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Consultation Response

Payday Lending Consultation
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Payday Lending: Consultation on a market investigation reference (Ref: OFT 1482)

Which? welcomes and supports the OFT's decision to make a market investigation reference (MIR) to the Competition Commission (CC) of the market for payday lending in the UK.

The widespread poor practice and uncompetitive practices identified in the OFT's compliance review of the payday loan sector echo the findings of Which?'s own investigations and research. We have set out below the four key areas where this market is not working competitively or effectively for consumers and which we believe fully justify a market investigation reference to the Competition Commission.

1. High default charges disguise the true cost of borrowing and distort competition

Default charges

Complex charging structures and high ancillary/penalty charges are bad for consumers and can distort competition. Consumers are often over-optimistic about their ability to repay their debts, particularly when they are under financial pressure. In our August 2012 survey of credit users (Credit Britain report, Appendix A), while a third (29%) of payday loan users have taken out credit they *knew* they couldn't repay, half (48%) of payday loan users have taken out credit in the past that it *turned out* they couldn't afford to repay.

Higher additional charges (that consumers do not factor in) can be used to increase prices without increasing the headline APR. Consumers may fail to consider or compare additional charges because of the lack of transparency or because they are over-optimistic about their ability to repay the loan, and so increases in additional

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charges would lead to a smaller decrease in demand than an equivalent increase in the headline interest charge.

There is also empirical evidence that consumers in high cost credit markets suffer from overconfidence. Skiba and Tobacman[1] (2008) used a large dataset from a payday lender to examine how borrowers behave. They find two features of the data that strongly suggest overconfidence. First, within one year of their first interaction with a payday lender, over half of borrowers defaulted on their loan. Second, default generally occurred after borrowers had repaid or serviced five payday loans. This leads to additional costs for consumers. If consumers correctly predicted that they would default in the future, logically they would not choose to continue 'rolling over' the loan but rather default sooner. Consumers incorrectly predict that they will pay back the loan in the future and therefore avoid the costs associated with default.

Intervention would be necessary to mitigate this market failure even if markets were competitive and arrears fees transparently displayed. In a competitive market, price competition can be expected to drive excessive profits down, but consumers will still be liable to overestimate their ability to meet a particular repayment schedule. Firms will gain the most competitive edge by exploiting these behavioural errors. By designing contracts that utilise high additional fees, high-cost credit firms will be able to offer consumers loans that appear to be good value from the offer lower headline rates, while generating enough income to break even. Consumers will still borrow too much. Transparency does not eliminate this problem as consumers may well underestimate their likelihood of going into arrears even when fully aware of the costs.

The risk is greatest for high-cost credit, where default and arrears fees affect a large proportion of the total customer base. Our survey found that one in five users of payday loans were hit by 'unexpected' charges and that, in the last 12 months, more than half of payday loan users had incurred charges because of missed or bounced repayments. The business model of some lenders appears to be based on the unsustainable default charges incurred by borrowers.

Which? recommends that firms should be required to set their additional charges and penalties at a fair level that reflects the actual administrative costs they incur. They should not be able to profit from consumers in financial difficulty.

2. Inappropriate marketing and incentives

Inappropriate advertising

Inappropriate marketing entices consumers to take on debt that may be inappropriate for their circumstances. For example, in June 2012 Which? research (Appendix B) found payday loan companies advertising loans for nights out or even 'to put in the

[1] Payday Loans, Uncertainty and Discounting: Explaining Patterns of Borrowing, Repayment, and Default; Paige Marta Skiba, Jeremy Tobacman, August 2008

bank for emergencies’. One lender, serveucash.co.uk, still advertises that a payday loan can help you to 'solve all your money problems'.

Payday loan advertising often prioritises speed of payment over cost. This can exploit the desperation of consumers unable to access mainstream credit. 34% of payday loan users in our August 2012 survey used the loan to pay for emergencies and unexpected expenses, while 32% used it for household bills.

In April 2013’s *Which? Money* magazine (Appendix C), we identified 74 advertisements from 27 payday firms offering cashback on sites such as Quidco and Topcashback. Offering cash rewards to customers through cashback sites risks borrowers choosing a deal based on the available cashback, rather than overall cost of credit, thereby reducing the chance they’ll shop around. In June 2012 we also found some lenders offering ‘refer a friend’ incentives. One lender, for example, offered borrowers a £20 discount on their next loan if they got a friend to sign up. These incentives not only encourage others into debt, they also discourage that friend from shopping around.

Inadequate privacy policies

In our June 2012 investigation we found four online lenders that did not have a privacy policy, while others hid it away in the terms and conditions. In most cases, the sharing of data with third-party marketing firms was the default option, and not all let you opt out at the application stage. Some privacy policies even stated that your details will be shared with third parties if your application is unsuccessful.

Borrowers appear to have little control over what happens to their personal data. In the October 2011 Which? investigation (Appendix D), one Which? researcher received 47 unsolicited emails within a few days of taking out a loan. Almost half of the third-party payday loan emails falsely claimed that an application had already been made to that company. This could lead borrowers to believe that their loan had already been processed and was therefore approved. The same researcher then received over 60 direct emails from the original lender itself, as well as letters, offering a variety of discounts, fast payments and increased loan amounts, as well as warnings that this was his ‘last chance to come back and save big’. Not only do these aggressive marketing techniques encourage additional borrowing, they may also reduce the chance that a borrower will shop around. Market pricing is distorted if lenders are able to subsidise the headline cost of loans with referral fees received from third-party marketers.

Opaque charging structures

Some lenders calculate the interest charge based on the number of days you borrow for, and allow potential customers to calculate the cost of a loan by using sliders on their website. Other lenders have a fixed charge for borrowing up to your next payday, so the actual daily cost will differ depending on when you take out the loan. In our June 2012 Which? article we also identified five payday loan websites that charged extra transfer or administration fees but did not include these in the headline price. One company charged £15 for same-day payments, but this charge was not included in the advertised total repayment.

As a result of these differing calculation methods, and the way they are presented on lenders' websites, consumers are unable to compare loans from different providers on a like-for-like basis, even where the APR is given, with a resultant detrimental effect on competition. To enable consumers to compare prices and shop around, Which? wants lenders to show the cost in pounds per £100 borrowed per 30 days.

3. Inappropriate use of rollovers

The OFT market review found that around half of a lender's revenue comes from loans that are rolled over. By automatically offering borrowers pre-approved rollovers on their existing loans, consumers are enticed into paying more overall and may be deterred from shopping around. In our October 2011 investigation one of our researchers, after taking out a loan, was told 'Need more time to pay back your loan? Don't worry, you still have five extensions available.'

If someone is allowed to roll over a loan four times, assuming interest of £25 per £100 borrowed the lender will have received £125 in interest, meaning it can turn a profit even where the borrower ultimately defaults on the whole capital amount. Given the cost to the borrower and the damage defaulting does to the borrower's credit file when shared with a credit reference agency, the needs and priorities of the lender and the borrower are severely misaligned.

For a customer in financial distress, rolling over a loan means only paying back the interest at the end of the first month, which could simply delay the point when they default or seek debt help. During the extended period of indebtedness their financial situation is likely to have worsened further due to further monthly interest charges.

Repeatedly presenting a continuous payment authority (CPA) until it is successful further distorts this balance of power as it enables lenders to lend irresponsibly, collect the repayment by CPA and leave the consumer or their other creditors to deal with the consequences of the borrower having insufficient remaining money to service other debts or to finance their basic household outgoings.

A further problem is the inappropriate increasing of credit limits by some lenders. In one case in our October 2011 investigation, having borrowed just £100, our researcher was then offered up to £1,200 the next time he enquired about a loan. Two other researchers received letters from their lender stating 'When you have paid back your outstanding loan, you will be eligible to borrow more – you are already pre-approved'. Pre-authorised increases in the amount you can borrow were a common experience of researchers in our test. Cross-selling and up-selling is common across the financial services industry, but the potential for consumer harm is significant in the high-cost credit sector. Not only does it encourage inappropriate borrowing, often without appropriate affordability checks, it also reduces shopping around and therefore competition.

4. Lack of thorough affordability checks

A failure to conduct full affordability assessments means consumers could take out more credit than they can afford to repay. The OFT's investigation into the payday loan market found lenders failing to conduct adequate affordability assessments before lending or before rolling over loans.

In June 2012's Which? article, eight of the 34 firms we looked at did not conduct a credit check as part of their approval procedure. Not only does this run the risk of borrowers overstretching themselves financially, it also means they are not rebuilding their credit rating, even if they repay every payday loan on time. Their route back to mainstream credit is therefore effectively cut off by the payday lender and competition is restricted. Half of the people in our survey who had used a payday loan or unauthorised overdraft had been rejected for credit within the past year. 55% of payday loan users also have no savings, with an additional 25% having savings of £2,000 or less.

Summary

We have described above a wide range of anti-competitive behaviours that Which? has uncovered in its research into the payday loan sector. The Competition Commission is the only body that has the necessary information-gathering powers regarding lenders' costs and revenues, so is best placed to investigate this £2bn market. While the FCA will have a wider remit than the current OFT powers when it takes over the regulation of consumer credit in April 2014, the problems in the payday loan sector identified by both the OFT and Which? cannot wait until then to be addressed.