and deteriorating, financial situation.¹⁰

3.13 We surveyed 2,000 customers, focusing on those who had just got or been refused HCSTC or who had high unpaid HCSTC debt or habitual loan usage. This, combined with credit reference agency data, showed that on average:

- **Income and age:** HCSTC users are younger than the UK population as a whole (33 versus 40 years) and have lower income levels (the majority under £18,000 versus £26,500 per year).¹¹
- **Savings:** Around 65% have no savings compared to 32% of the UK population; most of those who do save have less than £500 (compared to a median of £1,500-£3,000 for the UK population).¹²
- **Other borrowing options:** 64% have outstanding debt from other types of lender, mainly credit cards (20%) and overdrafts (28%) and on household bills or mobiles (28%).¹³ 24% said they chose to apply for HCSTC because it was their only option. 36% of borrowers also borrowed from family and 18% from friends.¹⁴
- **Loan use:** 55% said they used loans for everyday expenditure (housing, basic living costs and bills) and 20% for discretionary spending (for example, holidays, social activities, weddings and gifts).¹⁵
- **Financial distress:** Since applying for a loan, 50% reported experiencing financial distress and 44% missed at least one bill payment.

3.14 Credit reference agency data relating to all consumers who applied for HCSTC loans during 2012 and 2013 provides further evidence that, on average, their financial position was deteriorating before they sought HCSTC:

- consumers credit scores were already getting worse¹⁶
- their outstanding debt had increased in the year before they applied for HCSTC; 23% had breached overdraft limits and over 40% were overdue on at least one payment
- their debt continued to increase in the year after they borrowed HCSTC; overdraft breaches and missed payments increased to 33% and 60% respectively
- 30% of their outstanding credit balances (including HCSTC) were in default a year after they borrowed HCSTC¹⁷

¹⁰ For detailed results, please refer to Technical Annex 3.

¹¹ The majority of consumer survey respondents from the 'less marginal successful group' had an annual income less than £18,000. £26,500 is gross individual income (among those in the labour force) in the UK from ONS Family Resources Survey.

¹² ONS Family Resources Survey

¹³ Credit reference agency data where balance greater than zero.

¹⁴ Consumer survey responses from 'less marginal successful' group. Records whether consumer reports having actually borrowed since application for HCSTC (July-November 2013).

¹⁵ Consumer survey responses from 'less marginal successful' group.

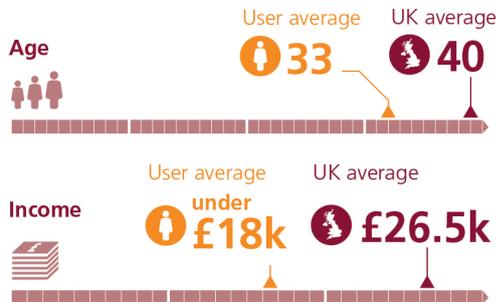
¹⁶ On average, decreased by 6 points over 12 months before taking out a loan. CRA scores are from 0-1000.

¹⁷ The average ratio of total default balances (including HCSTC) divided by total balances.

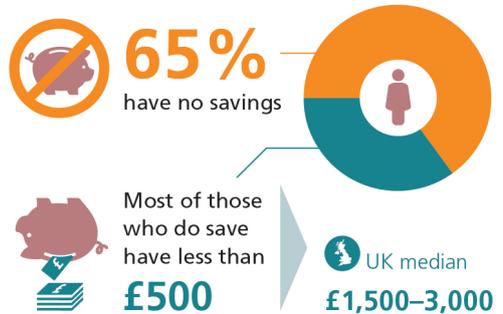
Our findings

We surveyed 2,000 customers of HCSTC. We found:

Income and age



Savings



Loan use



Financial distress



Other borrowing options



We combined information from our consumer survey with CRA data for the figures shown in the above graphic. This information is for the average HCSTC user.

Current regulatory requirements

- 3.15** We took over the regulation of consumer credit on 1 April 2014.
- 3.16** Lenders must comply with requirements under the Consumer Credit Act 1974 (CCA) and our Handbook rules, in particular, the Consumer Credit sourcebook (CONC), including rules on disclosure, affordability and payment difficulties. Most of the CONC rules carry across previous CCA requirements, plus OFT fitness guidance, in particular the Irresponsible Lending Guidance. PS14/3, 'Detailed rules for the FCA regime for consumer credit' (February 2014) confirmed our intention to substantially replicate the guidance in a way that meant that firms already complying were unlikely to need to change their behaviour.

- 3.17** The CCA requires the provision of pre-contract credit information and this is supplemented by CONC 4, which requires an adequate pre-contract explanation to enable the customer to understand the nature and key risks of the credit and whether they can afford it.
- 3.18** CONC 5 requires lenders to assess creditworthiness, including affordability. This must be based on sufficient information, obtained from the borrower where appropriate and from a credit reference agency where necessary. The lender must consider the potential for the credit commitment to make the customer's financial situation worse, and whether the customer is likely to be able to make repayments in a sustainable manner – without undue difficulties, while meeting other commitments and without having to borrow further.
- 3.19** CONC 6 deals with matters once the contract has been entered into, including prohibiting lenders from refinancing an agreement unless this is at the customer's request, or with their consent, and unless the firm reasonably believes that it is not against the customer's best interests.
- 3.20** CONC 7 deals with arrears, default and recovery and includes requiring lenders to treat borrowers in default or arrears difficulties with forbearance and due consideration. It also includes provisions regulating the use of continuous payment authorities (CPAs). In particular, firms must use CPAs in a way that is reasonable, proportionate and not excessive, and must exercise appropriate forbearance if they become aware that the customer may be experiencing financial difficulties.
- 3.21** Following our consultation last October,¹⁸ and in light of the findings of the OFT's payday lending compliance report, we have also introduced new rules for HCSTC lending aimed at increasing consumer awareness and enhancing protections.
- 3.22** These new rules, most of which came into force on 1 July, include:
- requiring a risk warning in financial promotions for HCSTC (this came into effect for electronic media on 1 April and for television and radio on 1 July)
 - prohibiting firms from refinancing or rolling over a loan more than twice
 - requiring firms to provide the customer with an information sheet, with details of free debt advice, when refinancing or rolling over
 - prohibiting firms from making more than two unsuccessful CPA attempts and from using CPA to collect
 - part payments
- 3.23** We made it clear in PS14/3 that we will keep under review the possibility of further changes to the CONC rules in light of developments and our experience of supervising the credit market (and taking account of the outcome of the CMA's investigation).
- 3.24** HCSTC lenders must apply for authorisation between 1 December 2014 and 28 February 2015, and will be subject to detailed scrutiny, including against our threshold conditions.¹⁹ Our best

¹⁸ CP13/10, 'Detailed proposals for the FCA regime for consumer credit' (October 2013), <http://www.fca.org.uk/your-fca/documents/consultation-papers/cp13-10> and PS14/3, 'Detailed rules for the FCA regime for consumer credit' (February 2014) <http://www.fca.org.uk/news/ps14-3-final-rules-for-consumer-credit-firms>

¹⁹ The threshold conditions are set out in an Order under FSMA, and summarised in COND in the FCA Handbook.

estimate of the number of firms currently offering HCSTC (not necessarily as their core business) or who have plans to do so in the near future is around 400, many of which are franchisees.²⁰

- 3.25** We will also be closely supervising their activities, before and after authorisation. This will include firm visits together with a thematic review of arrears handling practices.

²⁰ Our figure for firms active in the HCSTC market is higher than the CMA's because they counted all franchisees of a franchisor, and all subsidiaries of a parent company, as one payday lending company. All such companies need individual FCA permissions.

4

Our approach to developing proposals for a price cap

This chapter describes the duty placed on us to introduce a price cap for high-cost short-term credit (HCSTC) and our approach to designing the proposed cap.

We discuss our detailed analysis, which we framed around three key questions:

1. What happens to firms and their lending decisions as a result of a cap?
2. What options are there for customers who would no longer have access to HCSTC?
3. Are these customers better or worse off as a result of no longer having access to HCSTC?

Duty to introduce a cap

- 4.1** In April 2013 new regulatory powers relating to consumer credit lending took effect, including a power to cap the cost of unsecured loans. Parliament subsequently approved a duty on us to use this power to introduce a price cap to secure an appropriate degree of protection for borrowers of HCSTC from excessive charges.²¹ This must be in force by 2 January 2015.
- 4.2** In carrying out the duty we must, so far as is reasonably possible, act in a way that is compatible with our strategic objective and advances one or more of our operational objectives. We must also comply with our competition duty.²² We explain how we consider we have done this in Chapters 5 to 7 and in the Compatibility Statement in Annex 2. We must also carry out an analysis of the costs and benefits of our proposals, which is in Annex 1. This sets out the underlying data and methodology we have used to determine why the proposed cap is our preferred solution.
- 4.3** At the time of introducing the legislation, the Treasury sent a letter providing further context on the Government's policy rationale underpinning the legislation: 'in terms of consumer outcomes, the main aim of a cap is to ensure that payday loans customers do not pay excessive charges for borrowing and to minimise the risks to those borrowers who struggle to repay, to protect them from spiraling costs which make their debt problems worse. In short, far fewer payday loans customers should get into problem debt'.²³

²¹ In this consultation paper, references to the duty to introduce a cap are to the duty to make rules by virtue of subsection 1 (a) (ii) and (b) of section 137C FSMA.

²² <http://www.fca.org.uk/about/why-we-do-it/statutory-objectives>

²³ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/264223/FSTto__MW_payday_cap_letter_-_Dec_4_2013_FINAL.PDF

- 4.4** In the letter the Treasury also set out its view of the need to assess the impact of our rules on the ability of the market to meet consumers' needs and suggested that 'the main risk is that consumers may face reduced access to credit'.
- 4.5** We have consulted the Treasury on our proposals as required under the legislation.²⁴ We have taken the views of the Treasury into account in the design of our draft rules.

Are there excessive charges that should be addressed through a price cap?

- 4.6** We consider that charges are excessive if entering into HCSTC agreements that provide for such charges results in an unacceptable risk of harm to consumers. The harm we see caused to HCSTC borrowers can be linked specifically to price in two key ways:
- Charges contribute to borrowers' worsening financial situation. As set out in the previous chapter, HCSTC borrowers are often in a difficult and deteriorating financial situation when they apply for credit. Many borrowers are paying a high price for a loan that may be of limited benefit, or may make their situation worse. Borrowers in default²⁵ often find the costs escalating to unmanageable levels
 - Current high prices may encourage lending to borrowers who are at high risk of detriment as a result of borrowing. Lenders can mitigate their risk of losses by charging high prices and therefore are prepared to lend to borrowers with high rates of default (the other mitigating factors are the relatively small size and short duration of these loans)
- 4.7** Market features mean that there are insufficient constraints on prices. The CMA has found 'significant limitations in the effectiveness of competition between payday lenders on prices and that the competitive constraints that lenders face when setting their prices are weak'.²⁶
- 4.8** Excessive charges can arise from:
- high interest rates and charges during the agreed loan duration
 - additional interest and fees upon refinancing
 - high fees and interest payable upon default or late payment

The approach we have taken to designing a price cap

- 4.9** Our approach to designing a price cap was to identify the harm from entering into excessive charges for HCSTC and consider how to address this harm. To help us select an appropriate structure and measure the impact of a range of options, we reviewed existing academic and other research and examined experience in a number of other countries that have caps on the cost of credit. But we found that the evidence from other countries on the impact of caps on consumers is ambiguous and does not necessarily translate to the UK. There is existing research and commentary on use of HCSTC in the UK, from a variety of different sources. There are

²⁴ s137C(1B) FSMA

²⁵ Unless otherwise stated, default refers to any failure to repay on time.

²⁶ *Payday lending market investigation, summary of provisional findings report*; CMA, June 2014, page 8, paragraph 34.

indications of harm caused to consumers through use of HCSTC, but contrasting evidence that consumers value the speed and convenience of HCSTC and would not be able to access credit from elsewhere. However, as there was no analysis of the impact of different levels of price caps on firms lending in the UK and no econometric analysis of the impact on consumers, we conducted our own detailed quantitative research.

- 4.10** The Government legislated to give us early legal powers to gather information. We collected data on loans for around 99% of the market, and for 89% of the market we obtained very detailed financial and performance data on each loan that allowed us to model – at a granular level – the impact of a price cap on firms and their lending decisions. In order to estimate the impact on people of not getting access to loans we compiled two datasets. We obtained the full credit records (on an anonymised basis) for everyone who had applied for a loan in 2012 and 2013. To paint a full picture, we conducted a survey to understand informal borrowing, what happens if people do not borrow, and people’s levels of well-being or financial distress. A key aspect of understanding the impact of lack of access to credit is that we got data on people who did not get loans. We used a range of econometric and data analysis tools, and we were advised by international experts on the different parts of the analysis, who reviewed our results. Details of the analysis are below and are set out further in the CBA and the Technical Annexes. To our knowledge this is the most extensive analysis undertaken by a public body when setting a price cap for credit.
- 4.11** We tested a wide range of possible structures and levels for a price cap. The approach we have taken to excessive charges and our analysis of the harm they cause has also enabled us to consider the level at which we should set the cap, which could in principle be set at a level that had no economic effect on firms. We set out later in this paper why that would not deliver an appropriate degree of protection for consumers against excessive charges.

Summary of our data and methodology

- 4.12** We have carefully considered how we could provide evidence to support our decisions. We designed an analytical methodology that gives us a rigorous basis for developing our proposals. We also obtained data from firms and a credit reference agency using our statutory information-gathering powers and conducted a consumer survey.
- 4.13** We framed our analysis around three key questions:
1. What happens to firms and their lending decisions as a result of a cap?
 2. What options are there for customers who would no longer have access to HCSTC?
 3. Are these customers better or worse off as a result of no longer having access to HCSTC?

What happens to firms and their lending decisions as a result of a cap?

- 4.14** We collected data from a sample of eight groups of firms covering eleven legal entities (the largest and a selection of medium-sized firms – an 89% market share) to enable us to estimate the impact on each of those firms of different structures and levels of price cap. Each firm provided us with data on loans made to all their customers in 2012 and 2013 (16 million loans), costs and revenue data for each loan and management accounts. This enabled us to build dynamic models for eight of the eleven legal entities that allowed us to replicate their lending decisions by modelling the profitability of loans on a customer by customer basis.

- 4.15** For different structures and levels of a price cap, our model allowed us to estimate which customers would continue to be profitable and which would not. Assuming firms would not continue to lend to unprofitable customers, this enabled us to estimate for each firm how many of their customers would no longer get access to credit under different caps. We then extrapolated these results to give us overall loss of access figures for the whole market. This modelling process also enabled us to estimate whether or not firms would be profitable after applying different caps and so to estimate the risk of market exit for different caps and the resulting impact on competition.
- 4.16** A key part of the modelling process was taking into account the impact of our new rules on CPAs and rollovers. We adjusted the data provided by firms to assess what the impact would have been on 2012 and 2013 data, had these rules been in place. We made a number of assumptions based on information provided by firms, which we incorporated into the model; for example, revised recovery rates given that CPA use will be limited.
- 4.17** This first stage of the modelling work gave us a 'static' assessment of the impact of different caps. We then carried out further work to estimate how this might change as firms change their business models in response to the cap. We refer to this as our 'dynamic analysis'. We based this work on responses to questionnaires for our eight sample groups and 13 firms with revenue of greater than £0.5 million in 2013. We then modelled the impact of a range of different scenarios; for example, firms minimising reduction in revenue by changing their pricing strategies under the cap.

What options are there for customers who would no longer have access to HCSTC and would they be better or worse off?

- 4.18** First, to estimate whether customers who would no longer have access to loans would have had difficulties in payment, either from being late or by not paying back fully – a key part of our analysis – we used our model of firms' lending decisions and firms' data on the outcomes of loans. Second, using our legal powers, we obtained CRA data for 4.6 million people who applied for HCSTC in 2012 or 2013. Some of these applicants successfully borrowed and others were turned down. Third, we carried out a consumer survey, consisting of 2,000 in-depth interviews with people who had applied for HCSTC in 2013.
- 4.19** For both the CRA and survey data, we obtained information under our statutory powers for applicants who were successful in getting loans and those that were turned down. The data on unsuccessful loans is a key part of our methodology, which aims to understand the impact of no longer having access to loans by examining the outcomes of consumers who had previously been unsuccessful in getting loans.
- 4.20** The CRA data provided us with a rich source of wide-ranging financial information on consumers for a year or more after applying for their first loan. The data includes loan application records, extensive records on individuals holding a wide range of products and also data on personal insolvency and overall creditworthiness, including missed payments, delinquent and default balances and credit scores.
- 4.21** We designed the survey to obtain information on a variety of indicators that are not covered by CRA data. Specifically we asked questions on: i) the source of formal credit not fully covered by CRA data, in particular overdrafts; ii) information on borrowing; iii) measures of welfare, reported well-being and financial distress; iv) consumer perspectives on their loan application decision and use (e.g. regret); and v) socio-economic and behavioural characteristics of borrowers.
- 4.22** We identified a statistical method that would enable us to identify causal effects of HCSTC use. Our core econometric methodology can be characterised as isolating the impact of HCSTC by

measuring the difference in outcomes of two comparable groups: people who just qualified for HCSTC and people who were just at the threshold for acceptance but were turned down for HCSTC. We drew on this analysis and used other methods to assess the impact of using HCSTC for people further away from the threshold. We applied these methodologies to both the CRA and survey data.

- 4.23** The rest of this chapter summarises our key findings, which we have used in designing our proposals. More detail can be found in the CBA in Annex 1 and the accompanying Technical Annexes.

Impact on firms: what happens to firms and their lending decisions as a result of a cap?

- 4.24** Our key findings on the impact of a cap on firms are:
- in general, any level of cap on interest and other charges due when a loan is paid back on time or refinanced (which meets our duty given our findings) has an impact on the profitability of customers and will cause firms to not give loans to higher-risk borrowers;
 - this impacts firms' profitability;
 - firm revenues derive mainly from interest, so the part of the cap affecting this is the key driver of loss of access to credit;
 - firm revenues and profitability are less sensitive to different levels of a default cap; and
 - the total cost of credit cap protects customers in default, though this aspect affects firms' profitability little, and reduces the profitability of longer-term loans.
- 4.25** The context for these findings is the current profitability levels of HCSTC firms. The CMA profitability analysis during 2009 to 2013 has found (and our analysis supports this conclusion) that the three largest lenders have had high and in some cases exceptional returns that have been substantially above the cost of capital over much of the past five years. The largest three lenders account for 72% of the market by revenue (64% of the high-street). The CMA also finds there is significant variation in the profitability of smaller lenders – with some making losses in 2012. The CMA analysis based on 2012 shows online lending to be substantially more profitable than high-street lending. The CMA estimates that the adjusted operating margin delivered by online lenders was 24%, with high-street lenders achieving an adjusted operating margin of 0%.²⁷ When modelling any level of cap, therefore, a substantial number of firms are shown to be at risk of exit from their HCSTC businesses.
- 4.26** We made adjustments to the baseline data to account for the impact of rollover and CPA rules on revenues. This gave us our baseline against which to assess the impacts of different caps before we considered how firms may react to the cap. These results are discussed in further detail in Chapter 5 in the context of our proposed cap levels.

²⁷ Profitability of payday lending companies working paper, CMA, 2014 (n.b. these working paper profitability figures should be regarded as indicative only).

- 4.27** Because firm revenues are largely made up of interest and charges paid during the agreed loan period (and refinancing), the cap component that limits these changes has the greatest effect on firms (in our recommended structure, the initial cost cap).
- 4.28** In summary, there is a high risk of firms exiting under all the cap scenarios we tested (due to low profitability/losses in the current market). We do, however, expect some offsetting 'dynamic' responses from firms, in their business models, pricing strategies and product offerings. Remaining firms will also benefit from acquiring customers from firms that have exited.

Impact on customers

- 4.29** We described in Chapter 3 the characteristics of customers who take out HCSTC. Taking these into account, as well as our other research, we have:
- assessed the extent of harm to consumers;
 - considered what options there are for consumers who would no longer have access to HCSTC under a cap; and
 - whether they would be better or worse off without HCSTC.

Evidence of harm: to consumers who just qualify for HCSTC

- 4.30** We believe there is clear evidence that HCSTC use causes harm to borrowers who just qualify for HCSTC loans (i.e. have relatively low credit scores).
- **Late payment and non-payment:** There is currently a greater than 40% chance that a first loan will not be fully paid back and a 20% risk that any subsequent loan will not be paid back. Evidence shows that debt in arrears on unsecured loans leads to worsening mental health and decreasing overall life satisfaction.²⁸
 - **CRA analysis:** Using HCSTC also causes other financial detriment: it increases the likelihood that borrowers miss payments or do not fully pay back other non-HCSTC debt, or exceed their overdraft limits.
 - **Consumer survey:** Among these borrowers, 41% regret using HCSTC. Of the 53% who were happy to use HCSTC only 50% report that they would apply for a HCSTC loan in similar circumstances.
- 4.31** The consumer survey evidence does not show clear evidence of reduced well-being or increased financial distress associated with HCSTC when comparing responses of people who just did or just did not get HCSTC. However, we consider that on balance our evidence shows harm caused to borrowers who only just qualified for HCSTC.

Evidence of harm: to customers with better credit scores who currently get loans

- 4.32** The analysis suggests that the harmful effects of HCSTC are lower for borrowers with a better credit score, but they do not disappear. See the Technical Annexes for specific estimates for different cap levels.

²⁸ See the CBA, Annex 1, paragraph 1.125.

- **Late payment and non-payment:** Customers with better credit scores also have a relatively high chance of never fully paying back their HCSTC loan. Even if customers do pay back their first loan there is a very high chance of non-payment on any subsequent loan of around 50%
- **CRA analysis:** Using HCSTC causes other financial detriment but these effects are less severe than for customers who just qualify for HCSTC
- **Consumer survey:** Analysis shows lowers levels of regret and higher willingness to take out loans again when compared to consumers with lower credit scores, but regret remains material at 31% (and 19% for borrowers with very high risk scores)

Benefits of using HCSTC (costs of a price cap)

- 4.33** To get a balanced view of consumer harm, we also considered the benefits of HCSTC use. The direct benefit of HCSTC for consumers who pay back their loans is the net effect of the benefit from immediate increased consumption minus the cost of decreased consumption later.
- 4.34** For HCSTC to be beneficial for those that pay back, there must be a strong benefit from consuming earlier compared to later. This is true for all credit but is particularly the case for HCSTC because of the considerable expense and the short duration. This borrowing can certainly be beneficial in situations such as emergencies; for example, if a person's boiler breaks in winter and needs repair.
- 4.35** However, comprehensive analysis of CRA data and many alternative consumer survey outcomes measures, such as welfare or financial distress measures, does not find evidence of much consumer benefit of using HCSTC. For example, we do not find significant beneficial effects on reported well-being from accessing HCSTC. We do, however, show that consumers find the main alternative source of borrowing, from friends and family, to be uncomfortable. (Though only a minority of consumers use this alternative, most do without whatever they had intended to purchase.) We also find that for one month after borrowing, HCSTC borrowers at the margin are less likely to exceed their overdraft limit (although they are persistently more likely to exceed their limit after three months). Therefore, the benefits of accessing HCSTC appear short lived and relatively circumscribed.

Summary of the findings from our research on the extent of harm

- 4.36** On balance, we believe there is clear evidence of worse outcomes of using HCSTC for borrowers who just qualified for HCSTC, driven mainly by the large percentage of these borrowers who subsequently cannot pay back their loan or have other payment difficulties.
- 4.37** We find no evidence of a negative or positive impact from lack of HCSTC access on a variety of welfare and financial measures. There are some indicators of benefits from HCSTC for some borrowers in the CRA data, but they tend to last for a short period of time.
- 4.38** For higher creditworthiness consumers, the risk of negative outcomes for borrowers reduces, but does not diminish completely.
- 4.39** We have therefore concluded that a price cap with the right structure and level can mitigate the harm arising from excessive charges in the following ways:
- changing firms' incentives and so discouraging them from lending to people with a very high risk of default and increased risk of other negative outcomes

- lowering prices for borrowers who pay back on time, who are at lower risk of negative outcomes, and so increasing the net benefits of using HCSTC; and
- stopping borrowers getting into debt spirals due to excessive default fees and interest

What options are there for consumers who would no longer have access to HCSTC?

- 4.40** Our survey results and CRA data analysis show consumers have limited other options for accessing formal credit. The CRA data analysis finds no substitution to other formal sources of credit for those who are denied loans apart from a small increase in the frequency that consumers go over their overdraft limit in the month of application (which then becomes a decrease of the same magnitude that persists from month three onwards).
- 4.41** The consumer survey finds that only 36% of customers at the margin of receiving loans, and 45% with higher credit scores, have an overdraft facility.
- 4.42** The survey results indicate that, if consumers no longer had access to HCSTC, approximately 60% would not borrow, 25-30% would go to family and friends (we have taken steps to differentiate between 'friends' and 'illegal lenders'), and around 10% would borrow from formal sources of credit, and 5-10% would find funds in other ways (e.g. decrease savings).
- 4.43** Strong concerns have been voiced that consumers denied HCSTC will turn to illegal money lending as an alternative. We have assessed the risks of people turning to illegal money lenders, as a result of loss of access to HCSTC, in several ways: through consumer survey, desk-based analysis of publicly published research on the topic and interviews with international regulators.
- 4.44** Our survey found that fewer than 5% of people turned down for HCSTC use had considered using an illegal money lender. However, fewer than 2% of these people said they had attempted to borrow from or had outstanding debts with unlicensed lenders.²⁹ This is broadly consistent with findings elsewhere. For example, Bristol University's consumer survey found that 1% of online and 2% of retail payday loan customers said they considered using an illegal money lender.³⁰ Another large study, which looked at the impact of price restrictions across EU countries, found inconclusive evidence that such restrictions led to a substantial illegal market.³¹ Evidence on experience in other countries (see the final section of this chapter) is also inconclusive.
- 4.45** We have not found a significant link between people considering or having used illegal money lenders and being rejected for HCSTC. Our consumer survey found that 3.3% of consumers who got loans at the margin said they considered borrowing from an illegal money lender (not including responses where consumers considered an illegal money lender to be a licensed lender). This compares to 4.7% of consumers who were marginally rejected for loans. Although there is a difference in these figures, it is not statistically significant and we do not find significant differences when using more robust statistical methods. We find that a low percentage of our sample (under 2%) reported having used an illegal lender since July 2013 – again there were not significant differences found in this variable between consumers who marginally did and did not get loans (1% and 1.4% respectively).
- 4.46** We recognise that consumers would normally be reluctant to report using illegal lenders, so the results of our consumer survey, as well as others, may underestimate the numbers. We also acknowledge that even if very few consumers use illegal money lending as a result of the cap,

²⁹ The survey questions related to attempted and actual borrowing, and specifically differentiated between family members, friends and unlicensed lenders.

³⁰ *The impact on business and consumers of a cap on the total cost of credit*, Bristol University, 2013, p. 64

³¹ Iff/ZEW (2010), *Study on interest rate restrictions in the EU*, Final report, p.269.

the consequences for those consumers and their families are likely to be very serious, including threats, intimidation and violence. As stated in Chapter 8, we will continue to work closely with the Illegal Money Lending team to monitor trends in illegal lending before and after the cap comes into effect, and will take targeted action where necessary.

Are consumers who would no longer have access to HCSTC better or worse off?

- 4.47** The evidence on consumer harm and benefits, for consumers who just qualify for HCSTC, indicates that, on balance, they would benefit from no longer having access to HCSTC.
- 4.48** Removal of access to HCSTC would eliminate the direct costs arising from late and non-payment. And it would also lead to consumers avoiding other forms of financial detriment caused by HCSTC use. In particular, consumers will no longer be faced with an elevated risk of missing payments on, and failing to fully pay back, non-HCSTC loans or exceeding their overdraft limits. Consumers will also no longer experience the regret associated with HCSTC use. We do not find from the consumer survey that consumers' general well-being is significantly affected (positively or negatively) by a lack of access to HCSTC.
- 4.49** These benefits must be weighed against the costs. Consumers will no longer have access to HCSTC as a means of bringing forward consumption. To the extent that consumption funded by HCSTC is needed in the short-term, consumers will be worse off by this consumption being delayed. However, consumers will no longer pay interest and charges on HCSTC loans which will be reflected in higher overall consumption for consumers.
- 4.50** On balance, we judge that the benefits of a cap are greater than the costs and so that consumers who just qualify for HCSTC will be better off by no longer having access to HCSTC. We find that this is true for consumers who just qualify currently and those that would just qualify after adjusting for changes to the market arising from our rules set out in PS14/3.
- 4.51** For borrowers with better credit scores, the picture is less clear cut. The level of harm from HCSTC use is less severe than for borrowers who just qualify for HCSTC; rates of late and non-payment are lower, and the increased likelihood of financial detriment in the form of late or non-payment of non-HCSTC and exceeding overdraft limit is less.
- 4.52** The costs of HCSTC withdrawal may also be lower for these borrowers. Although they would be unable to borrow via HCSTC, their better credit score position implies they are most likely have access to other credit substitutes. Hence the negative welfare impact associated with removal of HCSTC may be less.
- 4.53** Overall, borrowers with higher credit scores would experience smaller benefits from no longer having access to HCSTC but perhaps also smaller costs. For a particular structure and level of the cap, we must judge – based on the evidence on the various costs and benefits – whether, on balance, access to HCSTC makes consumers better or worse off. Accessing HCSTC at lower prices may tip the balance in favour of retaining access.
- 4.54** A full discussion of our findings on the costs and benefits of loss of access to HCSTC is set out in the CBA, Annex 1.

Q1: Do you have any comments on our general approach to developing our proposals for the price cap?

International comparisons

- 4.55** To help us develop our proposals, we also sought to understand and draw lessons from other countries' experiences of setting price caps. In the US, caps are the responsibility of the individual states with 35 states having a cap in place. In Canada, similarly this is a provincial matter, with nearly all having a cap. In the EU, a majority of Member States have a cap, as do Japan and Australia.
- 4.56** Different countries have taken different approaches to the design and level of a cap. Some have a form of interest rate cap; others have particular caps for certain activities, such as a cap on default fees. We have set out our analysis of other countries' experiences and what lessons they offer below and in Annex 4.
- 4.57** We must be cautious when drawing conclusions from comparing other countries and their experiences of price caps with the UK market. The market, legal and social structures, and regulatory frameworks vary considerably across the countries in our case studies, and this significantly influences the impact a price cap may have on consumers and the industry.
- 4.58** However, even though each country has implemented price caps with varying degrees of success, we have identified some common lessons, in particular:
- Price caps generally cause some market exit. However, larger firms tend to offset this impact by adapting their business models/products and diversifying into other business areas, such as pawn broking, as was seen in Australia and Canada. In some jurisdictions firms employed various avoidance tactics to circumvent the cap (e.g. selling ancillary services with the loan, as seen in Nova Scotia).
 - Most of the international regulators we spoke to said that they did not empirically test the impact of the cap on consumers.³² Those who introduced caps more recently, such as Finland and Australia, are planning to do consumer research within or after two years from the implementation of the cap.
 - In countries where caps have been in place for longer, there is some evidence that suggests that there was a rise in the number of HCSTC customers, as the price of the loans went down, because of the cap making these loans more attractive, for example in Florida.
 - The structure of the cap is important in determining outcomes and opportunities for gaming. For example, in Finland some firms avoid the APR cap by moving to revolving credit products, where the APR calculation is more complex and certain costs might be hidden as a result.
 - There is a general lack of evidence on the impact of price caps on illegal money lending, with the exception of the emergence of unlicensed online companies in US, in particular.

³² We are aware, however, of extensive academic literature on the impact of price cap on consumers, particularly in US, which produced conflicting results. See *Cost benefit analysis, Annex 1, p. 73*.

5

Our proposals

In this chapter we explain the details of our proposed price cap and its three components, and our rationale behind the proposals. We believe that our proposals secure the appropriate degree of protection for borrowers against excessive charges, in line with the duty given to us by Parliament.

We also set out what lending is covered by the cap under our definition of high-cost short-term credit.

5.1 We are proposing a price cap with three components:

- 1.** An **initial cost cap of 0.8%** of the outstanding principal per day, on all interest and fees charged during the agreed loan duration³³ and when refinancing.
 - The initial cost cap will be calculated as a percentage of the outstanding principal according to the number of days of the loan.
 - Firms can structure their charges under the cap in any way they choose, e.g. a portion could be upfront fees or rollover fees.³⁴
- 2.** A cap for those in **default**³⁵ of:
 - A total of £15 on fixed charges.
 - Interest at the same rate as the initial cost cap calculated per day on outstanding principal and fixed default charges.³⁶
- 3.** A total cost cap of 100% of the total amount borrowed applying to all interest, fees and charges. Therefore the maximum anyone could ever pay on an individual loan in interest, fees and charges would be 100% of the original principal. A consumer borrowing £100 for 30 days would pay a maximum of:
 - £24 during the agreed loan duration.
 - Up to £15 fixed fees, if the loan is overdue.

³³ See paragraph 5.81 for details of how the cap applies to loans repaid early. See CONC 5A.2.3R (Appendix 1) which sets out the period for calculating the cap based on the earlier of when repayment is due under the agreement (unless it is postponed in which case it is that later date) or the date credit is repaid.

³⁴ Firms can charge the full amount under the cap calculated according to the agreed loan duration at any point during the loan.

³⁵ This applies to circumstances where the borrower fails to pay on the date required.

³⁶ Note that section 93 of the CCA provides that interest in default cannot exceed the rate of interest included in the Total Charge for Credit. This prohibits a firm from increasing the rate of interest on sums in default. So, if a firm chooses to charge 0.6% per day on the agreed duration, it may not increase this rate on default.

- Maximum default interest charge of 0.8% per day, up to £61 (only if the loan remained unpaid for 67 days beyond the agreed loan duration).

5.2 In order to protect consumers from escalating charges, firms may not charge compound interest when calculating the cap. Allowing compound interest would also increase the complexity of the cap.

Figure 5.1: illustration of costs to consumers of proposed cap for a £100 loan

Loan duration, months	Loan duration, days	Initial cap, £	Fixed default charge, £	Max default interest charges up to 100% total cost cap ³⁶ , £	APR (representative not actual cost / excludes default charges)
0.5	14	11.2	15	73.8	1,492%
1	30	24	15	61	1,270%
2	60	48	15	37	1,270%
3	90	72	15	13	1,270%

5.3 The illustration of two and three-month-loans assumes that the principal is paid in a single payment at the end of the loan duration. The impact is different on instalment loans with declining principal. Table 5.1 at the end of this chapter sets out how the cap will apply to these loans, to topped-up-loans, refinanced loans and running account credit.

Using the APR calculation

For our proposed cap, the APR is 1,270% for a 30 day £100 loan. But this is not the actual cost – the borrower does not have to pay back £1,270 in interest and charges.

The APR is a standardised way of showing relative costs of different credit agreements, expressed on an annual basis. Short-term loans tend to have high APRs because the costs are high relative to the amount borrowed and the duration of the loan – even if the actual cost to the consumer is less than for a longer-term loan with a lower APR. APR includes the charges a borrower must pay on the loan if they pay back on time. It does not include optional or contingent charges like rollover fees or any charges paid in default. Rollover fees and other charges paid during the agreed duration are included under our initial cost cap. Charges for failure to pay on the due date are included under the default cap.

Why we have chosen this approach

5.4 We believe our proposal provides the right protection for consumers:

- The **level of the price cap** discourages firms from lending to borrowers who will be harmed by HCSTC. It will have a significant impact on firms that have business models based on lending to those harmed by HCSTC.

³⁷ Interest in default can be applied to the fixed default charge as well as outstanding principal.

- It is **simple to understand**. This is essential for consistent application of the cap by firms and may help consumers identify breaches of the cap. In particular, it will be straightforward for consumers to work out if they have been charged more than twice what they have borrowed in breach of the total cost cap and whether the £15 fixed default cap has been exceeded.
 - The **initial cost cap** protects borrowers who pay back on time from excessive charges.
 - The **default cap** limits costs for borrowers paying back late, whilst ensuring there is still an incentive to pay back on time.
 - The **total cost cap** limits escalating interest, fees and charges, mitigating debt spirals.
- 5.5** The initial cost cap in particular has a significant impact on firms, but this is necessary to protect consumers.
- 5.6** We have set out in Table 5.2 at the end of this chapter, other options considered and why we are not proposing them.

The initial cost cap

- 5.7** The initial cost cap limits charges for all HCSTC borrowers. Capping these costs is the main driver in changing firms' incentives for lending to the riskiest borrowers.
- 5.8** A daily calculation of the allowable charge means that the costs of the loan for the consumer are directly proportionate to the duration. An initial cost cap calculated on a daily basis allows firms to price according to the length of the loan. We considered a monthly or weekly calculation, but this would, for example, enable firms to charge two months' charge for a one month plus one day loan duration.
- 5.9** Calculating the initial cost cap according to a percentage of the principal means pricing is proportionate to the size of the loan, so consumers only pay higher prices if they borrow more. This is also fair for firms as in general their costs increase with the size of the loan.
- 5.10** However, because the initial cost cap is calculated as a percentage of the principal, it could impact on the supply of the smallest loans (a few firms offer loans below £50 and about 10% of loans in our sample were for less than £50), particularly over shorter durations (30 days or less). A small fixed element to the initial cost cap could help make these loans viable. We are not proposing this because, on balance, we consider that the initial cost cap should be applied in a way that is proportionate to the size and duration of the loan, to provide the appropriate degree of protection for consumers. A fixed element could also encourage repeat lending of small, short loans in circumstances where the borrower would be better served by a single, longer loan.

The level of the initial cost cap

- 5.11** The level of the initial cost cap is a balance of a number of factors:
- Consumer protection from loss of access to HCSTC because the risks of using HCSTC are too high.
 - Benefits to consumers from paying lower prices.

- The potential impact of significantly limiting the high-street distribution channel.
- The detrimental impact on consumers of the loss of all HCSTC providers.

5.12 We looked at a range of initial cost caps between 0.4% per day and 1% per day of principal. In our judgement, 0.8% initial cost cap achieves the right balance of these factors.

Impact of a 0.8% initial cost cap

5.13 Firms generate most of their revenues from interest and charges made during the agreed loan duration (or refinancing period). This component of the cap therefore has the greatest impact on their revenues and so makes the most significant contribution to loss of access to HCSTC.

5.14 The current median revenue per day per loan for the 11 firms³⁸ in our modelling sample is 1.4% for loans shorter than 60 days and 0.6% for loans longer than 60 days.

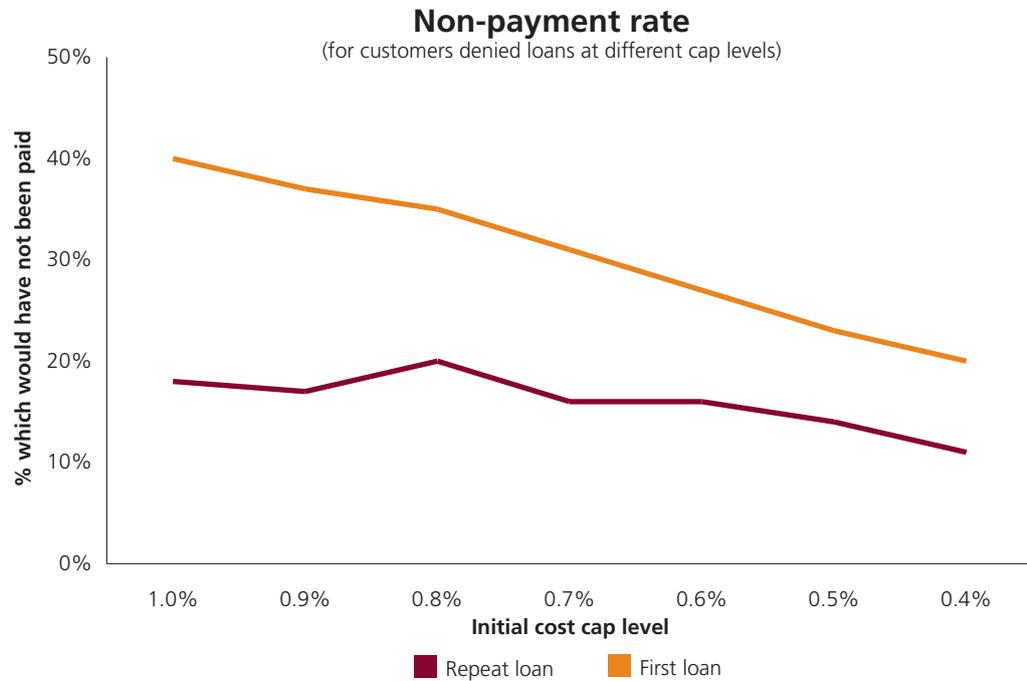
5.15 At a 0.8% initial cost cap, we estimate that a substantial number of consumers will lose access to HCSTC – approximately 11% of consumers who would otherwise be served, around 160,000 individuals. Our assessment of the impact of losing access to HCSTC is therefore critical to the judgement about the level of consumer protection that the 0.8% initial cost cap affords.

5.16 We conclude from the results of our consumer analysis that loss of access will benefit those borrowers who currently only just qualify for HCSTC (i.e. those borrowers with the lowest credit scores). These consumers have a high risk of late or non-payment (on average, greater than 40%) and an increased risk of other negative outcomes (defaulting on non-HCSTC and exceeding overdraft limits). For those with higher credit scores, the costs and benefits of using HCSTC becomes increasingly finely balanced to the point where the risk of negative outcomes diminishes to the extent that these borrowers will benefit from continuing to access credit at a lower price.

5.17 We have used a number of indicators to help us assess what level of cap gets the balance right. Looking at loans that would not be made at 0.8% but would be made if we set the initial cost cap at 0.9%, 35% of first-time loans would not have been fully repaid and 20% of subsequent loans. Figure 5.2 shows how this differs for different levels of initial cost cap. We consider for this group of borrowers as a whole, this is an unacceptably high risk of non-payment and loss of access to HCSTC is net beneficial. At higher levels of initial cap, each borrower in this group would otherwise be exposed to this level of risk of non-payment. Non-payment rates are also a useful proxy for the other indicators of financial detriment: higher non-payment rates indicate higher risk of other negative outcomes. Our baseline for these estimates already takes into account the impact of the rules capping rollovers and CPAs, so they anticipate tightening of lending criteria in response to these rules.

³⁸ 11 legal entities from eight groups.

Figure 5.2 Non-payment rate for loans not made at different levels of initial cost cap (100% total cost cap and default cap at proposed levels)³⁹.

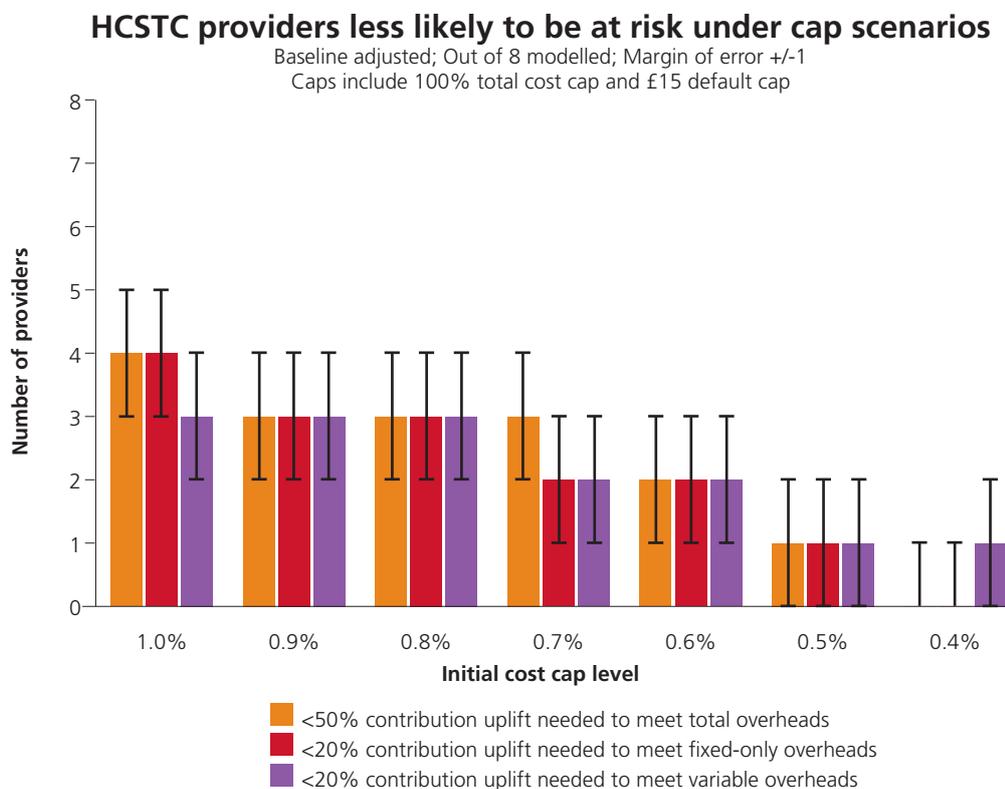


5.18 For initial cost caps lower than 0.8%, risks of non-payment are still high and could be considered unacceptably high. However, we need to consider the impact on firms: at levels below 0.8%, the impact on firms could start to negate the consumer protection effect of the cap because:

- Initial cost caps lower than 0.8% risk leaving only one firm in the market or closing down the HCSTC market.
- Initial cost caps lower than 0.8% risk closing down the high street distribution channel (see Figure 5.3).

³⁹ The figure shows our modelled estimates of non-payment rates for loans not made at different initial cost cap levels. For example the figure shows that we estimate that first loans that would have been granted at a 0.9% rate but would not be granted at a 0.8% rate have a 35% chance of non-payment. These estimated include a 100% total cost cap and default cap at proposed levels.

Figure 5.3 HCSTC providers less likely to be at risk of exit under different levels of initial cost cap (100% total cost cap and default cap at proposed levels)



- 5.19** We do not think it is desirable to leave consumers entirely without the option of using HCSTC. Our model estimates complete market closure at 0.4% and we consider that at levels below 0.8%, given that our models are estimates and have some uncertainty, there is a risk that fewer than three firms would remain. This risk is greater at lower levels of cap. At an initial cost cap level of 0.8%, we can be more confident that the three largest firms will continue to offer HCSTC, particularly as we would expect all firms to respond to the cap to limit the impact on them, and reduce the risk of exit.
- 5.20** Our model suggests that at caps below 1%, there is a risk that HCSTC will not be distributed through the high street. However, we think there are some offsetting dynamic responses by firms that may mean high-street distribution continues at lower levels of the cap, this being more likely at levels closer to 1%. Firms' potential dynamic responses include changes to pricing structures and products, and changes to acquisition costs. Firms may also benefit if they are able to gain additional customers from those firms that do choose to exit following the cap.
- 5.21** In addition, HCSTC is one of a range of services provided from high-street stores. Data suggests that for many high-street stores, the HCSTC element of the business has made very low or negative levels of profit since 2012. It is possible that even where our analysis suggests HCSTC would be at risk of being distributed through the high street, such firms may continue to offer HCSTC loans, at least in the short-term, as part of the range of products and services they offer. We therefore consider that at 0.8%, there is a possibility that one high-street firm can continue to provide HCSTC.

- 5.22** This is an important consideration because the high street accounts for a substantial minority of borrowers (around 20%). Our analysis suggests that the extent to which some high-street borrowers are able to switch online is likely to be limited.
- 5.23** Not all high-street borrowers would benefit from losing access to HCSTC and so the level of cap needs to trade-off the overall benefits to HCSTC borrowers of a lower initial cost cap and the potential detriment to high-street borrowers from complete loss of access to HCSTC. High-street borrowers also have a higher proportion of women and ethnic minorities and there are therefore relevant considerations in respect of equalities legislation.⁴⁰
- 5.24** We have considered a higher cap for high-street distribution, but we are not proposing this. We consider that the need for protection from excessive charges is of greater importance than lowering the risk of high-street firms exiting the market by allowing them to charge higher prices than online firms. The impact of excessive charges on high-street borrowers will be similar to that of online borrowers, although given the slightly worse financial position of an average high-street borrower it could arguably be worse. Having a different cap depending on the distribution channel could also open up opportunities for gaming the cap that could be difficult to mitigate.
- 5.25** Therefore, 0.8% gives a substantial improvement in consumer protection from high levels of default or non-payment, but is not so low as to rule out the continuation of the high-street distribution channel or risk complete closure of HCSTC markets. There is also sufficient margin away from the point where our modelling estimates a risk of exit of all firms.

Competition implications

- 5.26** At a cap of 0.8% per day (for a given default cap and total cost cap), we expect a large number of providers to be at risk of exit. A small number of firms already account for the majority of revenue in the market, and substantial exit following the cap would further increase levels of concentration. As noted above, our modelling suggests it is possible that as few as three online providers may continue to operate with a cap of 0.8%: we expect a large number of providers to be at risk of exit.
- 5.27** For online providers, we would not expect this level of supply to significantly reduce competition relative to current levels. The CMA found that the levels of non-price competition appeared consistent with a well-functioning market, but the degree of price competition was limited.
- 5.28** We expect competition will not be lessened in the future because:
- The cap itself will prevent prices rising, if there is upwards pressure due to the oligopolistic nature of the online market in future.
 - We expect the degree of non-price competition will not be lessened, on the basis that we expect consumer demand to continue to focus on the non-price aspects of product offerings (such as the speed of access to funds) in the future.
 - As forthcoming CMA remedies will tackle the currently limited degree of price competition that takes place, resulting in potentially greater price competition in the future.
- 5.29** In practice we may expect the number of online firms that continue to operate to be greater than implied by our static exit analysis, following changes to business models. For the high street, predicting the number of lenders that will continue to operate is subject to particular

⁴⁰ Our Equality Impact Assessment in Annex 5 provides further information.

uncertainty. If a single high-street supplier remained, we believe online providers would provide a competitive constraint, and the cap itself would provide a degree of protection for high-street consumers. However, the extent to which (some) high-street customers are able to switch online is likely to be limited. Currently, the CMA estimates that 12% of consumers use both online and high-street lenders. Our own data shows that for those consumers whose first use of HCSTC was through a high-street lender in Q1 2012, 24% subsequently use an online provider.

- 5.30** This competition assessment applies to the cap as a package (including a default cap and total cost of credit cap, as well as the initial cost cap shown here).

The default cap

- 5.31** The default cap limits default charges and so protects borrowers in difficult financial circumstances from excessive charges. Even if borrowers are unable to pay back default charges, there is an impact on their welfare from the stress of their mounting debts. However, it is appropriate that borrowers have an incentive to repay on time.
- 5.32** Firms incur costs at the point of late payment, unrelated to the size of the loan. We think it is therefore reasonable not to prevent them to an extent to recover costs directly from borrowers in default, providing these are not excessive. Firms also have to continue to service unpaid debt and we think it is therefore reasonable not to prevent them continuing to charge interest, providing this is not excessive and they treat customers in default or arrears difficulties with forbearance and due consideration, as required under CONC 7.3.4R. On that basis, we have not banned charges where a borrower is in default.
- 5.33** However, we consider that the relationship with firms' costs is not the most important factor when considering the appropriate degree of protection for consumers from excessive default charges. Charges which are cost-reflective can still be excessive if they result in an unacceptable risk of harm to consumers.
- 5.34** Many borrowers in our sample covering 2012 and 2013 incur late payment charges: our data shows that approximately 70% of individuals incurred at least one late payment on their first or subsequent loans. The impact of charges on consumers in default can also be significant: in most cases, defaulting on a loan is a sign of financial difficulty. These difficulties are compounded as charges increase. Unsurprisingly, people in problem debt (those with unpaid HCSTC debt greater than 100% of principal) reported in our consumer survey significantly lower levels of welfare and higher financial distress. Evidence from other sources also shows that debt in arrears on unsecured loans leads to worsening mental health and decreasing overall life satisfaction.⁴¹

The proposed level of default cap

- 5.35** Most firms have a fixed charge on late payment:⁴² most prices are in two clusters between £12-15 and £25-30 (from the CMA's sample of 30 products). The lowest price in the sample was £8, but for this product, further charges (totalling £50) are made for two further late payments.⁴³ Firms make further fixed charges for 11 products in the sample, typically conditional on the length of the late payment period. These range from £10 to £45.

⁴¹ See the CBA, Annex 1.

⁴² Payday lending pricing working paper, Competition Commission, February 2014, p.11.

⁴³ Payday lending pricing working paper, Competition Commission, February 2014, Table 4, p.14.

- 5.36** Most firms also continue to charge interest at the same rate as during the agreed loan duration. The CCA prevents firms from charging interest at a higher amount. This would continue to apply under the cap.
- 5.37** We consider it is reasonable in this context not to prevent firms charging interest in default to the extent it accrues up to the same level of interest per day as a loan accrues during the agreed loan duration, as long as the level of interest is not excessive and so long as firms treat borrowers in default or arrears difficulties with forbearance and due consideration, as required under CONC 7.3.4R. The total cost cap is the primary means of providing consumer protection when borrowers are in default, supported by the rules in CONC, in particular rule 7.7.5R which requires charges in default to reflect reasonable costs.

Impact of the default cap

- 5.38** We tested various scenarios for a fixed default fee cap (£10, £15, £25, £40) and found limited impact on firms of these various levels. This is because firms charge fees but collection rates are relatively low.
- 5.39** Although the impact of different levels of fixed default fee cap on firms is limited, the impact on consumers can be significant, particularly on those taking out smaller loans. Around 30% of loans in our sample for 2013 were for £100 or less, so a £30 charge would be a significant proportion of the principal, plus additional interest charge.
- 5.40** No firms in the CMA's sample charge £10 as a late payment fee for the first late payment. We therefore think that £15 is a proportionate level for the fixed charge, reflecting the need to provide consumers with an incentive to pay back on time, whilst also providing the right incentive to firms by not rewarding failure to properly assess affordability.
- 5.41** Our rule will still apply that requires firms to limit their charges to reasonable costs. Therefore the cap would be a ceiling and firms may need to make lower charges.
- 5.42** We propose to allow firms to distribute the fixed charge during the course of default as they choose (so they may levy several charges where the borrower fails to make a payment on time, so long as the total of the charge does not exceed £15). The £15 cumulative cap would impact on the pricing of all the firms who currently charge further fixed fees in the CMA's sample (although our modelling shows only a limited difference in impact on firms revenues if they are able to charge fixed fees over £15).

Competition implications

- 5.43** The CMA has found that customer demand is particularly insensitive to fees and charges incurred if customers do not repay their loan in full on time. Customers tend to be less aware of these potential costs of borrowing than they are of the headline interest rate when choosing providers. The CMA has proposed a remedy to improve the transparency of default charges, and customers' understanding of these charges. Our simple default cap structure should support the CMA's goal of improved understanding of default fees.

The total cost of credit cap

- 5.44** The primary purpose of the total cost cap is to protect borrowers from escalating interest and charges in two circumstances:

- on longer duration loans, where interest and charges can build up to excessive levels; and
 - to prevent late payment, default fees and interest from escalating to excessive levels.
- 5.45** It has some drawbacks: for shorter loans, a firm could still charge significant default charges before reaching the total cost cap (see Figure 5.1 above). To address this, we could have a separate fixed percentage cap for initial and default caps (e.g. a total initial cost cap of 80% of principal and a total default cap of 20% of principal), but on balance we consider this too complex for firms to implement and consumers to understand. We welcome views on this.
- 5.46** The combination of the initial cost cap with total cost cap requires firms to make a trade-off between loan duration and the price they charge. We believe this is necessary to protect consumers from interest and charges building up to excessive levels whilst allowing loans with more manageable payment periods. It is open to firms to choose their pricing below the cap in order to have longer loan durations. This is in line with current market practice: our data shows the revenue per day for loans over 60 days is substantially lower than for shorter loans (see paragraph 5.14). The same consumer protection considerations apply to refinanced loans and so the total cost cap will apply cumulatively to a refinanced loan.
- 5.47** We considered structuring the initial cap so that after a certain period, say one month, the daily rate of the cap would be lower. We are not proposing this because it could incentivise repeat borrowing. In our proposed structure, the interaction of the initial cost cap with the total cost cap means that firms can choose their pricing below the cap in order to extend loan duration, rather than the level being specified in the rules.
- 5.48** The proposed structure of the total cost cap aims not to create competitive distortions in terms of loan duration, affordability, and refinancing.
- 5.49** In relation to default interest and fees, the impact on firms largely depends on the level of the total cost cap, discussed below.

The level of the cap

- 5.50** We considered a range of total cost cap levels between 50% and 200%.
- 5.51** At 50%, there is a strict constraint on the length of loans, potentially limiting loans to between one and two months (depending on whether firms want to retain the option to charge default fees). We consider this to be an inappropriate impact on consumer choice.
- 5.52** We consider that a 200% total cost cap is inadequate protection against spiraling costs for those who struggle to repay, given the findings of our consumer survey which show that borrowers with greater than 100% of principal in bad debt report significantly lower welfare and higher financial distress.
- 5.53** We therefore considered options around the 100% range. Looking below this, at 75%, loan duration could be restricted to between two and three months and at 100% approximately three to four months. This is a finely balanced judgement, but we consider that a cap that potentially restricts loans to between two or three months does not strike the right balance between limiting excessive charges and providing consumers with options for longer term loans.
- 5.54** A 100% total cost cap is simpler than 75%. It is relatively straightforward for consumers to understand that even if they fail to repay on time they will never pay back in total more than

twice what they borrowed. This is important in helping consumers to provide a constraint on firms – they will find it easier to see if firms are charging them more.

Impact of different levels of total cost cap

- 5.55** We modelled the impact of a range of total cost caps on firms' revenues, profits, number of borrowers served and value of loans. Our modelling suggests limited changes to the risk of exit between 75%, 100% and 200% caps, but a total cost cap of 50% would significantly increase the risk of large firms exiting. Taking into account a margin of error, 75% appears too close to levels at which more large firms could exit, which could significantly reduce access.
- 5.56** We therefore judge that 100% is the appropriate level of protection, protecting nearly one third of the people not fully paying back their loans in our sample in addition to the limits imposed by the default cap, whilst allowing enough firms to continue offering HCSTC and for different lengths.

Competition implications

- 5.57** Modelling suggests limited changes to risk of exit between 100% and 200% caps, but that a total cost cap of 50% would significantly increase the number of large firms at risk of exit. While the nature and degree of competition may be sustained even with few firms in the market (implied under a 50% total cost cap), this would increase the risk that firms could not adapt their business models following the cap to remain in the market, or otherwise compete.

Application of the price cap

Products included under the price cap

5.58 The legislation does not define 'high-cost short-term credit'. We propose using the definition in our current rules, which we were consulting on at the time the legislation was agreed:

a regulated credit agreement:

- (a) which is a borrower-lender agreement or a P2P agreement;
- (b) in relation to which the APR is equal to or exceeds 100%;
- (c) either:
 - (i) in relation to which a financial promotion indicates (by express words or otherwise) that the credit is to be provided for any period up to a maximum of 12 months or otherwise indicates (by express words or otherwise) that the credit is to be provided for a short term; or
 - (ii) under which the credit is due to be repaid or substantially repaid within a maximum of 12 months of the date on which the credit is advanced;
- (d) which is not secured by a mortgage, charge or pledge; and
- (e) which is not:
 - (i) a credit agreement in relation to which the lender is a community finance organisation; or
 - (ii) a home credit loan agreement, a bill of sale loan agreement or a borrower-lender agreement enabling a borrower to overdraw on a current account or arising where the holder of a current account overdraws on the account without a pre-arranged overdraft or exceeds a pre-arranged overdraft limit.

5.59 We considered changing the definition of 'short-term' to cover a longer period. We are seeing evidence that firms are developing products with loan durations outside our definition which could be harmful to consumers because of the prolonged period of high charges. However, extending the definition of HCSTC to include loans substantially paid back in periods longer than 12 months starts to undermine the principle that the cap should cover 'short-term' products. We consider that there are risks arising from these extended products, but that we should look separately at our full range of regulatory tools to deal with them. This could include similar rules to those applying to HCSTC. Our affordability rules are well-placed to deal with some of the problems arising from these products – this is discussed further in Chapter 6.

5.60 We have considered whether to include other forms of high-cost credit which are excluded from the current definition (home-collected credit, pawn broking, log book loans and overdraft charges) and open-ended running account credit (most of which e.g. credit cards are excluded because they are open-ended and not substantially repayable in 12 months). We propose excluding these from the price cap for the time being but will keep this under review.

- 5.61** The products currently included in the HCSTC definition are a broadly similar set of products, which can be considered together when considering the detriment they cause and the tools that can be used to deal with that detriment.
- 5.62** Products currently excluded from the definition are quite distinct in the nature of the problems that they can cause for consumer and the causes of those problems. Our evidence, supported by the CMA's provisional findings⁴⁴, suggests that other credit products are not substitutes for HCSTC.
- 5.63** We are carrying out work into other credit products because we are concerned about the potential indebtedness they may cause. We want to ensure we understand the causes of problems with these other products and look at the wide range of regulatory options open to us to make sure we are using the best tools to deal with those problems. Work is already ongoing in a number of key areas.
- 5.64** In April, we published findings from our research that shows overdrafts still aren't providing good value and consumers are confused about costs. We will look into how providers set and monitor overdraft limits and their governance and strategies for doing so. As part of these next steps, we will also consider making some voluntary measures mandatory in Autumn 2014. We will also work alongside the CMA in its current work updating the OFT's 2013 review of the current account market.
- 5.65** There will be a market study of credit cards later this year (open-ended running accounts).
- 5.66** The Competition Commission market assessment on home-collected credit has already imposed remedies on this market to improve competition. We will look at these firms in the near future as part of our supervisory engagement.

Application to existing agreements

- 5.67** We do not propose applying the price cap to existing HCSTC agreements, but only to those made on or after 2 January 2015. This is reasonable as firms will need to change their lending criteria (and possibly make other changes to their business models) in order to respond to the price cap.
- 5.68** Any agreements made on or after 2 January 2015 that modify HCSTC agreements made before this date (e.g. if the loan is rolled over by a variation or supplemental agreement) must comply with the price cap. The draft rules also apply to the exercise of a contractual power on or after 2 January 2015 in an HCSTC agreement made before 2 January 2015 that varies or supplements the agreement.

Application to brokerage, debt collection charges and other ancillary charges

- 5.69** The price cap applies to any brokerage charges where the lender receives all or part of the brokerage charge and also where the broker is a member of the lender's group.
- 5.70** Debt collection charges made under the terms of the loan agreement are also included in the cap, including where a third party debt collector levies a direct charge on the consumer.
- 5.71** The price cap also applies to charges for ancillary services, such as services related to the processing the application, the transmission of money lent and insurance or insurance-like services. This is necessary in order to avoid the risk of gaming the cap through ancillary services.

⁴⁴ *Payday lending market investigation, provisional findings report*, CMA, P.152, June 2014

Repeat borrowing

- 5.72** Our analysis shows significant levels of repeat borrowing. On average, borrowers take out around six HCSTC loans per year from any firm.⁴⁵ Firms suggest that borrowers use HCSTC as an ongoing financial service to meet emergency needs, temporary income shortfalls and occasional expenditure. However, our evidence shows that people use HCSTC for regular, predictable expenditure and do so repeatedly. Borrowers take out a further loan in a relatively short period after they have paid off the first (for example 52% of loans are provided within 14 days of another being paid off). Furthermore, the majority of borrowers, within six months of taking out their first loan, will have unpaid debt on HCSTC. We are therefore concerned that repeat borrowing could indicate patterns of dependency on HCSTC that is harmful to the borrower – repeatedly paying high prices to access loans in order to make up shortfalls in their income. Therefore, we have considered whether it is appropriate to bring repeat borrowing (loans made by the same firm) under the total cost cap.
- 5.73** In order to be effective, the total cost cap would need to be calculated from the principal of the first loan. This would be a significant constraint on lending, particularly as the new principal could be higher. It would also add considerable complexity to the price cap. If the total cost cap was calculated with reference to the total amount borrowed, it would not have any effect because the total cost cap would be reset for the new loan because the previous loan had been paid off (this is different from refinancing where there will be an amount outstanding under the original loan duration which is included in the total cost cap for the refinanced loan). For these reasons, we are not proposing to apply the total cost cap cumulatively to repeat loans. We also looked at some alternatives for dealing with repeat borrowing:
- Capping the number of times a borrower can borrow from the same firm in a given period. This would be a very stringent measure and we are not proposing it at this time. Generally repeat loans are more profitable for firms than loans to first time customers, so this could lead to greater risks of firm exit and potential closure of the HCSTC market. Consumers could also simply use another lender.
 - Capping the number of times a borrower can borrow from any firm in a given period. This is a common solution in many US states, but again would be a very stringent measure.
- 5.74** Our conclusion is that the most appropriate way to use the price cap to deal with repeat borrowing is by applying the price cap in the same way as for a first loan. This will bring down the costs of borrowing for repeat borrowers. Other tools can be used to deal with detriment caused by repeat borrowing, particularly robust supervision of affordability requirements. Our affordability rules are an important constraint on preventing borrowers becoming trapped in debt cycles of repeat borrowing and we will take supervisory action to ensure that firms are making responsible assessments of the sustainability of borrowing in the event of repeat borrowing.
- 5.75** We are also considering if we need to change our rules to deal with inappropriate repeat lending which could be used to game our refinancing/rollover cap rules. If a loan is paid back and then a new loan is taken out, our rules do not define this as refinancing and the refinancing cap does not apply. We understand that some firms are repeat lending within periods as short as 20 minutes after the first loan has been paid off – this could be causing detrimental cycles of dependency on repeat borrowing that we need to address.

⁴⁵ Across all individuals uniquely identified in the broader sample of 30 firms.

- 5.76** We will be particularly alert to firms using repeat borrowing to avoid the effects of the total cost cap and will challenge firms with high levels of repeat lending to demonstrate how they identify borrowers whose repeat borrowing behaviour suggests problems with affordability. We will question firms about changes in the number and frequency of repeat loans after the introduction of the price cap and we will not hesitate to take action if we see that firms are using repeat lending as a way to minimise the impact of our price capping requirements.
- 5.77** We also see the benefit of real-time data sharing to enable firms to carry out more accurate affordability assessments and to prevent consumers from taking on multiple loans which they cannot afford to repay. Currently firms cannot be sure that they have an up-to-date picture of a consumer's outstanding HCSTC commitments even if they are using a CRA check. There has been progress, but the industry must do more. We expect the vast majority of firms to participate in real-time data sharing by November and to share data with more than one CRA. By vast majority we mean more than 90% of the current market. If we do not see sufficient progress by November, or CRA coverage does not improve, we will consult on the introduction of data sharing requirements. See Chapter 7 for further information.

Draft rules

- 5.78** The draft rules we are consulting on are in Appendix 1.
- 5.79** Key points to note:
- The rules prohibit 1) entering into agreements that charge prices above the cap and 2) imposing charges above the cap. The latter is a wider category and ensures that debt administrators, debt collectors and peer to peer platforms cannot impose charges under the cap, even though they are not the party that entered into the lending agreement.
 - Borrowers have a right under the CCA to repay before the end of the agreed loan duration, in full or in part. In the event of early repayment, the Early Settlement Regulations⁴⁶ apply to the calculation of the charges applied. So where the Regulations apply borrowers repaying early will be entitled to a rebate in accordance with the Regulations. Note that under the Regulations, the agreed settlement date may be specified by the lender as any day up to 28 days after the borrower has notified the lender that they want to repay early.
 - The draft rules include provisions to deal with avoidance by replacing agreements, varying or supplementing agreements or merely postponing the date of a payment obligation in an HCSTC agreement.
 - The draft rules include within the initial cost cap and the total cost cap charges imposed by credit brokers who are members of the lenders' group or who share some or all of their broking charge with the lender. Charges for ancillary services in connection with the provision of credit are also included in the initial cost cap and the total cost cap.
 - We set out further explanation of the draft on unenforceability and impact on activities in relation to agreements entered into by EEA E-commerce firms in Chapter 6.

⁴⁶ Consumer Credit (Early Settlement) Regulations 2004 (S.I. 2004/1483)

5.80 The draft rules in CONC 5A.4 apply the price cap to peer-to-peer (P2P) platforms. P2P platforms which facilitate lending within the HCSTC definition are caught by our rules for HCSTC on risk warnings, refinancing and CPA caps. Consumers borrowing through P2P platforms need the same protection from excessive charges and so, although P2P platforms are outside our duty to impose a price cap, it is appropriate that we apply the price cap in the same way. We are not aware of any P2P lenders facilitating borrowing within the HCSTC definition at present but firms could start to do so in future.

Q2: Do you have any comments on the proposed price cap structure?

Q3: Do you have any comments on the price cap levels?

Q4: Do you agree with our proposals on repeat borrowing?

Q5: Do you have any comments on the scope of the price cap?

Q6: Do you have any comments on our proposed Handbook rules?

Summary

5.81 Our proposals are our judgement on the structure and level of a price cap, based on supporting in-depth evidence from our analytical work, that meets our statutory duty to provide the appropriate degree of protection for borrowers against excessive charges.

5.82 The structure of the cap is designed to provide protection for borrowers whilst providing some flexibility for firms under the cap. It is designed to be straightforward for consumers to understand and firms to implement.

5.83 Cap levels protect borrowers who will benefit from no longer being able to access HCSTC. Other borrowers will benefit from continued access to HCSTC at a lower price.

5.84 Whilst there will be a significant impact on firms, this is necessary to achieve the appropriate degree of consumer protection. There will, however, still be a viable market in HCSTC: at stricter levels of cap, there is a risk that all firms will exit or only one firm will be left in the market. We consider that there are no other options that provide consumer protection whilst reducing the impact on firms or that are more pro-competitive (see also section 3 of our cost benefit analysis in Annex 1).

Table 5.1 Calculation of the price cap for instalment loans, topped up loans, refinanced loans and running account

Product features	Basis of the calculation of the cap	Impact
<p>Instalment loan with declining principal. Each payment made by the borrower is a combination of interest and principal, so with each payment the borrower pays off some of the money borrowed, along with interest. For some products the payments are uniform and the proportion of interest and principal changes. For others, payments decline as the principal declines uniformly.</p>	<p>Total cost cap: calculated as a percentage of amount the lender actually advances (CONC 5A.2.6R).</p> <p>Initial cost cap: calculated as a percentage of the outstanding principal from the date on which the borrower draws down until repayment is due or the credit is actually repaid (CONC 5A.2.3R)</p>	<p>There is no difference in how the total cost cap impacts single payment and instalment loans.</p> <p>Calculating the initial cost cap based on outstanding principal means that instalment loans with declining principal will generate less revenue for the lender over the same duration as a single payment loan or a loan with interest-only instalments.</p> <p>This could disincentivise lenders to offer products with declining principal, but the alternative – basing the initial cost cap calculation on the total amount borrowed – would mean that the borrower could be paying interest on sums they had already paid back.</p>
<p>Single payment loan with top up Lenders may allow borrowers to borrow more (top up) during the agreed loan duration.</p>	<p>The topped up amount is added to the original principal for the purposes of calculating the total cost cap. So for a £100 loan with a £20 top up, the total cost cap is £120.</p>	<p>The additional amount borrowed increases the amount that can be charged under the total cost cap. We consider it is reasonable to allow the lender to take into account this additional borrowing when calculating the total cost cap.</p>
<p>Refinanced loan A loan is refinanced if it is replaced by another loan (see the Glossary definition in the FCA Handbook for full details).</p>	<p>Charges already incurred in the original agreed duration must be taken into account for the refinanced period.</p> <p>The total cost cap will be based on the higher amount of original principal or the new principal. This accounts for situations where the refinanced loan is larger, because the borrower has borrowed more or where the refinanced loan is smaller, because they have partly paid off the loan.</p> <p>Initial cost cap is based on the actual amount outstanding.</p>	<p>The impact on refinanced loans is the same as if the extended loan duration had been agreed from the outset. If charges from the original loan period did not count towards the total cost cap in the refinanced period, there would be an incentive to refinance rather than agree longer duration loans from the outset.</p> <p>It is reasonable that the lender is able to take into account any additional sums borrowed at refinancing when calculating the total cost cap. It is also reasonable that they are able to take into account the original principal if the refinanced loan is smaller, otherwise the cap has a proportionately greater impact. This could lead to firms discouraging borrowers from part payment of the loan at refinancing.</p>
<p>Running account credit The borrower may draw-down credit up to an agreed credit limit and make repayments of a specified minimum. Cumulative borrowing over the course of the loan may exceed the credit limit. To be within the HCSTC definition, the running account will be for a fixed duration.</p>	<p>We propose that the total cost cap is calculated on the lower of:</p> <ul style="list-style-type: none"> – the credit limit – the maximum amount outstanding. <p>Initial cost cap is based on the actual amount of principal outstanding.</p>	<p>Calculating the total cost cap in this way does not allow the lender to take account of any borrowing which in aggregate, over the duration of the agreement taking into account repayments, exceeds the credit limit. This may make these products less attractive to lenders. However, if the total cost cap is calculated based on the maximum amount outstanding, for loan agreements which allow extensions of duration, there is inadequate constraint on the length of time that the borrower will be charged under the initial cost cap. If the total cost cap is based on the credit limit only, borrowers who borrow less than the credit limit are inadequately protected.</p>

Table 5.2 Other price cap options considered

	Consumer protection	Impact on firms	Competition implications	Conclusion
Total cost cap only	<p>Protects borrowers from charges escalating to more than 100% of principal, but would enable firms to continue to charge high default charges in the early stages of default (subject to the total cost cap level).</p> <p>Based on current pricing levels, no protection from these charges for borrowers paying back on time, as firms could continue to charge current prices on agreed loan duration and refinanced loans.</p> <p>Protects all borrowers from charges accumulating over long loan (and default) durations.</p>	Limited impact on firms' revenue, although impacts on their ability to offer longer duration loans.	<p>Limited impact on revenues; firms could charge current prices. Little incentive for competition to change.</p> <p>Disincentivises long-term loans</p>	Provides no protection for borrowers not in default on shorter loans (e.g. 30 days).
Initial cost cap, total cost cap but no default cap	<p>Indirectly, default costs are capped at the difference between the total cost and initial caps.</p> <p>Protects borrowers from charges escalating to more than 100% of principal, but would enable firms to continue to charge high default charges in the early stages of default (subject to the total cost cap level).</p> <p>Based on current pricing levels, offers protection to borrowers paying back on time, as firms can only charge up to the initial cap.</p> <p>Total cost element protects all borrowers from charges accumulating over long loan (and default) durations.</p>	Default caps above the proposed level have limited impacts on firms' overall revenues. Similar to proposed caps: limited impact on firms' revenue from excluding the default cap; impacts driven by initial and total cost caps.	As set out for the proposed option.	This option does not sufficiently deal with consumer harm arising from default charges.
Default cap, total cost cap, no initial cost cap	<p>Indirectly, initial costs are capped at the difference between the total cost and default caps.</p> <p>Based on current pricing levels, no protection from excessive charges for borrowers paying back on time as firms could charge current prices on agreed loan duration and refinanced loans.</p> <p>Consumers protected from high default charges in the early stages of default (subject to the total cost cap level).</p> <p>Total cost element protects all borrowers from charges accumulating over long loan (and default) durations.</p>	Impact on firms significantly reduced from excluding the initial cost cap.	No material impact on current competition levels as firms could charge current prices on agreed loan duration and refinanced loans.	Provides no protection for borrowers not in default on shorter loans (e.g. 30 days)
Initial cap, no default cap or total cost cap	<p>Protects borrowers who pay back on time as initial charges subject to initial cap.</p> <p>Provides no protection for borrowers from excessive charges accumulated due to loan duration and no protection for borrowers in default.</p>	Excluding the total cost cap removes restriction on loan duration.	No material impact of excluding default and total cost cap.	Provides no protection for borrowers in default or from charges accumulating to excessive levels due to loan duration.

	Consumer protection	Impact on firms	Competition implications	Conclusion
<p>Proposed option but with stepped initial cost cap</p> <p>Firms incur their largest costs at the outset of making the loan (risk of default and affordability checking). It could be argued that the initial cap should be lower after a certain period to reflect this.</p>	<p>Would enable consumers to borrow over longer periods without charges accumulating to excessive levels.</p>	<p>May create incentives to repeat lend rather than agree longer loan durations at the outset.</p> <p>Less flexibility than proposed option: firms can lower the level of charge under the cap to the level they chose in order to lend for longer periods.</p>	<p>Risk that competition focuses on repeat lending.</p>	<p>It is not desirable to create a structure that incentivises repeat lending (avoiding the total cost cap).</p> <p>On balance, we consider that the initial cost cap should be applied in a way that is proportionate to the size and duration of the loan, to provide the appropriate degree of protection for consumers.</p>
<p>Proposed option but with fixed element to initial cost cap</p> <p>Because the initial cost cap is calculated as a percentage of the principal, it could impact on the smallest loans (a few firms offer loans below £50), particularly over shorter durations (30 days or less). A small fixed element to the initial cost cap could help make these loans viable.</p>	<p>Would enable consumers to borrow over longer periods without charges accumulating to excessive levels.</p> <p>Facilitates continued supply of smallest, shortest loans to consumers.</p> <p>However, it makes these loans relatively expensive compared with larger loans.</p>	<p>An initial charge may enable firms to offer the smallest, shortest loans.</p> <p>It could encourage firms to lend for shorter durations and encourage repeat borrowing when the borrower would be better served by a longer duration loan from the outset.</p>	<p>Risk that competition focuses on repeat lending.</p>	<p>On balance, we consider that the initial cost cap should be applied in a way that is proportionate to the size and duration of the loan, to provide the appropriate degree of protection for consumers.</p>

6 Supervising the price cap

We will supervise the price cap as part of our standard supervisory model. We will be closely monitoring strategies which appear to be designed to avoid the price cap.

Our powers also allow us to propose that agreements that breach the price cap will be unenforceable against the borrower.

Supervision

- 6.1** The price cap will be supervised as part of our core package of consumer protection rules, alongside continuous payment authorities (CPA) rules, rollover limits and affordability rules.
- 6.2** Supervision of the cap will be part of our standard supervisory model, with particular focus on proactive firm supervision, where we engage with firms to assess whether they have the interest of consumers and the integrity of the market at the heart of their business; and event driven reactive supervision, where we will respond to intelligence on breaches of the price cap.⁴⁷ The structure of the cap has been deliberately designed to make it as simple as possible for consumers to identify breaches, specific questions on the cap will also be included in the Business Model and Strategy Analysis⁴⁸ of HCSTC firms, which would come into effect once firms become authorised.
- 6.3** We have designed the cap to minimise incentives that may have adverse outcomes for consumers. We will take a close interest in how firms change their strategies in response to the cap (we discuss this further in relation to repeat lending in Chapter 5).

Enforcement

- 6.4** We consider that there should be an incentive on firms to ensure they comply with the price cap and that firms should have adequate controls in place to ensure they do not charge the borrower more than the price cap.
- 6.5** We have the power to make agreements unenforceable if they are in breach of the price cap.
- 6.6** We are proposing that we exercise this power, so that any agreements in breach of the price cap are irredeemably unenforceable against the borrower. This will mean that:

⁴⁷ Pillar 1 and 2 supervision are explained in the following document:
<http://www.fca.org.uk/static/documents/consumer-credit-being-regulated-guide.pdf>

⁴⁸ Business model and strategy analysis (BMSA) – a detailed assessment of a firm's business model and strategies to understand the risks they could pose to consumers or market integrity. It also informs other aspects of the FCA's supervision work.

- Firms will not be able to apply to court and seek a court order (or an order from the FCA) that the agreement, or parts of it, is enforceable.
 - Generally, the whole of the agreement will be unenforceable, not just the portion of the agreement in breach of the price cap.⁴⁹
 - The consumer under an agreement which breaches the rules can elect not to perform the agreement (i.e. not to repay the loan with charges), and if so the lender has to repay all charges but the consumer has to repay the loan.
- 6.7** One effect of our rule is that the use of repayment obligations (including the use of CPAs and direct debits) imposed in relation to debts arising from agreements in breach of the cap are unenforceable against a debtor.
- 6.8** We will take breaches of the price cap very seriously. This is reflected in our decision that it should be subject to an unenforceability provision.

Q7: Do you agree with our proposals on unenforceability?

Scope for avoiding the price cap

Online lending from other EEA member states

- 6.9** In theory, firms could seek to avoid the price cap by setting up elsewhere in the EEA and using the E-commerce Directive (ECD) to lend to UK consumers. Incoming ECD firms that are providing only Information Society Services (ISS) must be operating exclusively online, and cannot use certain services such as voice telephony. They are not able to send unsolicited emails to consumers in the UK. Firms providing ISS under the ECD do not require authorisation in the UK and our rules do not apply to them.
- 6.10** Such firms are regulated by the Member States where they are established for their activities throughout the EEA. ISS providers have to comply with the requirements of the Consumer Credit Directive (CCD), the information requirements in the ECD and the Distance Marketing Directive (which provides for a right of withdrawal for consumers) and the controls on unfair trading in the Unfair Commercial Practices Directive and on unfair contractual terms in the Unfair Terms in Consumer Contracts Directive.
- 6.11** Under the ECD we are not able to make a rule that would apply to incoming EEA ISS providers generally. It may be possible, however, to establish that an incoming ECD lender was abusing the EU right of free movement if it establishes in another Member State but directs all or most of its activities to the UK with a view to evading rules that would apply had it been established in the UK. Recital 57 of the ECD highlights that the Court of Justice has consistently held that a Member State retains the right to take measures in these circumstances. We do not currently have a specific power to take action on this basis, and we are discussing this with the Treasury.
- 6.12** In contrast, we can prevent UK-based debt collectors from collecting debts arising under HCSTC agreements entered into by incoming ECD lenders or UK-based debt administrators from enforcing or exercising rights on behalf of a lender under such HCSTC agreements whose charges exceed the price cap. Therefore we propose a rule that UK-based debt collectors will

⁴⁹ However, see the different rule referred to in paragraph 6.12 that applies in relation to agreements entered into by EEA e-commerce firms.

not be able to collect charges in excess of the price cap. This will provide some protection for consumers using EEA ISS providers charging in excess of the price cap.

Q8: Do you agree that we should prevent UK-based debt administrators from enforcing HCSTC agreements on behalf of ECD lenders which include charges in excess of the price cap?

Extending loan duration to fall outside the HCSTC definition

- 6.13** We are seeing the emergence of products which appear to be designed to avoid our definition of HCSTC by extending their loan durations so that they are not substantially repayable within 12 months. We explain in Chapter 5 that we are not currently proposing to extend the definition with regard to duration. Firms will need to demonstrate that products that charge a high interest rate for periods longer than 12 months are affordable for consumers. The affordability assessment must consider the customer's ability to make repayments over the whole life of the loan. We will need to be persuaded how such payments are sustainable particularly if interest and charges are high. We will monitor market trends to identify if firms are changing the duration of their products to avoid the price cap. We will take action where we see the emergence of products harming consumers.

7

Data sharing

In this chapter we review progress by the industry in delivering real-time data sharing in the HCSTC market. There have been improvements, but more needs to be done. We are prepared to give industry more time to deliver a solution but we will be monitoring progress closely. If we judge that there is insufficient progress by November, we will consult on the introduction of data sharing requirements.

Introduction

- 7.1** In our policy statement in February⁵⁰ we strongly encouraged the industry to improve data sharing. We committed to discussing this with the industry and evaluating progress by the summer, including whether the industry could overcome the obstacles to effective real-time data sharing. We were clear that this is a priority for us and if the industry cannot overcome the obstacles, and we are best placed to bring about data sharing, then we will act.
- 7.2** There are differing views about the most effective way to introduce real-time data sharing. Most firms and credit reference agencies (CRAs) have been supportive of an industry-led solution through commercial CRAs. Others, such as the BIS Committee and consumer groups, support a regulatory solution where we mandate data sharing by HCSTC firms either through CRAs or by establishing a regulatory database.

Objective

- 7.3** The purpose of real-time data sharing is to enable firms to make a more informed assessment of the consumer's creditworthiness and the affordability of the loan. For real-time data sharing to be effective it needs to provide firms with comprehensive up-to-date information about a customer's current HCSTC commitments.
- 7.4** In this way real-time data sharing should enable firms to address the issue of consumers taking out multiple HCSTC loans from different providers that they are unable to afford. This may include, but is not limited to, consumers in financial difficulties taking multiple loans with different providers and consumers taking out a new loan with a different firm when they cannot afford to repay the original agreement.
- 7.5** Up-to-date CRA data is also useful for new entrants in the HCSTC market or for firms who wish to compete for consumers who use HCSTC. Currently, the ability of new entrants to reliably assess credit risk is undermined by the lack of comprehensive real-time data.

⁵⁰ PS14/3, 'Detailed rules for the FCA regime for consumer credit' (February 2014)

- 7.6** Some commentators have suggested that a regulatory database is necessary for us to supervise our rules on rollovers and the forthcoming price cap. In other jurisdictions, notably Florida, a regulatory database is used by the state to monitor and enforce a cap on the cost of the loan, a maximum loan amount and a restriction on a consumer having more than one payday loan outstanding at any one time.
- 7.7** We are not considering this approach at present because the various state-based models in the US rely on these restrictions instead of individual affordability assessments. As set out in the case study in Annex 4, there is no affordability requirement in Florida. In line with the requirements of the Consumer Credit Directive, our rules work on the principle that each and every loan must be assessed for the customer's creditworthiness including whether it is affordable to that customer; our rollover and CPA caps reinforce that rule. Consequently, a real-time solution through CRAs is a better fit for the UK market where lenders are required to make informed judgements.
- 7.8** Some commentators point out that a regulatory database enables the regulator to have access to additional data to assist with the supervision of the sector. We have placed a requirement on firms to provide product sales data on HCSTC agreements every three months once they are authorised. This product sales data will be one of a number of ways in which we monitor lending in this sector, and support our ability to supervise these firms effectively.
- 7.9** Our supervisory approach focuses on the firms and sectors that pose the greatest risk to our objectives. We will continue to undertake pro-active work to look at how firms are assessing affordability, and we will take swift action where we find breaches of the requirements we have imposed on the HCSTC sector. Consequently, we do not currently think that a regulatory database, which would require amendments to legislation, is necessary or proportionate to supervise this sector. However, we may reconsider this position if we find widespread non-compliance with our requirements.

The current system

- 7.10** Most firms see a CRA check as a necessary part of their lending decision. This is because it gives the firm an insight into the outstanding credit commitments of a consumer and their payment performance. The benefit of a CRA check is that it provides broad coverage of the range of debts that can contribute to a consumer's financial difficulties to inform an affordability assessment. However, there is general consensus that CRA searches of databases that are updated monthly are not sufficiently accurate in the short-term lending market.
- 7.11** Our analysis suggests that multiple borrowing (i.e. consumers taking out a loan from one lender when a loan with a different lender is outstanding) is widespread. When we analysed the behaviour over the two years of those consumers who took out a loan in Q1 2012, we found that 39% of customers had active loans with at least two providers at some point.
- 7.12** For firms that use CRA data in this market, more frequent data is necessary to enable them to make a more informed assessment of the affordability of the loan for the consumer and to ensure that they are not lending to consumers who are unable to repay. Many of the smaller firms in this market already see the value of real-time data sharing and use the real-time products offered by niche CRAs. However, the benefit of these databases is inhibited by their limited coverage of the market.

Pressure for more accurate data

- 7.13** Responsible lending rules in CONC already require firms to carry out an affordability assessment before they lend and consider the customer's ability to repay the loan and the potential for the loan to have an adverse impact on the consumer's financial situation. These requirements depend on the amount and the type of credit.
- 7.14** Since 1 April 2014, we have been assessing whether firms are conducting effective affordability assessments and we are taking appropriate action where this is found not to be the case. We expect lenders to demonstrate that they use adequate sources of data to be able to perform an effective assessment of affordability, covering HCSTC and other debts which can contribute to financial difficulties, which will include credit reference checks, where necessary.
- 7.15** As set out in CONC we encourage the sharing between lenders of accurate data about the performance of a customer's account and the settlement of outstanding debts, as the process of making affordability assessments is assisted by lenders registering such data with CRAs in a timely manner.⁵¹
- 7.16** Our rules limiting rollovers and CPAs, which came into force on 1 July 2014, and the forthcoming price cap will incentivise firms to make better lending decisions. Several firms and trade associations have indicated to us that as a result real-time data will become an increasingly important element of lending decisions in this market.
- 7.17** All HCSTC firms will also be aware that they are required to apply for full authorisation, starting on 1 December 2014. As part of our assessment of each firm's business model, we will expect them to be able to demonstrate how they are able to carry out robust affordability assessments. We will consider factors such as the variety of data sources they use and the age and reliability of the data, and willingness to report data to credit reference agencies. Access to up-to-date data is central to the adequacy of a firm's affordability assessment and the advantages for firms of real-time data are clear.

Recent progress

- 7.18** The technology is available to enable firms to share data in real-time through commercial CRAs. Niche CRAs already provide real-time data sharing services in this market, and mainstream CRAs have reacted to recent developments by developing their own products that update daily or in real-time. These products are being launched this summer.
- 7.19** While some lenders have been reluctant to participate in real-time data sharing in the past, several firms, including some of the largest lenders, have indicated that they intend to use these products. Although it will take some time for these new products to become fully operational and for the firms that propose to use them to integrate the data into their lending decisions, we do not anticipate that this will take more than a couple of months.
- 7.20** Our analysis of 2013 management accounts suggests that the largest ten firms by revenue account for 88% of industry revenues. Given recent progress by the CRAs and based on our discussions with the industry, we expect the vast majority of loans to be reported daily or in real-time in the next few months, and that the majority of firms will be using daily or real-time data to inform their lending decisions.

⁵¹ CONC 5.3.1 G(12)

- 7.21** As part of their market investigation into payday lending, the CMA⁵² is also considering requiring lenders to provide CRAs with a real-time update of any new credit facility granted. This is part of a potential remedy, which seeks to ensure that customers are better able to establish their likelihood of acceptance by a lender and are therefore in a better position to shop around for the best deal.
- 7.22** The CMA consulted on these remedies in June. We will continue to work closely with the CMA, and factor their remedies into our assessment of progress in this market.

Improving coverage and participation

- 7.23** Our analysis suggests that the industry is making clear progress towards more frequent reporting of data and its use in lending decisions. However, this will not be sufficiently effective unless the CRAs have more comprehensive data about lending in this market that firms are able to use as part of their affordability assessments.
- 7.24** In the rest of the consumer credit market, industry best practice is for lenders to share their data with at least two CRAs. In practice, payment performance information in the mainstream market is largely shared among all the mainstream CRAs. This is not the case in the HCSTC market where CRAs only have access to the real-time data that is reported to them by the firms that use their services. Consequently no real-time database has full coverage of all the available data.
- 7.25** There are also cost implications for firms using CRA checks and real-time products may add an additional burden. Our dialogue with industry indicates that this is not a major barrier for larger firms, but that the additional burden may be more significant for smaller firms who do not currently use real-time products, in particular the initial set up costs. However, this may be limited as a significant proportion of smaller firms are already using real-time databases.
- 7.26** The industry must work together to minimise the cost and inconvenience for firms of using real-time data and reporting to multiple CRAs in real-time. The Steering Committee on Reciprocity (SCOR) have indicated that they are willing to work with the industry to facilitate the dialogue necessary to enable real-time data sharing to be effective. This is a key obstacle to an effective data sharing solution through the commercial CRAs which we expect the industry to work together to overcome.

Next steps

- 7.27** We can see the value for firms in having access to comprehensive real-time data about their customers' outstanding HCSTC commitments when carrying out affordability assessments, and the positive effects on consumers from more accurate affordability assessments, including in some cases preventing them from taking on loans they cannot afford.
- 7.28** The regulatory framework that we have put in place for HCSTC will ensure firms make better lending decisions. We have introduced a cap on rollovers and a cap on the number of CPA attempts and a ban on part payments to ensure that firms only lend to borrowers who can afford it. We are taking a tough approach to assessing firms' business models through

⁵² Notice of possible remedies published on 11 June 2014

supervision, and this will continue. All HCSTC firms will be required to apply to us for full authorisation starting on 1 December 2014. We will be looking closely at how they assess affordability and rigorously challenging those who do not use real-time data to demonstrate how their alternative processes ensure compliance with our rules.

- 7.29** Although many firms recognise the benefits of real-time data sharing, difficulties remain. For more frequent data sharing to be effective, firms must both use real-time data and share data on their agreements more widely. We will continue to engage with the industry to ensure that CRAs and firms work together to minimise the cost and complexity of using real-time data and reporting to multiple CRAs in real-time.
- 7.30** We expect to see the vast majority of firms in this market participating in real-time data sharing by November, and the vast majority of loans being reported in real-time. By vast majority we mean greater than 90% of current market participants by market share and by volume of loans. In order to improve the coverage of real-time databases, firms will also need to share data with more than one CRA. We will request information from firms and CRAs in order to get an accurate picture of whether these standards have been met by November.
- 7.31** If we do not see the level of progress we expect by November or this does not sufficiently improve coverage of real-time databases, we will consult on the introduction of data sharing requirements.

Q9: Do you have any comments on the proposed approach to data sharing?

8 Next steps

What do you need to do?

8.1 Please send us your comments by **1 September 2014**. We will review all your responses and publish our feedback, guidance and final rules in early November.

8.2 The price cap will come into effect on 2 January 2015.

Applying for authorisation

8.3 Every firm with interim permission has been allocated a three-month period when they must apply to us for authorisation.

8.4 Firms that provide high-cost short-term credit must apply between 1 December 2014 and 28 February 2015. If they fail to apply by the end date then their interim permission will expire and they must stop carrying out consumer credit activities.

8.5 When applying we expect firms to demonstrate how they will comply with our rules, even if they apply before these rules come into force.

8.6 If you are unsure when your application period is, you should contact us at application.period@fca.org.uk, quoting your interim permission reference number.

Next steps for the FCA

What will we be doing between now and September?

8.7 Over the next two months we will be taking part in activities with a wide range of stakeholders – including consumers, firms and trade associations – to listen to their feedback and answer questions about our approach and how we have developed our proposed policy. We want to help people understand how the cap will affect them.

8.8 At the same time we will follow the progress on related initiatives, in particular the Competition and Markets Authority (CMA's) payday lending market investigation in which the final Report is due to be completed by January 2015.

8.9 We will also continue to work with HCSTC lenders, credit reference agencies (CRAs) and the CMA to deliver real-time data sharing in this market, which would lead to better informed affordability assessments. The CMA is considering requiring lenders to provide CRAs with a real-time update of any new credit facility granted. As stated in the previous chapter we expect to see the vast majority of firms in this market participating in real-time data sharing by November, and the vast majority of loans being reported in real-time. If we do not see sufficient progress by then, we will consult on the introduction of data sharing requirements.

What happens when the cap comes into place in January?

- 8.10** All former OFT-regulated firms that registered with us before the transfer currently have 'interim permission'. These firms will be asked to apply for FCA authorisation over the next two years. HCSTC firms are among the first to be required to apply.
- 8.11** As part of deciding whether or not to authorise a firm we will ask specific questions on firms' business models and strategy, and where we identify risks or problems, we will take action – including refusing permission where necessary – to ensure that firms follow our rules and treat their customers fairly.
- 8.12** We plan to carry out a review of the price cap in two years' time and we will continue to review whether we should consider imposing a price cap on other products.
- 8.13** We will also continue to work closely with the Illegal Money Lending team to monitor trends in illegal lending before and after the cap comes into effect, and will take targeted action where necessary.

Annex 1

Cost benefit analysis

Introduction

- 1.1** This annex summarises our cost benefit analysis (CBA) for the proposed price cap for high-cost short-term credit (HCSTC) loans – see Chapter 5 of the Consultation Paper for details of our proposal – including the key details of our analysis, the approach we took and our conclusions. The full detail of the analysis undertaken for this work is included in the three supporting annexes that follow.
- 1.2** Section 138I of FSMA requires us to publish a CBA unless, in accordance with Section 138L, we believe there will be no increase in costs or that the increase will be of minimal significance. Section 138I also requires us to publish an estimate of costs and benefits unless they cannot be reasonably estimated or it is not reasonably practicable to produce an estimate. This analysis presents estimates of the significant impacts of our proposal. We provide monetary values for the impacts where we believe it is reasonably practicable to do so. For others, we provide estimates of outcomes in other dimensions. In these cases it is not always possible to convert this reliably into a comparable scale, such as one based on monetary value. Our proposals are therefore based on carefully weighing up these multiple dimensions and reaching a judgement about the appropriate level of consumer protection, taking into account all the other impacts we foresee.
- 1.3** We have a duty under section 137C of FSMA⁵³ to impose rules which will prohibit firms from entering into regulated credit agreements which provide for certain charges on borrowers which exceed or are capable of exceeding a level we set (the price cap) or prohibit firms from imposing on borrowers specified charges which exceed or are capable of exceeding a level. The price cap rules are to apply to one or more FCA descriptions of those agreements which appear to us to involve high-cost short-term credit and are to be made with a view to securing an appropriate degree of protection for borrowers against excessive charges. There is no option in which we would not make a rule imposing a price cap of some kind, although the level could in principle be set at a level that had no effect on firms' products and pricing. In our analysis we look at the impacts of different options for the structure and level of a price cap in the HCSTC market, rather than the decision to place a cap on the market at all. To facilitate this comparison between options, we measure the options against a baseline of there being no price cap in place and taking into account the effect of the rules made in PS14/3 for HCSTC. This baseline is our best estimate of the market outcomes if we did not implement a price cap that affected the market.
- 1.4** This CBA focuses on how the proposals discussed in Chapter 5 directly affect firms and consumers, and also outlines the administrative costs to firms and the FCA. We judge that the administrative costs to firms (such as changing systems or hiring staff) and the FCA will be limited in comparison to the wider effect on firms, consumers and the market. So we focus on these elements in much more detail here and in the supporting annexes.

⁵³ Section 137C of FSMA was amended to include the duty by section 131 of the Financial Services (Banking Reform) Act 2013.

Box 1: Summary of impacts

In setting the level and structure of the price cap we considered the impacts on all consumers in the market, as well as any harm to competition in the market and the economic interests of HCSTC providers. We summarise the static impacts of our proposed cap below (in other words, before firms respond to the cap).

.....

Firms and competition: We estimate that our proposal would have the following impacts across the market:

- reduce the value of loans by 11% (by around £270 million)
- reduce revenues for firms by 42% (by around £420 million)⁵²
- reduce contributions (profitability before overheads) for firms by 43% (by around £190 million); and, as a consequence of the fall in profitability,
- cause significant numbers of firms in the market to exit, though dynamic responses from firms may mitigate this effect

As a conservative estimate, it is possible that around three firms would remain, accounting for 53% of current market share (by revenue).

For online providers, we would not expect this level of market withdrawal to significantly reduce the level of competition compared to current levels. For high-street lenders if a single supplier remained, we believe online providers would provide some competitive constraint, and the cap itself would provide a degree of protection for high-street consumers. However, the extent to which (some) high-street customers are able to switch online may be limited. It is unclear how much of a competitive constraint would be imposed on a single remaining high-street provider.

.....

Consumers who would continue to be served in the market: We estimate that 1.3 million people a year (89% of individuals who would otherwise be served) would continue to be served under our proposals. For these individuals we estimate an average saving of £193 each translating into £250m saving in aggregate per year due to lower prices. These savings are to consumers who pay back and those who do not pay back (reducing their debts). The cap would benefit these consumers, particularly those who are in financial difficulties and struggle to repay their loans.

54 The fall in revenues exceeds the fall in the value of the loans, reflecting that the cap constrains how much money firms can make in interest and charges for a given borrowed amount

.....

Consumers who would no longer get loans: We estimate that 160,000 people a year (11% of individuals who would otherwise be served) would be denied any loans. We estimate that a further 210,000 people a year (14% of individuals) would still have access but be unable to borrow as much as they currently can.

We find from our Credit Reference Agency (CRA) and survey data analysis that people who take out HCSTC are in declining financial circumstances, have exhausted most of their alternative sources of credit and use HCSTC to fund short term consumption.

The funding of immediate rather than later consumption through HCSTC can benefit consumers, typically for short duration, for example it can allow them access to money for emergencies. So a price cap that restricts HCSTC has costs for some people. However, under a price cap, a number of benefits can also arise for consumers because HCSTC is expensive and repayment reduces future consumption or has other knock-on effects.

Overall we judge that, on average, consumers who no longer get access to HCSTC under our proposed price cap would be better off. The impacts are summarised below.

Estimated costs from a price cap, in the short-run, for customers who would not have loans as a result of the cap:

Less consumption in the immediate term from not getting a loan. Around 55-60% of individuals would not borrow or find funds in another way

Need to access alternate funding sources. 25-30% would borrow from family and friends, around 10% would borrow from other sources and 5-10% would find funds in other ways (e.g. decrease saving). Many people would find these adjustments uncomfortable as they benefit from the speed and convenience of HCSTC. We do not find that lack of access to HCSTC would lead to a significant use of illegal lending.

A short-run increase in consumers exceeding their overdraft limit in the month of not obtaining a HCSTC loan. 14.9% of customers would go over their overdraft limits if they did have a loan, but not having a loan increases this percentage to 16.9%

No longer run negative impacts in aggregate. We do not find any impacts on well-being or financial distress from the lack of access to HCSTC.

These are the estimated benefits from a price cap, in the medium to long run, for customers who would not have loans as the result of the cap.

1. The primary benefit is the reduced risk of difficulties in paying back HCSTC loans which has stress, mental-health and welfare consequences:

Substantially reduced risk of non-payment of HCSTC loans. 39% of first-time HCSTC loans no longer made would have ended in non-payment. 19% of repeat loans no longer made would have ended in non-payment.

Substantially reduced risk of late payment of HCSTC loans. 78% of consumers would have had a late payment at least once.

2. A number of positive, though small, other financial effects:

Reduced non-payment of non-HCSTC loans. 31.5% of these customers' non-HCSTC credit balances would be unpaid 6- to 12 months after application if they did have a HCSTC loan. Not having a HCSTC loan decreases this to 29.1%.

Reduced late payment of non-HCSTC loans. 51.6% of these customers would be behind on non-HCSTC payments 6 to 12 months after application if they did have a HCSTC loan. Not having a HCSTC loan decreases this to 47.1%.

A medium to long run reduction in consumers exceeding their overdraft limit after the month that they apply for a HCSTC loan. 32.4% of these customers would go over their overdraft limits if they did have a loan. Not having a loan decreases this percentage to 30.1%. This decrease is persistent and lasts for many months.

3. **Increased future consumption from not getting a loan**, due to not paying HCSTC interest and charges (£80 for an average loan)

.....

Conclusion: As with all forecasts, there are uncertainties associated with our estimates and we have been purposefully conservative. On balance we are confident that the benefits to consumers of the proposed cap outweigh the costs, both for those that still get loans and those that do not. We need to balance these effects against the negative impact on competition that further exit of firms could lead to ultimately affecting the interests of consumers, and the economic interests of firms. We judge that proposed price cap provides the best balance of protection for borrowers against excessive charges while taking into account the economic interest of firms and the impact on competition. In our judgment there are no alternative options that could materially lessen the impact of the proposed rules on the economic interests of firms or on competition, but still achieve an appropriate degree of protection for borrowers against excessive charges. In particular we calibrated our proposals, being mindful of the risks they present to the continuance of the high-street-distribution channel.

1.5 This CBA has the following structure:

- Section 1 gives an **overview of the market**.
- Section 2 provides an explanation of the analysis that we use to underpin the CBA, including relevant context. This analysis is detailed further in the technical annexes. In particular this section of the CBA:
 - outlines the **market failures** in HCSTC relevant to setting a price cap
 - explains **how consumers may be harmed by excessive charges**
 - reviews the **empirical economic literature** relevant to setting a HCSTC price cap
 - describes the **data** that we collected for our analysis
 - explains **our analytical approach**, how the approach relates to the market failures identified, and how the analysis uses the data,
 - clarifies **how our analysis demonstrates consumer harm**
- Section 3 lays out our estimates of the costs and benefits for:
 - **firms**, and the impact on competition
 - **consumers**, both those still served in the market and those that no longer get loans
 - **peripheral and related markets**
 - **the FCA**

Section 1: Market overview

1.6 This section provides an overview of the market and the different products, firms and consumers within it. Our assessment is based on:

- previous FCA analysis of the market as part of the change in regime⁵⁵ and as part of our on-going regulation
- detailed discussions with HCSTC lenders, credit reference agencies (CRAs), credit brokers ('lead generators'), the Competition and Markets Authority (CMA), the Office of Fair Trading (OFT), and other industry experts and academics
- existing published academic and other forms of research, for example from the Department of Business, Innovation & Skills (BIS), OFT and the CMA,⁵⁶
- detailed FCA analysis of various datasets we have gathered as part of this project as outlined below and in the accompanying technical annexes

⁵⁵ See for example FSA CP13/7 and FCA CP13/10

⁵⁶ This includes the CMA's Payday Market Lending Investigation which we refer to throughout this chapter

Products, consumers and firms

- 1.7** In this section we describe the types of HCSTC products available, the consumers who use them and the firms who supply them. We finish by summarising the relevant market to which our rules will apply.
- 1.8** HCSTC loans are generally unsecured, short-term, typically small-sum loans, generally repaid in one instalment (although multiple repayment instalments are becoming more common). Consumers in the market use these loans because of their speed and convenience and because they do not think they have viable alternatives for their borrowing needs. Firms in the market distribute their products either directly online or via high-street stores, or through credit broker intermediaries who supply potential leads to HCSTC firms for a fee. Online is the predominant sales channel. The market is relatively concentrated, with ten companies earning 88% of the revenue. There is also a tail of small firms who have a turnover less than £500,000 each from their HCSTC business.⁵⁷

Products

- 1.9** HCSTC products are, by our definition, generally unsecured loans under which credit is provided for up to 12 months and at 100% APR⁵⁸ or higher – see Box 2 for details. Typically HCSTC loans are for small sums. We found from our research that the average loan has a principal of around £260 lent over an initial duration of 30 days.⁵⁹

⁵⁷ Based on data from firms collected by the FCA as part of this analysis

⁵⁸ APR: Annual Percentage Rate. This defines how much a loan would cost if borrowed over a 12 month period. The exact methodology is defined in the Consumer Credit Directive.

⁵⁹ See *Technical Annex 1* section 3

BOX 2: FCA definition of high-cost short-term credit

A regulated credit agreement:

- (a) is a borrower-lender agreement or a P2P agreement;
- (b) in relation to which the APR is equal to or exceeds 100%;
- (c) either:
 - (i) in relation to which a financial promotion indicates (by express words or otherwise) that the credit is to be provided for any period up to a maximum of 12 months or otherwise indicates (by express words or otherwise) that the credit is to be provided for a short term; or
 - (ii) under which the credit is due to be repaid or substantially repaid within a maximum of 12 months of the date on which the credit is advanced;
- (d) which is not secured by a mortgage, charge or pledge; and
- (e) which is not:
 - (i) a credit agreement in relation to which the lender is a community finance organisation; or
 - (ii) a home credit loan agreement, a bill of sale loan agreement or a borrower-lender agreement enabling a borrower to overdraw on a current account or arising where the holder of a current account overdraws on the account without a pre-arranged overdraft or exceeds a pre-arranged overdraft limit.

1.10 Products are typically single-repayment loans with principal and interest due on a fixed date (but in practice loans may be and often are extended by a 'rollover' or as we define it a 'refinance' (see CONC 6.7.17R)). In 2013, 3.4% of loans issued (by volume) were instalment products. In contrast to HCSTC loans overall, the actual duration of instalment loans is considerably shorter than the initial contracted duration (250 days), as many customers repay in full before the agreed due date. For HCSTC loans overall the initial contracted duration was 30 days on average but the actual duration after refinances or other changes was 48 days on average.⁶⁰ The strong skew in these figures suggests that there is a long tail of products that last for much longer than consumers initially intended.

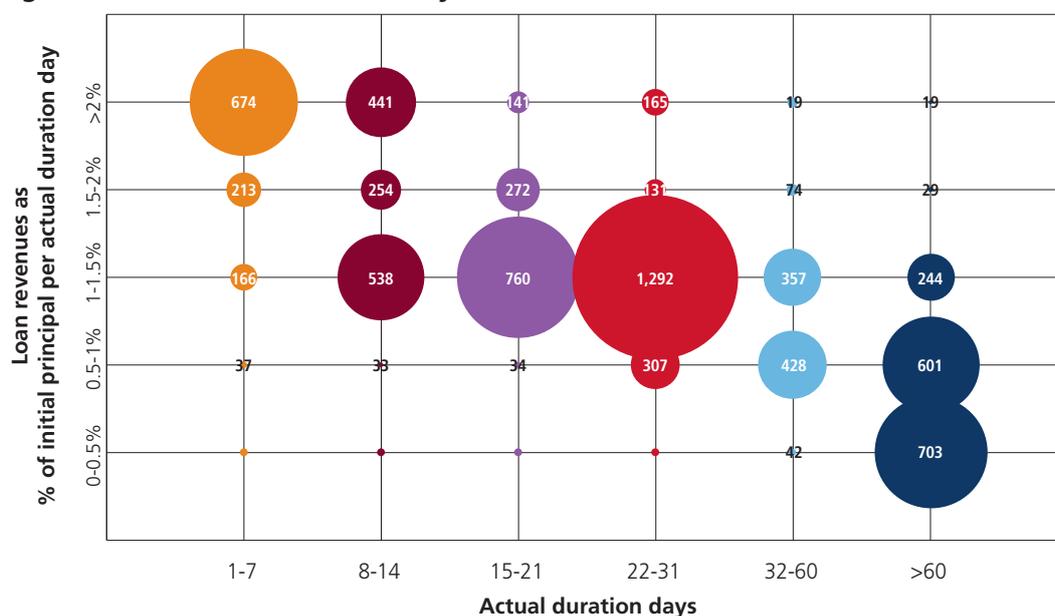
1.11 Pricing structures vary across HCSTC products, even across products that have similar characteristics. There are normally a number of distinct charges, fees or interest payments that can be levied and these will vary depending on the lender and according to the size, duration and type of loan that is being considered. The headline price, often based on the interest payment due at the end of the loan, does not always reflect the full cost of the loan, as there

⁶⁰ *ibid*

are additional charges for receiving the money more quickly, extending or topping up the loan, and repaying the loan after the due date.⁶¹

- 1.12** The CMA found that headline prices have tended to cluster at approximately £30 to borrow £100 for a month, equivalent to 30% a month or 1% a day. Our own analysis (supported by CMA findings) suggests that, when all costs and charges are considered, the per-day price can be higher. Our data shows that per-day prices vary across the market, from 0.4% to above 4%, with most in our sample of loans (Figure 1) being between 1% and 2% equivalent daily rate.

Figure 1: Number of loans issued by revenue and duration band



Consumers

- 1.13** Our evidence, supported by that of the CMA, shows that compared with the general population, HCSTC users are more likely to be male (57%), concentrated in younger age groups (33 on average), typically employed (64% full time and 14% part time), but with relatively low incomes (32% earn less than £12,000 a year).⁶² Online borrowers have slightly lower incomes than the UK average, but significantly higher incomes than borrowers who predominantly use high-street HCSTC lenders.
- 1.14** Typically, HCSTC consumers are at the margins of credit and have few alternatives. Evidence from CRA data shows that typical HCSTC applicants have low credit scores and many have exhausted their existing sources of credit. In the 12 months prior to their first HCSTC application a consumer's balances on a range of credit products increase, 23% of consumers have gone over their overdraft limit and 41% of consumers are overdue on at least one credit payment.⁶³ Our survey evidence suggests that 58% of HCSTC consumers had exceeded their overdraft limit since the month of applying for a HCSTC loan (July 2013 to November 2013 in our sample).⁶⁴

⁶¹ The headline price is often based on the interest payment due at the end of the loan (for example a £100 loan over 30 days at a daily rate of 1% would have a headline price of £30). This does not include default charges or optional charges (for example for receiving the money more quickly). Headline prices therefore do not always reflect the true cost of borrowing.

⁶² See *Technical Annex 3*, Consumer Survey Analysis section 13a for greater detail on the socio-demographic profile of HCSTC applicants

⁶³ See *Technical Annex 3*, CRA Data Analysis for further detail

⁶⁴ See *Technical Annex 3*, Consumer Survey Analysis section 13a for further detail on use of overdraft facilities by HCSTC applicants

We found that the two main reasons for consumers to choose a HCSTC loan were speed of access (43%) and lack of alternative options (24%).⁶⁵

1.15 The CMA found that consumers typically are not price sensitive, especially for contingent charges such as rollover and late payment fees. Even for upfront headline charges, consumers do not effectively constrain firms' pricing strategies, partly because at the stage of considering a HCSTC loan, these consumers perceive themselves to have few alternatives. Consumers generally value the speed of service and the certainty and simplicity of headline payment charges specified upfront in cash terms. The CMA outlined five reasons why consumers may be relatively insensitive to prices:

- Consumers often perceive their need for a loan to be urgent and attach considerable importance to speed. They are also often uncertain about whether, and from which firm they might be granted credit. Consequently consumers can be reluctant to shop around for the best deal.
- Some consumers have difficulty in comparing headline rates between lenders due to differences in pricing structure and product features. Further, some consumers underestimate the costs of paying back their loan. The CMA found that, on average, 17% of customers reported that repaying the loan was more difficult than expected. Our consumer research indicates 28% of HCSTC users repaid more than they expected to.
- Consumers are particularly insensitive to fees and charges incurred later on during the loan, such as rollover or late payment fees. The CMA ascribes this to limitations with information from providers and over-confidence from consumers who do not expect to face these charges.
- A significant proportion of first-time consumers use credit brokerage firms, which sell a customer's lead to the highest bidder, rather than try to obtain the best value for money for the consumer. This gives HCSTC firms little incentive to lower prices or improve value for money and could even create an incentive for firms to charge higher prices (to offer higher bids in customer auctions).
- Repeat consumers may perceive a loss of convenience, or be dissuaded by perceived risks, associated with applying to a new lender. These factors further reduce the constraint placed on lenders by the threat that existing customers will switch to another lender offering a better value product.

1.16 Related to this, many consumers do not shop around and may be insensitive to prices.⁶⁶ Our evidence (supported by the CMA's findings) suggests that other credit products are not close substitutes for HCSTC. Both our survey and the CMA's survey found that, if rejected, approximately less than 10% of HCSTC customers would plan to use other forms of formal credit.⁶⁷ Such behaviour may be because consumers have already exhausted other lines of credit, because they perceive that these options are not available, or simply because they prefer the convenience and speed of HCSTC.

1.17 A high and increasing proportion of HCSTC loans were made to repeat customers in 2012 and 2013. There is a distinct and consistent downward trend in the proportion of loans to 'new to market' customers over this period (from 33% for loans originated in Q1 2012 to 17% in Q4

⁶⁵ See *Technical Annex 3*, Consumer Survey Analysis section 13b for further detail on uses of HCSTC

⁶⁶ See *Technical Annex 3*, Consumer Survey Analysis section 13c for further detail on what customers would do without access to HCSTC. This includes consideration of informal sources (like friends and families) and formal sources (like banks)

⁶⁷ *ibid*

2013).⁶⁸ Our data suggests individuals took on average around six HCSTC loans per year. On average, three to four of these were taken with the same HCSTC firm.⁶⁹

- 1.18** 83% of customers take out HCSTC loans through online channels, while the remaining 17% go to high-street stores (see Table 1 below). There are material differences in the socio-economic characteristics of the two groups. High-street borrowers are older (38 compared to 33 for the average HCSTC consumer), they are more likely to rent from local authorities/housing associations (48% compared to 24% for online users), more likely to have state benefits (24% compared to 15%), and less likely to be employed or have income from employment (53% full-time employed compared to 64% for online users).⁷⁰ Income levels for high-street customers are also lower (71% have an annual income less than £18,000 compared to 57% for online customers).⁷¹
- 1.19** There is some switching between the two channels. Focusing on customers who took out a loan in the high street in the first quarter of 2012, we find 24% used an online provider in the subsequent two year period (until the end of 2013).

Firms

- 1.20** There is no single estimate of the number of authorised firms which are active in the HCSTC market. Our best estimate of the number of firms currently offering HCSTC (not necessarily as their core business) or having firm plans to do so in the future is around 400, many of which are franchisees.
- 1.21** From our analysis of 2013 management accounts, the largest ten companies by revenue account for 88% of firm revenues. There are then 21 firms with revenues exceeding £500,000, which account for a further 11% of the market. Thereafter, a long tail of smaller firms and franchisees cover the remaining 1% of the market.⁷²
- 1.22** Based on responses to a questionnaire that we sent to 150 HCSTC firms and to which we received 90 responses, around one third of firms formally report they are uncertain whether they will remain active following the cap. In practice, we expect that all providers will consider their future operation in the HCSTC market once the details of the cap are announced.
- 1.23** There are a number of business models in the market. They differ in the way they reach their customers (online direct to customer, online via credit brokers, high-street), in product terms (typically shorter duration single repayment vs. longer duration instalment), in their mix of new and repeat customers and in the way they charge customers.⁷³ High-street HCSTC lenders often carry out distinct business lines through the same stores, for example, pawn broking. The combined market share of high-street lenders was approximately 14% (by revenue for loans issued over 2012-13).

⁶⁸ See *Technical Annex 1* section 3 for further detail

⁶⁹ See *Technical Annex 1* section 3 for further detail

⁷⁰ See *Technical Annex 3* for further detail

⁷¹ *ibid*

⁷² The CMA estimated that 11 lenders operating 16 separate companies and 22 different brands account for 90% of loans issued and 90% of loan revenue in the financial year 2012. They estimated that there were in total at least a further 90 companies active in the market in Oct 2013. See CMA (2014), *Payday Lending Market Investigation: Companies Background Working Paper*

⁷³ There is considerable variation in charges for non-payment across firms, and there is some variation in the rate and fees charged. See the CMA (2014) *Payday lending Market Investigation: Payday lender pricing Working Paper*

Table 1: Overview of sample HCSTC loan data (2012 and 2013) split by high-street and online⁷⁴

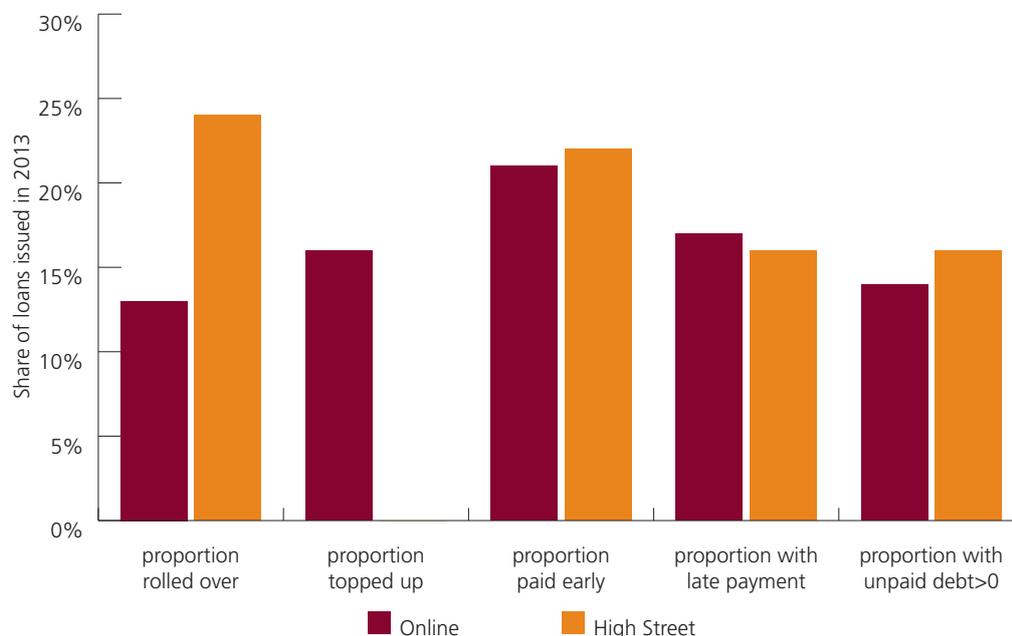
Loans issued in 2013	Online	High St	Total/Ave
Number of firm-customers (million)	2.0	0.4	2.4
Number of loans granted (million)	6.5	1.6	8.1
Value of loans granted (£ million)	£1,882	£264	£2,145
Average principal	£289	£169	£266
Average initial duration (days)	31	29	30
Revenues (£ million)	£759	£131	£890

Loans issued in 2012	Online	High St	Total/Ave
Number of firm-customers (million)	2.2	0.4	2.6
Number of loans granted (million)	6.8	1.4	8.2
Value of loans granted (£ million)	£1,935	£216	£2,151
Average principal	£285	£155	£261
Average initial duration (days)	29	30	29
Revenues (£ million)	£854	£137	£990

Source: Firm data provided to FCA. Figures for loans issued in 2012 and 2013 pre-baseline adjustments

- 1.24** Note that in Table 1 we refer to firm-customers but in other places we refer to individuals. It is important to understand the distinction. In the terminology we have used an individual (or 'consumer') is a person, while a firm-customer (or sometimes 'customer') reflects the relationship between a firm and an individual. One individual who takes out a loan with two different firms has two firm-customer relationships. Firms only see their own customers and so counting up firms' customers and adding them together overstates the number of people (or individuals) who borrow HCSTC.

⁷⁴ The number of customers is based on firm-level view i.e. does not account for individuals taking out loans with multiple firms

Figure 2: Characteristics of loans granted on the high street and online

Source: Firm data provided to FCA. Figures for loans issued in 2013, pre-baseline adjustments. Details in the Technical Annex 1

Relevant market

- 1.25** We have not undertaken an exhaustive market definition exercise, and we do not think it is necessary to fulfil our duty. We note that the CMA concluded in their provisional findings published in June 2014 that ‘the provision of payday loans in the UK was the relevant market’ for their analysis. They describe payday loans as ‘short-term, unsecured credit products that are generally taken out for 12 months or less’. The CMA’s description of payday lending is very similar to our own legal definition of HCSTC (see Box 2 for details).
- 1.26** We have considered whether other forms of high-cost credit excluded from the current FCA definition should be included for the purposes of the price cap. These include home-collected credit and overdrafts. We have not found evidence that such products are either used in the same way as HCSTC or act as effective substitutes. Therefore, in our rules and this analysis of the impacts of the proposed cap we exclude home collected credit and overdrafts from this definition.
- 1.27** The CMA noted that, although these consumers may also have access to, or use alternative credit products, the short-term and low-value nature of HCSTC loans and the speed and convenience of access differentiate them from other credit products. The CMA concluded that competition from other credit providers was likely to provide only ‘a weak competitive constraint on payday lenders [HCSTC].’ Our own analysis of the market supports this view.
- 1.28** Firms provide loans either online or from physical premises, or a combination of both. The CMA provisionally concluded, and we agree based on our analysis, that there are sufficient consumers who use both channels that they should not be considered separate economic markets. Moreover, there is an incentive for high-street lenders to move their existing customers to their own online platforms (or to sell customer details on to remaining online providers) were they to exit the high-street channel.

Section 2: Explanation of our analysis and relevant context

Market Failure Analysis

- 1.29** For significant regulatory interventions, we conduct a Market Failure Analysis (MFA) to understand the material economic problems within the market and to understand whether and what regulatory intervention might address those problems.⁷⁵ In this case, we have a duty to set a cap on one or more descriptions of regulated credit agreements, which appear to us to involve high-cost and short-term lending; however, we have discretion on the level and structure of the cap or caps, and on how to apply the cap and any sub-caps that we think might be helpful. This high-level MFA helps put into context the discussion of costs and benefits that follows. In particular, it is important to note that benefits arise from correcting market failures.
- 1.30** As noted in FSA CP13/07, consumer credit markets present risks to consumers, including borrowing unaffordable amounts, not getting good value for money when borrowing (for example, if prices are above what we might expect from a competitive market) and being sold an unsuitable product. Two key risks for considering a price cap in the HCSTC market are unaffordable borrowing and prices that are not set competitively. These risks can arise due to, or be exacerbated by, market failures.⁷⁶ As we explain below, we observe these risks translated into actual harm in the market, which makes the case for intervention much stronger.
- 1.31** A number of market failures were identified in consumer credit markets and discussed extensively in FSA CP13/07. Three main market failures that we think are most relevant for the HCSTC market, and that we discuss below, are:
- behavioural biases
 - information asymmetries, and
 - limited price competition
- 1.32** These market failures (traditional and behavioural) are closely linked together in shaping market outcomes, and we approach these in an integrated fashion.

Information asymmetries and behavioural biases

- 1.33** As noted in FSA CP13/07, borrowers may take out loans when their income is not sufficient to make repayments sustainably, while covering their essential expenditures. The borrower may consciously do this, or more likely, the borrower may mis-assess their ability to repay – because there are elements of the product that they do not understand, and/or because of behavioural factors that result in them taking on excessive credit.
- 1.34** With respect to consumers' understanding of products, the CMA found that HCSTC consumers do not always fully assess the costs of borrowing, especially for non-headline elements of prices, e.g. default charges. With respect to over-borrowing, consumers may be present biased – focused on the immediate need for consumption rather than whether they can repay in the longer term. Present bias is often characterised by the need for quick gratification and feelings of regret. As well as having strong preferences for immediate gratification, consumers can be overconfident about their ability to repay. And consumers may be unduly influenced by how

⁷⁵ For examples of past MFAs see Annex 2 in FSA CP13/07 regarding the transfer of the consumer credit regime and Annex 1 in FSA CP11/31 regarding the Mortgage Market Review

⁷⁶ Risks (and consequent losses) can of course arise from facts of life. For example a borrower suffering a future unexpected negative shock (like being made redundant, or boiler breaking down) can lead to repayment difficulties without a market failure being the underlying cause

the information is presented, focusing on particular prices or features without considering all the potential costs. Such behavioural traits can lead some consumers to take on excessive debt that they struggle to repay. To repay, they may take on even more debt or fail to repay their credit commitments. FCA OP1⁷⁷ provides a detailed discussion of behavioural biases and how these can lead to consumer detriment. Campbell et al (2011) provide an overview of the market failures in HCSTC including discussion of behavioural biases.

- 1.35** FSA CP13/07 notes that credit products that can be easily rolled over, incurring interest and charges in the process, may be a concern for consumers prone to present bias, as these products often accumulate charges or interest rapidly. We made a rule in CONC 6.7.23R to limit to two the number of rollovers a firm can grant a consumer (which could lead to the accumulation of significant levels of charges). However, we note that this rule does not directly protect a consumer who is unable to repay or refinance and is subject to late payment fees and the accumulation of interest on unpaid debt. In addition CONC 7.3.4R, which came into force from April 2014 requires firms to treat customers in default and arrears difficulties with forbearance and due consideration, and CONC 7.7.5R requires firms not to impose on customers in default or arrears difficulties charges, unless they are no higher than necessary to cover the reasonable costs of the firm. The proposed price cap rules protect consumers subject to these charges more directly.
- 1.36** From the supply side, lenders may have greater information than borrowers (for example, on the probability of going into arrears or default, and consequent likelihood of profit from additional charges) and some incentives to exploit this asymmetry to encourage consumers to over-borrow. The rules in CONC 5 (responsible lending) reinforced the requirement on lenders to conduct appropriate creditworthiness checks, including affordability assessments.

Limited price competition

- 1.37** Consumers may pay too much for credit or for a service where firms operate under limited price competition. The CMA note in their provisional findings that the HCSTC market is characterised by consumers who are generally not price sensitive and do not shop around effectively. Therefore some efficient firms have the ability to charge prices higher than would otherwise be expected.

How consumers may be harmed by excessive charges

- 1.38** We have a legal duty to 'make specified rules in relation to one or more description of agreement appearing to us to involve high-cost short-term credit, with a view to securing an appropriate degree of protection for borrowers against excessive charges'.
- 1.39** In doing so, we must consider the impacts on all consumers in the market in question, including those consumers who would be denied access, as well as any harm to competition in the market and the impact of such rules on the economic interests of HCSTC providers. We must then consider what is the level and structure of price cap that achieves an 'appropriate degree of protection for consumers' and strikes the right balance between impacts on consumers, firms and competition.
- 1.40** Our view of an appropriate degree of consumer protection is based on the evidence of consumer detriment we see in the HCSTC market. Chapter 4 of the CP sets out what are excessive charges and how consumers are harmed by those charges. In particular, price can contribute to consumer detriment in two key ways (Chapter 4 explains further how consumers are harmed by excessive charges in these ways):

⁷⁷ FCA Occasional Paper No. 1: Applying behavioural economics at the Financial Conduct Authority

- **Charges contribute to borrowers' worsening financial situation.** HCSTC borrowers are in a difficult and deteriorating financial situation. Many borrowers are paying a high price for a loan that is of limited short-term benefit, or makes their situation worse.
- **Current high prices facilitate lending to borrowers who are at high risk of detriment as a result of borrowing.** Lenders can mitigate their risk of losses by charging high prices to everyone and are therefore prepared to lend to borrowers with high non-payment rates.

1.41 These two ways relate to behavioural market failures as outlined in the section on MFA above.

1.42 Our analysis leads to a compelling set of evidence regarding the detriment suffered by HCSTC consumers who would most likely be affected by the reduction in supply that would occur as a result of our proposals. We present this evidence in the next section after describing our analytical approach. We review first the economics literature on the impact of HCSTC upon consumers.

Review of economic literature relevant to setting a HCSTC price cap

1.43 We have carefully considered the extensive existing economics literature on the impact of HCSTC upon consumers. On balance, our reading of this literature (which is dominated by studies using US data) is that existing research is ambiguous with regard to the impact of HCSTC use or restriction. In particular, while many studies find detrimental impacts arising from HCSTC (Melzer, 2011; Skiba and Tobacman, 2011; Carrell and Zinman, 2014) there are also a number of studies which find positive impacts on consumer outcomes (Morse, 2011). There is no clear conclusion that can be drawn as to whether HCSTC is good or bad for consumers.

1.44 Similarly, the extensive literature on the impact of HCSTC bans, price caps or lending restrictions yields ambiguous results. A collection of studies find evidence that restricting access to HCSTC causes consumers to substitute towards inferior alternative means of borrowing, such as 'bouncing' cheques, exceeding authorised overdraft limits of borrowing from a pawnbroker (Morgan and Strain, 2008; Zinman, 2010; Morgan, Strain and Seblani, 2011; Golbin and Homonoff, 2013). Some studies claim these effects are large. However, a number of studies find no consumer detriment from restricting use (Bhutta, 2014; Bhutta, Skiba and Tobacman, 2014; Desai and Elliehausen, 2014) and some positive effects from restricting use (Zaki, 2013). Again, we make no overall judgement on the validity of these findings other than that the balance of existing evidence is ambiguous.

1.45 On this basis we did not form a strong prior view from the existing literature as to the likely impact of a HCSTC price cap on consumer outcomes and wellbeing. However, we did learn much from the research design of existing studies and this has informed how we went about modelling the impact of the HCSTC price cap on consumers. This is discussed in more detail in Technical Annex 3 (in particular see Chapter 4 'Econometric Methodology').

1.46 The papers we mention are all for the US market and it is quite possible that there would be different conclusions in the UK. We further note that the approach taken in several of these US studies is not feasible for UK studies.⁷⁸

Data collection

1.47 We requested various pieces of data and created several unique datasets to help us develop our model of how the market would change as a result of different caps and estimate the impacts that this would have on firms and consumers, providing the basis for our CBA.

⁷⁸ The US market several of these studies analyse is store dominated, contrary to the online heavy market in the UK. The approach several of these studies take is to exploit differences in caps across states. Such an approach focusing on geographical variations is not possible in the UK.

Competition and Markets Authority (CMA)

1.48 We requested, and were given access to firms' data submissions under the statutory gateway under the Enterprise Act 2002, selected papers and analysis undertaken by the CMA for their market study. We used the accounting data firms had submitted to the CMA as a reconciliation tool for the firm data we collected. We used their assessment of the current state of competition in the market to provide context for our assessment of competitive effects in the future as a consequence of the proposed cap.

Firm data

1.49 We requested a substantial amount of information from firms, including all of the medium and large sized firms in the market.

- The bulk of our data was supplied (under FSMA statutory information requirements) by eight groups, representing 11 legal entities ('firms') which cover 12 active brands. These account for the majority of the HCSTC market by number of customers and revenues. They also offer a diverse range of products. The data from these 11 firms captures a broad range of diverse business models, products and customers. We collected detailed cost, revenue and transaction data from these firms at a loan-by-loan level for 16m loans, from 2.3m individuals, made in 2012 and 2013. These data also included details of applications that were not successful as well as those that were successful, which is important for our analysis of the impact of HCSTC on consumers.
- In addition to the detailed data provided by the 11 firms (again under statutory information requirements), we sourced a more limited set of consumer level loan data and basic financial and strategic information from a further 22 firms. The loan-by-loan transaction data – a total of 20m loans across the 33 firms – allowed us to understand better the impact of HCSTC on consumers. The financial and strategic information was used to help us extrapolate the impact of our proposals on the wider market. These firms were selected on the basis that they were active in the market at the time of the data collection, and that the OFT's revenue data suggested these firms had HCSTC turnover in excess of £500,000 in 2011.
- Together, these 33 firms accounted for over 99% of the HCSTC market by revenue in 2013, according to our data.
- We requested details of firms' statutory and management accounts for the remaining firms in the market that we could identify. We sent this to 150 firms and had responses from 90 firms, of which ten small firms told us that they were not planning to remain active in January 2015

Credit reference data

1.50 Using data from firms on successful and unsuccessful loan applications and data from a CRA we identified 4.6m unique individuals who had applied for HCSTC. We matched a very high percentage of the loan applications to these individuals. This dataset allowed us to understand all HCSTC borrowing and loan performance for the vast majority of individuals active in the market. For all these matched individuals, in addition, we used our statutory powers to obtain detailed CRA data, covering 6 years of raw credit file data, on average containing information on 11 credit products and over 700 pieces of credit file information for each individual, and additional CRA databases designed to capture elements of consumer characteristics and behaviour. More details can be found in Technical Annex 3.

Consumer research

1.51 As the CRA data only covers formal lending and related public information, we conducted a consumer survey to fill in relevant gaps in our data. For a sample of consumers who we know

applied for a loan between July and November 2013, we supplement the quantitative data with a survey of 2,000 individuals to gather further information on financial and non-financial outcomes, well-being and alternative credit options including informal borrowing from friends and family and from illegal money lenders.

Our Analytical approach

1.52 Our analytical approach is designed to help us calibrate and assess the impact of different price cap options on consumers and the impacts on firms and competition. Benefits arise from a price cap to the extent that it reduces the impact of market failures. Our analysis uses the detailed data that we have gathered (more detail on our analytical approach can be found in the technical annexes). As discussed in the Consultation Paper, to establish the impact of our proposals and the costs and benefits, our approach answered three key questions:

- What happens to firms and firms lending decisions as a result of our proposals?
- What options are there for consumers who no longer have access to loans?
- What is the impact on consumers denied loans as a result of our cap?

What happens to firms and firms' lending decisions as a result of our proposals?

1.53 We use individual-level loan data from the sample period to understand firms' lending decisions and analyse the impacts of the price cap. The first stage is to establish a 'baseline', or counterfactual, from which we can assess the impact of our different proposals. In our 'static' analysis we made one major change to the 2012 and 2013 data, to project forward a view (in the absence of the cap) in 2015. Specifically we adjusted for rules made in PS14/3, the most significant of which came into force this month, namely requiring firms to only grant two rollovers (CONC 6.7.23R) and limits on the use of CPAs (CONC 7.6.12R to 7.6.14R). These rules are expected to have a significant effect on HCSTC firms, before the cap is implemented. We have therefore adjusted the data provided by firms to assess what the impact would have been on 2012 and 2013 data, had these rules been in place. The counterfactual for the price cap then is a world with no price cap but assuming the new rules above are in place.

1.54 Using this baseline, we then assess the effect of different cap options on firms' lending decisions to estimate the loans they will continue to offer under the proposals. As a result of a price cap, revenue streams will change for different consumers and this feeds through into the lending decisions of each firm. We model each firm's lending decisions separately. We identify those consumers who would still get loans, but pay a lower price, and the consumers who are no longer profitable to lend to under the cap and therefore would not get loans. These feed through to the later analysis we undertake on the impact of our proposals on consumers. For firms, we assess how their revenues and profit contributions change as a result of our proposals and then assess the overall impact on firms and the likelihood that firms would be at risk of closing their HCSTC business. For modelling purposes, we apply the cap to each loan's initial principal, which is representative for more than 85% of loans in the model.⁷⁹ More detail on our approach and analysis can be found in Technical Annex 1.

⁷⁹ In conducting our CBA for the initial cost cap, we estimated impacts based on the initial principal of a loan rather than outstanding principal. This is how the cap would in practice be applied for 85% of the loans in the sample. For loans where the credit is paid in more than one instalment (15% of the loans in our sample), this is a less accurate estimate. It would not, however, have been reasonably practicable to produce a more accurate estimate for this small proportion of loans because of the impracticability of collecting, analysing and modelling data that reliably shows the reduction in initial principle over the lifetime of each type of loan. We have however considered the impact this may have had on the accuracy of our estimates, using firms' submitted data on repayments to calculate the average outstanding principal, and concluded that it does not materially affect our estimate of impacts. Our supplementary analysis indicates that this would change the impact on revenues, firm customers and contributions by 1% and the value of lending by 6%.

1.55 We adjust our data for the new rules on HCSTC and the impacts these will have. To ensure our conclusions are robust, we supplement these estimates with an analysis of alternative scenarios that could arise, either as a result of existing market trends or from potential responses from firms. More detail on how we have taken account of dynamic responses from firms and the effect on competition in the market can be found in Technical Annex 2.

1.56 It is not reasonably practicable to produce estimates that seek to predict the future post-cap HCSTC market characteristics such as the proportion of future loans that will be instalment loans, loan duration or pricing structures (nor are we reasonably able to estimate them). The degree to which firms will change their business practices and products is subject to a range of uncertainties at this point. Therefore our analysis of the likely costs and benefits of the proposed rules focusses on assessing the magnitude of the changes that would need to occur to materially affect the static results to give our view of the likely impact of firm exit.

What options are there for consumers who no longer have access to loans?

1.57 The first stage of the analysis allows us to identify those consumers who are still able to get a loan (at a lower price) and those who are denied access due to becoming unprofitable. For those who face either a reduction in access (because not all firms will lend to them) or are completely denied loans, we consider what alternatives consumers might consider. We use consumer research and CRA information to identify what substitutes consumers might consider and what they might actually use.

What is the impact on consumers denied loans as a result of our cap?

1.58 For those who do get HCSTC loans there is a trade-off between the short-term benefit of the consumption that the loan may facilitate, and lower consumption and persistent effects (both financial and non-financial) in the longer term due to the costs of borrowing. We examine the consequences of consumers being denied loans, through comparing outcomes for applicants denied access to HCSTC with those who are not.

1.59 To do this we use firm data to assess the number of consumers who no longer receive loans who would have experienced late payment or non-repayment of the HCSTC loan. We further use consumer research and CRA data to assess the impact on a range of other financial and non-financial outcomes derived from administrative and self-reported data. This suite of outcomes, alongside the benefits to consumers who are still able to access loans at a lower price, informs our judgement on the costs and benefits of the proposal. More detail on how we assess the impact of our proposals on consumers can be found in Technical Annex 3.

1.60 Analysing the impact on a consumer of taking out a HCSTC loan (or of being denied a HCSTC loan) is complex. We cannot observe the alternative outcomes for any individual consumer had they been denied (or given) a loan. To help solve this problem, we used statistical comparison methods⁸⁰ to compare the outcomes using two very similar groups of applicants.⁸¹ Both groups have very similar credit scores and other characteristics relevant to their financial and personal wellbeing. They are different in one fundamental respect – one group just qualified for the initial acceptance criteria of HCSTC lenders, whereas the other group just missed this threshold.

1.61 These two very similar groups of consumers either did or did not get a loan and this enables us to compare the impact on these people of getting, or being denied, a loan. By comparing the two groups we are able to robustly compare outcomes, where the only major difference is access to HCSTC (see Technical Annex 3 for further details). It is also important to analyse

⁸⁰ We use econometric methods based on quasi-experimental approximation of a Randomized Controlled Trial design. This is explained in detail in the Technical Annexes

⁸¹ We use the concept of groups here since this is a simple way to think about and present our analysis. More precisely we would say those around the threshold are not different groups, but in fact very homogenous.

outcomes for these particular consumers, since it is likely that these marginal consumers are at highest risk of the reduction in supply that would occur as a result of our proposed cap. We further estimate the effects of HCSTC use on consumers with better credit scores who are further away from the current threshold.

How our analysis demonstrates consumer harm

1.62 Based on our analysis of first-time applicants near the current lending margin (threshold), there is evidence that HCSTC use causes detriment in some areas for borrowers who just qualify for HCSTC. In particular, for those who just qualify for HCSTC:

- 43% of initial HCSTC loans, and 20% of repeat loans, end up not being fully paid back
- 76% of customers are late in paying back their HCSTC loans at least once⁸²
- they suffer worse outcomes across other financial dimensions in the medium term (6-12 months) after taking out HCSTC loans⁸³
 - 33.7% of these consumers' non-HCSTC credit balances are unpaid compared to 30.6% for applicants turned down for HCSTC
 - 44.4% of these consumers are behind on non-HCSTC payments compared to 38.6% for applicants turned down for HCSTC
 - 27.9% of these consumers exceed their overdraft limits compared to 24.9% for applicants turned down for HCSTC and
 - there is a greater decrease in these borrowers' credit scores (by 53.3 points) than the decrease for applicants turned down for HCSTC (by 31.7 points)
- 41% claim to regret using HCSTC. Of the 53% who claimed they were happy to use HCSTC, only 50% say that they would apply for a HCSTC loan in similar circumstances⁸⁴

1.63 As a consequence of the increased likelihood of not paying back loans, the sort of detriment borrowers can suffer includes going into insolvency procedures and/or suffering stress and mental-health effects due to being behind on payments, non-payment, being subject to debt collection procedures and potentially even legal action.

1.64 We note that there was no clear difference in consumers' self-reported welfare in the consumer survey between those who did and those who did not get HCSTC. We consider, however, that the wider evidence on a range of outcomes – in particular the harm from increased non-payment and late payment rates – forms a compelling set of evidence regarding the outcomes of HCSTC use for those most likely to be affected by the reduction in supply that would occur as a result of our proposals.

1.65 For consumers with better credit scores, it is harder to assess the direct effects of HCSTC use. We do not have a strictly comparable group of consumers with better credit scores that are denied loans. So our analysis does not necessarily enable us to identify the causal estimates of the impact on these consumers so well. However, we use two alternative methods to extrapolate to higher credit scores (see Technical Annex 3) and find very clear patterns in the

⁸² 77% of consumers in our sample covering 2012-13 incur charges (late fees, interest on arrears) from at least one late payment

⁸³ See *Technical Annex 3, CRA Data Analysis* for further detail

⁸⁴ See *Technical Annex 3, Consumer Survey Analysis* for further detail, particularly section 13c on consumers' experience of HCSTC use

data that indicate that the adverse impacts on financial outcomes from HCSTC use remain, but are less pronounced for consumers with better credit scores. Consumers with higher credit scores have the following outcomes associated with HCSTC use:

- a relatively high chance of not fully paying back their HCSTC loan
- greater likelihood to go over their overdrafts and fail to repay on other non-HCSTC debt and
- lower levels of regret and an increased willingness to take out loans again when compared to consumers with lower credit scores, but regret levels remains material at 31%

1.66 Additionally, looking at problem debt individuals (defined as consumers with unpaid debt on their existing loans greater than 100% of principal) we observe this group is in more severe financial difficulties than other HCSTC users. While 44% of consumers further away from the lending margin (threshold) miss a bill, the number for problem debt borrowers is 57%. This translates into low welfare outcomes for this group as well with 65% reporting high anxiety (compared to 53% for less marginal consumers).⁸⁵

Section 3: Costs and benefits of our preferred option

1.67 We assess the costs and benefits of our preferred option in this section. As noted previously, this takes into account a wide range of impacts on firms, consumers and the market as a whole. The main impacts we assess include:

- reduced revenues for HCSTC firms, leading to firm exit from this market, and effects on competition
- reduced costs for HCSTC borrowers who continue to be served in the market
- reduced or restricted access for some consumers and financial and non-financial consequences of this and
- administrative costs to firms and the FCA

1.68 While the majority of these impacts can be estimated in monetary terms, it is intrinsically difficult to assess consumer welfare as a result of loss of access in a comparable way, particularly where behavioural factors may distort consumer decision making. Therefore we estimate a wide range of consumer outcomes to help us assess the impact of the proposed option.

Our proposal

1.69 We are proposing a price-cap with three components:

- An **initial cost cap of 0.8%** per day of the amount borrowed on all interest and fees charged during the agreed loan duration and when refinancing
 - The initial cap will be calculated as a percentage of the principal according to the number of days of the loan

⁸⁵ See *Technical Annex 3*, Consumer Survey Analysis for further detail on problem debt borrowers

- Firms can structure their charges under the cap in any way they choose e.g. a portion could be upfront fees or rollover fees⁸⁶
- A cap for those in **default**⁸⁷ of
 - a total of £15 on fixed charges
 - interest at the same rate as under the initial cost cap calculated per day on principal and fixed default charges
- A **total cost cap** of 100% of the total amount borrowed applying to all interest, fees and charges. Therefore the maximum anyone could ever pay on an individual loan in interest, fees and charges would be 100% of the principal

1.70 A consumer borrowing £100 for 30 days would pay a maximum of:

- £24 during the agreed loan duration;
- up to £15 fixed fees if the loan is overdue; and
- maximum default interest charge of 0.8% per day, up to £61 if a £15 fixed fee is paid (only if the loan remained unpaid for 67 days beyond the agreed loan duration).

1.71 The proposed cap applies to loans that fall within our definition of HCSTC and is explained in greater detail in Chapter 5. There are some nuances around the proposed cap which are important to mention here:

- The proposals also apply to refinanced agreements. Chapter 5 explains in detail how refinanced agreements are impacted. For the purposes of the CBA our overall modelling includes refinanced loans, and so the impact on these is captured in our overall assessment.⁸⁸
- We are also proposing to apply the price cap to peer to peer (P2P) platforms. We are not aware of any P2P lenders facilitating borrowing within the HCSTC definition at present but firms could start to do so in future. This implies no material impact relative to now, but could prevent consumers borrowing through P2P platforms suffering harm from excessive charges in the future.
- Charges made by credit brokers who share some or all of their charges with the lender, or those who are in the same group as the lender are included in the total and the initial cost cap. The likely impact of this is considered in our Market Response section further in this CBA chapter, and in greater detail in Technical Annex 2 in the discussion around acquisition costs.
- Firms have to use simple interest and may not charge compound interest when calculating the cap. We think this will ensure the cap is not overly complex, and potentially improve comparability for consumers.
- The proposed rules include in the cap amounts that are charged for ancillary services. These services include for example charges for processing the application, transmitting money and

⁸⁶ Firms can charge the full amount under the cap calculated according to the agreed loan duration at any point during the loan.

⁸⁷ This applies to circumstances where the borrower fails to pay on the date required.

⁸⁸ See Technical Annex 1 for detail on adjustments made to the modelling to consistently treat refinanced agreements as single loans

insurance or insurance like products. We have included charges for ancillary services in our modelling and so our overall assessment.

- The effect of our proposed rules is to make agreements unenforceable to one extent or another depending on the circumstances. We expect one impact of this provision to be that firms take greater care to ensure agreements are in line with our proposals, increasing compliance. Further, where firms do not comply we could expect a transfer from firms to consumers (from not being able to enforce agreements). We do not estimate this transfer since it is a consequence of non-compliance.

Costs and benefits for firms and impact on competition

1.72 To answer Question 1, what happens to firms and firms' lending decisions as a result of our proposals, for the sample of eight companies who provided data sufficient for our analysis (covering 83% of the market by revenue), we analyse loan level data to assess lending decisions, costs and revenues.⁸⁹ Our analysis models how firms' lending decisions might change under different cap structures and levels, changes in revenues as a result of the cap, the impact on profit contribution, firm profitability and ultimately on the risk that firms may exit the market. See Technical Annexes 1 and 2 for more details of the analysis.

1.73 From this analysis, we estimate that our proposal would across the market:

- reduce the value of loans by 11%
- reduce revenues for firms by 42% and
- reduce contributions for firms by 43%

1.74 Contributions are defined as total revenues, less costs attributable to individual loans and not including fixed costs. We use contributions as a proxy for profitability, and though not precise, we use these two terms interchangeably in this CBA.

1.75 The percentages derived above are from our supply side model which covers two years of data (2012 and 2013) and a sample which covers 83% of the market by revenue. For the sample over the two years we estimate the proposal leads to a:

- reduction of around £450 million in the value of loans originated, from a base of around £3.9 billion
- reduction of around £700 million in revenues, from a base of around £1.7 billion and
- reduction of around £310 million in contributions, from a base of around £740 million

1.76 Simply extrapolating out for the entire market (based on the ratio of the sample to the market size) and calculating numbers on an annual basis (by dividing the sample period of two years by two) we estimate the proposal leads to an annual:

- reduction of around £270 million in the value of loans originated, from a base of around £2.4 billion
- reduction of around £420 million in revenues, from a base of around £1 billion and

⁸⁹ See Technical Annex 1 for full details

- reduction of around £190 million in contributions , from a base of around £450 million

- 1.77** Part of the reduction in revenue (an estimated £250 million for the entire market) is due to the lower prices that firms can charge for customers who remain in the market as a consequence of our proposed cap. This reduction in revenue is a direct transfer to consumers in the form of lower prices paid by those consumers still able to access loans.⁹⁰ The rest (an estimated £170 million reduction in revenue for the entire market) is because of loans not granted.
- 1.78** These numbers are based on a static view of the impact of the cap. Arguably, any response that firms would make to the cap would mitigate the impacts of the cap on their business relative to the static results shown (in other words, they would seek to increase revenues, profits, and lending volumes). Consequently, the static impacts presented can be viewed as a conservative scenario, in terms of the impact on HCSTC firms.⁹¹
- 1.79** The reduction in revenues leads to lower levels of profitability. We compare these new rates of profitability against the costs that firms face to assess how many firms would no longer be able to cover the costs of doing business. Based on this assessment, we estimate how many of the firms we have detailed data for would be at risk of leaving the market. We then extrapolate this to other firms in the market based on firm characteristics such as product mix, distribution channels and business models. See Technical Annex 1 for more on how we have assessed which firms are likely to leave the market.
- 1.80** For our proposed option, our analysis shows that it is possible that around three firms (of our sample) would have sufficient revenue to cover the costs of doing business and would remain in the market. These are predominantly firms who operate online, and have around 53% of current market share (by revenue in 2013). Our assessment of the impact of our proposal on the market suggests that the rest of the firms are all at risk of exiting.

Dynamic analysis

- 1.81** The outcomes we estimate above are based on 2012 and 2013 data, adjusted for the new rules in PS14/3 as noted above. However, there are a number of changes that might occur over time, either as part of an existing trend in the market or as a dynamic response to our rules. To test our proposals against these possible scenarios, we look at market trends, and several firm responses that could change the impact of our proposal.

Market trends

- 1.82** The number of new customers entering the market has been consistently falling. This might be expected in a market that is relatively new and is reaching maturity. Secondly, we note that over the more recent period, loans of longer durations have become more common. We have further seen an increase in the number of repeat customers, who are more profitable than new customers. This shift may reduce the risk of exit for some firms.

Market responses

- 1.83** We also expect the market to change and adapt in response to our proposals. In particular we look at three changes we might expect to see over time.
- 1.84** First, for firms whose prices are currently below different parts of our proposed cap, the cap may provide a focal point for firms to price towards, leading to an increase in prices. It is not clear how likely this response will be, especially in light of the CMA's proposed remedies

⁹⁰ We note that this loss in revenue (because of the fall in prices) is closer to a direct fall in profits because the costs of supply are in principle unchanged.

⁹¹ In particular, we would expect remaining firms to take more market share, reducing the effect on the supply of credit at market-level, and also mitigating the revenue losses for those firms. This is discussed in more detail in Technical Annex 2.

to improve price transparency and competition in the market. However, we include it in our analysis to provide a check on our conclusions and to assess outcomes. Under such a scenario, if firms are able to increase prices in areas where our proposed cap is non-binding, then this would offset to some degree the fall in revenues and reduce the likelihood that firms will exit the market.

1.85 Second, some firms told us they expected customer acquisition costs to go down following introduction of the cap, while others expected acquisition costs to rise. In our judgement, the reduction in the revenue that a provider may get will reduce the willingness and ability of HCSTC lenders to pay for leads. In theory, the level of acquisition costs could have a significant impact on firms' ability to offer loans i.e. reduced acquisition costs would allow more loans to be made. To test the impact of reduced acquisition costs, we modelled a 10% decrease in acquisition costs to test the sensitivity of our analysis. This suggests that there is very little impact. We conclude therefore that we do not expect changes to acquisition costs to significantly change our conclusions on firm exit or market structure.

1.86 Finally, this analysis of firm exit does not take account of potential redistribution of customers from those firms who exit to other firms. For example, we would expect that, after the first firm exits the market, its customers (those with good credit ratings who would still be served under a market with a cap) would consider using alternative suppliers, increase revenues to these firms and make it less likely that they would need to exit the market. Our analysis does not take into account the redistribution of current customers or the potential dynamic effects discussed here and can therefore be considered a 'conservative scenario' of firm exit.

1.87 See Technical Annexes 1 and 2 for how we expect these effects to change the impact of our proposals.

Competition

1.88 As a result of our proposal, we expect a large number of providers to be at risk of exit. The market is already concentrated, and substantial exit following the cap would further increase concentration levels.

1.89 For online providers, we would not expect this level of supply to significantly reduce competition relative to current levels. The CMA found that while there was some evidence of competition on non-price dimensions the degree of price competition was limited.

1.90 We expect the effect of competition in the market will not be lessened in the future because:

- the cap itself will prevent prices rising;
- we don't expect a reduction in the level of non-price competition and expect consumer demand to continue to focus on the non-price aspects of product offerings (such as the speed of access to funds) in the future; and
- the proposed CMA remedies could tackle the currently limited degree of price competition that takes place, potentially resulting in greater price competition in the future.

1.91 Additionally, since the current level of price competition is weak (as found by the CMA and as described above) and the proposed cap is set below current market prices, the market should be nearer a competitive price. The CMA found that headline prices have tended to cluster at approximately £30 to borrow £100 for a month. They estimate that a more effective price competitive market would lead on average to a saving per loan between £5 and £10 on the headline price. Our cap brings this headline price down by around £6, as described in Technical

Annex 2. The cap can hence protect people from one of the main risks of concentration i.e. increased prices.

- 1.92** In practice we may expect the number of online firms that continue to operate to be greater than implied by our static exit analysis, following changes to business models. For the high-street, predicting the number of lenders that will continue to operate is subject to particular uncertainty. If a single supplier remained, we believe online providers would provide a competitive constraint, and the cap itself would provide a degree of protection for high-street consumers. However, the extent to which (some) high-street customers are able to switch online is likely to be limited. Currently, the CMA estimates that 12% of borrowers have used both online and high-street lenders. Our own data shows that for those consumers whose first use of HCSTC was through a high-street lender in Q1 2012, 24% subsequently use an online provider.
- 1.93** In summary we expect as a result of our proposals:
- competition would continue to focus on non-price factors, including speed and convenience
 - price competition on non-payment charges and point of sale prices would continue be limited and
 - no material changes to firms' customer acquisition channels or debt recovery processes post FCA rules on CPA and rollovers
- 1.94** The CMA as part of its provisional findings set out some potential remedies for the HCSTC market. If applied, it is possible these could mitigate some of the issues around competition observed above.
- 1.95** We have a duty to choose the most pro-competitive option that is compatible with our objectives, and in addition here we have a duty to make certain rules with a view to securing an appropriate degree of protection of borrowers against excessive charges, taken together with our objective to secure an appropriate degree of consumer protection. We note that price caps are generally not pro-competitive and can have a distortionary effect on markets through setting prices lower than the equilibrium level. However, we do not have flexibility about whether to impose a cap that will have an impact on firms, given our findings on harm to consumers. We therefore need to consider whether there are different effects on competition from different structures and levels of the cap. We consider the competition implications of each in turn.
- 1.96** There are a number of common types of charges that suppliers use in different combinations in relation to the loans they make. For example, there are daily interest charges, loan agreement charges, faster payments charges, non-payment and late payment charges, etc. It would be technically possible to define and set caps for all the separate core elements of charges. However, that would unduly constrain flexibility in the market. Instead, our approach has been to identify the simplest, relatively non-prescriptive cap structure, which we believe meets our objectives, to give suppliers the greatest potential flexibility in product design and pricing structure and thus to enable as much competition to remain in the market as is possible. Suppliers will therefore be able to differentiate to some extent their product offerings while meeting the cap. This is an important element of imposing the cap while meeting the competition duty.
- 1.97** The second main element relates to the level of the cap. Our analysis has shown that, across the range of levels for the price cap that we consider could achieve our consumer protection objectives, there will be a reduction in the number of providers that can profitably remain in the market. As the cap level tightens, it further reduces the number of providers.

- 1.98** This holds for the HCSTC market under the majority of scenarios considered, because only the three largest lenders have had high returns above the costs of capital, and the operating margin of the high-street is much lower than online. We expect that around three firms will be able to maintain a profitable business, with the possibility that other firms remain in the market through their dynamic responses to the cap. In particular we consider that firms could change products and prices in response to the cap, and that acquisition costs may fall, offsetting our forecast.
- 1.99** For example, providers may change their pricing structures once the cap is in place. As a sensitivity check, we have modelled a scenario in which all lenders in our sample are able to charge the maximum allowable for every loan, under each cap level (see Technical Annex 2). Currently, the total amount charged on some loans will be lower than this maximum. It should be noted that this represents a maximum price response that firms could make. In practice, firms would be likely to find it difficult to charge and recover these maximum amounts per loan. The sensitivity check suggests while changes to pricing structure may allow an extra firm to meet overhead costs, we do not expect firms' pricing responses to significantly change our conclusions on firm exit or market structure in the static analysis.⁹²
- 1.100** To conclude, we have calibrated our proposals, being mindful of the risks they present to the continuance of the high-street distribution channel, and in a way that reduces those risks so far as can reasonably be done while achieving an appropriate degree of protection.

Impact on consumers

- 1.101** Consumers will be affected by our proposals in a number of ways.
- Consumers still able to access HCSTC loans will pay a lower price as a result of the price cap.⁹³ We estimate the median saving per loan to be £14. The median annual saving for every individual who remains in the market is £76, and the mean annual saving per individual is £193. Some customers will save substantially more. We estimate total savings for consumers will be approximately £250 million per year.⁹⁴ These savings are to consumers who pay back on time as well as those who end up paying later than they expected. We estimate these figures using the model that we described above to answer Question 1, "what happens to firms and firms' lending decisions as a result of our proposals?". Further details on the methodology behind these numbers can be found in Technical Annex 1.
 - We expect that some consumers will not be able to access loans as they are no longer profitable following the cap. We estimate approximately 11% of individuals will no longer be served by the market as a result of our proposal. A further estimated 14% of individuals will face reduced levels of access. Our model of firms lending decisions plus some ancillary analysis allows us to estimate these numbers, further details of which can also be found in Technical Annex 1.
 - Clearly for these people denied loans, there will be some who might benefit and some who might lose out. For some people, being denied access will remove the risk of taking out unaffordable debt, not fully taking into account long-term costs or being overconfident in their ability to repay. For others, being denied access will be costly, as using a HCSTC loan would have had positive outcomes. In practice, a cap will affect both types of people to

⁹² This scenario models the maximum possible response. If we were to find little difference in outcomes (as we do), then we can infer that our conclusions are not likely to be mistaken because of firms' responses to the proposed cap.

⁹³ Some individual consumers might face higher prices, but on average and in aggregate consumers who will continue to be served in the market will get savings

⁹⁴ For our sample over 2012-13 and covering ~ 83% of the market we estimate savings of around £410 million for customers who would continue to be served by the market. The £250 million estimate extrapolates out for the entire market (based on the ratio of the sample to the market size) and calculates numbers on an annual basis (by dividing the sample period of two years by two)

different degrees depending on where it is set. We can estimate the number of individuals who would no longer get loans, and of those, who would or would not have had trouble paying back their HCSTC loans. We can also (at the margin and on average) estimate financial and non-financial consequences for groups of individuals based on their credit score. However, as we are not estimating welfare impacts for each individual – which would not be reasonably practicable (as discussed elsewhere in this chapter)⁹⁵ and is not needed to consider the net effects of our policy – we do not estimate the number of individuals who definitely will or will not gain as a result of no longer having access to HCSTC.

- Our approach is to look at a range of evidence that proxies certain outcomes for groups of individuals, and on this basis make a judgement about the right level for the cap. We start by considering non-payment and late payment rates for those that we expect to be denied loans (again, using the model outlined in Technical Annex 1). We then go on to consider a range of financial and non-financial outcomes from CRA data and our consumer research. This analysis, along with loan performance data (late and non-payment) that comes from our model of firms' lending decisions, allows us answer Questions 2 and 3, "what options are there for consumers who no longer have access to loans?", and "what is the impact on consumers denied loans as a result of our cap?". Technical Annex 3 provides full details of our CRA and survey data analyses.
- We cannot precisely estimate the monetary value of all costs and benefits for all consumers denied access as a result of our proposals; however, we are able to estimate a range of outcomes for these groups, and use this to assess the balance of costs and benefits for these groups.

Impact on consumers still served in the market

Number of consumers still in the market

1.102 Our modelling suggests that at least 89% of those individuals served currently, would continue to be served under our proposals, or approximately 1.3 million individuals a year. We also assess the number of consumers who might face reduced access – for example where our modelling shows that if they currently use two firms, they might still be served by one of the firms, but not the other. We find that 14% of people face this reduced access. However, we note that it is possible that these consumers would be able to counteract this reduction in supply from one firm by using the other firm more frequently, so our modelling may overestimate the impact on consumers.

1.103 This static part of our modelling does not directly consider firm exit. Put simply, we focus on whether consumers remain profitable to serve and the numbers of consumers remaining in the market is based on which customers are still served by specific firms that they previously borrowed from. It does not take into account whether the firm would remain in the market. We can assume that, if a firm decides to leave due to concerns about profitability, its customers remain profitable to serve and are therefore able to access HCSTC from an alternative provider.⁹⁶

Lower prices for those still in the market

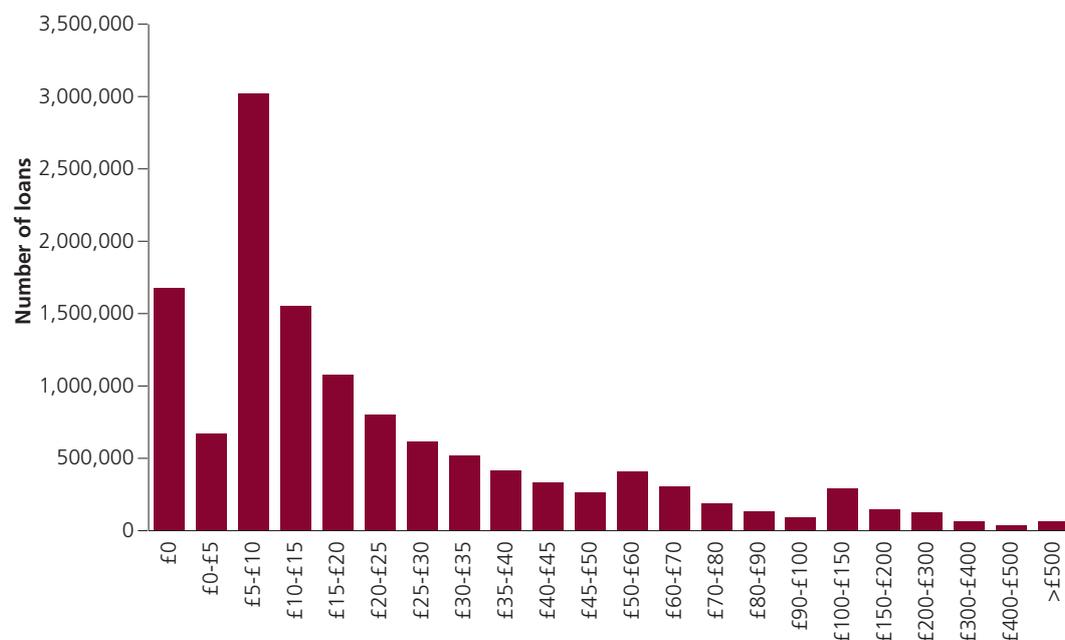
1.104 For the individuals that are still able to access loans, we have modelled the reduction in price as a result of the cap. For the 89% who remain in the market, we estimate that their median saving would be £14 per loan. Figure 3 shows the distribution of savings per loan. Given current consumer behaviour, this is equivalent to £76 per year (median) saving for every individual who remains in the market as a result of the cap (£193 per year mean saving). This is an approximate £250m per year direct transfer from firms to consumers as a result of lower prices. This transfer is partly captured in the reduction in revenues estimated above. Consumers may only observe savings related to a drop in headline prices, and not feel the benefit directly from a reduction

⁹⁵ We note in particular that assessing welfare outcomes in the presence of behavioural biases is particularly difficult

⁹⁶ Exiting firms are likely to have higher costs (be less efficient) than remaining firms, which suggests remaining firms should be able to lend profitably to individuals who obtained loans from firms who exited

in default balances, however these savings are estimated to accrue in both repayment of loans on time, and after the scheduled repayment date.

Figure 3 Distribution of savings per loan



1.105 This impact is likely to be an upper bound of consumer gains, since as discussed above one dynamic response to the cap is for firms to raise prices towards the cap, for those elements where they currently do not charge at the level of the cap. A dynamic scenario where firms increase prices towards the cap would reduce gains to consumers and return these back to the firm (and in such a scenario we expect fewer firms to be at risk of exiting the market). See Technical Annexes 1 & 2 on dynamic impacts for further details.

1.106 Although this is a transfer from firms to consumers, there are two reasons why this might be seen as a positive outcome of our proposals. First, the CMA has found that there is limited price competition and that some firms have been making exceptional levels of profit – falls in revenues for these firms can be transferred to consumers without endangering firm viability. Secondly, our operational objectives as set out in FSMA place an explicit objective for consumer protection and the competition duty is expressed to be subject to “acting in a way which advances the consumer protection objective ...”

Increase in borrowing from new and existing customers

1.107 It is possible that new customers would be attracted to the market by lower prices. And for existing consumers, lower prices may encourage more borrowing (either more frequent borrowing or higher values). However, the CMA found that consumers are relatively price insensitive, so we expect little increase in borrowing as a result of new customers entering the market or existing customers increasing their existing borrowing.

Impact on consumers who would no longer get loans

1.108 Assessing welfare outcomes in the presence of behavioural biases is particularly difficult. Consumers’ revealed preference may not be a good indicator of actual welfare outcomes as a result of consumption – specifically, if consumers fail to correctly assess the benefits or costs of goods, revealed preferences may not be a good indicator of true benefits derived from

consumption.⁹⁷ Self-reported measures of satisfaction may be subject to mis-reporting and/or contextual dependencies. Life-satisfaction approaches require very large datasets and rely on some assumptions of how life satisfaction translates into a monetary valuation of consumption, among other issues.

1.109 Our analysis of consumers unable to access HCSTC borrowing therefore presents a range of evidence on the impacts of taking out a HCSTC loan, including the late or non-repayment of those loans; available credit alternatives; self-reported life and product experiences; and, financial outcomes in other dimensions.

Costs

1.110 The main costs of the proposed cap for consumers who would no longer get loans arise from having to delay consumption. In summary, these potential costs are:

- A lack of convenience and speed in accessing credit
 - Survey respondents state convenience and speed as primary reasons for choosing a HCSTC loan rather than an alternative source
- People not getting loans when they really need them and the consequences of this
 - Restricted by lack of choices, borrowers may turn to illegal money lending, which is associated with very poor conduct and negative outcomes for borrowers. However, our research suggests that few HCSTC consumers (under 2%) use illegal lending, and that lack of access to HCSTC may have little effect on this usage.
 - Discomfort of other borrowing options, including family and friends, which is the primary alternative source of funding consumers consider and access. We note though the majority of consumers would not borrow if they did not get HCSTC.
 - Increased likelihood of going over overdraft limits (for one month).
- Negative welfare outcomes/ financial distress
 - Overall we do not find any conclusive evidence of negative welfare outcomes associated with lack of access to HCSTC.

Lack of convenience/ speed

1.111 Our research indicates consumers apply for HCSTC due to speed of access and being unable to borrow anywhere else. This echoes the findings of the OFT and the CMA. In our survey, speed and convenience was cited by 46% of those accepted, at the threshold of firms lending decisions, as their reason for applying for HCSTC.⁹⁸ However, the majority of those who apply for HCSTC but are rejected eventually do not borrow elsewhere and are able to adjust otherwise (with no significant loss in welfare according to our research). This loss of convenience as a cost then applies really only to those who otherwise would get another loan, which is a small subset.

People not getting loans when they really need them and the consequences of this

1.112 Consumers unable to access loans as a result of the cap will have to consider what to do as a result of not being able to take out a loan. For some, this will mean simply going without the planned consumption. For others, they may consider alternative forms of borrowing, either

⁹⁷ See 'Valuation Techniques for Social Cost Benefit Analysis' for more on the limitations of revealed preference techniques: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/209107/greenbook_valuationtechniques.pdf

⁹⁸ See *Technical Annex 3*, Consumer Survey Analysis for further detail

from formal sectors such as overdrafts or from informal sources such as borrowing from friends, family or, at the extreme, illegal money lenders.

- 1.113** Our survey showed that the majority (60%) of consumers state they would not borrow if they did not get a HCSTC loan – they would simply do without.⁹⁹ This finding reflects the actions of those who did not get loans in our consumer research. 62% of them do not proceed to get other loans. Other forms of credit are used alongside HCSTC lending, not as substitutes.
- 1.114** From our consumer research, between 19% and 25% of people, dependent on their credit score, said that they would have borrowed from friends or family if they had not been successful in taking out a HCSTC loan. By comparing the answers to this hypothetical question with the observed outcomes of consumers who were in fact denied loans, we are able to corroborate the hypothetical answers. We find that 28% actually borrowed from friends and family. The increased discomfort individuals might feel borrowing from family and friends is a potential cost of our proposal for those who would no longer get HCSTC loans.
- 1.115** Our analysis of consumers whose loan application is ‘just’ accepted relative to identical consumers who are ‘just’ denied their application shows they go over their current account agreed overdraft less frequently in the first month after the application. This implies that, as a consequence of the cap, some consumers who would no longer get loans may turn to overdrafts more as substitutes and get stretched. This is, however, a very short-term outcome. When examined over subsequent months, we find those ‘just’ accepted actually exceed their agreed overdraft more frequently.
- 1.116** A potentially significant cost of reducing access to HCSTC would be if consumers turned to illegal money. Illegal lending can be associated with very poor conduct and negative outcomes for borrowers. We are aware that consumers may not respond truthfully when replying to questions regarding illegal money lending, so we were very careful to design our questions to minimise this possibility.¹⁰⁰
- 1.117** Our consumer research supports other evidence that suggests that consideration of illegal money lenders is relatively low for HCSTC customers.¹⁰¹ Our consumer survey found that 3.3% of consumers who were marginally accepted for a loan said they considered borrowing from a loan shark (not including responses where consumers considered a loan shark to be a licensed lender). This compares to 4.7% of consumers who were marginally rejected for loans. Although there is a difference in these figures, it is not statistically significant and we do not find significant differences when using more robust statistical methods. To check our results, we looked at whether consumers reported any interaction with an illegal lender over the last six months (attempting to borrow, borrowing, having outstanding debts, repaying debts, having overdue debts). We found that a very low percentage (under 2%) of the entire sample had used an illegal lender since July 2013.¹⁰² There were no significant differences between consumers who did and did not get a HCSTC loan, suggesting that not getting a HCSTC loan does not increase the risk that consumers actually use illegal money lenders.

99 The CMA further found that 6% of HCSTC users would have used other formal credit products if an HCSTC loan was not available. Most respondents in that survey said they would have either gone without (28%) or borrowed from friends and family (31%). Just 6% said they would use a formal credit product; of which 21% said they would use a credit card. Overdraft (15%), bank/building society loan (12%), pawnbroker loan (3%) and home credit (1%) were also mentioned.

100 See *Technical Annex 3* for further detail.

101 While 7% of our sample said they considered borrowing from a loan shark, when asked some clarified that they meant home credit and HCSTC.

102 See *Technical Annex 3* for further detail.

1.118 This is consistent with findings on the substitution between illegal money lending and HCSTC elsewhere. For example, Bristol University's consumer survey¹⁰³ found that 1% of online and 2% of retail payday loan customers said they would consider using an illegal money lender. Another large study that looked at the impact of price restrictions across EU countries, did not find conclusive evidence that such restrictions led to a substantial illegal market. Our international comparison of the effect of price caps is also inconclusive.

1.119 We therefore conclude that as best as we can tell, a very small minority of consumers use illegal lending, and we did not find clear evidence in our analysis or in external research, that this would increase when the cap reduces access to HCSTC. Despite the small numbers expected to be affected by this issue it remains a cause for concern given the high financial and non-financial costs for those who may turn to illegal lenders. We are also mindful of the limitations of the evidence in this area; given the illegal nature of this activity, it is notoriously difficult to measure.

Negative welfare outcomes/ financial distress

1.120 We do not find that consumers' general well-being is significantly affected (positively or negatively) by a lack of access to HCSTC.

1.121 A high proportion of HCSTC applicants are financially distressed, however we do not find any evidence of a lack of access to HCSTC making this distress either better or worse. The majority of individuals surveyed reported suffering from distress as a consequence of financial difficulties. This ranged from 52% of consumers who were just denied access to HCSTC, to 53% with access to HCSTC at the margin and 50% for all other HCSTC consumers.¹⁰⁴ The differences in these were not significant. We also look at the distribution of wellbeing across a range of measures and across different consumer groups and do not find there to be significant differences.

1.122 If people faced short term emergencies or other necessities and did not have the ability to raise funds elsewhere, they would find the proposed cap particularly costly if it denied them access to HCSTC. If this were the case we would expect to see significantly more of those rejected for HCSTC with low well-being scores compared to the group of consumers marginally accepted. However, examining distributions across well-being scores we do not observe significant differences: the fractions of our survey population with low self-reported well-being are similar for these groups. Our analysis, which is presented mostly as differences in averages, is not masking a subset of people being significantly harmed by not having payday loans.

1.123 In summary, our analysis finds no evidence of significantly worse welfare outcomes or financial distress associated with lack of access to HCSTC. This is not to say that no consumers excluded would have negative welfare outcomes as a consequence of the proposed cap. Some of those deprived of loans may be worse off as a consequence, but our analysis suggests these welfare losses would be offset by the gains of those deprived by the cap who thereby avoid bad experiences.

Benefits

1.124 In summary, the potential benefits of the proposed cap for consumers who would no longer get loans are:

- no HCSTC non-payment and late payment issues for those who would have otherwise suffered payment problems

¹⁰³ Department for Business, Innovation and Skills, Personal Finance Research Centre, University of Bristol (2013), The impact on business and consumers of a cap on the total cost of credit.

¹⁰⁴ See *Technical Annex 3*, Consumer Survey Analysis for further detail

- improved financial consequences across a range of dimensions in particular a reduced risk of: missing non-HCSTC bills and payments, going beyond overdraft limits in the longer term and negative impacts on credit score.
- 1.125** First time loans denied as a result of our proposal would have had a 39% chance of non-payment. Repeat HCSTC loans denied as a result of our proposal would have had a 19% chance of non-payment. Since we estimate that firms would no longer be willing to lend to these consumers, they would avoid the risk of non-payment and the negative impacts that entails. Such negative impacts can include non-payment charges, insolvency events, stress, and effects on well-being and mental health associated with these events and with missing payments.
- 1.126** Widespread evidence exists that late or non-payment of consumer credit debt and arrears has negative effects on individual mental health and wellbeing. Gathergood (2012) uses UK data to estimate the impact of consumer credit repayment difficulties on overall wellbeing and psychological health. He finds that inability to make debt repayments causes an individual's psychological health score to deteriorate by 20% and the likelihood that they develop a psychological health condition to increase by 22% within the two year period following the onset of repayment difficulties. Fitch et al. (2011) and Richardson et al. (2013) review existing medical and health economics literature on the impact of problem debts on mental and physical health. Richardson et al. (2013) conclude for unsecured debt that there is a 'more than three-fold risk of a mental disorder in those with debt'. In addition, the Centre for Social Justice's 'Maxed Out' report cites evidence that those struggling with unmanageable debts have a 33% increase in risk of developing mental health problems.
- 1.127** We also find that, for consumers at the current credit score threshold of being either accepted or denied a loan, there are several negative impacts that are directly caused by the loan.¹⁰⁵ This allows us to estimate the effects of denying access to certain consumers as a result of our proposal:¹⁰⁶
- 33.7% of these customers' non-HCSTC balances would be unpaid 6-12 months after application if they did have a HCSTC loan. Not having a HCSTC loan decreases this to 30.6%;
 - 44.4% of these customers would be behind on non-HCSTC debts 6-12 months after their loan application if they did have a HCSTC loan. Not having a HCSTC loan decreases this to 38.6%;
 - 27.9% of these customers would go over their overdraft limit 6-12 months after their application if they did have a loan. Not having a loan decreases this percentage to 24.9%; and
 - there would be a decrease of 53.3 points in the credit score of these customers if they did have a loan. Not having an HCSTC loan reduces this fall in credit score to 31.7 points.¹⁰⁷
- 1.128** We observe similar trends in key variables between high-street and online firms which leads us to believe that these findings hold for receiving a loan from a high-street firm as well.
- 1.129** It is worth noting that these are average effects across this group of people – some may have much worse outcomes, others better. However, the overall negative effect on average is our key finding.

¹⁰⁵ Since HCSTC borrowers are already in debt, taking out HCSTC will have these effects for many borrowers since the HCSTC does nothing to increase their income. The issue that we attempt to judge here is whether the accelerated consumption made possible by HCSTC is worth these costs for borrowers

¹⁰⁶ See *Technical Annex 3*, CRA Data Analysis for further detail

¹⁰⁷ All applicants for HCSTC experience falls in credit score, but the effect of getting HCSTC is to reduce credit score faster

1.130 As credit scores improve, the negative effects of HCSTC use reduce but are still present.¹⁰⁸ We estimate the impact on consumers away from the current threshold and the impact on all customers who are denied loans as a result of our proposal:¹⁰⁹

- 31.5% of these customers' non-HCSTC credit balances would be unpaid 6-12 months after application if they did have a HCSTC loan. Not having a HCSTC loan decreases this to 29.1%;
- 51.6% of these customers would be behind on non-HCSTC payments 6-12 months after application if they did have a HCSTC loan. Not having a HCSTC loan decreases this to 47.1%; and
- 32.4% of these customers would go over their overdraft limits if they did have a loan. Not having a loan decreases this percentage to 30.1%. This decrease is persistent and lasts for many months

The balance of costs and benefits for consumers who would no longer get loans

1.131 What we are judging here is the trade-off between short-term consumption smoothing (over the duration of the loan) and lower consumption and persistent effects on risk of non-payment, credit score, and access to credit in the medium term. The benefits and costs are distributed over time such that the consumer is only likely to be a net beneficiary of HCSTC use if the consumption need is pressing. And we find evidence that there are longer term costs on a range of metrics. The evidence leads us to make the judgment, given the structure and level of cap proposed, that the benefits outweigh the costs for consumers who would no longer get loans. Having considered the costs and benefits in isolation, we now summarise the overarching argument here.

1.132 People in declining financial circumstances (increasing credit balances, high frequency of overdraft limit breaches) who have exhausted most of their alternative sources of credit (only 15% even consider other formal sources of credit at this stage) take out HCSTC to fund short term consumption while they adjust to their changing circumstances and/or optimistically hope that their situation improves. We find from our survey that some HCSTC use is for potential shocks and to pay off other debts, but that the majority is spent on regular non-discretionary expenditure.¹¹⁰

¹⁰⁸ An important caveat is that, while the analysis of individuals with lower credit scores provides direct causal estimates of the effect of HCSTC usage, as we look at consumers further away from the threshold, the analysis only provides information on the correlation between HCSTC use and outcomes. While this does not provide as much certainty as the estimates above, we believe that the results are consistent and robust and show that average negative outcomes associated with HCSTC borrowing remain, even for those further away from the current margin of lending. See Technical Annex 3 for further details of how we have looked at consumers affected by our proposals.

¹⁰⁹ See *Technical Annex 3*, CRA Data Analysis for further detail

¹¹⁰ For consumer credit at low cost and over a longer time period, accessing credit can clearly be good for consumers. When people are credit constrained their effective discount rates can be very high and much higher than interest rates that they pay. Given the very short term of HCSTC loans and their high prices, however, we hypothesise that a very pressing immediate need would be required for people to have discount rate high enough for such loans to be increasing utility. However, the data shows people use HCSTC for regular, predictable expenditure and do so repeatedly.

Table 2: Planned use of HCSTC¹¹¹

	Marginal unsuccessful applicants	Marginal successful applicants	Less marginal successful applicants
Regular non-discretionary expenditure	47%	54%	55%
Household bills	27%	24%	24%
Living expenses and general shopping	18%	26%	29%
Rent or mortgage payments	6%	8%	4%
Potential shocks	16%	11%	8%
Car/vehicle	12%	9%	6%
Repair/replace broken household items	4%	2%	2%
Discretionary spending	16%	19%	20%
Consumer electronics	1%	1%	<1%
A holiday, going out or socialising	10%	11%	14%
Present/gift/Christmas	3%	2%	5%
Wedding	<1%	<1%	0%
Gambling	<1%	0%	0%
For home improvements	<1%	3%	<1%
Other	16%	17%	19%
To pay off HCTC debts	<1%	<1%	0%
To pay non-HCSTC debts	5%	5%	5%
Other	6%	5%	6%
To help a friend or family member	3%	4%	3%
Business purposes	2%	<1%	1%
To have as spare/ extra money	<1%	1%	1%
Don't know	7%	0%	0%

1.133 However HCSTC is expensive and so can make borrowers' circumstances worse through rapidly increasing level of debt. While the short term consumption associated with HCSTC can have some benefits, evidence from our analysis strongly suggests that the average outcome is negative for the people affected by the price cap.

1.134 Broadly, we do not find evidence that welfare outcomes or levels of financial distress are worse for those who do not obtain HCSTC. Instead improved financial consequences are estimated across several measures (ability to keep up with bills and payments, credit score) for those denied HCSTC. Non-payments and late payments on HCSTC (and consequent harm) for those consumers who would no longer get loans are eliminated. And the consequences for people denied loans who might really need them are not found to be severe (no significant difference in reported take-up of illegal lending for those denied loans).

¹¹¹ See *Technical Annex 3, Consumer Survey Analysis* for further detail

- 1.135** While it is conceivable that sometimes the bringing forward of consumption associated with HCSTC could outweigh the welfare costs of adverse events, the results of our analysis (summarised above) suggests that this is not the typical outcome. Thus it is clear that a reduction in consumption of HCSTC is likely to be net beneficial.
- 1.136** We further note that, if people can adjust without significant welfare impacts, then the short-term utility loss from consumption foregone (postponed) cannot be very high. And our analysis, as further explained below, indicates adjusting when denied a HCSTC loan is very frequently possible.
- 1.137** We find that a substantial proportion of HCSTC applicants who were rejected for loans (63%) report it being for the best that their application was declined.¹¹² We further find that those who got loans at the margin were significantly more likely to regard the use of HCSTC as something they could not have gone without (55%), compared to those who did not get loans (28%).¹¹³ We also do not find any conclusive evidence of negative welfare outcomes associated with lack of access to HCSTC. Together with the fact that most people would not borrow without the HCSTC loan (58% would go without)¹¹⁴ and so would adjust in another way (reduce expenditure, reduce any savings etc.), this suggests that those who do not use an alternative source of borrowing are able to cope without a loan.

Impact on peripheral and related markets

- 1.138** We believe that there may be some incidental impacts on firms in related markets such as debt collection and credit brokerage. For credit brokerage, we note the CMA's expectation that – due to the lack of competitive pressure it identified – credit brokerage and lead generators in the broadest sense (including search engines generally) were likely to be the destination for some part of payday lenders' profits. We expect that the fees paid for credit brokerage will fall since a firm can earn less revenues from each individual borrower as a result of the cap. We discuss the impact on related markets further in Technical Annexes 1 & 2.

Direct costs to firms

- 1.139** There are likely to be some relatively small one-off costs to firms as a result of:
- reviewing and agreeing their pricing structure in light of the chosen price cap, once confirmed in the policy statement and before implementation on 2 January 2015; and
 - updating their marketing and promotional material as a result of the price cap.
- 1.140** Both of these costs are associated with the imposition of any cap, over which we have no discretion, and do not vary according to the structure or levels at which we achieve our consumer protection objective.
- 1.141** In any case, we believe that these one-off costs are likely to be relatively small and have minimal impact on firms and the market. We base this judgement on the current level of marketing spend and regular changes to products and prices, leading us to judge that any changes as a result of our proposals are likely to be absorbed in business as usual.

¹¹² See *Technical Annex 3, Consumer Survey Analysis* for further detail

¹¹³ See *Technical Annex 3, Consumer Survey Analysis* for further detail (particularly sections 13b and 13d which discuss uses of and welfare impacts associated with HCSTC)

¹¹⁴ *ibid*

1.142 The Australian Treasury estimated that implementation of their cap would cost firms approximate AUS\$2,500 – 10,000¹¹⁵ to make the required changes to software and materials. This is equivalent to between £1,500 and £6,000 of one off costs per firm.

1.143 Based on these figures and our static analysis of firm exit, we would expect around 3 firms to bear this cost, suggesting total administrative costs of around £20,000 for the industry. If as a result of dynamic adjustment to the cap additional firms remain in the market, then costs across the industry could be higher. However, the evidence collected suggests that these small costs would not be a significant factor in firms' decision to remain in the market, relative to the reduction in profits as a direct result of lower prices.

Direct costs to the FCA

1.144 We have estimated that the cost of our work in determining the cap and producing this consultation paper and subsequent policy statement will lead us to incur up to £2.4m in incremental one-off costs in the period from December 2013 to February 2015. This comprises up to £1.9m external spending and approximately £0.5m on internal resources. These costs will be recovered from consumer credit firms through their annual fee over the next ten years.

1.145 Going forward, our supervisory approach will have to take into account the price cap and we expect that this will have an impact on how we undertake both forward-looking assessments like business model and strategy analysis and backward-looking supervisory action. We currently expect this to be absorbed into our business as usual resource estimates.¹¹⁶ However, if supervisory work on the cap proves more demanding than currently anticipated, then it will be necessary to flex our current risk appetite in order to continue to supervise on current resources.

Breaking down the impacts of the components of the proposed cap

1.146 The proposed cap is made up of three components: an initial cost cap, a cap for those in default, and a total costs cap (explained in greater detail in Chapter 5). Chapter 5 further describes the process through which these elements of the cap were chosen as the preferred cap structure. Based on the modelling we have undertaken, changing the periodic cap (the initial cost cap of 0.8%) has the greatest impact on the results. This is because::

- firm revenues derive mainly from interest, so the part of the cap affecting this is the key driver for reduction in credit
- the total cost cap would bite more for longer duration loans, but most loans are not for long durations (30 days for a typical loan). Instalment loans generally have a longer duration but these make up only 3.4% of all HCSTC loans
- non-payments don't lead to complete recovery in practice, therefore the default cap may often be impacting a relatively small proportion of revenue

1.147 Technical Annex 1 explains the modelling and the analysis around the components of the proposed cap in greater detail.

Conclusion

1.148 On balance we are confident that the benefits to consumers of the proposed cap outweigh the costs, both for those that still get loans and those that do not. We need to balance these effects against the negative impact on competition that further exit of firms could lead to ultimately affecting the interests of consumers, and the economic interests of firms. We judge

¹¹⁵ Australian Treasury (2011), Regulation Impact Assessment: Regulation of Short Term, Small Amount Lending.

¹¹⁶ Though we note this could be an opportunity cost resulting in reduced focus on other areas

that proposed price cap provides the best balance of protection for borrowers against excessive charges while taking into account the economic interest of firms and the impact on competition. In our judgment there are no alternative options that could materially lessen the impact of the proposed rules on the economic interests of firms or on competition, but still achieve an appropriate degree of protection for borrowers against excessive charges. In particular we calibrated our proposals, being mindful of the risks they present to the continuance of the high-street-distribution channel.

- 1.149** Chapter 5 in the CP summarises the potential impacts of varying levels of caps. It further lays out how the chosen option is the most pro-competitive option while delivering the appropriate level of consumer protection in the view of the FCA

Q10: Do you agree with the costs and benefits identified?

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Annex 2

Compatibility statement

Compatibility with the general duties of the Financial Conduct Authority

1. This annex explains how we satisfy the requirements set out in section 138I of the Financial Services and Markets Act (FSMA). When consulting on new rules, we are required by section 138I FSMA to include an explanation of why we believe making the proposed rules is compatible with our strategic objective, advances one or more of our operational objectives, and has regard to the regulatory principles in s.3B FSMA.
2. This annex also sets out our view of how the proposed rules are compatible with the duty on us to carry out our general functions (which include rule making) in a way which promotes effective competition in the interests of consumers (s.1B(4)). This duty applies in so far as promoting competition is compatible with advancing our consumer protection and/or integrity objectives.
3. This annex must be read in conjunction with the rest of the consultation paper and the cost benefit analysis (in Annex 1) in addition to the Technical Annexes in demonstrating that we meet our statutory duties and objectives.

Our objectives

4. These proposals are intended to address our new duty to 'make specified rules in relation to one or more descriptions of high-cost short-term credit with a view to securing an appropriate degree of protection for borrowers against excessive charges'. In carrying out this duty, we will have to advance at least one of our operational objectives and meet the requirements of our competition duty.
5. The proposals set out in this consultation primarily advance our operational objective of 'securing an appropriate degree of protection for consumers.'
6. We consider these proposals to be compatible with our strategic objective of ensuring that the relevant markets¹¹⁷ function well.
7. To demonstrate that we have met our statutory duty, and our operational objective, we have set out what we consider to be 'excessive charges' and demonstrated why we consider current charges to be excessive. We have provided evidence of harm from HCSTC charges and explained how the proposed price cap will protect borrowers against this harm.

¹¹⁷ "relevant markets" are defined by s.1F FSMA

Consumer protection objective

8. In designing the proposals we have had regard to the matters set out in section 1C FSMA to the extent that it is compatible with the more specific duty imposed on us by section 137C(2) FSMA. In particular, we have considered the risk of borrowing HCSTC for consumers (including different types of consumer), the different degrees of experience and expertise of HCSTC consumers, noting that these consumers have lower incomes and are younger than the consumer population generally. We have had regard to the level of care firms should have given the risks involved in HCSTC loans and the capabilities of consumers. This is particularly relevant to the default and total cost cap which are aimed at protecting consumers from escalating charges. We have also had regard to the differing expectations of consumers; we note in particular that where consumers get HCSTC loans, they are in difficult and deteriorating financial circumstances and they often wish to obtain a HCSTC loan in a hurry, hence their expectations may be limited.
9. We consider that charges are excessive if entering into HCSTC agreements that provide for those charges result in an unacceptable risk of harm to consumers.
10. We assessed the impact on consumers of using HCSTC in a number of ways, including through the analysis of default and late payment figures from HCSTC, econometric analysis of credit reference agency (CRA) data and a consumer survey.
11. On balance, we believe there is clear evidence of worse outcomes of using HCSTC for borrowers who just qualified for HCSTC, driven mainly by the large percentage of those borrowers who subsequently default.
12. For higher creditworthiness consumers, the risk of negative outcomes for borrowers reduces, but does not diminish completely. For higher creditworthiness consumers, we have to make a judgement about whether they are better or worse off with HCSTC.
13. We have concluded that a price cap with the right structure and level can mitigate the harm arising from excessive charges in the following ways:
 - changing firms' incentives and so stopping them lending to people with very high risk of default and increased risk of other negative outcomes;
 - lowering prices for borrowers who pay back on time and are at lower risk of negative outcomes and so increasing the net benefits of using HCSTC;
 - stopping borrowers getting into debt spirals due to excessive default fees and interest charges.
14. We have set out why the benefit to consumers resulting from the proposed level and structure of the price cap clearly outweighs any potential harm to consumers (e.g. restriction on access to affordable credit).
15. The structure has been designed to protect the majority of borrowers – those who pay back on time – but the default cap and total cost cap also help to limit harm to borrowers struggling to repay and stop fees and charges escalating to excessive levels.

Our regulatory principles

16. In preparing the proposals set out in this consultation, we have had regard to the regulatory principles set out in s.3B FSMA. We set out below how our proposals demonstrate such regard for each of the regulatory principles.

The need to use our resources in the most efficient and economic way

17. We have a duty to introduce a price cap to secure an appropriate degree of protection for borrowers of HCSTC against excessive charges.¹¹⁸ This must be in force by 2 January 2015.
18. In developing the proposals for a price cap, we have designed a rigorous methodology that has given us a strong evidence base, and we have undertaken a thorough analysis of the impact on firms and consumers.

The principle that regulatory burdens and restrictions should be proportionate to the expected benefits

19. We have a duty to introduce a price cap. In deciding on the level and the structure of the price cap, we have taken account of the need to be proportionate. We have considered alternative options, but we have concluded that no alternative options for the proposed level and structure of the price cap would provide an appropriate degree of protection for borrowers against excessive charges.
20. We considered initial cost caps which are lower than the level we have proposed, but we have discounted these options as there is a greater risk that high street HCSTC will become unavailable, or that we prevent access to HCSTC completely.
21. The initial cost cap proposed means that pricing is proportionate to the size of the loan, which is reasonable for firms as their costs increase with the size of the loan.
22. The default cap allows firms to continue to charge interest following default where appropriate to do so.
23. We have considered a range of caps alone and in combination and come to the view following comprehensive analysis that the proposed set of caps is the only proposal that delivers the appropriate degree of protection for consumers, balanced against the impact on firms and on competition.

The general principle that consumers should take responsibility for their decisions

24. In developing our proposals for a price cap we have sought to reflect the principle that consumers should take responsibility for their decisions. However, as the CMA have confirmed, features of this market mean that there are insufficient competitive constraints to curb high prices. Our proposals will ensure that consumers are treated in a fair way while still being responsible for their own decisions.
25. However, we believe that it is in the best interests of certain consumers not to have access to HCSTC given the unacceptable risk of default, the lack of benefits and the consequences of access to HCSTC to them.

¹¹⁸ References to the duty to introduce a cap are to the duty to make rules by virtue of subsection 1 (a) (ii) and (b) of section 137C FSMA.

The responsibilities of senior management of persons subject to requirements imposed by or under FSMA including those affecting consumers, in relation to compliance with those requirements

26. As part of the transfer of consumer credit to the FCA, we have applied the approved persons regime to credit firms. As part of the authorisation process firms will have to identify the individuals who will be performing controlled functions and so must be approved by us.

The desirability where appropriate of the FCA exercising its functions in a way which recognises differences in the nature and objectives of the business it regulates

27. We have designed the proposed cap to provide flexibility for firms to develop different charging models (i.e. charges permissible under the cap could be distributed among different charges in any way they like). We have considered the impact of the proposals on both high street and online firms and reflected the different impacts in our proposals.

The desirability of publishing information relating to persons

28. We have the power to publish information relating to investigations into firms and individuals. However, as set out in the Enforcement Guide¹¹⁹, we will not normally make investigations, or any of our findings or conclusions public except in exceptional circumstances.

The principle that we should exercise our functions as transparently as possible

29. We are an open and transparent regulator. As we have developed the proposals we have met extensively with industry and consumer groups and with the CMA to explain our methodology.
30. We are publishing detailed Technical Annexes alongside this paper that sets out in detail the methodology we use and the conclusions we have drawn from the available data.

The desirability of sustainable growth in the economy of the UK in the medium or long term

31. Our proposals have regard to the desirability of sustainable growth in the medium and long term. We do not expect the proposals to have a material impact on growth in the UK. Although credit access may fall for some, we do not expect this to have a significant impact on credit provision in the UK generally (HCSTC is a small percentage of total credit advanced) and therefore on consumption and growth.

Compatibility with the duty to promote effective competition in the interests of consumers

32. In preparing the proposals as set out in this consultation, we consider we have met our duty under s.1B(4) FSMA. This provides that we must, so far as is compatible with acting in a way that advances the consumer protection objective or the integrity objective, carry out our general functions in a way that promotes effective competition in the interests of consumers.
33. As indicated, we have a legal duty to introduce measures that are principally intended to advance the consumer protection objective. We have taken care to design our proposals so that they fulfil our legal duty to secure an appropriate degree of protection for borrowers against excessive charges while to the extent compatible with that aim designing proposals which promote effective competition in the interests of consumers.

¹¹⁹ EG 6

34. This statement should be read together with the cost benefit analysis and with Technical Annex 2 to that analysis which sets out our view of the likely impact on competition of the proposals.
35. We expect a large number of providers of HCSTC loans to be at risk of exit. Price caps are generally not pro-competitive and have a distortionary effect on markets through setting prices lower than the equilibrium level. Therefore our approach in meeting our competition duty is to consider the competition effects of many options and to choose the most pro-competitive among those options. In setting the level of the cap we have been particularly mindful of the risk of firm exit when balanced against the appropriate level of protection of consumers against excessive charges.
36. To determine the impact on firms and competition of different levels of the cap, we have taken into account factors such as the impact of the structure and level of the cap on firms' revenues and profitability and the degree of flexibility provided by the cap to differentiate through pricing and products.
37. We have considered the extent to which consumers substitute other products of HCSTC and our analysis (supported by CMA's) suggests that other credit products are not substitutes for HCSTC as we define it.
38. We have considered alternative options for the proposed level and structure of the price cap, but have concluded that there are no other options that could lessen the impact on competition but still achieve an appropriate degree of protection from excessive charges.
39. We have balanced consumer protection with adverse impacts on competition. The level of the default cap and the total cost cap, are estimated to have a limited impact on firms. We have tried as far as possible not to create competitive distortions in terms of loan duration, affordability and refinancing.
40. The initial cost cap has a significant impact on firms' revenue, but this is necessary to achieve an appropriate degree of consumer protection. At the level of (the initial) cap proposed, we expect a large number of providers to be at risk of exit. This is likely to lead to further concentration in this market, although for online providers we do not expect this level of supply to lead to a substantial lessening of competition relative to the current situation. The outcome for the high street is less clear.
41. The structure is sufficiently flexible to give firms the opportunity to differentiate themselves from their competitors through their pricing structure.
42. Our duty is to impose rules dealing with excessive prices for certain HCSTC products, but in designing the proposed rules we have sought to make sure that consumers can understand the proposed limits of charges. In particular, it will be straightforward for consumers to work out if they have been charged more than twice what they have borrowed in breach of the total cost cap and whether the £15 fixed default cap has been exceeded. Firms are required to set out the cost of the loan clearly in the pre-contractual information which enables consumers to make informed choices.

43. We have also taken into account the impact on high-street consumers some of whom may be more likely to be affected by social or economic deprivation (since their average income is less than that for online consumers). As discussed in Chapter 5, not all of these borrowers would benefit from losing access to HCSTC and as a result, our proposals take into account the trade-off between overall benefit from lower charges and the potential detriment from complete loss of access to HCSTC. We have also taken into account the impact the effect on distribution through the high street might have on borrowers who are members of protected groups, see further analysis as part of our Equality Impact Assessment in Annex 5.
44. The CMA has conducted competition analysis as part of their ongoing investigation into payday lending. They have considered the ease with which consumers can change suppliers, the ease with which new entrants can enter the market and how competition is encouraging innovation. We have been in contact with the CMA throughout our work on the price cap, and we have not sought to replicate this work. Instead we have considered the implications of their analysis in these areas for the price cap.
45. Our cost benefit analysis (Annex 1) explains the effects we expect to see on competition as a result of our proposals.

Any impact of changes in our proposals on mutual societies

46. Section 138K of FSMA requires us to prepare a statement about the impact of proposed rules on mutual societies. In particular, we are required to set out whether this will be significantly different from their impact on other authorised persons and if so, details of the difference.
47. We have considered the potential impact of the price cap in relation to building societies, credit unions, industrial and provident societies, friendly societies and EEA mutual societies. Given the proposed definition of high-cost short-term credit we do not expect our proposals to affect mutual societies.
48. We are not aware of any mutuals which are involved in the provision of HCSTC.
49. Credit unions are outside the HCSTC definition, as they are precluded by law from offering loans at rates higher than those specified.
50. Loans offered by a 'community finance organisation' are exempt from the definition of HCSTC and as such will be excluded from the price cap. This includes registered charities, community interest companies limited by guarantee, and community benefit societies registered under the Industrial and Provident Societies Acts. These bodies will continue to be subject to the remaining requirements in CONC and our high-level rules, if they engage in regulated activities.
51. We would welcome any comments or information respondents may have on any issues relating to mutual societies that they believe would arise from our proposals.

Legislative and Regulatory Reform Act 2006 (LRR)

52. We are required under the LRR to have regard to the principles in the LRR and to the Regulators' Compliance Code when determining general policies and principles and giving

general guidance (but this duty does not apply to regulatory functions exercisable through our rules).

- 53.** We have had regard to the principles in the LRA and the Regulators' Compliance Code for the parts of the proposals that consist of general policies, principles or guidance. We have engaged with firms throughout this process, and consider that the proposals are proportionate and result in an appropriate level of consumer protection, when balanced with impacts on firms and on competition.

Annex 3

List of questions

We would like to invite your responses to the following questions. Please ensure that your responses reach us by **1 September 2014**.

- Q1:** Do you have any comments on our general approach to developing our proposals for the price cap?
- Q2:** Do you have any comments on the proposed price cap structure?
- Q3:** Do you have any comments on the price cap levels?
- Q4:** Do you agree with our proposals on repeat borrowing?
- Q5:** Do you have any comments on the scope of the price cap?
- Q6:** Do you have any comments on our proposed Handbook rules?
- Q7:** Do you agree with our proposals on unenforceability?
- Q8:** Do you agree that we should prevent UK-based debt administrators from enforcing HCSTC agreements on behalf of ECD lenders which include charges in excess of the price cap?
- Q9:** Do you have any comments on the proposed approach to data sharing?
- Q10:** Do you agree with the costs and benefits identified?
- Q11:** Do you agree with our assessment of the impacts of our proposals on the protected groups? Are there any others we should consider?

Annex 4: International case studies

Introduction

1. This annex summarises the work we carried out to learn from other countries' experiences of setting price caps. We looked at Australia, Canada, the United States, Finland and Japan. The research was mainly desk-based, but we supplemented it with telephone interviews with international experts and regulators.
2. We want to thank all international experts and regulators who helped us in researching price cap experiences in different countries, in particular, staff at the Australian Securities and Investments Commission (ASIC), Department of Finance Canada, Industry Canada, Manitoba Consumer Protection Office, Government of Nova Scotia, US Consumer Financial Protection Bureau (CFPB), Florida Office of Financial Regulation, Ministry of Justice Finland and Damon Gibbons at the Centre for Responsible Credit.

Australia

Background

3. Australia has had a uniform consumer credit law since 1996 across its states and territories. This law unified disclosure and forbearance regulations across all states. However, states had the discretion to impose interest rate caps to loan agreements performed in their state. New South Wales, the Australian Capital Territory and Queensland all set a cap at 48% APR, including credit fees and charges (an inclusive interest rate cap). Victoria has taken a slightly different approach: it has set the cap at 30% for loans secured by a mortgage and 48% for all other credit contracts, but it was not inclusive of other fees and charges. Other states did not have any limitation on the cost of credit.¹²⁰
4. The first high-cost short-term lender in Australia began operating in the state of Queensland in December 1998. By 2001 there were 82 outlets across Australia and 800 outlets by 2008.¹²¹ In addition, a booming online market has emerged with more than 70 providers offering online lending services in 2014¹²². In 2010 it was estimated that only 4% of the Australian HCSTC market was conducted online¹²³, while in 2014 this has risen to about 30%.¹²⁴

120 Centre on Household Assets and Savings Management (CHASM), *The Challenges of Regulating High-cost Short-term Credit: A Comparison of UK and Australian Approaches*, 2014, p.7

121 Consumer Action Law Centre (CALC), *Payday Loans: Helping Hand or Quicksand?* 2010, p. 9-10

122 <http://www.abc.net.au/news/2014-07-02/payday-lenders-taken-to-court-over-interest-rate-charges/5567400>

123 CALC. p.90

124 <http://www.abc.net.au/news/2014-07-02/payday-lenders-taken-to-court-over-interest-rate-charges/5567400>

5. In 2013, the Consumer Credit Legislation Amendment (Enhancements) Act 2012 (CCLAEA) was enacted, providing for a national interest rate cap and additional protections for borrowers of high-cost short-term credit. The CCLAEA also introduced three different consumer credit definitions – small amount credit contracts (SACCs), medium amount credit contracts (MACCs) and short-term credit contracts (STCCs).
6. A STCC is a loan for under AUD\$2,000 with a length of 15 days or less. These types of loans have been banned under the new legislation. SACCs are unsecured loans of AUD\$2,000 or less with a length of 16 days to one year. MACCs are loans for AUD\$2,001 to \$5,000 for a period of 16 days to two years.

The rationale and design of the price cap

7. The Australian price cap has three elements:
 - a maximum up-front fee, called the ‘establishment fee’ of 20% of the amount loaned;
 - a monthly fee capped at 4% of the amount loaned;
 - all loan costs, including default fees or charges, must not exceed 200% of the loan amount.
8. For SACCs, the lender is only entitled to charge an establishment fee of 20% of the adjusted credit amount and a monthly fee of 4% of the amount loaned.¹²⁵ No other fees, charges or interest are permitted on the loan.¹²⁶ For MACCs, the lender is entitled to charge an establishment fee of up to AUD\$400 and interest and charges of 48% per year.
9. There is also an additional cap that applies to individuals who receive more than half of their income in benefits. For these people, there is an additional cap for a SACC which prohibits the repayments on any SACC (including the one being applied for) exceeding 20% of the individual’s income.

The impact of the price cap

On industry

10. A difficulty in assessing the impact of the price cap in Australia is that it coincided with a number of other regulatory changes in the consumer credit market, including requirements for lenders to obtain bank statements from prospective clients covering the last 90 days and changes to the credit reporting laws.
11. The cap is still relatively new and there is limited public data available on payday lending businesses turnover to assist with an assessment of the impact of the price cap on industry as a whole at this early stage. The CCLAEA provides for an independent review of the price cap and other provisions relating to SACC’s as soon as practicable after 1 July 2015 so it is likely further information on the impact on industry of the price cap will be available at that time.
12. There are only a few publicly listed payday lending companies in Australia that have provided information to the market that may give an indication as to how the price cap is affecting their business. Interestingly however, the information from Cash Converters International and Money 3 conflicts, with Cash Converters¹²⁷ highlighting a loss in revenue in the early stages and Money 3 advising of an increase.¹²⁸

¹²⁵ Authorised Deposit Taking Institutions (e.g. Banks, credit unions) are exempt from the price cap.

¹²⁶ Class Order CO13/818 currently enables lenders in a certain class to recover third party direct debit charges from consumers.

¹²⁷ <http://www.cashconverters.com/CompanyOverview/LatestNews>

¹²⁸ <http://www.money3.com.au/reports-announcements.html>

13. The number of lenders in the Australian market has fallen since 1 July 2013 by about a third, mainly through consolidation. However, it is unclear if this is a result of the cap, additional regulations, economic or business challenges.
14. The Australian Securities and Investment Commission (ASIC) told us that they have seen a diversification in the industry, where lenders of HCSTC have expanded their business activities into other areas, such as pawn broking, cheque cashing, gold selling and other loan products.
15. The distinction between SACCs and MACCs has caused some confusion in industry and the legislation has recently been amended to clarify this as well as to address credit avoidance by unlicensed credit providers, including in relation to credit that looked like SACC, but was not.¹²⁹
16. ASIC has also advised that whilst it is aware of some payday lenders leaving the industry it has also seen new players entering the market since the introduction of the cap with a mix of both smaller entrants and large businesses, which are expanding previous operations to include a SACC lending arm.

On consumers

17. The impact of the price cap on consumers in Australia is also difficult to assess, as no empirical study has yet been conducted to establish the impact. Whilst the provisions in the law do ensure consumers will pay less for SACC loans than before the price cap, it is yet to be seen whether consumers who receive more than half their income from benefits have the same level of access to these types of loans as before the introduction of the CCLAEA.
18. The Centre on Household in Assets and Savings Management based at the University of Birmingham conducted interviews of key stakeholders in Australia to try and assess the impact of the cap. The research noted that commentators, including debt advisers and consumer lawyers, have stated that the regime is too complicated, making it difficult for borrowers to understand whether their loan is legally compliant.¹³⁰
19. The independent review to be undertaken next year into the price cap and other provisions relating to SACC's is likely to consider the impact of the cap on consumers. Comment on that impact should be available at that time.

Canada

Background

20. The payday loan industry emerged in Canada in the mid-1990s and has rapidly expanded. The industry has grown from a reported few stores in the early 1990s to around 1,400 retail outlets nationwide in 2007.
21. Since 1980 Canada had a prohibition against usury in the form of section 347 of the Criminal Code, which made it a criminal offence to enter into an arrangement to receive, or to actually receive, interest of more than 60% per year. For the purposes of Section 347, interest is defined broadly and includes all charges and expenses (such as fees, fines, penalties and commissions) with the exception of a few categories, such as insurance charges, official fees and overdraft charges. The 60% cap applies to any lending transaction across the consumer credit sector. The

¹²⁹ National Consumer Credit Protection Amendment (Small Amount Credit Contracts) Regulation 2014

¹³⁰ CHASM, p.9

legislation was designed to aid police in prosecutions of loan sharks, rather than as a consumer protection tool.

22. Section 347 was considered to be 'a deeply problematic law'¹³¹, as most payday lenders structured their fees and charges to evade the legal maximum of 60% interest cap through brokerage, cheque cashing and other fees and charges that are not covered under the interest rate definition. In its May 2007 Issue Brief, SHARE commented on the tactics used by payday lenders to avoid the usury limit: 'although Canada's criminal code clearly states that annual effective interest rates must not exceed 60 per cent, the total cost of borrowing from payday lenders can be between 300 and 1,000 per cent. How do they get away with it? They hide the costs of borrowing in various fees, including collection fees, processing fees, convenience charges and brokerage fees'.¹³²
23. The enactment of federal Bill C-26 in May 2007 started a process of legitimising payday lending and shifting significant responsibilities for the oversight of payday lending from the federal government to the provinces. This Bill exempts payday lenders from criminal prosecution under section 347 of the Criminal Code if the loan is for \$1,500 or less, with a term of 62 days or fewer and the lender is licensed by a province designated by the federal government. To obtain designation, a province must enact legislation that protects payday loan borrowers and provides for limits on the total cost of borrowing.

The rationale and design of the price cap

24. Almost every province has chosen to pursue the legalisation of payday loans in some form. Measures include limiting the maximum rates of interest, prohibiting rollover loans, and specifying how the cost of credit should be disclosed. Provinces have set a maximum cap on the cost of borrowing of between \$17 per \$100 in Manitoba and \$31 per \$100 borrowed in Nova Scotia. The latter later lowered the cap to \$25 per \$100. They also set out limits on default fees and interest on arrears (see Table 1).

¹³¹ Manitoba Public Utilities Board, Order No.39/08, *Maximum Charges for Payday Loans*, 2008, p.17

¹³² Office of Fair Trading, *OFT international case studies: Australia and Canada, Annex C*, 2009, p.77

Table 1 Price caps across Canadian provinces

Province	Level of cap	Default fee cap	Maximum Interest on Arrears
Alberta	\$23 per \$100	\$25	30% per year
British Columbia	\$23 per \$100	\$20	30% per year
Manitoba	\$17 per \$100	\$20	30% per year
New Brunswick	60% per year		
Newfoundland & Labrador	60% per year		
Northwest Territories	60% per year		
Nova Scotia	\$31, lowered to \$25 per \$100	\$40	60% per year
Nunavut	60% per year		
Ontario	\$21 per \$100	\$50	60% per year
Prince Edward Island	60% per year		
Quebec	35% per year		
Saskatchewan	\$23 per \$100	\$50	30% per year
Yukon	60% per year		

Source: Manitoba Public Utilities Board, *The 2013 Payday Loans Review*, 2013, p.52

Note: New Brunswick and Prince Edward Island are in the process of setting a provincially determined cap. Until provincial legislation comes into force, federal cap of 60% applies to all credit agreements.

25. Newfoundland has chosen not to enact legislation for payday lending, therefore leaving any restrictions up to the federal government's cap of 60%. Quebec decided not to license lending of any kind that exceeds an effective annual rate of 35%, making payday lending unviable under such a low rate cap.
26. We examined in detail price cap regulations in two provinces: Manitoba and Nova Scotia. These two provinces represent two extremes of the price cap level, with Manitoba setting the lowest cap, and Nova Scotia, the most liberal cap among all provinces (although it later revised its cap and decided to lower it from \$31 to \$25 per \$100 borrowed).

The case of Manitoba

27. Manitoba was the first province to seek designation as the authorised regulator of payday lending. In 2007 the province assigned the task of determining the price cap to its Public Utilities Board (PUB). Following four months of hearings with industry, consumer groups and academics, and careful consideration of all information put forward and reviewed, the Board concluded that the maximum charges to be set for payday loans should be to reduce the cost of credit for consumers while promoting increased efficiency within the industry. In 2008 they proposed to set up a sliding scale of charges based on the size of the loan:
- 17% of value received up to \$500.
 - 15% of value received from \$501 to \$1,000.
 - 6% of value received between \$1,000 and \$1,500.

28. For payday loans to people on benefits, the maximum cost of credit can be 6% of the value received up to \$1,500. The maximum amount that may be charged, required or accepted in the case of default is \$20, which can only be charged once, plus a maximum rate of interest of 2.5% per month, not to be compounded.
29. Implementation of these rules was delayed after one of the largest payday lending firms was granted leave by the Manitoba Court of Appeal in January 2009 to challenge PUB's authority to set the rates. The Manitoba government then amended the legislation to take the rate setting authority out of the PUB's hands and put it into its own, making new rules in 2010 that were similar to the PUB's initial recommendations. The recommendation on the sliding scale of charges has not been accepted and a 17% cap for all loans up to \$1,500 was introduced. PUB's role was changed from rate setting to advisory.
30. The cap in Manitoba was reviewed three years after it was set, as required by the legislation.¹³³ Following a public hearing process at which payday lenders and consumer groups participated, the Board recommended that the original limit of \$17 per \$100 and the maximum interest rates for loans in arrears of 2.5% per month non-compounding (30% per year) remain unchanged. However, it recommended removing the cap of \$20 for default fees to enable lenders to recover full expenses incurred, but subject to proof of the actual costs incurred and disclosure. The provincial government has not yet made a final decision on these recommendations.

The impact of Manitoba's price cap On industry

31. The number of licensed outlets in Manitoba has dropped from 77 in 2008 to 34 in 2013.¹³⁴ However, the PUB reports that this reduction came mostly from withdrawal of one of the largest lenders who stopped payday lending in the province. There is evidence that one lender tried to circumvent the cap by offering brokered lines of credit that had similar features to payday loans. However, the Manitoba Consumer Protection Office determined that these products were violating Manitoba's laws and ordered lenders to stop them and refund fees that were charged to consumers.

On consumers

32. Manitoba saw a significant drop in consumer complaints regarding payday loans from 135 in 2011/12 to 70 in 2012/13. Impact on consumers has not been empirically tested and therefore it is not known if and how many consumers could have lost access to credit as a result of the cap. There is some evidence of the emergence of unlicensed online payday lending after the introduction of the cap.

The case of Nova Scotia

33. In 2008, following a similar process as in Manitoba, Nova Scotia's Utility and Review Board (NSUARB) introduced a very different price cap level of \$31 per \$100 borrowed, inclusive of all expenses. This was the second highest rate in North America. It also set up a maximum penalty for default on a payday loan of \$40 per loan, to be consistent with that charged by chartered banks. 60% is the maximum interest rate that should apply, in the case of default, to any balance outstanding on the loan.
34. In the hearings in Nova Scotia, attention was focused almost exclusively on what constituted a reasonable costing model for payday loan providers. The Board concluded that a Cost

¹³³ Manitoba Public Utilities Board, *The 2013 Payday Loans Review*, 2013 (available at: http://www.pub.gov.mb.ca/payday_loan/final_payday_loans_triennial_report_sep_23_2013.pdf)

¹³⁴ *Ibid*, p. 45. These figures do not include licensed internet companies.

Approach¹³⁵ is of little practical use in regulating the payday lending industry, which is characterised by numerous lenders, and therefore applied a Market Approach¹³⁶ to determine the maximum cost of borrowing. The Board based its decision on the premise that increased competition, along with improved disclosure to borrowers, would afford proper protection to consumers.

35. However, in 2011, following intense pressure from consumer groups and taking into account Ontario experience¹³⁷ of setting the cap, Nova Scotia decided to lower its price cap from \$31 to \$25 per \$100. The maximum default charge remained at \$40 per loan.

The impact of Nova Scotia's price cap On industry

36. The lowering of the cap from \$31 to \$25 per \$100 did not cause exit. In June 2010, when the maximum rate was \$31, province had 13 lenders in 43 locations. In December 2011, when the rate was \$25, there were 11 lenders in 50 locations. Today, there are 13 lenders in 51 locations.
37. There is evidence that some firms operating in Nova Scotia were avoiding the cap by selling ancillary services with the credit, such as payment protection plan insurance. However, in 2011, the regulator ruled that such insurance should be included in the calculation in the total cost of borrowing (\$25 per \$100).

On consumers

38. Nova Scotia regulators told us that they do not have data on the effect of the cap on consumers, other than to say that borrowers now have a high cost but regulated borrowing alternative. Consumer complaints about payday lenders remain few. No evaluation before or after the introduction of the cap has been conducted in the province.

United States (US)

Background

39. The payday lending market in the US is more mature than in the UK, estimated at \$48 billion (120 million transactions annually compared to 10-15 million transactions in the UK). The regulation of the payday lending industry in the US is mostly at the state rather than national level. However, now the Consumer Financial Protection Bureau (CFPB) has authority to regulate the industry at a national level. In 35 states payday lending is legal, while in 15 states it is either illegal or not feasible, given the state law. A variety of approaches have been introduced to regulate the industry, including:
- **Outright bans:** 15 states in the US eliminated payday lending by either introducing a ban or capping the maximum charge for credit at a low level, driving lenders out of business.
 - **Caps on prices:** 35 states in the US have introduced higher caps on the price of payday loans which protect consumers from high charges but keep the market viable.

135 Cost Approach refers to the model commonly used in the regulation of public utilities, such as electricity or natural gas. It involves determining the reasonable cost of providing a service (including capital and operating expenses), and then applying whatever return on capital the regulatory body has determined to be reasonable.

136 Market Approach refers to a model where a price limit is derived on the basis of rates actually charged in the market.

137 Ontario set up maximum cost of borrowing at 21% of the principal to deter lenders from making excessively risky loans. However, the evidence suggested that this did not occur, but firms coped with the strict cap by increasing profits from other products (cheque cashing, money transfers, etc.).

- **Caps on amounts of loan relative to the borrower's income:** for example both Illinois and Nevada have put in place a clear requirement that loans should not exceed 25% of the borrower's income.
 - **Limits on the number of loans that can be provided in any given period:** for example, Arizona, California, Colorado and Florida restrict the number of loans that can be provided to just one at a time, and Indiana prohibits more than one loan from a single lender and limits the total number of loans a consumer can have at any time to two.
 - **The number of times a loan can be rolled over:** Alabama restricts the number of times a loan can be rolled over to just one; Alaska allows just two; and Florida, Illinois, Kentucky, and Louisiana prohibit this practice entirely.
 - **Limits on the level of fees that can be charged for overdue loans:** with limits ranging from \$15 to \$30 for failure to pay on time.
40. Opinions vary on what the impact of these regulations has been and many have not been in force long enough for their full impact to be assessed. There is some evidence in the states where price caps have been introduced that lenders moved away from short-term single repayment loans towards loans that are repaid over the longer term in instalments that may not be subject to these restrictions. There is also evidence that indicates that some lenders have moved offshore and are operating online, 'exporting' their loans into other states. While some other lenders have partnered with Native American Tribes and operate online from tribal land, relying on sovereign protection to avoid state regulations.¹³⁸
41. We selected one state, Florida, for our detailed case study. Florida has been often referred to in UK parliamentary debates about the price cap and is often cited as an example of successful regulation of high-cost short-term credit.

The case of Florida

The rationale and design of the price cap

42. The regulation of high-cost short-term credit in Florida is supervised by the Office of Financial Regulation. The law in Florida focuses on preventing consumers from becoming entangled in a 'credit trap' where the borrower is continuously forced to request ever larger loans, making it virtually impossible to emerge from indebtedness. To deter this 'trap', the law limits the number of payday loans an individual may have at any one time, puts a cap on a cost of a loan, sets a maximum loan amount and mandates a 'grace period' for those who fail to repay their loans on time.
43. The Florida statute prohibits a consumer from having more than one payday loan at a time. Under state supervision, a real-time database is maintained of all outstanding transactions. When an application is submitted, the lender enters the database to verify that the borrower has no current open loan, is not in arrears on any past loan and that there has been a 24 hour cooling off period after the last loan. Once verification is successful, the borrower is still required to sign a statement confirming that no loan is outstanding and, in addition, give assurance that no loan was successfully terminated within the past 24 hours. The amount of the new loan, excluding all fees, is limited to \$500.
44. The statute also intervenes in the situation where a payday loan cannot be repaid. It is illegal for a lender to 'rollover' the loan or, in essence, to extend the maturity date of a loan for an additional set of fees tacked onto the original amount due. According to the statute, if a

¹³⁸ Centre for Responsible Lending, *Payday Lending Abuses and Predatory Practices*, 2013, pp.18-20

borrower informs the lender of insufficient funds in the checking account then the borrower receives an automatic loan extension or 'grace period' of 60 days without additional cost. During this grace period the borrower is obliged to complete a consumer credit counselling course conducted by a state approved outside agency and to follow a repayment plan worked out with the agency during this counselling session.

45. As a means of limiting the interest cost of a payday loan, the statute sets a ceiling on the fees charged of 10% of the loan amount. An additional verification fee up to maximum \$5 is allowed to cover the lender's cost of accessing the database, verifying borrower's identity, residence, employment, credit history to determine the his/hers eligibility.
46. The cap was introduced in Florida by state legislation in 2001. No research or analysis was done to determine the cap: the level was based on a pre-existing cap for cheque cashing. In the US payday lenders frequently require borrowers to leave a post-dated check for the principal plus fees so it was felt appropriate to set the same limits. There are no affordability requirements in Florida so the \$500 borrowing limit mitigates possible detriment.

The impact of the price cap on industry

47. The cap has not deterred the growth of the payday lending industry, as the number of transactions in this sector has grown from 3.9 million to 6.2 million between 2003 and 2009. There are some problems with the emergence of unlicensed online lending.

The impact of the price cap on consumers

48. The payday loan business in Florida has been growing rapidly in terms of the number of customers, which has increased at an annual rate that ranges from 13.5% to 35.7% with an average of 22.1% between 2005 and 2009. There is evidence that the default rates for the same period declined from 2.7% to 1.7%.¹³⁹ However, in the absence of specific limits or prohibition on repeat borrowing, a proportion of borrowers continue to use payday loans as an ongoing line of credit.

Finland

Background

49. In Finland, payday loans, which are referred to as 'instant loans', first started appearing in 2005. The industry appears to have grown quickly and by the start of 2013 there were about 80 instant loan companies providing 1.5 million of loans with a total value of €400 million.¹⁴⁰
50. The instant loan industry has some notable differences to the UK HCSTC sector. In particular, there is no retail presence on the high street, with firms preferring to focus on providing a service either online or via phone text messages.
51. There have been a number of problems which could be linked to the growth of the instant loan industry. These include a rise in the number of court judgements in debt collection cases relating to debts below €300. These have increased from 3,000 in 2005 to 80,000 in 2011.¹⁴¹
52. A series of reforms has been enacted in Finland to deal with the perceived issues in the instant loan sector. The first package of reforms came into force in February 2010, which included

¹³⁹ Centre for Responsible Lending, Payday Lending Abuses and Predatory Practices, 2013,

¹⁴⁰ Finland Ministry of Justice presentation, Legislative Amendments in Finland due to Instant Loans, 2014, unpublished

¹⁴¹ Finland Ministry of Justice presentation, Legislative Amendments in Finland due to Instant Loans, 2014, unpublished

requirements to disclose APR on loans less than €200 and more robust verification of client identity. The reforms also banned loan transfers into consumers' accounts between 11pm and 7am.

- 53.** In December 2010, a second package of reforms was brought into force that created a licencing regime for firms offering consumer credit. It was also decided that the scope of the Consumer Credit Directive, as applied in Finland, should include loans under €200.
- 54.** A third set of reforms – including the APR cap discussed below – came into force in June 2013. As well as capping APR, firms were banned from including additional charges for text messages sent as part of the loan service so that consumers could better assess the total costs of the loan.¹⁴² There were also provisions to tighten the requirements on firms to conduct rigorous credit checks and affordability assessments.

The rationale and design of the price cap

- 55.** In December 2011, a working group consisting of key stakeholders was set up to discuss issues around instant loans. The group delivered its report in April 2012, recommending a cap on the APR for small instant loans. After a consultation period, the recommendations were submitted to the Finnish Parliament in September 2012. The resulting bill was passed and came into force on 1 June 2013.
- 56.** The APR cap applies to all loans under €2,000 and is set at 50% plus a reference rate, which is referred to in the Interest Act 1982 (as amended in 2013) and derives from the rates set by the European Central Bank. For comparison, before the introduction of a price cap in June 2013, the average APR of an instant loan was around 920%.

The impact of the price cap

On industry

- 57.** During the consultation period, before the Government Bill was submitted, the instant loan industry in Finland raised concerns that a cap of around 50% would lead to an effective ban on small instant loans. However, after the cap came into effect, out of the 90 firms registered in this sector before the cap, around 50 continue to operate in the market.
- 58.** There has been a noted shift in the products offered by instant loan firms, with a move from single instalment loans to revolving loans, possibly in an attempt to circumvent the cap. Further to this, some SMS loan companies have changed their business model towards loans above €2,000, therefore moving to a more traditional consumer credit business.

On consumers

- 59.** As the cap was introduced in June 2013, it is too early to judge its effects on consumers. There is a lack of research on this point, although a study is planned by the Finnish Ministry of Justice for June 2015 to assess the impact on consumers.
- 60.** The Finnish Ministry of Justice told us that the country does not have a problem of illegal money lending. It has been suggested that for many of those who might have lost access to instant loans, such loans would have been unsuitable in the first place.

¹⁴² Government Bill, see <http://www.borenius.com/InEnglish/News/Legalalerts/Article/tabid/10572/ArticleId/1362/Default.aspx?Return=10571>

Japan

Background

- 61.** The consumer credit market in Japan started growing substantially from the late 1970s, with one study reporting the volume of short-term consumer loans outstanding in 1977 being 1 trillion Yen and growing to 2.5 trillion by 1981. According to a report from the Japan Credit Rating Agency in 2012, the volume of unsecured loans peaked in March 2003 at 12 trillion Yen before dropping steadily to 3.6 trillion in March 2011.
- 62.** In 2004 at the time the market was peaking, there were around 14,000 firms operating in this market. There were number of key players, with firms such as Takefuji Corporation extending unsecured loans totalling 1.5 trillion Yen in 2006. The number of firms has since reduced, in particular, the Takefuji Corporation filed for bankruptcy in September 2010.

The rationale and design of the price cap

- 63.** Japan's price cap, which is a cap on the total cost of credit, is the result of a series of laws between 1954 and 2006. 1954 saw two key laws passed in Japan: the Capital Subscription Law (CSL) and the Interest Rate Restriction Law (IRRL). The CSL made it a criminal offence for the total cost of credit to be greater than 109.5% of the principal. The IRRL, a civil law, put in place tighter restrictions on the cost of credit.
- 64.** The IRRL 'caps' on the total cost of credit are:
- 20% for loans less than 100,000 Yen (around £584),¹⁴³
 - 18% for loans between 100,000 and 1 million Yen (between £584 and £5,840);
 - 15% for all loan greater than 1 million Yen (over £5,840).
- 65.** However, unlike the CSL, breaches of the IRRL did not lead to any penalties and therefore acted more as guidelines.
- 66.** The difference between the 109.5% cap of the CSL and the tiered caps of the IRRL, which is referred to as the 'grey zone', has been a source of confusion in Japan. It appears unclear from the IRRL whether lenders could extend loans at rates in the grey zone and what rights borrowers had if they take out such loans. Over time the law has evolved and tightened the criminal cap imposed by the CSL, thereby shrinking the 'grey zone'.
- 67.** In 1983 the Money Lending Business Act (MLBA) reduced the CSL cap of 109.5% to 73%. This Act also introduced requirements for lenders to carry out affordability checks before extending loans and prohibited lending to those who failed to meet these checks. The cap of 73% was successively tightened to 54.75% (1986), 40% (1991) and 29.2% (2000). Finally, in 2006 the Money Lenders Law (MLL) formally ended the 'grey zone' between the IRRL and the caps enforced by criminal law; however this was not brought into force until 18 June 2010.
- 68.** The MLL also laid out stricter prudential regulations for money lenders, created registers for loans and a requirement for loans to be reported to the designated credit bureaus. In addition, the MLL mandated that at any one time the total number of unsecured loans taken out by a borrower cannot exceed one third of their annual pre-tax income, so called Aggregate Debt Control.

¹⁴³ Based on the exchange rate on 12 June 2014

69. Whilst there was the delay between the passing of the MLL in 2006 and the implementation of its price cap in 2010, a ruling of the Japanese Supreme Court in 2006 decided that loans within the 'grey zone' were excessive and that borrowers had the right to sue money lenders in order to recover the excess interest. Unlike the similar ruling in 1968 which had little effect, this ruling led to many people taking money lenders to court. In 2009, such claims made up over 40% of all new civil lawsuits in Japan's district courts.

The impact of the price cap On industry

70. Japan's consumer credit industry has been operating under a price cap for 60 years. The consumer credit sector grew significantly during that time, peaking in 2003. From the late 1970s to 2003 the volume of unsecured loans increased from under 1 trillion Yen to 12 trillion, while simultaneously the price cap enforced by criminal law was tightened progressively from 109.5% (pre-1983) to 29.2% (2000).
71. A number of studies have stated that the introduction of the Money Lenders Law in 2006 led to a decrease in the number of market participants and a general decreasing trend in the total volume of loans.¹⁴⁴ However, it is difficult to separate out the effect of the price cap from other factors including the large volume of law suits against firms, the increased standards in assessing affordability and tighter prudential rules. The effect of the recent global financial crisis should also not be overlooked as many of the large firms in the industry obtained funding from the global credit markets and therefore were vulnerable to the financial crisis.
72. As an illustration of the variety of factors affecting the industry the 2010 Annual Report of the Takefuji Corporation, which filed for bankruptcy in 2010, cited the collapse of Lehman Brothers, the severe financial environment which followed, the increase in repayments of 'grey zone' interest and market fears over the impact of the Aggregate Debt Control as factors which contributed to its decline.
73. Despite the difficulty in assessing the precise impact of caps in the total cost of credit, the Japanese experience suggests that the growth and development of the consumer credit industry is possible under a price cap.

On consumers

74. According to one study¹⁴⁵, the number of consumers in the market fell between 2007 and 2011 from 11.7 million to 8 million. This has coincided with a reduction in outstanding debt of roughly 50%. As the report points out, this drop probably has more to do with the Aggregate Debt Control; however the 2006 Supreme Court judgement which led to an effective cap of 15-20% on loans will have had a cost saving effect on consumers as interest rates prior to 2006 were, on average, around 26%. Arguably, the fact that loans were cheaper as a result of a price cap may have had a significant effect on the level of outstanding debt as borrowers found their loans easier to repay.
75. In terms of bankruptcies, there has been a marked downward trend from the peak of 2003 when there were 242,000 bankruptcies reported, decreasing to 150,000 in 2006 and 100,000 in 2011.¹⁴⁶ This decline is likely to be linked with the contraction in the consumer credit market and, as discussed above, how far this contraction is a result of price caps is unclear.

¹⁴⁴ Japan Credit Rating Agency, Rating Methodology by Sector: Consumer Finance, 2012, p.1

¹⁴⁵ Gibbons, D., Taking on the Money Lenders: Lessons from Japan, 2012, Centre for Responsible Credit, p.23

¹⁴⁶ *Ibid*, p.24

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- 76.** Japan has a noted problem with illegal money lending, which is often linked to organised crime groups, and a general concern raised with price caps is that it leads to consumers being pushed to illegal lenders as legal lenders leave the market. However, the levels of illegal lending appear to have grown alongside growth in the legal consumer credit industry, rather than as result of a contraction in mainstream lending.
- 77.** Another factor in illegal money lending is how punishments have evolved over time. In 1983 the MLBA laid down penalties of a maximum term of three years in prison for loan-sharking, which was increased to five years in 2003 and ten years in 2007.
- 78.** There is conflicting evidence on the levels of illegal lending from 2003. According to one study, reports to a Credit Victims Association in Tokyo dropped over 50% between 2003 and 2005 (from 422 to 210) and there were only two reports in 2011. These figures suggest that as penalties have increased, the level of illegal lending has decreased significantly despite the tightening of caps on the cost of credit.
- 79.** Another report¹⁴⁷, however, points to growing rates of illegal money lending between 2009 and 2011, following a fall from 2008 to 2009. Whilst the rise would correspond to the introduction of the MLL, these caps had essentially been in force since 2006.

¹⁴⁷ Domoto, H., The risk of Yamikin (illegal lenders) morkey, which is spreading quietly in Japan, 2012, Working Paper, Institute for Research on Credit Business, Waseda University

Annex 5:

Equality impact assessment

Introduction

1. We are required under the Equality Act 2010 to consider whether our proposals could have a potentially discriminatory impact on groups with protected characteristics (age, gender, disability, race or ethnicity, pregnancy and maternity, religion, sexual orientation and gender reassignment). We are also required to have due regard to the need to eliminate discrimination and advance equality of opportunity when carrying out our activities.
2. We have conducted an initial equality impact assessment (EIA) of our proposals to ensure that the equality and diversity implications are considered. This annex sets out the results, explaining the potential impact of our proposals on protected groups where we have identified them and, where relevant, the steps we have taken or will take to minimise them.
3. The main outcomes of our initial assessment are that:
 - the proposals in this paper do not result in direct discrimination for any of the groups with protected characteristics;
 - some people, especially those with lower credit scores, may no longer be offered a HCSTC loan;
 - while loss of access to credit might be viewed as detrimental, evidence suggests it will be beneficial for many consumers with lower credit scores, as they are more likely to have negative welfare impacts from taking these loans and ending up in debt cycles;
 - the impact might be more substantial for users of high-street stores, a larger proportion of whom are women and those from Black and Minority Ethnic (BME) groups.

Next steps

4. The EIA process is ongoing, and will not be completed until we develop and publish our final policy. As a result, at the end of this annex, we are seeking additional input from all stakeholders to help us further investigate and establish the extent of any potential impacts of the proposals in this paper. We would also welcome any comments or information respondents may have on any equality and diversity issues they believe arise from our proposals. We intend to undertake a post-implementation review and we will look at the impacts on the protected groups, as well as on consumers generally.

Initial assessments

Positive impacts

5. The key policy goals of this proposal are to protect consumers from getting into debt spirals and making credit more affordable. We expect that, overall, consumers – including the protected groups who are disproportionately vulnerable to consumer detriment – will benefit from the introduction of the price cap. We consider that the following proposals would lead to positive outcomes for all the protected groups:
 - Protected groups are disproportionately vulnerable to the risks in the consumer credit market. For example, vulnerable consumers are more likely to be exploited by high interest rates and charges. In Chapter 5, we outline our proposals to introduce a cap on the total cost of credit, so that consumers will never have to repay more than 100% of the original loan amount. This would prevent them from getting into debt spirals.
 - In Chapter 5 we also propose to cap the initial costs charged for HCSTC loans. This would make credit more affordable for most consumers, including those in the protected groups.
 6. Our analysis indicates that there is a risk that HCSTC will not be distributed through the high street as a result of the cap. This may lead to a disproportionate impact on protected groups because of their gender or race, as set out below. However, as noted in Chapter 5, we think there are some offsetting dynamic responses by firms that may mean high-street distribution continues after the cap. These responses may include changes to pricing structures and products, changes to acquisition costs and expansion into other services.
- Age**
7. We have not identified any concerns that specifically relate to age but, as our proposals develop, we will continue to ensure we consider age-related issues within our assessment.
- Gender**
8. We know from the CMA research that a higher proportion of women use high-street stores.¹⁴⁸ Therefore, if the high-street distribution channel of HCSTC is at risk, women might be disproportionately affected by our proposal. However, as noted above, we think that firms on the high street would develop dynamic responses to the cap and will continue to offer HCSTC.
- Race**
9. The CMA also found that BME groups are over-represented among users of loans provided on the high street. Therefore, if the high-street distribution channel of HCSTC is at risk, consumers from BME groups might be disproportionately affected by our proposal. However, as noted above, we think that firms on the high street would develop dynamic responses to the cap and will continue to offer HCSTC.
- Disability**
10. We have not identified any concerns that specifically relate to disability but as our proposals develop, we will continue to ensure we consider disability-related issues in our assessment.
- Pregnancy and maternity**
11. We have not identified any concerns that specifically relate to pregnancy and maternity, but as our proposals develop, we will continue to ensure we consider pregnancy and maternity-related issues within our assessment.

¹⁴⁸ Competition and Markets Authority, Research into the Payday Lending Market, 2014, p.49 (available at: https://assets.digital.cabinet-office.gov.uk/media/5329df8aed915d0e5d000339/140131_payday_lending_tns_survey_report_.pdf)

Religion

12. We have not identified any concerns that specifically relate to religion but, as our proposals develop, we will continue to consider religion in our assessment.

Sexual orientation

13. We have not identified any concerns that specifically relate to sexual orientation but, as our proposals develop, we will continue to consider sexual orientation issues in our assessment.

Transgender

14. We have not identified any concerns that specifically relate to transgender but, as our proposals develop, we will continue to consider transgender issues in our assessment.

Marital status

15. While marital status is not specified as a protected characteristic in itself, we are required to have due regard to the need to eliminate discrimination on the grounds of marital status or civil partnership.
16. We have not identified any concerns that specifically relate to marital status but, as our proposals develop, we will continue to consider marital status issues in our assessment.
17. We would welcome any information that respondents could share with us that could help us to continue to explore the impact of our proposals on the availability of high-cost short-term credit for protected groups.

Q11: Do you agree with our initial assessment of the impacts of our proposals on the protected groups? Are there any others we should consider?

Appendix 1

Draft Handbook text

CONSUMER CREDIT (COST CAP) INSTRUMENT 2014

Powers exercised

- A. The Financial Conduct Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 (“the Act”):
- (1) section 137A (The FCA’s general rules);
 - (2) section 137C (FCA general rules: cost of credit etc);
 - (3) section 137T (General supplementary powers); and
 - (4) section 139A (The FCA’s power to give guidance).
- B. The rule-making powers listed above are specified for the purpose of section 138G(2) (Rule-making instruments) of the Act).

Commencement

- C. This instrument comes into force on 2 January 2015.

Amendments to the FCA Handbook

- D. The Consumer Credit sourcebook (CONC) is amended in accordance with the Annex to this instrument.

Citation

- E. This instrument may be cited as the Consumer Credit (Cost Cap) Instrument 2014.

By order of the Board of the Financial Conduct Authority
[*date*]

Annex

Amendments to the Consumer Credit sourcebook (CONC)

In this Annex, the text is all new and is not underlined

5A Cost cap for high-cost short-term credit

5A.1 Application, purpose and guidance

Application

5A.1.1 R This chapter applies to:

- (1) a *firm* with respect to an agreement for *high-cost short-term credit* entered into, on or after 2 January 2015; or
- (2) a *firm* with respect to an agreement entered into on or after 2 January 2015 which varies or supplements an agreement for *high-cost short-term credit*; or
- (3) a *firm* with respect to the exercise of a contractual power on or after 2 January 2015 to vary or supplement an agreement for *high-cost short-term credit*.

Statutory context and purpose

5A.1.2 G Section 137C of the *Act*, as amended by the Financial Services (Banking Reform) Act 2013, places a duty on the *FCA* to make general rules with a view to securing an appropriate degree of protection for borrowers against excessive charges.

5A.1.3 G In accordance with that duty, the purpose of this chapter is:

- (1) to specify the descriptions of *regulated credit agreement* appearing to the *FCA* to involve the provision of high-cost short-term credit to which this chapter applies by using the definition of high-cost short-term credit set out in the *Glossary*, and
- (2) to restrict the charges for such high-cost short-term credit.

Guidance

5A.1.4 G Examples of the sorts of charge (which expression is defined in *CONC* 5A.6) applied in connection with the provision of *credit* covered by this chapter include, but are not limited to:

- (1) interest on the *credit* provided;
- (2) a charge related to late payment by, or default of, the borrower;

- (3) a charge related to the transmission of *credit* or for using a means of payment to or from the borrower;
- (4) a charge related to early repayment, or refinancing or changing the payment date or termination of the agreement;
- (5) a charge related to the application for, or drawing down of, *credit*;
- (6) a charge imposed by a *credit broker* in the same *group* or with whom the *lender* has arrangements to share the charge;
- (7) a charge for ancillary services related to the provision of *credit*; and
- (8) interest on any of the charges referred to in (1) to (7).

5A.2 Prohibition from entering into agreements for high-cost short-term credit

Application

5A.2.1 R This section applies to:

- (1) a *firm* with respect to *consumer credit lending*; or
- (2) a *firm* with respect to *credit broking*.

Cost caps: entering into agreements: Total cost cap

5A.2.2 R A *firm* must not enter into an agreement for *high-cost short-term credit* that provides for the payment by the borrower of one or more charges that, alone or in combination with any other charge under the agreement or a connected agreement, exceed or are capable of exceeding the amount of *credit* provided under the agreement.

Cost caps: entering into agreements: Initial cost cap

5A.2.3 R A *firm* must not enter into an agreement for *high-cost short-term credit* that provides for the payment by the borrower of one or more charges that, alone or in combination with any other charge under the agreement or a connected agreement, exceed or are capable of exceeding 0.8% of the amount of *credit* provided under the agreement calculated per *day* from the date on which the borrower draws down the *credit* until the date on which repayment of the *credit* is due under the agreement, but if the date of repayment is postponed by an indulgence or waiver, the date to which it is postponed.

5A.2.4 R A reference to a charge in *CONC 5A.2.3R* (Initial cost cap) excludes a charge to which *CONC 5A.2.11R* (Default cap) applies.

5A.2.5 G (1) The initial cost cap is calculated on a daily basis. However, a charge or charges that may be provided for in an agreement in compliance with this cap can amount to 0.8% of the credit provided (determined

in accordance with *CONC* 5A.2.6R to 5A.2.8G) multiplied by the number of days from the date on which the borrower draws down the *credit* until the date indicated in *CONC* 5A.2.3R.

- (2) Where *credit* is drawn down in tranches or is repaid in instalments, the calculation of the initial cost cap takes into account the different amounts of *credit* outstanding and the different durations for which the *credit* is provided.

Determining the amount of credit provided

- 5A.2.6 R The amount of *credit* provided under an agreement for *high-cost short-term credit* for the purposes of *CONC* 5A.2.2R (Total cost cap) is the lesser of:
- (1) the amount of *credit* that the *lender* actually advances under the agreement; or
- (2) the *credit limit*.
- 5A.2.7 R The amount of *credit* provided under an agreement for *high-cost short-term credit* for the purposes of *CONC* 5A.2.3R (Initial cost cap) is the amount of *credit* outstanding on the *day* in question under the agreement, disregarding the effect of the borrower discharging all or part of the borrower's indebtedness in accordance with section 94(1) of the *CCA* (right to complete payments ahead of time) by repayment of *credit* before the date provided for in the agreement.
- 5A.2.8 G For these purposes, where a *lender* allows a borrower to make a number of drawdowns of *credit* (which may be expressed to be possible up to a specified *credit limit*) but only with the *lender's* consent to each respective drawdown, each drawdown is a separate agreement for *high-cost short-term credit* and this chapter applies to each drawdown as a separate agreement accordingly.

Refinancing

- 5A.2.9 R A *firm* must not enter into an agreement for *high-cost short-term credit* that replaces an earlier agreement for *high-cost short-term credit* if the replacement agreement provides for the payment by the borrower of one or more charges that, taken together with the charges under the earlier agreement or a connected agreement (which is connected to either the earlier or the replacement agreement), exceed or are capable of exceeding the higher of the amount of *credit* provided (determined in accordance with *CONC* 5A.2.6R to 5A.2.8G) under the replacement agreement or the earlier agreement.
- 5A.2.10 R A *firm* must not enter into an agreement for *high-cost short-term credit* that replaces an earlier agreement for *high-cost short-term credit* if the replacement agreement provides for the payment by the borrower of one or more charges in connection with a breach of the agreement by the borrower that, taken together with such charges provided for by the earlier agreement,

exceed or are capable of exceeding £15.

Default cap

- 5A.2.11 R A *firm* must not enter into an agreement for *high-cost short-term credit* if:
- (1) it provides for one or more charges payable by the borrower in connection with a breach of the agreement by the borrower, which alone or in combination (and whether in relation to one breach or cumulatively in relation to multiple breaches of the agreement) exceed or are capable of exceeding £15; or
 - (2) it provides for the payment by the borrower of interest on a charge of a type in (1) that exceeds or is capable of exceeding 0.8% of the amount of the charge calculated per *day* from the date the charge is payable until the date the charge is paid; or
 - (3) it provides for the payment by the borrower of one or more charges (except for a charge to which (1) or (2) applies), on any amount of *credit* provided which in breach of the agreement has not been repaid, that alone or in combination exceed or are capable of exceeding 0.8% of that amount calculated per *day* from the date of the breach until the date that the amount has been repaid.
- 5A.2.12 G *Firms* are also reminded of the provisions of section 93 of the CCA (Interest not to be increased on default).

Connected agreements

- 5A.2.13 R Where a borrower or a prospective borrower pays a charge:
- (1) to a *firm*, that carries on or has carried on *credit broking* in relation to an agreement or prospective agreement for *high-cost short-term credit*, which is in the same *group* as the *firm* which is to provide, provides or has provided *credit* under the agreement for *high-cost short-term credit*; or
 - (2) to a *firm*, that carries on or has carried on *credit broking* in relation to an agreement or prospective agreement for *high-cost short-term credit*, which shares some or all of that charge with the *firm* which is to provide, provides or has provided *credit* under the agreement for *high-cost short-term credit*;

the reference to a charge in *CONC* 5A.2.2R (Total cost cap) and *CONC* 5A.2.3R (Initial cost cap) includes this charge and the agreement providing for the charge is a connected agreement.

- 5A.2.14 R Where a *person* imposes, on a borrower or a prospective borrower under an agreement for *high-cost short-term credit*, a charge for an ancillary service to the agreement, the reference to a charge in *CONC* 5A.2.2R (Total cost cap) and *CONC* 5A.2.3R (Initial cost cap) includes this charge and, if the charge is not provided for under the agreement for *high-cost short-term*

credit, the agreement providing for the charge is a connected agreement.

- 5A.2.15 G Examples of the types of ancillary service to an agreement for *high-cost short-term credit* referred to in CONC 5A.2.14R include, but are not limited to, services related to processing the application, to the transmission of the money being lent and insurance or insurance-like services ancillary to the agreement.

Prohibition on compound interest

- 5A.2.16 R A *firm* must not enter into an agreement for *high-cost short-term credit*, which provides for a charge, by way of interest, other than a charge by way of simple interest.

5A.3 Prohibition from imposing charges under agreements for high-cost short-term credit

Application

- 5A.3.1 R This section applies to:
- (1) a *firm* with respect to *consumer credit lending*;
 - (2) a *firm* with respect to *debt administration*;
 - (3) a *firm* with respect to *debt collecting*; or
 - (4) a *firm* with respect to *operating an electronic system in relation to lending*.

Cost caps: imposition of charges etc.: Total cost cap

- 5A.3.2 R A *firm* must not:
- (1) impose one or more charges on a borrower under an agreement for *high-cost short-term credit* that, alone or in combination with any other charge under the agreement or a connected agreement, exceed or are capable of exceeding the amount of *credit* provided under the agreement.
 - (2) arrange for or instruct another *person* to take the step described in (1).

Cost caps: imposition of charges etc.: Initial cost cap

- 5A.3.3 R A *firm* must not impose on a borrower under an agreement for *high-cost short-term credit*, one or more charges that, alone or in combination with any other charge under the agreement or a connected agreement, exceed or are capable of exceeding 0.8% of the amount of *credit* provided under the agreement calculated per *day* from the date on which the borrower draws

down the *credit* until the date on which repayment of the *credit* is due under the agreement, but if the date of repayment is postponed by an indulgence or waiver, the date to which it is postponed.

- 5A.3.4 R A reference to a charge in *CONC* 5A.3.3R (Initial cost cap) excludes a charge to which *CONC* 5A.3.13R (Default cap) applies.
- 5A.3.5 G (1) The initial cost cap is calculated on a daily basis. However, the charge or charges that may be imposed in compliance with this cap can in one or more charges amount to 0.8% of the *credit* provided (determined in accordance with *CONC* 5A.3.6R to 5A.3.8G) multiplied by the number of days from the date on which the borrower draws down the *credit* until the date indicated in *CONC* 5A.3.3R.
- (2) Where *credit* is drawn down in tranches or is repaid in instalments, the calculation of the initial cost cap takes into account the different amounts of *credit* outstanding and the different durations for which the *credit* is provided.

Determining the amount of credit provided

- 5A.3.6 R The amount of *credit* provided under an agreement for *high-cost short-term credit* for the purposes of *CONC* 5A.3.2R (total cost cap) is the lesser of:
- (1) the amount of *credit* that the *lender* actually advances under the agreement; or
- (2) the *credit limit*.
- 5A.3.7 R The amount of *credit* provided under an agreement for *high-cost short-term credit* for the purposes of *CONC* 5A.3.3R (Initial cost cap) is the amount of *credit* outstanding on the *day* in question under the agreement, disregarding the effect of the borrower discharging all or part of the borrower's indebtedness in accordance with section 94(1) of the *CCA* (right to complete payments ahead of time) by repayment of *credit* before the date provided for in the agreement.
- 5A.3.8 G For these purposes, where a *lender* allows a borrower to make a number of drawdowns of *credit* (which may be expressed to be possible up to a specified *credit limit*) but only with the *lender's* consent to each respective drawdown, each drawdown is a separate agreement for *high-cost short-term credit* and this chapter applies to each drawdown as a separate agreement accordingly.

Refinancing

- 5A.3.9 R A *firm* must not impose one or more charges by way of an agreement that varies or supplements an earlier agreement for *high-cost short-term credit* if the amount of the charge or charges payable by the borrower taken together with such charges imposed under the earlier agreement or in a connected

agreement to any of those agreements, exceed or are capable of exceeding the amount of *credit* provided (determined in accordance with *CONC* 5A.3.6R to 5A.3.8G) under the combined effect of the varying or supplemental agreement and the earlier agreement.

- 5A.3.10 R A *firm* must not impose one or more charges in connection with a breach of the agreement by the borrower by way of an agreement that varies or supplements an earlier agreement for *high-cost short-term credit* if the amount of the charge or charges payable by the borrower, taken together with such charges imposed under the earlier agreement or in a connected agreement, exceed or are capable of exceeding £15.
- 5A.3.11 R A *firm* must not impose one or more charges under an agreement for *high-cost short-term credit* that replaces an earlier agreement for *high-cost short-term credit* if the charge or charges under the replacement agreement, taken together with the charges under the earlier agreement or a connected agreement (which is connected to either the earlier or the replacement agreement), exceed or are capable of exceeding the higher of the amount of *credit* provided (determined in accordance with *CONC* 5A.3.6R to 5A.3.8G) under the replacement agreement or the earlier agreement.
- 5A.3.12 R A *firm* must not impose one or more charges in connection with a breach of the agreement by the borrower under an agreement for *high-cost short-term credit* that replaces an earlier agreement for *high-cost short-term credit* if the charge or charges under the replacement agreement payable by the borrower, taken together with such charges imposed under the earlier agreement or in a connected agreement, exceed or are capable of exceeding £15.

Default cap

- 5A.3.13 R A *firm* must not impose, under an agreement for *high-cost short-term credit*:
- (1) one or more charges payable by the borrower in connection with a breach of the agreement by the borrower, which charges alone or in combination (and whether in relation to one breach or in combination relate to multiple breaches of the agreement) exceed or are capable of exceeding £15;
 - (2) a charge by way of interest on a charge of a type in (1) that exceeds or is capable of exceeding 0.8% of the amount of the charge calculated per *day* from the date the charge is payable until the date the charge is paid;
 - (3) one or more charges (except for a charge to which (1) or (2) applies), on any amount of *credit* provided which in breach of the agreement has not been repaid, that alone or in combination, exceed or are capable of exceeding 0.8% of that amount calculated per *day* from the date of the breach until that amount has been repaid.
- 5A.3.14 G *Firms* are also reminded of the provisions of section 93 of the *CCA* (Interest

not to be increased on default).

Connected agreements

- 5A.3.15 R Where a borrower or a prospective borrower pays a charge:
- (1) to a *firm*, that carries on or has carried on *credit broking* in relation to an agreement or prospective agreement for *high-cost short-term credit*, which is in the same *group* as the *firm* which is to provide, provides or has provided *credit* under the agreement for *high-cost short-term credit*; or
 - (2) to a *firm*, that carries on or has carried on *credit broking* in relation to an agreement or prospective agreement for *high-cost short-term credit*, which shares some or all of that charge with the *firm* which is to provide, provides or has provided *credit* under the agreement for *high-cost short-term credit*;

the reference to a charge in *CONC 5A.3.2R* (Total cost cap) and *5A.3.3R* (Initial cost cap) includes this charge and the agreement providing for the charge is a connected agreement.

- 5A.3.16 R Where a *person* imposes on a borrower or a prospective borrower, under an agreement for *high-cost short-term credit*, a charge for an ancillary service to the agreement, the reference to a charge in *CONC 5A.3.2R* (Total cost cap) and *5A.3.3R* (Initial cost cap) includes this charge and, if the charge is not provided for under the agreement for *high-cost short-term credit*, the agreement providing for the charge is a connected agreement.

- 5A.3.17 G Examples of the types of ancillary service to an agreement for *high-cost short-term credit* referred to in *CONC 5A.3.16R* include, but are not limited to, services related to processing the application, to the transmission of the money being lent and insurance or insurance-like services ancillary to the agreement.

- 5A.3.18 G Where an agreement passes to another *firm* by assignment or by operation of law, any charges imposed in connection with the provision of *credit* under the agreement for *high-cost short-term credit* before the agreement passed to the *firm* are included within the charges referred to in *CONC 5A.3*.

Prohibition on compound interest

- 5A.3.19 R A *firm* must not impose a charge under an agreement for *high-cost short-term credit*, which provides for a charge, by way of interest, other than a *charge* by way of simple interest.

5A.4 Cost cap for operating an electronic system in relation to lending

Application

- 5A.4.1 R This section applies to a *firm* with respect to *operating an electronic system in relation to lending* in relation to a borrower or a prospective borrower under an agreement for *high-cost short-term credit*.

Cost cap rules for operating electronic systems in relation to lending: Total cost cap

- 5A.4.2 R A *firm* must not facilitate an *individual* becoming a borrower under an agreement for *high-cost short-term credit* that provides for the payment by the borrower of one or more charges that, alone or in combination with any other charge under the agreement or a connected agreement, exceed or are capable of exceeding the amount of *credit* provided under the agreement.

Cost cap rules for operating electronic systems in relation to lending: Initial cost cap

- 5A.4.3 R A *firm* must not facilitate an *individual* becoming a borrower under an agreement for *high-cost short-term credit* that provides for the payment by the borrower of one or more charges that, alone or in combination with any other charge under the agreement or a connected agreement, exceed or are capable of exceeding 0.8% of the amount of *credit* provided under the agreement calculated per *day* from the date on which the borrower draws down the *credit* until the date on which repayment of the *credit* is due under the agreement, but if the date of repayment is postponed by an indulgence or waiver, it is the date to which it is postponed.

- 5A.4.4 R A reference to a charge in *CONC 5A.4.3R* excludes a charge to which *CONC 5A.4.11R* (Default cap) applies.

- 5A.4.5 G (1) The initial cost cap is calculated on a daily basis. However, a charge or charges that may be provided for in an agreement in compliance with this cap can amount to 0.8% of the credit provided (determined in accordance with *CONC 5A.4.6R* to *5A.4.8G*) multiplied by the number of days from the date on which the borrower draws down the *credit* until the date indicated in *CONC 5A.4.3R*.
- (2) Where *credit* is drawn down in tranches or is repaid in instalments, the calculation of the initial cost cap takes into account the different amounts of *credit* outstanding and the different durations for which the *credit* is provided.

Determining the amount of credit provided

- 5A.4.6 R The amount of *credit* provided under an agreement for *high-cost short-term credit* for the purposes of *CONC 5A.4.2R* (Total cost cap) is the lesser of:
- (1) the amount of *credit* that the *lender* actually advances under the agreement; or
- (2) the *credit limit*.

- 5A.4.7 R The amount of *credit* provided under an agreement for *high-cost short-term credit* for the purposes of *CONC 5A.4.3R* (Initial cost cap) is the amount of *credit* outstanding on the *day* in question under the agreement, disregarding the effect of the borrower discharging all or part of the borrower's indebtedness in accordance with section 94(1) of the *CCA* (right to complete payments ahead of time) by repayment of *credit* before the date provided for in the agreement.
- 5A.4.8 G For these purposes, where a *lender* allows a borrower to make a number of drawdowns of *credit* (which may be expressed to be possible up to a specified *credit limit*) but only with the *lender's* consent to each respective drawdown, each drawdown is a separate agreement for *high-cost short-term credit* and this chapter applies to each drawdown as a separate agreement accordingly.

Refinancing

- 5A.4.9 R A *firm* must not facilitate an *individual* becoming a borrower under an agreement for *high-cost short-term credit* that replaces an earlier agreement for *high-cost short-term credit* if the replacement agreement provides for the payment by the borrower of one or more charges that, taken together with the charges under the earlier agreement or a connected agreement (which is connected to either the earlier or the replacement agreement), exceed or are capable of exceeding the higher of the amount of *credit* provided (determined in accordance with *CONC 5A.4.6R* to *5A.4.8G*) under the replacement agreement or the earlier agreement.
- 5A.4.10 R A *firm* must not facilitate an *individual* becoming a borrower under an agreement for *high-cost short-term credit* that replaces an earlier agreement for *high-cost short-term credit* if the replacement agreement provides for the payment by the borrower of one or more charges in connection with a breach of the agreement by the borrower that, taken together with such charges provided for by the earlier agreement, exceed or are capable of exceeding £15.

Default cap

- 5A.4.11 R A *firm* must not facilitate an *individual* becoming a borrower under an agreement for *high-cost short-term credit* if:
- (1) it provides for one or more charges payable by the borrower in connection with a breach of the agreement by the borrower, which alone or in combination (and whether in relation to one breach or cumulatively in relation to multiple breaches of the agreement) exceed or are capable of exceeding £15; or
 - (2) it provides for the payment by the borrower of interest on a charge of a type in (1) that exceeds or is capable of exceeding 0.8% of the amount of the charge calculated per *day* from the date the charge is payable until the date the charge is paid; or

- (3) it provides for the payment by the borrower of one or more charges (except for a charge to which (1) or (2) applies), on any amount of *credit* provided which in breach of the agreement has not been repaid, that alone or in combination exceed or are capable of exceeding 0.8% of that amount calculated per *day* from the date of the breach until the date that the amount has been repaid.

5A.4.12 G *Firms* are also reminded of the provisions of section 93 of the CCA (Interest not to be increased on default).

Connected agreements

5A.4.13 R Where a borrower or a prospective borrower pays a charge:

- (1) to a *firm*, that carries on or has carried on *credit broking* in relation to an agreement or prospective agreement for *high-cost short-term credit*, which is in the same *group* as the *firm* which is to facilitate, facilitates or has facilitated the provision of *credit* under the agreement for *high-cost short-term credit*; or
- (2) to a *firm*, that carries on or has carried on *credit broking* in relation to an agreement or prospective agreement for *high-cost short-term credit*, which shares some or all of that charge with the *firm* which is to facilitate, facilitates or has facilitated the provision of *credit* under the agreement for *high-cost short-term credit*;

the reference to a charge in CONC 5A.4.2R and 5A.4.3R includes this charge and the agreement providing for the charge is a connected agreement.

5A.4.14 R Where a *person* imposes, on a borrower or a prospective borrower under an agreement for *high-cost short-term credit*, a charge for an ancillary service to the agreement, the reference to a charge in CONC 5A.4.2R and CONC 5A.4.3R includes this charge and, if the charge is not provided for under the agreement for *high-cost short-term credit*, the agreement providing for the charge is a connected agreement.

5A.4.15 G Examples of the types of ancillary service to an agreement for *high-cost short-term credit* referred to in CONC 5A.4.14R include, but are not limited to, services related to processing the application, to the transmission of the money being lent and insurance or insurance-like services ancillary to the agreement.

Prohibition on compound interest

5A.4.16 R A *firm* must not facilitate an *individual* becoming a borrower under an agreement for *high-cost short-term credit* which provides for a charge, by way of interest, other than a charge by way of simple interest.

5A.5 Consequences of contravention of the cost caps

Application

- 5A.5.1 R This section applies to:
- (1) a *firm* with respect to *consumer credit lending*;
 - (2) a *firm* with respect to *debt administration*;
 - (3) a *firm* with respect to *debt collecting*; or
 - (4) a *firm* with respect to *operating an electronic system in relation to lending*.

Contravention of cost caps and unenforceability of agreements and obligations

- 5A.5.2 R Where a *firm* enters into an agreement for *high-cost short-term credit* in contravention of a *rule* in *CONC 5A.2* or a *firm* within *CONC 5A.5.1R* (1) or (4) or a *firm* within *CONC 5A.5.1R* (2) or (3) on behalf of a *firm* within *CONC 5A.5.1R* (1) or (4) imposes a charge in contravention of a *rule* in *CONC 5A.3*:
- (1) the agreement is unenforceable against the borrower; and
 - (2) the borrower may choose not to perform the agreement and if that is the case:
 - (a) at the written or oral request of the borrower, the *lender* must, as soon as reasonably practicable following the request and in any case within *7 days* of the request, repay to the borrower any charges paid by the borrower under the agreement; and
 - (b) where the borrower recovers those charges, the borrower must repay any *credit* received by the borrower under the agreement to the *lender*.
- 5A.5.3 R Where an agreement for *high-cost short-term credit* provides for or imposes one or more charges that alone or in combination exceed or are capable of exceeding an amount set out in *CONC 5A.2* or *CONC 5A.3*:
- (1) the agreement is unenforceable against the borrower to the extent such a charge or such charges exceed or are capable of exceeding that amount; and
 - (2) the borrower may choose not to perform the agreement to that extent and if that is the case at the written or oral request of the borrower, the *lender* must, as soon as reasonably practicable following the request and in any case within *7 days* of the request, repay to the borrower any charges to the extent in (1) paid by the borrower under the agreement.

5A.6 Interpretation

5A.6.1 R In this chapter:

- (1) “ancillary service” is a service that relates to the provision of *credit* under the agreement for *high-cost short-term credit* and includes, in particular, an insurance or payment protection policy;
- (2) “borrower” is an *individual* and includes:
 - (a) any person providing a guarantee or indemnity under the *regulated credit agreement*; and
 - (b) a person to whom the rights and duties of the borrower under the *regulated credit agreement* or of a person falling within (a) have passed by assignment or operation of law;
- (3) “charge” is a charge payable, by way of interest or otherwise, in connection with the provision of *credit* under the *regulated credit agreement*, whether or not the agreement itself makes provision for it and whether or not the *person* to whom it is payable is a party to the *regulated credit agreement* or an *authorised person*;
- (4) “connected agreement” is an agreement which provides for a charge within *CONC 5A.2.13R*, *CONC 5A.2.14R*, *CONC 5A.3.15R*, *CONC 5A.3.16R*, *CONC 5A.4.13R* and *CONC 5A.4.14R*;
- (5) “impose one or more charges on a borrower under an agreement for *high-cost short-term credit*” includes taking the following actions under the agreement:
 - (a) taking steps to perform duties, or exercise or enforce rights, on behalf of a *lender* in relation to a charge; or in relation to a *firm* with respect to *operating an electronic system in relation to lending*, exercise or enforce rights, on behalf of a *lender* in relation to one or more charges;
 - (b) taking steps to procure the payment of a debt due in relation to one or more charges;
 - (c) undertaking to receive payments in respect of interest due under an agreement for *high-cost short-term credit* and make payments in respect of interest due under the agreement to the *lender*;

- (d) arranging for or instructing another *person* to take any of the steps described in (a), (b) or (c); or
- (e) exercising the rights of the *lender* in a way that enables the imposition on the borrower of one or more charges.

Financial Conduct Authority



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