Financial Conduct Authority

Policy Statement PS14/16

Detailed rules for the price cap on high-cost short-term credit

Including feedback on CP14/10 and final rules

November 2014

Contents

In this Policy Statement we report on the main issues arising from Consultation Paper 14/10 *(Proposals for a price cap on high-cost short-term credit)* and publish the final rules.

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You can download this Policy Statement from our website: www.fca.org.uk.

Abbreviations used in this document

APR	Annual percentage rate of charge
CBA	Cost benefit analysis
CCA	Consumer Credit Act
CCD	Consumer Credit Directive
CDFI	Community development finance institutions
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
EAR	Effective annual rate of interest
EU	European Union
FCA	Financial Conduct Authority
FSMA	Financial Services and Markets Act
HCSTC	High-cost short-term credit
IML	Illegal money lending
MAS	Money Advice Service
MFA	Market failure analysis
OFT	Office of Fair Trading
P2P	Peer-to-peer

PS	Policy statement
PSD	Product sales data
SCOR	Steering Committee on Reciprocity
SECCI	Standard European Consumer Credit Information
SMEs	Small and medium-sized enterprises
TAR	Total amount repayable
TCC	Total cost of credit
UK	United Kingdom
US	United States

1. Executive summary

Introduction

1.1 In December 2013, Parliament gave us a duty to introduce a price cap to secure an appropriate degree of protection from excessive charges for borrowers of high-cost short-term credit (HCSTC).[1] Our price cap rules must be in force by 2 January 2015.

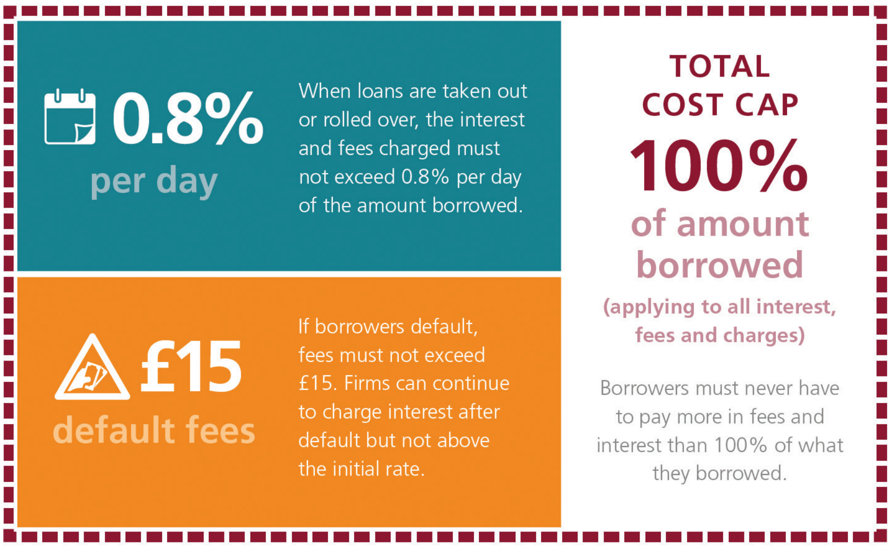
1.2 We consulted on our proposals in July 2014 (CP14/10)[2] and, having considered all the responses, we have now made our final rules, which we publish in Appendix 1 of this policy statement.

1.3 The Competition and Markets Authority (CMA) has also published proposals to increase price competition between payday lenders and help borrowers get a better deal.[3] We will continue to work closely with the CMA as it finalises its remedies.

1.4 The price cap that will come into effect on 2 January 2015 is set out below.

The final price cap

FCA price cap for HCSTC loans



1 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.
2 www.fca.org.uk/news/cp14-10-proposals-for-a-price-cap-on-high-cost-short-term-credit
3 www.gov.uk/government/news/cma-sets-out-proposals-to-lower-payday-loan-costs

1.5 This means that customers taking out a loan on or after 2 January will never need to pay back more than twice what they borrowed, and someone taking out a typical loan over 30 days and repaying on time will not pay more than £24 per £100 borrowed.

What changes have we made?

1.6 Most of the proposals on which we consulted will be implemented (see Table 1.1 at the end of this chapter). We have, however, made some changes and clarifications in response to points raised in the consultation. These are described and explained in Chapter 4.

1.7 In summary, we have clarified:

- how the cap applies to loans that are made before 2 January 2015 but modified on or after that date
- how the cap should be applied to loans which are refinanced
- the obligations on borrowers in relation to any loans that are unenforceable because they breach the price cap
- a few technical issues, as set out in Chapter 4.

Impact on firms

1.8 The firms in our modelling sample told us that the volume and value of their lending had dropped very significantly this year, so the baseline we had used for our analysis was too high and our estimates of the impact of the cap on firms should be revised.

1.9 As a result we collected additional information from firms and re-ran our modelling, based on an adjusted baseline, to re-test the impact on market exit and loss of access to credit. We took the results of this (which are set out in the technical annex to this statement) into account when considering the responses to the consultation and making our final rules.

1.10 The revised baseline indicates that, due to fewer loan applications being granted more firms are currently unprofitable than we previously estimated, so they are at greater risk of exiting the market. However, the incremental impact of the cap is smaller. The size of this change depends on whether more loan applications are granted in the future, compared to current levels – but we believe it is probable that this will occur, with some of the decline being temporary.

1.11 We believe that, with an initial cap at 0.8%, there will be a viable market giving affordable loans, and with some presence on the high street. Several firms have said that they intend to continue operating in this market when the cap comes into effect. At caps lower than 0.8% we think that there would be a greater risk to a viable market.

Impact on consumers

1.12 Because many customers have already lost access to credit due to other changes in the market, we expect the number of customers that will lose access to credit as a result of the cap to be lower than we previously estimated.

1.13 However, the cap still protects borrowers that do get loans from excessive charges, including default-related charges and interest. It also means that a significant number of customers who would be harmed by HCSTC loans lose access to them.

1.14 Many respondents to our consultation were concerned that we had underestimated the number of consumers who lose access to HCSTC who would turn to unauthorised money lenders. Illegal activity is particularly difficult to measure or predict, and the consequences for individuals and their families can be very serious. We still think we made reasonable estimates but will continue to work closely with the Illegal Money Lending teams and other stakeholders to monitor this.

1.15 We have used static analysis to assess the impact on both firms and consumers. The dynamic effects are likely to be more complex and subtle; this is explored in more detail in the technical annex.[4]

Responses to our consultation

1.16 We received over 70 responses to our consultation from a wide range of stakeholders. In addition, at the request of certain firms, their professional advisers were given access to the analytical models we used through a data room in our offices. Chapters 2 to 6 and Annexes 2 to 5, summarise the points made and our responses to them. Annex 2 contains our revised cost benefit analysis (CBA).

1.17 In addition to updating our baseline (the market before implementing a cap) based on new evidence, the main issues arising from the responses we considered and satisfied ourselves on were:

- whether our proposals were proportionate, striking the right balance between protecting consumers and the impact on firms and on competition (see Chapter 2)
- whether we had failed fully to consider the impact on high-street lenders (see Chapter 2)
- whether the cap structure should be adjusted to enable firms to continue providing very short-term/small loans (see Chapter 3)
- the treatment of instalment loans, and in particular whether these should have a different structure or level of default cap (see Chapter 3)
- other issues relating to the structure and levels of the cap (see Chapter 3)

4 Refer to the Competition Issues and Challenges to Exit Model Assumptions sections in Annex 3 of this document.

1.18 We concluded that each of the components of the cap plays a different role in protecting consumers from excessive charges, and so have maintained the three component structure. An 0.8% initial cap provides the appropriate degree of protection for borrowers against excessive charges and is the least onerous means to achieve the appropriate balance between the consumer protection objective in the duty and the impact of the cap on the economic interests of firms, and on competition.

1.19 We concluded that a 75% total cost cap would have too great an impact on the length of loans, and a sub-limit on the total cost cap – restricting the level of default-related charges – would add too much complexity. The simplicity of the total cost cap will in itself protect consumers, giving them and their advisers a simple way to identify when the cap has been breached. A 100% total cost cap is therefore the least onerous way to achieve the necessary level of protection for consumers from the harm caused by excessive charges.

1.20 We will be doing further work on certain aspects of the HCSTC market and keeping other areas under review. In particular:

- We will do further work to assess the impact of repeat borrowing and the extent to which lenders are adequately assessing affordability in this context (see Chapter 5).
- Although we continue to think it would be inappropriate to apply a price cap to other high-cost products at this stage because they are not direct substitutes for HCSTC, we will keep this under review. Other relevant work includes our forthcoming credit cards market study, the CMA's market investigation into the personal current account market, and the Law Commission's review of the Bills of Sale legislation that underpins logbook lending.

Real-time data sharing

1.21 We want firms to improve the way they share information about consumers, so lenders can be sure that the information they use in their affordability assessments is up to date and accurate.

1.22 In our consultation we said that we expected to see the vast majority of firms in the HCSTC market participating in real-time data sharing by November 2014. We also wanted firms to share data more widely to improve the coverage of real-time databases. We said we would assess whether these standards had been met and, if we did not see sufficient progress, we would consult on introducing data sharing requirements.

1.23 The majority of respondents supported greater use of real-time data sharing, but views were mixed about the need to mandate this. Significant progress has been made in this area recently with the vast majority of the HCSTC market (around 90%) now participating in real-time data sharing (see Chapter 5).

1.24 In view of this significant progress and the anticipated consolidation within the HCSTC market, we do not propose to consult on introducing real-time data sharing requirements at this time. This could add unnecessary complexity and impede the development of innovative market solutions. However, we will continue to press the industry to deliver further improvements in real-time data sharing, and will work with the CMA on its proposed measures relating to data sharing.

Who should read this policy statement?

1.25 This statement will interest:

- FCA-authorised firms involved in HCSTC as lenders, operators of peer-to-peer platforms or brokers (most of which 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 gender reassignment) as they may be interested in responses to our equality impact assessment (Annex 4) and
- 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

What happens next?

1.26 The price cap will come into effect on 2 January 2015 and we will review it two years after implementation, in the first half of 2017. In the meantime we will monitor whether there are any unintended consequences emerging for firms or consumers, including the impact on people who are no longer able to get this type of credit. Consumers who think that the cost of their HCSTC loans breaches the cap should complain in the first instance to the lender and, if they are not satisfied with the response, to the Financial Ombudsman Service.

1.27 Most HCSTC firms must apply for FCA authorisation between 1 December 2014 and 28 February 2015. When deciding whether to authorise a firm, we will ask specific questions on its strategy and business plan, including how it will comply with the price cap and our other rules.

1.28 Chapter 7 includes information about forthcoming FCA consultations that are relevant to the HCSTC market.

Table 1.1 – Summary of our proposals and the changes we have made in response to consultation

Proposals consulted on: position unchanged

Structure of the cap

- **The cap will have three components:** an initial cost cap; a cap on default fees and interest; and a total cost cap.

Initial cost cap

- The **initial cost cap will be set at 0.8%** of the outstanding principal per day, on all interest and fees charged during the loan and when refinancing.
- Firms can structure their charges under this cap in any way they choose, for example, a portion could be upfront or rollover fees.

Default cap

- The **cap on default charges** will be **£15**.
- Interest can continue to be charged but at no higher rate than the initial cost cap (calculated per day on the outstanding principal and fixed default charges).

Total cost cap

- The **total cost cap** will be **100% of the total amount borrowed**, applying to all interest, fees and charges.

Application of the cap

- It will apply to high-cost short-term credit (HCSTC) as defined in our current CONC rules.
- The cap will cover debt collection, debt administration and other ancillary charges; and charges for credit broking for a firm in the same group or where the broker shares revenue with the lender.

Repeat borrowing

- The price cap will apply to each loan agreement, and so to repeat borrowing in the same way as for a first loan.

Data sharing

- Firms engaging in this market should be participating in real-time data sharing, so that the vast majority of loans are reported in real-time.
- Recent progress is in line with our expectations. This will be kept under review.

Supervision

- Our supervisory approach will follow our standard model.

E-Commerce Directive (ECD)

- UK-based debt collectors will be prevented from collecting debts arising under HCSTC agreements entered into by incoming ECD lenders whose charges exceed the price cap.
- UK-based debt administrators will not be able to enforce or exercise rights on behalf of a lender under such HCSTC agreements.
- The Treasury has already announced its intention to lay before Parliament, ahead of the cap coming into effect on 2 January, an Order to confer a power on the FCA allowing us to take action if an incoming firm abuses the EU right of free movement by establishing in another member state directing all or most of its activities into the UK, with a view to avoiding rules that would apply if it had been established in another member state.

Review period

- There will be a review of the price cap in the first half of 2017.

Proposals consulted on: changes and clarifications made

Application of the cap to loans made before January 2015

- We have adjusted the rules so that if an HCSTC agreement is modified after 2 January 2015, charges imposed before 2 January must be taken together with charges imposed after that date for the calculation of the cap.

Calculation of the cap

- We have amended the rules to cover calculation of the cap when loans are refinanced.

Unenforceability

- We have clarified that when an agreement is unenforceable, consumers still have a statutory duty to repay the principal, once a firm has repaid the interest or charges to the consumer, or indicated that there are no charges to repay. Customers must repay within a reasonable period. Lenders cannot make a demand in less than 30 days. We give guidance on what is reasonable in different circumstances.

Repeat borrowing

- We will do further work to assess the impact of repeat borrowing and whether firms are adequately assessing affordability.

2.
General approach to developing the price cap

This chapter summarises feedback on our general approach to developing the proposals for the price cap and the scope of the price cap.

We received a number of challenges to our general approach which are described below. These include challenges to the baseline used for our CBA, arguments that excessive charges have not been identified, concern about whether our proposals are compatible with our competition duty and the requirement to ensure that our proposals are proportionate.

We also received a substantial number of more analytical challenges which we respond to in greater detail in the technical annex.

Key challenges are addressed here, and further detail on the impact of the proposals and our analysis and methodology can be found in the CBA and Technical Annex.

We have decided not to make any changes to the scope of the price cap.

Our approach to developing proposals for a price cap

2.1 We set out in the consultation paper our general approach to developing proposals for a price cap, including the detailed analysis we carried out to give us a rigorous basis for our proposals. We explained how we framed our analysis and examined the impact of the price cap on firms and consumers, and on competition.

2.2 In the consultation we asked:

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

2.3 Overall many respondents welcomed the approach and were supportive of the extensive research and analysis that we conducted to determine the structure and level of the cap. However, consumer groups and others argued that we had underestimated the negative impacts of HCSTC on consumers, while firms and trade associations argued that we had misjudged the impact on firms and competition, that the proposal was not proportionate and that we had not complied with our competition duty.

Data and methodology

2.4 A substantial number of detailed issues were raised on the methodology of our analytical work and some of the assumptions and conclusions that went into building our evidence base. Overall, we identified around 400 issues and allocated these to 20 distinct issue types within three high-level groupings: supply, competition and demand. These are addressed in detail in the CBA and in the technical annex.

2.5 The most fundamental challenge to our proposals was the contention that we needed to revisit our analytical work in the light of major changes to the HCSTC market since we carried out our analysis. Several firms who responded said that there have been large reductions in lending volumes in 2014. They argued that this needed to be reflected in our supply-side models which we used to estimate the scale of loss of access to credit and market exit under different cap levels in the consultation paper.

Our response

We have carefully considered the points raised by respondents about our analysis, and where necessary we have undertaken further modelling work to explore the issues. We cover the analytical challenges and our response to them in detail in the technical annex and in the CBA. We have considered whether any of the challenges have a material impact on our analysis and decisions and have factored this into our decision on the structure and levels of the price cap. In particular responding to the challenge raised by firms around recent reductions in lending volumes we have gathered additional data, and undertaken further modelling. This has led to revised estimates of the impact of the price cap beyond the revised baseline (detailed in the CBA). These changes affect our estimates of the loss of access to credit and market viability, which are key components of our decision making on the cap proposal.

New evidence around reductions in lending volume was not available at the time of carrying out our analytical work for the consultation. After recent feedback, we gathered additional data from firms to provide an updated view of lending volumes and values. We considered this alongside other sources of information such as whether firms have exited and public statements on firms' future intentions.

Analysis of the data provided by firms shows:

- Fluctuating loan applications, but an overall increase of 20% between September 2013 and August 2014 and a clear reduction in the volume and value of loans written between September 2013 and August 2014 (approximately 40% and 35% respectively), although this differed between firms. This reflects a sharp reduction in firms' acceptance rates by 50% for the same period.

- Recent changes that lenders have made to lending criteria will primarily impact consumers who have higher credit risks. A large majority of the reduction in lending by firms with the most sophisticated credit scoring systems, which represents a majority of the market, is concentrated among consumers with lower credit scores.[5]

5 Whereas the reduction in lending by firms with less sophisticated credit scoring systems is more evenly spread across the range of credit scores.

Considering the dynamic nature of this market, it is difficult to determine exactly what has led to the reduction in lending or whether it will be sustained. Firms cited the transfer to FCA regulation, closer supervision of the affordability rules and the new CPA and rollover rules (which came into force in July 2014) to explain the recent reduction in lending volumes. It is also possible that it reflects firms' changing practices ahead of seeking FCA authorisation or uncertainty ahead of the final price cap rules. In our previous modelling we made adjustments for the impact of rules restricting CPAs and rollovers, but not for firms' implementation of FCA rules on affordability. This was because the FCA's affordability rules reflect the relevant section of the OFT's Irresponsible Lending Guidance, and we assumed for modelling purposes that firms had implemented the guidance.

The data suggest that the reduction in lending largely affects borrowers that are least creditworthy. The significance of this is that compared to the results presented in the consultation we now expect the price cap to have less of an effect on access (as the bigger impact of reduced access comes from the baseline reduction in lending). The price cap does have an additional effect on firms' revenues on top of the baseline impact; however, we consider that impact to be necessary in order to secure protection for borrowers who will continue to get loans once the price cap is in place.

Assessing whether this will be a sustained impact or if lending volumes will recover over time (and to what extent) is a difficult judgement. To account for the uncertainty, we have re-run the supply-side models using the new base case and three sensitivities:[6]

- Base case – current market: adjusting the volume of lending to August 2014 levels
- Recovery in lending – Scenario A: half of the base case volume reduction
- Slight recovery in lending – Scenario B: three-quarters of the base case volume reduction
- Further reductions in lending – Scenario C: base case volume change plus additional 20% volume reduction.

The updated results of our modelling are presented in the Technical Annex and CBA sections. We consider that these revised results continue to support our price cap proposals.

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

2.6 Several firms and a trade association argued that we have failed to establish what 'excessive charges' are and so cannot be in a position to set the level at which prices should be capped to address excessive prices. They also argue that the consultation paper did not consider the likely mitigation of non-repayment by lenders showing appropriate forbearance.

Our response

As we set out in the consultation, 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. In particular we noted that charges contribute to borrowers' worsening financial situation and current high prices facilitate lending to borrowers who are at high risk of detriment as a result of borrowing. We undertook extensive research to give us a robust basis

6 In each case, we have assumed that 80% of the baseline reduction in lending impacts the lowest credit score borrowers (who are least creditworthy) and the remaining 20% is distributed between higher credit score borrowers.

upon which to make those judgements. We set out in the consultation, CBA and technical annexes how the evidence that we had collected demonstrated that excessive charges are resulting in an unacceptable risk of harm to consumers.

Various consumer bodies noted substantial and continuing consumer detriment as a result of HCSTC lending. They provided various case studies which illustrate the harm some consumers suffer. Some examples included:

"My initial loan was £240 with interest of £180 making the total £420. As I couldn't afford to pay I rolled it over 2 or 3 times. With the interest they charge they now say I owe them £1700 possibly more now."

"I borrowed £100… I had some difficulty paying the loan back due to loss of job. [The payday lender] are now saying I owe them £800".

"I got a loan for £200. I now owe £750".

These examples demonstrate how borrowers can end up paying back excessive charges on relatively small HCSTC loans. Some customers' debts spiralled to more than five times the amount they borrowed.

Given our duty to introduce the price cap with a view to securing protection for borrowers, we consider it reasonable to interpret 'excessive charges' by reference to the harm they cause to the consumer, based on our extensive quantitative and other research, and illustrated by the examples above.

Impact on consumers

2.7 Several firms and trade associations argued that we have underestimated the harm that will be caused by consumers losing access to credit under our proposed cap. Around 15 respondents, mostly firms and trade bodies, argued that we had underestimated the risks of illegal and unlicensed money lending.

2.8 Some responses argued that we have not fully taken into account the benefits of HCSTC use, in particular the enabling effect of HCSTC/ importance of short-term benefit.

2.9 One firm challenged our review of the previous literature as being ambiguous on the impact of a price cap on consumer thinking that we were selective in our representation of previous research. Others interpreted our results as saying there were no benefits to HCSTC use.

2.10 Another firm challenged our assumption that individuals from firms that would exit would find loans elsewhere.

2.11 A firm also argued that we did not provide a balanced portrayal of HCSTC customers, focusing on customers' vulnerability, whilst ignoring the evidence on customer sophistication (i.e. level of education, income and employment of HCSTC customers being broadly similar to the UK population).

Our response

Harm to consumers caused by loss of access

In the consultation, we considered what the options would be for customers who would no longer have access to HCSTC and whether they would be better or worse off. We set out our findings in detail in the CBA and technical annex. We explained that the evidence on consumer harm and benefits, for consumers who just qualify for HCSTC, indicated that, on balance, they would benefit from no longer having access to HCSTC. The risk of these consumers defaulting was unacceptably high and our demand-side analysis shows that, on average, it caused a worsening in their wider financial positions.

We concluded that removal of access to HCSTC would: reduce stress, mental health and welfare consequences associated with the risk of difficulties in paying back HCSTC loans; lead to consumers avoiding other forms of financial detriment caused by HCSTC loans; and in the longer run would not in aggregate cause negative well-being impacts.

We highlighted that our analysis shows that consumers have limited other options for accessing formal credit.[7] In the consultation paper we addressed concerns that consumers denied HCSTC will turn to illegal money lending. The future risk of illegal money lending (IML) is a difficult area to estimate and we consider that the work we have done is reasonable and sufficiently robust to reach a conclusion that there is a low risk of IML use as a result of the cap.

In drafting the questions on our survey, we considered carefully how to frame the questions as well as seeking advice from the England Illegal Money Lending team, who are well placed to advise on this issue. A previous survey by the University of Bristol for the Department of Business Innovation and Skills found (similar to the results of our survey) that a very small percentage of HCSTC borrowers would turn to IML in the absence of HCSTC. This does not mean that consumers with or without access to HCSTC will not use IML; just that we do not expect significantly more consumers to use IML as a direct result of a lack of HCSTC access. We discuss the methodological issues in greater detail in the technical annex (see section on 'Future use of Illegal Money Lending higher than estimated').

The Consumer Finance Association recently published the results of a survey which showed a greater number of consumers would consider borrowing from an illegal money lender, if they did not get access to HCSTC. There are a number of reasons for the difference in the results (see Technical Annex section titled 'New survey evidence contradicts FCA survey findings'), but we recognise that the consequences for consumers of turning to illegal money lending could be severe, even if the risks are low in terms of number of people affected. For this reason, we will continue to use our enforcement teams and liaise closely with the IML teams to monitor trends and take action where necessary.

Benefits of using HCSTC

We gave careful consideration to the benefits to consumers of using HCSTC to bring forward consumption in our CBA. We concluded that benefits accrue typically where there is a short-term need, such as accessing money for an emergency, and acknowledged that for consumers in these circumstances there would be a cost of not having access to HCSTC due to the price cap. However, this is balanced against the high costs for consumers of using HCSTC (in particular the risk of non-payment and impact on other finances) and reduced future consumption from repayments. Overall, we did not find that the short-term benefits of HCSTC

7 We quantified the percentage of borrowers losing access to HCSTC who would borrow from family and friends and discussed in our assessment of costs how such adjustments could be uncomfortable for individuals. Our overall assessment of well-being, however, showed no longer term negative impacts in aggregate from the loss in access to HCSTC.

for the group of people who would no longer get access to HCSTC under our proposed cap were sufficient to outweigh the costs of using it.

Some respondents argued that, given our findings, we have overestimated the benefit of using HCSTC. Some interpreted our analysis as meaning that HCSTC use causes 50% of users to experience financial distress. However we did not find that HCSTC use causes 50% of users to experience financial distress. Instead, half of HCSTC applicants report having already experienced some form of distress as a result of financial difficulties.

As we noted above and in our CBA analysis, there can be benefits from HCSTC use for immediate consumption, such as access to money for emergencies and where other sources of formal credit are unlikely to be available to HCSTC applicants. So whilst the level of risk of harm to borrowers at the margin allowed us to draw a clear conclusion from our evidence that there is a net cost to these HCSTC users, the judgement is more nuanced moving further away from the margin as the risks of using HCSTC decrease.

We found that for higher creditworthiness consumers, the risk of negative outcomes for borrowers reduces, but does not diminish completely. We consider that a price cap with the right structure and level can mitigate the harm arising from excessive charges. Not only does the price cap change firms' incentives and so prevent them from lending to people with a very high risk of default and increased risk of negative outcomes, but it also protects those borrowers who continue to access HCSTC from negative outcomes by reducing the cost, and stops borrowers getting into debt spirals due to excessive default fees and interest.

One respondent argued that there is significant empirical evidence that HCSTC is welfare-increasing and that we had misinterpreted the balance of evidence from empirical literature. Having reviewed the evidence cited it appears to be a selective representation of previous research. We maintain our position that the empirical evidence is ambiguous. Our assessment is supported by academic papers which also describe the evidence as mixed or conflicting[8]. Additionally, as noted in the consultation paper we have concerns about how applicable the findings of the research are to the UK market. Previous literature is largely on the US market, which has a very different market structure (US is predominantly high-street whereas UK is predominantly online) and legal environment.

As we said in the consultation, it is our view that borrowers who are more creditworthy will continue to be profitable, and so they will continue to be served by another firm even if their current lender exits the market.

Did not provide a balanced view of HCSTC customers

One respondent argued that we did not present a balanced view of HCTSC customers, focusing on customer vulnerability. We presented the socio-economic characteristics and financial circumstances of customers in detail in the CBA and in supporting technical annexes of our consultation paper. The socio-economic characteristics observed are broadly similar to findings from previous independent surveys commissioned by the Department for Business, Innovation and Skills and the Competition Commission.

Impact on firms

2.12 *Limiting the high-street distribution channel* – a number of firms and trade associations stated that our proposals could lead to no high-street lenders remaining in the market and proposed to increase the cap level to 1% to avoid consumer detriment from the loss of the high street.

8 Carrell & Zinman (2014) 'In harm's way? Payday loan access and military personnel performance'; Morgan, Strain & Seblani (2012) 'How payday credit access affects overdrafts and other outcomes'; Bhutta, Skiba & Tobacman (2014) 'Payday loan choices and consequences'

2.13 *Level of harm necessary to warrant impact on firms* – one firm argued that the evidence of harm was not sufficiently material to warrant the significant impact of the cap on the industry.

2.14 Concern was also expressed by a number of respondents about the potential for growth of non-authorised firms in the UK, and the impact on both firms and consumers.

Our response

Limiting the high-street distribution channel
As stated in the consultation paper, we considered a higher cap for high-street distribution, but decided not to propose this. We considered 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 on 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.

We stated that our static analysis of firm exit provides a conservative estimate and firms will develop dynamic responses to adapt to the cap. Since the publication of the consultation paper, one of the largest high-street providers publicly announced that they expect to remain in the market post-cap. Other lenders have commented that they are planning to continue to operate post-cap. This indicates that more firms will remain in the market than the static firm viability modelling estimates. All of the firms modelled are still in the market and have not announced their intentions to exit. We therefore conclude that the implementation of the price cap at the structure and level set out in this policy statement will not prevent a viable market.

Level of harm necessary to warrant impact on firms
As we set out in the consultation paper and technical annexes to it, we think that there is clear evidence that HCSTC use causes harm to borrowers who just qualify for HCSTC loans (i.e. have relatively low credit scores). The analysis suggests that the harmful effects of HCSTC are lower for borrowers with a better credit score, but they do not disappear. In particular:

- We find from our CRA and survey data analysis that people who take out HCSTC are in declining financial circumstances.

- Having taken out HCSTC loans many get into severe payment problems evidenced by high late and non-payment rates across HCSTC loans, with these rates being particularly high for the group of customers who we estimate will lose access as a consequence of the price cap. Further for those losing access we find exclusion leads to reduced risk of getting into financial difficulties on other bills and payments.

- For those who continue to get HCSTC loans our proposals similarly reduce the risk of getting into payment problems (both HCSTC and non-HCSTC related).

- There is extensive evidence of negative consequences (substantial harm) of being in payment problems i.e. financial, stress-related, mental-health and welfare consequences. One dimension of this is the effect on psychological health and well-being associated with being unable to repay debt on which widespread evidence exists (and which we elaborate on in the CBA and the technical annex).

In the consultation paper and the CBA we noted that excessive charges contribute to borrowers' worsening financial situation and current high prices facilitate lending to borrowers who are at high risk of detriment as a result of borrowing. In their responses, many consumer groups highlighted these results and argued that the level at which we had set the cap was not sufficient to protect consumers from the level of harm caused by HCSTC which we had identified.

We set out in the consultation why we consider each element of the price cap to be necessary given the harm caused to consumers by excessive charges and the proportionate impact on firms. This is explained in more detail in Chapter 3.

Non-UK authorised lenders
We recognise the risk that responses have raised in relation to non-UK authorised lenders operating in the UK. As we set out in Chapter 4, these firms would not be unregulated, but we have taken steps to mitigate these risks as far as possible, subject to EU law. We will take action where we see firms abusing their rights under the E-Commerce Directive.

Competition implications

2.15 A number of respondents challenged our assessment of the competition implications of the cap and our evidence on price competition.

2.16 Key points included:

- Insufficient consideration to the scope for competition to achieve an appropriate degree of protection for borrowers, and the need to preserve a market structure which can deliver pro-competitive and pro-consumer outcomes through rivalry.
- The scale of market exit demonstrates that the FCA has failed to meet its competition objective.
- Benefits of non-price competition will be lost: product choice will be more limited and firms will stop providing additional services which are currently points of competition.
- The cap increases the market share of the largest firms at the expense of small firms.
- The level of the cap is detrimental to new market entrants and the resulting ability of smaller firms to grow and challenge the larger ones.
- Cap levels do not allow for price competition and the CMA remedies to work. No compelling evidence indicating that firms will be able to adapt to the price cap, thereby allowing price competition to occur.
- It is inappropriate to rely on the CMA findings on price competition.
- Too much consideration given to competition impact.
- Appropriate affordability checks are a more pro-competitive means to address the harm to consumers.

Our response

Scope of competition to achieve positive outcomes

We have taken care to design our rules so that they fulfil our duty to secure an appropriate degree of protection for borrowers against excessive charges while also promoting effective competition in the interests of consumers.

We recognised that price caps are not generally a pro-competitive regulatory tool. Therefore our approach has been to consider the competition effects of many options and to choose the most pro-competitive among those options in each case and as a whole.

The structure of the cap is sufficiently flexible to give firms the opportunity to adapt their pricing and products; for instance under the initial cost cap we allow firms to charge an upfront charge for the duration of the loan. We have considered the impact on longer duration loans when setting the level of the total cost cap. The initial cost cap is set at a level at which price competition can take place. The CMA said in its Provisional Decision on Remedies that it considers 'there is scope for substantive price competition to take place within the framework of the proposed price cap'[9].

The proposed structure and level of the price cap also ensures that the amount of revenue a firm can gain is proportionate to the amount of credit lent and the duration thus allowing larger, longer duration loans (where a lender has more risk) to gain higher revenue than smaller, shorter duration ones.

We have revised our supply-side analysis in view of the new data received from firms and the impact on firms' profitability in the absence of dynamic responses by firms. We have also considered the feedback received from firms on whether they expect to continue to operate with the proposed cap. As a result we have concluded there will be a viable market at the level and structure proposed but at lower levels of the price cap, in particular the initial cost cap, viability of the market is at risk.

Scale of market exit; benefits of non-price competition; impact on smaller firms

Some responses argued that a greater number of firms in the market means there is greater competition in the interests of consumers. Our analysis is that for online firms, we do not expect the reduction in the number of firms to reduce competition, given that price competition is already limited. More firms does not necessarily equate to better quality products. The market is already highly concentrated, and the presence of a large number of small firms in the market is not encouraging competition in the interests of consumers. Our own analysis, as well as that of the CMA, is that a small number of firms have a high market share without evidence of smaller firms exerting price pressure on them. While there may be fewer brands to choose from post-cap, we expect that a number of lenders would continue to operate in the market and differentiate their product offering as part of their competitive strategy.

We noted that it is unclear how much of a competitive constraint would be imposed on a single remaining high-street firm. Our updated baseline shows a greater impact both on online firms and on the high street. Some responses argued that there was no compelling evidence that competition might be stronger than our static models due to dynamic responses, or that firms will be able to adapt to the price cap. However, we still consider our exit analysis to be conservative. Based on responses to the consultation and public announcements by some firms it is clear that a number of firms do believe that they will be able to respond dynamically

9 See pages 7-36 of the CMA's provisional findings report 'Entry by new firms has not resulted in existing lenders being effectively constrained when setting their prices.' assets.digital.cabinet-office.gov.uk/media/539b1d16e5274a103100000a/Main_report.pdf

and continue to operate in both the online and high-street market once the cap is in place. In our view, this significantly reduces the risk that the number of operators will fall in line with the static analysis and limits the extent to which consumer choice will fall in practice.

Possibility for price competition and CMA remedies to work; inappropriate to rely on provisional CMA findings
We agree with the CMA's assessment that the price cap will mitigate some of the harm to customers currently arising from high prices, and 'there is scope for substantive price competition to take place within the framework of the proposed price cap, leading to further reductions in price for customers.'10

As previously stated in the consultation paper evidence suggests HCSTC consumers are insensitive to default charges, and relatively insensitive to point of sale prices and that there is competition for non-price factors. After considering the evidence presented we do not consider these lead to a fundamental change in our assessment. We have considered the impact of the cap on lenders and expect the market to remain viable under this cap structure and level. We have designed the cap to be flexible to allow different price structures.

Too much consideration given to competition impact
As set out above, we have a duty to introduce a price cap to secure an appropriate degree of protection for borrowers of HCSTC from excessive charges, and in carrying out this duty we must comply with our competition duty. We judged that the risks of market exit below an initial cost cap of 0.8% were too high. This was not, however, to protect the firms for their own sake. We concluded that leaving all consumers without the option of HCSTC is not a desirable outcome. Given that we can see the benefit of HCSTC for some borrowers, we consider that this is still an appropriate conclusion.

There are more pro-competitive means to address the harm identified
Several respondents argued that the problems from HCSTC use have already been addressed by the FCA, as demonstrated by the recent reduction in lending. One respondent also argued that the affordability rules are a more pro-competitive way to achieve the aims of protecting borrowers against excessive charges.

In the consultation, we explained that excessive charges can arise from:

- high interest rates and charges during the agreed loan duration
- additional interest and fees upon refinancing and
- high fees and interest payable upon default or late payment.

We set out in Chapter 3 why we still consider each element of the price cap to be necessary to protect consumers from the unacceptable risk of harm from excessive charges.

Many firms put the recent reduction in lending down to more robust affordability assessments, which they argue is a more pro-competitive way to achieve a similar outcome to a price cap in preventing lending to the riskiest borrowers. However, the requirement to carry out an affordability assessment does not change firms' underlying commercial incentives (one consumer group argued that the cap should be lower in order to 'codify' the requirements of the affordability rules). This is an important part of meeting our duty to protect borrowers

10 CMA press release (09/10/14): https://www.gov.uk/government/news/cma-sets-out-proposals-to-lower-payday-loan-costs

against excessive charges because it is the excessive charges that allow lenders to take risks that harm consumers.

In addition, affordability assessments do not mitigate the harm caused by excessive charges to consumers who continue to access credit, whereas price cap rules do. This is because affordability rules apply only before a person is granted credit; in contrast the price cap rules mitigate detriment to those who are granted credit, but would suffer detriment as a result of excessive charges without the price cap, for example, by defaulting on other commitments, or getting into financial difficulty (neither affordability rules nor the price cap mean zero defaults). For this reason, it is not correct to say that improved affordability assessments would be a better way of achieving the same outcome, nor is it right to suggest that we have not properly discharged our competition duty.

Scope of the price cap

2.17 In the consultation paper, we explained that the legislation does not define 'high-cost short-term credit' but that we proposed using the definition of HCSTC in our current rules. We said that we had considered changing the definition of 'short-term' to cover longer term products and we had also 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). We explained why we did not propose to extend the definition.

2.18 In the consultation we asked:

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

2.19 Some respondents questioned the definition of 'short-term'. Several consumer groups raised concerns that lenders could extend loan durations to circumvent the definition and avoid the cap. One firm challenged our definition of 'substantially repaid', suggesting that it is ambiguous and needs clearer interpretation. Another firm recommended we should look at international experiences of firms gaming the definition through the development of instalment products that were very similar to payday loans with multiple rollovers built in.

2.20 Some respondents, mostly consumer bodies and charities, supported our proposed definition of HCSTC and agreed that it was reasonable, fair and proportionate. However, others who were generally supportive of the scope, think that some other high-cost credit products could have been included, such as credit cards or home-collected credit. Respondents in this group said that the scope of the cap should be kept under review.

2.21 One respondent queried why we have chosen to include peer-to-peer lending within the scope of the price cap, but not other forms of lending. The firm called on us to explain why P2P alone is considered to be a special case compared to other forms of lending.

Our response

We do not propose to change the definition of HCSTC as it would begin to undermine the principle that the cap should cover 'short-term' products.

Where we identify risks from emerging products, we will look separately at them and consider the full range of regulatory tools to deal with them. In particular, we will expect firms which develop products with longer durations but high costs to demonstrate how they are complying with our affordability rules as part of the authorisation process.

We will be monitoring the market closely to see if there are genuine practical problems arising with the 'substantially repaid' part of the HCSTC definition.

We recognise that many respondents are concerned about the scope of the HCSTC definition and would like to see the price cap applied to other products.

We continue to think that products currently excluded from the definition, although high-cost, are quite distinct in the nature of the products and the problems that they may cause consumers.

Our evidence, supported by the CMA's findings, suggests that other credit products are not substitutes for HCSTC. We have gathered a significant amount of evidence to support our proposals for HCSTC, and we think that it would be inappropriate to extend the price cap to other products without doing the appropriate analysis.

Furthermore, our credit cards market study and the CMA's market investigation into the personal current account market, including overdrafts, will shed light on the problems in these sectors; and the Law Commission's review relating to Bills of Sale (logbook loans) may also change business models in that sector.

Therefore, we have *not* changed the HCSTC definition to include other types of products at this stage, but we will consider the scope when we review the price cap.

As we explained in the consultation, lending through P2P platforms shares the same features as HCSTC lending through other channels and consumers borrowing through P2P platforms need the same protection from excessive charges, for what from a consumer's point of view would be an identical product. We are concerned that there is a potential gaming risk if P2P lending is not included in the price cap and that there will be lesser protection for borrowers compared with other HCSTC channels.

We have therefore decided that P2P lending should remain within the HCSTC definition and scope of the cap.

3.
The structure and levels of the price cap

We proposed a price cap consisting of three components, and we received a lot of feedback from a variety of stakeholders about the structure and level of each component of the price cap, as well as the overall structure.

We have considered the feedback we received on the overall structure of the price cap and each element.

We have concluded that each element is necessary, and that the levels proposed are proportionate to secure the appropriate degree of consumer protection for borrowers of HCSTC from excessive charges and that each element individually and as a whole is the least onerous way of achieving the appropriate degree of protection of borrowers against excessive charges.

Structure and levels of the price cap

General structure and levels

3.1 In the consultation paper, we proposed a price cap consisting of three components:

1. An **initial cost cap** of 0.8% of the outstanding principal per day on all interest and fee charges during the agreed loan duration and when refinancing.
2. A cap for those in **default of**:
   - a total of £15 on fixed charges
   - interest at the same rate as the initial cost cap calculated per day on the outstanding principal and fixed default charges
3. A **total cost cap** of 100% of the 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.

3.2 In the consultation we asked:

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

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

Overall structure

3.3 There was strong support for the three component structure (initial, default and total cost caps). Some respondents had suggestions for changes, but within the three component structure.

3.4 One respondent argued that we had failed to consider whether each individual component of the price cap is necessary and proportionate to address the risk of harm to consumers. A small number of respondents questioned whether the initial cost cap was necessary, given the substantial consumer protection benefits arising from the default and total cost caps.

3.5 A number of respondents raised concerns about the structure of specific elements of the price cap, and their impact. For example, they were concerned about the impact of the initial cost cap on the smallest/shortest loans, and the impact of the default charge on instalment loans. We have summarised comments made by respondents about the structure of specific elements of the price cap in the relevant sections below.

Our response

The overall structure of the cap is designed to secure an appropriate degree of protection for borrowers of HCSTC against excessive charges. In the consultation, we explained how charges can result in an unacceptable risk of harm to borrowers, and therefore be excessive. Excessive charges can arise both during the agreed loan duration and when borrowers are in default, and each element of the price cap is needed to properly address these charges.

The harm that we see caused to borrowers, that we regard as a defining feature of an excessive charge, includes the following:

- HCSTC charges exacerbate the difficult and deteriorating financial situation of many HCSTC users
- current high charges facilitate lending to borrowers who are at high risk of detriment as a result of borrowing

We have updated the impacts of the price cap in light of the new baseline, and set out in the updated CBA (Annex 2) the revised impact on consumers. In our view, the price cap will provide substantial protection against excessive charges for those consumers who continue to be served in the market and consumers who no longer get access to HCSTC will be on average better off.

Each of the components of the cap plays a different role in protecting consumers from excessive charges:

- The initial cost cap protects all borrowers, including those who pay back on time and those who refinance, as well as those who default, from excessive charges caused by HCSTC. It is a particularly important element of discouraging firms from lending to borrowers who will be harmed by HCSTC. Calculating the initial cost cap according to the percentage of the principal means pricing is proportionate to the size and duration of the loan.
- The default cap protects borrowers that pay back their loans late from excessive charges following default, and from excessive interest continuing after default, while ensuring there is still an incentive to pay back on time.

- The total cost cap limits escalating interest, fees and charges, mitigating debt spirals (this also protects borrowers paying back on time but using longer duration loans, as well as borrowers in default). It also provides a further over-arching degree of protection because it contributes to the efficacy of the cap as it is clear and simple to understand.

The structure of the price cap as a whole changes firms' incentives and stops them lending to borrowers who just qualify for HCSTC currently and have relatively low credit scores. These borrowers are at the highest risk of default and the highest risk of worsening their financial situation.

We have considered whether each element of the price cap is necessary and proportionate in light of responses and of recent changes in lending volumes. We have concluded that if one component of the cap is missing, the corresponding consumer protection is missing, and both consumers that are denied credit and those that continue to be granted loans will not be afforded the appropriate degree of protection from excessive charges.

Initial cost cap: structure

3.6 There was strong support for a daily initial cost cap based on a percentage of the amount borrowed.

3.7 There were, however, some criticisms, mostly from firms and trade associations but also an MP that this structure threatens the viability of the shortest loans, because the small amount that could be charged would be an inadequate contribution to the fixed costs of making the loan. One firm argued that an assumption that firms would nonetheless lend as a loss-leader to benefit from higher profitability on repeat borrowing would not necessarily follow for the shortest loans. They suggested that borrowers using the shortest loans tended to continue using short duration loans with only a small extension in their duration, and suggested allowing firms to charge an initial fixed fee whatever the level of the initial cost cap.

3.8 The CMA also indicated that the industry had suggested that our proposals would have an impact on the shortest loans.[11] A number of firms made the point that there is a real customer benefit from accessing funding for a very short period to cover a temporary shortfall in finances. Some argued that this was more useful to consumers than durations which extend from payday to payday (for example 30 days) and longer, which indicate ongoing problems with cash shortfalls. Respondents argued that there will still be a demand for the shortest loans, but borrowers will be forced to take out longer loans than they want to access funds. This will result in them paying interest over a longer duration than is necessary.

3.9 However, some consumer respondents expressed the opposite view and argued that short-term loans were more detrimental to consumers. One respondent called for the review to consider a ban on all loans that required full repayment in less than two months, arguing that the single payment nature of much of HCSTC is the main reason that people get into financial difficulties and repeat borrowing cycles. Another respondent argued that it is preferable for borrowers to pay in instalments over more manageable periods. One response argued that the initial cost cap is the only way to reduce the risk of long term repeat use.

3.10 A user of HCSTC who responded to our consultation noted that the daily rate is the most helpful component of the cap because most firms currently charge a flat rate regardless of whether or not the borrower wants the loan for a shorter duration.

11 *Payday lending market investigation. Provisional decision on remedies.* Competition & Markets Authority, 9 October 2014, Appendix 6.1, para 27-28

Our response

We acknowledged in the consultation paper that, because the initial cost cap is calculated on a percentage of the principal, it could have an impact on the supply of the smallest, shortest loans. We said we considered a small fixed element to the initial cost cap when we designed the structure, but concluded 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. We also noted that a fixed element could encourage repeat lending of small, short loans in circumstances where the borrower would be better served by a single, longer loan.

We recognise that the shortest term loans could be of benefit to consumers, for example, where the expenditure is unexpected, essential and urgent. The significant number of online loans between one and seven days (around 12%) indicates significant demand for these durations, although we noted that few loans below seven days are made by high-street firms. We similarly recognise that consumers taking out small loans that meet their needs is beneficial, preventing them from borrowing more than they require.

We have done some further analytical work to check the impact of the initial cost cap on the shortest, smallest loans. We found that:

- There is a close link between small and short-term loans. These are typically used by borrowers with better credit scores and are less likely to be paid late or remain unpaid than longer term or larger loans. On average, the duration of loans initially agreed to last fewer than seven days is extended by four days.

- The proposed cap would make these loans significantly less profitable at a loan level, although the subsequent borrowing by customers of these loans would make them profitable at an individual level after the cap.

- 70% of consumers who initially took out short loans subsequently took out longer loans. This indicates that consumers do not have strong preferences for these products and that they are prepared to switch to longer loans. Similar patterns were found for small loans.

To make individual loans profitable under the price cap, the initial cost cap would need to include a large fixed element, such as allowing firms to charge 0.8% for the first 14 days regardless of the duration of the loan. We are concerned that such a large fixed element is a significant portion of the average HCSTC loan (£260 in 2012/13) which is not proportionate to the small size / short duration of the loan. We also have significant concerns that this approach could incentivise firms to re-lend to take advantage of the fixed element and consumers over optimism that they will be able to repay quickly.

Our analysis shows that giving short-duration and small-size loans to new customers will be profitable, once we take into consideration the likelihood of longer duration and larger future loans that customers come back for and the fact that the people currently getting short-duration and small-size loans are actually more creditworthy. Our data also suggests that these consumers would be willing to switch to loans of a longer duration rather than not take out a loan at all. For these reasons, we have decided not to introduce an additional fixed element for the smallest or shortest loans. This approach does not prevent firms from choosing to have a minimum duration of loan. However, in practice, we expect that some firms will still provide shorter and smaller loans.

Initial cost cap: level

3.11 Around 50 of the 70 responses received expressed a view on the proposed level of the price cap. Many of these did not specifically link to a component of the cap, but the general points raised are most relevant to the level of the initial cost cap because this is the component of the cap that has the greatest impact on firms and affects the majority of borrowers.

3.12 Consumer associations, professional bodies, local authorities, academics and individuals were split between those that supported the proposals and those who argued that a lower level is necessary.

3.13 Consumer groups and other non-industry respondents argued that:

- The initial cost cap is a compromise to allow for the higher costs of high-street firms, but other factors would lead to high-street exit, so this should not be a factor in our decision making.

- Default rates at 0.8% are too high and we could achieve greater savings for borrowers at lower levels of cap, particularly considering the cumulative effect of repeat borrowing.

- The current median revenue per day for longer term loans (over 60 days) is 0.6%, demonstrating that an initial cost cap of 0.8% per day will not bite.

- One respondent argued that lower caps will go further to 'codify' the requirements of the affordability rules and give firms greater certainty that compliance with the cap means compliance with the affordability rules.

- Specific proposals put forward from non-firm respondents included calls for a 0.4%, 0.5% or 0.6% cap. One respondent said the cap should be the same as for credit unions (3% a month), while another thought that 0.8% is reasonable for a short-term, low value loan, but questioned if it was a reasonable reflection of costs for longer or higher value loans.

3.14 Although a couple of firms did support the proposed level, generally firms and trade associations argued that the initial cost cap should be higher, or that it was unnecessary.

3.15 Firms and trade associations argued that:

- 0.8% is not sufficient to maintain a competitive market and enable consumers to continue to access credit

- a cap of 1% still provides the protection desired by imposition of a cap but allows a reasonable level of compensation to firms

- an 0.8% cap risks that no high-street lenders remain in the market, a separate cap for high-street firms would be relatively simple, but failing this, we should raise the cap to 1% to avoid consumer detriment from the loss of the high street.

- an 0.8% cap is disproportionate to the harm suffered, and we have not demonstrated that an initial cost cap of 0.8% rather than 0.9% or 1% gives rise to an unacceptable level of consumer harm. Customers would still gain a significant welfare benefit under an 0.9% initial cost cap, and consumers would benefit from accessing a larger volume of loans

- the rates of late and non-payment for 'marginal' new and repeat customers are very similar regardless of whether the initial cost cap is set at 0.8% or 0.9%, and the number of 'marginal' repeat customers incurring a late payment charge increases when the initial cost cap is set at 0.8% rather than 0.9%. This indicates that repeat customers may actually be better off with an initial cost cap set at 0.9% rather than 0.8%

- we have not demonstrated that the initial cost cap is necessary and proportionate in light of the total cost cap and the default cap which will substantially address any harm suffered by customers
- the detriment that we are seeking to address has already been mitigated by FCA regulation as demonstrated by the fall in lending volumes, the initial cost cap is unnecessary in this context

3.16 Specific proposals from firms and trade associations included a proposal that the initial cost cap should be 1%, and contended that we had failed to demonstrate that an 0.8% initial cost cap was necessary and proportionate compared to a 0.9% or 1% initial cost cap. In particular, these firms argued that the revised supply side analysis would show that 1% is the minimum viable level for most firms, and that 0.8% will lead to a reduction in the number of lenders in the market.

Our response

As set out above, a number of respondents made the point that there had been large reductions in lending volumes in 2014. They contend that FCA regulation has already caused them to tighten their lending criteria significantly.

The proposal for the 0.8% initial cost cap was based on a number of factors:

- consumer protection from loss of access to HCSTC because the risks of using HCSTC are too high
- protecting consumers who still get access to HCSTC from the harm caused by excessive charges
- the potential impact of significantly limiting the high-street distribution channel
- the detrimental impact on consumers of the loss of all HCSTC providers

We judged that at caps above 0.8%, consumers were inadequately protected from the risks of HCSTC due to the significant risk of worse outcomes from HCSTC use. While risks were still high at caps below this level, there was too high a risk that there would be no viable HCSTC market at caps below 0.8%.

In light of the responses to the consultation and our updated analysis, we have re-considered the weight to give to these factors, and whether a 0.8% initial cost cap is proportionate to deliver an appropriate degree of protection for borrowers of HCSTC from excessive charges. We view the protection provided by the initial cost cap to those who are still granted credit as having a substantial benefit (and a greater proportion of the total benefit than considered at the time of our consultation) but we still believe there is a substantial justification in terms of protecting those who will no longer have access to HCSTC. The fact that this latter group is smaller is relevant as we explain below and in the CBA.

Benefits to consumers who continue to access HCSTC

There are substantial benefits from the price cap not related to loss of access to credit and, given the smaller number of consumers benefiting from loss of access to HCSTC, we recognise that the relative importance of these benefits has increased in terms of ensuring that our decision is proportionate. While recent reductions in lending volumes have already reduced the risks of harm to borrowers who would benefit from loss of access to credit, they have not delivered the appropriate degree of protection for borrowers of HCSTC who continue to get HCSTC access from excessive charges.

In the revised CBA we estimate that around 870,000 people a year will continue to get access to HCSTC. We have identified consumer savings of £157m per annum and estimate an average saving of £180 per annum for each individual who continues to access credit. Many of these customers may be in financial distress as demonstrated in the consultation paper. We found the average HCSTC user has lower income levels than the UK population as a whole, 32% earn less than £12,000, 60% less than £18,000 and, on average their financial position was deteriorating before they sought HCSTC[12]. Consequently these individuals would also likely benefit from the materially reduced risk of suffering payment problems which have financial, stress-related, mental-health and welfare consequences.[13] We consider the protection from excessive charges and the likely further welfare gains to be a substantial benefit of a 0.8% initial cost cap, which would be reduced by increasing the initial cost cap to 0.9% or 1%.

A number of non-firm respondents argued that the level of protection at 0.8% is too low and that the cap should be lower for greater protection to be realised. Clearly, there is greater protection for HCSTC borrowers as the cap lowers and so potentially greater benefits. However, at levels below 0.8% the potential benefits, in terms of avoiding harm from excessive charges, still need to be balanced against the risks to consumers of there being no viable HCSTC market and the impact on the high street.

As we highlighted in the consultation, although the risks of using HCSTC reduce, they do not disappear, for borrowers with higher credit scores. Given that many less creditworthy borrowers predicted to lose access in the consultation have already lost access, the impact on higher credit score borrowers is important.

We set out in the consultation the evidence of harm to customers with better credit scores who currently get loans. We found very clear patterns in the data that indicate that the adverse impacts on financial outcomes from HCSTC use remain, but are less pronounced for consumers with better credit scores. This was covered in more detail in the CBA we published with the consultation, which explained that 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 of going over their overdrafts and failing to repay on other non HCSTC debt and
- lower levels of regret when compared to consumers with lower credit scores, but regret levels remaining material at 31%[14]

12 See technical annex – evidence on client characteristics

13 See the CBA for evidence of negative non-financial consequences of being in payment problems

14 CBA paras 1.65 and 1.66

Around half of individuals who would continue to have access to HCSTC recorded non-payment on at least one loan over our two-year sample period[15]. The protections created by a 0.8% initial cost cap are therefore critical in mitigating harm from HCSTC use for these borrowers. At 1%, there is very limited benefit for borrowers paying back on time, because the average existing prices for these borrowers are just over 1%.

One large firm argued that the consumer protection benefits from savings identified at a 0.8% cap as opposed to 0.9% or 1% are not sufficiently material to justify the significant impact on firms. They contend that customers would still gain a significant welfare benefit under a 0.9% initial cost cap.

We considered whether a 0.9% cap would provide sufficient protection for consumers from the harm caused by excessive charges while reducing the impact on firms. We recognise that a 0.9% initial cost cap does provide some protection for consumers, and for those that continue to be granted a loan it is also lower than the current equilibrium for consumers who pay back on time. However, it is our view that 0.9% does not provide appropriate protection for consumers given their difficult and deteriorating circumstances, the likelihood that these consumers will borrow repeatedly and the financial and non-financial impacts on consumers of default. The level of the initial cost cap is also linked to the same level for the default interest cap which sets the level for the amount that can be charged to consumers in default, so this is also particularly important.

One firm argued that affordability checks are a more targeted and effective strategy for tackling late or non-repayment and that the price cap is a very blunt tool. Their contention seems to be made in particular about the impact of the 0.8% initial cost cap. We demonstrate elsewhere that the impact of the price cap is justified in relation to the level of consumer detriment. Affordability rules, however, do not protect borrowers once a loan has been granted. In contrast, the price cap will protect all those granted credit, for example, by protecting those who do not default but are harmed by charges, by protecting those that do default by limiting default charges and the continuing interest charges following default. Although the price cap and affordability assessments are complementary, the price cap rules have a separate and substantial protective effect for a large number of consumers. On this basis, relying on affordability rules alone would not secure an appropriate degree of protection for consumers against excessive charges.

Consumer protection from loss of access to HCSTC

The updated data and our analysis shows a much smaller number of people losing access to HCSTC as a result of the price cap because many people have already been denied credit as a result of firms' reactions to FCA regulation. We have therefore considered whether loss of access to HCSTC for this smaller group is still beneficial as a whole and, if so, whether the 0.8% initial cost cap is a proportionate way of securing those benefits given the other elements of the price cap.

In the consultation paper, we assessed the extent of harm to consumers from HCSTC, 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. We said that, on balance, 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.

15 This compares to 61% for individuals who would lose access to HCSTC

Despite the recent reduction in lending, under the revised baseline, default rates of loans not granted at a 0.8% cap are still very high (and close to previous figures). 38% of first-time HCSTC loans (and 12% of subsequent loans) no longer made would have ended in non-payment (compared to 39% of first-time loans and 19% of subsequent loans in the consultation). The loss of access as a result of the price cap continues to be beneficial in terms of preventing consumer harm, but these benefits apply to a much smaller group of consumers.

Many non-firm respondents argued that further loss of access would be beneficial, based on the high level of default risk at levels below 0.8%, but this must be balanced against the risks to consumers of there being no viable HCSTC market.

Several firm respondents argued either that we had failed to demonstrate why 0.8% was necessary and proportionate in comparison to 0.9% or 1%, or that that problems from HCSTC use have already been addressed by our new CPA and rollover rules and our more effective supervision of the affordability rules.

Following further analysis of the updated baseline, we consider that the initial cost cap is still necessary to secure the appropriate degree of protection for potential borrowers of HCSTC against excessive charges. We recognise that the actual numbers of consumers not served by setting the price cap at 0.8% as opposed to 0.9% or 1% may be small (9,000 individuals excluded per year by 0.8% rather than 1%, and 7,000 individuals excluded per year by 0.8% rather than 0.9%). However, our evidence of harm demonstrates that these consumers are in difficult and deteriorating circumstances and that the initial cost cap will not achieve an appropriate degree of protection at levels above 0.8%.

Whether the recent changes demonstrate a more cautious approach by firms, or more effective supervision, a price cap is still necessary to change the underlying incentives for risky lending and lock in the consumer protection benefits for those who would be better off not borrowing. Affordability checks also require a judgement by the firm about each individual borrower. The ‘bright line’ rule of the price cap provides a consistent level of protection for consumers as higher-risk customers simply become unviable to lend to. Any relaxation by firms of their risk tolerance would be prevented by the bright line created by the price cap.

The potential impact of significantly limiting the high-street distribution channel
We continue to believe that the option of the high-street channel is of benefit to those borrowers for whom an HCSTC loan is beneficial because some are unlikely to switch to online providers.

As we said in the consultation, we considered a higher cap for high-street loans, but we did not propose it for a number of reasons.

The CMA has assessed that the majority of high-street customers are likely to consider online to be a viable alternative, and therefore high-street lenders are likely to compete with online lenders and based on the data we collected and our analysis, we agree[16]. This, combined with the potential for significant gaming resulting from a split cap for high-street and online firms, means that a single cap is necessary. In addition, setting a separate (higher cap) for high-street lenders would discriminate against the customers of high-street providers who on average have lower incomes than borrowers from online lenders and who are slightly more likely to come from protected groups.

16 However the competitive constraint imposed on online lenders by high street lenders is likely to be weaker, given the relatively small proportion of online customers who also use or consider taking out loans from high-street lenders.

Our revised analysis does not show a change in the risks of exit for high-street firms (it still shows that at caps below 1%, there is a risk that HCSTC will not be distributed through the high-street). This is because the model suggests that even in the absence of the cap, the HCSTC high-street business for firms is currently unprofitable or making only a low level of profit.

In practice, we know that high-street firms carry out a range of activities from their high-street premises and we judged that there are some offsetting dynamic responses that may mean high-street distribution continues at levels below 1%, but that this is less likely at levels below 0.8%. We now have evidence from firms that the high-street will be able to continue at 0.8%. One high-street firm has stated publicly it expects to continue to operate under the cap and has acquired nine new stores in 2014.

The detrimental impact on consumers of the loss of all HCSTC providers
As we said in the consultation, we still consider that HCSTC can be beneficial to some borrowers to bring forward consumption – such as in emergencies and when they do not have access to other credit options – so we do not think it is desirable to leave consumers entirely without the option of using HCSTC.

As we explain in the CBA and the technical annex, the revised modelling estimates an increased number of firms becoming unprofitable at the revised baseline. The model suggests that the incremental impact of the cap is smaller than previously estimated: the model estimates that of the eight firms modelled, two or three (+1) firms become unprofitable as a result of a 0.8% cap. However, the overall impact of the revised baseline (incorporating recent reductions in lending) and the price cap on firms' revenues is greater than previously estimated.

We have considered whether we should increase the initial cost cap. However, there are a number of reasons why we do not think this should be the case:

- The baseline (our central estimate in our revised modelling) is a deliberately conservative assumption that recent reduced levels of lending will continue. We consider that it is likely that lending will recover to some extent as firms resolve the uncertainty caused by authorisation and the implementation of the price cap.

- When we model a scenario of 'no price cap' with the new baseline, the estimate is that only four firms are at low risk of exit. All eight of the firms in our sample are, however, continuing to operate at present. While some firms may exit in the future, we think it is probable that part of the difference is due to the cautious nature of the model.

- A combination of consultation responses, public announcements and discussions with lenders indicates that a higher number of lenders are likely to remain in the market then the model indicates.

We therefore remain confident that there will be a viable market at 0.8%, but that at levels lower than this, there is a risk that consumers would be harmed by the potential threat to the viability of the HCSTC market.

Summary
We have considered the level of the initial cost cap in light of the responses to the consultation. In particular, we have considered whether an 0.9% or 1% initial cost cap would provide sufficient protection to consumers from the harm caused by excessive charges while reducing the impact on firms. We remain convinced that an 0.8% initial cost cap is a proportionate level and that it is necessary to deliver an appropriate degree of consumer protection to those

borrowers who continue to access HCSTC, whether or not they go on to default, and thereby prevent harm from excessive charges. An 0.8% cap is also necessary to lock in the benefits of a reduction in lending to consumers who just qualify for HCSTC at the moment and change the underlying commercial incentives to lend to the riskiest borrowers.

Given the reduction in lending volumes which has already taken place, there is a smaller impact on firms as a result of the cap, although we recognise that this is incremental. However, at 0.8% firms (including at least one high-street firm) have the chance to respond dynamically to the price cap and continue operating in the HCSTC market, but at levels below 0.8%, we judge that the risks to a viable HCSTC market are too great.

Overall, for the reasons stated above, and as a result of our consideration of the other options considered in the consultation, we consider that this proposal to be the least onerous way to secure the appropriate degree of protection for borrowers against excessive charges.

Default cap: structure and level

3.17 There was strong support for a default cap from a majority of respondents. However, a number of responses suggested changes to the structure or level. One firm argued that the default cap is unnecessary because of CONC rule 7.7.5R, which limits firms to recovering their reasonable costs from a customer in default or arrears difficulties.

Structure

3.18 One issue raised by several respondents concerned the impact of the fixed default charge cap on instalment loans. A number of firms and a trade association made the point that the fixed default cap does not take into account the multiple instances of late payments that can occur during an instalment loan. They argued that firms incur fixed costs at each instance of late payment and that the proposed default cap did not adequately reflect this.

3.19 Respondents came up with a number of alternative suggestions to address this issue:

- a fixed monthly default fee for instalment loans
- fixed default charges should sit outside the cap for loans longer than three months
- two fixed default charges of £15 should be allowed within a 12-month period
- charging £15 for each occurrence of default

3.20 One firm suggested that third party debt collection costs should be excluded because these are third party costs levied on the lender.

3.21 One stakeholder argued that we should consider requiring firms to freeze interest and charges on HCSTC when a consumer is 30/60 days in default.

Level

3.22 Most respondents commented on the level of the fixed default cap, while very few commented specifically on the default interest charge cap. There was a split between consumer groups and non-firm responses who argued that the default cap was too high, and firms and their trade associations who contended that it was too low to cover costs.

Default cap should be lower

3.23 A number of non-firm respondents argued that £15 seemed too high to be reflective of reasonable costs of default. These respondents argued that £15 is a substantial proportion of a typical HCSTC loan and that this would distort incentives for borrowers and lenders. Another stakeholder suggested that allowing firms to charge such a large proportion of a typical loan as a fixed default fee would incentivise firms to generate income from default charges.

- One stakeholder argued that there is limited impact on firms from lowering default charges, but there is significant impact on borrowers, because default fees increase the risk of cross-subsidisation of strategic defaulters who do not pay them, by those who do pay them.

- Respondents put forward a number of alternative suggestions including a £5 fixed default fee, default interest of 0.03% and reducing default interest charged for each day of default to incentivise firms to remedy debt early.

Default cap should be higher

3.24 Conversely, several firms argued that the £15 was inadequate to cover costs. One firm argued that a £15 default fee was disproportionately low compared with other industries and that no evidence had been presented to justify different treatment from other industries.

3.25 One firm provided a calculation to show that their fixed default costs are £15.66 for each instance of default. One alternative proposal put forward was to allow a £12 fixed fee for every instance of late payment.

3.26 One firm and one trade association argued that inadequate consideration had been given to the incentive effects of default charges. They suggested that the fixed default charge could encourage borrowers to default because they knew they could only be charged £15. They also see a possible perverse incentive for the lender to take court action against debtors to recover costs. Another firm also argued that inadequate consideration had been given to the incentive effects of default charges and that loan losses would increase under a £15 cap, although it noted that this would have a limited impact on its revenues.

Our response

Default cap unnecessary because of CONC rules

CONC 7.7.5R requires charges to customers in default or arrears difficulties to be no higher than a firm's reasonable costs. The wide variety of default charging practices currently in the market demonstrates that the default cap is a necessary component of the price cap. It complements the CONC rule by setting a maximum amount chargeable. Firms will still have to demonstrate that their default charging practices are compliant with CONC 7.7.5R.

Instalment loans

For instalment loans, borrowers will be paying interest charges over a longer period and so these loans will already be costing them more. Multiple instances of late payment on an instalment loan could suggest borrowers are in financial difficulties, in which case the existing CONC rule on forbearance would suggest that a firm should consider suspending further charges. The fixed default cap is therefore an important means of limiting the further escalation of costs for these borrowers.

Allowing a monthly fixed charge or a certain number of £15 charges within a set time period would mean a more rapid escalation of costs up to the total cost cap. It is also worth noting that the responses on the default cap level from many consumer groups argued that £15 is excessive and does not reflect reasonable costs where lenders take proportionate action in the event of default.

Setting a higher fixed default cap for instalment loans would mean that borrowers using instalment loans are afforded less protection than those making a single repayment. It could also incentivise firms to create 'false' instalment products – artificially splitting repayments within a short time period so that they had the opportunity to charge higher default fees.

Our modelling shows, given that this default revenue is largely not collected, it has limited impact on firms' profitability.

Firms can already charge a fixed default fee multiple times, providing the cumulative total does not exceed £15. They may also charge interest at the same rate as charged during the agreed loan duration and can charge interest on any fixed default charge already made. This should give sufficient incentive for borrowers to pay back on time and in this context we do not think that it is reasonable to allow firms to charge the maximum default cap amount for each instance of default. For these reasons we still consider that the £15 ceiling is proportionate, in light of its importance to consumer protection and the ability of firms to continue to charge interest, where appropriate, post default.

Third party debt collection costs should be excluded
Excluding third party debt collection costs from the default cap would undermine its effects by creating incentives for firms to outsource as much of their debt collection costs as possible.

Freezing interest/charges in default
Section 93 CCA relieves a debtor of the obligation to pay interest at a higher rate than interest provided for in the total charge for credit. That section assumes that it is permissible to continue to charge interest.

The Consumer Credit Sourcebook includes a rule[17] that requires firms to treat customers in default and arrears difficulties with forbearance and due consideration. The accompanying guidance states that this would include considering suspending further interest or charges.

The price cap is designed to protect borrowers of HCSTC from excessive charges that arise during the agreed loan duration, and in default. It will do this by limiting interest, fees and charges which will mitigate debt spirals. We do not propose to also require firms to freeze interest/charges in default at this point.

If, however, we find that the combined effect of the default cap and the total cost cap are not adequately addressing debt spirals for those in default, we will consider other potential measures when we review the cap, including freezing interest and charges.

Level
While we acknowledged that firms incur costs when borrowers default (and so a fixed charge at this point is reasonable) and we accepted that it was important that borrowers have an incentive to pay back on time, we did not set the level of the fixed default cap to ensure firms could recover the fixed costs of default.

We stated 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." A separate provision of the CONC rules (CONC 7.7.5R) already ensures that firms

17 CONC 7.3.4R

cannot impose charges which are higher than the firm's reasonable costs on customers in default or arrears difficulties.

The aim of the default cap is different. In setting its level, an important consideration was protecting consumers from the rapid escalation of the debt, which is consistent with our statutory duty. We were also concerned about the extensive evidence of negative consequences of being in payment problems, including financial and non-financial consequences. In particular, we highlight in the technical annex the effect on psychological health associated with being unable to repay debt.

So in setting the default cap level we balanced a number of considerations: the need to protect borrowers from quickly spiralling debt; allowing the lender to recover at least part of the costs occasioned by default; having appropriate incentives for the borrower to repay the loan; and not rewarding poor affordability assessments by firms. We consider that a ceiling of £15 strikes the right balance, although we acknowledge that a default cap of £15 may still be considered high in proportion to the average HCSTC loan of £260.

Summary
Overall, we continue to consider that the £15 default cap strikes the right balance between protection of borrowers against excessive charges and the impact on firms and on competition and is the least onerous level which secures the appropriate degree of such protection.

Total cost cap: structure and level

3.27 We explained in the consultation paper that the 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
- to prevent late payment, default fees and interest from escalating to excessive levels

3.28 The proposal for a 100% total cost cap was a balance of factors:

- the limitations that a total cost cap can have on loan duration
- mitigation against spiralling costs from interest on longer duration loans and/or from default charges
- simplicity
- the impact on firm profitability (risks to a viable market)

3.29 There was strong support for the total cost cap as it is seen as an important means of preventing debts escalating to unmanageable levels.

3.30 Most responses expressed a view on the proposed total cost cap. Of these, the majority related to the level of the cap, although a few also commented on its structure. There was a clear split between responses which wanted to see a lower total cost cap, and those who argued that a 100% total cost cap was too low.

Responses favouring a lower total cost cap

3.31 Several respondents arguing for a lower total cost cap contended that allowing debts to double is inadequate protection for borrowers against debt spirals.

3.32 One consumer group called for the total cost cap to be split between initial and default charges, so – for example – no more than 20% of the total cost cap could be made up of default fees and interest. They argued that for higher value loans in particular, a 100% cost cap will still lead to significant levels of detriment for consumers. They cited precedents for splitting caps in other financial services products such as NEST pensions as evidence that it would not be too complicated for people to understand if set out clearly.

3.33 One respondent highlighted that a borrower taking an average loan of £260 could end up with £520 debt under the proposed cap. They argued that for many of their clients this would be a significant proportion of their income. Similarly, another consumer body commented that users of their online service are reported in the last 12 months as having an average amount owed on payday loans of £1,704.27. This, they argue, illustrates that a 100% total cost cap will still allow vulnerable consumers to get into large debts.

3.34 Some respondents argued that the cost savings from a 75% or 50% total cost cap would reduce the consequences of indebtedness and interest accrued post-default. Two respondents argued that firms would be incentivised to accrue default up to the level of the total cost cap.

3.35 Respondents arguing for a lower total cost cap noted that our evidence shows that few loans are currently over 60 days, so a total cost cap designed to allow loans over 60 days is unnecessary. One stakeholder argued that there is no need to protect longer loans as HCSTC is designed to meet emergency cash needs. They believe that the benefits of protecting consumers who default on their loans greatly outweigh the costs to consumer choice of not offering longer loans.

3.36 Some respondents pointed out that our estimates do not show a difference in the number of firms exiting at a 75% cap compared with a 100% cap, and suggested that this weakened the rationale for a 100% cap. One comment suggested that we have provided insufficient data on the impact of a 50% cap to make a judgement.

3.37 Although a number of respondents who supported the 100% total cost cap welcomed its simplicity, some of those arguing for a lower cap felt that we had got the wrong balance between simplicity and consumer protection and that a lower cost for consumers was a better outcome than the cap being straightforward. One respondent argued that 50% is easy to understand, whereas another did not agree that 100% was easier to understand than 75% or 50%.

Responses favouring a higher (or not lower) total cost cap

3.38 One firm argued that if the total cost cap restricts default charges further, then a total cost cap will be so prescriptive it will prevent product innovation in any dynamic way and instead will encourage lenders to develop products at the most profitable point of the spectrum.

3.39 A number of firms and a trade association argued that a 100% total cost cap will restrict loan length which will be detrimental to consumers. One firm proposed that a higher overall cap of 150% would allow lenders to respond dynamically with the development of longer term products (up to one year) in line with the definition of HCSTC. One firm argued that it could lead to shorter loans with higher repayments, which may be unaffordable for consumers. A large firm also argued that the restriction on loan length would create competitive distortions as longer duration loans are outside the HCSTC definition.

3.40 Some firms argued that the 100% total cost cap will incentivise lenders to take court action against defaulters.

Our response:

We share concerns expressed by some respondents that allowing interest and charges to inflate to the same amount as the principal is still a high amount given the average loan size and frequency of borrowing and we judge that this rules out a higher total cost cap because this would not provide an appropriate degree of protection. However, this needs to be weighed against the other effects of lowering the total cost cap.

A number of firm and non-firm respondents also make the point that longer term loans can be better for borrowers as they can, depending on the terms of the loan, allow payment over a more manageable period. At 100% firms can still offer loans of longer durations than four months if they price below the initial cost cap, or if it is an instalment loan with declining principal. This is an effective way of enabling longer term loans to continue whilst ensuring the costs for consumers do not escalate to excessive levels.

Although lowering the total cost cap would further mitigate the risks of debt spirals, it would deprive consumers of the benefits of longer loans, without resulting in a further substantial prevention of consumer harm. This is because our analysis shows that although firms charge default fees over 75% (and over 100%), they are unlikely to collect them.

A lower total cost cap may also have unforeseen consequences for a viable market. Our modelling suggests that a 75% total cost cap would have only a limited additional impact on firms, as compared with 100%, and cause no overall impact on market exit estimates. However, our judgement of the impact on viability is based not solely on our modelling but also on information from firms about whether or not they will continue to operate in the market following the implementation of the price cap. This information from firms has been provided on the basis of the proposed 100% total cost cap, so reducing the level without any adjustment to other aspects of the price cap could have an unforeseen impact on market viability overall.

Another key consideration was competition and the impact on the market and product innovation of a lower total cost cap. Many firms argued that the overall impact of the price cap will be to reduce competition and limit product innovation. A lower total cost cap will have an impact on viable loan durations. We think that the 100% cap gives more flexibility for firms and hence is more pro-competitive in leaving more space for product differentiation within the protection secured by the cap.

A straightforward approach that is easy to understand was also a factor in our decision making on the price cap proposal.

The purpose behind a simple cap structure was to promote consumer protection by helping consumers and their advisers identify when the cap had been breached and ensuring it is simple for firms to interpret and comply with the cap. So there is not necessarily a trade-off between simplicity and consumer protection.

As stated in the consultation, we considered a sub-limit on the total cost cap but concluded that it would add too much complexity, and that further analysis would be required before such a measure could be considered.

It is also worth noting, that we will undertake a review in two years (see Chapter 6). This will enable us to consider the impact on the market in terms of the number of firms participating, the diversity of products and the availability of longer term loans as well as the impact on consumers who continue to access HCSTC. This will enable us to review the price cap's effectiveness at protecting consumers and the harm caused by excessive charges and adjust if necessary. We recognise that unintended consequences for consumers and firms could arise earlier than this, and we will monitor for this and take action if necessary.

Finally, we do not agree that the total cost cap proposed will incentivise lenders to take court action against defaulters, any more than they currently do. As we have seen many firms already charge default fees above 100%, but they are unlikely to collect them. Court action may not be practicable for firms, especially given the small amounts lent. Instead, we think that firms will concentrate on making better lending decisions.

Summary

Overall, for the reasons set out here and in the consultation paper, we consider a 100% total cost cap strikes the right balance between an appropriate degree of protection for borrowers against excessive charges and impact on the firms and on competition and is the least onerous level which secures the appropriate degree of protection for borrowers against excessive charges.

4. Changes and clarifications to our proposals

This chapter explains the changes we have made to the draft rules we consulted on. These include rules on unenforceability, calculating the cap, the range of charges the cap applies to and applying the cap to agreements made before 2 January 2015 but modified after that date. It also covers issues relating to the E-Commerce Directive, where the Treasury has announced that it will ask Parliament to give us a new power. The final rules published with this policy statement are set out in Appendix 1.

Unenforceability

4.1 As set out in the consultation paper, we propose to make credit agreements that breach the cap irredeemably unenforceable against the borrower (so that there is no opportunity to apply to court to allow the agreement to be enforced). The effect of our proposal was that the consumer, under an agreement that breached the rules, could elect not to perform the agreement (i.e. not to repay the loan with charges) and, in those circumstances, the lender had to repay any charges made but the consumer had to repay the credit.

4.2 In the consultation we asked:

> **Q7: Do you agree with our proposals on unenforceability?**

Summary of responses

4.3 There was strong support for our proposal to make agreements irredeemably unenforceable, although some firms argued that the approach was disproportionately in favour of the consumer. Some of these responses suggested alternative approaches, such as refunding charges collected in excess of the price cap, differentiating between deliberate and accidental breaches or applying a 'de minimis' principle to breaches of the rule.

4.4 A small number of non-industry respondents argued that consumers should not be required to repay the loan, or should only be required to repay 80% of the principal.

4.5 A few responses argued that we had outsourced the enforcement of the price cap to vulnerable consumers. In particular, a couple of consumer bodies argued that these provisions will rely on consumers being aware of their rights and taking action, so we will need to raise awareness. There was also some confusion about our role in supervising and enforcing the cap.

4.6 Several responses queried how the rules will apply to consumers and the consequences for the consumer of failing to repay. One lender argued that there will be no practical means available to the lender to recover the principal from the borrower. They sought clarification about the steps that a firm may take to recover the credit if the borrower fails to repay an unenforceable agreement.

4.7 A couple of firm responses proposed amending the rules to clarify the timeframe within which a consumer must repay the capital once the interest and charges have been refunded by the firm, and to introduce a provision to enable a firm to net out these payments.

Our response

The aim of this proposal is to incentivise firms to ensure that they comply with the price cap. Most responses agreed that we had got the balance right and that making any agreements in breach of the price cap, irredeemably unenforceable would have the required deterrent effect. We do not think that any of the alternatives would have the desired incentive effect, without unnecessarily penalising firms. We have not changed our proposal, but we have clarified how it will work in practice.

Under the proposed rules, when an agreement is unenforceable against the borrower, the borrower may choose not to perform the agreement and the lender must repay to the borrower any charges paid by the borrower under the agreement within seven days of the request. Where the borrower recovers those charges, the borrower must repay any credit received under the agreement to the lender.

Firms will be able to take legal action for restitution of the credit where the borrower fails to repay the outstanding principal. We have amended the draft rules to clarify that once a firm has repaid the interest or charges to the consumer, or indicated that there are no charges to repay, a consumer should repay the outstanding principal 'within a reasonable period and that in any event the lender must not demand repayment in less than 30 days'. We have also highlighted that in these circumstances we expect firms to treat their customers fairly, and in line with the Principles for Businesses (particularly PRIN 6).

We would expect firms to take into account the financial situation of the borrower in deciding what is a reasonable period. That will depend on the circumstances of the case, for instance, where the loan was repayable by instalments the firm should consider issuing a repayment schedule which reflects the instalment periods under the loan.

One advantage of the total cost cap is that it will help consumers to identify breaches of the price cap. As with any complaint, where consumers believe that they have an agreement with a firm that breaches the price cap, they should first contact the firm and complain. If they feel that the firm has not handled the complaint fairly, they can contact the Financial Ombudsman Service. We also anticipate that many breaches will be identified by organisations that are providing consumers with debt advice.

We have set out our approach to supervising the cap in Chapter 6. We will carry out pro-active supervision with firms as well as event-driven work responding to intelligence about breaches of the price cap. We collect intelligence in a variety of ways, including directly through our consumer contact centre, as well as through debt advice organisations and the Financial Ombudsman Service. Where we identify breaches of the cap, we have a range of supervisory and enforcement tools that we can use to address the issue.

E-Commerce Directive

4.8 As we highlighted in the consultation paper, there is a risk that some firms will try to avoid the price cap by lending online from other European Economic Area (EEA) member states under the E-Commerce Directive (ECD). We proposed rules to prevent:

- UK-based debt collectors from collecting debts arising under HCSTC agreements entered into by incoming ECD lenders whose charges exceed the price cap
- UK-based debt administrators from enforcing or exercising rights on behalf of a lender under such HCSTC agreements

4.9 We also said that we had been discussing a power to take action where firms are abusing their EU right to free movement with the Treasury.

4.10 In the consultation we asked:

> **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?**

Summary of responses

4.11 The responses from firms and consumer groups were overwhelmingly supportive of these proposals, although there was concern from some firms about whether these measures would be effective. Some respondents also suggested that consumers need to be better informed or educated so that they can identify FCA-regulated firms.

Our response

We are aware of the potential of online firms establishing elsewhere in the EEA and selling into the UK under the ECD.

These firms would not be unregulated. They would be authorised in their home member state and would need to comply with relevant provisions of the Consumer Credit Directive, the ECD, the Distance Marketing Directive, the Unfair Commercial Practices Directive and the Unfair Terms in Consumer Contracts Directive. They would not be able to engage in unsolicited marketing by email and the directive is limited to online services, so for example they cannot use voice telephony. In the event of non-compliance with those provisions, we would be able to request the home state regulator to take action against an incoming firm. We are also able to take action against an incoming ECD firm on an individual firm basis in limited circumstances.

The Treasury has already announced its intention to lay before Parliament, ahead of the cap coming into effect on 2 January, an Order to confer a power on the FCA allowing us to take action if an incoming firm abuses the EU right of free movement by establishing in another member state, with a view to avoiding rules that would apply if it had been established in another member state.

Given the strong support, we have not made any changes to the proposals. However, we propose to make improvements to the search function on the Financial Services Register to help consumers identify FCA-regulated firms.

Handbook rules

4.12 We included the draft Handbook text in appendix 1 to the consultation paper, and highlighted a number of key points in relation to the draft rules in paragraph 5.79. In addition to the unenforceability and the ECD discussed above, this included the interaction with early repayment, provisions to deal with avoidance of replacement agreements and charges for ancillary services.

4.13 In the consultation, we asked:

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

Summary of responses

4.14 A number of firms raised detailed questions in relation to the proposed Handbook rules and how they would work in practice. The main issues are set out below.

- applying the cap to agreements entered into before 2 January 2015, but modified on or after that date.
- how the price cap is calculated
- the range of charges that the cap applies to – ancillary charges

4.15 Firms raised a number of other minor technical issues which we have considered, and in a number of cases we have provided further clarification. These are set out below.

Applying the cap to agreements entered into before 2 January 2015 but modified on or after that date

4.16 One firm queried how the rules would apply to agreements that are entered into before 2 January 2015 but supplemented or varied after that date. They wanted to know whether the rules are intended to apply to these agreements only in a forward-looking manner, or whether lenders need to consider costs applied before 2 January.

Our response

In light of this response, we have decided to amend the rules and provide guidance to make it clear that – if the effect of a variation or an exercise of a contractual power is to impose a charge, or if a charge results from the variation or an exercise of a contractual power – charges imposed before 2 January 2015 must be taken together with charges imposed after that date for the calculation of the price cap. This was the intention of our proposal.

If a firm rolls over or refinances an agreement (by varying or supplementing it) and continues to charge interest, the price cap will apply. It would not apply where the variation is to postpone repayment because the firm is exercising forbearance and is not charging any further interest or charges on or after 2 January, or where the variation is to change an address after 2 January, or other variations unrelated to charges.

We recognise that this may make firms reluctant to vary an HCSTC agreement that is entered into before 2 January 2015 if that would impose a charge. This will mean that some consumers may be unable to refinance HCSTC agreements. In this situation firms are required to comply with Principles for Businesses (in particular PRIN 6) and CONC 7 and treat consumers in arrears and default with due consideration which includes considering suspending, reducing, waiving or cancelling any further interest or charges.

Calculating the cap

4.17 Two specific points were raised in relation to calculating the cap.

4.18 One firm argued that the proposed rules relating to refinancing would have a disproportionate impact on loans with declining principal, and that it was inconsistent with the way that the rule applied to other loans which are refinanced. They argued that it would have an adverse impact on the way in which they deal with their customers' requests for further credit.

4.19 Another lender suggested that running account credit should be treated the same way as instalment products for the purpose of the calculation of the total cost cap.

Our response

We have considered the impact of the rules on refinancing and whether this is inconsistent. We have decided to amend the rule on refinancing to ensure that it is consistent and that it does not have an adverse impact on loans with declining principal. The outcome is that the total cost cap will be based on the combined amount of the earlier and the later agreement but that this must not include any amount under the replacement agreement that merely repays the earlier agreement (whether credit or a charge for credit). This is to ensure no double counting.

The combined effect rule is equivalent to allowing a firm to enter into a separate agreement. The effect of these changes will be to ensure consistency between different types of refinancing (replacement agreement, variations, etc.) and different types of agreements (single payment, instalment, declining principal). It will ensure that the total cost cap is calculated as a percentage of the amount that the lender actually advances. It is also consistent with our decision not to allow compound interest and will avoid gaming of the total cost cap rule by firms re-lending where no amount is repaid at all or only a small amount is repaid or where charges are capitalised and added to the amount lent to inflate the amount of credit provided.

We have also added a rule to make clear that a variation or supplement done by exercising a contractual power which imposes a charge is counted in the calculation of the total cost cap. This is merely another way to achieve the same effect as the existing refinance rule.

We do not propose to amend our position on running account products in light of the responses to the consultation. For these products, where a borrower makes a repayment that refreshes the credit facility, our rules ensure that the total cost cap is the lesser of the amount of credit actually advanced or the credit limit. This is necessary to ensure that the protection of the total cost cap is not undermined for consumers who use running account products. If the total cost cap is calculated as a percentage of the amount that the lender actually advances, there will not be sufficient constraint on the amount of time that the consumer can be charged under the initial cost cap. We consider this to be particularly problematic for running account products as firms are only required to carry out a further assessment of affordability before significantly increasing a credit limit, and not before each drawdown.

In practice, we have found that some of these products are not genuine running account credit. Where the lender requires a consumer to seek permission for each additional drawdown, our rules make it clear that the lender should treat these as separate credit agreements, applying affordability assessments and the price cap rules and the relevant provisions of the CCA to each instalment. For further information on the calculation of the price cap, please see Table 4.1 at the end of this chapter.

The range of charges that the cap applies to – ancillary services

4.20 There was general support for the inclusion of debt collection, brokerage and other ancillary services, suggesting that this would help to prevent the risks of gaming the cap. However, some consumer groups suggested that it was not clear what restrictions would be placed on brokers who do not have a direct relationship with the lender. They argued that in most cases the fees charged by brokers are excessive and often charged irrespective of whether a loan is actually taken out.

4.21 Other respondents raised concerns that third party debt collection charges will only be included if they are included in the initial loan agreement. Some firms and trade bodies strongly argued that debt collection charges made by third party agencies should be excluded from the cap.

Our response

We share the serious concerns of some respondents about the fees charged by HCSTC brokers but do not consider that the price cap is the way to address them. We are taking supervisory action where appropriate. We have existing rules in relation to broker fees but are looking at whether they need to be strengthened in the light of evidence of abuse by some firms.

As we made clear in the consultation paper, all contractual debt collection charges are within the scope of the cap, including where a third party debt collector levies a direct charge on the consumer. The cap would also apply if the loan is sold to a debt purchaser, or the collection is outsourced to a third party debt collector. However, it should be noted that if a firm is able to recover damages in court proceedings under a court order, these are outside the cap rules.

We have made a small amendment to make clear that a charge for an ancillary service (defined in CONC 5A.6) is to be included in the calculation of the default cap, as well as in the other elements of the cap (see CONC 5A.3.21R). We have not made significant amendments to the other rules on the application of credit brokerage, debt collection charges and other ancillary charges.

Other minor changes

4.22 Various respondents asked for further guidance on how the price cap rules apply where there is early settlement.

4.23 A respondent queried if the word 'impose' is appropriate in relation to a situation where a firm agrees to a modification of an agreement.

Our response

We have provided further guidance to make clear that while early settlement does not reduce the amount of credit outstanding for the calculation of the initial cost cap, this has no impact on the application of the Consumer Credit (Early Settlement) Regulations 2004 under which a consumer may be entitled to a rebate.

We have addressed the query about the meaning of 'impose' by adding guidance to clarify what it covers (see CONC 5A.6). We take the view it has a broad meaning and includes making an agreement with the borrower as well as other situations where a lender makes a charge.

Table 4.1 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
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.	Initial cost cap: calculated as a percentage of the outstanding principal on the day in question from the date on which the borrower draws down until repayment is due or the credit is actually repaid (CONC 5A.2.3R and 5A.2.7R, 5A.3.3R and 5A.3.7R) Total cost cap: calculated as a percentage of amount the lender actually advances (CONC 5A.2.6R and 5A.3.6R).	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. There is no difference in how the total cost cap impacts single payment and instalment loans.
Single payment loan with top up Lenders may allow borrowers to borrow more (top up) during the agreed loan duration.	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. This could be done either by separate loans or by variation/ supplement or a replacement loan.	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.
Refinanced loan A loan is refinanced if it is replaced by another loan or the original loan is varied or supplemented. .	The total cost cap will be based on the amount of credit provided under both agreements, however firms must not count any amount provided to the borrower to repay any amount of credit or charge outstanding under an earlier agreement (CONC 5A.2.13R), Where a loan is extended by the lender exercising an indulgence (i.e. there is no replacement agreement) that is covered by CONC 5A.2.2R and 5A.2.3R and 5A.3.2R and 5A.3.3R (the total cost cap and initial cost cap).	The impact on refinanced loans is the same as if the loan was a single payment loan with top up. The additional borrowing is added to the original principal for the purposes of calculating the total cost cap, but that this must not include any amount that merely repays the earlier agreement (whether credit or a charge for credit). This is to ensure no double counting. It is reasonable that the lender is able to take into account any additional sums borrowed at refinancing when calculating the total cost cap. The effect of these changes is to ensure consistency between different types of refinancing (replacement agreement, variations, etc.) and different types of agreements (single payment, instalment, declining principal)
Running account credit The borrower may draw-down credit up usually to an agreed credit limit and make repayments of a specified minimum amount. Repayments are taken into account and borrowers may make drawdowns to that limit. Cumulative borrowing over the course of the loan may exceed the credit limit.	Initial cost cap is calculated on the actual amount of principal outstanding on the day. The total cost cap is calculated on the lower of: – the credit limit – the amount the lender actually advances.	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.

5.
Data sharing and repeat borrowing

This chapter summarises the feedback we received on our proposals relating to real-time data sharing and repeat borrowing, and our response.

Significant progress has been made in this area recently, with the vast majority of the HCSTC market now participating in real-time data sharing and the vast majority of loans being reported in real time, in line with the target set out in the consultation paper.

In view of this significant progress, and likely impact on the HCSTC market following the introduction of the price cap, we do not propose to consult on introducing real-time data sharing requirements at this time. However, we expect further improvements in coverage in the near future following the recent launch of real time services by the larger credit reference agencies (CRAs). We will continue to press the industry to make progress on real-time data sharing so that up to date information is available to enable lenders to make adequate affordability assessments, delivering better outcomes for consumers.

We also propose to undertake further work to assess the impact of repeat borrowing and the extent to which lenders are adequately assessing affordability in this context.

Data sharing

Introduction

5.1 We have strongly encouraged the industry to improve data sharing in the HCSTC market. In the consultation paper we reviewed progress and indicated that there had been improvement, but that more needed to be done. We said that if there was insufficient progress we would consult on introducing data sharing requirements. We said that, by November 2014, we expected:

- the vast majority of firms in the HCSTC market to be participating in real-time data sharing
- the vast majority of loans to be reported in real time and
- firms to share data with more than one credit reference agency (CRA)

5.2 We indicated that by ‘vast majority’ we meant more than 90% of current market participants by market share and by volume of loans. We said that we would request information to get an accurate picture of whether these standards had been met.

5.3 In the consultation we asked:

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

Summary of responses

5.4 There was general agreement about the potential benefit of real-time data sharing for both consumers and lenders. The majority of respondents therefore supported the greater use of real-time data sharing, although views were mixed about the need to mandate data sharing.

5.5 Many consumer groups and social lenders argued that mandatory requirements should be introduced to encourage real-time data sharing. They were concerned about the impact on consumers of having multiple HCSTC products at once and argued that real-time data sharing is necessary to enable firms to make accurate lending decisions. Most consumer groups supported mandating real-time data sharing between firms and CRAs, although some noted that improved data sharing would not automatically lead to better affordability assessments. Many responses highlighted that there are different definitions of what constitutes 'real-time' data sharing, and expressed concerns about the effectiveness of different products to capture multiple borrowing within a very short period.

5.6 A small number of respondents supported the introduction of a regulatory database, i.e. where information regarding HCSTC borrowers is held on a central database to which all HCSTC lenders are required to contribute. Some argued that such an approach is necessary to monitor and enforce compliance with lending rules, for example on rollovers or the use of continuous payment authorities (CPAs).

5.7 Trade associations and some firms argued that mandating real-time data sharing was unnecessary following recent progress in developing market solutions, and identified a number of consequences of mandating data sharing that may have an impact on the efficient operation of the market. These included an increase in costs, which may have a disproportionate impact on smaller firms and create additional barriers to entry in the market. In addition, some argued that mandating real-time data sharing in the HCSTC market could affect the ability of individuals to obtain mainstream credit.

5.8 Firms were generally supportive of the benefits of real-time data sharing, although they had concerns about the November target given practical and technological constraints. They also raised concerns about the cost implications and the potential for CRAs to increase their charges if mandatory requirements were introduced. However, some firms strongly supported mandating data sharing in real-time, and argued that such a solution should be extended beyond HCSTC across the entire consumer credit market.

Recent progress

5.9 We made an information request to six CRAs in September using our formal powers to get an accurate picture about the nature and extent of real-time data sharing in the HCSTC sector. The request also sought information about non real-time services offered by the CRAs to build up a fuller picture of the CRA market for HCSTC. We also reviewed a list of changes that a number of lenders have made to their lending criteria since the introduction of FCA regulation in response to a separate data request for the price cap.

5.10 The responses indicate that CRAs offer a diverse range of services and products, which have been developed in response to market and regulatory developments. There has been considerable progress in the last year, and the larger CRAs have all launched real-time data sharing products, alongside the products provided by smaller CRAs.

5.11 Recent product developments include:

- Callcredit (Moda) – launched June 2014
- Experian – launched July 2014
- Equifax in partnership with LendingMetrics (TrueTime) – launched September 2014

5.12 As we said in the consultation, we expected the 'vast majority' of firms in this market to be participating in real-time data sharing by November, and the vast majority of loans being reported in real time. Based on the data we received, we calculated that around 90% of HCSTC lenders by market share (based on 2013 revenues) are presently sharing data in real-time, representing between 80-90% by volume of loans written. All the CRAs are in discussion with lenders to expand their take-up of real-time services, with more lenders expected to be participating by the end of the year.

5.13 However, not all lenders report data to more than one CRA in real time. Where firms are using niche CRAs that re-sell data held by larger CRAs, the data from the lenders is usually reported to the larger CRAs on a monthly basis, so we do not consider this to be sharing with two CRAs in real time.

5.14 There is no standard industry definition of what constitutes 'real-time' data sharing. Some CRAs provide for instantaneous updating and searching of data, while others operate on the basis of daily batch reporting.

5.15 Trigger events for reporting generally include events such as new accounts, settled accounts, missed payments, credit extensions, roll overs and changes to payment terms. However, the events that trigger a real-time update vary between CRAs, with some providing updates in real time across a range of triggers, while others only report open and closed accounts in real time.

Our response

We recognise the benefits of real-time data sharing, which will help firms to get a more accurate and up to date picture of a consumer's outstanding credit commitments and enable them to better assess the affordability of a loan. This should lead to positive outcomes for consumers, including preventing some consumers from taking on loans they cannot afford. We also recognise that up to date CRA data is important for new entrants in the HCSTC market.

Given the significant progress made, and the likely impact on the HCSTC market following the introduction of the price cap, we expect the high proportion of HCSTC firms currently participating in real-time data sharing to increase even further by the time the authorisation process for the vast majority of HCSTC firms is complete in early 2016.

There have been significant improvements, but more needs to be done. In order to improve coverage of real-time databases, not only do firms need to participate in real-time data sharing but they also need to share data in real time with more than one CRA.

In their payday lending market investigation, the CMA noted the progress made in this area and that real-time systems are still evolving, so there may be additional risks of seeking to achieve change through imposing prescriptive requirements. Instead, the CMA provisionally recommended that we continue to work closely with lenders and CRAs to encourage the development and use of real-time data sharing systems that are open to all payday lenders and other credit providers.

Many respondents expressed concern about the frequency of certain 'real-time' products, and whether it would capture multiple borrowing within a very short period. We have undertaken further analysis to understand the extent of multiple borrowing within a very short period. Our data indicates that only 1% of loans taken out are from different lenders on the same day. As all of the 'real-time' products currently available in the market are updated at least on a daily basis, they would capture the vast majority of loan decisions in the HCSTC market.

It is also worth noting that application searches do appear in real-time, so lenders will be aware if consumers are applying for multiple loans on the same day. However, we expect the industry to continue to improve the services they offer, and to improve consistency between databases to make it easier for firms to share data in real-time with more than one CRA.

We require firms to carry out individual affordability assessments, which includes considering consumers' other financial commitments. This requires an individual judgement in each case, rather than applying blunt lending restrictions enforced by a regulatory database such as the models used in some US states. We believe that our approach to regulation is already having a significant impact on the HCSTC market as reflected by the recent reductions in lending.

Our authorisation and supervision processes will rigorously assess the business models of lenders to ensure that these rules are complied with and consumers are treated fairly. In view of this we do not think that it is necessary to introduce a regulatory database.

In view of recent progress made by the industry on real-time data sharing, we do not propose to mandate data sharing requirements at this time. We are concerned that this would add unnecessary complexity and may impede the development of innovative market solutions.

Next steps
Most HCSTC firms will be required to apply for FCA authorisation by 28 February 2015. As part of that process, we will challenge firms about the robustness of their affordability assessments, and their use of CRAs and real time data in particular. If HCSTC firms are not using real-time data, they will need to be able to demonstrate how they are factoring consumers' up to date credit commitments into their affordability assessments.

We will consider the recommendations made by the CMA and what role we should play in addressing these.

We see clear benefits to real-time data sharing. We will monitor progress closely to ensure that CRAs and firms continue to make improvements in this area, and come forward with rules if we detect any loss of momentum.

Repeat borrowing

5.16 In the consultation paper, we noted significant levels of repeat borrowing that could indicate patterns of dependency on HCSTC that are harmful to borrowers. We said we had considered several options:

- bringing repeat loans under the total cost cap

- capping **repeat borrowing** (the number of times a borrower can borrow from the same lender in a given period) and
- capping **multiple borrowing** (the number of times a borrower can borrow from any firm in a given period)

5.17 We did not propose that the total cost cap should include repeat loans due to the significant constraint this would impose on repeat lending and the additional complexity this would add to the rules. We concluded that the most appropriate way to tackle repeat borrowing was to apply the price cap in the same way as for a first loan. We noted that we have other tools which could be used to deal with the detriment caused by repeat borrowing, in particular robust supervision of affordability requirements and the rollover cap that came into effect on 1 July 2014.

5.18 In the consultation we asked:

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

5.19 We received over 40 responses to this question, with just under half supporting our proposals and the majority wanting us to introduce specific rules on repeat borrowing. Some stakeholders were very concerned that we were not proposing any new measures beyond monitoring, which would encourage firms to exploit loopholes. Others pointed out that real-time data sharing would be an invaluable tool for reducing the rate of repeat and multiple borrowing.

5.20 One firm argued that a restriction which further reduces profitability will significantly affect and further reduce the financial viability of the HCSTC market. Another respondent suggested that applying stringent restrictions on repeat lending could harm borrowers if they are not able to access credit that they could otherwise afford.

5.21 Only three respondents specifically referred to multiple borrowing from different lenders rather than repeat borrowing from the same lender. One firm agreed that customers should not have concurrent loans from multiple lenders, suggesting that responsible lenders should have procedures in place to ensure this does not happen.

5.22 Several respondents wanted specific rules to address repeat borrowing including:

- limiting repeat borrowing in the same way as rollovers
- capping the total number of loans per consumer
- introducing a cooling-off period between loans
- a ban on direct marketing to existing customers
- lower prices for repeat loans; and
- more signposting to information on debt advice

Our response

In considering the issue of repeat lending, we must balance consumer protection against the impact on firms and competition, and consider the most proportionate way to minimise harm to consumers. The wide range of types of intervention proposed by respondents highlights this difficulty, particularly when so many other changes are in progress or have yet to take effect.

We have considered all the suggestions to tackle repeat borrowing proposed by respondents. Introducing a cap on the number of loans a firm can give to a consumer in any given period could exacerbate multiple borrowing with different lenders or drive consumers to other sources of potential credit. Introducing a limit on the number of loans a consumer could have at any one time would be a very blunt measure which would require a regulatory database (see our response above on data sharing). Introducing a cooling-off period between loans with the same firm could potentially increase the risk of multiple borrowing, including via other forms of credit. A ban on direct marketing to existing customers links into wider work that we are doing about financial promotions generally, including frequent texts and emails customers receive from lenders encouraging them to take out more loans.

We understand the logic behind the suggestions for rules to try to prevent harm to borrowers who have clearly suffered through debt spirals. Such individuals are repeatedly paying an unnecessarily high price for their initial shortfall. However, we must weigh up the balance between the impact on firms and the consequential impact on competition, and consider the most proportionate way to act to minimise harm to consumers.

Given the strong concerns expressed about repeat and multiple borrowing, we intend to do further work in addition to planned supervisory, enforcement and authorisation work. We will review more up to date data on the extent and impact of repeat lending, determine whether lenders are adequately assessing affordability, and identify which tools would be most effective in reducing detriment. If we decide that new rules would be appropriate, we will consult next year.

6.
Supervising and reviewing the price cap

In this chapter we set out the comments received on our proposed approach to supervising the price cap (Chapter 6 of the consultation paper) and give our response. We also confirm that we will review the cap two years after implementation, in the first half of 2017. In the meantime we will monitor its operation closely, focusing on any unintended adverse consequences for consumers or firms.

Supervision

6.1 In paragraphs 6.1-6.3 of the consultation paper we said we would supervise the price cap as part of our standard supervisory model, with particular focus on proactive supervision (where we engage with firms to assess whether they have the interests of consumers and the integrity of the market at the heart of their businesses) and event-driven reactive supervision (where we will respond to intelligence on any breaches of the cap).

6.2 There was some confusion about our role in supervising and enforcing the cap, with respondents to the proposed unenforceability provisions suggesting that we were outsourcing the enforcement of the cap to vulnerable consumers.

6.3 Other respondents commented that we needed to ensure we were resourced to carry out proactive and robust supervision of the cap and affordability requirements, and that this monitoring should be constant, or at least frequent, and should not be simply in response to complaints. Some suggested using supervision or enforcement visits, or mystery shopping, to monitor compliance.

Our response

We will supervise compliance with the price cap as part of our standard supervisory model.[18] We believe that this adequately supports our objective of being forward-looking and pre-emptive through: proactive structured assessment of firms (which usually involves focused firm visits); event-driven work dealing with emerging problems identified through intelligence; and thematic reviews, which can involve firm visits or mystery shopping.

18 Our standard supervisory approach is explained in the following document: www.fca.org.uk/static/documents/consumer-credit-being-regulated-guide.pdf

We will monitor carefully how firms change their strategies in response to the cap, which will be assessed as part of the supervisory, as well as the authorisation, process. We will also respond to any instances where we believe firms are seeking to circumvent the new rules, and monitor the orderly wind down of any HCSTC lenders that leave the market.

When HCSTC lenders are fully authorised, the regular reporting requirements will start to apply, giving us product sales data providing details of all loans agreed. In some cases, we will need to supplement this with data on the performance of loans throughout their lives to assess compliance with the cap.

Review period

6.4 In paragraph 8.12 of the consultation paper we said we planned to carry out a review of the price cap in two years' time. There was general support for monitoring and thoroughly reviewing the cap.

6.5 On the consumer side, respondents mainly argued that the review should be brought forward from two years after implementation because firms are likely to act quickly to evade the cap, and there may be a more severe impact on consumers than anticipated.

6.6 A number of firms and trade associations also called for an earlier review in the event of unintended consequences, arguing that we have underestimated the impact on firms and the possible risks for consumers of losing access to HCSTC. One called for an annual review over the next two years (setting the price cap high for the first period).

6.7 One respondent asked for clarity about how consumer groups will feed in to the review.

Our response

We chose two years to allow a period of stability after the introduction of the cap and other recent regulatory changes for HCSTC firms. A review period of less than two years would also not provide an adequate run of data for assessing the impact of such a complex intervention.

We also considered it to be a proportionate use of resources given that a substantial amount of work is likely to be necessary to review the impact of the cap and explore whether alternative structures and levels would be more appropriate. We need to consider the burden it will place on firms, given the extensive amount of data that will be needed.

We consider that the difficulty of adequately assessing the effect of the price cap while the market is still adapting to the transfer of regulation and FCA rules is still a good reason to review the cap in no less than two years' time rather than earlier. Any future rule changes, including the implementation of the CMA remedies, might justify waiting for more than two years.

On balance, we consider that two years is a reasonable period over which to measure the impact of the cap, so we still plan to do this in the first half of 2017. We will announce nearer the time how we propose to involve consumers, industry and other stakeholders.

We recognise that unintended consequences for consumers and firms could arise earlier than this, and we will monitor for them. We will work with other stakeholders, including the Illegal Money Lending teams, to assess the impact on consumers who lose access to credit because of the cap.

7. Next steps

The price cap will come into effect on 2 January 2015 and will be reviewed in 2017. We will ask all HCSTC firms about their policies for complying with it as part of considering their applications for FCA authorisation.

Key dates

7.1 The price cap will come into effect on **2 January 2015**. Firms must ensure they are ready to comply by then with the final rules we are now publishing. We will review the cap in the **first half of 2017**.

7.2 All former OFT-regulated firms that currently have interim permissions have been told when they must apply for FCA authorisation. The application period for most HCSTC lenders starts on **1 December 2014** and ends on **28 February 2015**. All firms due to apply in this period have already been contacted on several occasions and have been sent a Credit Ready pack, containing a guide to the regime, and a jargon buster.

7.3 We also held a webinar in September, which addressed a number of questions from HCSTC firms. It is available to replay on our website.[19] We will be sending out further communications when the application period starts and as the deadline approaches.

7.4 As part of deciding whether to authorise an HCSTC firm, we will ask specific questions on its strategy and business plan, including its policies for complying with the price cap and our other rules.

Future FCA policy consultations

7.5 We plan to publish another consumer credit consultation paper in January 2015, which although not primarily focused on HCSTC is relevant in some respects to this sector. It is expected to include proposals to address issues in financial promotions, credit broking, the treatment of guarantors and referring customers in arrears to sources of debt advice.

19 fca.org.uk/firms/firm-types/consumer-credit/authorisation/authorisation-webinar

7.6 We said in Chapter 5 of this statement that we will do further work on repeat borrowing. If we decide that new rules and guidance are needed, we will consult on these, possibly at the same time as we consult on any FCA rule changes stemming from the final remedies resulting from the CMA's payday lending market investigation.

Annex 1:
List of non-confidential respondents to CP14/10

Association of Chartered Certified Accountants (ACCA)

Association of British Credit Unions Limited (ABCUL)

Bates Wells Braithwaite

BCCA

BHP Wealth Management

Care Retirement Options Limited

Cash Converters (UK) Limited

Consumer Credit Trade Association (CCTA)

Centre on Household Assets and Savings Management (CHASM)

Chapeltown Citizens Advice Bureau

Christians Against Poverty

Citizens Advice (England and Wales)

Citizens Advice Scotland

City of Lincoln Council

Community Development Finance Association (CDFA)

Community Investment Coalition (CIC)

Dollar Financial UK Limited

Fair Finance

Fidelity Works Limited

Financial Services Consumer Panel

Financial Services Practitioner Panel

Flintshire Citizens Advice Bureau

Gipton Supported Independent Living (GIPSIL)

Institute of Credit Management

IRCS Commercial Insurance Brokers

Islington Debt Coalition

Kettering Borough Council

Leeds City Council

Leeds City Credit Union

Money Advice Scotland

Moneyline

MoneySavingExpert.com

MYJAR.com

Northern Ireland Trading Standards Service

Oakam Limited

Registry Trust

Smartloan Limited

Smart-pig.com

StepChange Debt Charity

Suffolk County Council

The Consumer Council

The Key Fund

The Money Advice Trust

The Money Charity

Think Finance UK

Toynbee Hall

Trading Standards Institute

Veritec Solutions

W & A Pearson

Which?

Brian Healy

Carl Packman

Dr Carl Walker

Fergus Ewing MSP

Ian Ashworth

Julian Downing

Julian Sanders

Justin Tomlinson MP

Richard Hands

Dr Sarah Brown

Wayne Barrett

Annex 2
Feedback (and our response) to our Cost Benefit Analysis (CBA)

Introduction

1. This annex provides:

- an overview of our response to the feedback we received to

  Q10: Q10 of the consultation paper (CP) (Do you agree with the costs and benefits identified in CP14/10?)

  and to other questions where the views expressed by respondents were directly relevant to our CBA

- our views on how other amendments being made within this Policy Statement (PS) to the policy proposals as presented in the CP impact on our CBA

2. On the feedback received related to the CBA:

- we have revised our CBA estimates in response to one significant challenge. Respondents contended that changes to affordability assessments as a consequence of FCA regulatory pressure, subsequent to the period covered in our analysis, had contributed to a sharp fall in loan volumes and, consequently, revenue. This changes the 'baseline' for our CBA, and our estimate of the incremental impact of the price cap. We cover this in detail below (and further in the Technical Annex).

- we also received a number of detailed analytical challenges, which we address at a high level in the second section of this annex, and which we respond to in greater detail (including additional analysis where necessary) in the Technical Annex. Overall, we identified around 400 analytical issues, which we grouped into 20 issue types and allocated to one of three high-level groupings: supply, competition or demand.

3. We have made some amendments to the rules proposed in CP14/10. In the third section of this chapter we present our view on the costs and benefits of these amendments. We think that these changes in the main act to provide greater clarity, and align specific rules with the original policy intention.

The impact of recent changes in lending volumes and consequent changes to our CBA

4. A number of respondents made the point that there have been significant changes to the HCSTC market in 2014, primarily large reductions in lending volumes. Firms contend that much of the reduction is due to our approach to affordability rules. They argue that this has caused them to tighten their lending criteria significantly.

Our response

5. This new evidence was not available at the time of carrying out our analytical work for the consultation. It was therefore not captured in our 2012/13 data sample and was not reflected in our supply-side analysis estimating the scale of loss of access to credit and market exit under different cap levels.

6. In our previous modelling we made adjustments for the impact of rules restricting CPAs and rollovers, but not for the impact of FCA regulation on lenders' affordability assessments. In setting the baseline for our original analysis, we had discussed the adjustments that should be made with firms. Our affordability rules reflected the OFT's guidance, and we had assumed for modelling purposes that firms were implementing the guidance[1] and therefore would be compliant with the rules.

7. Given the responses received, we undertook further analysis to assess the impact of the recent changes in lending volumes.

Revised supply-side analysis

8. We requested data from each of the 11 firms we had modelled in our previous supply side analysis as set out in CP14/10. This data included monthly volume and value of loan applications, and loans written between September 2013 and August 2014 in total and split by credit score band, as well as a list of changes the lenders had made to their lending criteria since FCA regulation.

9. We started by considering three key questions:

- to what extent did fluctuation in demand, affordability assessments, pre-authorisation changes and expectation of the price cap change lending volumes?
- to what extent do these changes overlap with the effects of the price cap?
- to what extent are these changes temporary or permanent?

10. Our analysis of the data provided by firms shows:

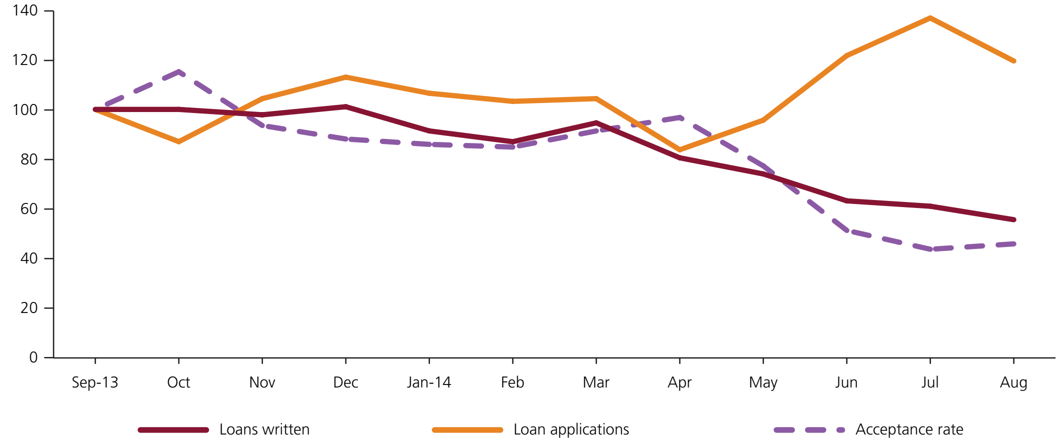
- a clear reduction in the volume and value of lending (of around 35%) between March and August this year – though this varies between firms. This does not appear to be driven by decreasing demand. Overall applications increased during this period (see Figure 1). However, some of this increase in applications may actually arise due to firms rejecting customers and those customers applying for loans elsewhere, hence increasing the overall number of applications.

1 OFT was entitled to take into account the failure of a licensee to comply with its guidance in its licensing decisions (see section 25A of the CCA).

- a sharp reduction in firms' acceptance rates from April 2014 when the FCA regulation of the consumer credit market transferred from the OFT. This suggests that FCA regulation has affected firms' lending decisions although it is currently unclear whether the magnitude of this change will be sustained as regulatory uncertainty recedes for firms.

- that, among the firms with the most sophisticated credit scoring systems, virtually all of the lending reduction has been among lower credit score borrowers (who are less creditworthy). This evidence suggests changes in acceptance rates have primarily affected less creditworthy applicants. Analysis of the changes lenders have made to their lending criteria shows that by construction these will largely affect less creditworthy individuals.[2]

Figure 1: Monthly volume of loan applications and loans written Aggregate; Indexed (September 2013 =100)



Source: Additional firm data request. Acceptance rate defined as loans written / loan applications

11. The data therefore suggests that the reduction in lending largely affects the least creditworthy group of borrowers. The significance of this is that the price cap also works to exclude the least creditworthy customers. Therefore the price cap will have a smaller incremental effect on the loss of access to credit (compared to the analysis presented in the CP). Many less creditworthy borrowers predicted to lose access in the CP analysis have already lost access. The loss of access for higher credit score borrowers is limited.

12. We ran additional analysis using our supply side model. To capture the composition of reduced lending seen over the recent period, we applied an assumption that 80% of the reduction in lending volumes goes to customers with the lowest credit scores.[3] Given uncertainty about how firms might change their behaviour in the future we have modelled four different scenarios for the evolution of total lending in the market, the results of which are detailed in the Technical Annex. These scenarios range from a further reduction in lending to a partial recovery in lending. We present here the outcomes of the 'base case', which models the current market using 2014 lending volumes.[4]

2 Details in Technical Annex supply section

3 Our analysis of evidence suggested a very strong relationship between reduction in lending volumes and the creditworthiness of customers affected. We tested the sensitivity of the assumed 'credit score related weight' to use for modelling (as displayed in Table 1 of the Technical Annex). This showed limited difference if the weight was chosen to be 70%, 80% or 90% – not changing firm viability estimates or the value of loans, making a negligible difference to revenue and firm customers, and a fairly small impact on contributions. Therefore combining our analysis of data received from firms and this sensitivity analysis we chose to use an 80% credit score related weight.

4 The volume reduction was set for each firm based on the change each had experienced from 2012/13 to August 2014.

Revised baseline

13. The revised baseline (i.e. without any price cap) using the base case scenario shows that firms would write loans that were 41% less in value, and would have 45% less revenue and consequently 36% less contribution (profit before overheads) than the baseline employed in the original CBA in CP14/10.

14. More firms are unprofitable than previously estimated (and so are at greater risk of exit) before the impact of the cap because their revenues have already fallen due to reduced lending levels. However, in practice these firms have not exited the market or indicated that they plan to do so. Our exit modelling appears conservative given that there has been less market exit than predicted in the CP, with a number of firms (including listed firms) making public statements of their intention to remain in the market.

15. While we have modelled this revised baseline and consequently revised our estimates of the incremental impact of the price cap (presented below), disentangling and precisely allocating impacts to drivers is difficult for the following reasons:

- firms that are operating in regulatory uncertainty, being the focus of supervisory action, and in the process of applying for FCA authorisation may be acting cautiously, explaining in part the reduction in lending volumes. This would suggest a partial recovery in volumes in future, implying that the incremental impact of the price cap could be higher than our central estimates.

- despite not knowing the price cap's level or structure, lenders might have anticipated that this would reduce the expected future profitability of customers and therefore changed their lending decisions. This would imply that part of the impact of the price cap is actually captured in the revised baseline and the actual impact of the cap is greater than in our estimates below. This effect may be somewhat offset by firms trying to lend as much as they can before the price cap comes into effect.

- while we are confident in our modelling of CPA and rollover restrictions in the original and revised baselines, interactions of these with the affordability regime could mean that the counterfactual is different than our baseline in ways not yet observed in the data.

16. We partly address these through our modelling of four different scenarios for the evolution of total lending in the market.

Box 1: Revised impact of price cap

We summarise the revised static incremental impacts of the price cap to the new baseline using the base case scenario below.

Firms and competition

We estimate that our proposals would have the following impacts across the market:

- reduce the value of loans by 4% from the revised baseline – around £60m p.a. (in the CP we had estimated an 11% reduction of around £270m from the original baseline)
- reduce revenues for firms by 39% – around £220m p.a. (in the CP we had estimated a 42% reduction of around £420m)
- reduce contributions (profitability before overheads) for firms by 43% – around £120m p.a. (in the CP we had estimated a 43% reduction of around £190m)
- as a consequence of the fall in profitability, cause a limited number of firms in the market to exit (beyond exit already initiated by other factors captured in the revised baseline), though dynamic responses from firms may mitigate this impact

The static model suggests perhaps an additional two or three firms (±1) of eight firms modelled may be at risk of exit from becoming unprofitable as a result of the cap. This assumes that such firms would not change their business practices to operate profitably under the cap.

The static model estimates an increased number of firms becoming unprofitable at the revised baseline. In combination the model would suggest fewer firms remaining operational in the market than estimated in the CP (where the static analysis suggested that, as a conservative estimate, perhaps three firms might remain).

There are several reasons why we do not consider this likely to be reflective of the actual situation in terms of market participants:

- the static model of firm profitability under the cap is a cautious assessment as it does not fully reflect firms dynamically changing their business to remain viable.
- a combination of consultation responses, public announcements and discussion with lenders indicates that a significantly higher number of lenders are likely to remain in this market than the model indicates. This includes some of the lenders the static model estimates as becoming unviable.
- the base case makes a cautious assumption that the reduced levels of lending at August 2014 will continue. We consider that it is probable that lending volumes will recover to some extent, as firms see reduced regulatory uncertainty following the imposition of the cap and having completed authorisation.

- when we model a scenario of 'no price cap' with the new baseline, the estimate is that only four firms are at low risk of being unviable. All eight of the firms in our sample are, however, continuing to operate at present. While some firms may exit shortly, we think it is probable that part of the difference is due to the cautious nature of the model.
- one high-street firm has stated publicly that it expects to continue to operate under the cap and has acquired several new stores recently.

We are confident that the implementation of the price cap at the structure and level set out in this policy statement will not prevent a viable market.

Consumers who would continue to be served in the market

We estimate that around 870,000 people a year (93% of individuals who would otherwise be served in the absence of the price cap) would continue to be served under our proposals. For these individuals we estimate an average saving of £180 each, translating into £157m saving in aggregate per year, due to lower prices.

This £157m saving for consumers is a transfer from firms who suffer a reduction in revenue. However, it is likely that beyond the transfer this leads to welfare gains, one aspect of which we describe here. Many of these customers may be in financial distress, as demonstrated in CP14/10. They would consequently further benefit from the reduced risk of suffering payment problems (both HCSTC and non-HCSTC related), which have financial, stress-related, mental-health and welfare consequences. There is extensive evidence of negative non-financial consequences of being in payment problems.[5] One dimension of this is the effect on psychological health associated with being unable to repay debt on which widespread evidence exists. For example, Gathergood (2012) finds that the inability to make debt repayments causes an individual's psychological health score to deteriorate by 20%.[6] The Centre for Social Justice's 'Maxed Out' report further cites evidence that those struggling with unmanageable debts have a 33% increase in risk of developing mental health problems.[7]

This revised estimate compares to our original CP CBA estimate of 1.3 million people (89% of individuals[8]) continuing to be served, benefitting from an average saving of £193 each, translating into £250m saving in aggregate per year due to lower prices.

5 A detailed discussion of wellbeing and psychological impacts associated with consumer debt difficulties please is in the Technical Annex demand section

6 Gathergood, J (2012), Debt and depression: causal links and social norm effects, Economic Journal, 122(563), 1094-1114

7 Centre for Social Justice (2013), Maxed Out: Serious Personal Debt in Britain

8 The 870,000 people a year that we estimate will continue to be served is 93% of all people who would otherwise be served using the revised baseline. Our previous estimate of 1.3 million people continuing to be served is in absolute terms higher, but this is a lower percentage (87%) of the original baseline (where a larger number of people were served).

We view the protection provided by the initial cost cap to those who are still granted credit as having a substantial benefit, and a greater proportion of the total benefit than considered at the time of our consultation (with 93% of those who would otherwise be served now continuing to be served after the price cap).

For consumers who continue to obtain HCSTC loans the price cap rules, in contrast with the affordability rules which have no effect once an applicant has been granted a loan, continue to provide substantial protection against excessive charges.

Consumers who would no longer get loans
We estimate that 70,000 people a year (7% of individuals who would otherwise be served) would be denied any loans due to the incremental impact of the price cap given the revised baseline. This is a smaller number of people losing access to HCSTC (relative to the impact originally calculated in the CP, where we estimated 160,000 people a year would be denied loans) as a result of the price cap. This is because many people have already been denied credit as a result of changes firms have made to their lending criteria in response to FCA regulation.

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.

As explained in CP14/10, 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 CBA in CP14/10 provides estimates made for the majority of the costs and benefits noted below. We consider that the analysis we conducted for the CP broadly still stands. We have updated the most critical of these numbers here, which are around benefits from reductions in payment difficulties.

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

- less consumption in the immediate term from not getting a loan, with the majority of individuals not borrowing from other sources
- the need to access alternate funding sources, with some individuals borrowing from family and friends, and a short-run increase in consumers exceeding their overdraft limit after not obtaining an HCSTC loan

We do not find longer-run negative impacts in aggregate on well-being or financial distress from the lack of access to HCSTC.

Benefits from the price cap, in the medium to long run, for customers who would not have loans as the result of the cap are discussed below.

1. In our original CBA we said that the primary benefit for consumers who would no longer get loans would come from the reduced risk of difficulties in paying back HCSTC loans that have stress, mental-health and welfare consequences. In our revised analysis, the new group of individuals affected by the cap show similar, though slightly lower, levels of payment difficulties compared to the group originally estimated to be affected in the CP analysis:

   - 38% of first-time HCSTC loans no longer made would have ended in non-payment (compared to 39% in the CP)

   - 12% of repeat loans no longer made would have ended in non-payment (compared to 19% in the CP)

   Other payment difficulties avoided include the substantially reduced risk of late payment of HCSTC loans.

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

   - reduced non-payment and late payment of non-HCSTC loans

   - a medium to long-run reduction in consumers exceeding their overdraft limit

3. Increased future consumption from not getting a loan, due to not paying HCSTC interest and charges.

Overall we judge that, on average, consumers who no longer get access to HCSTC under our proposed price cap would be better off, but that these benefits now apply to a smaller group of consumers. If lending volumes increased, the price cap would affect a greater number of people. In this way it provides a 'bright line' backstop to ensure that it is economically unviable for firms to lend to customers with a high risk of non-payment, and for whom this borrowing may cause harm.

Summary response to feedback received related to the CBA

17. We identified around 400 analytical issues from the responses received to CP14/10, we grouped these into 20 distinct issue types and allocated these to three high-level groupings: supply, competition and demand. Detailed responses to each of the issues, including additional analysis where this was undertaken, are included in the Technical Annex (which follows the same sequence and includes the same headings as in the tables here). We provide below high level summaries of our responses.

Table 1: Supply issues

Analytical challenge	Actions and conclusion
Baseline used is out-of-date Analysis does not consider 2014 fall in lending volumes.	This required us to redo our analysis which we have done. The details of the revised analysis and our results are presented in the first section of the CBA above, and in the Technical Annex.
Appropriateness of baseline adjustments previously made Baseline adjustments for CPAs and rollovers are incorrect, with either: our estimates being too low, so we should use previous external estimates; or we have misinterpreted evidence submitted.	This was discussed in detail with firms over the pre-consultation period, on multiple occasions. The impact of the rules is uncertain, and after significant discussion with providers, it proved difficult to create an agreed set of impacts. We employed a range of assumptions based on these discussions and our analysis in our previous modelling. No consultation response contained estimates or other information that would allow us to model these adjustments with any greater degree of certainty. In any case the results from the analysis on recent volume changes supersede this.
Challenges to estimates of compliance cost Some compliance costs are either missing or incorrect. This includes: a challenge on the cost of implementing the cap; not accounting for increasing costs of FCA supervision; and not accounting for potential future costs of interventions by FCA, CMA or other.	The CBA in CP14/10 extrapolated from the Australian estimate of implementing a price cap in providing an estimate for compliance costs. This estimate (£1,500 to £6,000 per firm) suggested total administrative costs of around £20,000 for the industry (based on our static analysis of firm exit). We had noted that if as a result of dynamic adjustment to the cap additional firms remain in the market costs across the industry could be higher. Europe Economics suggest compliance costs for firms may range between £5,000 to £30,000 per firm instead, which based on our static analysis of firm exit suggests total administrative costs of less than £100,000 across the industry. The implementation costs are negligible in relation to firms' contributions and other overheads (less than 0.05% across the 11 firms modelled), and changing the value would have no impact on results. In our supply side modelling the higher costs implied by the Europe Economics estimates were used. Finally, the scope of the CBA covers costs and benefits relating to the introduction of the price cap, not an estimate of the costs attributable to other FCA activities, or CMA remedies. While no respondents touched on this we further considered social costs including resources absorbed in winding up companies. We judge that these are likely to be very small relative to benefits and have no material influence on our overall assessment.
Costs classification Some elements classified as overhead costs should instead be considered direct costs.	For the purpose of making a lending decision, which is the focus of our analysis, marketing (customer acquisition) costs are a sunk cost so should not be considered as direct costs.

Analytical challenge	Actions and conclusion
Challenges to exit model assumptions Assumptions on the level of efficiency savings and contribution uplifts that would be achievable through mitigation strategies are too optimistic and, as a result, the exit model understates risk of exit. Others argued that the exit modelling is too conservative.	Assessing the number of firms that will remain in the market involves making judgements on firms' willingness and ability to adapt post-cap. The static firm viability modelling gives results for firms' profitability post-cap, but ultimately whether a firm chooses to exit is a commercial decision based on expected future profitability. To address this we used three different measures to assess risk of exit and used 'buffers' in the analysis. Where we made assumptions on level of efficiency savings and buffers, we carried out extensive sensitivity analysis on these assumptions. We view these results as cautious as they do not allow for firms to remain who are currently unprofitable, nor for firms who could become profitable post-cap to adapt and remain via dynamic responses. The decision process took into account that our results of the number of firms at risk of exit included a margin of error. Since the publication of the CP, some firms have publicly commented that they expect to remain in the market post-cap. Other firms (who were and were not directly modelled) have indicated their intentions to continue to operate post-cap. This suggests that the static model estimates should be considered as cautious.
Representativeness of the supply model results to the wider market Are SME business models sufficiently covered by the modelling? Why was the modelling undertaken on a conservative basis?	In our original analytical process, we engaged SMEs, but were mindful of the fact it would not have been proportionate to ask small firms to provide the level of detail needed to undertake detailed modelling. Small firms were invited to respond to as much of the market questionnaire and to submit as much detailed data as they wished within the timescales available. Revenue data provided by SMEs were used to estimate market size, and market questionnaire responses was used to match small firms to the most equivalent modelled firm for the purposes of exit modelling. Overall, we are confident that our model provides representative results for the market overall. No further information was received from SMEs over the consultation period that would enable us to undertake further modelling or revise our previous assessments. We have addressed the point about estimates from our exit model being cautious in detail in: the first section of this chapter, in response to the issue above 'Challenges to exit model assumptions', and in more detail in the Technical Annex.
Challenges to supply model methods and assumptions Responses questioned the conceptual model used to model firms' responses to the cap, or did not recognise the statistical methods used	The supply model was subject to a significant degree of testing, was built on a firm-by-firm basis to account for different business models and lending decisions, and involves calibration. We are confident that we have a reasonable model that captures how firms lend, based on the information provided to us. In general, we also did not receive any new evidence on the points raised that would require a change to our assumptions. We therefore consider that the supply model is fit for purpose and do not think that we need to make changes to its assumptions, based on the responses received. We have responded in detail to individual challenges received on the supply model method and assumptions in the Technical Annex.

Table 2: Competition issues

Analytical challenge	Actions and conclusion
Firm responses to the cap not previously considered Would firms choose to lend to riskier customers than implied by our modelling, and increase the aggressiveness of debt collection following the cap?	During our previous analysis, we asked firms specifically about how their commercial lending strategy is set. Evidence indicated that they would be unlikely to increase the overall level of risk they were willing to take on. Examining incentives, it is not clear that this would be a sustainable (profitable) strategy should any firm choose to do so. New evidence received from firms relating to changes in the interpretation of affordability assessments suggests that firms are likely to be less willing to lend to risky customers in future. At the time of the cap design, we also asked firms whether a response to the cap could be to increase the aggressiveness of debt recovery processes to which firms said no. It is unclear why firms would have an incentive to pursue debt recovery more aggressively (beyond the incentives that exist before the cap). Even if firms were minded to pursue debts more vigorously, FSMA and the rules in CONC and the general law including under the Consumer Protection from Unfair Trading Regulations 2008, contain rules preventing aggressive and unfair methods of debt collecting. We have secured voluntary agreements from a number of firms to improve their debt collection practices and, where appropriate, to pay redress to customers affected by past misconduct. We are also currently conducting a thematic review into the debt recovery practices of HCSTC firms, which will report in early 2015.
Challenges to assumptions made when considering firm responses to the cap	There were a range of comments disagreeing with our analysis of firms' responses to the cap, and sensitivity analysis. Several of the suggestions were already within existing sensitivities modelled. The dynamic responses that we modelled in the CP were carefully considered, based on the evidence available to us. No new evidence has been received that would affect the judgments we made previously regarding which responses would be plausible, or the scale of possible responses. The sensitivity analysis previously carried out suggests that any changes to the assumptions underpinning the responses modelled would not significantly affect our results or conclusions. We have responded in detail to individual points in responding to this issue in the Technical Annex.

Analytical challenge	Actions and conclusion
Challenges to interpretation of future operation of the HCSTC market In particular that the cap has particularly significant effects on loans of small size or short duration.	We have conducted further analysis on the impact on short-term loans. On balance, we expect that customers interested in these loans will still be served after the introduction of the cap. This is because consumers with a demand for credit appear willing to switch to longer loan durations and do not appear to show such strong preferences that they would choose to take out a loan of less than seven days or no loan at all. From a lender perspective it is optimal to lend to these customers post-cap as they are lower than average risk and profitable at the customer level based on expectations of future loans. The cap might slightly affect the duration of written loans as part of lenders' dynamic responses to the cap; however, we don't expect that to affect our conclusions as this dynamic response was considered in the consultation. Based on the evidence, we concluded the current cap structure and level does not indicate that it would have a disproportionate impact on small or short-duration loans.
Scope of the cap The cap should apply to a wider set of consumer credit markets.	We did not receive evidence that other markets are substitutes and we further set out our position in the Policy Statement. We do not propose to alter the definition. Research is being carried out on the credit card market and overdrafts.
Challenges to concentration analysis Whether we double-counted revenue for larger firms with franchise operating structures in our estimate of total market revenue	We have checked and no franchisee revenue was double-counted in our market revenue estimates in CP14/10.

Table 3: Demand issues

Analytical challenge	Actions and conclusion
Credit reference agency (CRA) data analysis misapplied or inadequate 1) the Regression Discontinuity Design (RDD) analysis methodology is not robust due to a bunching of applications just above lenders' approval thresholds 2) estimates for overdraft use are biased by sample selection (through including individuals who do not have access to overdraft facilities) 3) the analysis neglects high-street lenders	1) We show in the Technical Annex that bunching is limited and explained by the behaviour of lead generators in such a way that it does not threaten the analysis. In particular, we do not find statistically significant differences between groups before the time of HCSTC application (the falsification tests), and restricting our sample to the processes with the smallest changes in density produces results consistent with our earlier findings. 2) We consider the sample selected is justified because even where an arranged overdraft facility does not exist on a bank current account, a negative balance can occur due to fees being charged to the account or the bank deciding to allow a payment even if there are insufficient funds in the account. We provide further analysis of CRA data in the Technical Annex, which shows similar (though slightly different) proportions of cases exceeding their overdraft limit within a year of taking out an HCSTC loan for those with and those without stated overdraft facilities. 3) We have undertaken additional analysis of high-street lenders which indicates that the impact of high-street loans on customers is the same as for online customers.

Analytical challenge	Actions and conclusion
Assumption of CRA data analysis methodology not stated In particular that the original analysis may have neglected to state an important methodological assumption (monotonicity) of the RDD approach, necessary in order for the analysis to return Local Average Treatment Effects (LATE).	We acknowledge that the methodological monotonicity assumption required to assert our results constitute LATE effects was absent from the original technical annex and disclose this assumption here. Our results and their implications remain unchanged by this. The monotonicity assumption is most likely appropriate in our data where non-compliance with the instrument (defiant activity) is likely to be very uncommon. Further detail on why this assumption is not central to the validity of the analysis is presented in the Technical Annex in our response to this issue.
Future use of Illegal Money Lending (IML) higher than estimated 1) Underestimated increase in illegal money lending as a result of the cap. 2) The evidence presented underestimates the true extent of illegal lending in the UK.	We have considered the evidence presented during the consultation and remain concerned about the welfare of consumers turning to illegal money lenders. Our consumer survey evidence indicates that it is unlikely that many customers left without access to HCSTC would turn to illegal money lending. Based on the evidence we have, a lack of access does not lead to statistically significantly more consumers using illegal money lenders. However, as acknowledged in the consultation paper, it is difficult to elicit honest answers to a question that asks whether an individual would or has borrowed from illegal money lenders.
Increased use of non-UK authorised lenders Potential growth of non-UK authorised lenders.	We acknowledge the risks consultation respondents raised regarding non-UK authorised lenders operating in the UK. We have taken measures in CP14/10 to mitigate these subject to EU law and there remain material barriers to avoiding FCA regulation of the consumer credit market. Discussions with firms and industry groups do not indicate strong evidence of a risk that following the introduction of the price cap a significant amount of incoming lending under the E-Commerce Directive will take place in the UK.
Welfare impacts not captured in previous analysis The analysis overlooks some aspects of consumer outcomes and welfare. In particular the modelling should have attempted to estimate consumer surplus from approximated 'demand curves'.	Our choice not to undertake welfare analysis using direct measures of consumer welfare or through the construction and analysis of 'demand curves' for HCSTC was deliberate. Direct measures of welfare are inadequate means of quantifying the effects of HCSTC use and denial on consumers because choices made are unlikely to reflect true preferences given behavioural biases (as we explain in greater detail while discussing this issue in the Technical Annex). We opted instead to combine a number of outcome measures and form an overall judgement on the effect of HCSTC on various aspects of consumer experience and welfare. This included measures of ex-ante creditworthiness assessments and HCSTC repayment outcomes observed alongside wider financial and non-financial outcomes evaluated at various time horizons, direct measures of life-satisfaction using survey questions and direct measures of ex-post regret also using survey question instruments.
Inaccurate welfare impacts in consumer survey analysis Doubts raised about the extent to which respondents could recall loan applications and effects.	We have re-analysed consumer survey responses by sub-groups of individuals defined over the confidence with which they could recall their loan application. We have also considered how the absence of list randomisation may have affected answers to two specific questions in which the question ordering may have biased respondent answers. This analysis yielded no new insights into how HCSTC firms use the impacts on consumer outcomes and welfare, and so has no impact on the policy judgement.

Analytical challenge	Actions and conclusion
Consumer survey uses misleading sample 1) The consumer survey does not draw on a representative sample of all HCSTC users. 2) The survey design and analysis devotes insufficient attention to high-street customers.	1) Concerns raised for the most part reflect a misunderstanding of the analytical approach undertaken in the demand side analysis, in which individual applicants with credit scores close to lender credit score cut-off thresholds were deliberately over-sampled to undertake RDD analysis. Extrapolation analysis was also presented to show the effects of HCSTC use away from the lender credit score cut-offs. 2) The sample of HCSTC applicants included in the survey was split into five groups. High-street applicants were included in three of these groups. Importantly, high-street applicants were included in the sample 'Group 3', the representative sample of accepted applicants, on which the estimation of consumer outcomes under different initial cap levels was undertaken, which was a critical component of the demand side analysis for informing the policy decision. Group 1 and 2 comprised the sample of marginally accepted and marginally denied applicants. These groups did comprise only online applicants as it was only in data provided by online firms where 'marginal' applicants could be identified based on the RDD. Without this information, simply comparing consumers who did and did not take out loans from the high-street would have yielded misleading results as the treatment and control groups would not be similar. We do not therefore deem it necessary to reconsider the consumer survey methodology on the basis of these concerns.
New survey evidence contradicts FCA findings Other contradictory survey evidence exists on a number of points.	Evidence presented by respondents from other data sources does not lead us to alter our conclusions on the topics considered in our consumer survey analysis. New survey data provided by a respondent does not aid an evaluation of the effects of HCSTC use or denial. We are confident that we have used the best available survey data to understand the characteristics of HCSTC applicants and the causal impacts of HCSTC use.

Amendments to proposed rules in the CP

18. In a small number of cases, amendments are being made to the rules proposed in CP14/10. These in the main provide greater clarification and we do not consider these amendments lead to increases in costs that would be of more than minimal significance.

19. **Transitional period:** the new drafting sets out explicitly that if a firm varies or uses a contractual power on or after 2 January 2015, to impose one or more charges by varying an HCSTC agreement made before 2 January 2015, then the charges imposed before that date under the HCSTC agreement are used in calculating the price cap. We consider that this explicit statement has the effect of clarifying how agreements over the transitional period should be dealt with, in particular making clear that variations unrelated to charges (e.g. a change in address) will not be captured.

20. **Replacement agreements:** the existing replacement agreements rule is being amended, so that instead of the cap being the higher of the amount under the earlier or replacement agreement, this will be based on the combined amount of both agreements. We are also introducing a rule that prevents double counting of sums under the replacement agreement and the earlier agreement.

21. For instalment loans this is now equivalent to allowing a firm to enter into a separate agreement. These changes ensure consistency between different types of refinancing (replacement agreement, variations, etc.) and different types of agreements (single payment, instalment, declining principal) in line with our policy intention.

22. The new drafting makes it clear what our 'no compounding' policy should lead to (which we consulted on in CP14/10). We therefore think the amendment (when read in combination with our other rules) should not lead to significant incremental costs.

23. In any case, data from firms suggests that refinanced instalment loans make up around 1% of all HCSTC loans, so any impact (if this did occur) would be small.

24. **Unenforceability:** where an agreement contravenes the price cap rules it is rendered unenforceable. The borrower may elect not to perform the agreement (in these circumstances, the lender has to repay any charges made and the consumer has to repay the credit). Various firms raised queries about how exactly this mechanism worked and how they could obtain repayment. A rule is being introduced to the effect that in the case of unenforceable agreements the borrower has to pay back in a reasonable period. The lender may not in any case demand repayment for 30 days from the lender repaying any charges or confirming there are no charges to repay. Our amendments provide greater clarity and further guidance on how firms can go about obtaining repayment of the credit in such cases.

25. **Refinancing:** a rule is added to deal with when a firm varies an agreement using a contractual power under its existing HCSTC agreement. This clarifies the effect of the existing draft rules. We also add a rule to the same effect to deal with a default charge imposed by the exercise of a contractual power.

26. **Ancillary service charges:** the proposed rules included amounts that are charged for ancillary services in the total and initial cap. The redrafted rules have been amended for ancillary service charges to be included in the default cap as well. This is in line with the actual policy intention. We had included charges for ancillary services in our modelling for all caps and therefore our overall assessment.[9] We do not think the amendment leads to significant changes in the output of our modelling, and therefore the CBA.

9 In the absence of data we did not include in our modelling potential charges imposed by third parties to whom HCSTC lenders might sell off non-performing loans. However, we think this would not significantly change the outcome of our assessment.

Annex 3
Feedback (and our response) to our Technical Annex (supplement to CP14/10)

1. Introduction

Context

1.1 PS14/16 describes the detailed rules for the price cap on HCSTC and responds to issues raised during the consultation period. Proposals for the price cap were previously set out in CP14/10, and supporting material on the analytical approach used in support of the cap was published in a supporting technical annex.

1.2 A specific question in CP14/10 asked for comments on the accompanying cost benefit analysis published as part of the consultation, including the analytical approach used. A summary of responses to this question, and our subsequent response is set out in the main body of PS14/16. This technical annex is a supporting document that provides a more detailed response to the analytical issues raised in the consultation responses. It should be read in conjunction with PS14/16 and the accompanying updated CBA.

1.3 A large number of responses to the consultation related to general policy issues including the chosen level and structure of the cap. Where responses question our eventual choice of cap on the basis of methodological issues with the underlying analysis, the issues raised are covered in this technical annex. However, where responses call for different types of caps for non-analytical reasons, these issues are not covered in this technical annex. The main body of PS14/16 covers both sets of issues.

Approach

1.4 We received over 70 responses to CP14/10 from a variety of stakeholders which covered a wide range of analytical issues.

1.5 We identified around 400 analytical issues and allocated these to 20 distinct issue types within three high-level groupings: demand, supply and competition.

1.6 For each issue type, we carefully considered the points raised by respondents. We made an assessment of each issue, and where necessary undertook further modelling work to explore these issues, including based on further information requests to firms where further evidence was required to make an appropriate judgement.

1.7 This technical annex is structured based on the 20 issue types we identified, split into the general 'supply', 'competition' and 'demand' headings. Where additional analysis was undertaken, results are presented.

Issues identified

1.8 We identified 20 analytical issues in total: eight issues relating to our demand analysis, seven to our supply analysis, and five relating to our competition analysis.

Supply
- Baseline used is out-of-date
- Appropriateness of baseline adjustments previously made
- Challenges to estimates of compliance costs
- Cost classification
- Challenges to exit model assumptions
- Representativeness of supply model results to the wider market
- Challenges to supply model methods and assumptions

Competition
- Firm responses to the cap not previously considered
- Challenges to assumptions made when considering firm responses to the cap
- Challenges to interpretation of future operation of the HCSTC market
- Scope of the cap
- Challenges to concentration analysis

Demand
- Credit reference agency (CRA) data analysis misapplied or inadequate
- Assumption of CRA data analysis methodology not stated
- Future use of Illegal Money Lending (IML) higher than estimated
- Increased use of non-UK authorised lenders
- Welfare impacts not captured in previous analysis
- Inaccurate welfare impacts in consumer survey analysis
- Consumer survey uses misleading sample
- New survey evidence contradicts FCA survey findings

1.9 The following sections of this technical annex outline each of these issues and our response to them. Section 2 covers supply issues, Section 3 competition issues, and Section 4 demand issues.

2.
Supply issues

2.1 The following section covers the responses received that related to the supply analysis previously undertaken, which set out the impact of the price cap on HCSTC firms. It is divided in to the main issues that were raised:

- Baseline used is out-of-date
- Appropriateness of baseline adjustments previously made
- Challenges to estimates of compliance costs
- Cost classification
- Challenges to exit model assumptions
- Representativeness of supply model results to the wider market
- Challenges to supply model methods and assumptions

Baseline used is out-of-date

Summary of responses

2.2 The majority of firms who responded commented that the price cap analysis did not consider the fall in lending volumes in 2014. Firms argued that changes to affordability assessments as a consequence of FCA regulatory pressure had resulted in a sharp fall in loan volumes and therefore revenues, which had not been factored in to the analysis.

2.3 One firm argued that the new affordability assessments would affect customers of all levels of creditworthiness, 'since the rejections on affordability grounds are primarily intended to address concerns relating to the availability of information used to obtain proof of income, rather than underlying factors which affect creditworthiness.' The firm did not provide evidence to support this argument, but included analysis to show the impact of such an assumption on revenues and contribution.

2.4 As mentioned elsewhere, consultation responses argued for both higher and lower caps, with a particular focus on the initial cost cap and total cost cap levels proposed. Given the challenge over the baseline previously used, this section revises the results previously presented in CP14/10.

Assessment

2.5 This section covers the following:

- The analytical considerations in response to the challenges received.
- The potential reasons for the decline in lending and evidence on which consumers, in terms of credit score levels, are receiving fewer loans.
- Our choice of revised baseline and scenarios to use.
- The impact this revised baseline has on i) firms and ii) consumers, after applying different initial cost caps.
- The impact of a 75% total cost cap under the new baseline.

Analytical considerations

2.6 Our previous analysis was based on detailed loan level information for 2012 and 2013. Responses suggested there has been a sharp drop in loan volumes in 2014, which was new information not previously available to factor into our original estimates.

2.7 We undertook further analysis to examine the potential impact of the recent decline in lending volumes which is set out in this section. We considered:

- whether changes in loan volumes were being primarily driven by lower customer demand or the effect of FCA regulations
- how affordability assessments (ascribed as a primary driver for the recent reduction in volume) affect the lending decisions of firms
- the extent to which the price cap and effects of FCA regulation on lending volumes would have similar impacts on lending decisions, and therefore on firms and consumers
- how firm viability has changed before implementing the effects of the cap and
- the incremental impact of the price cap against a revised baseline incorporating the effect of the recent reduction in volume

2.8 A central issue here which we explored is whether the price cap will act to exclude additional customers from the market on top of those already excluded by recent reductions in lending volumes or whether the customers the price cap would exclude have already been excluded by these reductions.

- If the same individuals are excluded from accessing HCSTC as a result of the recent reductions in lending as would have been due to the price cap then the incremental effect of the price cap would be to exclude fewer, or possibly no, additional individuals.
- If different individuals are excluded from accessing HCSTC as a result of the reductions in lending as would have been due to the price cap then the incremental effect of the price cap would be to exclude more individuals.
- Irrespective of how much cross-over there is between these measures the price cap would still have an additional impact, on top of the new baseline, on firms' revenue and profitability.

This is because the price cap reduces the revenue from loans still written whereas the effects of the other measures are more focused on whether to initially grant loan applications.

- We would expect the effect of the decline in lending volumes in the new baseline to leave more firms less viable (and therefore at increased risk of exiting the market) before implementation of the price cap.

Why have lending volumes declined?

2.9 Declining lending volumes may have resulted from a combination of FCA supervisory pressure (including of affordability assessments), firms' changing practices ahead of seeking FCA authorisation, adapting their businesses in expectation of the price cap (and with the uncertainty it creates before the rules are confirmed) and a decrease in consumer demand for these products.

2.10 In our previous modelling we made adjustments for the impact of rules restricting CPAs and rollovers, but not for closer FCA supervision of affordability assessments. This was on the basis that the FCA's affordability rules reflected the OFT's guidance. We assumed for modelling purposes that firms were implementing the guidance and therefore were compliant with the rules.

2.11 Specifically with respect to FCA supervision of affordability rules (primarily contained within CONC 5): these set principles for responsible lending which may take lenders time to adapt to, and firms might also take time to understand what the FCA expects of them. In order to better understand the reduction in lending we obtained additional information from firms. This comprised monthly data regarding the volume and value of loan applications and loans written between September 2013 and August 2014, in total and split by credit score band.

2.12 We also requested the timings and detail of changes in their lending criteria. We requested this information from each of the 11 operating units we had previously requested detailed loan-level data for as set out in CP14/10. This information was requested alongside 2014 management accounts and details of outstanding lending stocks to assess the impact these changes to lending volumes have had on their business.

2.13 This data confirmed that there was a clear reduction in the volume and value of loans written between September 2013 to August 2014 (approximately 40% and 35% respectively), although the reduction differed between firms (with some expanding). The value of outstanding lending had decreased less (9% over the same period). Compared to the average monthly volume of lending recorded for the period 2012-13 the volume of lending in August 2014 is 60% lower.

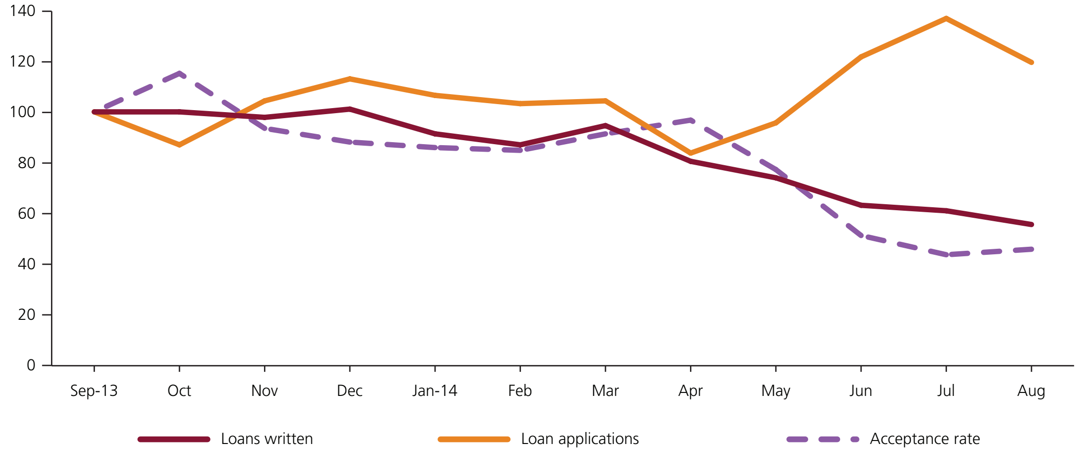
2.14 We first analysed if the decline in lending was primarily attributable to falling demand. We found that application volumes were up by around 20% between September 2013 and August 2014 and the acceptance rate went down by around 50%.

2.15 We think that that higher numbers of applications are, at least partially, the result of individuals applying more times after an unsuccessful application. Based on the data we had available at the time of CP14/10 each unsuccessful loan application generated, on average, 1.7 further applications in the two weeks after initial application (85% of which were unsuccessful). If these proportions remain similar then we estimate that demand has broadly remained unchanged.

2.16 Ideally we would have liked to collect transaction-level data from firms and match individuals across firms in the same way as was done for the consultation paper. This was not feasible in the time available and also was not considered a proportionate use of resources.

2.17 We have therefore modelled the full reduction in loan volume to August 2014. Based on the evidence, we conclude that the fall in loans written primarily reflects a change in the lending decisions of firms and not a reduction in demand, displayed in Figure 1 by the reduction in loan acceptance rates. We define this as the volume of loans written as a share of the volume of loan applications.

Figure 1: Monthly volume of loan applications and loans written aggregate; indexed (September 2013 =100)



Source: Additional firm data request. Acceptance rate defined as loans written / loan applications

2.18 Why has the acceptance rate fallen? Some of the decline in lending volume since December 2013 may be explained by a gradual response by lenders to the forthcoming price cap which, before the publication of the consultation paper, will have created uncertainty for firms in its impact. Despite not knowing its level or structure lenders might have anticipated that a price cap would reduce the expected future profitability of customers and therefore changed their lending decisions. This effect may be somewhat offset by firms trying to lend as much as they can before the price cap comes into effect[1].

2.19 Figure 1 indicates a decrease in the acceptance rate from April 2014 when we took over supervision of the consumer credit market implying that FCA regulation may have directly impacted firms' lending decisions[2].

2.20 We expect the main impact of FCA regulatory pressure, in particular regarding affordability assessments, would be to reduce firms' lending to customers who are less creditworthy. As a measure of creditworthiness we used credit score (as previously described in the consultation paper technical annex).

2.21 To test which customers firms were no longer lending to we have analysed how the acceptance rate had changed for customers with different credit scores, as defined by firms. For the firms where our earlier analysis found their credit scoring models to be particularly effective at measuring credit risk (a high discriminatory power for differentiating groups of individuals with low and high credit risks), the data supported the hypothesis that there had indeed been a fall in acceptance rates for the lowest credit score customers, with little to no change in the

1 While this is a possibility, for modelling purposes we do not attribute the decline in lending volumes to the potential anticipation effects – viewing, on balance, the result was primarily from other FCA regulatory pressures (firms seeking authorisation, supervisory and enforcement of rules – especially regarding affordability assessments).

2 It will also include some customers who initially apply for a loan but subsequently choose not to take out the loan when offered. This is expected to account for only a small proportion.

acceptance rates for higher credit score customers. These firms account for the majority of the HCSTC market by 2013 revenue. This implies the volume reduction has primarily resulted from consumers with lower credit scores losing access to HCSTC.

2.22 In addition to quantitative data, firms also provided descriptions of recent changes to their lending criteria. A minority of firms had made no changes but for those that did we would expect the impact of these changes to primarily impact consumers who have higher credit risks. The changes included:

- higher credit score thresholds for applications to be approved
- use of additional lender information as part of the decision process, such as a customer's disposable income and outstanding CCJs
- use of additional credit bureau affordability checks
- 'cooling-off periods' within which would not re-lend to customers

2.23 Taken together, this evidence suggests that the decline in lending is focused among consumers who are less creditworthy. As a result we built a new baseline and a set of scenarios based on the assumption that the majority of the decline in lending has occurred among less creditworthy consumers.

New baseline

2.24 The new baseline incorporates the decline in lending before modelling the impact of the price cap. Incorporating this decline in lending involves two components: first the magnitude of the overall decline and, second, the share of the overall decline in lending across different credit score groups.

2.25 This evidence suggests a very strong relationship between the reduction in lending volumes and the creditworthiness of customers affected (potentially with them affecting exactly the same customers – 100% concentration in lower credit score groups). However, we decided to use a concentration in lower credit score groups below 100% to allow for the impact of some higher credit score customers' applications being unsuccessful, which appeared to be the case for some firms.

2.26 We tested the sensitivity of the assumed concentration in lower credit score groups to use for modelling (as displayed in Table 1). This shows limited difference in the revenue for firms, contribution, value of loans and number of firm customers if the concentration was chosen to be 70%, 80% or 90%. In addition, the market exit results are unchanged by the different concentration chosen (4 online lenders at low risk of exit, 0 high-street). Therefore combining our analysis of data received from firms and this sensitivity analysis we chose to use an 80% credit score related weight.

Table 1: Impact of different assumptions of distribution in the declines in lending upon static supply model results, with no price cap

Assumptions	Firm effects			Customer effects	Market viability
No cap; Base case volume reduction with x% concentration in lower credit score groups	Change in revenue	Change in contribution	Change in value of loans	Change in number of firm customers	Number of firms less likely to be at risk out of 8 modelled (Margin of error ±1)
70%	-44%	-38%	-41%	-49%	4
80%	**-45%**	**-36%**	**-41%**	**-50%**	**4**
90%	-46%	-33%	-41%	-52%	4

Source: FCA HCSTC supply side model output; reduction calculated against FCA adjusted baseline; eight firms, 2012-13 data

2.27 Have chosen the 80% value as the assumed share of the overall decline in lending among lower credit score groups, we then formed an assumption for the overall decline in lending. This assumption required a judgement as to whether the decline in lending is likely to be temporary or permanent. We considered four scenarios a 'base case' where the recent decline in lending is permanent, plus three additional cases in which lending either recovers or declines further.

2.28 On the basis of this evidence we modelled results for a base case plus three additional scenarios:

- **base case – current market:** volume change calculated as the difference between the 2012 and 2013 two year average monthly volume and the volume at August 2014, firm-specific, change across firms
- **recovery in lending – Scenario A:** half of the base case volume reduction (i.e. x0.5)
- **slight recovery in lending – Scenario B:** three-quarters of the base case volume reduction (i.e. x0.75)
- **further reduction in lending – Scenario C:** base case volume change plus an additional 20% volume reduction (i.e. x1.2)

2.29 We modelled these using our supply model, which is based on detailed loan data for 2012 and 2013. The volume reduction was set for each firm based on the change each had experienced from the average monthly volume in 2012/13 to August 2014. We then applied this by denying loans to customers with the lowest credit scores (including all subsequent loans to the same customers) until 80% of the volume reduction was achieved. We applied the remaining 20% reduction in volume by denying loans at random across all remaining customers (i.e. with no relationship to credit score). In the same way as previously modelled, when denying a loan we also denied all subsequent loans to the same customer from that firm.

Results from new baseline

2.30 The results show that, after adjusting for the reduction in lending volume in the new baseline, the effect of the price cap is to exclude fewer customers than previously estimated in the consultation paper. This is because many of the customers have been excluded due to the effect of FCA regulations on lending decisions reducing lending volumes in the new baseline. The combination of the new baseline incorporating decline in lending volumes and the price cap results in a greater impact on firms than the impact of the price cap alone as modelled in CP14/10.

2.31 Table 2 shows the effects of different baselines on lenders before applying the price cap. Examining these results shows that the base case volume reduction (current market volumes) leads to a 45% decrease in firms' revenue and a similar impact on other measures. By comparison scenarios A and B, where there are recoveries in lending volumes, have less of an impact, and scenario C, where there is a further reduction in lending, a greater impact.

Table 2: Impact of the different volume reduction scenarios, with no price cap

Baseline	Firm effects			Customer effects
(No cap)	Change in revenue	Change in contribution	Change in value of loans	Change in number of firm customers
Base case (current market)	-45%	-36%	-41%	-50%
Recovery in lending (scenario A)	-21%	-16%	-19%	-25%
Slight recovery in lending (scenario B)	-33%	-25%	-30%	-38%
Further reduction in lending (scenario C)	-57%	-45%	-53%	-61%

Source: FCA HCSTC supply side model output; reduction calculated against FCA adjusted baseline; eight firms, 2012-13 data

2.32 A significant proportion of loans, previously estimated to be excluded due to the price cap, are now already excluded from the market when modelling the reduction in lending volume in the new baseline. The consequence of this is that, by comparison with the results presented in the consultation paper, the cap has a relatively smaller effect on the value of loans written and firm-customers served. Table 3 shows the cap still affects revenue and contributions strongly because it impacts the revenue that can be earned from customers that still receive loans. With an initial cost cap of 0.8% the cap reduces contributions by 43% relative to the baseline (unchanged from the estimate presented in the consultation paper)[3]. This similarity is unsurprising given that the way the cap applies is unchanged, it merely applies to a subsample of the loans previously estimated due to the volume reduction in the new baseline.

3 Technical Annexes Supplement to CP14/10 (July 2014) Technical annex 1: Impact of the cap on HCSTC supply, Table 7, page 68

Table 3: Impact of price cap after applying 'base case' (current market) volume reduction

Cap level	Firm effects			Customer effects
Initial cost cap level (100% TCC, £15 default)	**Change in revenue**	**Change in contribution**	**Change in value of loans**	**Change in number of firm customers**
0.4%	-70%	-77%	-28%	-43%
0.5%	-61%	-68%	-17%	-32%
0.6%	-52%	-60%	-8%	-17%
0.7%	-46%	-51%	-6%	-15%
0.8%	**-39%**	**-43%**	**-4%**	**-12%**
0.9%	-35%	-35%	-4%	-11%
1.0%	-30%	-28%	-3%	-11%

Source: FCA HCSTC supply side model output; reduction calculated against FCA adjusted baseline including base case volume reduction; eight firms; cap includes 100% total cost cap and £15 default cap; static impact, 2012-13 data

2.33 Table 4, 5 and 6 below show that the impact of the cap on firms is proportionally consistent across different scenarios which allow respectively for a recovery, slight recovery and a further reduction in lending.

Table 4: Impact of price cap after applying 'recovery in lending' (scenario A)

Cap level	Firm effects			Customer effects
Initial cost cap level (100% TCC, £15 default)	**Change in revenue**	**Change in contribution**	**Change in value of loans**	**Change in number of firm customers**
0.4%	-73%	-78%	-36%	-52%
0.5%	-63%	-69%	-24%	-38%
0.6%	-53%	-61%	-13%	-23%
0.7%	-46%	-52%	-9%	-17%
0.8%	**-39%**	**-43%**	**-6%**	**-13%**
0.9%	-34%	-35%	-5%	-11%
1.0%	-29%	-29%	-3%	-9%

Source: FCA HCSTC supply side model output; reduction calculated against FCA adjusted baseline including scenario A volume reduction; eight firms; cap includes 100% total cost cap and £15 default cap; static impact, 2012-13 data

Table 5: Impact of price cap after applying 'slight recovery in lending' (scenario B)

Cap level	Firm effects			Customer effects
Initial cost cap level (100% TCC, £15 default)	**Change in revenue**	**Change in contribution**	**Change in value of loans**	**Change in number of firm customers**
0.4%	-71%	-77%	-32%	-47%
0.5%	-62%	-69%	-20%	-35%
0.6%	-52%	-61%	-10%	-19%
0.7%	-45%	-52%	-7%	-15%
0.8%	**-39%**	**-43%**	**-5%**	**-12%**
0.9%	-34%	-35%	-4%	-11%
1.0%	-29%	-28%	-3%	-9%

Source: FCA HCSTC supply side model output; reduction calculated against FCA adjusted baseline including scenario B volume reduction; eight firms; cap includes 100% total cost cap and £15 default cap; static impact, 2012-13 data

Table 6: Impact of price cap after applying 'further reduction in lending' (scenario C)

Cap level	Firm effects			Customer effects
Initial cost cap level (100% TCC, £15 default)	**Change in revenue**	**Change in contribution**	**Change in value of loans**	**Change in number of firm customers**
0.4%	-68%	-75%	-21%	-37%
0.5%	-59%	-67%	-11%	-25%
0.6%	-50%	-59%	-5%	-13%
0.7%	-44%	-50%	-4%	-12%
0.8%	**-39%**	**-41%**	**-4%**	**-12%**
0.9%	-34%	-34%	-4%	-12%
1.0%	-30%	-27%	-3%	-11%

Source: FCA HCSTC supply side model output; reduction calculated against FCA adjusted baseline including scenario C volume reduction; eight firms; cap includes 100% total cost cap and £15 default cap; static impact, 2012-13 data

Firm viability

2.34 While the proportionate impact of the price cap is consistent across baseline scenarios the combined impact of lower overall lending volumes (from the new baseline and price cap) can produce differing estimates for our assessments of firm viability post-cap. Updated modelling following the changes (results of which are displayed in Table 7) shows that more firms become unprofitable than previously estimated (and so are at greater risk of exit) under the base case, compared to the previous results published in CP14/10[4].

2.35 Our firm viability modelling is based on a static assessment of firm profitability and does not allow for firms dynamically changing their businesses to remain viable or continuing when loss making. The base case result for our revised baseline (i.e. with no cap in place), which should approximate the market today, shows only four (online) firms remaining in the market out of the eight firms modelled. In fact, all of these eight firms are in operation today. When assessing the potential for firms staying in the market this is one piece of evidence considered alongside

4 CP 14/10 – Technical Annex 1, Table 5

other information, such as public and private statements from lenders regarding their future intentions, and the analysis of potential dynamic responses by firms. This aspect is considered in more depth in the 'challenges to exit model assumptions' issue within this supply issues chapter.

2.36 Under all baseline scenarios there are no high-street lenders estimated to be at low risk of exit. These model results indicate that high-street lenders would be at high risk of exit even if a higher cap was chosen (which, for the reasons set out in the consultation paper and policy statement would not secure the appropriate degree of protection for consumers).

Table 7: Static impact of price cap on market viability. Potential remaining firms at low risk of exit under different periodic cap levels, out of 8 modelled. 100% total cost cap and £15 default cap. (Margin of error ±1)

	Number of firms at low risk of exit (margin of error ±1)					
Cap level	**Previous results**	**Base case (current market)**	**Recovery in lending (Scenario A)**	**Slight recovery in lending (Scenario B)**	**Further reduction in lending (Scenario C)**	**Increase in number of firms at low risk of exit in base case (relative to no cap with margin of error ±1)**
0.4%	0 – 1 O; 0 HS	0 – 1 O	0 – 1 O	0 – 1 O	0 – 1 O	3-4
0.5%	1 O; 0 HS	0 – 1 O	0 – 1 O	0 – 1 O	0 – 1 O	3-4
0.6%	2 O; 0 HS	0 – 1 O	1 – 2 O	0 – 1 O	0 – 1 O	3-4
0.7%	2 – 3 O; 0 HS	1 – 2 O	2 O	2 O	1 – 2 O	2-3
0.8%	**3 O; 0 HS**	**1 – 2 O**	**3 O**	**3 O**	**1 – 2 O**	**2-3**
0.9%	3 O; 0 HS	2 – 3 O	3 O	3 O	1 – 3 O	1-2
1.0%	3 O; 0 – 1 HS	3 O	3 O	3 O	2 – 3 O	1
No Cap	**5 – 6 O; 1 HS**	**4 O; 0 HS**	**5 O; 0 HS**	**4 O; 0 HS**	**4 O; 0 HS**	**N/A**

Source: FCA analysis, out of eight firms modelled (six online, two high street)

Impact on consumers

2.37 One measure of the consumer protection effect for excluded customers is their current chance of non-payment on HCSTC loans (if they had access). The non-payment rates on first loans remain similar to those previously estimated whereas non-payment rates are smaller for subsequent loans (and for non-payment by firm customers in the sample two-year period). The cap functions as before with the difference being that fewer individuals are served in the absence of the cap. Table 8 and Table 9 update the results previously presented and display that fewer customers are left without access due to the price cap than previously estimated. Table 9 shows that those loans not granted still have high non-payment rates comparable to those previously presented.

2.38 A respondent previously criticised the cap chosen to be 0.8% rather than 0.9% citing the evidence in CP14/10 that the non-payment rates of marginally excluded customers are only slightly lower at 0.8% rather than 0.9% (and using a weighted average of first time and subsequent loans excluded shows the non-payment rates to be lower at 0.9% rather than at 0.8%). First, we note that there is some uncertainty inherent in financial modelling and we should not focus on small deviations from the clear relationship between a decrease in the level of the price cap and a decrease in the non-payment rate of first loans for marginally excluded customers. Second, we considered this response further and we clarify our earlier position that the non-payment rates are unacceptably high for consumers excluded at 0.8% as well as for consumers who would be excluded if the cap was set at a lower rate (we did not chose a lower cap due to the risk of a lack of a viable market). By setting a cap at 0.8% rather than 0.9% there is an incremental benefit from excluding customers where borrowing would be risky and, on average, there would be consumer detriment from accessing HCSTC.

2.39 Under the revised baseline a smaller number of individuals are marginally excluded by setting the cap at 0.8% rather than 0.9% in the base case compared to the figures presented in CP14/10. This small number of consumers excluded leads to a small anomaly with low non-payment rates of individuals excluded by a 0.9% cap. In the scenarios with recoveries in lending (and more consumers marginally excluded) non-payment rates for consumers excluded at 0.9% are similar to those previously presented. The consumers marginally excluded by the cap being 0.8% rather than 0.9% have similar non-payment rates to the base case to those previously presented.

Table 8: Static impact of price cap on individuals and firm customers not served after applying 'base case'

Initial cap level (100% TCC, £15 default)	# unique individuals NOT served *(000s)*	Firm customers NOT served *(000s)*	Firm customers NOT served (marginal) *(000s)*	…which would have not paid in sample two-year period (marginal)[5]
0.4%		737	198	49%
0.5%		539	244	44%
0.6%	168	295	43	65%
0.7%	126	252	48	64%
0.8%	**85**	**204**	**13**	**68%**
0.9%	72	191	4	35%
1.0%	68	187	187	54%
from baseline of:	*1,560*	*1,702*	*n/a*	*n/a*

Source: HCSTC supply side model output; 8 firms; cap includes 100% total cost cap and £15 default cap; static impact; base case volume impact assumption; 2 year figures from 2012-13 data

5 'Not paid' defined as unpaid debt greater than £5

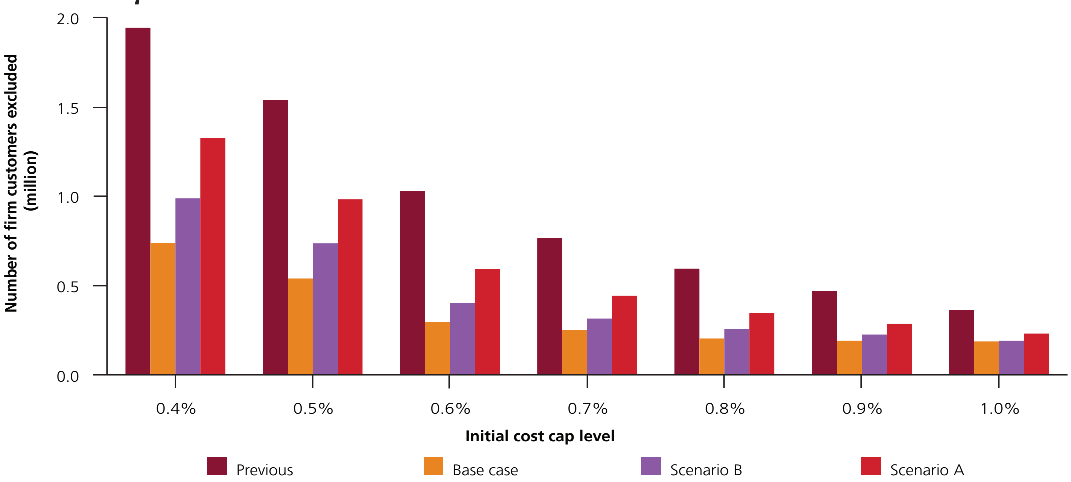
Table 9: Loans not given (base case volume impact)

Initial cap level (100% TCC, £15 default)	First loans NOT given *(000s)*	First loans NOT given (marginal) *(000s)*	...which would have not paid	Subsequent loans NOT given *(000s)*	Subsequent loans NOT given (marginal) *(000s)*	... which would have not paid
0.4%	785	192	19%	1,748	700	10%
0.5%	593	283	20%	1,047	479	12%
0.6%	311	45	32%	568	142	12%
0.7%	266	54	36%	426	137	10%
0.8%	**211**	**16**	**39%**	**289**	**30**	**11%**
0.9%	195	4	7%	258	25	5%
1.0%	191	191	39%	234	234	13%
from baseline of:	*1,505*	*n/a*	*n/a*	*7,175*	*n/a*	*n/a*

Source: HCSTC supply side model output; 8 firms; cap includes 100% total cost cap and £15 default cap; static impact; base case volume impact assumption 2 year figures from 2012-13 data

2.40 The results for Scenarios A and B show how if lending volumes recover in the baseline then the number of firm customers excluded as a result of the price cap will increase.

Figure 2: Number of firm customers excluded by the price cap, under different volume impact scenarios



Source: HCSTC supply side model output; 8 firms; cap includes 100% total cost cap and £15 default cap; static impact; 2 year figures from 2012-13 data

2.41 The results shown in Table 10 and Table 11 display the impact of recoveries in lending (scenarios A and B respectively). They show that if there is a recovery, the cap structure and level provides a 'bright line' preventing lending to consumers with a very high risk of non-payment. A higher baseline volume of lending than assumed in the base case would mean more customers are excluded due to the price cap. From the results in these tables we can see that these excluded customers have high chances of non-payment on their HCSTC loans with these rates similar to those previously displayed in CP14/10.

Table 10: Impact of cap on customers and loans not granted – recovery in lending (scenario A)

Initial cap level (100% TCC, £15 default)	Firm customers NOT served *(000s)*	Firm customers NOT served (marginal) *(000s)*	...which would have ever not paid in sample two-year period (marginal)	First loans NOT given *(000s)*	First loans NOT given (marginal) *(000s)*	...which would have not paid	Subsequent loans NOT given *(000s)*	Subsequent loans NOT given (marginal) *(000s)*	... which would have not paid
0.4%	1,326	345	46%	1,340	349	20%	2,927	1,022	11%
0.5%	982	389	45%	992	393	21%	1,906	798	13%
0.6%	592	149	55%	598	142	29%	1,107	328	15%
0.7%	443	97	63%	456	96	35%	779	252	14%
0.8%	**346**	**60**	**69%**	**360**	**60**	**40%**	**527**	**121**	**18%**
0.9%	286	55	69%	300	62	42%	406	112	13%
1.0%	232	232	57%	238	238	41%	294	294	14%
from baseline of:	*2,574*	*n/a*	*n/a*	*2,187*	*n/a*	*n/a*	*9,586*	*n/a*	*n/a*

Source: HCSTC supply side model output; 8 firms; cap includes 100% total cost cap and £15 default cap; static impact; Scenario A volume impact assumption 2 year figures from 2012-13 data

Table 11: Impact of cap on customers and loans not granted – slight recovery in lending (scenario B)

Initial cap level (100% TCC, £15 default)	Firm customers NOT served *(000s)*	Firm customers NOT served (marginal) *(000s)*	...which would have ever not paid in sample two-year period (marginal)	First loans NOT given *(000s)*	First loans NOT given (marginal) *(000s)*	...which would have not paid	Subsequent loans NOT given *(000s)*	Subsequent loans NOT given (marginal) *(000s)*	... which would have not paid
0.4%	988	252	47%	1,024	252	20%	2,246	801	10%
0.5%	736	332	45%	772	354	21%	1,445	659	12%
0.6%	404	89	60%	418	90	30%	786	230	14%
0.7%	315	59	65%	328	58	36%	555	177	12%
0.8%	**256**	**30**	**70%**	**270**	**36**	**40%**	**378**	**63**	**13%**
0.9%	226	33	68%	234	39	40%	315	76	12%
1.0%	192	192	54%	196	196	40%	239	239	13%
from baseline of:	*2,117*	*n/a*	*n/a*	*1,841*	*n/a*	*n/a*	*8,350*	*n/a*	*n/a*

Source: HCSTC supply side model output; 8 firms; cap includes 100% total cost cap and £15 default cap; static impact; Scenario B volume impact assumption 2 year figures from 2012-13 data

2.42 Table 12 below shows how if there are further reductions in lending in the baseline rather, then the price cap has a smaller impact with incrementally fewer additional loans not granted and fewer customers not served.

Table 12: Impact of cap on customers and loans not granted – further reduction in lending (scenario C)

Initial cap level (100% TCC, £15 default)	Firm customers NOT served *(000s)*	Firm customers NOT served (marginal) *(000s)*	...which would have ever not paid in sample two-year time period (marginal)	First loans NOT given *(000s)*	First loans NOT given (marginal) *(000s)*	...which would have not paid	Subsequent loans NOT given *(000s)*	Subsequent loans NOT given (marginal) *(000s)*	... which would have not paid
0.4%	489	154	47%	575	178	18%	1,121	511	9%
0.5%	335	165	42%	397	223	19%	610	303	11%
0.6%	170	8	61%	174	8	30%	307	44	8%
0.7%	162	6	46%	166	3	35%	264	34	6%
0.8%	**156**	**<1**	**40%**	**163**	**0**	**N/A**	**230**	**5**	**5%**
0.9%	155	3	35%	163	4	7%	226	21	5%
1.0%	152	152	52%	160	160	36%	205	205	12%
from baseline of:	*1,332*	*n/a*	*n/a*	*1,226*	*n/a*	*n/a*	*5,985*	*n/a*	*n/a*

Source: HCSTC supply side model output; 8 firms; cap includes 100% total cost cap and £15 default cap; static impact; Scenario C volume impact assumption 2 year figures from 2012-13 data

2.43 Table 13 displays the number of individuals without access under different cap scenarios. We can see how, if there is a recovery in lending volumes in the baseline, a greater number of individuals are additionally excluded by a 0.8% initial cost cap than would occur if the initial cost cap was set at a higher rate. We have also presented the comparable figures for the number of individuals without access if the TCC was set at 75% rather than 100%. This shows that the additional loss of access by setting the TCC at a lower level would potentially be fairly small. These figures are presented on the same assumption as previously assumed in CP14/10 that if an individual is profitable to lend to by a firm who exits they will be served elsewhere.

Table 13: Impact of cap on number of individuals without access (across scenarios)

	Number of unique individuals NOT served *(000s)*				
	100% Total Cost Cap (TCC)				75% TCC
Initial Cost Cap (ICC) level (£15 default)	Base case (current market)	Recovery in lending (scenario A)	Slight recovery in lending (scenario B)	Further reduction in lending (scenario C)	Base case (current market)
0.6%	168	264	207	84	192
0.7%	126	195	154	72	129
0.8%	**85**	**147**	**114**	**70**	**93**
0.9%	72	117	89	69	73
1.0%	68	79	60	65	72
from baseline of:	*1,560*	*1,923*	*1,747*	*1,382*	*1,560*

Source: HCSTC supply side model output; 8 firms; cap includes 100% total cost cap and £15 default cap; static impact; revised volume impact assumptions 2 year figures from 2012-13 data

2.44 For consumers with access post-cap there are significant savings as a result of the protective effect of the rules against excessive charges as lenders are constrained in how much they can charge. Table 14 displays annual consumer savings. In the base case with a 0.8% initial cost cap consumers are estimated to save £157m p.a. This is a transfer from firms to consumers. The value of this is smaller than previously estimated in the consultation paper due to the lower volume of lending now present. The aggregate value of these savings is dependent upon the volume of loans written post-cap – these are displayed for a range of scenarios below. It is likely that beyond the transfer from firms to customers this further leads to welfare gains (as discussed in the CBA Annex).

Table 14: Annual consumer savings for individuals with access post-cap (across scenarios)

Initial Cost Cap level (100% TCC, £15 default)	Base case (current market)	Recovery in lending (scenarios A)	Slight recovery in lending (scenarios B)	Further reduction in lending (scenario C)
0.6%	£200m	£263m	£234m	£164m
0.7%	£178m	£242m	£212m	£142m
0.8%	**£157m**	**£217m**	**£188m**	**£121m**
0.9%	£133m	£190m	£162m	£101m
1.0%	£111m	£166m	£139m	£84m

Source: HCSTC supply side model output; 8 firms; cap includes 100% total cost cap and £15 default cap; static impact; revised volume impact assumptions

2.45 While aggregate savings have decreased compared to the estimates previously presented, loan-level savings remain consistent. Table 15 below displays that at a 0.8% initial cost cap the median loan saves £14 and the average (mean) saves £32. Given the frequent repeat borrowing by consumers these savings are large per individual (£180 p.a. in the base case).

Table 15: Loan-level savings for individuals with access

Initial Cost Cap level (100% TCC, £15 default)	Median	Average (mean)
	Base case (current market)	Base case (current market)
0.6%	£20	£43
0.7%	£17	£37
0.8%	**£14**	**£32**
0.9%	£10	£27
1.0%	£6	£22

Source: HCSTC supply side model output; 8 firms; cap includes 100% total cost cap and £15 default cap; static impact; base case volume impact assumptions

Consideration of a Total Cost Cap of 75%

2.46 Some consultation responses questioned the rationale for choosing a 100% rather than 75% Total Cost Cap (TCC). With this in mind the following tables present the impact of a 75% compared to 100% TCC under the revised baseline with volume reduction.

2.47 Under a 75% TCC very few individuals are excluded from access in addition to those excluded under a 100% TCC (displayed in Table 13). Results show that a lower TCC (keeping the initial rate constant at 0.8%) has an impact on lenders reducing their contributions by 4%, produces additional consumer savings of £10m and, based on our static firm viability model does not change the number of lenders assessed to be at a low risk of exit.

2.48 A 75% rather than 100% TCC would reduce the duration of time principal can be outstanding for and still earning revenue. For example, if a lender priced to the cap and the consumer only pays down principal in a single repayment they could charge 0.8% per day for 125 days without hitting the 100% TCC cap but it would take 93 days to hit the 75% TCC (both of these could occur sooner if a consumer incurred a default fee). For instalment loans, where principal is paid down each month in equal instalments the TCC would be reached after 5 months at a 75% TCC compared to after 7 months under a 100% TCC.

Table 16: Additional impact on firms from 75% rather than 100% Total Cost Cap (TCC)

Cap level	Firm effects			Customer effects
Initial cost cap level	Change in revenue	Change in contribution	Change in value of loans	Change in number of firm customers
0.4%	1%	2%	0%	1%
0.5%	2%	2%	0%	1%
0.6%	3%	2%	1%	3%
0.7%	2%	3%	0%	0%
0.8%	**3%**	**4%**	**1%**	**1%**
0.9%	3%	4%	0%	0%
1.0%	3%	5%	0%	1%

Source: HCSTC supply side model output; 8 firms; cap includes 100% total cost cap and £15 default cap; static impact; base case volume impact assumptions

Table 17: Additional consumer savings from 75% rather than 100% Total Cost Cap (TCC)

Initial cost cap level	Previous CP results	Base case (current market)	Recoveries in lending (scenarios A,B)	Further reduction in lending (scenario C)
0.6%	£3m	£5m	£3m	£6m
0.7%	£13m	£10m	£12-14m	£8m
0.8%	**£18m**	**£10m**	**£14-15m**	**£9m**
0.9%	£20m	£13m	£17-20m	£11m
1.0%	£25m	£14m	£19-20m	£11m

Source: HCSTC supply side model output; 8 firms; cap includes 100% total cost cap and £15 default cap; static impact; base case volume impact assumptions

Table 18: Static impact of price cap on market viability for 75% compared to 100% Total Cost Cap (TCC) keeping default cap constant at £15. Potential remaining firms at low risk of exit under different periodic cap levels, out of 8 modelled. (Margin of error ±1)

Cap level	100% TCC	75% TCC	Difference
0.4%	0 – 1 O; 0 HS	0 O; 0 HS	Yes
0.5%	0 – 1 O; 0 HS	0 – 1 O; 0 HS	No
0.6%	0 – 1 O; 0 HS	0 – 1 O; 0 HS	No
0.7%	1 – 2 O; 0 HS	0 – 1 O; 0 HS	Yes
0.8%	**1 – 2 O; 0 HS**	**1 – 2 O; 0 HS**	**No**
0.9%	2 – 3 O; 0 HS	2 – 3 O; 0 HS	No
1.0%	3 O; 0 HS	2 – 3 O; 0 HS	Yes
No Cap	4 O; 0 HS	4 O; 0 HS	No

Source: HCSTC supply side model output; 8 firms; cap includes 100% total cost cap and £15 default cap; static impact; base case volume impact assumptions

Conclusion

2.49 Analysis of the new firm data showed (on aggregate) that while demand has not decreased, the volume of loans written has fallen by around 35% over March-August 2014, following reductions in firms' acceptance rates. Falls in acceptance rates are concentrated around those customers with lower creditworthiness.

2.50 We modelled the impact this would have using assumptions for volume reduction and how this reduction was distributed between customers according to their creditworthiness. We informed our choice of assumptions with sensitivity analysis of parameters.

2.51 Results show that after accounting for reductions in market volume the revised impact of the price cap is lower, but the total impact (of the recently reduced lending volumes plus the price cap) on firms is greater than previously estimated. This revised model impact combined with new additional information from lenders regarding their intentions to remain in the market indicates a viable market should exist even after this greater combined effect. Meanwhile, individuals impacted by the cap in our revised analysis show similar levels of payment difficulties compared to the group originally estimated to be affected in CP14/10.

2.52 In summary, we carefully considered the impact of recent reductions in volumes in lending by requesting data from lenders and carrying out further analysis. The result of this was to reach the conclusion that the cap structure and level, as previously proposed, continues to be the most appropriate way to meet our statutory duty.

Appropriateness of baseline adjustments previously made

Summary of responses

2.53 A number of firms (or trade bodies on behalf of member firms) argued that the baseline adjustments made previously underestimate the reductions in volume that result from recent regulatory rule changes in relation to CPAs and rollovers.

2.54 In summary, there were three claims:

- the impact of these changes is uncertain, and our estimates are too low (alternative estimates not provided)
- the previous estimates published by Europe Economics should be adopted and
- for the FCA-adjusted baseline, the figures used are inappropriate, either because the evidence provided was misinterpreted, or as firms that expect CPA and rollover rules to have little impact are poor comparators for firms where these changes will have greater impact

Assessment

2.55 This issue was discussed in detail with firms before the consultation period, on multiple occasions. As discussed in CP14/10 it proved difficult to create an agreed set of impacts and we therefore presented two estimates for the impact of these rules.

2.56 At the time of the previous analysis, firms provided us with a range of estimates, some of which involved very significant reductions in revenue. We ran the supply model with the adjustments as provided to us, and we also created an 'FCA-adjusted' baseline, incorporating our judgements as to what recovery might be achievable based on our knowledge of firms' business models. Largely, we took the 'best practice' recovery rates as reported and applied these to other firms, on the basis we would expect firms to adopt successful recovery strategies in the medium-term.

2.57 The effects of restrictions on CPAs, rollovers and prices are all expected to reduce the available revenue from loans. In practice, we found significant overlap between the loans no longer viable post-baseline adjustments, and those no longer viable after the cap. Therefore, changing the baseline adjustments has relatively little impact on the estimated HCSTC market post-cap (in terms of total loans granted, remaining firms, profit levels etc.).

2.58 With regards to the previous estimated published by Europe Economics, these were based on very conservative assumptions taken at the time without the data we now have access to from lenders. We chose not to use these assumptions, on the basis that if firms believed these were correct at the time of their final submissions to us, they would be free to submit that. In addition, we note that firms provided us with markedly different assumptions from the previous Europe Economics estimates.

2.59 While the responses to the consultation received on this issue stated that the previous estimates were incorrect, we received no new estimates with supporting information that would allow us to model these adjustments with any greater degree of certainty.

Conclusion

2.60 This issue was discussed in detail with firms before the consultation period, on multiple occasions. As discussed in CP14/10 it proved difficult to create an agreed set of impacts and we therefore presented two estimates for the impact of these rules.

2.61 No consultation response contained estimates with supporting information which would allow us to model these adjustments with any greater degree of certainty. We continue to think that the estimates are reasonable of the impact of the rules. On this basis, we did not change the estimates previously provided to us.

Challenges to estimates of compliance costs

Summary of responses

2.62 A small number of firms commented that using Australian estimates for cost of implementation (of compliance measures) was not appropriate.

2.63 A small number of firms argued that the analysis is missing additional costs of compliance in relation to:

- real-time data sharing
- CMA price comparison website and other (as yet unknown) remedies
- new FCA levies payable by lenders (including the levy to fund the Money Advice Service)
- increased costs to high-street lenders through tightening of planning regulations and excluding 'payday' lenders from business rate relief schemes

2.64 A small number of firms commented that compliance costs have increased as a result of increased FCA scrutiny.

Assessment

Compliance costs previously used

2.65 Compliance costs are overheads, which are considered only as part of our assessment of firm viability. The values are small in relation to the contributions and other overheads, so changing the value would not have a material impact on results.

2.66 The cost benefit analysis in CP14/10 stated that we used an Australian estimate on cost to implement a price cap as the basis for modelling the implementation cost. In our firm viability modelling for CP14/10 we actually used the higher estimate from Europe Economics from making detailed rules for consumer credit (CP13/10 and PS14/3) to estimate the cost of the new CPA and rollover rules.

2.67 We view the Europe Economics estimates as more appropriate for the UK market and therefore chose to use it. However, either the Australian or Europe Economics estimates would have no material impact on our results. The cost estimate from Europe Economics was higher than the Australian estimate, but both costs are very small in comparison to total overheads. The Europe

Economics estimate was £5k-£30k per firm, whereas the Australian estimate was £1.5k-£6k per firm. Based on the Europe Economics estimate, the aggregate cost of implementing the cap across the 11 firms is less than 0.05% of aggregate overheads. Given this it is clear that even if the implementation costs had been underestimated in the CBA, changing them would have no material impact on our assessment of firm viability.

Future non-price cap compliance costs not included

2.68 The scope of the CBA is 'to analyse the costs together with the benefits that will arise if the price cap rules are made' and 'an estimate of those costs and of those benefits'. Consideration of other costs are factored into the assessment of the appropriate baseline before the cap takes effect.

2.69 The argument that compliance costs have increased due to FCA regulation would not materially impact our analysis. These costs of compliance are small relative to other costs, such as unpaid debt. They also only factor in when assessing firm viability for estimating exit; the other results from the static model (on customers, loans, revenues and contribution) would be unaffected by changing compliance costs. This argument is covered in more detail in the section on exit model assumption (Section 2.87 below). In addition to this our revised baseline can be thought of reflecting somewhat the effects of FCA regulation on firms – the impact of this the reduction in lending volumes is far larger than increasing compliance costs from our current estimates – based on discussions with firms.

Conclusion

2.70 Compliance costs are overheads so are only considered as part of the firm viability analysis. The implementation costs are negligible in relation to the contributions and other overheads, so changing the value would have no impact on results. The argument that there may be additional compliance costs in the future is not relevant: the scope of the CBA is to include costs and benefits that arise from the making of the price cap rules, not an estimate of the costs of other FCA activities, or CMA remedies. Overall, we made no change to our approach, as a result of the responses received. The four baseline scenarios modelled incorporate a range of potential future lending volumes in the absence of the cap and therefore the effect of FCA regulations on lenders in the absence of a cap.

Cost classification

Summary of responses

2.71 One firm disagreed with the approach used in our modelling that the pay-per-click (PPC), affiliate and TV advertising charges are included as overheads rather than direct costs. Instead they argue that these charges are customer acquisition costs and should therefore be considered as direct costs.

2.72 One response argued that some of the overhead costs (in particular credit checks) should be more closely linked to volumes and activity.

Assessment

Treatment of overheads

2.73 There are two elements to the response received: i) the decision on use of acquisition channels and, ii) the lending decision. Whether 'marketing' acquisition costs (PPC, TV advertising) should be allocated (to loan-level) as direct costs will differ between these two:

- For the first (acquisition) decision – not a focus for our analysis – marketing acquisition costs are not sunk so should be considered as direct costs

- For the second (lending) decision – the focus of our model – marketing acquisition costs are sunk[6] so should not be considered as direct costs

2.74 The firm's challenge is based on the first and whilst we agree this is valid for assessing acquisition strategy, that is not relevant for our assessment so we do not propose to change our approach.

2.75 We felt it was helpful to clarify the difference between flexible overhead costs (with 100% flexibility) and loan-level direct costs. Both will change with volume of loans. However, flexible overhead costs are not factored into the decision to lend whereas loan-level direct costs do. If these flexible overhead costs were switched to be loan-level direct costs then lenders would end up granting fewer loans but earn higher profits because the lender would be able to deny loan applications which were unprofitable after considering these costs. This is another reason to view the results of our static model of firm viability as a cautious assessment.

Overhead cost flexibility

2.76 There is no need to adjust the approach as the exit model already includes analysis that accounts for overhead cost flexibility through the 'variable' and 'fixed' overhead measures, as outlined in the CP14/10 technical annex.[7]

Conclusion

2.77 For the purpose of making a lending decision, which is the focus of our analysis, marketing acquisition costs are a sunk cost so should not be considered as direct costs.

2.78 Based on the responses received, we have made no changes to our approach on these points.

Challenges to exit model assumptions

Summary of responses

2.79 The responses related to the exit model vary between firms and other groups. A number of firms argue that the exit model understates risk of exit due to a number of factors:

- Three firms challenged the assumption that a 20% efficiency saving in overhead costs is achievable under the cap. They argue that there is a lack of justification for the level, point to a number of ways in which costs will increase due to compliance and other factors, and argue that firms already have incentives to be as efficient as possible. One firm argued that the exit model buffers used to identify risk of exit are set arbitrarily.

- One firm argued that the way the exit model results are presented does not appropriately reflect the uncertainty around mitigation strategies firms can use to generate additional contribution specified within the exit model 'buffers'. Instead they present analysis using four categories of exit risk (clearly unviable, nearly viable, just viable, clearly viable).

6 The acquisition costs are paid before the lending decision and the two are not linked, in the same way that a lead is linked to an application. At the point of the acquisition decision firms can't identify the profitable customers and pay the marketing acquisition costs for those customers, whilst rejecting to pay costs allocated to the unprofitable customers

7 CP 14/10 Technical Annex 1, section 5.1.1

- One firm argued that the assessment does not consider the need to recover profits in relation to risks borne by firms (i.e. WACC), nor in relation to intangible investments that they may have made.
- A number of firms argued that costs of compliance have increased as a result of FCA supervision, and that costs may rise further as a result of regulatory-driven initiatives, so to use historic cost information is not valid.

2.80 By contrast to the firms, consumer groups argued that the exit modelling is too cautious:

- One group pointed to the ability of firms to adapt, specifically a public statement by Cash America (QuikQuid) on their ability to respond to the cap
- One group argued that acquisition, marketing and advertising costs (included as overheads) will reduce 1:1 with revenue, and that that there will be additional cost reductions as the supply of leads grows and if legislation on payday TV advertising proceeds

Assessment

2.81 The challenges to the exit model draw particular attention to the analytical steps taken to account for the uncertainty inherent in financial modelling. This includes representations regarding some the assumptions related to the firms response to the price cap (efficiency savings), and to the margins of error when modelling (buffers). We clarify the methodology previously presented in section 5 of CP14/10 technical annex as well as displaying a broader range of results in response to the challenges received, in particular, with respect to how the exit model attempts to anticipate and model these dynamic responses.

2.82 The modelling takes a static view of firm profitability after the cap, and incorporates assumptions that firms can improve profitability before being considered at risk of exit. However, whether a firm actually exits is a commercial decision based on expected future profitability. Firms who are unprofitable today may decide to remain in the market and raise sufficient capital to do so, whilst others may not. The exit modelling will not answer whether a firm will choose to remain even when it is unprofitable, instead that includes qualitative judgement. As explained in the competition section of the consultation paper technical annex alongside this static model we have considered the potential dynamic responses of firms, such as pricing to the maximum level allowed by the cap and changing the duration of their loan offerings to remain viable post-cap. The static exit model used a range of 'buffers' to assess risk of exit with sensitivity analysis carried out for different baseline lending volumes and parameter choices. To consider the results of the model without taking account of dynamic effects, margins of error or other pieces of evidence would be incorrect.

2.83 In our view the exit modelling approach taken remains valid and should be taken as one piece of evidence alongside other new pieces of evidence not available at the time of the time of the consultation paper but subsequentially collected regarding firm viability. Since the publication of CP14/10, CashEuroNet and Cash Converters have both publically commented that they expect to remain in the market post-cap[8]. Other lenders have commented (through consultation responses and discussions with lenders) that they are planning to continue to operate post-cap indicating that more firms will remain in the market than the static firm viability modelling indicates. All of the firms modelled are still in the market and have not announced their intentions to exit.

8 Cash America Q2 2014 earnings call; Cash Converters 2014 annual report

2.84 The other main challenge relates to how the results are presented and whether this accurately reflects the risks. The way results were presented and discussed throughout the previous stage (set out with a margin of error ± 1).

Summary of our previous approach

2.85 The exit model compares a firm's projected contribution under the cap (from the supply model) against historic overhead cost (average of 2012 and 2013 management account data).

- Where contribution was more than overheads the firm was assumed not at risk of exit.
- Where contribution was less than overheads, the uplift in contribution required to meet overheads was calculated. Firms were judged at risk of exit where this uplift was greater than a specified level, or 'buffer'.

2.86 We developed three different measures for risk of exit by calculating three different overhead cost levels – total, variable, and fixed. The three levels relate to: i) firms' existing overheads (total); ii) overheads with flexible components adjusted in line with change in value and volume of loans (variable); and iii) overheads excluding all flexible costs (fixed). Costs were identified as fixed or flexible based on input from firms and FCA judgement. As explained in the consultation paper technical annex before viewing a firm at risk of exit we allowed for differing uplifts in contributions a firm could potentially make ('buffers') in relation to the different overhead types.

2.87 The buffers were used to address uncertainty of information in relation to: i) whether firms will operate with contributions below overheads, and ii) how firms will respond to the cap, in particular to reduce overheads.

- There are firms in operation today that appear unprofitable in i) their management accounts; and ii) when comparing overheads against uncapped contributions from the model. The CMA analysis also identifies a number of unprofitable firms that remain in operation today. Several firms submitted data that showed their organisation to be loss making during the period of study. No representations were made to show that these were firms in financial distress. We therefore judged it not appropriate to consider a firm as at risk where contribution was below existing overheads without any buffer. Instead our modelling assumption is that these firms would exit the market irrespective of the choice of cap as they are not profitable.
- Firms can adapt to the cap through increasing revenues or cutting costs. We modelled firms' ability to raise revenues through 'pricing to the cap' as a dynamic response. The buffers allow us to consider the ability to cut overheads, according to the scale of gap between contribution and overheads.

2.88 To address the specific points raised:

a. The 20% efficiency saving assumption relates to the amount of total overheads that can be considered 'flexible', and by taking these costs out leave a 'fixed' overhead cost that would be required to continue to operate the business. This level is an estimate but is based in part on efficiency savings in other regulated industries. The level used is higher than in regulated industries. This partly to reflect a number of years of efficiency savings, since the risk of exit is considered over a period of time. Further we judged it reasonable to expect a relatively young industry to be able to achieve a higher level of savings as it transitions from a race for growth to a more mature industry with a focus on cost reduction. We conducted sensitivity analysis to assess the impact of changing the level and found it was not sensitive. [See results section for sensitivity analysis] This method of assessing exit was used in conjunction with two other approaches as a further test of the sensitivity of our results, plus all exit model results were presented with further ±1 margin of error. We do not think that changing this approach or level would change the findings of the assessment or the decision made based on these findings.

b. The level of buffers was set based on FCA judgment after consideration of how flexible the cost bases of these firms were and what appeared plausible. Given uncertainty over the precise level of buffer to use sensitivity analysis was carried out and displayed to assess the impact of a differing levels and this did not show a change in the results. Indeed, given the fact that unprofitable firms are remaining in this market it could be argued that our threshold was too cautious rather than too aggressive for assessing firms at risk of exit.

c. We calculated three different measures for risk of exit and showed all three. The results were presented with a margin of error of ±1 for the reasons set out in the consultation paper technical annex. Alternative ways to present results, as specifically suggested by one firm, are available but do not change the conclusions drawn from the static exit model when combined with other evidence available.

d. The analysis does consider returns on risks borne by firms, as WACC was included as a direct cost in the supply model. WACC was not included in the exit model, given uncertainty as to whether the capital firms included on management accounts related to the HCSTC business or other units. Additional analysis was done that concluded the levels of overhead WACC costs were low in relation to other costs, so it was reasonable to exclude them from consideration.

e. The exit model analysis is based on overhead cost information from 2012 and 2013 management accounts, as this is in line with the sample period for the loan information used as a basis for the analysis. Whilst costs may have risen for some firms since then, the scale of the additional cost is unlikely to be significant in relation to total overheads or contributions. We would expect firms to be able to manage their cost base as the business evolves, in line with the efficiency saving we expect. In any case there would be inherent difficulties estimating the future cost of compliance for potential new, unconfirmed initiatives.

f. Our modelling recognises the uncertainty around firms' ability to adapt and the FCA's judgment is that the assumptions were and remain reasonable. As listed above, firms have challenged these assumptions in the other direction. In relation to one firm's comment, they are a firm we expect to continue under the cap so the comment can be seen as a counter to the other firms' comments above.

g. Given the likely impact of a price cap on lenders we took a cautious approach to assessing firm exit. This was partially due to the fact that the policy would be reviewed in two years' time and it would be possible to lower the cap and reduce supply, if required, but be potentially impossible to increase the cap and encourage supply if no market remained and all firms have exited.

h. As discussed above firms respond dynamically to the loss of financial performance. One way in which our model addressed this is to ask firms what proportion of cost could be adjusted in response to managing short term financial performance. Acquisition cost, marketing and advertising we typically seen by firms and the FCA as highly flexible in response to a sudden change in organisational scale. Our modelling assumes that acquisition, marketing and advertising costs will be flexible for the purposes of calculating of the 'fixed' and 'variable' overhead measures.

Summary of new results

2.89 This section sets out the sensitivity analysis carried out on the assumptions for efficiency saving, buffers and use of cost of capital in the exit model. The sensitivity analysis was completed during the analysis stage and the results were used to inform decisions. Given that this sensitivity analysis was carried out during the previous analysis stage the results reflect the baseline adjustments used at that point; they do not include the impact of recent volume adjustments. However, this does not affect the validity of the analysis and the conclusions we make.

2.90 Table 19 below shows the effect on exit results of changing the assumption of the percentage of overheads that are flexible, which can be thought of as the 'efficiency saving' assumption. The results set out in CP14/10 are based on a 20% assumption. A number of firms argued that 20% was too high. However as the table shows, reducing the value would not materially change the exit results for the 0.8% cap.

Table 19: Sensitivity analysis of percentage of overheads that are flexible
Number of firms remaining (i.e. not at risk)
vs. Fixed OH costs, using 20% cut-off

	% overheads that are flexible						
Cap level	**0%**	**5%**	**10%**	**15%**	**20%**	**25%**	**30%**
0.4%	0	0	0	0	**0**	0	0
0.5%	0	0	1	1	**1**	1	1
0.6%	1	2	2	2	**2**	2	2
0.7%	2	2	2	2	**2**	2	2
0.8%	**3**	**3**	**3**	**3**	**3**	**3**	**4**
0.9%	3	3	3	3	**3**	4	4
1.0%	3	3	3	3	**4**	4	4
No Cap	6	6	6	7	**7**	7	7

2.91 Table 20 below shows the effect of changing the cut-off level ('buffer') used for the fixed overhead exit measure[9]. The results set out in CP14/10 are based on a buffer at 20%. However, as Figure 5 shows, the exit results for the 0.8% cap would not be changed by setting the buffer anywhere between 10% and 30%, at a cap of 0.8%. Setting more extreme buffers (0% to 50%) would only change results within the ±1 margin of error.

9 A lower buffer (e.g. 10%) would potentially mean that more firms are flagged as at risk of exit (or fewer not at risk), as a firm that required say a 16% increase in contributions to meet overheads would not be classified as at risk with a buffer at 20%, but would be classified as at risk with a buffer at 10%.

Table 20: Sensitivity analysis of buffer used for increases in contributions required relative to fixed overheads to not be at risk of exit
Number of firms remaining (i.e. not at risk)
vs Fixed OH

	Buffer set at					
Cap level	**0%**	**10%**	**20%**	**30%**	**40%**	**50%**
0.4%	0	0	**0**	0	1	1
0.5%	0	1	**1**	1	2	2
0.6%	1	2	**2**	2	2	2
0.7%	2	2	**2**	3	3	4
0.8%	**2**	**3**	**3**	**3**	**4**	**4**
0.9%	3	3	**3**	4	4	4
1.0%	3	3	**4**	4	4	5
No cap	6	7	**7**	7	7	7

2.92 Table 21 below shows the effect of changing the cut-off level ('buffer') used for the total overhead exit measure. The results set out in CP14/10 are based on a buffer at 50%. However, as Figure 6 shows, the exit results for the 0.8% cap would not be changed by setting the buffer anywhere between 20% and 50%. Setting more extreme buffers below 20% would only change results within the ±1 margin of error.

Table 21: Sensitivity analysis – of buffer used for increases in contributions required relative to total overheads to not be at risk of exit
Number of firms remaining (i.e. not at risk)
vs Total OH

	Buffer set at					
	0%	**10%**	**20%**	**30%**	**40%**	**50%**
0.4%	0	0	0	0	0	**0**
0.5%	0	0	0	1	1	**1**
0.6%	0	1	1	2	2	**2**
0.7%	2	2	2	2	2	**3**
0.8%	**2**	**2**	**3**	**3**	**3**	**3**
0.9%	3	3	3	3	3	**3**
1.0%	3	3	3	3	3	**4**
No cap	3	4	6	6	7	**7**

2.93 Table 22 below shows the effect of changing the cut-off level ('buffer') used for the variable overhead exit measure. The results set out in CP14/10 are based on a buffer at 20%. As Figure 7 shows, the exit results for the 0.8% cap would not be changed by setting the buffer any higher, up to 50%. Setting a lower buffer lower would change results by 1, within the ±1 margin of error.

Table 22: Sensitivity analysis – of buffer used for increases in contributions required relative to variable overheads to not be at risk of exit

Number of firms remaining (i.e. not at risk)

vs Variable OH

	Buffer set at					
	0%	**10%**	**20%**	**30%**	**40%**	**50%**
0.4%	0	0	**1**	1	1	1
0.5%	0	1	**1**	1	2	2
0.6%	1	1	**2**	2	2	2
0.7%	2	2	**2**	2	3	3
0.8%	**2**	**2**	**3**	**3**	**3**	**3**
0.9%	3	3	**3**	3	3	3
1.0%	3	3	**3**	3	3	4
No cap	3	4	**6**	6	7	7

2.94 As we noted in CP14/10,[10] we do not include the cost of capital related to fixed assets in the overhead figures used for the exit analysis. The supply model already includes cost of capital for lending, so the question was whether to include cost of capital for other fixed assets included in the management accounts. We decided not to include these costs as:

- the way in which some of the HCSTC firms are incorporated in larger corporate entities makes it difficult to robustly assess the capital employed in the HCSTC element of the business
- there is considerable variation in the stated level of capital between similar firms in our sample leading us to be less confident in the figures provided to us and
- for most firms, this cost of capital is a minor element of the overall cost base and would not have an effect on results for the 0.8% cap

Conclusion

2.95 In our view the existing approach remains valid. We acknowledge that estimating potential firm exit is inherently difficult. This is particularly so when some firms, in a concentrated market, are unprofitable and yet remain present. It is even more so when the market is expected to change through lenders changing their businesses in response to FCA regulation and, in particular the price cap. The results of the static model should be considered a cautious approach to estimating firm exit and as one piece of evidence available to informing this judgement.

2.96 Given this uncertainty the static firm viability modelling relies on making judgements on firms' willingness and ability to adapt post-cap. To address this we used three different measures to assess risk of exit and used 'buffers' in the analysis. Where we made assumptions, we carried out extensive sensitivity analysis on these assumptions, which found that the exit results would not materially change by varying the assumptions. We consistently presented our results with a margin of error ±1.

2.97 Since the publication of CP14/10, CashEuroNet and Cash Converters have both publically commented that they expect to remain in the market post-cap[11]. Other lenders have commented

10 CP Technical Annex 1, section 5.1

11 Cash America Q2 2014 earnings call; Cash Converters 2014 annual report

(through consultation responses and discussions with lenders) that they are planning to continue to operate post-cap indicating that more firms will remain in the market than the static firm viability modelling indicates. All of the firms modelled are still in the market and have not announced their intentions to exit. We therefore conclude that the implementation of the price cap at the structure and level set out in this policy statement will not prevent a viable market of affordable lending.

Representativeness of supply model results to the wider market

Summary of responses

2.98 One response suggested that the model does not sufficiently take into account Small and Medium-sized Enterprise (SME) business models, or the impact of the cap on SMEs.

2.99 One response suggested that if we think three firms remaining under the chosen cap is a cautious assessment, the CBA estimates are also overly cautious, which is inappropriate.

Assessment

SMEs

2.100 Throughout the previous analytical process, we engaged SMEs, but were mindful of the fact it would not have been proportionate to ask small firms to provide the level of detail needed to undertake detailed modelling.

2.101 Our and the CMA's analysis both indicates that the HCSTC market is highly concentrated. While CP14/10 reported over 400 lenders in the market, 37 lenders accounted for 99% of the market by 2013 revenue. Within this 37 some of these lenders do not appear to offer a competitive constraint to the larger firms as they are less able to build models to effectively discriminate between consumers who are higher and lower credit risks.

2.102 Small firms were invited to respond to as much of the market questionnaire and to submit as much detailed data as they wished within the timescales available. Revenue data provided by SMEs was used to estimate market size, and market questionnaire responses was used to match small firms to the most equivalent modelled firm for the purposes of exit modelling. We estimated that where a modelled firm was at risk of exit, it was likely that all other matched small firms would also be at risk of exit at that point.

2.103 Overall, we are confident that our model provides representative results for the market overall. No further information was received from SMEs over the consultation period that would enable us to undertake further modelling or revise our previous assessments.

Overly cautious estimates

2.104 We consider that the estimates set out in CP14/10 were reasonable estimates given the data and other information available to us, and that there is no better alternative available. However, we are aware that our analysis predicts many fewer firms in the market than we observe in practice. At the time of CP14/10 we did not predict that only three firms would remain in the market; rather we set out that all but three appeared at risk of exit before allowing for dynamic responses, given the information available. We acknowledged the uncertainties involved in making these judgements, and made all the assumptions made very clear.

2.105 We do not consider that the results contained in the CBA are overly cautious estimates. These represented our best view, given the uncertainties and the information available to us at the time of the analysis. We modelled a number of sensitivities, which are included in the CBA. Further, we have explained the logic behind the judgements we have made.

2.106 We are aware that our static firm viability model predicts fewer firms in the market than we observe today. However, we consider the modelling approach we took to be reasonable given the information available and the absence of a better alternative. The static model is one piece of evidence used alongside other information we have regarding how many lenders may remain in the market post-cap. Alongside this evidence we have considered the fact that we observe more firms in the market now than our model indicates and that lenders have announced their intentions to remain, represents important new information.

Conclusion

2.107 Having considered these responses we acknowledge the limitations in the aspects they raise, however, following consideration we were not presented with alternatives which were proportionate and feasible improvements to the method previously taken. In 2013 a small number of large firms account for the majority of the market by revenues, while there is the potential for some smaller lenders to remain, our static firm viability model assumes that they do not given that larger, and currently profitable ones are modelled as becoming unviable. Previous analysis from the CMA concluded that entry by new firms in the market has not provided an effective constraint on established lenders' prices. It is therefore our conclusion that we factor in new evidence received over the course of the consultation with respect to these challenges but not change our underlying analytical methods.

Challenges to supply model methods and assumptions

Summary of responses

2.108 There are a range of challenges raised by respondents in relation to the methods and assumptions in the supply model:

- The statistical tools, methods, and assumptions used in the supply model are not robust
  - **a.** The choice of score components used and the predictability of the scores is questionable
  - **b.** Loan pricing is determined by more than default rates
  - **c.** Our definition of default is inappropriate
  - **d.** The statistical methods we have used are not recognised
  - **e.** Use of historic data is not appropriate
  - **f.** Consumers consider price is important
  - **g.** We should fully model dynamic responses, including changes to acquisition costs
- The outputs of the model are overstated, incorrect, or are at odds with data and estimates held by firms.
  - **a.** Estimated volume of loans granted for a particular duration is not correct
  - **b.** Non-payment rates are higher than firms see in practice
  - **c.** (Implied) decline rates are too low.

Assessment

Statistical tools and methods

Scores

2.109 We do consider that the creation of scores for use in our supply model was appropriate, and produced robust results.

2.110 A key part of the supply model is the determination of credit risk for each customer. The standard practice, adopted by many lenders, is to use credit score and we followed that approach. However, use of scores in the model is different to how they are used by firms.

2.111 Firms construct scorecards in order to assess credit risk of future applications (therefore predicting the future). Assessing credit risk in this way is challenging, as noted in some of the consultation responses received.

2.112 Our modelling goal was much simpler. In order to be able to evaluate multiple scenarios (cap levels and structures), we needed to assume some measure (score) of credit risk that differentiates riskier loans from less riskier ones. The key issue about that score is that it should imperfectly differentiate individual customers, in order to reflect the uncertainty faced by firms at the point they make their lending decisions.

2.113 Where firms use credit scores which performed well at estimating customers' probability of default these were used in the model. Where firms either did not use credit scores or these were not reasonable estimators of probability of default, scores were constructed with reasonable discriminatory power (in comparison to other lenders), factoring in the availability of information, data quality issues and specific features of respective firms.

2.114 It is worth stressing that we did not aim to construct scores with the highest discriminatory power. Rather, our aim was to replicate the discriminatory power of lenders' risk assessment processes that could allow us to match their lending decisions in the absence of the cap, as shown in the data submitted to us.

2.115 Over time we expect that lenders can achieve improved discriminatory power than assumed in our model. If this occurs the profitability of lenders will be higher than modelled and therefore more lenders may be present in the market than our static model of firm profitability indicates[12].

Non-payment rates

2.116 We use non-payment rate (referred to in the description of the supply side model methodology in CP14/10 technical annex as default rates) as a main component of firms' lending decisions, but not the only one. Firm decisions are modelled at customer-level, based on firms' expected profits without a separate consideration of default rates.

2.117 The non-payment rates reported are not firms' expectations of non-payment probabilities under different cap scenarios. Instead they are measuring the actual levels of non-payment that would have occurred, according to the assumptions and data within the model. In reality, for any given cap, firms' expectations of non-payment could be different to the actually realised non-payment rates, and to the rates reported in our model.

2.118 Apart from the determination of default fee cap (which allows flexible application of these charges after late payment) the assumed definition of non-payment serves two purposes:

- building of scores for some of the lenders

12 This implicitly assumes the investment costs are less than the future stream of income that could be gained.

- reporting the number of non-payments in the final results

2.119 Regarding our definition of non-payment, taking into account the aim and approach to construct the scores, other reasonable definitions of default could be assumed. However, based on our earlier analysis setting different unpaid debt thresholds (higher or lower than £5) would make limited difference to the number of defaults and therefore would not fundamentally change our conclusions.

2.120 On this basis, we did not make adjustments to the definitions of default used.

Statistical methods

2.121 Information is publically available on the statistical methods used, and we published technical annexes with the consultation paper to provide a detailed explanation of the approach. We are confident that the methods used generate robust results.

Historic data

2.122 Our analytical approach is based on empirical evidence – the nature of this is that only historical data is available. We view that using recent, historical data, and adjusting it for changes in the market, offers a more objective approach than the alternative, which is not using data. Where changes were made, such as the accounting for the effect of rollovers and CPA, we carried out sensitivity analysis and presented this in the consultation paper technical annexes.

2.123 We considered different time periods when planning the work and designing the data requests, but were conscious that (a) we needed a sufficient time period to develop a customer lifetime view of the data; (b) the market had grown rapidly and been subject to a number of regulatory and commercial changes, lessening the value of data from more historic time periods; (c) the nature of the data requested would be difficult to provide, and any request should be proportionate; (d) the timeline for analytical work was driven by our statutory duty to impose a price cap in January 2015.

2.124 Ultimately, we were able to get data to the start of 2014 – the most up to date data available at the time.

2.125 Where firms raised concerns that the loan volumes had changed significantly as a result of the impact of affordability assessments, we asked firms to submit updated information, and ran updates to the model to assess the impact this would have on results. Given the timescales involved to fulfil our statutory duty this data request was designed to be the least burdensome way for firms to provide the data we required while giving us sufficient time to feasibly consider its implications and carry out further analysis.

Price sensitivity

2.126 As discussed in detail in CP14/10, we assume demand is price inelastic. This assumption is consistent with previous estimates of price sensitivity in the market from consumer surveys, and is consistent with the interim findings of the CMA investigation.

2.127 While we received responses suggesting otherwise, we did not receive any new information that would cause us to revise our view on this point.

2.128 Moreover, even if the demand was price elastic, the drop in prices after introduction of the cap would cause increased demand thus improving lenders' profitability. If the result was to bring more price sensitive customers to this market they would be expected to be more creditworthy (as less creditworthy customers have few, if any, alternative credit options) which would further increase lenders' profitability. Such a scenario would be expected to result in more firms staying in the market than our static firm profitability model estimates.

Dynamic responses

2.129 We modelled a range of dynamic responses. In relation to the specific query raised, we did in fact model the impact of a 10% increase in acquisition costs at the time of CP14/10, but did not publish the results. These results have now been published in this technical annex (Table 23: Impact of 10% increase in acquisition costs) they make no significant difference to our conclusions.

Model outputs not recognised

2.130 Reported outputs are either created by the model directly, or require further off-model calculations and adjustments to create. All outputs reflect the definitions and coding used within the model.

2.131 Model outputs are reported on an aggregated basis across the eight firms modelled. Where individual firms state they do not recognise or disagree with model outputs, this may be because their own data differs from the aggregated results reported. This does not mean the reported results are incorrect.

2.132 As above, we are confident that the supply model accurately represent firms' decision making absent the cap (based on the data provided to us). We have been careful to present the results as static, based on historic data only, have made adjustments to the baseline, and have then considered a range of firm responses.

Conclusion

2.133 The supply model was subject to a significant degree of testing, was built on a firm-by-firm basis to account for different business models and lending decisions, and involves calibration. We are confident that the supply model accurately matches and explains the lending decisions of each firm absent the cap, based on the information provided to us. On this basis we consider that the supply model is fit for purpose and do not consider that we need to make changes to its assumptions, based on the responses received.

2.134 In general, we received no new evidence on the points raised that would require to change our assumptions. Where firms did provided evidence that there had been significant changes compared to the information covered by our sample period (relating to overall loan volumes), we did collect further information and use this to estimate the impact of the cap, based on the new information. The methods used and the results of this analysis is described elsewhere in this technical annex.

3.
Competition issues

3.1 This section covers the responses received that related to the competition analysis previously undertaken. The following issues are covered:

- firm responses to the cap not previously considered
- challenges to assumptions made when considering firm responses to the cap
- challenges to interpretation of future operation of the HCSTC market
- scope of the cap
- challenges to concentration analysis

Firm responses to the cap not previously considered

Summary of responses

3.2 We received a number of responses from firms and other groups that suggested a number of possible responses that firms could make, that were not mentioned in CP14/10. Broadly, responses suggested that in response to the cap, firms would:

- increase their overall level of risk they are willing to take on following the cap i.e. choose to lend to riskier customers than implied by our model
- change their debt recovery processes, using more aggressive debt recovery techniques, including through the court system and greater sale of debt to third parties
- exploit loopholes to avoid the cap

Assessment

Levels of risk

3.3 During our previous analysis, we asked firms specifically about how their commercial lending strategy is set, and whether they were likely to increase the overall level of risk they were willing to take on following the cap. Evidence from firms suggested that they would be unlikely to increase the overall level of risk they were willing to take on, and consequently that firms' response to the cap would be to reduce lending thresholds.

3.4 It was also unclear why firms would have an incentive to accept more risk overall following the cap, or that this would be sustainable (profitable). For firms to change the overall level of risk they are willing to take on following the cap, either firms' owners could change the level of overall risk they were willing to take on, firms' commercial lending targets could change, or firms' current strategy could be something other than to lend to all customers with positive expected profitability.

3.5 In fact, new evidence received from firms relating the approach of affordability assessments suggests that firms are likely to be less willing to lend to risky customers in future.

Debt collection

3.6 At the time of the cap design, we asked firms specifically whether a response to the cap could be to increase the aggressiveness of debt recovery processes, or otherwise change these. We asked 150 firms about this as part of the market questionnaire. Firms did not expect to make changes to their debt recovery processes.

3.7 Firms are currently able to accrue charges once loans enter default, which may provide firms with limited incentive to aggressively pursue debts. Our data shows that current levels of write off as bad debt are high. If the cap restricts growth opportunities and squeezes margins, debt recovery may become a more important business focus in the future.

3.8 We consider it unclear why firms would have an incentive to pursue debt recovery more aggressively (beyond the incentives that exist prior to the cap), and note that in previous discussions some firms suggested that post-cap, customer relationships would be of even greater importance, leading to if anything, less aggressive debt recovery procedures. Furthermore, aggressive debt recovery techniques, particularly litigation, are not necessarily more cost-effective. A number of firms have told us that, in addition to providing a means to rehabilitate customers, agreeing affordable and sustainable repayment plans with customers who are struggling to repay should help provide them with a stable and predictable cash flow.

3.9 In addition even if firms were minded to pursue debts more vigorously, FSMA, the CCA (for example section 140A) and the rules in CONC and the general law including under the Consumer Protection from Unfair Trading Regulations 2008, contain rules preventing aggressive and unfair methods of debt collecting. We expect customers to be treated fairly irrespective of whether or not their debt was sold and would expect seller and purchasers to do effective due diligence to assure themselves that they are meeting obligations in this respect. We proactively supervise the risk that firms do not offer appropriate forbearance to customers in financial difficulties. We have already secured voluntary agreements from a number of firms to improve their debt collection practices and, where appropriate, to pay redress to customers affected by past misconduct. Further, we are currently conducting a thematic review into the debt recovery practices of HCSTC firms, which will report in early 2015.

Avoidance

3.10 In relation to avoidance activities, we made it clear in our consultation paper that we have designed the rules to seek to address avoidance measures. For example, the definition of HCSTC is a broad and flexible one drafted with avoidance in mind, the price cap rules include provisions concerning refinancing and rules applying to debt administration and collection. In addition the Price Cap chapter reminds firms they needs to interpret the rules with their purpose in mind (as to which see Handbook GEN 2.2.1R).

Conclusion

3.11 We do not expect firms to be willing to take on a greater level of risk overall following the cap, and we do not expect that this would be a sustainable strategy should any firm choose to do so. Evidence received over the consultation period suggests firms are in fact behaving in a more cautious manner. On this basis, we have made no changes to our approach.

3.12 We do not expect debt recovery practices to become more aggressive following the cap. On this basis we have made no changes to our approach.

3.13 The rules have taken potential avoidance into account when possible and we are confident the rules will be effective.

Challenges to assumptions made when considering firm responses to the cap

Summary of responses

3.14 We received a number of responses questioning how we had developed and considered the impact of possible firm responses to the cap. The majority of these were from firms, and covered a wide range:

- the ability of firms to respond to the cap is overstated and therefore the potential for firm exit is underestimated
- the likelihood of entry following the cap is underestimated
- the ability of customers to switch from the high-street to online is overestimated
- customers unable to gain loans from one firm are unlikely to be able to receive a loan from remaining firms in the market
- the impact of forthcoming CMA remedies is overstated
- customer acquisition costs will increase following the cap, not decrease

Assessment

Ability of firms to respond to the cap

3.15 Our previous analysis covered a range of responses that we considered to be plausible, based on the evidence provided by firms, and our own judgement. Overall, where we have modelled specific firm responses to the cap, this is for the purposes of testing the sensitivity of the static results to different assumptions about firm behaviour. This assists in making judgements about the risks involved in setting different cap levels and structures, and in comparing different options.

3.16 The responses modelled should not be viewed as predictions about how firms will respond to the cap. Firms may reasonably be expected to change any aspect of their business model in response to the cap, and are likely to test changes in practice over an adjustment period. The responses modelled were based on our judgement about what could reasonably be expected to happen, in light of information gathered from firms and other parties. These are scenarios used for modelling purposes that aid judgements, rather than predictions, and any results incorporating firm responses should be viewed in this light.

3.17 We did not model unspecified and fundamental changes to firm business models following the cap, which in practice may occur. We capture this partially in the exit modelling, where we imposed a 20% profit uplift when considering whether firms are at risk of exit (as previously explained in the 'Challenges to exit model assumptions' section of this document and in the technical annex accompanying the consultation paper). This uplift could be generated through efficiency savings or revenue increases following firms' adaption to the cap. Beyond this, we cannot model responses in any greater level of detail in a robust manner, given the nature of any modelling would be highly speculative.

Entry and substitution

3.18 Our approach to firm entry and substitution between high-street and online channels were reached based on the evidence received, which suggested limited scope for entry, and limited substitution between high-street and online. No new evidence has been received over the consultation period that would affect these conclusions.

3.19 Based in part on the CMA's analysis, our analysis indicates 24% of high-street customers may subsequentially switch to remaining online firms[13], modelled as a sensitivity to the analysis. We previously modelled the impact that general volume increases would have on remaining firms.

3.20 The cap will reduce the revenue HCSTC lenders can get and therefore returns investors in these firms can make. We acknowledge this may deter some investors from funding lenders. The business models of lenders at the time of the consultation indicated that the firms are not capital constrained, instead, lending to all who they expect, on average, to be profitable. The effects of FCA regulation have purposefully changed this to mitigate consumer detriment from lending to less creditworthy individuals.

CMA remedies

3.21 Some responses question whether the CMA remedies will be effective, and the extent to which the CMA remedies interact with the price cap. Given the CMA remedies are provisional at this stage and are subject to consultation, any comment on their future effectiveness would be speculative at this point.

3.22 While the CMA investigation and forthcoming remedies were relevant context for our work, the design of the cap did not rely on the CMA remedies – given that they are currently provisional and untested.

Acquisition costs

3.23 The impact of the cap on customer acquisition costs was the subject of much debate during the previous analytical work, and we asked firms about how acquisition costs had changed over time, the drivers of any changes, and what they expected to happen to acquisition costs after the cap. This was also an area covered in the market questionnaire, sent to 150 firms.

3.24 Based on the responses received at the time, and consistent with the responses to the consultation, while some firms expected these costs to rise, some expected them to fall. While some consultation responses suggested acquisition costs will rise, we have received no evidence showing acquisition cost increases, and nor have we received estimates of the scale of any increases.

3.25 In our view, given the cap reduces the revenues available to firms, this is likely to reduce firms' willingness and ability to pay for acquisition in the future, and as a consequence we expect acquisition costs to fall. In the technical annex to CP14/10, we included sensitivity analysis showing the impact of a reduction in acquisition costs.

3.26 In light of the consultation responses received on this point, we have undertaken further sensitivity analysis to look at the impact of increasing acquisition costs.

13 The customer survey commissioned by the CMA found that 26% of those who had never used an online lender said that they had considered doing so.

3.27 As shown in Table 23 below, the incremental impact of a 10% increase in acquisition costs would be small: the incremental changes to revenue and contributions after the cap is applied would be less than 2% overall for the modelled firms.

3.28 These results are based on a cap of 100% total cost of credit, 0.8% initial cost cap, and default cap of £15. While results would differ slightly for other specifications of the cap, any differences would not be significant.

Table 23: Impact of 10% increase in acquisition costs

	Increase Acquisition Costs by 10%	
Firm	**Revenue**	**Contributions**
Change in values	0.7%	1.8%

Source: HCSTC supply model, six of eight firms modelled, 2012-13 data, FCA baseline adjustments

3.29 Changes to acquisition costs have relatively little impact, and would not materially affect the conclusions of our exit analysis.

Conclusion

3.30 The dynamic responses that we modelled set out in the consultation paper were carefully considered, based on the evidence available to us. No new evidence has been received that would affect the judgements we made previously regarding which responses would be plausible, or the scale of possible responses. The sensitivity analysis previously carried out suggests that any changes to the assumptions underpinning the responses modelled would not significantly affect our results or conclusions.

3.31 We continue to expect that acquisition costs will fall after the cap, but have made no changes to the assumption used for modelling purposes that there will be no changes to acquisition costs. We also note that changing this assumption – in either direction within sensible margins – would have no significant impact on the results of the model. On that basis we do not intend to alter our conclusions.

Challenges to interpretation of future operation of the HCSTC market

Summary of responses

3.32 A number of responses from firms questioned our approach to how we assessed how the HCSTC will operate in future. Criticisms included that:

- the market will become oligopolistic, restricting consumer choice and creating additional entry barriers, but no account is made for this in the analysis
- the price cap disadvantages some firms as it has differential impacts depending on loan amount and duration – particularly impacting the smallest and shortest loans

Assessment

Entry barriers

3.33 One respondent to our consultation suggested that our analysis did not adequately take into account the effect of the price cap proposals on potential new market entrants, and the resulting ability of smaller firms to be able to grow and challenge incumbent firms.

3.34 As part of our competition analysis, we considered the impact of a firm such as a retail bank entering the market. However, we noted the difficulties involved in robustly estimating the impact of new entry, and based on the evidence available to us we concluded that entry from a retail bank was unlikely. We did not mention the likelihood or impact of entry of small firms.

3.35 We noted in our consultation that there do not appear to be significant operational entry barriers in the HCSTC market, and that while any reputational barriers may fall post-cap, we did not think this would be sufficient to induce additional entry[14]. Further, we noted that the cap was likely to reduce the incentives to enter, in terms of the revenues available to firms. As we set out in the consultation paper:

'On balance, we consider the likelihood of any new entry to the market to be low.'

3.36 We do not consider that there are material barriers to entry or expansion in the HCSTC market, or that the cap itself will create any barriers to expansion – as long as lending is affordable. We also note that forthcoming CMA remedies which are designed to increase price competition which should help new lenders compete.

Consumer choice

3.37 One respondent noted that following the cap, consumer choice would fall, with an associated (negative) impact on consumer welfare. The response noted that this was not considered as part of the analysis conducted.

3.38 According to our analysis of the impact of the cap, the number of active firms in the market is indeed expected to fall. However, in general terms the products on offer in the market are relatively homogeneous. While there may be fewer brands to choose from post-cap, it is unclear whether this would in fact represent a material reduction in the choice of products available to HCSTC consumers or a reduction in effective competition in the interests of consumers. We have maintained our earlier assumption that if firms exit, profitable customers, who it is affordable to lend to, will be picked up by other firms.

3.39 Further, our assessment of firm exit analysis based on static model of firm profitability was arguably cautious, and based on responses to the consultation it appears that a significant number of firms are planning to continue in the market once the cap is in place. This limits the extent to which consumer choice (in terms of brand) will actually fall in practice.

3.40 Finally, our demand analysis shows that, on average, HCSTC loan use leads to negative financial outcomes in the medium-term and our consumer survey analysis did not find statistically significantly worse financial or non-financial welfare outcomes resulting from a lack of HCSTC access. At the time of the consultation, we noted the methodological difficulties associated with estimating direct welfare impacts, and we did not make direct welfare estimates. However, given the findings of the demand analysis that we undertook and published, it is not clear that any reductions in consumer choice in the HCSTC market would necessarily lead to welfare reductions in principle.

Provision of small and short duration loans

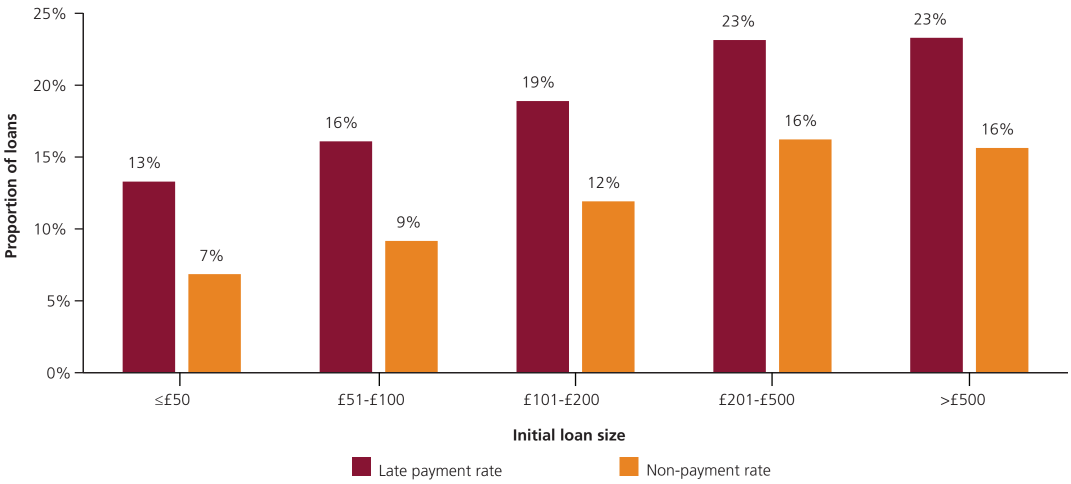
3.41 Specifically, we received comments that the cap would reduce the availability of very short-term loans, which would be one element of reduced choice. We acknowledged in CP14/10 that as the cap is calculated as a percentage of principal, it could impact on the supply of the smallest and shortest duration loans. Based on the consultation responses received, we undertook

14 Technical Annex 2, P123

some further analytical work to check the impact of the initial cost cap on the shortest, smallest loans, and found that:

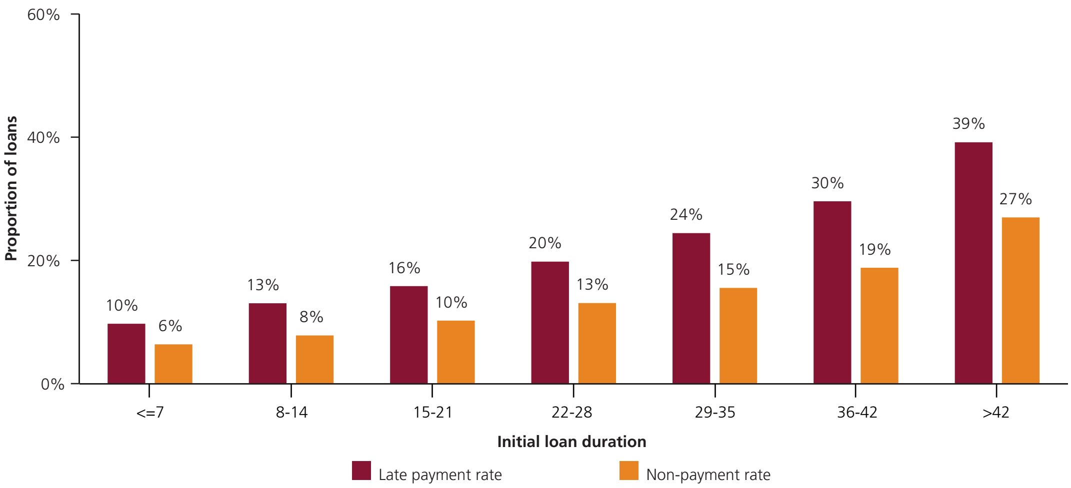
a. Small (≤£50) and short duration loans (≤7 days) are used by borrowers who are more creditworthy at the time of loan application than longer and are less likely to result in loans being paid late or remain unpaid than longer duration or larger loans[15]. This is displayed in Figure 3 and Figure 4 below which respectively show the proportion of loans with late and non-payment by loan size and duration. For the cohort of consumers who first took out loans in Q1 2012 the duration of loans initially agreed to last seven or less days is, on average, extended by four days.

Figure 3: Proportion of loans incurring late payment charges or not being repaid by initial loan size



Source: FCA HCSTC supply side model output; 8 firms; cap includes 100% total cost cap and £15 default cap; static impact; base case volume impact assumption

Figure 4: Proportion of loans incurring late payment charges or not being repaid by initial loan duration



Source: FCA HCSTC supply side model output; 8 firms; cap includes 100% total cost cap and £15 default cap; static impact; FCA

15 Loans are considered to be paid late if either total post default revenue is higher than £5 or late payment fee is higher than 5 GBP.

adjusted baseline as in consultation paper.

b. Table 24 displays that there is a close link between loan size and borrowing duration. Half of loans with an initial principal less than or equal to £50 are taken out for less than 14 days.

Table 24: Distribution of loans by initial size and duration

Initial loan size	Initial loan duration (days)							Total
	<=7	7-14	15 – 21	22 – 28	29 – 35	36 – 42	>42	
<=£50	3%	2%	1%	1%	2%	0%	0%	**10%**
£51 – £100	3%	4%	3%	3%	4%	1%	1%	**19%**
£101 – £200	3%	5%	5%	5%	5%	1%	2%	**26%**
£201 – £500	2%	5%	6%	9%	7%	1%	3%	**34%**
>£500	0%	1%	1%	4%	4%	0%	2%	**13%**
Total	**12%**	**17%**	**16%**	**22%**	**22%**	**4%**	**8%**	**100%**

Source: Firm data provided to FCA (37 firms, pre-baseline adjustments)

c. Borrowers whose first loan is a short loan have an average higher repeat loan usage (those starting with a 1-7 day loan will take on average a further 11 loans). The majority of repeat loan usage (70%) is for a longer loan duration.

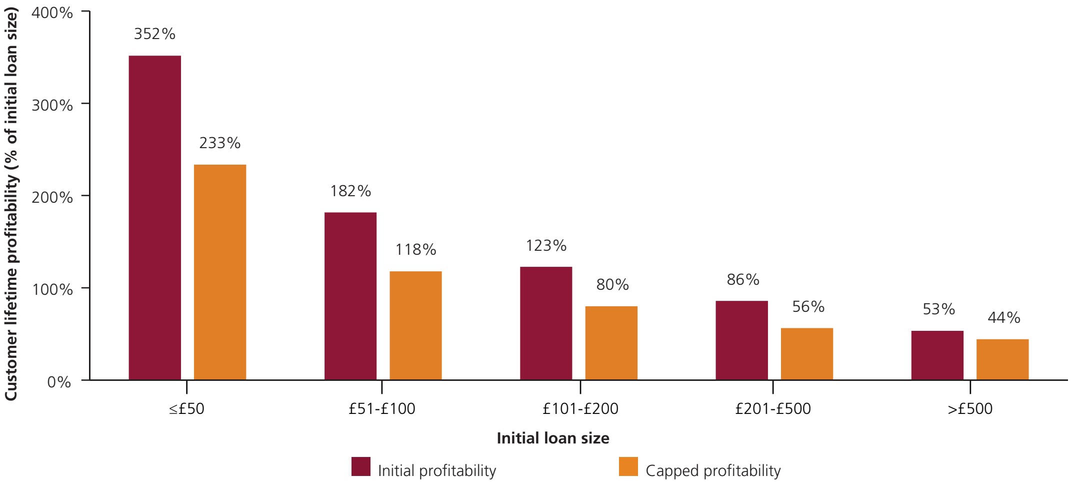
Table 25: Loan use by duration

Mean number of loans used	Duration of subsequent loans (days)						Total number of loans used
Initial duration of first loan	1-7	8-14	15-21	22-31	32-60	61+	
1-7 days	3.4	2.7	1.9	2.4	0.6	0.3	**11.3**
8-14 days	1.4	2.1	2.0	3.0	0.8	0.4	**9.7**
15-21 days	0.7	1.2	2.4	3.0	0.7	0.3	**8.3**
22-31 days	0.5	1.0	1.3	3.3	0.9	0.3	**7.3**
32-60 days	0.3	0.8	1.1	2.7	1.4	0.4	**6.7**
61+	0.3	0.6	1.0	1.9	0.6	1.2	**5.6**

Source: Firm data provided to FCA (37 firms, pre-baseline adjustments) for consumers whose first use of HCSTC was in Q1 2012

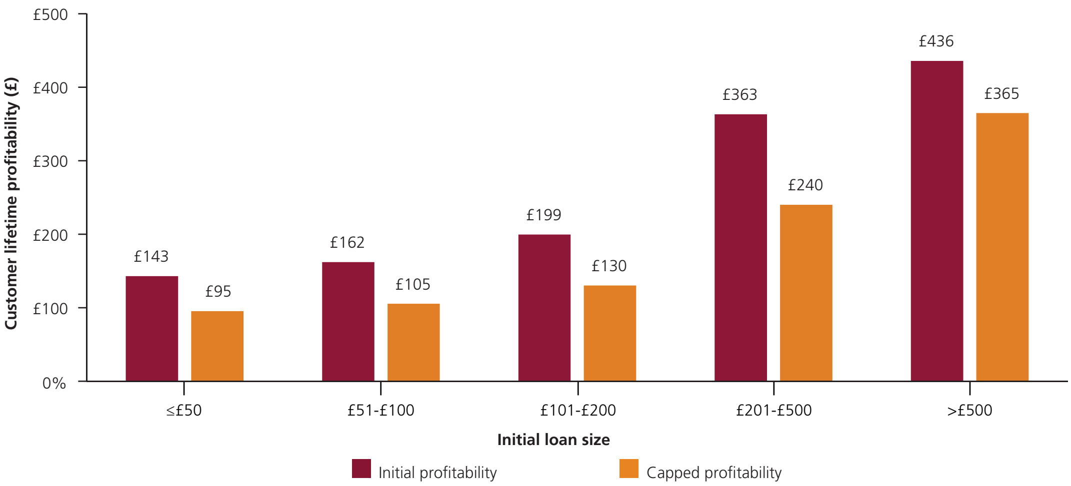
d. Small loans are profitable at a customer level after the cap (although significantly less profitable at a loan level) as displayed by Figure 5. This is due to consumers who initially take out small loans often coming back for multiple, larger loans over time (which are therefore a high relative proportion of the initial, small loan). Figure 6 shows unsurprisingly that the pound levels of customer profitability are lower than for larger loan sizes (where more revenue can accrue). Figure 7 shows how, on average, small loans are also profitable at the loan level. When assessing the impact of the cap we see in Figure 8 that acceptance rates do not indicate that disproportionately more of these loan applications will be denied due to the price cap than other loan sizes.

Figure 5: Relative customer lifetime profitability relative to initial loan size (split by initial loan size)



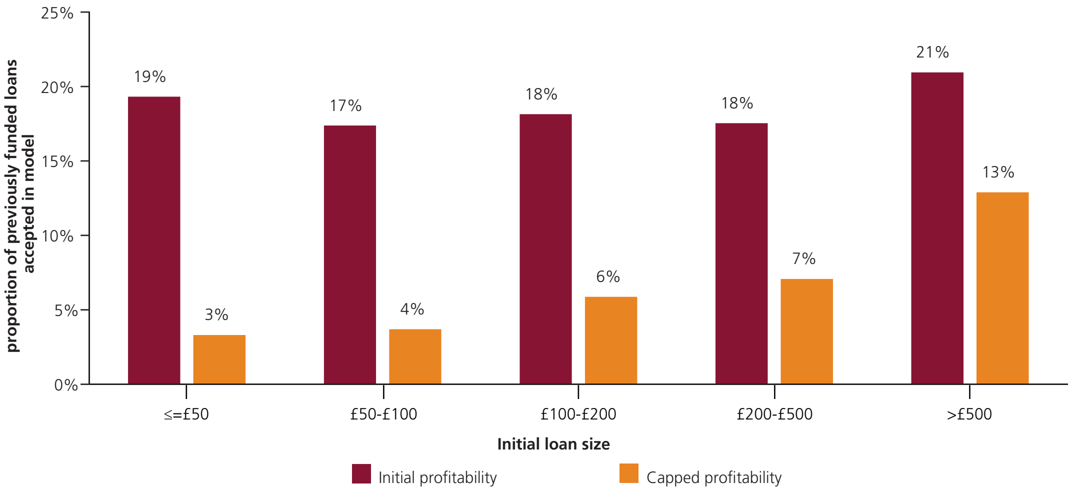
Source: FCA HCSTC supply side model output; 8 firms; cap includes 100% total cost cap and £15 default cap; static impact; FCA adjusted baseline as in consultation paper.

Figure 6: Customer lifetime profitability (split by initial loan size)



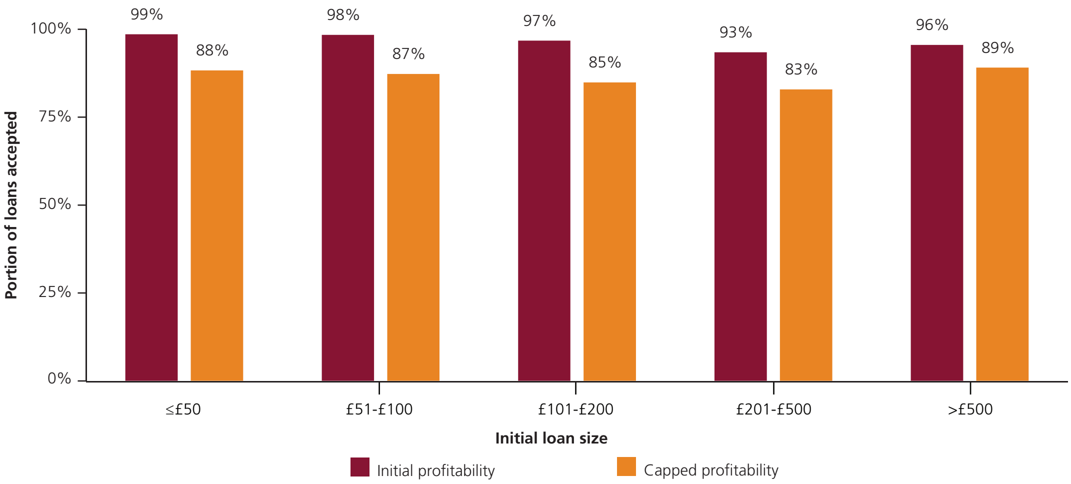
Source: FCA HCSTC supply side model output; 8 firms; cap includes 100% total cost cap and £15 default cap; static impact; FCA adjusted baseline as in consultation paper.

Figure 7: Relative loan profitability relative to initial loan size (split initial loan size)



Source: FCA HCSTC supply side model output; 8 firms; cap includes 100% total cost cap and £15 default cap; static impact; FCA adjusted baseline as in consultation paper.

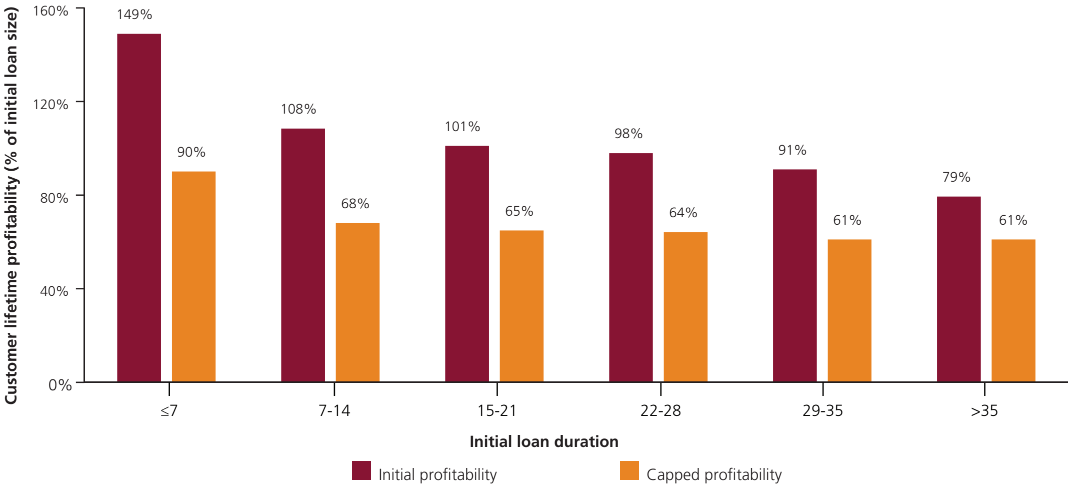
Figure 8: Acceptance rates (split by initial loan size)



Source: FCA HCSTC supply side model output; 8 firms; cap includes 100% total cost cap and £15 default cap; static impact; FCA adjusted baseline as in consultation paper.

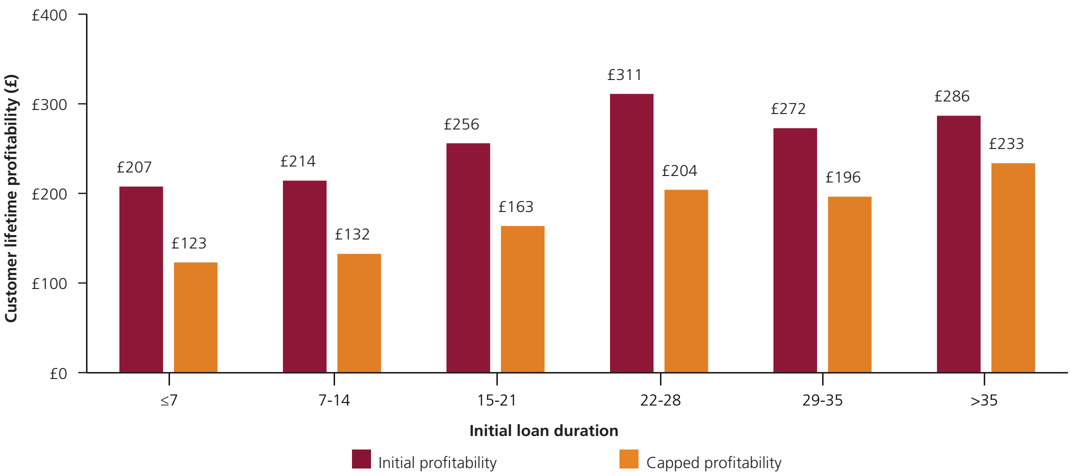
e. Performing the same analysis for loan duration rather than loan size produces similar conclusions. The main difference is that, as presented in Figure 11, at a loan level, loans under seven days are barely profitable. As the initial cost cap is proportional to loan duration the loan-level profitability is noticeably reduced by the cap. Focusing on loan-level expected profitability therefore appears an inaccurate basis to decide on whether loans will be granted post-cap especially – especially given the volume of repeat lending. However, taking a customer-level view displays that post-cap these loans remain profitable to lend to (relative and absolute profitability displayed in Figure 9 and Figure 10 respectively) and post-cap acceptance rates are actually higher for these compared to longer loan durations (Figure 12).

Figure 9: Relative customer lifetime profitability relative to initial loan size (split by initial loan duration)



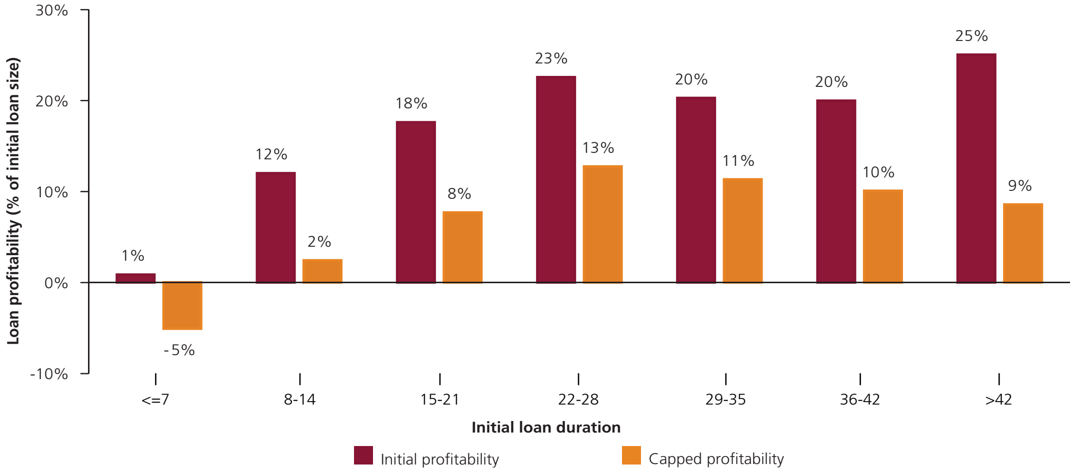
Source: FCA HCSTC supply side model output; 8 firms; cap includes 100% total cost cap and £15 default cap; static impact; FCA adjusted baseline as in consultation paper.

Figure 10: Customer lifetime profitability (split by initial loan duration)



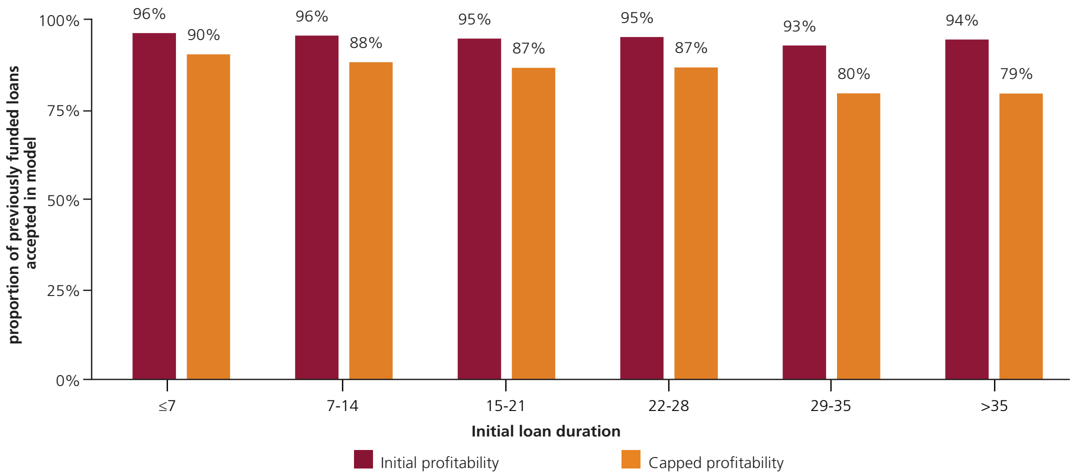
Source: FCA HCSTC supply side model output; 8 firms; cap includes 100% total cost cap and £15 default cap; static impact; FCA adjusted baseline as in consultation paper.

Figure 11: Relative loan profitability relative to initial loan size (split initial loan duration)



Source: FCA HCSTC supply side model output; 8 firms; cap includes 100% total cost cap and £15 default cap; static impact; FCA adjusted baseline as in consultation paper.

Figure 12: Acceptance rate (split by initial loan duration)



Source: FCA HCSTC supply side model output; 8 firms; cap includes 100% total cost cap and £15 default cap; static impact; FCA adjusted baseline as in consultation paper.

3.42 To calculate the effect of the cap on loans of different sizes and durations (the results of which are shown above) we carried out additional sensitivity analysis of our model allowing lenders to vary their lending strategy depending on the size or initial duration of loans[16]. This sensitivity analysis has been conducted without the calibration exercise carried out in the original model as described in the consultation paper. The consequence of this is that it may lead to slightly lower loan volumes and slightly higher profits for lenders. The level of calibration that could be needed can be assessed based on acceptance rates of different loans pre cap.

3.43 The falls in acceptance rates are similar for small or short duration loans compared to larger and longer duration loans indicating that the cap is not expected to disproportionately (adversely) affect the provision of these loans.

16 More precisely, we allowed lenders to take different lending decisions with respect to loans having the same score but different loan sizes or durations depending on the expected profits from these different loan sizes or durations.

3.44 We investigated the potential incentives to lenders from offering customers larger or longer duration loans through customer lifetime profitability (both in absolute and in relative terms) for different loan types. The analysis showed relative customer level profitability has fallen similarly for different loan sizes and smallest loans remained the most profitable in relative terms. It can be explained by the fact that with quite a small amount of initial lending (that might be considered as an investment) lenders gain customers who often take out (often larger) loans in the future providing the firm with a stream of income.

3.45 Some caution has to be taken when considering potential incremental profits of offering larger loans (as the respective observations refer to different borrowers and potentially also different lenders), however, also in absolute terms lenders do not seem to receive significant customer level profits for offering larger loans (in relation to the required additional lending).

3.46 Analysing the shortest duration loans it is important to note that those are usually smaller loans that are more profitable in relative terms but less profitable in absolute terms (in comparison to the remaining loans). As highlighted in the consultation paper, lenders may respond to the cap by extending the duration of their product offerings as a dynamic response. We also acknowledge that by lenders dynamically changing their minimum lending durations and using Early Settlement Regulations they can still profitably offer loans to these customers desiring short-term loans.

3.47 We note the CMA's assessment of these impacts is also consistent with our assessment[17]:

'An incentive will nevertheless exist for lenders to continue to offer small or short-duration loans. Specifically, this could be the case if there are marketing benefits associated with the simplicity or flexibility of a product offering that allows customers greater control over how much they borrow and how long for. Moreover, the propensity of customers to return to a lender for further loans implies that the expected revenue associated with a customer taking out a loan of limited value or duration is likely to extend beyond that single transaction.'

Conclusion

3.48 We do not consider that there are material barriers to entry or expansion in the HCSTC market, or that the cap itself will create any barriers to expansion – as long as lending is affordable. Nor do we consider that consumer choice will be reduced significantly, or that any reduction in choice would necessarily have negative impacts on consumers.

3.49 With regards to small or short duration loans, on balance, we would expect the customers interested in applying for these loans will still be served by lenders after introduction of the cap (if it is affordable for them to do so).

3.50 This is partly because consumers with a demand for credit appear willing to switch to longer loan durations and do not appear to show such strong preferences that if they could not access a seven day loan they would go without funds rather than take out a longer duration loan.

3.51 From a lender perspective it is optimal to lend to these customers post-cap as they are lower than average risk and profitable at the customer level based on expectations of future loans.

3.52 The cap might slightly impact the duration of written loans (less likely their size) as part of lenders' dynamic responses to the cap, however, we don't expect that effect to materially impact our conclusions as this dynamic response was considered in the consultation.

17 CMA (2014) provisional decision on remedies, bullet point 29, page A6(1)-7

3.53 Based on the evidence, we concluded the current cap structure and level does not indicate that it would have a disproportionate impact on small or short-duration loans. As explained in the consultation paper the initial cost cap has been designed to be proportionate to the borrowing amount and duration of lending to ensure an appropriate degree of protection for borrowers (ensuring small, short loans do not incur disproportionately high charges) and being fair to firms (allowing them to gain more revenue from larger loans outstanding for more time incurring greater costs). As explained in the consultation paper and Policy Statement alternate structures could create gaming issues and unintended consequences. Overall, we did not consider that these responses warranted a change to our overall approach.

Scope of the cap

Summary of responses

3.54 We received a number of responses from firms and consumers organisations arguing the cap should apply to a wider set of consumer credit markets, particularly those where headline rates are equivalent or can be higher than HCSTC. Credit markets suggested include: credit cards; overdrafts; logbook loans; home credit; pawn broking; and some credit union products.

Assessment

3.55 We discussed the scope of the cap with firms as part of the market questionnaire, concentrating on duration, size of loan, and other credit markets. We also spoke to the CMA and assessed previously available research, as well as conduct our own research. This suggested there is very limited substitution between HCSTC and other credit markets.

3.56 Parliament has given us a statutory duty to impose price cap rules in relation to at least one type of regulated credit agreements which appear to us to involve HCSTC. We have set out the definition of HCSTC. To satisfy that duty the lending must be a type for high cost short term credit and hence this consultation was not concerned with other credit markets. Further, we set out in detail in CP14/10 the reasoning behind the chosen scope of the cap, including that our analysis and conclusions on the scope of the cap was consistent with the work done by the CMA as part of their investigation, and previous research.

3.57 While responses call for the scope of the cap to be widened, no new evidence has been received that would lead to us changing the chosen scope of the cap.

Conclusion

3.58 We do not propose to amend the scope of the cap.

Challenges to concentration analysis

Summary of responses

3.59 One firm response queried whether we double counted revenue for larger firms with franchise operating structures in our estimate of total market revenue.

Assessment

3.60 Market revenue estimates were created based on reported revenues submitted by firms either as part of detailed data submissions, or in responses to the market questionnaire.

3.61 For firms that submitted detailed data that do use a franchise model, the revenue data was submitted at group-level. No franchisee revenue was double counted in our market revenue estimates.

Conclusion

3.62 No franchisee revenue was double counted in our market revenue estimates. The estimates, and our assessment of concentration in the market previously set out in CP14/10 therefore still stand.

4. Demand issues

4.1 This section covers the responses received that related to the demand analysis previously undertaken. The following issues are covered:

- credit reference agency (CRA) data analysis misapplied or inadequate
- assumption of CRA data analysis methodology not stated
- future use of illegal money lending (IML) higher than estimated
- increased use of non-UK authorised lenders
- welfare impacts not captured in previous analysis
- inaccurate welfare impacts in consumer survey analysis
- consumer survey uses misleading sample
- new survey evidence contradicts FCA survey findings

Credit reference agency (CRA) data analysis misapplied or inadequate

Summary of responses

4.2 Some respondents expressed concerns relating to the empirical analysis of CRA data. One firm commissioned an expert economist to review the technical analysis of the 'demand side' work. The reviewer agreed with the choice of methodology (as discussed below at paragraph 4.43) but identified two concerns with the empirical analysis.

4.3 First, the reviewer expressed concern that firm credit score data might not be appropriate for the application of the Regression Discontinuity Design (RDD) on the grounds that the data appears to indicate some manipulation of the credit score variable by individual applicants. This is evidenced in some 'bunching' of the credit score variable just above lender credit score cut-off thresholds.

4.4 Second, the reviewer raised a concern that the estimated models for the outcome 'exceeded overdraft limit' included in the estimation sample observations for individuals without access to an overdraft. In doing so, the precision of the estimated coefficients had been artificially increased and the magnitude of the estimated coefficient is biased by mis-measurement.

4.5 In addition to these concerns, one firm raised a criticism that the analysis had placed too much weight on online lenders and insufficient regard had been given to high-street lenders.

Assessment

4.6 The expert economist reviewer's concerns relating to the RDD analysis merited further consideration. The first concern, relating to the density of the credit score running variable, was acknowledged with explanation in the consultation paper technical annex[18]. Below we further elaborate on this issue and explain why it does not constitute a challenge to identification.

4.7 The expert economist's second concern is also valid in light of the technical annex description of the analysis. However, further examination of the data provided below demonstrates the concern relating to sample selection is not warranted.

4.8 Finally, acknowledging the concern of one firm that the technical annex included insufficient analysis of high-street lending, we present new analysis of high-street lending below.

4.9 The first concern related to manipulation of the running variable. This topic was described in Chapter 7 'Additional Analysis: RDD Robustness' at Section D 'Density Test' p. 210. We do not repeat the explanation provided in that section regarding the potential violation of identification indicated by bunching of the running variable observations just above the credit score cut-off threshold. Instead, we present new evidence which clarifies why this occurs in our data and why, based on this evidence, our conclusion is this does not constitute a violation of identification.

4.10 As explained in the consultation paper technical annex, for some lender-processes there is some evidence of small increases in density just above the cut-off threshold. However, this increase in mostly attributable to observations for loan applications made via lead generators.

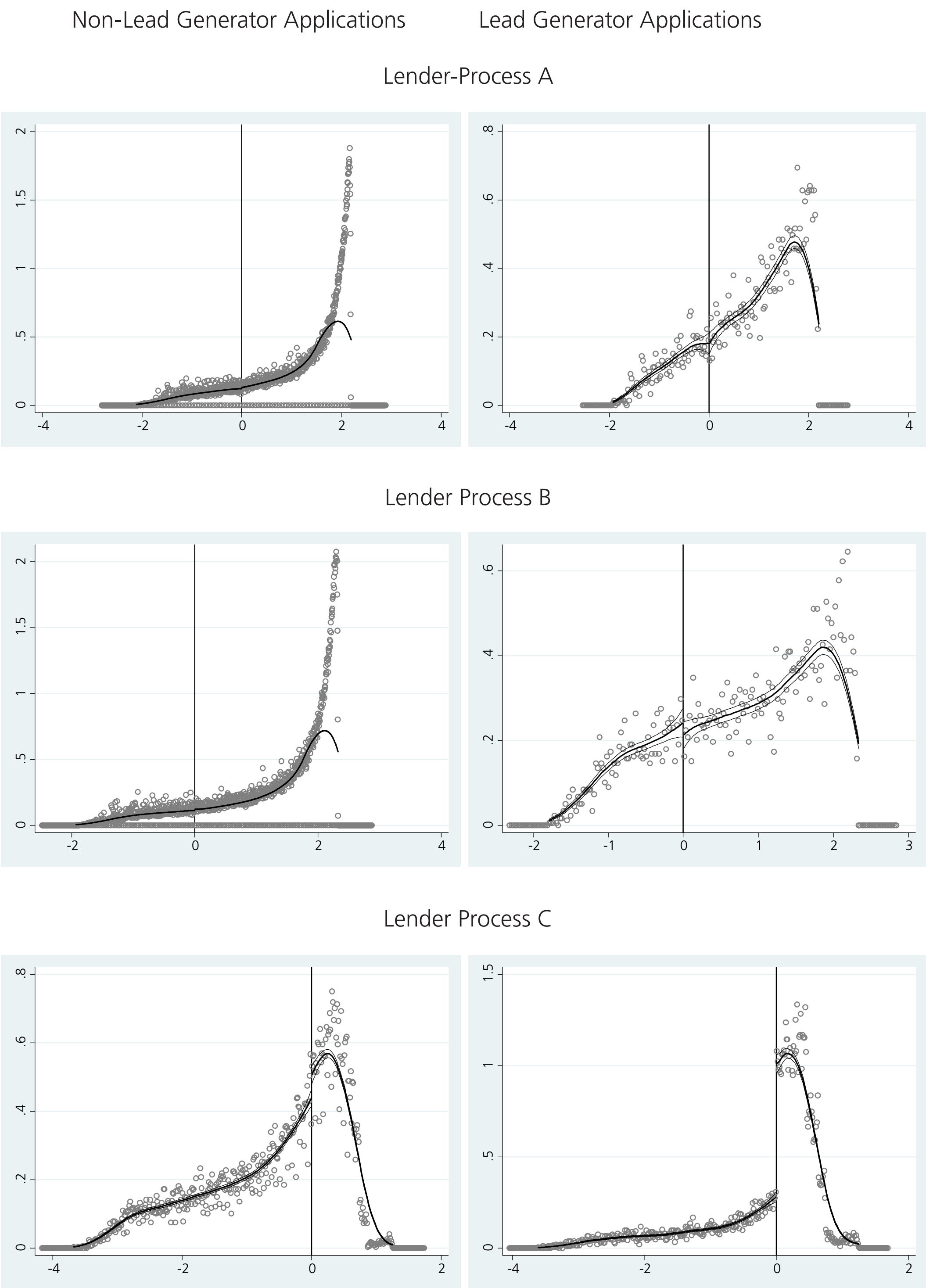
4.11 To illustrate this, Figure 13 below shows illustrations for the density (y axis) distributions of the running variable (the normalised firm credit score on the x-axis) around the firm's credit-score cut-off threshold for the four lender-processes in the sample. These are produced using the STATA 'DCdensity'.do file provided by Justin McCrary which accompanies McCrary (2008). These illustrations are labelled A, B, C and D.

4.12 As can be seen from the illustrations, for observations from applicants not using lead generators there is no discernible jump in the density at the threshold level other than a small jump in Lender-Process C (the plots include 95% confidence intervals). For samples of observations which include applications made via lead generators we do see some jumps in density, though these only exceed the confidence intervals for Lender-Process C. These occur for Lender-Process C where there is a clear upwards jump in density and for Lender-Process D where there is a clear downwards jump in density.

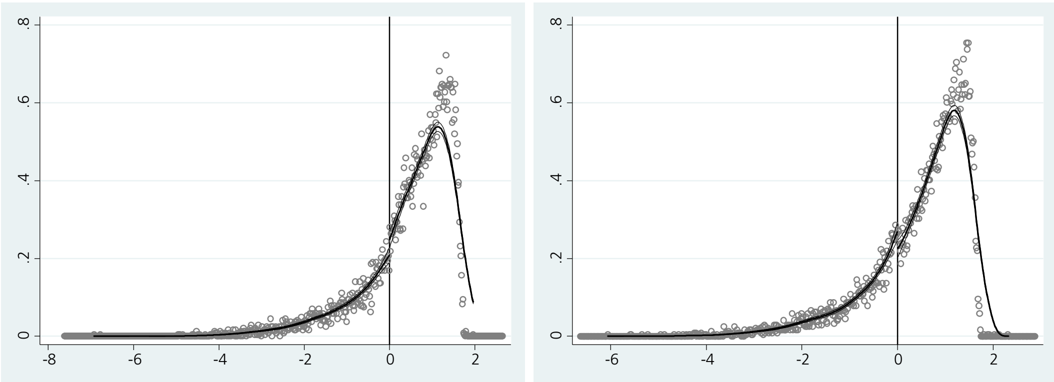
18 The running variable was specified as the distance from the credit score cut-off threshold normalised by the standard deviation of the firm-process credit score variable.

See CP14/10 Technical Annexes: Technical Annex 3: Impact of the cap on HCSTC demand, Section 7d (page 210).

Figure 13: RDD illustrations for distributions of standardised lender credit score



Lender Process D



4.13 In addition, Table 26 below summarises RDD estimates of the discontinuity jump in the running variable for all the lender-processes used in the RDD analysis. The table shows Local Wald Estimates for the (log) increase in density at the threshold together with standard errors reported in brackets. Results show small jumps in density for those samples not including lead generators for most lender processes but large jumps in density, in some cases downwards, for lender-process samples in which the applicant applied via a lead generator.

Table 26: Discontinuity estimates for running variable densities, lender processes A-I

	Observations from lead generators	
Lender-Process	**No**	**Yes**
A	0.078 (0.023)	0.062 (0.021)
B	0.065 (0.021)	0.067 (0.022)
C	0.138 (0.039)	0.583 (0.031)
D	0.191 (0.010)	0.915 (0.023)
E	0.039 (0.074)	-0.11 (0.071)
F	0.172 (0.076)	-0.192 (0.072)
G	0.059 (0.042)	0.631 (0.084)
H	0.234 (0.126)	0.635 (0.094)
I	0.0146 (0.041)	1.283 (0.061)

4.14 Why do these jumps in density occur, in particular for the samples of applicants using lead generators? As explained in the consultation paper technical annex, there are good reasons to think that individual applicants in the HCSTC are unable to precisely manipulate their credit scores around lender credit score cut-off thresholds. Hence it is unlikely that this is the cause of the apparent bunching of observations.

4.15 It is highly unlikely that individual applicants could know the credit score model of the firm, how the scores were calculated and where the relevant threshold is located. Neither do individual applicants have the ability to manipulate their credit file or other inputs into a credit score calculation.

4.16 However, this may not be the case for applications received via lead generators. There is some evidence, from the loan application records we collected and the evidence the CMA received to suggest that lead generators obtain loan acceptances for an individual applicant through submitting multiple applications to the same lender with modified details until a successful application is achieved[19].

4.17 This process of multiple applications involves incremental changes to the application form details and hence, in general, incremental movements in credit score. Once an incremental adjustment proves sufficient to gain a local acceptance the process of multiple applications ceases. Consequently, the activity of lead generators results in a bunching of successful applications with credit scores just above lender credit score cut-off thresholds.

4.18 Does this threaten identification in our RDD approach? Assignment to lead generators may be non-random. Lead generator applicants typically exhibit worse financial characteristics compared with non-lead-generator applicants. This may threaten identification as the effect of lead generators on the running variable distribution is to place a selected sample of individuals with typically poorer outcomes as credit-score marginal accepts. This would then bias RDD estimates.

4.19 However, crucially the falsification results presented in the consultation paper technical annex show no evidence of such effects. For the lender processes used in the RDD analysis we did not find pre-treatment differences. Were lead generator applicants with poor financial characteristics and observations of the outcome variable located just-above lender acceptance thresholds we would expect the falsification tests for these outcomes to fail as these applicants demonstrate persistently worse outcomes including the period before HCSTC application. The falsification tests for the outcomes of interest do not fail.

4.20 For completeness we also present here the coefficient estimates from the RDD models from a sample comprising the three lender processes with the smallest jumps in density. This sample comprises the majority of the original sample of nine lender processes in the technical annex results accompanying the consultation paper. We re-estimate RDD models for the three main outcomes of interest at 0-6 and 6-12 month horizons. Table 27 reports results. As can be seen from the table, the estimates from the three lender process sample are very similar to those from the nine lender process sample. In each case the estimated coefficients are slightly higher. Taken together with evidence from the falsification tests, we do not see evidence that the jumps in density around lender-process credit score cut-off thresholds pose a challenge to the validity of the results or our interpretation of them.

19 CMA (2014) Addendum to the provisional findings – further evidence on lead generators. Point 42 (b), page 14

Table 27: Discontinuity estimates only using lender processes with small jumps in density

	Months after loan application	3 lender processes with small jumps in density (standard error)	Coefficients from nine lender processes which passed falsification tests (as presented in consultation paper)
Exceeding overdraft limit	0-6	0.0615 (0.0648)	0.0568
	6-12	0.1953** (0.0700)	0.1697**
Ratio of non-HCSTC default balances	0-6	-0.015 (0.0104)	-0.0122
	6-12	0.0350** (0.0116)	0.0306**
Worsening credit event	0-6	0.0115 (0.0129)	0.0084
	0-6	0.0666*** (0.0113)	0.0577***

4.21 Therefore, given this evidence, and taken together with our previous findings that lead generator activity in the HCSTC market is limited, we do not see this as sufficient grounds to warrant concern regarding the robustness of the RDD estimates presented in the consultation paper technical annex.

4.22 The second concern related to the estimates for the 'exceeded overdraft limit' outcome of interest. These estimates were one of the outcomes modelled where there was clear evidence of consumer detriment arising due to HCSTC use, especially over the medium-term. The concern was raised that inclusion of observations in the estimation sample where the individual concerned had not access to an overdraft (and hence zero risk of exceeding their overdraft limit) would artificially increase the precision of the estimates and potentially bias the estimated coefficients upward. The direction of this effect is ambiguous and therefore it is possible that the coefficient estimates underestimate the effect of HCSTC use.

4.23 Further examination of the data demonstrates that the outcome variable 'exceeded overdraft limit' includes cases of unauthorised overdraft excesses where individuals had no arranged overdraft facility. This is because even where an arranged overdraft facility does not exist on a bank current account, a negative balance can occur due to fees being charged to the account or the bank deciding to allow a payment even if there are insufficient funds in the account. We observe this in the CRA data used in the analysis.

4.24 Table 28 below provides some summary statistics for the dependent variable 'exceeded overdraft limit' for individuals by their overdraft status. Data is presented for individuals by whether they held an authorised overdraft at any point 0-12 months after their first HCSTC application as evidenced by a stated overdraft facility (of any amount) on their credit file.

4.25 There are approximately 18.5 million individual-month observations without an overdraft facility and approximately 20 million individual-month observations with an overdraft. Among those with an overdraft, approximately 14% of individual-month records show the individual exceeding their overdraft limit in that month. However, among those without a stated overdraft facility 11% of cases record the individual exceeded their overdraft limit.

4.26 The small difference in these summary statistics is most likely due to selection effects, but is not so low to suggest that a significant proportion of those without a stated overdraft limit are not at risk of exceeding their 'overdraft limit' as coded in the dependent variable. Hence the variable 'exceeded overdraft limit' captures limit excesses both for those with stated overdraft lines and those with zero overdraft.

Table 28: Summary statistics for 'Exceeded overdraft limit' by overdraft status

Held Authorized Overdraft*	Exceeded Overdraft Limit 0-12 Months After HCSTC Application		Total	% of Total Exceeding Overdraft Limit
	No	Yes		
No	16,317,120	2,098,524	18,415,644	11%
Yes	8,592,334	1,396,166	9,998,500	14%

* at any time 0-12 months after HCSTC application

4.27 On this basis we consider it reasonable to present estimates of the RDD model for the whole sample of individual-month observations with and without arranged overdraft facilities as a valid approach to modelling the outcome of interest. This is because we are reasonably confident that the vast majority individual-month observations in the sample can be considered 'at risk' of a positive observation of the outcome variable of interest, and have no means of identifying the minority of cases which may not (which would be cases of, for example, 'basic bank accounts' where unauthorised overdraft occurrences are prevented by banks through not clearing fund requests which would take account balances below zero).

4.28 A third issue, raised by a firm, is the limited analysis of high-street lenders and their customers in the CRA analysis in the technical annex. The RDD approach could not be applied to these firms given the necessary condition of a clear jump in the likelihood of loan applications being accepted either side of a credit scoring threshold.

4.29 As this approach was not possible, the technical annex presented some indicative data illustrations which suggested that results from online lenders could be extrapolated to high-street firms. The three illustrations which comprise Figure 11 on page 223 of the consultation paper technical annex show very similar time trends in the main outcome variables of interest for high-street customers and online customers.

4.30 To further demonstrate the equivalence in data patterns seen between online and high-street lenders in CRA data below we present further analysis of high-street lender customer data. Specifically, we replicate the analysis shown in Figure 5 on page 216 of the consultation paper technical annex which shows trends in outcome variables by credit score bands.

4.31 Those estimates suggest HCSTC use leads to stronger effects on adverse outcomes of interest for individuals with poorer credit scores as evidences in similar trends in the outcome variable prior to the month of HCSTC acceptance but differential trends in the months following HCSTC application. The patterns shown on page 216 of the consultation paper technical annex can be interpreted, under assumptions, as indicative of differential treatment effects.

4.32 Figure 14 below presents new illustrations for high-street customers using data from the high-street lenders we received detailed data from. Each figure presents four lines which show trends in the outcome variable of interest for customers in four quartile credit score bands in which 'quartile4' includes applicants with the highest credit scores.

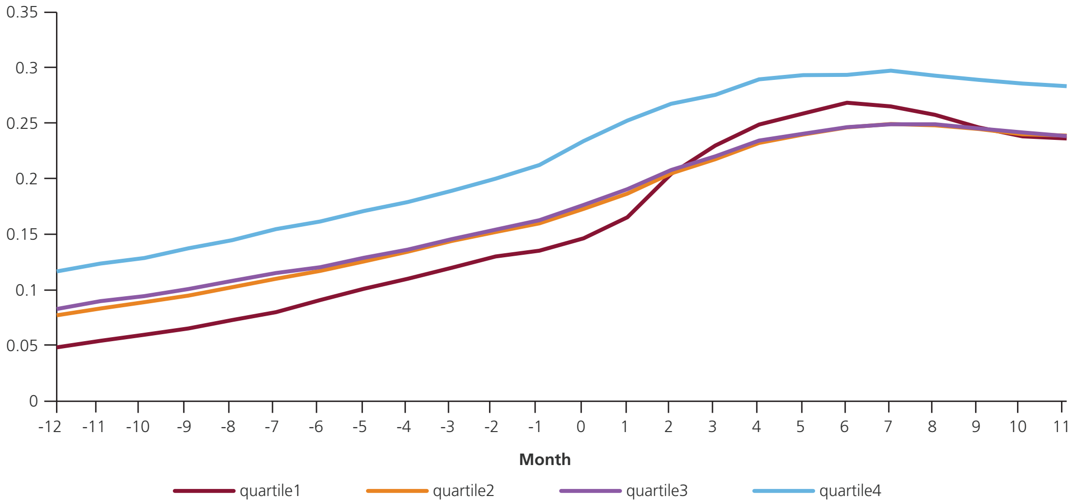
4.33 As can be seen from the figures, in each case all four credit score groups show very similar trends (though different levels) in the outcome of interest in the months preceding HCSTC acceptance. However, the lowest credit score quartile group sees a greater increase in the outcome variable of interest in the months following HCSTC acceptance compared with higher quartile groups.

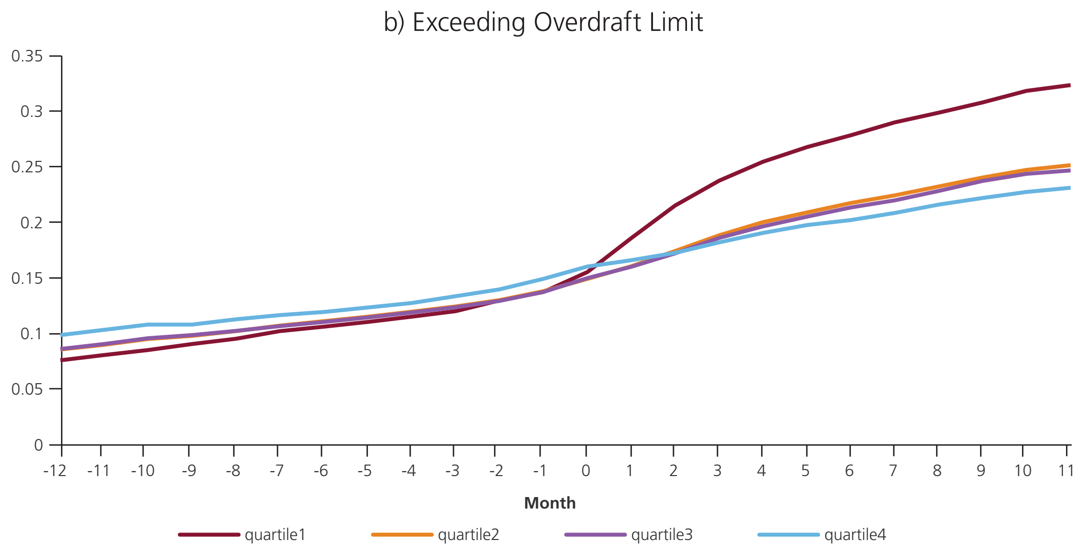
4.34 This result mimics that seen for online firms as shown in Figure 5, page 216 of the consultation paper technical annex. This presents additional evidence that the trends in the outcome variables of interest are very similar for online and high-street firms but, importantly, that differential trends associated within the timing of loan acceptance are also very similar between the two groups.

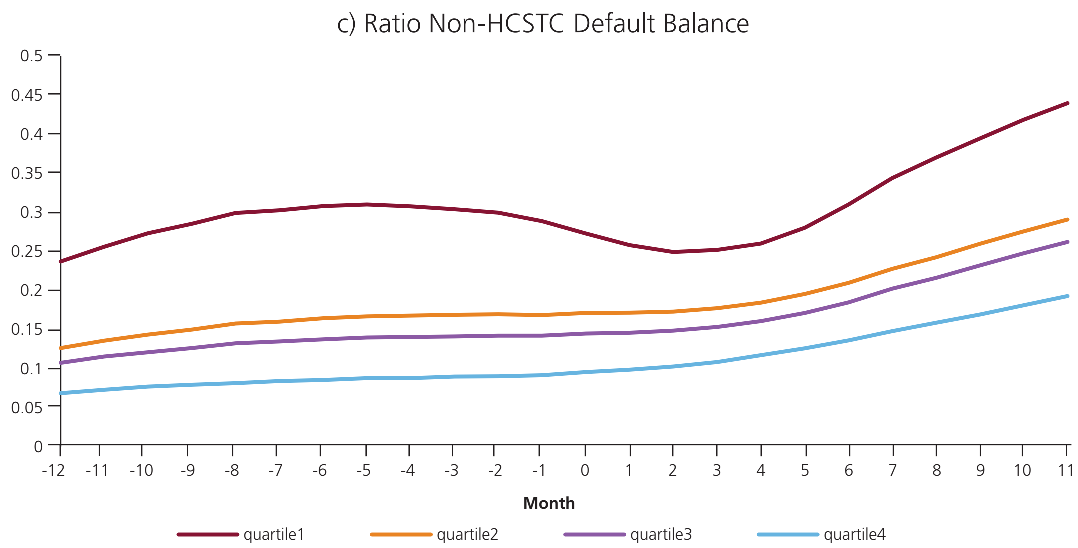
4.35 The evidence strongly suggests treatment effects of HCSTC use for high-street customers are quantitatively similar to those seen for online customers.

Figure 14: Trends in outcome variables by credit score bands for high-street customers, -12 to +11 months following HCSTC acceptance

a) Worsening Credit Event



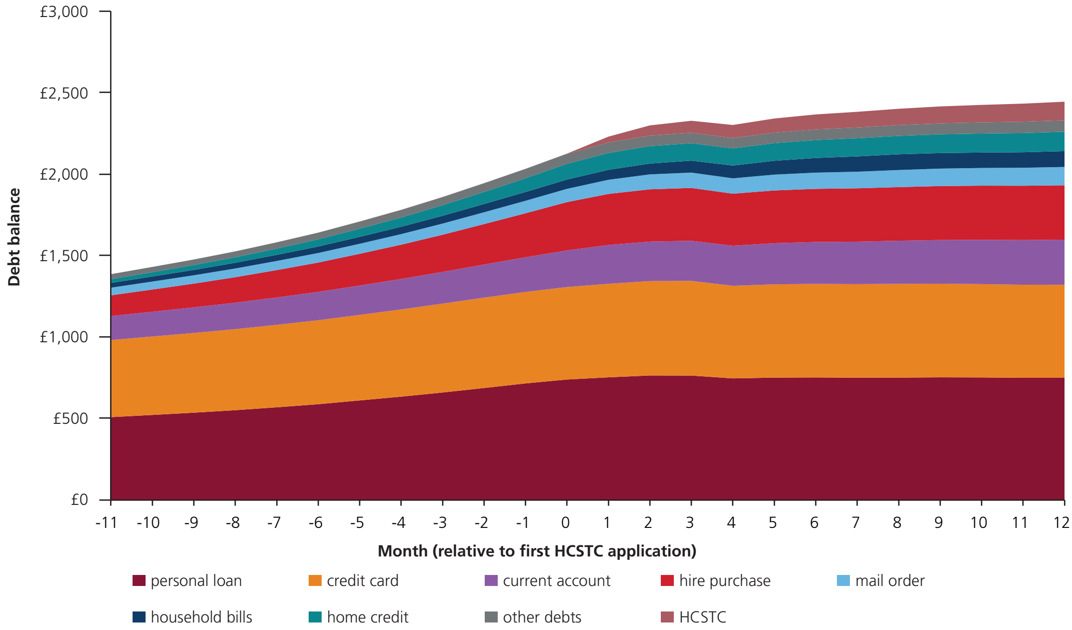




4.36 Given the consultation responses questioning our inferences of the circumstances of borrowers from analysing CRA and consumer survey evidence we decided it would be helpful to display the following charts. These show the financial circumstances of HCSTC applicants (through debts split by product type) before, during and after their first application for HCSTC.

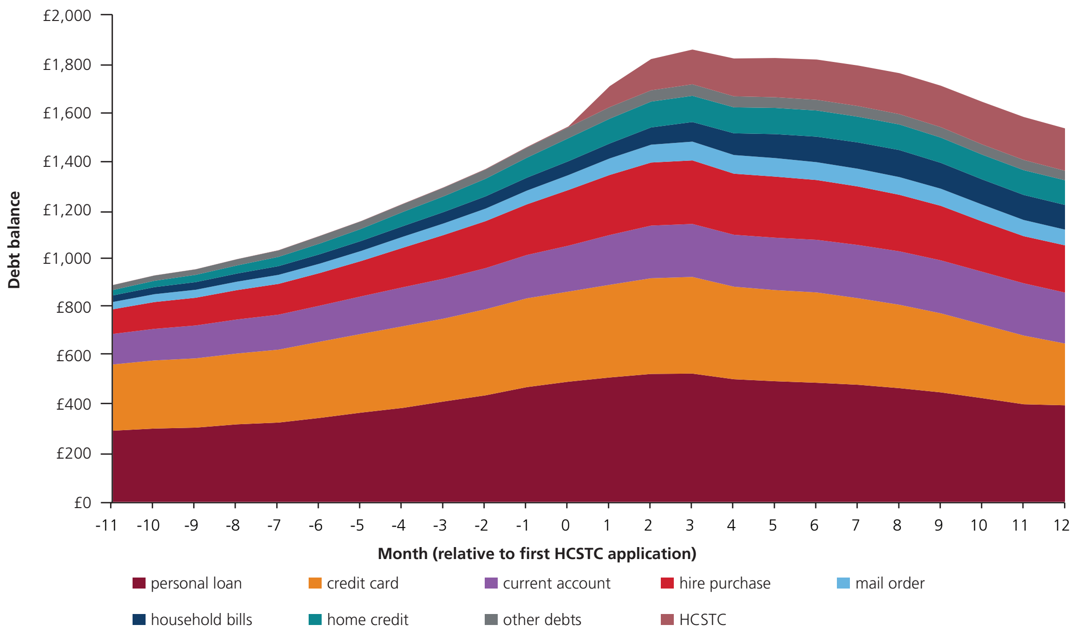
4.37 Figure 15 shows how, on average, debts were increasing before individuals first applied for HCSTC during the period 2012-2013. These rising debt balances, can be combined with other information regarding these individuals' circumstances from the supply-side, CRA and consumer survey analysis which shows these consumers are often financially distressed with high ex-ante chances of not fully repaying loans and ex-post realised late and non-payment rates, often with a significant proportion of their debt portfolio in arrears or default.

Figure 15: Average debt balances split by product type for all applicants whose first loan application was in 2012-2013



4.38 Figure 16 displays how the debt balances for applicants just above the application threshold for the nine lender processes with sharp discontinuities take on HCSTC debt which adds to their sharply rising debt balances and remains persistent for the next 12 months.

Figure 16: Average debt balances split by product type for applicants whose first loan application was just successful (displayed -12 to +11 months following HCSTC acceptance)



Conclusion

4.39 Following consideration of the concerns raised by the respondents and further analytical work we conclude, based on the evidence, that we do not have substantial concerns for the analysis undertaken or inferences drawn from it.

4.40 Further examination of the density of the running variable together with other robustness tests shows that, while there are some jumps in density seen at lender credit score cut-off thresholds, these are mainly associated with applications through lead generators which account for a small proportion of applications. Evidence from falsification tests shows the mechanism by which lead generator activity could bias RDD estimates is not evident in our data and therefore our results remain valid. We also present results which only use the three lender-processes where there are small changes in density. The estimates from these are similar to those using the 9 lender processes and therefore do not warrant us to materially altering our conclusions.

4.41 Further analysis of CRA data shows that the results for the exceeded overdraft limit outcome of interest presented in the consultation paper technical annex are valid as consumers who do not have an arranged overdraft can still record negative balances or subsequently access an overdraft.

4.42 We also show additional evidence that the trends in the outcome variables of interest are very similar for online and high-street firms but, importantly, that differential trends associated within the timing of loan acceptance are also very similar between the two groups. This evidence strongly suggests the treatment effects of HCSTC use for high-street customers which are quantitatively similar to those seen for online customers.

Assumption of CRA data analysis methodology not stated

Summary of responses

4.43 A small number of respondents commented on the methodology used in the analysis of Credit Reference Agency (CRA) data. The analysis used the technique known as Regression Discontinuity Design (RDD). Not all respondents were familiar with this approach, which was explained extensively in the technical annex accompanying the consultation paper.

4.44 One firm had commissioned an expert economist to review the analysis. The expert agreed with the choice of using the RDD approach, stating 'the methodology chosen by the FCA, under suitable assumptions, is appropriate in order to establish causal effects of HCSTC use on a variety of outcome measures'.

4.45 However, the expert also expressed some reservations regarding the analysis which we address here and in the following section. In particular, the expert highlighted that the technical annex may have neglected an underlying methodological assumption of the RDD approach as applied to the 'fuzzy' design in question relating to the relationship between the credit score and credit reference agency outcomes of interest.

Assessment

4.46 The respondent was correct to highlight this omission from the technical annex and we correct the omission here by stating the extra assumption required in order for the analysis to return Local Average Treatment Effects (LATE) in addition to those detailed in the consultation paper technical annex. The omission of this assumption did not affect the ability of respondents and their expert advisors to consider and intelligently respond to the consultation paper.

4.47 The expert reviewer states: 'In order to identify the LATE for compliers, typically a monotonicity assumption is invoked; this assumption stipulates that observational units correctly respond to the instrument, i.e. it excludes defiers (who take up HCSTC in the event that their credit score falls below the cut-off, and who do not use HCSTC if the credit score were to exceed the cut-off)'.

4.48 This remark is correct. We are aware that in this market there may be some occurrences of 'defiers' in the form of individuals whose applications for HCSTC were denied by their credit score but whom obtain loans or in the form of individuals who are accepted for HCSTC but choose not to take loans. Based on our previous analysis of consumers we expect the proportion of total individual loan observations which could constitute 'defiers' is very low in the market. We know the proportion of consumers who do not take out loans post credit score approval are fairly high (see Figure 2, page 190 CP14/10 technical annex). From the information we gathered regarding lenders' loan approval systems, we can primarily attribute this to the more stringent checks lenders complete for the consumers who pass the creditscoring thresholds, for example fraud checks. Filtering out fraudulent applications is known to be a critical part of online lenders' businesses in order for these to remain viable.

4.49 Applicants for HCSTC are often in financial difficulty and unable to access alternative sources of credit due to exhausting these options (displayed in both CRA and consumer survey datasets). This makes them unlikely to turn down a loan following approval by a lender. This evidence is further supported by consumers valuing speed and convenience (which would discourage them to defy). While there is little evidence of consumers being price sensitive and shopping around it should also be noted that 'defiers' would only contain consumers who defied all opportunities to take out loans rather than merely turning down one to borrow from another lender. Given the above evidence we conclude that 'defiant' activity is expected to be minimal in this market and this assumption is not central to the validity of the analysis.

Conclusion

4.50 We note the methodological monotonicity assumption required to assert our results constitute LATE effects was absent from the consultation paper technical annex and disclose its assumption and implications as described in the proceeding four paragraphs. We note the presence of 'defiers' but expect this to be a minimal proportion of applications given the systems used by lenders to filter out applications after the credit scoring stage and circumstances of applicants which makes them unlikely to make such choices. Our results and their implications remain unchanged by this.

Future use of illegal money lending (IML) higher than estimated

Summary of responses

4.51 Many responses referred to illegal lending. Responses raised two main concerns. First, that the consultation paper underestimated the increase in illegal lending as a result of the cap. One respondent cited evidence that unlicensed lending was an extensive problem in the US. Second, that the evidence presented in the consultation paper underestimated the true extent of illegal lending in the United Kingdom. This concern was raised by debt advice charities as well as lenders and consumer groups. The large number of comments and concerns expressed about this topic demonstrates the importance of averting illegal lending in the UK.

Assessment

4.52 The analysis of the extent of illegal lending presented in the consultation paper was based upon a survey measure of illegal lending. The consumer survey undertaken by FCA included a question (asked to all survey groups) on whether the respondent had considered borrowing from a 'loan shark'. This term was chosen on the advice of England's Illegal Money Lending Team.

4.53 As the term 'loan shark' may be ambiguous, for each individual who answered 'yes' a follow-up question asked the respondent to provide a short explanation of the term 'loan shark'. Some respondents' descriptions of 'loan shark' included the name of a licensed lender, or a description of regulated credit activities. Verbatim responses were recorded and filtered for responses which did not describe illegal lending activity. This edit reduced the number of identified cases of respondents considering borrowing from a 'loan shark' down from 137 to 90. The technical annex to the consultation paper stated the methodology for this filtering and summarised the verbatim responses which were edited out. The technical annex tables display results both with and without this filtering. The differences between those with and without access to HCSTC are not statistically significant using either measure across a range of empirical approaches.

4.54 A further question asked of all respondents was whether they had any interaction with a loan shark over the period following their HCSTC application (where interaction is defined as attempting to borrow from, actually having borrowed from, holding outstanding debts with, repaying debts to or having overdue debts with a loan shark). Overall, the consultation paper analysis showed that less than 2% of the response sample reported any interaction with a loan shark since application.

4.55 The analysis focusing on consumers close to the margin of lending showed that marginally unsuccessful applicants were more likely to have considered borrowing from a loan shark compared with marginally successful applicants. However, there was no statistically significant difference in these numbers. Among the 'marginally accepted' group 3.3% of respondents stated they had considered borrowing from a loan shark. Among the 'marginally unsuccessful' group 4.7% of respondents stated they had considered borrowing from a loan shark.

4.56 This evidence that a higher percentage of 'marginally unsuccessful' applicants are more likely to consider borrowing from a loan shark compared with those 'marginally successful' applicants could be misinterpreted as showing that HCSTC denial causes individuals to turn to illegal lending. Crucially, this difference in reported rates of considering borrowing from a loan shark between these groups is not statistically significant across a range of statistical tests. The methods of these tests (t-tests, regressions controlling for different factors such as socio-economic circumstances) were explained in CP14/10 technical annex 3 along with the results.

4.57 Consultation responses took issue with this analysis on the basis that the survey question used most likely under-reported the true extent of respondent consideration of illegal lending as a borrowing option, plus under-reported actual levels of illegal lending activity on the part of consumers.

4.58 Responses cited many reasons why consumers might under-report borrowing from an illegal lender. These included ambiguity over the term 'loan shark' (notwithstanding the filter analysis), social stigma concerns and reluctance to report what might be considered 'suspect' activity in a survey commissioned by the financial regulator.

4.59 We acknowledge these concerns that respondents to a consumer survey are likely to under-report borrowing from illegal lenders. There is evidence more generally that consumers tend to under-report levels of debt when asked about their debts in household surveys. Zinman (2009) shows that US consumers under-report credit card debt by comparing aggregated survey responses to the national accounts[20]. Karlan and Zinman (2007) use data on the actual credit holdings of South African consumers together with a consumer survey to show that nearly 50% of recent borrowers do not report their high-interest consumer loans[21].

4.60 We do not have any reason to believe our consumer survey is immune to these biases, or that in this instance the bias in responses is greater or lesser than that which would be found in other surveys. As explained in the consultation paper technical annex, the questions on 'loan sharks' included in the consumer survey were constructed based on the advice of England's Illegal Money Lending Team.

4.61 Although there may be under-reporting of borrowing from an illegal lender, this is the best evidence we have available. There is no evidence that a lack of access to HCSTC causes a statistically significant increase in the reported likelihood of borrowing from an illegal lender.

4.62 Our analysis for setting the price cap is not based on the level of borrowing from illegal lenders among HCSTC applicants, but instead based on the evidence, we currently have, that a lack of access to HCSTC does not result in a statistically significant increase in illegal lending.

4.63 Under-reporting of the level of IML use does not invalidate our analytical approach estimating the relationship between HCSTC access and use of IML unless there is reason to believe that the extent of under-reporting varies between the 'marginally successful' and 'marginally unsuccessful' groups.

4.64 We believe it to be unlikely that under-reporting differs between those in the marginally successful and marginally unsuccessful groups. This is because, by design, these groups are very similar in their characteristics as they span a relatively narrow interval of the credit score distribution.

4.65 Nevertheless, we cannot rule out the possibility that illegal lending is more under-reported among those in the 'marginally unsuccessful' group compared with those in the 'marginally successful' group. Equally, we cannot rule out the possibility that the reverse occurs and there is more under-reporting among the 'marginally successful' group compared to the 'marginally unsuccessful' group.

4.66 One important difference between the marginally successful and marginally unsuccessful groups was the confidence with which respondents, on average, reported they could recall their loan experience. In particular, respondents in the marginally unsuccessful group were statistically significantly less likely to report they could remember the loan application 'very well' and more likely to report they remembered the loan application 'not very well' or 'not well at all' compared with the marginally successful group (technical annex p.252, Figure 12 and following).

4.67 This difference could be important for the question on illegal lending if poor recall of a loan application causes respondents to under-report considering borrowing from an illegal lender. One respondent to the consultation raised this difference in 'recall confidence' as a concern with the consumer survey results, though this was not raised as a concern specifically relating to illegal lending.

4.68 On this basis, we have re-examined the survey data focuses on respondents by 'recall confidence'. We undertake a similar comparison of marginally successful and marginally

20 Ziman, J. (2009) 'Where is the Missing Credit Card Debt? Clues and Implications', Review of Income and Wealth 55: 249-265.

21 Karlan, D. and Zinman, J. (2008) 'Lying About Borrowing', Journal of the European Economic Association Papers and Proceedings', 6:2-3.

unsuccessful consumers who state they would consider borrowing from a loan shark but in this case analyse sub-samples by recall confidence.

4.69 First we consider only respondents who remember the loan 'very well', 'fairly well' or 'not very well' (hence excluding the 'not at all well' group'). Second we consider only respondents in the 'very well' or 'fairly well' group. Third we consider only respondents in the 'very well' group. For each sample, we again find no statistically significant difference in the likelihood of reporting the respondent considered using a loan shark (p-values from t-tests for equivalence of means are, respectively, 0.2481, 0.1214, 0.3037).

4.70 Instrumental Variable regression estimates also confirm that loan denial, instrumented by a dummy variable for the respondent's credit score falling just below the credit score cut-off threshold, does not cause the respondent to be more likely to report borrowing from a loan shark. The coefficient estimates and standard errors for the three samples described above are -0.0138 (0.0364), -0.0129 (0.0303) and 0.0563 (0.0289) respectively.

4.71 Hence there is no evidence among sub-samples of respondents who report higher recall confidence that loan denial causes higher rates of borrowing from illegal lenders. This may not be the only cause of differences in under-reporting between applicants above and below the lender credit score cut-off thresholds, but it was the only cause cited by a respondent. The evidence suggests this is not a valid concern.

4.72 In summary, the first objection to the analysis of illegal lending presented in the consultation paper raised a legitimate concern about the limitations of a consumer survey in measuring borrowing from illegal lending and the likely downward bias in reported rates of borrowing from illegal lenders. This is a valid concern.

4.73 While the level of illegal lending in the UK is thought to be low, as previously highlighted in CP14/10, the consequences of illegal lending activity can be severe for individuals – including threats, intimidation and violence[22]. While the FCA survey evidence is corroborated in new survey evidence provided in a response to the consultation, under-reporting is likely to be a widespread problem in surveys concerning illegal lending.

4.74 However, inference on the impact of the cap and resulting loan denial on illegal lending is not based upon the level of reported borrowing by HCSTC applicants from illegal lenders but instead upon the difference between consumers marginally successful and marginally unsuccessful in their loan applications.

4.75 New survey evidence was presented by the Consumer Finance Association (CFA), a trade association representing high-cost short-term credit lenders. This consisted of a survey of over 700 individuals whose applications were recently unsuccessful in the application for HCSTC included a question: 'Which of the following, if any, did you do when your short-term loan or payday loan application was declined?' This question invited multi-coded responses, one of which was 'borrowed from unlicensed lender who is NOT a friend or relative'. 4% of respondents reported this answer.

4.76 The survey evidence seen by FCA does not include details as to whether the sample principally comprises 'marginal rejected consumers' (as in the FCA TNS-BMRB survey) or some other selection of rejected consumers. But the similarity in responses to that seen in the FCA TNS-

22 For further information on the effects of illegal lending activity see the report by Policis for BIS (2010) 'Interim Evaluation of the National Illegal Money Lending Projects – Summary'. Department for Business, Innovation and Skills.

BMRB survey (in which 5% of respondents stated they considered borrowing from a loan shark following loan rejection) may corroborate the FCA TNS-BMRB survey result.

4.77 Some respondents took the view that, although the FCA survey analysis showed loan denial was unlikely to cause consumers to turn to illegal lenders in the current market environment, the introduction of the cap could generate developments in the 'market' for illegal lending which would cause illegal lending to increase.

4.78 An example mentioned by one respondent is activity in some US states where lenders based in states where a form of high-cost credit is legal trade into states where it is illegal to provide such credit. In a recent example of this alleged behaviour in the United States is that the Illinois Department of Financial and Professional Regulation filed five lawsuits against out-of state lenders operating exclusively online, selling loans into the state of Illinois and charging fees that are double the amount allowed under state law[23]. When considering this evidence in the UK context we had drawn a distinction between illegal lending, addressed in this section, and legal non-UK authorised lending, addressed in the following section.

4.79 Recent research by Pew Charitable Trusts has found the majority of aggressive and illegal actions undertaken by 'payday lenders' in the US are concentrated among lenders not licensed to operate in all state where they lend[24].

4.80 A firm presented survey data which suggests the majority of consumers do not check whether the lender they are borrowing from is licensed to lend within the UK market. This was cited as evidence for the concern that UK based unlicensed lenders lend in excess of the price cap. Such activity would be illegal and we have systems to identify such firms and an Unauthorised Business Division to take action against such activities.

4.81 Some respondents from the third sector highlighted that levels of illegal lending in the UK are thought to be low with, for example, very few clients contacting free-to-client money and debt advice providers regarding problems with debts to illegal lenders. One respondent cited a prior study by the Personal Finance Research Centre at the University of Bristol which showed illegal lending in the UK is limited and focused on particular urban geographies.

4.82 We have considered the concerns raised and will work with other organisations to monitor the extent of illegal money lending. These responses do not cause the FCA to revise its previous conclusion from the consumer survey evidence which stated the difficulties in estimating illegal money lending use and what we did to try to mitigate these and our results.

Conclusion

4.83 We have considered the evidence presented during the consultation and remain concerned about the welfare of consumers turning to illegal money lenders. Our consumer survey evidence indicates that it is unlikely that many customers left without access to HCSTC would turn to illegal money lending. Based on the evidence we have, a lack of access does not lead to statistically significantly more consumers using illegal money lenders. However, as acknowledged in the consultation paper, asking whether an individual would or has borrowed from illegal money lenders is an inherently difficult question to elicit individuals to answer honestly.

23 Press release, Illinois Attorney General, viewed online 7 October 2014 http://www.illinoisattorneygeneral.gov/pressroom/2014_04/20140408.html

24 Pew Charitable Trusts (2014) 'Fraud and Abuse Online: Harmful Practices in Internet Payday Lending'

Increased use of non-UK authorised lenders

4.84 Some concerns related to the potential for non-UK authorised lenders to operate in the UK – citing the international experience of regulation of the 'payday lending' market, focusing on evidence from the United States.

Assessment

4.85 Particular concern was expressed by some respondents on the potential for growth of a market of lending by non-UK authorised firms offering payday loans in the UK. The only avenue in the UK for a non-UK authorised firm to operate without being subject to CONC and the price cap rules is for an EEA lender to provide loans in the UK under the E-Commerce Directive. It is important to note that this is lawful under EU law.

4.86 We explained this further in CP14/10 Paragraphs 6.9-6.12. Firms undertaking such lending would need to comply with the legal provisions of their EEA State, including the provisions of various Directives, such as the Consumer Credit Directive (including the right to withdraw), the Unfair Terms in Consumer Credit Directive and Unfair Commercial Practices Directive.

4.87 We have applied the price cap to UK established debt collectors and UK established debt administrators working for EEA lenders to protect consumers of those lenders, where they are seeking to recover charges in excess of the cap.

4.88 We have also set the price cap at a level which is expected to keep a viable UK market, therefore discouraging firms from establishing in the EEA with a view to avoiding the price cap rules. The Treasury has announced that it intends to give us the power to allow us to take action if an incoming firm abuses the EU right of free movement by establishing in another member state, directing all or most of its activities to the UK and with a view to avoiding the rules that would apply if it had been established in another member state. The Treasury intend this power to in place by the time the price cap comes into force on 2 January 2015. These barriers and risks constitute significant fixed costs and business risks to firms who might seek to undertake this activity.

Conclusion

4.89 We acknowledge the risks consultation respondents raised regarding non-UK authorised lenders operating in the UK. We have taken measures in CP14/10 to mitigate these, subject to EU law in particular in relation to debt collection.

Welfare impacts not captured in previous analysis

Summary of responses

4.90 Some respondents were concerned that the FCA analysis of the impacts of a cap had overlooked some welfare impacts. A number of responses claimed the cap would be detrimental to consumers without citing any specific evidence or argument. Other respondents criticised the approach to modelling consumer outcomes used in the technical analysis.

4.91 In particular, some respondents were concerned the analysis did not sufficiently estimate the impact of the cap on direct measures of consumer welfare. Two respondents cited examples of cost benefit analysis in other areas of regulatory economics in which direct analysis of consumer surplus has been employed in order to evaluate welfare effects of a policy intervention. These respondents were of the view that the FCA should have employed similar analysis in modelling the price cap decision.

4.92 The challenge received from one firm that the FCA has misinterpreted the balance of evidence from the impact of price caps on consumers is also addressed here.

Assessment

4.93 In the technical analysis for the consultation paper, the approach to modelling consumer outcomes from the imposition of a price cap focused on the impact of HCSTC use on a range of measurable financial and non-financial outcomes.

4.94 The FCA chose to measure welfare indirectly using a broad range of proxy measures for consumer welfare. These included: ex-ante creditworthiness assessments, HCSTC repayment outcomes, wider financial and non-financial outcomes evaluated at various time horizons, direct measures of life-satisfaction and ex-post regret using survey questions.

4.95 The analytical approach deliberately did not attempt to construct a single measure of 'consumer welfare' on the basis of which the policy intervention could be judged. This decision was based on a number of factors explained below.

4.96 First, as discussed further below, the technical complications of taking such an approach are considerable. There are three major issues which individually may be solvable but together are insurmountable. The HCSTC market is not a market in which consumer welfare can be inferred via explicit estimation of consumer surplus measured using demand curves given the behaviour of borrowers does not match the assumptions traditional economic models require to be used in such an approach.

4.97 Second, existing research on the impact of HCSTC use of consumers demonstrates that HCSTC use impacts upon a broad range of consumer outcomes, including both financial and non-financial outcomes which extend to effects upon employment, family breakdown and psychological health. Aggregating these various effects into a single measure would require making assumptions so strong that the results would be unreliable.

4.98 Third, in order to quantify the differential effects of alternative proposed caps it was necessary to focus on measurable outcomes. The FCA drew upon a very broad range of outcome measures available within CRA data and the consumer survey. While measures of consumer welfare based on self-reported life satisfaction questions or psychological health questionnaire modules can provide quantitative measures of 'welfare', these measures were considered too narrow for the analysis.

4.99 In particular, the decision was taken not to attempt to estimate consumer 'demand curves' for HCSTC and then evaluate the impact of a price cap through the notion of 'consumer surplus'.

4.100 This 'consumer surplus' approach is widely used in many settings to evaluate the impact of price changes, arising through regulatory actions or otherwise, on consumer welfare. If consumer preferences are well defined over good and services, and the goods and services in question are 'normal goods', then an inverse relationship between the price of a particular good and demand (willingness and ability for pay for that particular good) can be defined via the existence of income and substitution price effects. If a continuous demand function can be recovered from observational data, consumer surplus can be measured as the difference between the market price and consumer willingness to pay. In this way, the welfare impacts of proposed policy changes can be evaluated.

4.101 There are three reasons why the FCA did not adopt this approach.

4.102 Firstly, demand curves for credit cannot be defined without ambiguity as the magnitude and direction of the relationship between changes in price (i.e. the interest rate) and desired demand (i.e. the amount a consumer wishes to borrow).

4.103 This is because the features of consumer choice decisions at a point in time yield defined income and substitution effects of price changes for normal goods which do not hold for choices across time. In simple choice consumers choose between goods and services for a fixed income (intra-temporal choice). Increases in price decrease real income (yielding an income effect) and increase the opportunity cost of purchasing one good in terms of the quantity of another good foregone (yielding a substitution effect).

4.104 By contrast, when consumers choose between consumption at different points in time (inter-temporal choice) the nature of income and substitution effects differs. The income effect arises from the impact of a change in the interest rate on the present value of the consumer's wealth. The substitution effect arises from the opportunity cost of future consumption foregone. In addition, a human capital effect arises due to the effect of a change in the interest rate on the present discounted value of the consumer's flow of future incomes.

4.105 It is well known that the magnitude and direction of these effects will differ according to a consumer's lifetime income profile, accumulated wealth, planning horizon and discount rate (and time consistency or otherwise of their discount rate). This yields the well-known result that the impact of a change in the interest rate on consumer demand for credit in the current period is ambiguous. Hence the researcher cannot be confident in the notion of a defined relationship between the interest rate and demand for credit, be that a positive or inverse relationship, against which to apply an evaluation of 'consumer surplus'.

4.106 Secondly, the inherent riskiness of inter-temporal contracts, especially consumer credit contracts, yields the application of 'consumer surplus' measures of welfare to be invalid. Consumers and lenders writing contracts by which consumers seek to smooth consumption over periods of time (through the credit market) and states of the world (through the insurance market) face uncertainty in the payoffs they receive from the contracts written. Consumers face some probability of being unable to pay, which translates to some expected loss upon default for firms.

4.107 In this uncertain setting, the relevant evaluation for a consumer when considering a possible contract is the evaluation of the expected utility of that credit contract. An ex ante evaluation of the expected utility of a contract may prove correct or incorrect. Notwithstanding this, in a risky environment consumer welfare cannot be measured through the notion of 'consumer surplus' and consumer welfare will be dependent upon moments of the utility function (attitude to risk) as well as its first order approximation.

4.108 Thirdly, there are good reasons to believe that the existence of behavioural biases in consumer choice within the HCSTC market invalidate the application of well-behaved preferences as a means of evaluating welfare outcomes. There is evidence, including evidence from the FCA's own consumer survey, that consumers in this market exhibit low levels of financial literacy, poor financial planning behaviours and time inconsistent ('impulsive') preferences.

4.109 These all suggest consumers do not have 'well behaved' preferences as traditional economic theory assumes. As a result consumer welfare cannot accurately be measured directly via a consumer surplus approach distilling welfare into a single number. For example, where consumers exhibit time inconsistent preferences the willingness to pay for a given credit contract today differs from the willingness to pay for the same contract in an identical economic environment in the future. Hence it is unclear how to evaluate consumer surplus when willingness to pay is time variant. This is a well-known result in modern welfare economics.

4.110 Given these substantial problems with attempting to model consumer welfare effects using a 'demand curve' approach the FCA decided to adopt an alternative approach based on observed outcome measures which pertain to welfare but do not constitute direct welfare measures.

4.111 This approach was chosen from the very broad range of financial information available in credit files, but also through survey questions relating to financial outcomes not measured in credit files. Other measures of welfare were chosen based on existing research relating to survey measurement of life satisfaction following extensive consideration of alternative approaches.

4.112 No particular position was taken on the relative importance of these outcomes or magnitudes, though it is notable that the analysis showed no clearly positive effects of HCSTC use across the very broad range of outcomes considered. We note here additional evidence related to the detriment consumers may find.

4.113 Substantial consumer detriment arises when consumers are unable to meet loan repayments. This consumer detriment is seen in financial consequences, but also associated non-financial consequences. First, consumers are faced with additional charges relating to non-payment or default, plus interest on those charges. This places an additional financial burden upon the consumer. Second, non-payment or default registers on a consumer's credit file. Markers of poor repayment behaviour on a credit file will typically lead to consumers being having less access to credit in the future, or having access to credit only at higher cost, or both. This reduces the opportunities for consumers to borrow in future for years to come. Third, as a consequence of reduced access to credit, consumers are less able to smooth future consumption in light of adverse events, such as fund emergency expenses or maintain expenditure in the face of fluctuations in income. Consumers with impaired credit files also face the prospect of being denied products and services which require credit agreements, such as mobile phone contracts or utilities payment contracts.

4.114 There is extensive evidence of negative non-financial consequences of being unable to repay debt. One dimension of these negative effects is the effect upon psychological health arising from the stress and anxiety associated with being unable to repay debt. 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.

4.115 Additional evidence shows that the negative effects of inability to meet debt commitments extend beyond the individual debtor. Extensive research by Stepchange (2014a) based on 110,000 client records evaluates the social cost of problem debt in the UK at £8.3billion[25]. This comprises over £2bn costs arising due to job loss and reduced productivity at work, £1bn

25 Stepchange (2014a) 'Cutting the Cost of Problem Debt' Stepchange Debt Charity

in mental health costs, £800m in costs associated with relationship breakdown and £300m in costs associated with children being taken into care. Analysis by Citizens Advice (2009) shows 43% of debt clients are in fuel poverty and 50% in water poverty due to the burden of unpayable debts. These costs also extend to children in the household[26]. Stepchange (2014b) in collaboration with The Children's Society shows families encountering problem debt experience strained familial relationships and increased anxiety plus embarrassment among children within the family unit[27]. Taken together, existing research shows that substantial consumer detriment arising from problem debt is multi-faceted and also involves a social cost of unpayable debt'.

4.116 There was a challenge received that in CP14/10 the FCA has misinterpreted the balance of evidence from empirical literature on the impact of price caps on consumers. From reviewing the evidence this challenger cited it appeared to be a selective representation of previous research. Our assessment is supported by academic papers which also describe the evidence as mixed or conflicting[28]. We therefore maintain our position that the empirical evidence is ambiguous. Previous literature focuses on the US market, however, it is unclear how applicable this is to the UK HCSTC market given a very different market structure (US is predominantly high-street whereas UK is predominantly online) and legal environment.

Conclusion

4.117 The FCA's choice not to undertake welfare analysis using direct measures of consumer welfare or through the construction and analysis of 'demand curves' for HCSTC was a deliberate choice. Measures that distil welfare into a single number are inadequate means of quantifying the complex and multifaceted effects of HCSTC use and denial upon consumers. The FCA opted to combine a number of outcome measures and form an overall judgement on the impact of HCSTC on various aspects of consumer experience and welfare.

4.118 The application of 'demand curve' analysis by which 'consumer surplus' can be measured and use to evaluate potential regulatory interventions is invalid it the context of a risky inter-temporal market, particularly the HCSTC market in which consumer are unlikely to exhibit well behaved preferences.

4.119 We considered the challenge received regarding our interpretation of the literature on the effect of price caps on consumers. From reviewing this challenge, we concluded that our presentation of previous evidence was not misleading. As noted earlier we have concerns over how applicable the findings of this research are to the UK lending market.

Inaccurate welfare impacts in consumer survey analysis

Summary of responses

4.120 Some respondents were concerned that elements of the consumer survey design and data resulted in inaccurate estimates of the welfare impacts of the policy. One respondent cited three specific grounds for concern.

4.121 First, that the comparison of marginally successful and marginally unsuccessful applicants (Groups 1 and 2 in the survey design) is invalid due to differences in the degree of self-reported recall of the loan application between these groups. Second, some survey questions were

26 Citizen's Advice (2009) 'A Life in Debt' Citizens Advice

27 Stepchange (2014b) 'The Debt Trap: Exposing the Impact of Problem Debt on Children' Stepchange Debt Charity

28 Carrell & Zinman (2014) 'In harm's way? Payday loan access and military personnel performance' Morgan, Strain & Seblani (2012) 'How payday credit access affects overdrafts and other outcomes' Bhutta, Skiba & Tobacman (2014) 'Payday loan choices and consequences'

flawed due to the absence of a random ordering of responses. Third, some interpretations of comparisons between Groups 1 and 2 are incorrect as differences in characteristics between groups were not taken into consideration.

Assessment

4.122 Survey results show differences in average rates of recall quality between applicants were marginally successful and marginally unsuccessful in their loan application. The consumer survey section of the technical appendix accompanying the consultation paper included a comparison of the answers to a question on how well the respondent to the survey could recall their experience of applying for the HCSTC loan.

4.123 The proportion of consumers in the marginally unsuccessful group who could remember their loan experience 'very well' (approximately 20%) was less than half that for the marginally successful group (for which the proportion remembering the loan experience very well was approximately 50%, p-value from t-test for equivalence of means 0.000).

4.124 Hence there are statistically significant differences in 'recall quality' between these groups. Conversely, the proportion of consumers who remembered the loan application 'not very well' and 'not at all well' was higher among the marginally unsuccessful group compared with the marginally successful group. These differences are also statistically significant at the 1% level or lower.

4.125 These differences in recall quality may bias the comparison outcomes for consumers in these groups. It is unclear whether poor quality recall systematically biases respondent answers to survey questions in a particular 'direction', such as reporting their loan application experience as typically 'better' or 'worse'.

4.126 It is also unclear whether poor quality recall would affect respondent answers to questions unrelated to the loan experience, such as their reported income or assets at the point of the survey, or welfare measures which we can use to infer the effect of HCSTC use but were not explicitly linked to it in the survey wording. Inability to recall the loan experience might indicate poor quality memory which could increase error in responses to questions more generally. However, one can be more confident that poor quality recall will increase the variance in responses (whether the induced error at the individual level is classical or not) and this will affect the statistical significance of comparisons of means, or estimated standard errors, in the analysis.

4.127 Given these concerns, the FCA has re-examined consumer survey responses by sub-groups of respondents categorised by self-reported recall quality. The analysis of consumer characteristics and outcomes in the consultation paper technical annex survey section (Questions 1 to 3 in that section) has been re-estimated for these separate 'recall quality sub-groups'.

4.128 The sub-groups were defined as follows: one sub-group comprised only consumers who stated they recalled the loan experience 'very well'; a second sub-group comprised those who remembered the loan experience 'well' or 'fairly well'; a third sub-group comprised those who remembered the loan 'very well', 'fairly well' or 'not very well'. Hence the third group omitted applicants who stated they recalled the loan 'not at all well'.

4.129 Comparing responses between individuals with the same recall quality in the marginally successful and marginally unsuccessful groups will remove bias in comparison arising from poor recall. However, other sources of (unknown) selection bias will be introduced by focusing on these sub-sets of respondents. This is because we are excluding more people from the marginally unsuccessful group.

4.130 Results from this analysis reveal some differences in the comparison of marginally successful and marginally unsuccessful applicants among these recall quality sub-groups compared with the all-group sample for which results were presented in the technical annex accompanying the consultation paper.

4.131 There is no consistent pattern of deviation in the new results from the original results, plus the magnitudes of the differences are small in economic terms. We describe these differences here. In the 'very well' sub-sample, IV regression estimates (using controls and applying sample weights) show HCSTC use increases consumer 'happiness' as measured by the life satisfaction metric, increases the likelihood an individual suffers embarrassment due to financial distress arising from the loan and decreases the likelihood a bank refused a payment after HCSTC use.

4.132 Results also show HCSTC use increases the likelihood an individual attempted to borrow from families or friends following the loan application. Most of these findings also hold for the other recall quality sub-groups. In all cases where statistically significant estimates were found using the whole sample, as described in the technical annex to the consultation paper, statistical significance remains when estimating the same models among recall sub-samples.

4.133 The FCA does not see these sub-sample results alter the evidence base for the impact of HCSTC on consumer outcomes and welfare. While the finding that HCSTC increases consumer happiness suggest a positive effect of HCSTC use, the additional finding that HCSTC use increases embarrassment for those unable to repay underlines the risk of welfare loss arising from non-payment for consumers who face a risk of default (which is shown to be a large sub-set of consumers in the consultation paper technical appendix). Other new findings on substitution effects following HCSTC use are of marginal insight in the context of the CRA analysis.

4.134 The absence of list randomisation was noted by one respondent as relevant to questions 18 and 98 of the survey. Question 18 asked consumers to describe how they were 'keeping on top of your bills and credit commitments at the moment' with a selection of possible answers ranging from 'keeping up without any difficulties' to 'falling behind with many bills and credit commitments'. Candidate answers to this question formed a natural ordering. In the context of a telephone survey list randomisation in infeasible where a natural ordering to the responses occurs. At Question 98, on financial literacy, respondents were asked to calculate a financial literacy example. Here list randomisation was also not applied.

4.135 The FCA acknowledges the absence of list randomisation may have affected respondent answers in these cases by increasing the likelihood of stated responses being those towards the beginning of the list. However, the FCA also notes that responses to these questions were not attributed significant weight in the policy analysis or decision.

4.136 Interpretations of comparisons between Groups 1 and 2 did take differences in characteristics between groups into consideration through the regression analysis. However, where differences exist they are not relevant to the outcomes of interest and therefore did not affect interpretation of the group comparison results.

Conclusion

4.137 The FCA has re-analysed consumer survey responses by sub-groups of individuals defined over the confidence with which they could recall their loan application. It has also considered how the absence of list randomisation may have affected answers to two specific questions in which the question ordering may have biased respondent answers. This analysis has yielded no new insights into how HCSTC use impacts upon consumer outcomes and welfare. As a consequence this additional analysis has no impact on the policy judgment.

Consumer survey uses misleading sample

Summary of responses

4.138 Some respondents questioned the consumer survey design – in particular the sample it uses. A number of respondents raised the concern that the survey did not draw on a representative sample of HCSTC users. Other respondents raised a similar concern when querying why individual applicants whose applications had been credit scored to be near the lender's acceptance threshold had been over-sampled.

4.139 In addition, high-street lenders and industry groups reflecting the views of high-street lenders expressed concern that the survey design and analysis devoted insufficient attention to high-street customers.

Assessment

4.140 The consumer survey formed an integral component of the demand side technical analysis as it provided information on consumer behaviour not present in data from lenders or credit reference agencies.

4.141 Consultation responses questioned the unconventional survey design used. The survey was designed to answer the specific analytical task required to inform setting a price cap on HCSTC. As set out in the consultation paper technical annex the survey was designed to complement analysis of CRA data and aspects of the survey design were heavily informed by the Regression Discontinuity Design approach employed in the CRA analysis. We repeat and elaborate on the survey design aspects here.

Consumer Survey Methodology and Sample Design

4.142 The choice not to base the survey wholly on a representative sample of HCSTC users was a deliberate choice informed by the research questions of interest. A wholly representative sample of HCSTC users was also not chosen as the Competition and Markets Authority (Competition Commission at the time) was carrying out a survey using this approach – the findings from which are public. Two of the three key research questions to be addressed concerned the impact of consumers no having access to HCSTC as would occur through a price cap. These were 'What options are there for consumers who no longer have access to HCSTC' and 'Are consumers better or worse off without access to HCSTC'? Both questions involve an evaluation of the consequence of loan denial.

4.143 A representative survey of HCSTC users would not be the best means of collecting data relevant to analysis of these questions as it would provide little information about loan denial (other than answers to hypothetical questions about loan denial).

4.144 Consequently, one element of the survey design focused on comparison of outcomes between those successful and unsuccessful in their loan applications (samples named 'Group 1' and 'Group 2' in the survey design). In particular, the sampling focused on individuals who were marginally accepted and marginally unsuccessful in their loan applications as these are the most comparable groups of consumers with and without access to HCSTC. The RDD approach informed this choice. This was the basis for over-sampling consumers with credit scores located close to the firm credit score cut-off thresholds (i.e. consumers marginally accepted and marginally denied loans).

4.145 Some respondents acknowledged the sampling approach of comparing consumers marginally successful in their loan applications to those marginally unsuccessful in their applications, but questioned whether this approach sufficiently modelled the change in margin of lending which would most likely occur as a consequence of the cap. Here the survey design also incorporated analysis of this dimension of the policy. The survey sample 'Group 3' comprised a representative sample of accepted applicants and it was analysis of this group which formed the basis for estimation of the consequences on consumers of exclusion under the various initial cap levels analysed in the technical annex via estimating consumer survey responses for consumers excluded under different caps.

Inclusion of High-street Customers in Consumer Survey

4.146 A concern raised by high-street lenders and industry groups was that the consumer survey neglected to survey and analyse the impact of an HCSTC cap on high-street customers. Two respondents raised the particular concern that the consumer survey focused on online HCSTC applicants only.

4.147 However, this was not the case. The sample of HCSTC applicants included in the survey was split into five groups. Group 1 and 2 comprised the sample of marginally accepted and marginally denied applicants. These groups did comprise only online applicants as it was only in data provided by online firms where 'marginal' applicants could be identified based on the Regression Discontinuity Design. However, for the other three groups, high-street applicants were included.

4.148 Importantly, high-street applicants were included in the sample 'Group 3', the representative sample of accepted applicants, on which the estimation of consumer outcomes under different initial cap levels was undertaken. This element of the analysis micro-simulated consumer outcomes at the margin of lending under lending margins induced by different initial cap levels and was an important component of the demand side analysis for informing the policy decision.

4.149 The inclusion of high-street applicants in this analysis was made clear in the technical annex to the consultation paper. Group 3 is a representative sample of accepted applicants; hence the number of high-street customers included in this group is consistent with the representation of high-street customers in the UK market of first-time applicants. Compared to current market shares, we expect, if anything, this is an oversampling.

4.150 On this basis, we do not see that the consumer survey design neglected to include high-street applicants. Where they were not included in Groups 1 and 2 this arose due to limitations in the data which meant that we could not isolate consumers who were marginally successful or unsuccessful in their loan applications to compare. Without this information simply comparing of consumers who did and did not take out loans from the high-street could yield significantly misleading results as the treatment and control groups would not be similar.

Conclusion

4.151 Concerns raised by respondents relating to the consumer survey design for the most part reflect misunderstanding of the analytical approach undertaken in the demand side analysis. Our survey design enables us to infer how results vary for consumers further away from the threshold as explained in the consultation paper technical annex. Some queries regarding the representation of high-street applicants in the survey data sample are misplaced. Given this, we do not deem it necessary to reconsider the consumer survey methodology on the basis of these concerns.

New survey evidence contradicts FCA survey findings

Summary of responses

4.152 Some respondents referred to additional survey analysis the results of which were presented as contradicting the findings of the FCA survey analysis. One respondent submitted evidence from a new survey of unsuccessful HCSTC applicants which occurred over the course of the consultation period. Some respondents referred to the differences between the profile of HCSTC clients presented in the FCA survey analysis and profile presented in other survey analyses. One respondent also presented survey evidence to suggest the degree of consumer substitution between high-street and online lending was very low.

Assessment

4.153 The consumer survey designed and analysed by the FCA is one of many surveys of HCSTC consumers which have been undertaken in the recent past. The technical annex provided a justification for commissioning a new survey and explained the particular features of the FCA survey and analysis.

4.154 Where surveys differ in their design, content and sampling frame due consideration should be given to inference drawn from their results. Here we review the findings of the new survey data provided to the FCA and consider differences between findings of the FCA and CMA surveys plus additional survey evidence presented by respondents.

Evidence from a new survey

4.155 A respondent to the consultation provided initial findings from a new survey of HCSTC clients drawn from a number of lenders and conducted by a market research organisation. At the conclusion of the consultation period the survey fieldwork was incomplete and the respondent provided a preview of findings in their consultation response submission.

4.156 Details of the findings were presented in a short report. We requested, but did not receive, technical documentation relating to the survey design and questionnaire plus individual level responses. Nevertheless, from the information provided the FCA has been able to form a view of the survey findings.

4.157 The survey dataset comprised over 700 responses (achieved from a target sample of 50,000) to a survey of declined applicants a number of lenders. The survey was conducted between 1 April 2014 and 5 August 2014. Fieldwork was conducted between 14 August 2014 and 2 September 2014.

4.158 In particular, the survey comprised only applicants who were denied credit due to changes in lending criteria made after 1 April 2014 in response to regulatory changes. No customers that were declined for fraud, anti-money laundering or other non-credit related declines were surveyed. Information has not been provided on the characteristics of the achieved sample compared with the target sample or the distribution of credit scores relative to lender credit score cut-off thresholds among the target or achieved sample.

4.159 Questions included in the survey focused on the experiences of consumers following their declined application for HCSTC. Answers to survey questions demonstrate that, on average, in the period following the decline of their HCSTC application consumers in the sample exhibited high rates of default on household bills and use of unauthorised overdraft. As we discuss earlier in consideration of responses relating to illegal lending, the survey did not find high reported rates of borrowing from illegal money lenders among this group.

4.160 The inference provided by the respondent submitting the survey evidence was that these detrimental outcomes were caused by a lack of access to HCSTC. However, this inference is not warranted by these data alone. While these data are informative about the situation of the sample of respondents, they do not allow a conclusion that the consumer detriment observed is caused by a lack of access to HCSTC.

4.161 This data does not allow for the construction of a counterfactual outcome i.e. outcomes observed where respondents successfully apply for HCSTC. Such a counterfactual is crucial for understanding what would have happened to these applicants had they been accepted for HCSTC. As documented in the consultation paper technical appendix, applicants for HCSTC typically exhibit poor and deteriorating financial circumstances. For example, we see high proportions of consumers reporting having experienced financial distress due to their financial situation but did not find a statistically significant difference between marginally successful and unsuccessful groups which would indicate an effect caused by HCSTC access.

4.162 They may exhibit detrimental financial circumstances irrespective of whether their HCSTC application is successful or unsuccessful. Observations from individuals denied HCSTC do not allow us to infer the causality between HCSTC denial and the outcomes of interest.

4.163 The need to establish a counterfactual identification strategy in order to derive causal inference was central to the design of the FCA consumer survey. The survey followed the intuitive approach of Regression Discontinuity Design by sampling individual applicants who were marginally successful in the HCSTC application as measured by their credit score and those who were marginally unsuccessful.

4.164 The marginally successful group were utilised as, all else being equal, a counterfactual construction for the marginally unsuccessful group. A comparison of survey estimates of consumer detriment among those marginally successful and marginally unsuccessful in their HCSTC application showed that for nearly all measures of consumer outcomes the groups were indistinct. Both groups showed high rates of consumer detriment with no statistically significant differences induced by access to HCSTC.

4.165 In the CRA analysis, which exploited the Regression Discontinuity Design approach in large data, results show HCSTC acceptance causes consumers to be more likely to exceed their agreed overdraft limit. This is the opposite finding to that asserted from the new survey data, in which the assertion is flawed by the lack of causal inference.

Evidence on client characteristics

4.166 Some responses from firms and industry groups took issue with the characterisation of HCSTC customers presented in the consultation paper and technical annex. In particular, respondents queried the description of HCSTC customers as 'low-income' and appealed to findings from the CMA survey which described HCSTC customers as exhibiting 'average incomes'.

4.167 The FCA and CMA survey documents do describe the income levels of HCSTC customers differently. The consultation paper technical annex characterises the representative sample of HCSTC customers as have 'relatively low incomes' with 32% earning less than £12,000 and 60% less than £18,000. The CMA survey found the average income of HCSTC customers is £17,500 but described this as close to the average for the whole population.

4.168 This difference arises due to the comparison made with the 'population', not due to differences in the incomes of HCSTC customers as measured in the surveys. The FCA and CMA findings for income levels among HCSTC customers are very similar. The difference arises in that the CMA compared the income of HCSTC customers to the whole-population average income in the UK whereas the FCA compared to UK working age population given the demographic of HCSTC applicants.

4.169 Whole population average income is a measure of average income derived by taking the total values of all incomes earned in the UK and dividing this by the total population of the UK. Hence this is an average value over all individuals including non-workers (the elderly, students, children). Consequently the average value is much lower than average earnings for those who work.

4.170 The FCA survey, by way of contrast, compared average income of HCSTC clients to average incomes among working age individuals in the UK as working age individuals were seen as the appropriate comparison group. Most individuals who borrow using HCSTC are of working age and in work (the majority are towards the younger end of the working age spectrum). Among this group average earned income is £26,500. This is approximately £10,000 greater than whole population average income. It is this comparison which warrants the description of HCSTC customers as typically low income.

4.171 Figure 15 also provide context for the financial circumstances of HCSTC applicants relative to the time of their first application for HCSTC to support our previous assessments of these consumers.

Conclusion

4.172 Evidence presented by respondents from other data sources does not lead us to alter our conclusions on the topics considered in the FCA consumer survey analysis. New survey data provided by a respondent does not aid an evaluation of the effects of HCSTC use or denial. We are confident we have used the best available survey data to understand the characteristics of HCSTC applicants and the causal impacts of HCSTC use.

Annex 4
Feedback (and our response) to our Equality Impact Assessment

Impact on protected groups

1. We are required under the Equality Act 2010 to consider whether our proposals could have a potentially discriminatory effect 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. Annex 5 to our consultation paper contained an equality impact assessment. It concluded that our proposals did not result in direct discrimination for any of the groups with protected characteristics. Our findings suggested that as a result of our proposals some people, especially those with lower credit scores, may no longer be offered HCSTC loans. However, our analysis showed that this loss of access to credit would be beneficial for many consumers with lower credit scores, as they were more likely to have negative welfare impacts from taking out these loans and ending up in debt spirals.

3. We also indicated that, as there is a risk that HCSTC will not be distributed through the high-street as a result of the price cap, the impact might be more substantial for women and those from Black and Minority Ethnic groups, who are over-represented among users of loans provided on the high street.

Responses to consultation

4. In the consultation we asked:

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

5. Most respondents did not comment on these questions. Of those who did comment, the majority agreed with our assessment of the impact of our proposals on protected groups. Some stakeholders raised concerns about the impact on low income consumers who will no longer get credit under the price cap. However, income is not a protected characteristic under the Equality Act 2010.

6. Two stakeholders argued that our consumer survey was mainly focused on online customers, and therefore the views of the high-street customers were not represented.

Our response

As stated in the technical annex (paragraphs 4.146-4.150), we included high-street customers in our consumer survey sampling. In particular, they were included in the sample 'Group 3', the representative sample of accepted applicants, on which the estimation of consumer outcomes under different initial cap levels was undertaken. The number of high-street customers included in this group is consistent with the representation of high-street customers in the UK market of first-time applicants for the sampling period used.

As there is a risk that HCSTC will not be distributed through the high street as a result of the cap, we still think that women and those from Black and Minority Ethnic groups might be affected by our proposals more than some other groups.

However, overall we think that protection from harm caused by high-cost products to these groups of borrowers outweighs the risks that these products will not be distributed through high-street channel. Based on our analysis we think that this is a positive impact and would prevent some people from taking unaffordable loans and getting into debt spirals. More generally, those who retain access, if HCTCS is still available through the high-street or they switch to an on-line source (although this may be difficult for some high-street borrowers), will also benefit from the cap through cheaper credit.

Based on responses to the consultation and public announcements by firms, it is clear that a number of firms do believe that they will be able to respond dynamically and continue to operate in both the online and high-street markets once the cap is in place. This will help to mitigate the potential negative impact on these protected groups, as predicted by the static analysis.

We will review the cap in the first half of 2017, and will look then at the impact on the groups with protected characteristics, as well as on consumers generally. In the meantime, we will monitor for any unintended consequences of the cap on consumers on an ongoing basis.

Annex 5
Feedback (and our response) to our Compatibility Statement

Introduction

1. Section 138I of the Financial Services and Markets Act (FSMA) requires us to explain why we believe making the proposed rules is compatible with our strategic objective, advances one of more of the operational objectives, and has regard to the regulatory principles in s. 3B FSMA.

2. We set out a compatibility statement on the proposed price cap on HCSTC in Annex 2 of CP14/10. We set out the feedback we received that is relevant to the compatibility statement in this annex.

3. Our response must be read in conjunction with the rest of the policy statement including the responses to the cost benefit analysis and the technical annex in demonstrating that we have met out statutory duties and objectives.

Our objectives

4. These rules are intended to address our statutory duty to 'make [specified] rules in relation to one or more descriptions of regulated credit agreements appearing to the FCA to involve the provision 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 have complied with our strategic objective of ensuring that the relevant markets function well. The rules primarily advance our operational objective of 'securing an appropriate degree of protection for consumers'.

5. To demonstrate that we met our statutory duty and our operational objective, we set out what we consider to be 'excessive charges' and demonstrated why we consider current charges to be excessive. We provided evidence of harm from HCSTC charges and explained how the price cap will protect borrowers against the harm caused by excessive charges.

Responses to consultation

6. Some respondents made comments which related to the compatibility statement, in particular responses expressed concern about whether we had fulfilled our competition duty and whether the proposals were proportionate. The following paragraphs summarise issues raised by respondents where they relate to the compatibility statement. These issues are addressed in greater detail in Chapter 2 (General approach) and Chapter 3 (Structure and levels) of the policy statement, and in the technical annex Section 3 (Competition) and Section 4 (Demand).

7. A number of respondents challenged our assessment of the competition impacts of the cap. They argued that we gave insufficient consideration to the scope for competition to achieve an appropriate degree of protection for borrowers, and on the need to preserve a market structure which can deliver pro-competitive and pro-consumer outcomes through rivalry. Others argued that we had put too much emphasis on maintaining a competitive market over our consumer protection objective. Further details of these arguments and our response are given in Chapter 2 and in section 3 of the technical annex.

8. Several firm respondents argued that we had failed to demonstrate that our proposals were proportionate given the substantial impact on firms. They argued that the evidence of harm was not sufficiently material to justify the negative impact on firms.

9. Others argued that the proposals were not proportionate as the detriment that we are seeking to address has been tackled by our new CPA and rollover rules and more effective supervision of the affordability rules (see Chapter 2).

10. Some responses expressed concern about the way in which we propose to secure an appropriate degree of protection for consumers. One firm challenged our review of the previous evidence and argued that we had not provided a balanced portrayal of HCSTC customers. Others argued that we had not accurately estimated the harm to consumers caused by loss of access or the benefits of using HCSTC. This is covered in greater detail in Chapters 2 and 3.

11. We did not receive any comments on the impact of the proposals on mutual societies.

Our response

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

We have taken care to design our rules so that they fulfil our statutory duty to secure an appropriate degree of protection for borrowers against excessive charges while also promoting effective competition in the interests of consumers, to the extent that they are compatible and fulfil other applicable legal requirements. We have summarised the challenges we received in relation to competition and our response in Chapter 2 of the policy statement and section 3 of the technical annex.

Failed to demonstrate that the proposals are proportionate

We have addressed concerns that we have not demonstrated the level of harm necessary to warrant the significant impact on firms in Chapter 2 of the policy statement. We have also set out in Chapter 3 why we consider each element of the price cap to be necessary and proportionate to secure an appropriate degree of protection for borrowers of HCSTC from excessive charges both individually and as a whole. In light of the new information we gathered from firms about the recent reduction in lending volumes, we have also revised our CBA estimates (Annex 2).

Consumer protection objective

We have set out in Chapter 2 of the policy statement why we consider that charges are excessive. In response to the feedback we received, we have also addressed concerns about the impact on consumers. We consider whether we have underestimated the harm to consumers caused by loss of access including the risks that consumers denied HCSTC will turn to illegal money lending or whether we have either underestimated or overestimated the benefits of using HCSTC. In Chapter 3 we explain how each element of the price cap will address the harm caused to consumers as a result of excessive charges. In the technical annex we address some more technical issues raised such as the characteristics of HCSTC customers, and challenges that we have misinterpreted the evidence on the impact of price caps on customers.

Impact of our proposals on mutual societies

We have not changed our view that these rules will not affect mutual societies as set out in paragraphs 46 to 51 of the compatibility statement in CP 14/10. Given what we said in the compatibility statement the minor changes to the price cap rules described in Chapter 4 would not affect mutual societies.

We continue to believe that the final rules including the changes described in Chapter 4 are compatible with our duties under section 1B(1) and 5(a) of FSMA (objectives and regulatory principles).

Appendix 1
Made rules (legal instrument)

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
6 November 2014

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* which imposes one or more charges; 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* which imposes one or more charges.

5A.1.2 G (1) A variation or supplement of, or an exercise of a contractual power to vary or supplement, an agreement for *high-cost short-term credit* made before 2 January 2015 will be covered by this chapter if it has the result that a new charge, or an increase in an existing charge, is payable.

(2) An example of where a charge results from a variation or supplement is where the duration of an agreement made before 2 January 2015 is extended and a further charge by way of interest or otherwise is calculated by reference to the period of the extension. A variation or supplement which alters the address of the borrower stated in the agreement or which is followed by the *firm* permanently waiving any right to interest or charges which would otherwise be imposed or result does not fall within *CONC* 5A.1.1R (2) or (3).

(3) If this chapter applies to an agreement for *high-cost short-term credit* as a result of *CONC* 5A.1.1R(2) or (3), charges imposed under the agreement before 2 January 2015 are to be included in the calculation of the total cost cap, the initial cost cap and the default cap. If charges imposed before 2 January 2015 exceed the total cost cap, the initial cost cap or the default cap, a variation or supplement of that credit agreement on or after 2 January 2015 that results in any additional charge is not permitted.

5A.1.3 G *Firms* are reminded that, as a result of *GEN* 2.2.1R, the provisions of this chapter have to be interpreted in the light of their purpose.

Statutory context and purpose

5A.1.4 G Section 137C of the *Act* (FCA general rules: cost of credit and duration of credit agreements) 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.1.5 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*;

(2) to secure an appropriate degree of protection for borrowers against excessive charges; and

(3) as a result, to restrict the charges for such high-cost short-term credit.

Guidance on application and interpretation

5A.1.6 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.1.7 G Certain other terms used in this chapter are defined in *CONC* 5A.6.

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.2.14R (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.2.7R) 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 for the purposes of that *rule* the effect of the borrower discharging all or part of the borrower's indebtedness in accordance with section 94 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 the purpose of the calculation of the initial cost cap, if there is an early repayment by the borrower of an amount of *credit* repayable under an agreement for *high-cost short-term credit* (including where that early repayment is financed by a replacement agreement), the amount of *credit* outstanding on the *days* that follow the early repayment is not reduced to reflect the amount of the early repayment. There is no effect, however, on the right of a borrower to any rebate applicable under the Consumer Credit (Early Settlement) Regulations 2004 and, where applicable, a borrower therefore continues to be entitled to a rebate.

5A.2.9 G For the purposes of this chapter, 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 amount of *credit*) but only with the *lender's* consent to each respective drawdown, each drawdown is a separate agreement for *high-cost short-term credit* and each agreement needs to be documented as a separate *regulated credit agreement* in accordance with the *CCA* and with the rest of *CONC*. This chapter applies to each drawdown as a separate agreement accordingly.

Refinancing

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 that, taken together with the charges under the earlier agreement or 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.2.6R) under the combined effect of the replacement agreement and the earlier agreement.

5A.2.11 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 or in a connected agreement to any of those agreements, exceed or are capable of exceeding £15.

5A.2.12 R If the effect of a replacement agreement is to repay an amount outstanding under an earlier agreement for *high-cost short-term credit* before the date on which the earlier agreement requires repayment, any charge imposed under the earlier agreement which never becomes payable as a result of the early settlement is disregarded for the purposes of *CONC* 5A.2.10R.

5A.2.13 R A *firm* must not count any amount provided to the borrower to repay any amount of *credit* outstanding under an earlier agreement for *high-cost short-term credit* or any amount provided to pay any charge outstanding under the earlier agreement:

(1) in calculating the amount of *credit* provided for the purposes of *CONC* 5A.2.10R; or

(2) where the *firm* replaces an earlier agreement for *high-cost short-term credit,* in calculating the amount of *credit* provided for the purposes of *CONC* 5A.2.3R (Initial cost cap).

Default cap

5A.2.14 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.2.15 G *Firms* are also reminded of the provisions of section 93 of the *CCA* (Interest not to be increased on default).

Connected agreements

5A.2.16 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.2.17 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), *CONC* 5A.2.3R (Initial cost cap) and *CONC* 5A.2.14R (Default 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.2.18 G Examples of the types of ancillary service to an agreement for *high-cost short-term credit* referred to in *CONC* 5A.2.17R include, but are not limited to, services related to processing the application and to the transmission of the money being lent, and insurance or insurance-like services ancillary to the agreement.

Prohibition on compound interest

5A.2.19 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 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 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.3.18R (Default cap) applies.

5A.3.5 G (1) The initial cost cap is calculated on a daily basis. However, a charge or charges that may be imposed in compliance with this cap can amount to 0.8% of the *credit* provided (determined in accordance with *CONC* 5A.3.7R) 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 for the purposes of that *rule* the effect of the borrower discharging all or part of the borrower's indebtedness in accordance with section 94 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 the purpose of the calculation of the initial cost cap, if there is an early repayment by the borrower of an amount of *credit* repayable under an agreement for *high-cost short-term credit* (including where that early repayment is financed by a replacement agreement), the amount of *credit* outstanding on the *days* that follow the early repayment is not reduced to reflect the amount of the early repayment. There is no effect, however, on the right of a borrower to any rebate applicable under the Consumer Credit (Early Settlement) Regulations 2004 and, where applicable, a borrower therefore continues to be entitled to a rebate.

5A.3.9 G For the purposes of this chapter, 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 amount of *credit*) but only with the *lender's* consent to each respective drawdown, each drawdown is a separate agreement for *high-cost short-term credit* and each agreement needs to be documented as a separate *regulated credit agreement* in accordance with the *CCA* and with the rest of *CONC*. This chapter applies to each drawdown as a separate agreement accordingly.

Refinancing

5A.3.10 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) under the combined effect of the varying or supplemental agreement and the earlier agreement.

5A.3.11 R A *firm* must not impose one or more charges by exercising a contractual power to vary or supplement an 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 agreement or in a connected agreement to that agreement, exceed or are capable of exceeding the amount of *credit* provided (determined in accordance with *CONC* 5A.3.6R) under the agreement as varied or supplemented.

5A.3.12 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 to any of those agreements, exceed or are capable of exceeding £15.

5A.3.13 R A *firm* must not impose one or more charges in connection with a breach of the agreement by the borrower by exercising a contractual power to vary or supplement an 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 agreement or in a connected agreement to any of those agreements, exceed or are capable of exceeding £15.

5A.3.14 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 to any of those agreements, exceed or are capable of exceeding the amount of *credit* provided (determined in accordance with *CONC* 5A.3.6R) under the combined effect of the replacement agreement and the earlier agreement.

5A.3.15 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 to any of those agreements, exceed or are capable of exceeding £15.

5A.3.16 R If the effect of a replacement agreement is to repay an amount outstanding under an earlier agreement for *high-cost short-term credit* before the date on which the earlier agreement requires repayment, any charge imposed under the earlier agreement which never becomes payable as a result of the early settlement is disregarded for the purposes of *CONC* 5A.3.14R.

5A.3.17 R A *firm* must not count any amount provided to the borrower to repay any amount of *credit* outstanding under an earlier agreement for *high-cost short-term credit* or any amount provided to pay any charge outstanding under the earlier agreement:

(1) in calculating the amount of *credit* provided for the purposes of *CONC* 5A.3.10R, 5A.3.11R or 5A.3.14R; or

(2) where the *firm* replaces an earlier agreement for *high-cost short-term credit*, in calculating the amount of *credit* provided for the purposes of *CONC* 5A.3.3R (Initial cost cap).

Default cap

5A.3.18 R A *firm* must not impose, on a borrower 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.3.19 G *Firms* are also reminded of the provisions of section 93 of the *CCA* (Interest not to be increased on default).

Connected agreements and guidance on charges before assignment

5A.3.20 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.3.21 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), 5A.3.3R (Initial cost cap) and *CONC* 5A.3.18R (Default 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.3.22 G Examples of the types of ancillary service to an agreement for *high-cost short-term credit* referred to in *CONC* 5A.3.21R include, but are not limited to, services related to processing the application and to the transmission of the money being lent, and insurance or insurance-like services ancillary to the agreement.

5A.3.23 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.3.24 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, unless the *charge* is 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.4.14R (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.4.7R) 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 for the purposes of that rule the effect of the borrower discharging all or part of the borrower's indebtedness in accordance with section 94 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 the purpose of the calculation of the initial cost cap, if there is an early repayment by the borrower of an amount of *credit* repayable under an agreement for *high-cost short-term credit* (including where that early repayment is financed by a replacement agreement), the amount of *credit* outstanding on the *days* that follow the early repayment is not reduced to reflect the amount of the early repayment. There is no effect, however, on the right of a borrower to any rebate applicable under the Consumer Credit (Early Settlement) Regulations 2004 and, where applicable, a borrower therefore continues to be entitled to a rebate.

5A.4.9 G For the purposes of this chapter, 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 amount of *credit*) but only with the *lender's* consent to each respective drawdown, each drawdown is a separate agreement for *high-cost short-term credit* and, where applicable, each agreement needs to be documented as a separate *regulated credit agreement* in accordance with the *CCA* and with the rest of *CONC*. This chapter applies to each drawdown as a separate agreement accordingly.

Refinancing

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 that, taken together with the charges under the earlier agreement or 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.4.6R) under the combined effect of the replacement agreement and the earlier agreement.

5A.4.11 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 or in a connected agreement to any of those agreements, exceed or are capable of exceeding £15.

5A.4.12 R If the effect of a replacement agreement is to repay an amount outstanding under an earlier agreement for *high-cost short-term credit* before the date on which the earlier agreement requires repayment, any charge imposed under the earlier agreement which never becomes payable as a result of the early settlement is disregarded for the purposes of *CONC* 5A.4.10R.

5A.4.13 R No amount is to be counted which is provided to the borrower to repay any amount of *credit* outstanding under an earlier agreement for *high-cost short-term credit* or any amount provided to pay any charge outstanding under the earlier agreement:

(1) in calculating the amount of *credit* provided for the purposes of *CONC* 5A.4.10R; or

(2) where an earlier agreement for *high-cost short-term credit* is replaced, in calculating the amount of *credit* provided for the purposes of *CONC* 5A.4.3R (Initial cost cap).

Default cap

5A.4.14 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.4.15 G *Firms* are also reminded of the provisions of section 93 of the *CCA* (Interest not to be increased on default).

Connected agreements

5A.4.16 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 (Total cost cap) and 5A.4.3R (Initial cost cap) includes this charge and the agreement providing for the charge is a connected agreement.

5A.4.17 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 (Total cost cap), *CONC* 5A.4.3R (Initial cost cap) and *CONC* 5A.4.14R (Default 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.4.18 G Examples of the types of ancillary service to an agreement for *high-cost short-term credit* referred to in *CONC* 5A.4.17R include, but are not limited to, services related to processing the application and to the transmission of the money being lent, and insurance or insurance-like services ancillary to the agreement.

Prohibition on compound interest

5A.4.19 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, unless the charge is 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:

(1) a *firm* enters into an agreement for *high-cost short-term credit* in contravention of a *rule* in *CONC* 5A.2; or

(2) a *firm* facilitates an *individual* becoming a borrower under an agreement for *high-cost short-term credit* in contravention of a *rule* in 5A.4; or

(3) a *firm* within *CONC* 5A.5.1R(1) imposes a charge in contravention of a *rule* in *CONC* 5A.3; or

(4) a *firm* within *CONC* 5A.5.1R(4) imposes a charge on behalf of a *lender* in contravention of a *rule* in *CONC* 5A.3; or

(5) 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:

(a) the agreement is unenforceable against the borrower; and

(b) the borrower may choose not to perform the agreement and if that is the case:

(i) 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 or confirm by notice in writing to the borrower that there are no charges to pay;

(ii) where the *lender* complies with (i), the borrower must repay any *credit* received by the borrower under the agreement to the *lender* within a reasonable period from the day on which the charges in (i) are received by the borrower or the day on which the notice of confirmation in (i) is received; and

(iii) in any case, the *lender* must not demand payment of the sum in (ii) in less than 30 days from the day in (ii).

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 that 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 or confirm by notice in writing to the borrower that there are no charges to that extent to pay.

5A.5.4 G Once the *lender* has repaid the charges to the borrower or has confirmed there are no charges to repay the borrower is then under a statutory obligation to repay any *credit* received under the agreement.

5A.5.5 G What is a reasonable period for the borrower to repay the *credit* depends on the circumstances of the case, including the terms for repayment under the agreement. Where the agreement provided for repayment in instalments, the *firm* should consider issuing the borrower with a schedule for repayment under which the *firm* would collect the *credit* in instalments at the same periodic intervals as under the agreement.

5A.5.6 G *Firms* are reminded that Principle 6 applies to how they deal with borrowers in relation to repayment of the *credit* required by *CONC* 5A.5.2R. The *FCA* would expect *firms* to take into account the financial situation of the borrower in considering what is a reasonable period for repayment.

5A.5.7 G *CONC* 5A.5.3R is a residual provision that applies to a *firm* established in the *UK* which carries on *debt administration* or *debt collection*, but where the *rules* in *CONC* 5A do not apply to a *lender* because the *lender* is established outside the *UK* and provides *electronic commerce activities* into the *UK*. Where a borrower gives notice to the *lender* referred to in *CONC* 5A.5.3R, only charges which exceed the amounts set out in *CONC* 5A.2 or 5A.3 are void. The borrower remains under a contractual obligation to repay the *credit* received under the agreement and any charges under the agreement permitted by those provisions.

5A.6 Interpretation

5A.6.1 R In this chapter:

(1) "ancillary service" is a service in connection with the provision of *credit* under the agreement for *high-cost short-term credit* and includes, but not limited to, 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.2.16R, *CONC* 5A.2.17R, *CONC* 5A.3.20R, *CONC* 5A.3.21R, *CONC* 5A.4.16R and *CONC* 5A.4.17R;

(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.

5A.6.2 G The meaning of the expression "impose one or more charges on a borrower under an agreement for *high-cost short-term credit*" is set out in *CONC* 5A.6.1R(5). The meaning of "impose" in relation to a charge in this chapter is broad and includes, but is not limited to, situations including where a *firm*:

(1) enters into an agreement containing a clause obliging the borrower to pay a charge;

(2) varies or supplements an agreement and this has the result that there is:

(a) an increase in the amount of a charge; or

(b) where the amount of a charge is determined by reference to a period of time, an increase in the period of time to which a charge applies;

(3) adds a charge to a borrower's account;

(4) communicates with a borrower demanding payment of a charge or indicating that the borrower is, will be or may be obliged to pay the charge; and

(5) is *operating an electronic system in relation to lending*, and it does any of activities in (1) to (4) for a *lender*.

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