Impact of regulation on High Cost Short Term Credit:

How the functioning of the HCSTC market has evolved

March 2017

Contents

1 Executive summary

Over the past four years, the market for High Cost Short Term Credit (HCSTC) has experienced arguably the most extensive changes to the regulatory regime of any financial services sector in recent times. This process has created a significantly different, and more consumer-friendly, market. Below are just some of the improvements in consumer outcomes:

- the cost of credit has come down by around a third;
- default rates have approximately halved;
- due to regulatory interventions, lenders have been incentivised to offer affordable loans, that consumers pay-off according to the original terms of the loan;
- the average amount paid by consumers in additional fees has halved since 2013;
- lenders are offering longer-term loans, better meeting the needs of consumers, giving them an opportunity to take advantage of early repayment at lower rates, and improving the affordability of each repayment instalment.

The introduction of the HCSTC price cap, which the Financial Conduct Authority (FCA) is reviewing, has been only a small part of a much wider spectrum of regulatory and market change. Investigations into the sector were conducted firstly by the Office of Fair Trading (OFT), then by the Competition and Markets Authority (CMA, which was previously the Competition Commission) and then by the FCA. The FCA put in place a new regulatory regime specifically designed to improve market functioning, to order to make the sector work in the interests of consumers, in line with FCA objectives. To understand the role of the price cap, it is important to consider this wider context of regulatory and market changes.

In this note, we take stock of where the industry is today, compared with where it was before the market investigations and the introduction of FCA regulation, to provide a realistic picture of what has been achieved. This CFA research, conducted with assistance from economic analysts, Oxera, builds on the work of the Social Market Foundation (SMF),[1] to explore how consumer outcomes and business models have changed, and how the functioning of the HCSTC market has evolved. While the price cap has delivered benefits to consumers in terms of lower cost of credit, there have been much more fundamental changes to market functioning since the introduction of FCA regulation. This process has created a significantly different, and more consumer-friendly, market. However, market reform on this scale, and at this pace, does not come without costs, and access to credit has been significantly reduced.

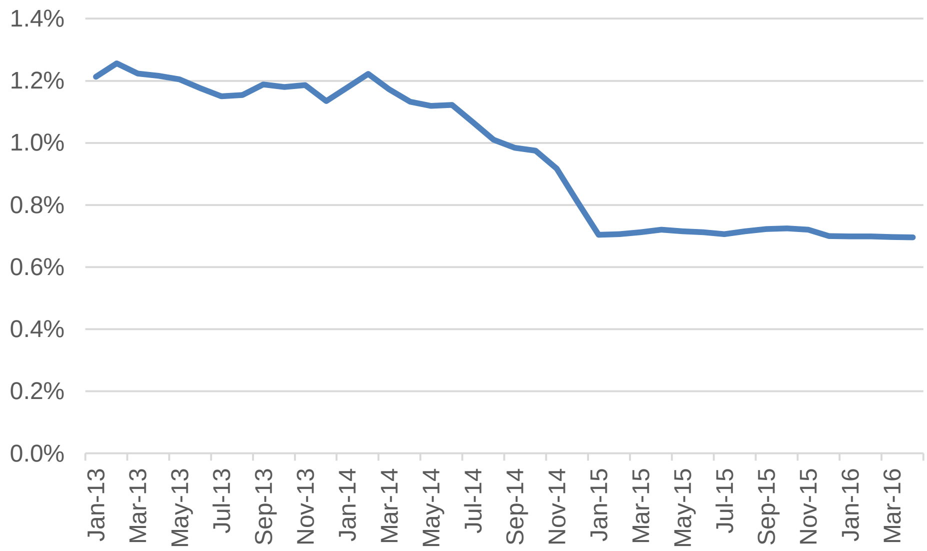
The impact of FCA regulation

The whole package of reforms to the regulation of HCSTC, including the price cap, was focused on protecting consumers. Objectives included ensuring that consumers do not pay excessive charges for borrowing and that the risks to those borrowers who struggle to repay are minimised. In addition, the CMA called for reforms to improve the effectiveness of competition in the sector, including a price comparison website and increased clarity on charges. These came into effect in December 2016.

[1] See SMF (2016), 'An analysis of the short-term credit market'.

Following the introduction of the price cap, the cost of loans in the market has significantly decreased (see Fig. 1). But, in addition, the proportion of customers being charged late fees has fallen sharply, both due to a reduction in late payment by customers and many lenders choosing not to charge late fees at all. The number of rollovers and extensions of loans has fallen sharply, and the average number of new loans taken out by HCSTC customers each year, across all lenders according to FCA data, has fallen from 6 in 2013 to around 4 today.

Fig. 1 **Average daily cost, as a daily interest rate**



Source: SMF (2016), 'Industry data'.

Lenders' business models have changed

One of the concerns of the CMA was lenders' reliance on revenues earned as a result of consumers incurring late fees, extending loans or relending. The initial investigation[2] found that half of lenders' revenues were coming from the 28% of loans that were rolled over or refinanced at least once.

But now lenders' business models are far less reliant on consumers incurring late fees, extending loans or relending. Instead, many consumers are, on average, paying back their loans on time and indeed often ahead of schedule. We estimate that HCSTC lenders now receive, on average, more than 80% of their revenues from the original contractual interest of the loan, excluding all late fees, late interest and revenues from rollovers and early relending.[3] This compares to an estimated 60% of revenues from the contractual interest payments in 2013. Lenders may charge additional fees for late payment, rollovers, etc., for certain activities by customers that still occur, but these revenues are now much less important to lenders,[4] and may fail to cover the costs of those activities. This means that lenders no longer rely on revenues that were not agreed with consumers upfront.

Market functioning has therefore fundamentally changed. Business models are better aligned with the consumer interest, without the reliance on behavioural biases – such as optimism bias, where

[2] OFT (2013), 'Payday Lending: Compliance Review Final Report', page 2.
[3] See Section 3 for details of these estimates.
[4] Revenues from late fees, late interest and rollovers have halved in relative terms, and more than halved in absolute terms due to the decline in lending.

consumers are over-optimistic about their ability to repay and therefore tend to underestimate the actual costs they end up incurring. This is the key change that puts the HCSTC sector on the right footing to work in consumers' interests.

This change is consistent with the major improvements in customer outcomes reported by the FCA, including lower default, improved affordability, and the wider variety of products on offer.

Restricted access to credit

At the same time, there has been a significant reduction in the size of the market. This has led to many consumers not having access to the credit that they have in the past. This reduction in access to credit was much larger than the FCA expected during the price cap consultation and has resulted in a mixed set of outcomes. Some consumers who would previously have found themselves incurring unaffordable costs are no longer exposed to such a problem. However, many consumers no longer have access to credit, and so are less able to manage their cash flow and ensure they have sufficient finances to meet their spending requirements. As documented by the SMF, this has changed the demographic of HCSTC consumers, as certain groups of customers no longer have access to credit.

Firms' profitability has also fallen, with sharp drops in gross profits per loan, per customer and per amount funded. The drop in profits reported by lenders in recent years reflects both the immediate impact of complying with the new regulatory regime and a more fundamental change to the profitability of lending.

Firms now offer longer term loans than previously, improving affordability for consumers and better meeting the needs of consumers. This has resulted in what was previously referred to as the 'payday loan' market becoming, in many ways, indistinguishable from the broader market of credit available to subprime consumers. This change is reflected in the FCA issuing a call for input into the high cost credit market as part of its review into the HCSTC price cap.

A more effective market

Regulatory intervention in the HCSTC sector has achieved its objectives in terms of fundamentally changing market functioning, transforming lenders' business models and producing significant benefits for consumers. Lenders now compete to deliver affordable products that meet the needs of consumers. These fundamental changes have, however, come at a greater cost than the FCA expected in the form of reduced access to credit.

The challenge for regulators is to ensure that all providers of high cost credit services compete on a level playing field so that consumers have access to the most suitable products. Since the HCSTC market operates effectively, much like other credit products, the distinction between HCSTC and other forms of high cost credit is much less relevant – they provide different products within the same market. Therefore, measures introduced in one part of the market need to be carefully designed so as not to distort the broader market. HCSTC loans are now much more often instalment loans than single period loans, and this should be reflected in the regulatory framework. More generally, specific regulatory interventions should seek to ensure the alignment of the interests of consumers and lenders, suitable for the particular credit solutions being delivered.

As well as ensuring effective price competition, the regulator must ensure that the same rigorous affordability assessments are required across the consumer credit industry. HCSTC lenders are now conducting affordability assessments that go beyond what is typical for other consumer credit products, including detailed questions and independent checks on income, expenditure and credit commitments. In this context, a level playing field between the credit services available to borrowers is important to ensure that consumers are not inappropriately channelled to certain credit services solely on the basis of weaker requirements for affordability.

2 The impact of the new regulatory regime

No other financial services sector has experienced both CMA and FCA market investigations (as well as the previous investigation by the OFT), combined with the requirements of FCA authorisation and the imposition of a price cap, all within a space of four years. This was arguably the first time that the FCA brought to bear its new toolkit of behavioural economics, competition economics, and extensive data analysis to directly address market functioning through regulation and supervision in order to better meet consumers' needs. To understand the changes to the HCSTC sector, it is important to consider the full package of remedies introduced by the FCA and CMA, which sought to improve market functioning in the interests of consumers.

Key messages

- The HCSTC sector experienced a huge transformation of the regulatory regime under the FCA from April 2014, in addition to the measures brought in by the CMA market investigation and the HCSTC price cap.
- The objective was to improve market functioning in the interests of consumers, by improving information, addressing misconduct by firms, and more generally putting consumers in a better place to make borrowing decisions.
- These extensive changes to the regulatory regime had a significant impact. The volume of HCSTC lending has fallen sharply since 2013, with reduced loan acceptance, reduced default and late fees, longer loans and lower loan usage per customer.
- This note assesses the functioning of the HCSTC sector following these changes. In particular, we consider whether the 'right balance' is being struck between HCSTC firms carrying on lending to borrowers who can benefit, and consumers being protected from spiralling debts and unaffordable loans.

First, the CMA market investigation

The Office of Fair Trading (OFT) referred the payday lending market to the Competition Commission (CC) (now the CMA) for a market investigation in June 2013. In February 2015, the CMA published its final report on the sector. The report found a clear demand for short term, small sum credit, which many customers were meeting by taking out payday loans, but also concluded that competition was not working effectively in the interests of consumers. A package of remedies was introduced aimed at empowering consumers and improving market functioning more generally. Lenders were ordered to publish details of their products on price comparison websites, which are authorised by the FCA. Other recommendations included the FCA taking steps to:

- improve the disclosure of late fees and other additional charges;
- help customers to shop around without unduly affecting their ability to access credit;
- improve real-time data sharing between lenders and credit reference agencies; and
- ensure that lead generators[5] explain how they operate much more clearly to customers.[6]

Then the Government called for a price cap

[5] Websites that sell potential borrowers' details to lenders and through which 40% of first-time online borrowers access their loans.
[6] CMA (2015), 'CMA finalises proposals to lower payday loan costs'.

In December 2013, the Government wrote to the FCA stating that it believed that there was a need for a cap on the cost of payday loans, and that it would be seeking to place a duty on the FCA to introduce such a cap. The Government explained that:

> *'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 spiralling costs which make their debt problems worse. In short, far fewer payday loans customers should get into problem debt'.*[7]

In July 2014, the FCA proposed a price cap for HCSTC. This included:

- an initial cost cap of 0.8% per day;
- a £15 cap on late fees; and
- a total cost cap of 100%.[8]

The final rules were confirmed in November 2014.[9]

In introducing the price cap, the FCA was concerned with 'striking the right balance' – to allow enough HCSTC firms to carry on lending to borrowers who can benefit, while protecting consumers against spiralling debts and unaffordable loans.

The FCA took over regulation of consumer credit in April 2014

While the CMA was still conducting its investigation, there began a huge transformation of the regulatory regime for HCSTC that has had a massive impact on the sector. This included:

- the introduction of new regulation specifically aimed at the HCSTC sector, including:
    - a restriction on the number of rollovers to no more than two per loan; and
    - a maximum of two unsuccessful Continuous Payment Authority (CPA) attempts to draw money from customer's bank accounts to repay loans.
- HCSTC lenders (along with all of consumer credit providers) were required to apply for authorisation, which includes the need to demonstrate that they can meet threshold conditions (COND);
- a supervisory regime, whereby the FCA, on a proactive basis, seeks to identify evidence of consumers suffering due to poor services and products. Where the FCA identifies such issues, it has the power to intervene;
- handbook requirements – firms are required to comply with the standards set out in the FCA's handbook including the Principles for Businesses (PRIN), rules on senior management arrangements, systems and controls (SYSC), and some general provisions including rules on setting out firms' regulatory status. Since authorisation, HCSTC lenders are also subject to quarterly product sales data (PSD) reporting and annual regulatory reporting requirements.

[7] HMT (2013), 'Capping the Cost of Payday Loans', page 2.
[8] FCA (2014), 'FCA proposes price cap for payday lenders'.
[9] FCA (2014), 'Detailed rules for the price cap on high-cost short-term credit: including feedback on CP14/10 and final rules'.

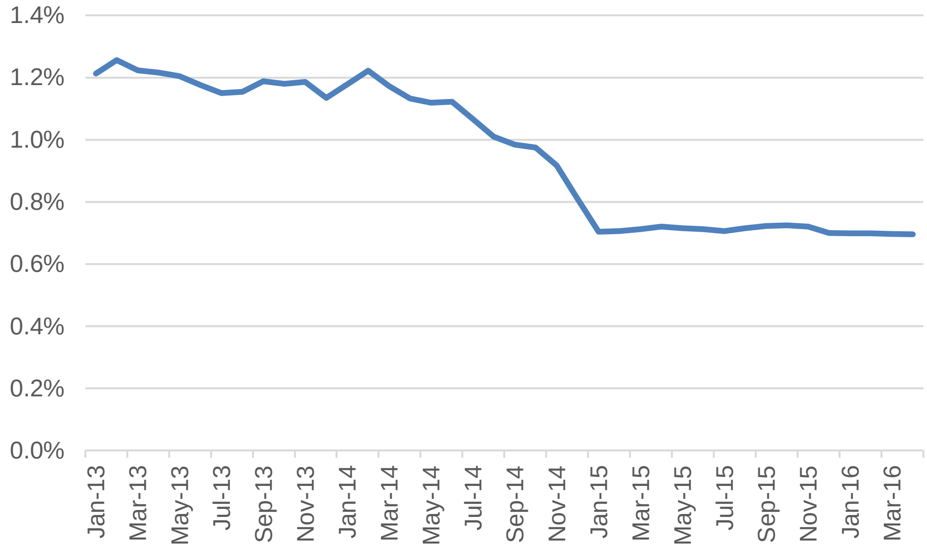
FCA regulation had the objective of making the market function better for consumers, by improving information,[10] addressing misconduct by firms and more generally putting consumers in a better place to make borrowing decisions.

Overview of the impact of regulatory intervention

These extensive changes to the regulatory regime had a significant impact.

First, FCA regulation – in particular the price cap – has reduced the cost of credit. Fig. 2 shows the reduction in the average daily cost of credit following the introduction of the price cap. The SMF found that up to April 2016, the cost of borrowing was down £36 for a 30-day loan, and that over half of borrowers say loans are more affordable.

Fig. 2 Average daily cost, as a daily interest rate



Source: SMF (2016), 'Industry data'.

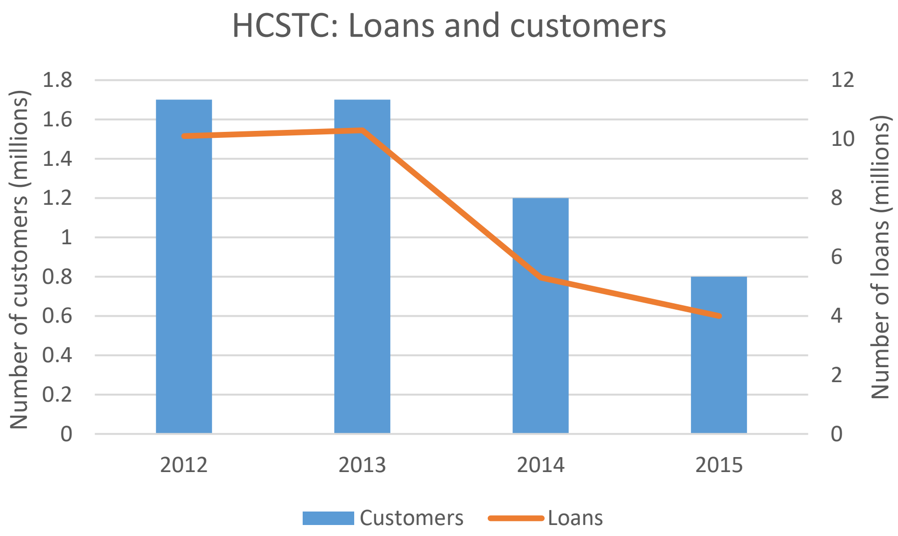
While the price cap reduced the cost of credit, the impact of the broader spectrum of FCA regulation, including requirements on rollovers, relending and affordable lending, has arguably been much more far-reaching. The volume of HCSTC lending has fallen sharply since 2013, with reduced loan acceptance, reduced default and late fees, longer loans and lower loan usage per customer. The sharp contraction is well-documented – FCA data shows that:

- the loan acceptance rate, as measured by the FCA, fell from around 50% to around 30%;[11]
- the proportion of loans being charged a late payment fee has decreased from 16% to below 8%;
- the proportion of loans entering arrears for seven days or more has decreased from 16% to 12%;

[10] Firms have also significantly increased their use of real-time data.
[11] The FCA measure of acceptance differs from industry measures, as the FCA is understood to exclude from its measure customers who do not reach the creditworthiness assessment using credit reference agency data.

- loan size has stayed broadly constant, while loan duration has increased from nearly 30 days to nearly 80 days, which has improved the affordability of the loans and resulted in more clarity about the total costs upfront;
- the number of loans taken out by consumers over a 6-month period has significantly fallen.

Fig. 3 HCSTC loans and customers per year



Note: Estimate for 2015

Source: FCA

This report provides a further assessment of the current functioning of the market, as well as consumers' access to credit. In particular, we consider whether the 'right balance' is being struck between HCSTC firms carrying on lending to borrowers who can benefit, and consumers being protected from spiralling debts and unaffordable loans. This assessment aims to inform the FCA's ongoing post-implementation review of the price cap and wider review of the high cost credit sector.

3 Market functioning

It is useful to go back to where the industry was before FCA regulation, in 2013, and compare it with where the industry is now, in terms of the alignment of business models with consumer interests and market functioning. This is to assess how well the FCA has met its objective of making markets work in the interests of consumers, and to consider what the consequences of the changes have been.

Key messages

- In a well-functioning consumer credit market, lenders' incentives are aligned with those of consumers, as lenders do not benefit from unaffordable lending decisions. Concern about the alignment of incentives was a key driving force behind the change in regulation for the HCSTC sector.
- The massive changes in the HCSTC sector have resulted in the business models no longer benefitting from poor outcomes for consumers. Lenders now receive the vast majority of their revenues from the contractual interest payments agreed with the customer at the start of the loan, rather than revenues from late fees, late interest or rollovers. Consequently, lenders are incentivised to issue loans that are affordable and that consumers can pay back on time, so that the lender is more likely to successfully collect the contractual interest payments.
- The HCSTC sector consequently works much more effectively in the interests of consumers. With the increased focus of lenders on the contractual interest of the loan, lenders are increasingly competing in terms of offering longer term loans that meet the affordability requirements of borrowers while still offering the amounts required.
- But this very rapid change to the fundamental functioning of the market has had severe impacts on access to credit and lender profitability.

Addressing concerns about the alignment of incentives

Concerns about the alignment of incentives were a key driving force behind the change in regulation for the HCSTC sector. The OFT found evidence of widespread conduct issues in the payday lending market and referred the sector to the CC (now CMA) for investigation, owing to concerns that certain features of this market were leading to these issues. The CMA in turn found that the behaviour of consumers – in particular, consumers being overoptimistic about their ability to repay and thereby underestimating the total cost of the loan – was resulting in many consumers taking out loans through rollovers, extensions and relending. This in turn affected the nature of competition in the market, as lenders focused on those customers most likely to take out a series of loans. This can be a bad outcome for customers, with some consumers repeatedly rolling-over loans, or taking out new loans, owing to the amount of debt (and associated charges) they are now faced with.

In terms of behavioural economics, some consumers (but certainly not all) exhibited optimism bias, whereby the consumer overestimates their ability to repay. They took out a single-period loan expecting to be able to repay it on their next payday, but this was not possible, leading to late payments and loan extensions. This dynamic altered the nature of competition in the market. Within the 'access, assess and act' framework used by the FCA,[12] price information may have been readily available,[13] but some consumers were not appropriately assessing or acting upon that information. It is, however, also fair to say that there were many other consumers using payday loans as intended, to cover expected short term cash flow needs.

Regulation changed the dynamic

FCA regulation has fundamentally changed this dynamic. Lenders are no longer able to profit from excessive lending, as regulation limits the number of rollover to two. The requirements of FCA authorisation and supervision have, in practice, pushed the average numbers of rollovers even lower. The cap of total interest and fees being no more than 100% of the principal funded also places a limit on the extent to which a lender can profitably roll over a loan, as any (instalment) loan longer than 6 months needs to have an interest rate below the 0.8% per day cap in order to meet the 100% of principal requirement.[14]

Furthermore, lenders now also limit the extent to which they relend to customers, even if they have paid back in full. In addition, the limit of two unsuccessful CPA requests reduces the ability of lenders to collect money from late-paying customers, as it is more difficult for lenders to collect funds from the customer's bank account. The price cap also limits the total value of late fees that can be applied (the cap is £15 in total for all late fees).

In terms of consumer behaviour, it is likely that all of the regulatory interest and press coverage has also further increased consumer awareness of the problems associated with rolling over short term loans, in part addressing optimism bias. While the underlying nature of consumer behaviour cannot be changed – consumers are still likely to exhibit optimism bias in certain circumstances – awareness has improved and, importantly, the incentives for the lenders have changed.

Lenders no longer benefit from behavioural biases…

Instead, lenders now benefit to a much greater extent on the contractual interest payments agreed with consumers upfront, rather than revenues from late fees and rollovers which the consumer may not have expected when agreeing the loan. While some consumers were intentionally using a number of sequential one-month loans to manage their finances in the past, there was clearly a risk that some consumers were running up additional charges they had not expected. Lenders no longer benefit from these behavioural biases.

In 2013, the OFT found that 28% of loans were rolled over or refinanced at least once, providing 50% of lenders' revenues.[15] In addition, many lenders were receiving significant additional fees, primarily from late fees.

Starting with additional fees, the landscape has changed markedly since 2013. A number of lenders do not charge late fees at all now, and all are now bound by the £15 total cap. Consequently, since

[12] See FCA (2016), 'Occasional Paper 13: Economics for Effective Regulation', March.
[13] The CMA found that payday loan price information was typically readily available online, suggesting that 'access' to information was not a key issue, but many consumers failed to properly 'assess' that information, or 'act' upon it by making decisions to minimise the cost of credit. See CMA (2015), 'Payday lending market investigation: final report'.
[14] An instalment loan of seven months or more, with an interest rate at 0.8% per day, would produce total interest payments of more than 100% of the loan principal. Therefore the interest rate needs to be lower than 0.8% per day.
[15] OFT (2013), 'Payday Lending: Compliance Review Final Report', page 2.

2013, the average amount of additional fees per loan funded (including loans that were no fees were applied) has fallen by three quarters (see Fig. 4), to around £2 per loan.[16]

Fig. 4 **Average additional fees, £ per loan funded**

Source: Based on data from SMF (2016), 'Industry data for CFA'.

Rollovers and refinancing of loans has also fallen very sharply. Again, now many lenders do not allow for rollovers and refinancing at all. There has not just been a sharp fall in the immediate refinancing of loans, but also more generally in repeat lending to the same customers. Rollovers have not been replaced by relending to consumers in the following month after the previous loan was repaid. Based on data provided to the CFA by member firms, the number of loans to customers within a given quarter has fallen substantially, by at least 50%, compared to 2013.[17] Based on these estimates, even when relending in the following month is included, the 28% figure estimated by the OFT (for rolling over or refinancing) will now be more like 10% at most.

Putting this altogether, one can assess the overall impact on the sources of revenues of lenders. Based on the FCA's estimate that the total revenue charged to consumers per loan (which is understood to actual revenue collected, net of default losses) has fallen from around £105 at the beginning of 2014 to around £60 following the introduction of regulation,[18] Table 1 provides an illustration of how the typical revenue per loan, before operating costs, has changed, based on the various sources of information described above.

Table 1 **Illustration of average revenue breakdown per loan funded**

Revenue source	2013	2016
Contract interest	£70	£50

[16] SMF (2016), 'Industry data for CFA'.
[17] This reduction in the number of loans per customer is also apparent in the FCA data presented in FCA (2016), 'Call for Input: High-cost credit including review of the high-cost short-term credit price cap'
[18] See Figure 9 of Annex 3 of FCA (2016), 'Call for Input: High-cost credit including review of the high-cost short-term credit price cap'

% of loans with rollover or early relending	*28%*	*10%**
Rollover / early relending revenues	£32	£8
Late fees	£8	£2
AVERAGE REVENUE PER LOAN	**£110**	**£60**

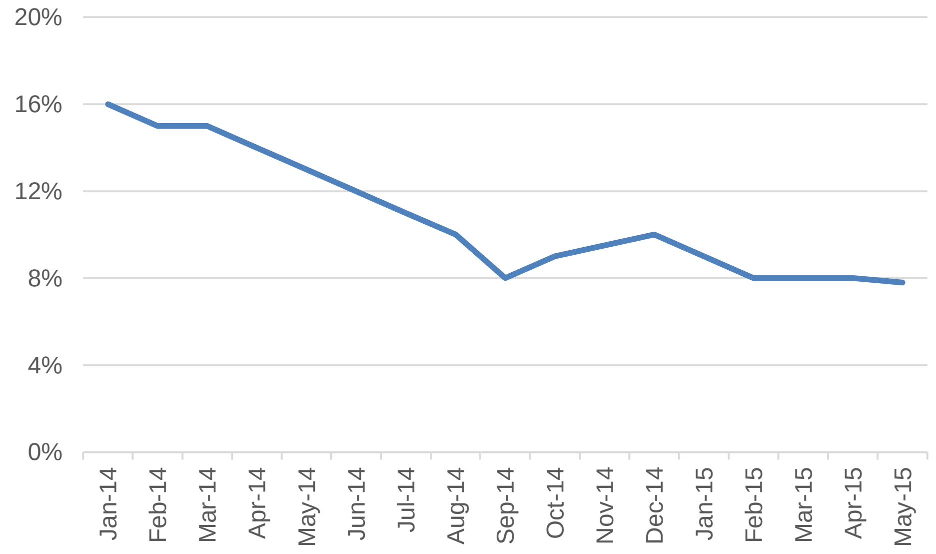
Sources: Total net revenue per loan from the FCA. 2013 data from the OFT and FCA reports. Late fees data from SMF. * 2016 data for rollovers and relending based on discussions with members. Calculations based on an illustrative £200 loan.

These key changes in market functioning have therefore shifted the focus of lenders, based on where they earn their revenues. Based on the FCA and SMF data, in addition to the CFA's understanding of the market informed by its members, the estimates in Table 1 suggest that HCSTC lenders now receive, on average, more than 80% of their revenues from the original contractual interest of the loan, excluding all late fees, late interest and revenues from rollovers and early relending. This compares with an estimated 60% from the contractual interest payments in 2013. Some lenders charge additional fees for late payment, rollovers, etc., for certain ongoing customer activities, but these revenues are now much less important to lenders,[19] and less likely to cover the costs of those activities.

Consequently, there is no longer an incentive for lenders to adopt business models that involve customers extending loans or otherwise failing to pay back in full and on time. In other words, the lender is more likely to successfully collect the contractual interest payments, rather than relying on revenues from rollovers and late fees. This change in incentives has led to a greater focus on creditworthiness checks and affordability assessments.

As can be seen from the chart below, delinquency rates have approximately halved.

Fig. 5 **Delinquency rates (proportion of loans)**



[19] Revenues from late fees, late interest and rollovers have halved in relative terms, and more than halved in absolute terms due to the decline in lending. SMF (2016), 'Industry data for CFA'.

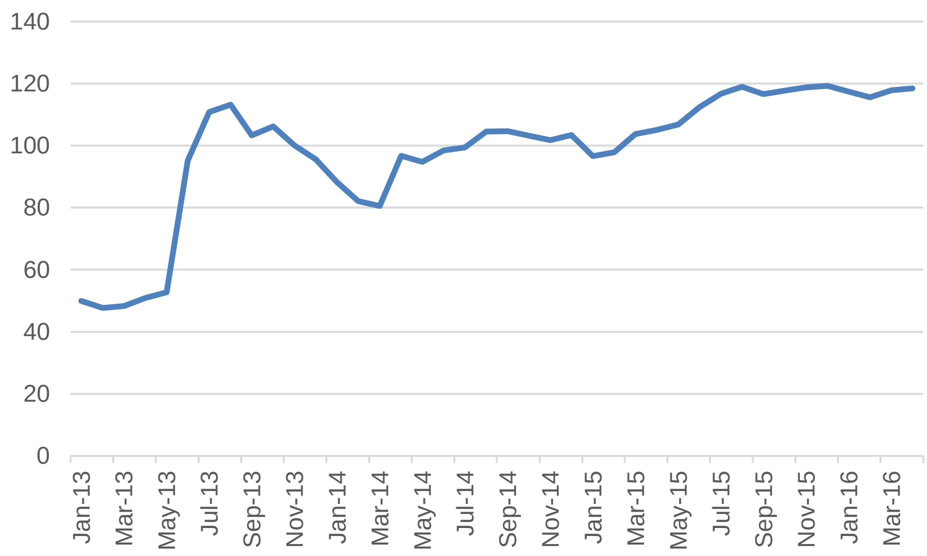
Source: FCA (2016), 'Call for Input: High-cost credit including review of the high-cost short-term credit price cap', page 40.

Lenders have responded by offering longer term loans

With the increased focus of lenders on the contractual interest of the loan, lenders are increasingly competing by offering loans that meet the affordability requirements of borrowers while still offering the amounts required. This has meant that many lenders have started offering longer term loans, typically instalment loans, and there has been a significant shift away from single-period loans.[20] Only a few HCSTC lenders still advertise one-month loans on their websites – although it is important to note that many consumers still effectively obtain a one-month loan by taking out a longer duration loan and then repaying it early (see data below on early repayment). This shows that people are using the product in a flexible way to manage their finances and minimise cost.

Consequently, there has been an increase in the average length of loans.

Fig. 6 **Average contractual loan term, number of days**

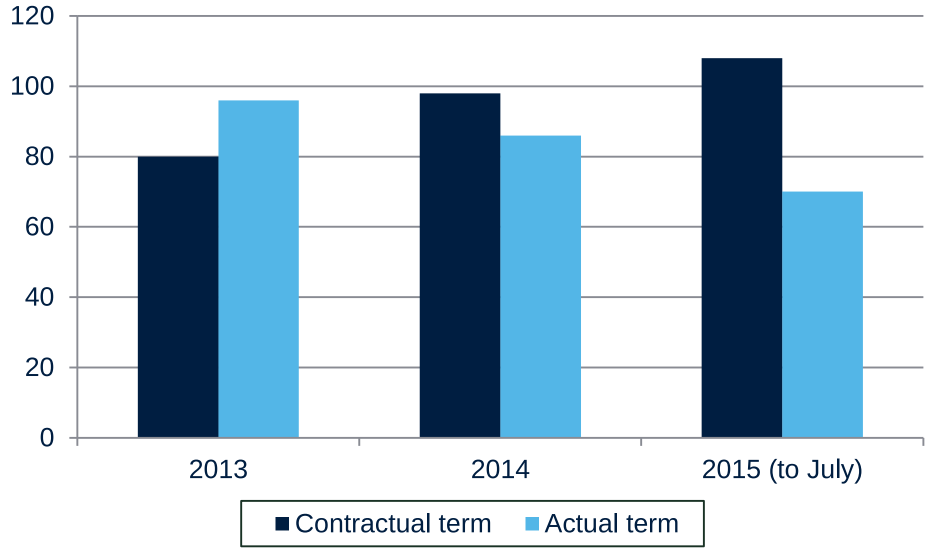


Source: SMF (2016), 'Industry data'.

As lenders have offered longer term loans to ensure that the repayments are affordable, there has been an increase in early repayment by customers – since they are able to afford larger repayments than anticipated in the loan agreement and hence take advantage of early repayment to reduce interest payments. The graph below shows the ratio of actual to contracted loan duration.

[20] One-month HCSTC loans have also been discouraged by rules put in place by Google on the advertising of 'payday' loans.

Fig. 7 **Actual and contracted loan durations, number of days (excluding defaults)**



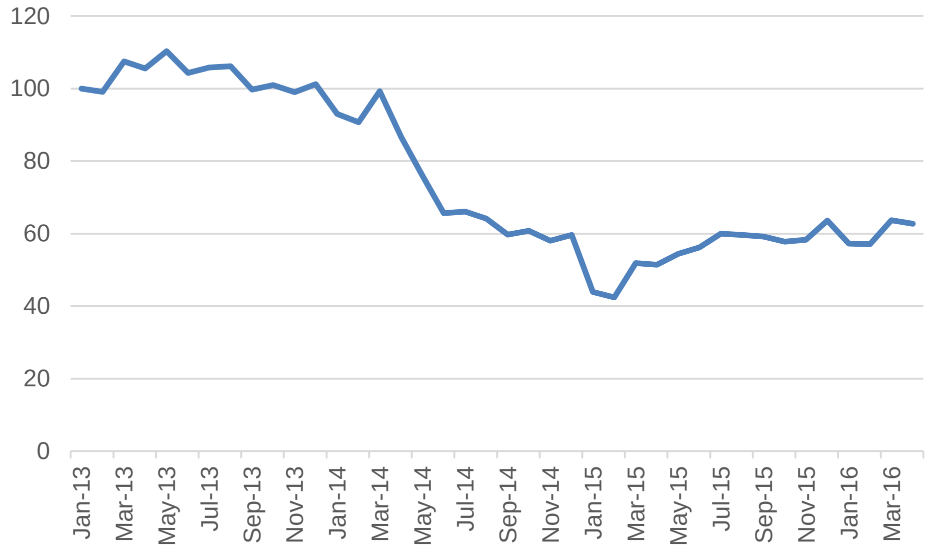
Source: SMF (2016), 'Industry data'.

As can be seen from the chart above, at the start of 2013 consumers were, on average, extending their loans beyond the contracted duration. As of April 2016, the repayment of loans ahead of time appears to be widespread. This indicates that, in general, consumers are able to manage their credit commitments more effectively, rather than regularly overrun the contract duration – risking late fees and debt recovery action.

But HCSTC has become a much smaller and less profitable sector

Inevitably, given the significant regulatory change and imposition of a price cap, there has been a sharp contraction in the HCSTC sector, with much lower loan volumes – some 40% lower in 2015 than 2013.

Fig. 8 **Volume of loans, index**



Source: SMF (2016), 'Industry data'.

Note: Indexed (January 2013 = 100).

These findings are supported by the FCA's analysis, which found a major reduction in the number of loans in 2014 compared with 2013.[21] The SMF found that by April 2016, 6 out of 10 high street lenders had left the market. Further contraction of the HCSTC market is likely.

The provision of HCSTC has also become an intrinsically less profitable enterprise, particularly given the reduction in revenues per customer and per loan. This has been only partly offset by reduced default rates, as other major cost elements, such as providing customer service and customer acquisition, have not changed significantly, or in some cases have increased. Complying with regulation and providing customer service over longer loan durations have created additional costs for lenders. Consequently, gross profit (revenues minus loan losses) has fallen relative to the number of loans, number of customers and the size of the loan book.

The rapid change to the fundamental functioning of the HCSTC sector has therefore come at the cost of restricted access to credit and severe impacts on lender profitability.

[21] FCA (2016), 'Call for Input: High-cost credit including review of the high-cost short-term credit price cap', page 37.

4 Access to credit

The sharp decline in the HCSTC sector represents an equally sharp decline in the number of customers with access to this form of credit, as a direct consequence of the new regulatory regime.

Key messages

- The impact of regulation, including the price cap, on access to HCSTC was much greater than the FCA expected when it set the cap in 2014. The FCA expected a decline of approximately 250,000 consumers per year, whereas the actual decline has been some 600,000 consumers per year.
- The available evidence suggests that the majority of customers who, under the previous regulatory regime, would have turned to HCSTC to meet their credit needs, were not able to access other formal sources of credit.
- There have been wider changes to the market for subprime credit, with significant growth in some areas, including instalment loans, guarantor loans and subprime credit cards. These changing patterns of usage are expected to be a focus of the FCA review of high cost credit.
- The credit products available to subprime customers vary along several dimensions. But the annual cost of accessing credit, using HCSTC, is broadly in line with the other subprime credit sources, relative to the size of the credit facility available.

The impact on access to credit was greater than the FCA expected

In the consultation for the price cap, the FCA estimated that the cap would result in some 11% of HCSTC customers no longer having access to this product, with an additional 5% no longer having access owing to other FCA regulations[22] – producing an overall reduction in the number of consumers using HCSTC each year of approximately 250,000.[23]

FCA data shows that the decline up to June 2015 was already much greater than this. Between January 2014 and June 2015 there were approximately 40% fewer (over 800,000) individuals taking out at least one HCSTC loan than there were between January 2012 and June 2013. This would suggest that on an annualised basis, there are some 600,000 fewer consumers using HCSTC each year, many of whom would have repaid on time, but have been excluded due to their risk-profile.[24] The actual decline in consumers has been more than twice that expected by the FCA.

Many of these consumers no longer have access to formal credit sources

The sharp reduction in HCSTC usage appears to be predominately driven by a reduction in the acceptance rates of loans. According to FCA data, from the start of 2014 until mid-2015, the acceptance rate at the final stage of the loan application process fell from around 50% to around

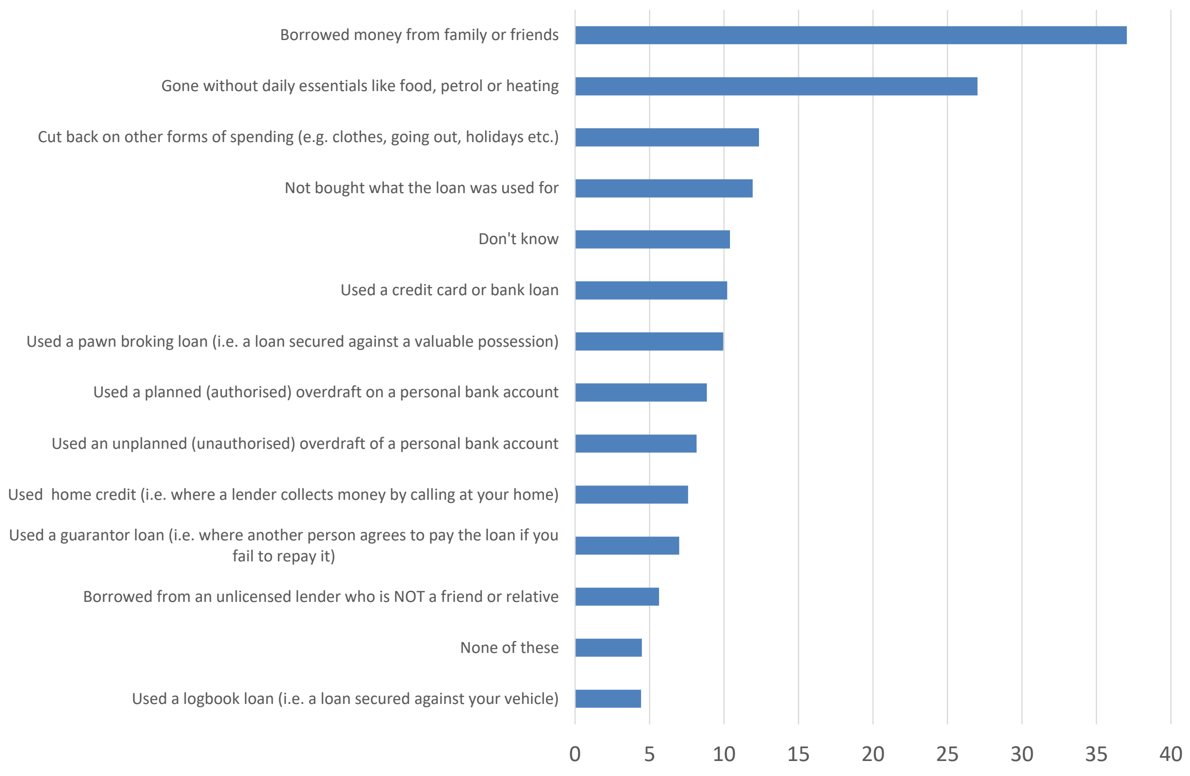
[22] The FCA referred to the 'baseline' reduction of 5% due to other regulation in Table 1 of the Technical Annex of the Consultation Paper. See FCA (2014), 'CP14/10: Proposals for a price cap on high-cost short-term credit'.
[23] The FCA estimated that there were 1.6 million consumers of HCSTC in 2013. 16% of 1.6 million is approximately 250,000.
[24] Estimate based on 800,000 fewer individuals using HCSTC over an 18 month period, adjusted according to the FCA estimates of how many people use HCSTC over 12- and 18-month periods.

30%.[25] This has led to many consumers not having access to the credit that they would have had in the past. The reduction in usage is primarily a supply-side issue, rather than a shift in demand.

It would appear that the majority of these consumers who no longer have access to HCSTC do not have access to other formal credit sources either. The FCA data shows that, even after some recent increases in the use of other credit products, only 13% of declined HCSTC customers used another source of credit in the following 30 days.[26] The SMF study identified changes to the demographics of HCSTC consumers, showing that certain groups of people no longer have access to HCSTC and are likely no longer to have access to formal credit sources at all.

The FCA evidence is further supported by survey evidence. YouGov was commissioned to conduct a survey of consumers that had received HCSTC loans. They were asked to state what they would have done if the loan had not been available (multiple answers were allowed). The findings are shown below.

Fig. 9 **Percentage of consumers citing potential alternatives had a HCSTC loan not been available**



Source: YouGov (2015), 'CFA YouGov data'.

As can be seen from the above, there are potentially detrimental outcomes for consumers that are excluded from the HCSTC market.

The largest alternative is to borrow money from friends of family (a response given by over 35% of respondents). The fact that this is considered as a secondary option to a loan suggests that for many people such borrowing carries some degree of social detriment, otherwise they probably would not

[25] FCA (2016), 'Call for Input: High-cost credit including review of the high-cost short-term credit price cap', page 39.
[26] FCA (2016), 'Call for Input: High-cost credit including review of the high-cost short-term credit price cap', Figure 15.

have decided to use HCSTC. It is also not clear what proportion of these people would have actually been able to borrow from friends and family.

The second most expected alternative is to go without expenditure. Other choices such as using an unlicensed lender may also be detrimental to those in question.

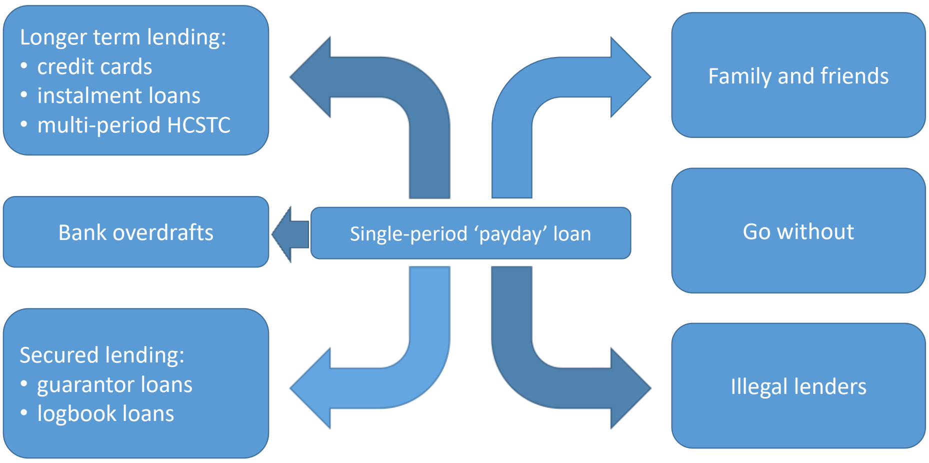
So while the new regulations have had a number of positive effects, there has been a substantial reduction in consumers' access to credit. For some consumers this is clearly detrimental.

There has been some shift to alternative sources of finance

For those consumers who do have access to other credit sources, both formal and informal, usage patterns have changed in response to the reduced availability of HCSTC. As the FCA has noted, a small proportion of consumers have been able to shift to products that were traditionally for higher credit quality customers, such as credit cards, as credit providers have adapted their business models to meet demand. Other customers have shifted to credit products requiring some form of security, such as guarantor or logbook loans. As explained, there is also a significant proportion of consumer who, in the past, would have used HCSTC, but now no longer use formal credit products.

But it is important to note that HCSTC was only ever a relatively small component of the overall subprime credit market, providing services at its peak to some 1.6 million customers per year out of perhaps some 6 to 7 million 'subprime' customers in the UK (this would be even bigger if home credit were included). There have been significant broader trends, which are likely to be of a similar or even greater magnitude to those observed with HCSTC.

Fig. 10 Shifting use of credit sources



These changing patterns of usage are expected to be a focus of the FCA review of high cost credit, which (appropriately, in the opinion of the CFA) broadens the focus from being not just on HCSTC but also other sources of credit that subprime and near-prime consumers use, including bank overdrafts.

There has been significant growth in other areas of high cost credit. For example, there has been a growing presence in the market of lenders offering longer term (12 months or more) instalment loans with rates just below 100% APR, such as '118 118 Money' and 'Avant Credit'. Guarantor loans and logbook loans are understood to have increased in prevalence.[27] There has also been significant growth among the 'credit-building' credit cards.

The credit products available to subprime customers vary along several dimensions, including size of loan, loan duration and the creditworthiness (and other) characteristics of the customers. Different products will meet different consumer needs, but arguably what matters most to consumers in terms of access to credit facilities is the amount of credit that can be accessed and the total cost of doing so.[28] Based on information drawn from annual accounts, Table 2 provides some illustrative estimates of typical amounts for a selection of high cost credit sources.

Table 2 Selected high cost credit: illustrations of usage and revenue

Credit type	Average revenue per customer (users of the credit facility), per year	Typical amount borrowed	Typical APR
Bank overdrafts	c.£100	c.£100 for unarranged, £500-£1,000 for arranged	Primarily fee based, c.15-20% interest
HCSTC	£200-£300	£200-£500	c.1,000%
Subprime credit cards	£300-£400	£800-£1,000	c.40%
Guarantor loans	c.£1,000	£2,000-£5,000	c.50%

Source: Based on a number of different sources, including the CMA report for retail banking investigation, annual reports for lenders and company websites. These are illustrative estimates, as there is considerable variation between different providers of credit in each category.

On this basis, the annual cost of using HCSTC is broadly in line with the other subprime credit sources relative to the size of the credit facility available. This result may at first sight seem surprising, given that these alternative credit sources typically have representative APRs that are much lower than HCSTC, but the result arises due to differences in usage patterns. HCSTC users may pay a higher interest rate, but the cost of credit over a year is relatively less as they pay off the debt more quickly, and there are few other fees involved. This is highlighted by the relatively simple metric of average lender revenue per customer, per year. The cost of access to credit depends not just on the APR, but also on how credit is used, which means the distinction between 'high cost credit' (with relatively high APRs) and mainstream credit can be quite misleading—as mainstream credit can create a high cost for consumers if overly used.

Summary

It is clear that FCA regulation, including the price cap, has had a significant impact on access to credit by the subprime customer base. The fundamental change to market functioning has come at the price of reduced access to credit, beyond what the FCA expected at the time of the price cap consultation.

[27] See Citizens Advice, 'Logbook loans campaign', on their website.
[28] In principle the total cost of credit should include the value of any collateral collected in the case of default on a secured loan.

5 Impact on competition

At the time of the CMA investigation, payday lenders primarily competed in the provision of one-month loans. Competition in the HCSTC sector has changed markedly since their investigation, in terms of competition between HCSTC lenders and in the wider subprime credit market.

Key messages

- In a better functioning market, one would expect to see competition across several dimensions, including price, choice of product and quality of service. This is indeed what is observed.
- Further change in the competitive dynamics between HCSTC providers can be expected following the introduction of the CMA measures in December 2016. We believe that price competition among lenders could be further encouraged with a greater focus on the total cost of credit, across a number of products that are likely to meet the needs of the consumer, rather than just on the daily price of a specific duration of loan.
- Competition between HCSTC lenders and other credit providers has also changed significantly, as market reforms have reduced the distinction between HCSTC and other types of high cost credit. The relevant market is now that for all subprime credit products.
- In this context, a level playing field between the credit services available to subprime consumers is important to ensure consumers have access to the most suitable products.

Competition among HCSTC lenders has evolved

The CMA found that the focus of consumers on finding a lender willing to lend to them reduced their focus on pricing, even if many borrowers were already using multiple providers (and could easily compare prices and switch).[29] Instead, the CMA found that lenders competed primarily on quality factors such as speed of funding and quality of customer service, while offering broadly similar one-month loans.

In a better functioning market, one would expect to see competition across several dimensions, including price, choice of product and quality of service. This is indeed what is observed today. Product diversity has increased as lenders compete on providing affordable loan options to consumers, requiring longer term loans to be offered. To increase the affordability of longer term loans, and comply with the 100% element of the price cap, interest rates typically decline with loan length.

As one would expect in a competitive market, a number of lenders are pricing loans below what is required by the price cap, as they compete for a diverse customer base including customers who may otherwise choose non-HCSTC products, such as instalment loans over 12 months or credit cards. Pricing below the cap can be observed by various lenders at all different loan durations. Importantly, with the greater variety in the duration of products, lenders are now competing more on the total cost of credit, rather than simply on the price of a specific one-month loan contract. Other forms of competition include product variation, and use of different distribution channels.

[29] See CMA (2015), 'Payday lending market investigation: final report'.

Further change in the competitive dynamics between HCSTC providers can be expected following the introduction of the CMA measures in December 2016. The price comparison website aims to further increase price competition between lenders, while the measures regarding regular updates on loan usage and chargers aim to encourage consumers to shop around for their next loan and to better monitor their use of credit. This suggests that price competition among lenders could be further encouraged with a greater focus on the total cost of credit, across a number of different products that are likely to meet the needs of the consumer, rather than just on the daily price of a specific duration of loan (as currently required of the FCA-mandated price comparison websites).

Competition across the wider high cost credit has also intensified

Competition between HCSTC lenders and other credit providers has also changed significantly, as changes in the market have reduced the distinction between HCSTC and other types of high cost credit. As HCSTC lenders have offered longer loan durations, the distinction between their products and those of longer term (1- to 3-year duration) high cost credit providers becomes less distinct.

Credit cards aimed at subprime consumers, which have attracted considerable new demand since the decline of HCSTC, also compete more directly with HCSTC than before. HCSTC lenders offer greater flexibility in terms of loan duration, with rates on longer term loans more similar to subprime cards than with the single-period loan. As shown above, the cost of accessing credit is similar.

There has also been a more fundamental change in the competitive dynamics due to shifts in consumer behaviour, further reducing the distinction between HCSTC and other forms of high cost credit. The dynamic of HCSTC lenders seeking customers taking out a series of single-period loans has largely gone away, with the focus now being on issuing affordable loans, and finding borrowers who are likely to be able to meet the contractual interest payments (within the context of the risk thresholds of the lender). This is more in line with what can be expected with other types of lender, where the dynamic of relending is not important.

High cost credit is now the relevant market

With improved market functioning, longer loan terms and changing patterns of competition, the distinction made by the CMA between HCSTC and other high cost credit options is no longer relevant. HCSTC is now a normal functioning element of this wider credit market.

Regulation of HCSTC has achieved its objectives in terms of fundamentally changing market functioning. In this context, a level playing field between the credit services available to subprime consumers is important to ensure consumers have access to the most suitable products. In particular, consistency in the requirements for affordability assessments across all credit services is required to ensure that higher risk customers are not inappropriately channelled to certain credit services solely on the basis of weaker requirements for affordability. For example, HCSTC lenders are now conducting affordability assessments that go beyond what is typical for other consumer credit products, including detailed questions and independent checks on income, expenditure and credit commitments. A level playing field is important for effective competition among the different providers of consumer credit.

About the Consumer Finance Association:

The CFA is the principal trade association representing the interests of some of the best known short-term lending businesses operating in the UK. Members include Lending Stream, Mr Lender, MyJar, Payday Express, Payday UK, Peachy, Quick Quid, Satsuma, Speedy Cash, Sunny, The Money Shop and WageDayAdvance.

About Oxera

Oxera advises companies, policy-makers, regulators and lawyers on any economic issue connected with competition, finance or regulation. Oxera has been doing this for more than three decades, gathering deep and wide-ranging knowledge as it expands into new sectors. Oxera has a reputation for credibility and integrity among those we advise, and among key decision-makers, such as policy-makers, regulators and courts. With offices in Berlin, Brussels, London and Oxford, Oxera is able to advise our international clients in a highly flexible way, including providing advice in several languages.