



dti

FAIR, CLEAR AND COMPETITIVE

The Consumer Credit
Market in the 21st Century

White Paper



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Fair, Clear and Competitive

The Consumer Credit Market in the 21st Century

Presented to Parliament by the
Secretary of State for Trade and Industry
by Command of Her Majesty
December 2003

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Foreword



Britain has the most energetic and competitive consumer credit market in Europe. However, the legislation regulating it is almost thirty years old. Although it has generally stood the test of time extremely well, the credit market has developed to an extent never envisaged in the early 1970's.

The time is right for a thorough-going modernisation of the consumer credit framework; one that encourages and enables innovation and competition in the marketplace, yet still provides appropriate protection for today's consumers.

Credit has become an integral part of our daily lives. For many, it is the lifeline that enables them to deal with the emergencies that arise, helping match regular income against the irregular demands and risks of modern life.

But credit, of course, can also introduce risks of its own. Some consumers take out loans that are inappropriate and expensive. Others are tipped into debt by a sudden change in circumstance. But there are also consumers that are preyed upon by loan-sharks, whose activities often exploit the socially deprived sections of our community.

It is simply not possible to escape from poverty if what little you have is asset-stripped by predatory lenders. And this White Paper sets out tough measures to police and crack down on loan-sharks and other such rogue lenders.

But it is also about providing consumers with the right information at the right time, so they can make informed decisions. Consumers need to be able to consider the key factors of a loan before they take it out. To do this they need clear, understandable information.

New protections will go hand in hand with a series of changes to promote a more open, competitive market, offering more choice and less restriction.

This White Paper proposes a range of legislative changes relevant to the credit market of today. It will be regulated in a way that provides consumers with choice, information and protection – at the right time.

A handwritten signature in black ink, appearing to read 'Patricia Hewitt', with a stylized flourish at the end.

Rt Hon Patricia Hewitt MP

Secretary of State for Trade and Industry and
Minister for Woman and Equality

Executive Summary

The Objective

Consumer credit is central to the UK economy. Economic stability based on sound fundamentals is bringing rising prosperity, record employment and low interest rates, all underpinning increased demand for credit. For most, credit cards and other secured and unsecured lending provide people with greater control and flexibility when managing their finances – collectively benefiting the economy

A competitive and efficient financial sector, of which the consumer credit market is an important part, is essential to raise the level of economic growth in the UK economy. Our vision is to create an efficient, fair and free market where consumers are empowered to make fully informed decisions and lenders are able to compete on a fair and even basis.

Drivers for Reform

The laws governing this market were set out a generation ago. In 1971, there was only one credit card available; now there are 1,300. 30 years ago, £32m was owed on credit cards; now it is over £49bn.

The regulatory structure that was put in place then is not the same as the regulatory structure required today. As the credit market has developed, reforms have become necessary to modernise the current regime and update it for the 21st century.

Over the last two years we have reviewed the consumer credit market. Our investigations and consultations with a wide range of stakeholders have revealed problems in the consumer credit market, which the reforms outlined in this White Paper aim to address. These problems can be summarised as follows:

- **Informational problems pre-purchase:** Consumers need clear, consistent information to be able to make informed comparisons between the plethora of products currently available to them. Innovation and evolution in the credit market has benefited consumers through increased choice and flexibility. However, many of today's products have become difficult for consumers to understand because they are so complex, and because there is a lack of transparency of standardised information, for example on the way the APR is calculated
- **Undue surprises post-purchase:** Often, problems arising from misinformation occur after a credit agreement has been signed and the consumer is committed. In this way, the widespread use of large early settlement fees and other hidden costs can cause undue surprises post-purchase
- **Unfair Practices:** Although most traders treat consumers fairly there are a few whose practices are unfair. Often it is difficult for consumers to obtain redress and for the regulatory authorities to take effective action to stop a trader continuing these practices
- **Illegal money lenders:** Illegal money lenders, who are unlicensed and operate outside the law, are commonly referred to as loan sharks. These loan sharks not only take advantage of vulnerable lenders but also bring disrepute to legitimate lenders
- **Over-indebtedness:** while the majority of consumers do not experience any difficulties with borrowing, 20% of households who have credit, experience financial difficulties, while 7% have levels of credit use associated with over indebtedness.

Chapter one of this White Paper reviews the consumer credit market including more information on these problem areas summarised above.

The Scope of Consumer Credit Reform

Establishing a Transparent Market

We want to create a more transparent regime so consumers can make better-informed decisions and get a fairer deal. To this end, we will:

- Change the Advertising Regulations to make credit advertisements clearer and simpler for consumers to understand, and the regulations easier for authorities to enforce;
- Provide consumers with clearer information, before and after agreements are signed;
- Enable consumers to enter and conclude credit agreements online, speeding up application procedures and reducing burdensome paperwork; and
- Raise awareness of early settlement charges and change the law to prevent those who repay early from being penalised.

These reforms are described in chapter two. A significant first step towards their implementation is the consultation document published alongside this White Paper, inviting views on draft regulations on Early Settlement, Consumer Credit Advertising and Form and Content of Credit Agreements.

Creating a Fairer Framework

We want a modern framework that encourages and rewards vigorous competition, innovation, choice and enterprise, while stamping out irresponsible and unfair lending practices.

To this end, we will:

- Strengthen the credit licensing regime to target rogue and unfair practices and provide enforcers with the powers they need to supervise a fair and effective credit market;
- Change the law to end unfair selling practices – replacing a limited ‘extortionate’ test with a wider ‘unfairness’ test – as well as providing an effective dispute resolution mechanism; and
- Remove the £25,000 financial limit – that currently creates a two-tier lending framework and curtails consumer protection – and further examine some of the existing provisions governing the enforceability of agreements.

These reforms are described in chapter three, and we will bring legislation forward to effect these reforms as soon as parliamentary time allows.

Shaping the European Agenda

We want a properly functioning single European marketplace for credit with the potential to boost competition, generate better deals and ensure consumers have enough protection to shop confidently across borders.

To this end, we will press for:

- Cross-border data access on an equal and fair basis;
- A common approach to advertising and information regulation, unfair practices, rules on the calculation of the APR, and debt-recovery and collection practices;
- High level consumer rights and redress mechanisms; and
- An effective passporting regime for lenders wanting to market and sell credit products cross-border.

Chapter four contains more information on current European initiatives and our vision for a properly functioning single European market for credit.

Minimising Over-indebtedness

We can contribute to social justice and prosperity for all by tackling over-indebtedness and improving financial inclusion. We want to educate consumers and provide easier access to help and advice for those in financial difficulty. And we want low-income consumers to have access to affordable credit. To this end, we will:

- Work in partnership with the Financial Services Authority (FSA) to roll out a co-ordinated strategy to deliver financial education, information and generic advice to consumers;
- Implement a new, co-ordinated strategy, drawn up with the voluntary sector and others, for the provision of free, targeted debt advice to consumers;
- Pilot an enforcement scheme to tackle illegal moneylenders;

- Review the current statutory (and non-statutory) remedies available under insolvency regimes to ensure effectiveness;
- Put in place standing mechanisms to ensure that strategies and objectives in tackling over-indebtedness and financial exclusion are shared and pursued across government;
- Publish a strategy for tackling over-indebtedness in Spring 2004.

Chapter five gives more details on our strategic approach to minimising over-indebtedness.

Implementation

This represents a formidable programme of action. Some changes require primary legislation, which we will seek at the first available opportunity. Others will be taken forward through secondary legislation: we are consulting on key draft regulations to coincide with the White Paper's publication.

We will also engage actively within the European Union (EU) on a draft Consumer Credit Directive to ensure it genuinely opens up a single market and create the confidence and certainty needed for lenders and consumers to trade cross-border.

We will work closely with the voluntary sector, credit industry and other stakeholders to tackle over-indebtedness and move closer to prosperity for all.

Chapter six contains the implementation plan summarising how and when the government and other bodies will take forward the reforms described in this White Paper.

Our vision is to create
a fair, clear and
competitive market

Chapter 1:

Drivers for Reform



Introduction

1.1 This Chapter provides an overview of the current economic background and details the inefficiencies in the consumer credit market our reform programme is designed to address. Our vision is to create a fair, clear and competitive credit market; where consumers are empowered to make fully informed decisions, and lenders are able to compete on a fair and even basis. This chapter:

- reviews the current consumer credit market;
- analyses current imperfections in the credit market;
- and sets out the scope of consumer credit reform.

Review of the Current Consumer Credit Market

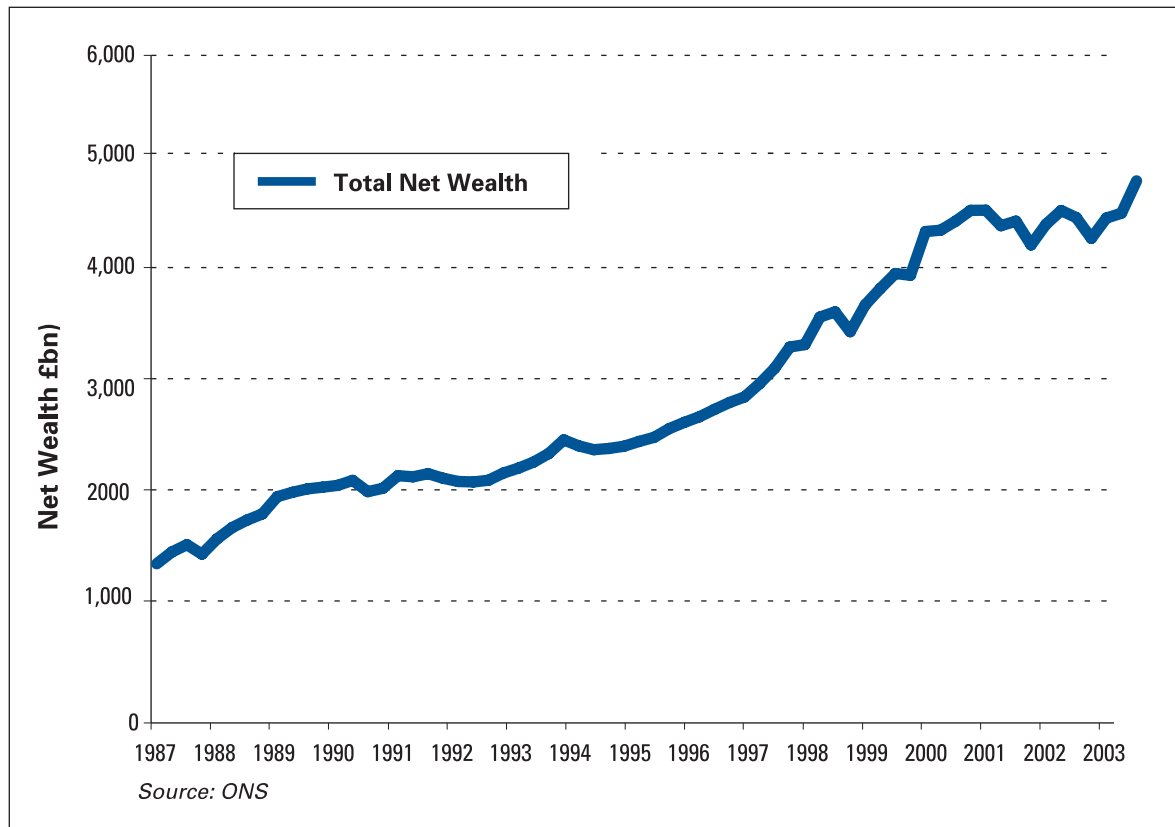
The Macro-Economic Context

1.2 A competitive and efficient financial sector is essential to raise the level of sustainable economic growth in the UK economy. An innovative consumer credit market has developed rapidly over the last 30 years. Economic stability, supported by low inflation and low interest rates, has delivered rising prosperity and record employment,¹ which has underpinned robust growth in consumer spending. In recent years, this has helped to support growth in the UK economy and cushion the impact of subdued global demand.

1.3 Consumer confidence has remained high, reflecting the sound fundamentals the UK economy is built upon. Despite global uncertainty, households remain confident in their own financial situations. This should continue to underpin robust consumption growth. Growth in consumption, at around 4% a year for the past six years, is significantly below the levels seen in the late 1980s' boom, when it reached over 7.5% in 1988.

¹ Unemployment is at its lowest since the 1970s.

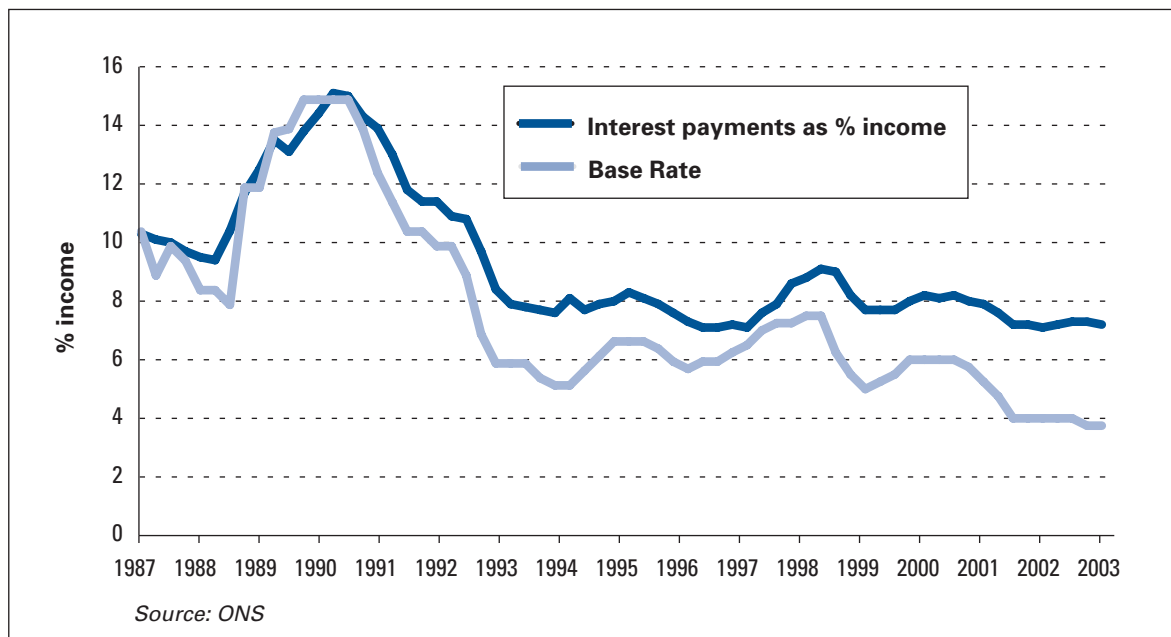
- 1.4 Households are in a strong position to borrow, average household incomes have continued to increase in real terms, and total net household wealth remains high, up over 50% since 1997.



- 1.5 Low interest rates make household debt more affordable by reducing the proportion of income spent on interest payments. Interest rates have fallen considerably over the past decade or so, from a peak base rate of almost 15%, in October 1989, to the current level of 3.75%, close to their lowest levels since 1955. This has ensured that debt-servicing costs are easily affordable by historical standards. Households paid only 7.2% of their disposable income² on interest payments in the second quarter of 2003; compared to the peak of 15.1% in the second quarter of 1990. We estimate that a 1 percentage point increase in current interest rates would increase the debt servicing costs of households to around 7.8% of disposable income, still low by historical standards.

- 1.6 The following chart shows how interest payments, as a proportion of income, have changed over time, and how they mirror the impact of changes in the base rate. It shows that debt-servicing costs have remained relatively stable in recent years, despite cuts in the base rate. This reflects increases in the overall debt stock, although debt-servicing costs remain easily affordable.

² Income after taxation and National Insurance.



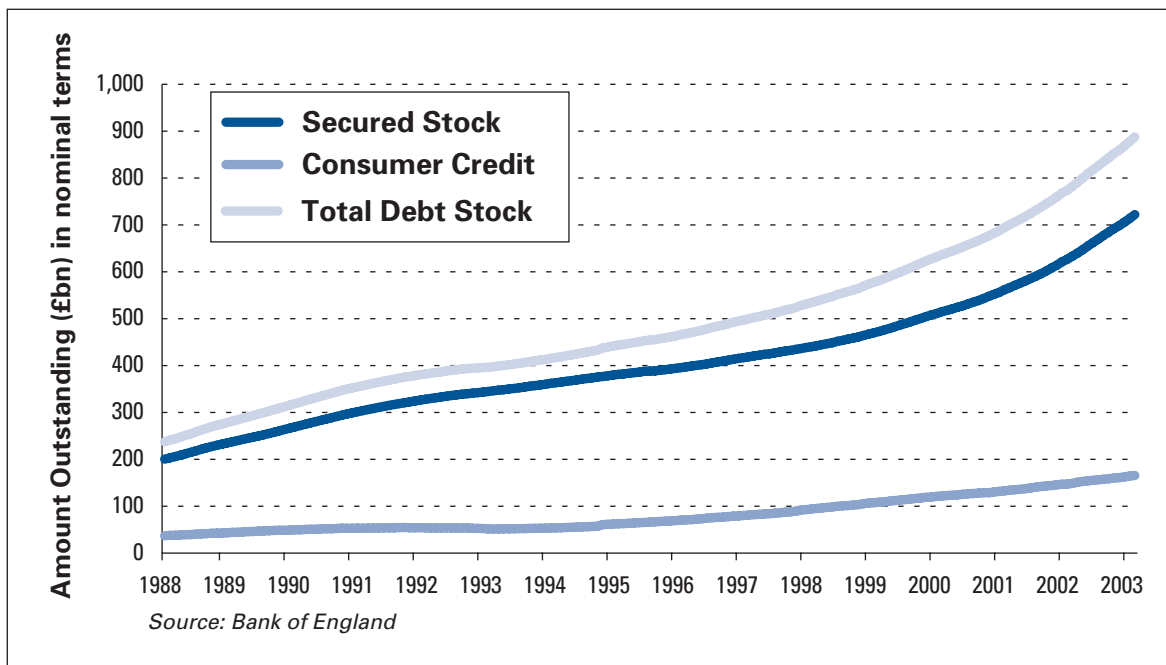
Composition of the Consumer Credit Market

1.7 The consumer credit market comprises:

- Secured lending other than first charge mortgages. Under the Financial Services and Markets Act 2000 (FSMA), the FSA will have the power to regulate first-charge mortgages from 31 October 2004, including advising on, and arranging of, mortgages. This will be applicable to all first-charge mortgages on property where at least 40% is used as, or in connection with, a dwelling by the borrower or a member of their immediate family;
- Credit cards;
- Loans, including small value short term loans;
- Mail order, hire purchase, and store cards;
- Credit unions.

1.8 The consumer credit market has changed fundamentally since the introduction of the Consumer Credit Act 1974. September 2003 figures from the Bank of England show the total level of outstanding debt to individuals in the UK is £906bn – of which £737bn is secured lending and £168bn is, largely, unsecured. In real terms, this compares with a level of outstanding debt of £521bn (£454bn secured) ten years ago. Therefore in

real terms, unsecured consumer credit has increased from £67bn to £168bn over the last ten years. The following chart shows how the amount of outstanding debt has changed in nominal terms between 1988 and today.

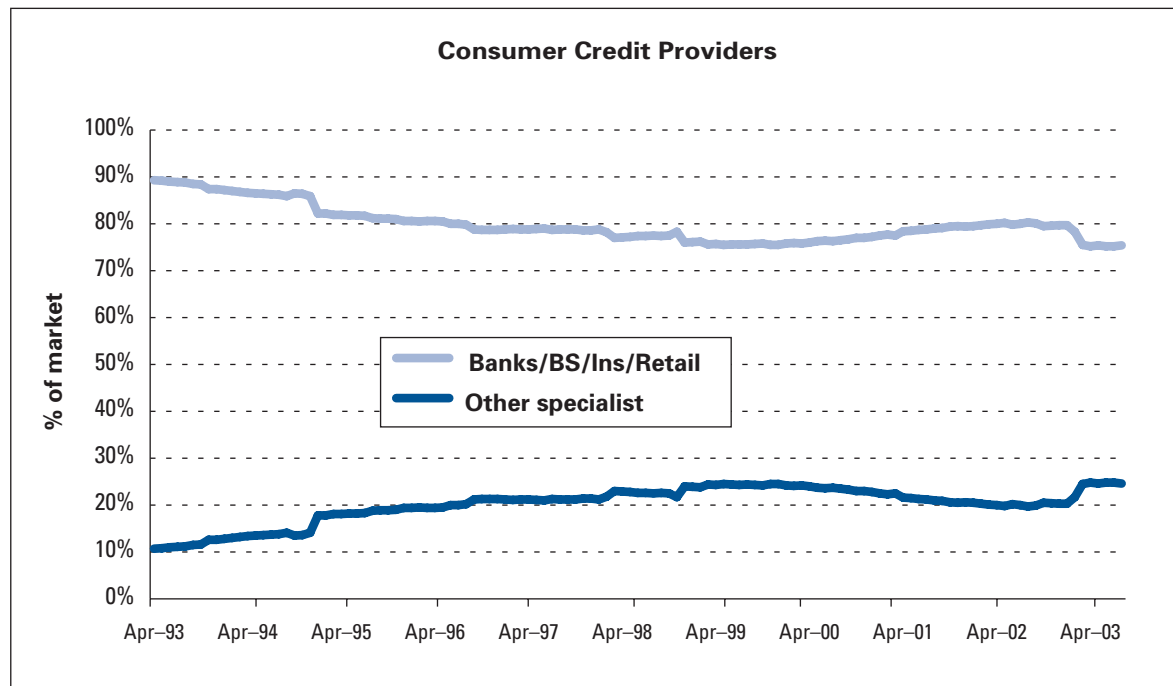


1.9 The following table shows how the composition of consumer debt, between different types of credit products, has changed over time.

	Proportion of households with current commitments (%)		Average amount owed per household (£, adjusted to 2002 prices)	
	2002	1989	2002	1989
Credit Cards	19	15	1,570	565
Mail order	17	23	240	na
Loans	15	16	5,000	*2,190
HP/credit sale	13	17	3,800	*
Overdraft	9	12	450	1,676
Store cards/accounts	8	7	210	197
*either loan or hire purchase				

Source: Kempson E (2003), Household Survey of Over-indebtedness, DTI

- 1.10 Growth in the overall size of the consumer credit market has been matched by changes to its composition—banks and building societies have seen their share of the market fall from 81.5% in 1993 to 73.3% today; retailers, from 4.7% to 1.3%; and insurance companies, from 2.7% to 0.7% over this period. These falls have been offset by increases in the market share of other, specialist lenders³ – increasing from 11.2% to 24.6%.



- 1.11 With lower entry barriers due to advances in IT and risk-assessment procedures, the number of licensed lenders has increased rapidly. Specialist lenders are targeting specific sections of the market, and the widespread introduction of new and innovative products means consumers now have an ever-increasing number of credit options available to them.

Consumer Credit Products

- 1.12 Credit options that are currently regulated by the existing CCA regime and that fall within the scope of our review, include:

Secured Loans

- 1.13 Personal loans secured by way of a second charge over the consumer's home, remain a popular way of raising finance. These loans are usually

³ These comprise non-bank credit grantors and specialist mortgage lenders extending consumer credit.

sold through brokers and are heavily marketed in the press and on television, often for debt consolidation purposes.

- 1.14 These loans tend to be for periods between 5 and 15 years, and have a variety of interest rates. There are about a dozen specialist second-charge mortgage lenders currently operating in the UK market, some of which are part of major banks. A number concentrate on making loans available to consumers with debt problems or who have difficulty in proving their income.

Credit Cards

- 1.15 In 1971⁴ there was only one type of credit card (Barclaycard) available in the UK; now, there are around 1,300. The big five⁵ banks still account for 64.1% of the market, The amount of money owed on credit cards has increased exponentially from £32m, in 1971, to over £49bn, today.

- 1.16 According to the Cruickshank Report,⁶ the credit card market in the UK is the most developed in Europe, accounting for about a third of all EU transactions, with many consumers now using credit cards as their preferred payment medium. A major driver for the take-up and usage of credit cards, in recent years, has been the rapid development in e-commerce.

Loans

- 1.17 The market for non-mortgage loans includes unsecured loans, as well as loans secured on personal assets other than residential property. The market as a whole is not concentrated.

- 1.18 Unsecured loans are usually sold direct to customers, either at bank branches, by telephone, post or the internet. Competition to the big five comes from other traditional banks, newer banks, some building societies, and other lenders including: the Automobile Association, the Prudential, some high street stores and supermarket chains, as well as doorstep collection companies.

- 1.19 While UK banks do not charge fees for granting loans, interest margins are relatively high,⁷ suggesting that competition is not fully effective. The main source of innovation in this sector has been the development of

⁴ Cmnd 4596 Consumer Credit, Report of the Committee, Lord Crowther, London, Her Majesty's Stationery Office 1971.

⁵ The big five banks are: Barclays, HSBC, Lloyds TSB, HBOS and RBS/Natwest.

⁶ The Cruickshank Report is available at <http://www.hmtreasury.gov.uk/Documents/Financial_Services/Banking/BankReview/fin_bank_reviewfinal.cfm> The review of banking led by Don Cruickshank found there are serious competition problems in the UK's payment systems. The Government is committed to tackling competition concerns raised by Cruickshank, and to give the OFT the remit to ensure effective competition in payment systems.

⁷ Op Cit 6.

new delivery systems such as internet-based, loan-application and processing systems, the creation of products with greater repayment flexibility (such as offsetting loans), and segment-specific targeting such as home-improvement and student loans.

Small-value Short-term Loans

1.20 There are several forms of small-value, short-term loans that feature in today's credit market – for example, doorstep lenders, cheque cashers and pawnbrokers, along with other companies linking credit to the possession of goods. A feature of this type of lending is that the term of the loan is normally taken over a period of less than 12 months.

1.21 There are around 30,000 agents working in the home credit industry – mostly women – with an estimated 3 million customers. The sums advanced are usually small, typically between £100 to £300, with a repayment period in the range of 26 to 52 weeks. The charges are fixed and 'all-in' (even if the customer misses a payment there is nothing extra to pay).

1.22 Pawnbroking is a form of secured lending. The average size of loans provided by pawnbrokers is around £100, 85% of which are redeemed within the statutory, 6-month redemption period.

Mail Order, Hire Purchase and Store Cards

1.23 *Mail order* credit provides a convenient method of shopping, allowing consumers to make purchases that can be paid off weekly, over an agreed period of time. 'Agency' mail order has about 20.8 million users, of which somewhere between 8 and 10 million are drawn from the same socio-economic groups as the home credit customer-base.⁸

1.24 *Hire purchase* agreements are often used by individuals to finance the purchase of expensive assets, such as a car. The finance is usually structured so the consumer pays a deposit, a number of monthly instalments and then a final payment to secure ownership of the asset.

1.25 *Store cards* allow consumers a form of running-account credit to purchase goods from a particular store. The cards are normally store-branded, but the credit will usually be provided by a finance company. Often, there are incentives attached, such as exclusive promotions and discounts.

1.26 *Overdrafts* are a feature of current account products and offer consumers a more short-term form of credit. Some accounts have a fixed limit, while others are negotiated on a month-by-month basis. Invariably, overdrafts are repaid more quickly than unsecured loans.

⁸ See Monopolies and Mergers Commission Report (1997) on the proposed merger between Littlewoods and Freemans.

1.27 *Credit unions* have been in existence for about 40 years, in the UK. The first credit union was started in Northern Ireland in 1960, arriving on mainland Britain in 1964.⁹ There are about 200,000 borrowing members and a total membership of around 400,000. The credit union movement is more developed in Scotland, which has 139 unions – holding 45% of the movement’s assets, in the UK – compared with 547 throughout the whole of England and Wales.

Who Uses Credit?

1.28 Credit use is traditionally highest among families with children, especially lone parents – three quarters of whom have current commitments.¹⁰ The arrival of a baby and the purchase of a house are clearly linked to higher-than-average levels of credit use. Young people living as independent householders are also heavy users. In contrast, few single pensioners have current credit commitments.

1.29 Credit cards tend to have relatively better-off clientele, drawn disproportionately from: householders in full-time work (30% of whom use a credit card for revolving credit); people in their forties (32%); two-parent families (31%); and mortgagors (32%). Young people in their late teens are not heavy users.

1.30 Loans are most common in lone-parent households (33%); two-parent families (26%); families with a new baby in the past 12 months (32%); and those whose income has both fallen and risen over the past 12 months (38%). There are also marked differences in the source of loans for these groups. Three quarters of two-parent families have borrowed from a bank or building society. In contrast, half of lone parents on benefits have borrowed from the Social Fund,¹¹ and a quarter have taken out a loan with a doorstep-collection credit company, lending in low-income neighbourhoods.

1.31 Overdrafts are especially common among householders in their teens (23%), their twenties (24%), and those under 25 and still living at home (23%). Overdraft use declines steeply with age. Only 1% of householders aged over 60 were overdrawn. Overdrafts are strongly associated with unstable incomes (27% of households whose incomes had both increased and decreased during the past twelve months used overdrafts).

⁹ See ‘Credit unions in the United Kingdom’, Berthoud and Hinton, 1989.

¹⁰ Kempson E (2002), Household Survey of Over-indebtedness, DTI.

¹¹ Op. Cit. 10.

- 1.32 In contrast, use of mail order credit and small-value loans declined steeply with income – this includes lone parents (43%), two-parent families with children (27%), and social tenants (25%). Mail order credit is also heavily used by those who are unable to work through long-term ill health or disability (66%), who, otherwise, make little use of credit.
- 1.33 Although debt-servicing costs have stayed fairly constant, in recent years, household indebtedness has risen rapidly in relation to incomes. This implies that the fall in interest rates has resulted in consumers accumulating more debt, as debt-servicing costs remain affordable. At the aggregate level, interest payments (secured and unsecured) as a proportion of income increased only marginally from 8.0% to 8.2% for borrowers as a whole, between 1995 and January 2000.
- 1.34 Research from the Bank of England¹² indicates that consumers are becoming more confident about their higher levels of debt – possibly reflecting the sustained period of low interest rates experienced recently in the UK. However, that confidence could be eroded if circumstances deteriorated.
- 1.35 Evidence from the British Household Panel Survey (BHPS) shows that, among those households who reported no difficulty meeting their unsecured loan commitments, the average unsecured debt-income ratio rose, from 11.9%, in 1995, to 15.6%, in 2000 (see table in Annex C).
- 1.36 Research¹³ shows that, while the majority of consumers do not experience any difficulties with borrowing, some households who have credit do experience financial difficulties, and the problem of over-indebtedness which some face is analysed in more detail in the next section.

Drivers for Reform

- 1.37 Over the last two years we have reviewed the consumer credit market. Our investigations and consultations with a wide range of stakeholders have revealed problems in the consumer credit market, which the reforms outlined in this White Paper aim to address. These problems are summarised below.

¹² Bank of England (2003), Financial pressures in the UK household sector: evidence from the British Household Panel Survey.

¹³ Op Cit 10.

Informational Problems Pre-purchase

- 1.38 Consumers need clear, consistent information to be able to make informed comparisons between the plethora of products currently available to them. Innovation and evolution in the credit market has benefited consumers through increased choice and flexibility. However, many of today's products have become difficult for consumers to understand because they are so complex, and because there is a lack of standardised information, for example on the way the APR is calculated.
- 56% of consumers do not understand the terms used on credit agreements¹⁴;
 - 77% find the language in advertising confusing.¹⁵
 - 68% of consumers are aware that lenders do not calculate the APR in the same way, but because they do not know how the calculations are made they find it difficult to price one loan against another.¹⁶ This can make it difficult for consumers to shop around for the cheapest deals and lessens the pressure on lenders to keep their prices competitive or risk losing their customers.
- 1.39 Informational problems can also result in consumers ending up with the wrong form of credit at the wrong price. The consumer detriment from dealing with complaints, alone, is estimated to be around £40m per annum.¹⁷

Undue Surprises Post-purchase

- 1.40 Often, problems arising from misinformation occur *after* a credit agreement has been signed and the consumer is committed.
- 1.41 The widespread use of large early settlement fees and other hidden costs causes consumers undue surprises, post-purchase. For example, 62% of borrowers are not aware of early settlement charges when they take out a loan¹⁸.

¹⁴ Consumer Credit Awareness survey, DTI, 2003.

¹⁵ Op Cit 14.

¹⁶ Op Cit 14. The APR is a notional rate for calculating the annual total cost of credit at the start of a credit agreement. However, the assumptions underlying the calculation may vary between lenders.

¹⁷ Based on the methodology used by the OFT in its paper entitled Consumer Detriment (2000). The detriment figure is based on the number of complaints received regarding credit agreements and includes all the potential costs incurred by the consumer in complaining. These include legal and advice costs, telephone and stationary costs, the use of personal time and lost earnings etc. See table 6.5 of the OFT paper for a fuller exposition of the costs included.

¹⁸ Op Cit 14.

- 1.42 If hidden charges are used to cross-subsidise up-front rates, a lack of awareness can result in over-commitment and over-expansion of the market. For example, 58% of consumers who were unaware of early settlement costs said that, if they had been informed, they might have gone to another lender¹⁹.
- 1.43 Hidden costs may also lead consumers into financial difficulty and over-indebtedness. High default interest charges are often made by lenders when borrowers fall into arrears. When interest on these charges is compounded interest, it can lead to a spiral of debt.

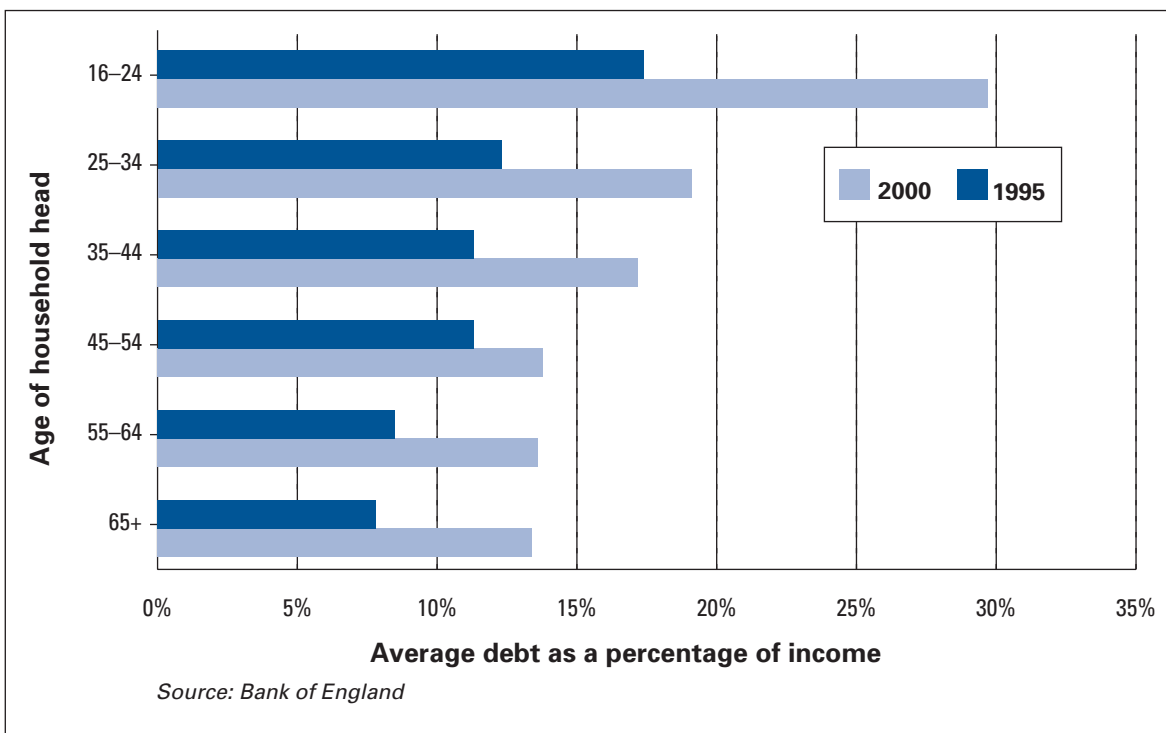
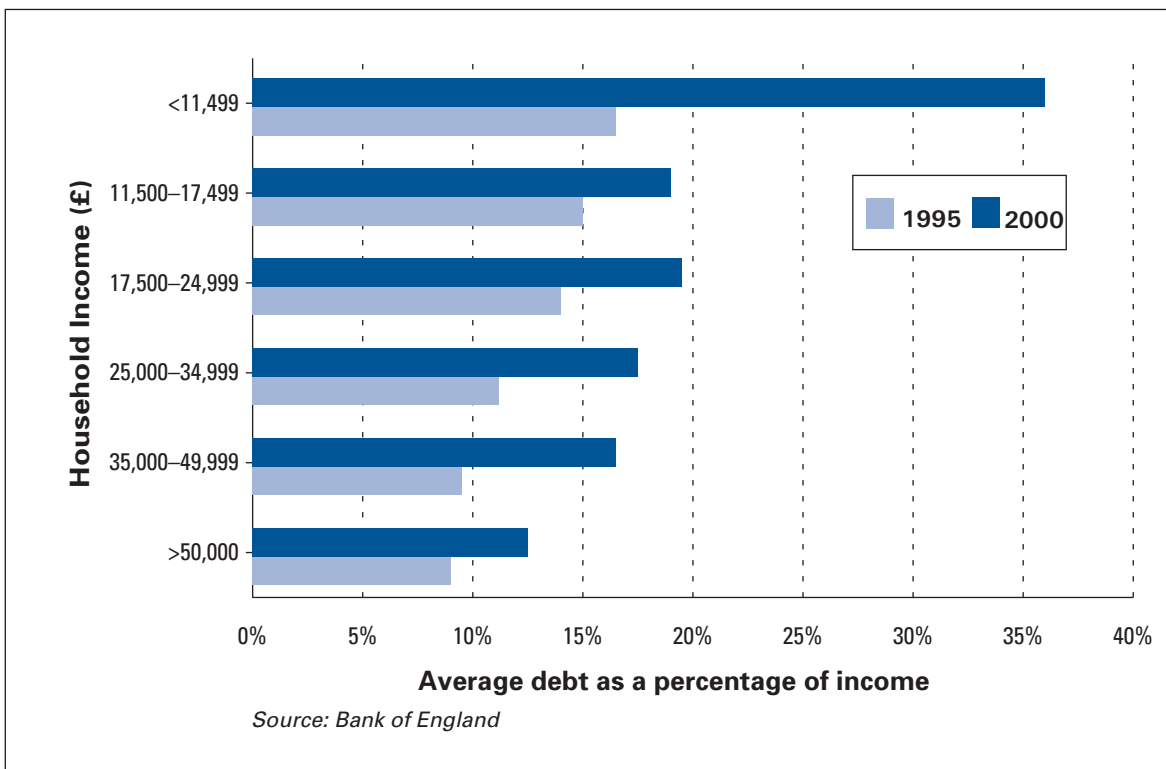
Illegal Moneylenders

- 1.44 Illegal moneylenders, who are unlicensed and operate outside the CCA, are commonly referred to as loan sharks. These loan sharks not only take advantage of vulnerable consumers, but also bring disrepute to legitimate lenders.
- 1.45 Illegal moneylenders often lock consumers into exorbitant rates of interest, which are compounded weekly. This leads to escalating debt, while failure to pay can lead to violence and intimidation. The wider costs created by illegal moneylenders are similar to those of over-indebtedness, and it is the most vulnerable in society who suffer most because they feel they have no legitimate credit options available to them.

Over-indebtedness

- Vulnerability to over indebtedness*
- 1.46 While borrowing is increasing in the population as a whole, the BHPS survey suggests that debt-to-income ratios vary widely across households. It is the lowest-income groups, and the young, who increased their debt-to-income ratios by most, and from the highest levels, between 1995 and 2000, as illustrated below. These are the households that are most vulnerable to sudden financial changes, such as spells of unemployment or increases in interest rates.

¹⁹ Op Cit 14.



1.47 The stable macroeconomic framework with low interest rates and low unemployment has helped to change households expectations about their expected level of future income. As a result, those groups with the highest propensity to consume, i.e. the young and the low income groups, are taking on proportionately more debt (especially when it comes to starting up a new home, having children, covering university courses etc) as they become more optimistic about their future circumstances. However, we intend to carry out further work to understand the spending patterns and attitudes to credit for the young and the low-income groups in order to fully understand the changes in spending patterns. Progress will be overseen by the New Ministerial Group on the over-indebtedness as outlined in chapter five.

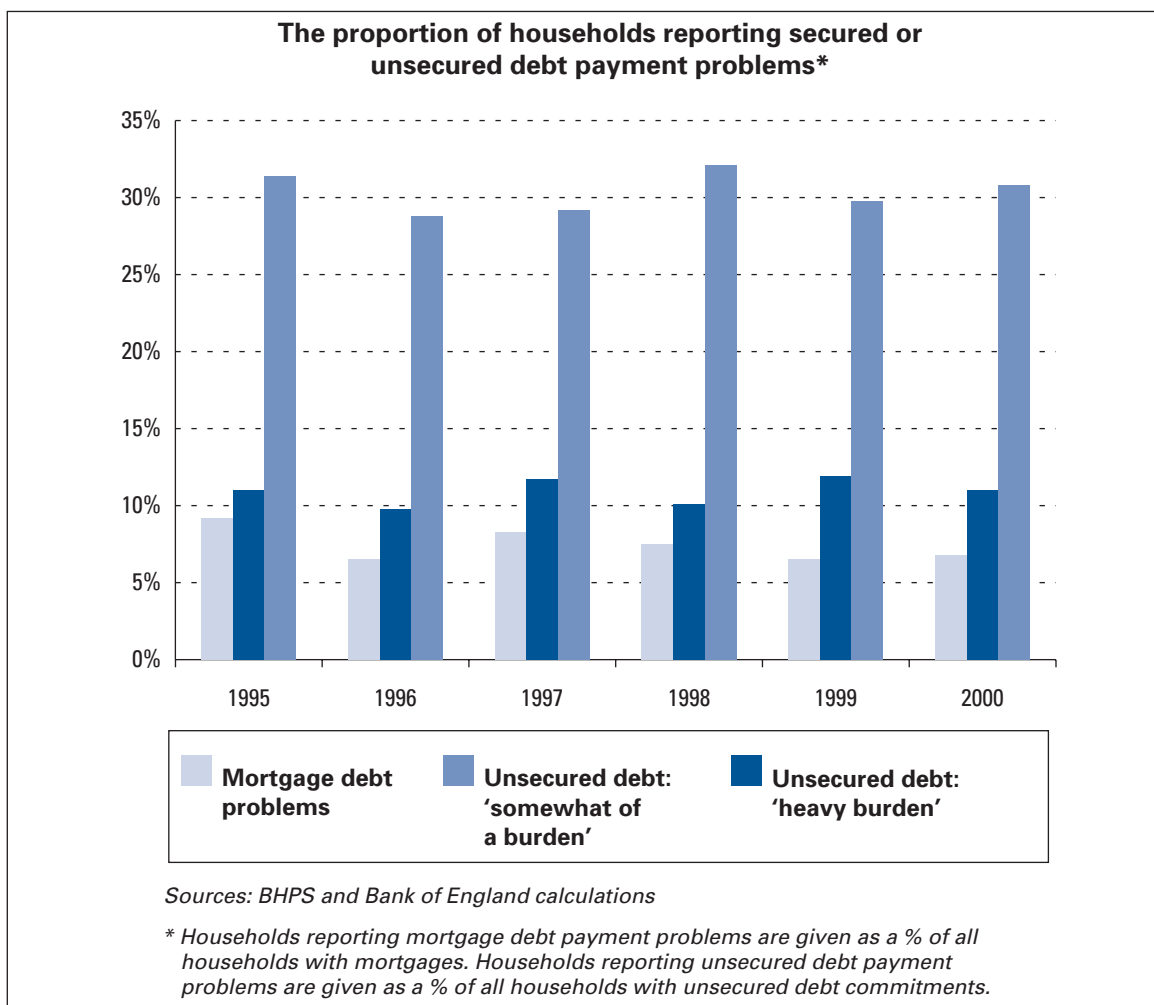
Those Who Struggle With Debt

1.48 Aggregate data show that, while the majority of consumers do not experience any difficulties with borrowing, 20% of households who have credit, experience financial difficulties, while at least 7% have levels of credit use associated with over-indebtedness²⁰. Over half of those with financial difficulty attributed it to either a loss of income (for example illness, unemployment, relationship breakdown, new baby) or to a consistently low income.

1.49 Further research²¹ shows that the proportion of households with unsecured debt commitments that found them either to be a 'heavy burden' or 'somewhat of a burden', remained broadly stable, at around 11% and 30%, respectively, between 1995 and 2000.

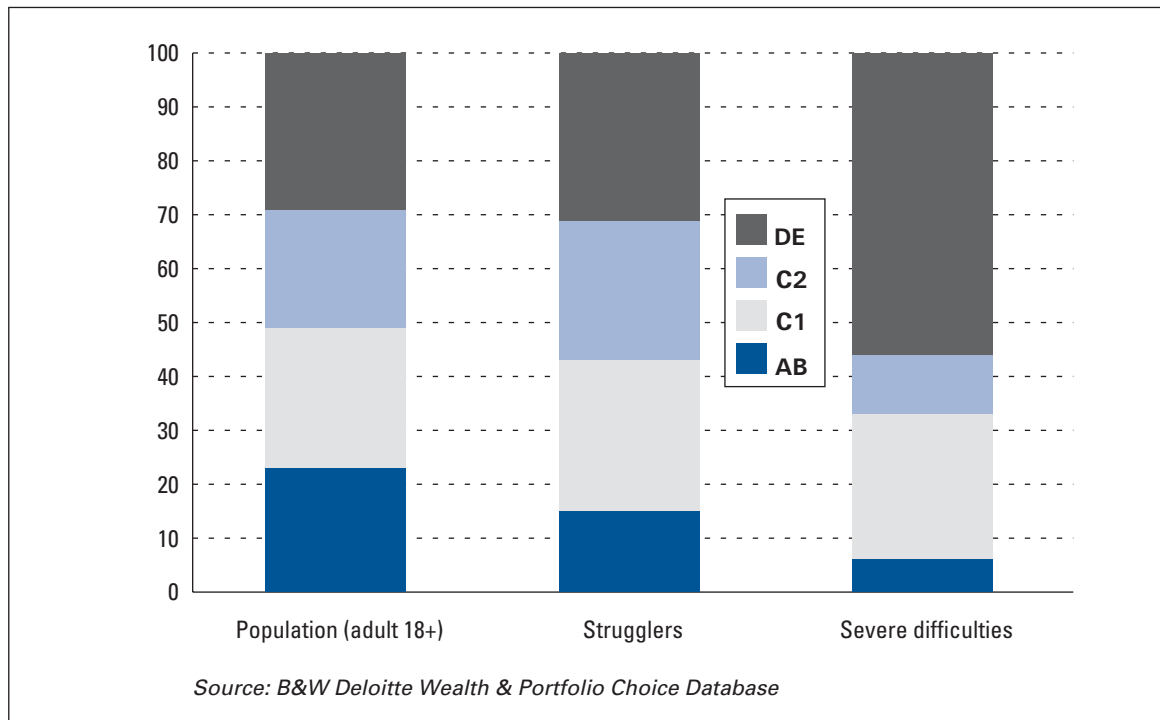
²⁰ Op Cit 10

²¹ Op Cit 12



Those With Severe Debt Problems

1.50 The profile of borrowers that struggle with debt is relatively consistent with the profile of the UK population as a whole. However, those that suffer severe debt problems reveal a profile skewed towards the lower (DE) socio-economic group, as illustrated below (see Annex C for definitions of the social grade groupings).



The Consequences of Over-indebtedness

- 1.51 **The consequences of over-indebtedness are often worse for the lowest income groups**, who are more likely to have ‘priority’ debts (rent, council tax, utility bill or mortgage arrears) that may have serious repercussions, such as eviction, imprisonment, disconnection or repossession. Over-indebtedness in these groups is often linked to financial and social exclusion. Tackling over-indebtedness for these groups is, therefore, a wider government issue as it has implications for our objectives on social justice – such as tackling child poverty, and the promotion of neighbourhood renewal.
- 1.52 Imperfections in the credit market also have other associated costs. For example, as well as being damaging to health, over-indebtedness may also result in people losing their homes, being excluded from receiving credit in the future, as well as potentially being a barrier to future employment.
- 1.53 **There are significant wider costs to consumers from over-indebtedness.** For example, evidence shows that one of the main costs to borrowers from over-indebtedness is manifested in increased stress and the adverse medical conditions this can trigger. A clear link between stress and absenteeism from work has been established, which inevitably imposes additional costs on: government, that picks up the bill for health, housing, legal costs etc.; businesses; fellow colleagues; and on the economy as a whole, through lower productivity and growth.

The Scope of Consumer Credit Reform

- 1.54 The proposals, outlined in the following chapters, are designed to address the current problems in the consumer credit market and have been developed over two years of consultation. The review of the CCA – incorporating discussions on tackling over-indebtedness – was begun at the same time the Government decided to implement statutory regulation of mortgages, two years ago.
- 1.55 We have consulted widely with consumer groups, the lending industry, different-sized businesses, regulators and many others. And we have looked to see what we can learn from overseas, in the US, for example, as well as embarking on discussions regarding a new EU framework.

Scope of Reforms

- 1.56 This White Paper sets out the Government's proposed policy in relation to second charge mortgage lending, running-account credit, unsecured lending and other forms of credit regulated by the CCA.
- 1.57 The CCA currently applies to the whole of the UK – with certain special provisions for Northern Ireland, which do not affect the substance of the statutory regime. The Office of Fair Trading (OFT) exercises its responsibilities under the Act across the whole of the UK. However, consumer credit is now a devolved matter with respect to Northern Ireland. It is intended that the proposed reforms would apply across the whole of the UK and so we are in discussions with the Northern Ireland Office, and other devolved administrations, to develop a co-ordinated implementation strategy. Responsibility for aspects of over-indebtedness is also a devolved matter and, again, ongoing discussion will continue with these administrations to ensure coherent and effective action.
- 1.58 The Government aim to create a modern, fair market with confident consumers is shared by the European Commission. The drive for European reform has begun with the publication of proposals to modernise the regulation of credit at an EU level. We want to participate in a fully integrated and properly functioning single European marketplace for credit; one that will generate better deals for consumers, through increased competition, and also benefit lenders, through access to a much larger marketplace.

- 1.59 As we have the biggest and the most developed consumer credit market in the EU, the UK has the opportunity to put itself in the driving seat of reform and influence the European process through early action against out-dated regulation. We are working to achieve similar objectives to those of EU policy-makers. EU reform could take several years, but by acting now, it is our intention to be at the forefront of any future negotiations and policy developments.

Policy Proposals

- 1.60 Our policy responses must tackle the distortions in information so that consumers can make fully informed decisions pre-purchase. And, where there are undue surprises post-purchase, consumers must have recourse to suitable advice and redress mechanisms. Only by taking both an ex ante and ex post approach can we be sure of achieving our aims.
- 1.61 The package of measures promoting transparency described in chapter two is designed explicitly to remove informational distortions before consumers have committed to a credit agreement. This should enable consumers to compare products with confidence, make informed decisions and therefore drive competition between lenders.
- 1.62 In addition chapter three explains how the government intends to create the concept of an unfair credit transaction to replace the current extortionate credit provisions which are relatively limited and provide little protection for consumers. We will also develop an Alternative Dispute Resolution mechanism to make it cheaper and easier for consumers to challenge unfair credit transactions.
- 1.63 Due to the information problems consumers face it is difficult for them to distinguish between the good and the bad lenders. The current credit licensing system has weaknesses since it has not been able to root out some lenders that conduct unfair business practices.
- 1.64 The proposals in chapter three to improve the licensing regime will include extending the fitness test to take account of preparedness to run the business as well as the applicant's past conduct. This will provide greater assurance that licence holders will run the business to high standards. The reforms will extend the current duties on information provision to OFT in line with the wider fitness test. They will also allow the OFT to seek additional information from licensees and third parties to enable them to take a more proactive approach to compliance.

- 1.65 The reforms will empower OFT to impose special conditions on licence holders or take undertakings from them. A breach could lead to a financial penalty. This will strengthen the range of sanctions available to OFT short of revoking the licence.
- 1.66 These measures to address the imperfections of the consumer credit market described in chapters two and three will go some way to reducing the burdens of over indebtedness. However further measures are needed to deal with the wide range of factors that contribute to over-indebtedness and to help consumers deal with debt problems once they have occurred. Chapter five outlines proposals to tackle over-indebtedness.

Conclusion – Our Vision for the Future

- 1.67 The consumer credit market has developed rapidly since the introduction of the CCA. Not only has it been dynamic and grown in size, but the composition of lenders has changed, and the range and choice of products available has also increased, as has their complexity.
- 1.68 The reforms set out in more detail in the following chapters are designed to achieve the Government's vision for the consumer credit market.
- 1.69 We want to encourage an open and fair credit market where consumers can make fully informed decisions and businesses can compete aggressively on a fair and even basis. Vigorous competition provides a spur for businesses to be more productive, innovative and efficient, which will provide benefits to consumers in terms of lower prices, higher quality, and more choice and innovation.²² By allowing resources to be put to their most efficient use, we will increase economic welfare and promote prosperity for all. Only by dealing with the market failures will we see a credit market fit for the 21st Century that will reap genuine rewards, for both lenders and borrowers alike, as well as contributing to the Government's aim of raising UK productivity.
- 1.70 Promoting a fair and open credit market enables consumers and business to interact in a more efficient way – however it is not an end in itself. Consumers' circumstances can change rapidly, and there can be undue surprises post-purchase. We can contribute to social justice and create prosperity for all by tackling the problems associated with over-indebtedness and improving financial inclusion. We want to educate consumers and provide easier access to help and advice for those in financial difficulty. And we want low-income consumers to have access to affordable credit.

²² The consumer benefits underpin the reforms in the Enterprise Act.



Consumers need transparency to stop being confused by complex credit products

A close-up, high-resolution photograph of a person's eye, looking directly at the camera. The eye is dark and detailed, with visible eyelashes and the texture of the skin around it. The lighting is soft, highlighting the contours of the eye and the surrounding facial features.

Chapter 2:

Establishing a Transparent Market

- 2.1 Consumers are confused by the complexity of modern credit products, and a lack of transparency in the way they are sold. The package of measures promoting transparency described in this chapter is designed explicitly to remove informational distortions. This should enable consumers to compare products with confidence, make informed decisions and therefore drive competition between lenders.
- 2.2 This chapter sets out the agenda for changes to the current consumer credit legislation to ensure a more modern, transparent and, as a result, competitive credit market. It deals with four key areas:
- Consumer credit advertising;
 - Form and content of agreements;
 - Online agreements;
 - Early settlement.
- 2.3 While our principal policy on each of these areas is outlined below, we invite stakeholders to comment on the detail of the proposed changes to the current regulatory structure as set out in the consultation document published alongside this White Paper. The consultation will run until 15 March 2004 with a view to introducing, subject to consultation, the new regulations by end-October 2004.
- 2.4 Many of the transparency provisions described in this chapter relate to the transparency of information pre-agreement. Chapter three deals with unfair practices that lie outside the specific provisions in this chapter. The unfair practices reforms in chapter three combined with the reforms to the form and content of agreement and to early settlement charges should help to ensure that consumers do not suffer undue surprises post-agreement.

Consumer Credit Advertising

- 2.5 The original aim of the Consumer Credit (Advertisements) Regulations 1989 (the Regulations) was to provide a framework that delivered transparency for consumers and certainty for lenders. However, due to the rapid evolution of the credit industry, the current rules have resulted in a highly technical and complex regime, creating confusion for lenders,

enforcers and consumers.²³ As we have seen, there are a number of areas of ambiguity requiring clarification. Among them, the use of the APR in credit card advertisements has attracted considerable interest recently, particularly from the Treasury Select Committee enquiry into credit card charges.

2.6 Consumers are often uninformed about the detail contained in the small print in advertisements although, paradoxically, they tend to be reassured that its very presence suggests that the product is closely regulated.²⁴

2.7 **The Government, therefore, intends to introduce measures designed to ensure greater consistency and transparency in credit advertising, so that consumers can compare financial products with confidence and make informed purchasing decisions.** These Regulations will apply to all forms of media used to advertise credit.

2.8 They will be brought more into line with the new FSA regime on mortgage regulation²⁵ (which will include Financial Promotion Rules), and a number of EU initiatives affecting consumer credit (draft Directives on consumer credit, unfair commercial practices as well as the Distance Marketing of Consumer Financial Services Directive). By introducing new, simplified Advertising Regulations that are easier to enforce, we will:

- Ensure that all credit advertisements are clear, fair and not misleading.
- Replace the existing categories of Simple, Intermediate and Full credit advertisements with a new, straightforward hierarchy of advertisement forms, aimed at ensuring consistency in the way that key financial information is used and presented.
- Require a single set of assumptions to be used by credit card issuers in determining the APR. This will enable consumers to make like-for-like comparisons.
- We have been consulting with the credit industry body, the Association for Payment Clearing Services (APACS) and the OFT regarding a single set of assumptions that card issuers must use in advertisements. These assumptions are set out in the accompanying consultation document on reform of the advertising regulations and will bring consistency of interpretation to the marketplace and ensure consumers receive comparable information.

²³ "Research Findings: Consumer Credit Advertising" July 2002 Report prepared for DTI by Research Business International Ltd.

²⁴ Op Cit 26.

²⁵ from October 2004.

- 2.9 Regulation will apply where financial information is included in the advertisement, or certain statements are made regarding the credit itself or to whom it is targeted.
- 2.10 Where the interest rate for a product will vary according to the credit-worthiness of the applicant (personal pricing), lenders will be permitted to quote a typical APR. However, this will have to be the highest rate reasonably expected to be given to at least 66% of the eventual number of consumers who accept a credit agreement in response to the advertisement.
- 2.11 And, where any one of a number of pieces of information linked to the cost of a loan are displayed, they will be shown together and with equal prominence. This is to ensure that additional charges and costs etc. are not hidden in small print. This information is:
- Amount of credit (however, the amount of credit may be displayed on its own with the APR);
 - Deposit, if one is required;
 - Any advance payment, if required;
 - Frequency, amount and number of payments;
 - Total amount payable;
 - Notification of any other charges or fees associated with obtaining the credit;
 - (where appropriate) the cash price of the goods or services purchased; and
-
- where the advertisement is for a mortgage or loan secured on property – a warning statement; and where the repayments are to be made in a foreign currency – a warning that changes in the exchange rate may increase the sterling equivalent of the debt.
- 2.12 Whenever this information is required, the APR – as defined above – will also have to be given, in the same place as the other information, double the size and more prominent.

- 2.13 In developing the new information regime we will aim to strike a balance between imposing new costs on lenders and consumer benefit from any additional information. We will therefore consult widely to ensure the regulations are suitable and transparent and therefore easy for businesses to comply with and for consumers to understand.

Impact Assessment

- 2.14 The reforms will benefit borrowers, who will find it easier to compare financial products across lenders. The APR quoted will provide a consistent comparative factor. In addition, there will be consistency with FSA regulations concerning APRs.
- 2.15 Advertisements will have less confusing small print, so borrowers will have a better idea of the product before they make enquiries. This should encourage vulnerable and less sophisticated borrowers to look at products offered by mainstream lenders rather than resorting to 'back-street' lenders, thus helping to keep the cost of personal credit down. Advertisements directed at vulnerable consumers with a difficult credit history will always carry an APR.
- 2.16 We accept that credit products will continue to get more complex. However, with more straightforward advertisements, consumers will have a clearer understanding of the key information they need. This will make the buying and selling of credit products a simpler and more transparent procedure.
- 2.17 Lenders will also benefit, as increased clarity and certainty will mean competition takes place on a level playing-field.

Form and Content of Credit Agreements

- 2.18 Although the existing legislative provisions require credit agreements to be documented in a prescribed format, there remains confusion among consumers about the information they receive from lenders, due to a lack of clarity. Research indicates that 39% of borrowers only read the main information on the front page of a credit agreement before signing, and are therefore unaware of clauses that may be to their detriment.

- 2.19 To help consumers fully understand the terms of the credit they are taking, the Government intends to ensure lenders provide:
- Clear pre-contractual information;
 - Agreements in a clear and transparent format;
 - Clear post-contractual information.
- 2.20 To guarantee the provision of upfront, clear information on credit products and the simplification of the format of regulated agreements, the Government will require key financial particulars to be given as upfront, pre-contractual information and in agreements (similar to the content of the Schumer 'honesty' boxes in the USA). These will set out key information on a credit product in a clear and truthful manner that enables the consumer to compare it with other offers and make a more informed decision.
- 2.21 These changes, to be tested with consumers and lenders, prior to being introduced, will be made by means of secondary legislation under the CCA. They will apply appropriately to each form of credit covered by the CCA.

Clear Pre-contractual Information

- 2.22 The provision of clear and concise pre-contractual information to consumers has been highlighted as a key area for reform. **The Government will ensure that pre-contractual information will be provided to consumers before any agreement is concluded.** This will provide an opportunity for the consumer to be able to consider and reflect on the information before making a final decision. The pre-contractual information will be required to include the following:
- The APR and all the costs/charges included; if the interest rate is variable; its duration; if it will change during the lifetime of the agreement, and if so, what it moves to;
 - The amount, frequency and number of repayments;
 - Whether the loan is secured, and on what;
 - A 'wealth warning' for any loan secured on a consumer's home;

- The duration of the agreement;
- The total charge for credit;
- Examples of the cost of early settlement of agreements;
- Information about the right to cancel.

2.23 There is a link between the requirements prescribed by the Distance Marketing of Consumer Financial Services Directive in relation to pre-contractual information and the general pre-contractual information we propose to introduce under the CCA. We consider that all customers will benefit from receiving the information required by the Directive, regardless of whether contracts have been concluded at a distance or not. As such, we have decided to extend these requirements to all contracts. This approach will also mean lenders are not required to produce separate pre-contractual documentation differentiating between those sales concluded at a distance and those conducted face to face.

2.24 As part of the provision of pre-contractual information to consumers, we want to encourage them to use this to 'shop around' for the best deals available. However, currently undertaking more than about five or six such actions in a short period can have an adverse effect on a consumer's credit rating as each application leaves a 'credit application footprint' on their file. The Government is aware that the industry and credit reference agencies are working on improving the process and the way in which such enquiries are recorded, so that searches differentiate between enquiries and applications. **The Government will review the progress on this industry initiated review by February 2004.**

Agreements in a Clear and Transparent Format

2.25 One of the reasons consumers do not read their credit agreements in detail, is due to the way in which the information is presented, and the terminology used. **The Government intends to revise the format of agreements to make them clearer and more transparent.** This will include a requirement to state key financial particulars in addition to the following key information:

2.26 Where applicable, requirements will include information on: 'Your Rights'; 'Your Responsibilities'; early settlement; cancellation; Hire Purchase; lost or misused cards; exchange-rate/cross-border charges; pawned goods; as well as statutory wealth warnings, such as: 'Missing payments will have severe consequences and may make obtaining credit more difficult in the

- future'. This is in response to our finding that 81% of borrowers said that they would welcome more information on their rights²⁶.
- 2.27 In addition, the key financial information will be required to be presented together as a whole and with appropriate prominence. The content of this information is outlined in the accompanying consultation document on the form and content of credit agreements. More specifically, **we intend to undertake further discussions with industry and consumer bodies on how the various interest rates that can apply to separate elements of a credit card, can be clarified and presented as part of this information in a transparent manner for consumers.**
- 2.28 Card issuers employ different methods for calculating the interest on the use of the credit card. The time at which the consumer starts paying interest can vary considerably. **We will discuss with industry ways in which this can be standardised and made more transparent, without inhibiting competition. We will conclude these discussions by February 2004.**
- 2.29 Where a lender is selling additional products funded by a regulated credit agreement, for example, PPI, we will ensure that, while this can remain within the one document, an extra signature will be required from the borrower to signify their consent to purchase the product. In addition, information will need to be given separately regarding the associated costs and the cash price.

Case Study

A customer signed up for credit without realising he had signed for Payment Protection Insurance (PPI). On the form, he was not asked to put a separate signature by the purchase of the complementary PPI product, and so it was unclear whether he had cover. He was later off work through illness and made no claims on his PPI because he did not realise he was covered. As a result, he got behind with his payments and into great financial difficulties.

Clear Post-contractual Information

- 2.30 As well as information prior to entering a credit agreement, consumers need regular information during the course of their contracts. At regular intervals, consumers should be made aware of the outstanding amount they owe, and informed if they fall into arrears or have incurred additional charges upon which interest will be charged.

²⁶ Op Cit 14.

- 2.31 **For credit cards, we will discuss with industry and consumer groups the scope for introducing details of various repayment scenarios in customers' regular statements. We have set a deadline of February 2004, to agree a way forward.**
- 2.32 Other post-contractual information requirements will include warnings about the implications of only making minimum payments on credit card debt; and the consequences of defaulting on payments.

Impact Assessment

- 2.33 The reforms will have the following effects:
- The introduction of prescribed pre-contractual information will allow consumers to 'shop around' with confidence, allowing them to increase their choice of credit products;
 - The technical requirements of regulations under the CCA make it difficult for lenders to write and make agreements for their increasingly complex products in a straightforward, consumer-friendly way. The proposed changes will clarify areas of ambiguity and make it easier for lenders to comply;
 - Clarity of information and consistency in the layout of documentation should encourage consumers to read agreements prior to entering into them. This will encourage lenders to develop more user-friendly material, thereby enabling consumers to conclude agreements that are right for them;
 - By providing consumers with clearer information, they will be better able to make informed decisions regarding the suitability of credit products;
 - Increased post-contractual requirements will ensure that consumers are always made aware of their financial position.

Online Agreements

- 2.34 The internet has become an important means for many consumers for purchasing goods and services. Research shows that credit cards and loans are likely to be the most popular credit products to be concluded online. It is, however, accepted that in some circumstances, the internet can result in increased instances of fraud.

- 2.35 When the Act was conceived, credit agreements were concluded on paper. There is no clear provision in the Act or regulations for facilitating or regulating the conclusion of electronic agreements. At present, consumers wishing to take out a mortgage on land are able to proceed to the point where the agreement is issued, but then must wait for a paper copy of the agreement to be sent out by post. This needs to be signed and then returned. For other types of agreement, the requirements for copies to be supplied before or within a set time after conclusion of the agreement assume that agreements will be dealt with face to face or through the post.
- 2.36 **The Government intends to bring forward legislation to enable consumers to have greater flexibility in the way they enter into credit agreements.** We want to make it possible, but not mandatory, to contract electronically. The changes will also encompass the requirements laid down in the Distance Marketing of Consumer Financial Services Directive,²⁷ with the aim of protecting consumers who enter into consumer credit agreements at a distance. The Government intends to amend the CCA in line with EU law to enable agreements to be concluded in an electronic format; provided that both parties agree, and subject to the overriding provision that the consumer can retain a copy of the agreement in a 'durable medium' (for example, by an email stored on a PC hard drive).
- 2.37 **We will ensure that cancellation and default notices are still sent in paper format to protect consumers' interests.**
- 2.38 We have concluded that it is not appropriate to require all consumers to use one particular form of digital signature for online agreements. Regulations will set out how the consumer's consent is to be indicated in online agreements. For detailed information see consultation document published alongside this White Paper.
- 2.39 Following the consultation we intend to introduce these changes by way of an order under the Electronic Communications Act by October 2004.

Impact Assessment

- 2.40 There will be considerable benefit for those consumers who already use the internet, as they will be able to complete their transactions wholly online.
- 2.41 It will be up to individual lenders to determine whether or not they wish to offer online capabilities. However, these measures should increase competition, as the costs associated with online lending are less than

²⁷ 2000/65/EC, Official Journal L 271 of 09.10.2002.

other sales channels – notwithstanding the likely increased costs/provisions due to the risk of increased fraud.

Early Settlement of Existing Loan Agreements

- 2.42 Consumers are entitled to settle credit agreements at any time but if they settle before the end of the agreed term of the loan, the lender is entitled to make a charge which is intended to reflect the cost he will incur or has incurred. Lenders can currently use the early settlement provisions to calculate the amount outstanding on early repayment and also defer the settlement date. These provisions, including the calculation formula known as the Rule of 78²⁸ can result in substantial benefits to the lender, as the settlement fee is not necessarily in proportion with the actual ‘breakage’ costs associated with repaying the loan early.
- 2.43 At present, 79% of unsecured personal loan providers in the UK charge an average of two months’ interest to borrowers who pay their debts off early²⁹.
- 2.44 Our research³⁰ shows that 41% of consumers interviewed that have had loans, paid them off early (48% for HP agreements). However, other research has indicated that, of the 7.7 million unsecured loans arranged in 2002 – worth £65bn – up to 70% will be repaid early.³¹ Of those consumers who repaid early, 17% were not aware of any charge (22% for HP). When questioned, around 60% of those that were unaware of the charge said that they might have gone to another lender had they been fully informed when they signed the agreement.
- 2.45 However, not all lenders choose to apply the Rule of 78. Some levy much lower repayment charges, and some, nothing at all. The move to internet banking, and offsetting loans and credit accounts has brought about the emergence of new flexible loans, without such penalties and with very competitive APRs. The result is that some borrowers are penalised for repaying early and others do not pay any form of charge, depending upon the lender they choose.

²⁸ Rule of 78 is a mathematical formula prescribed under the CCA governing the early repayment of loans and is based on the fact that borrowers do not pay off interest in equal instalments. At the start of a loan borrowers will be paying off more interest than at the end, even though monthly payments are the same.

²⁹ Egg’s “Redemption Racket” Report, June 2003.

³⁰ Op Cit 14.

³¹ Datamonitor.

- 2.46 **The Government has already announced its intention to abolish the Rule of 78 and to introduce a new actuarial method to calculate the early settlement figure – one that is fair to both lender and borrower.**³² The move is designed to bring the amount payable on early settlement more into line with the amount of capital still outstanding on any loan. This will be a maximum figure that can be charged, and so still gives lenders the flexibility to be more competitive.
- 2.47 **The Government will ensure that agreements state the right to early settlement and give three examples of the amount payable at different stages of the repayment period.** This will ensure that borrowers are aware of the costs associated with repaying their loan early, prior to signing a loan agreement. This will be consistent with the approach adopted by the FSA.
- 2.48 As well as applying the Rule of 78, lenders can also currently delay the settlement date for winding-up the loan; for up to two months for loans of five years and under, and for one month for loans over this period.
- 2.49 The Government believes this current system is detrimental to consumers and so will limit the lender to deferring the settlement date for no more than 28 days.
- 2.50 **In addition to the 28 days deferment, we intend to allow lenders to charge an extra interest payment of one month for loans with an original term of over one year.** However, no charge will be allowed for loans with a term of less than one year. This is consistent with the current draft European Consumer Credit Directive. This uniform approach was adopted following extensive consultation, as it creates a solution which is easy to apply and straightforward for consumers to understand.
- 2.51 These measures will make the pricing of loans more transparent, so consumers can assess all of the costs they face upfront. They will reduce the switching costs faced by consumers in moving to different lenders and increase competition in the marketplace.
- 2.52 **We intend that the new legislation will impact on existing loans after a suitable period of transition, which we propose as two years.**

³² DTI PN 23 July.

Impact Assessment

The reforms on early settlement will have the following effects:

- The reforms on early settlement are most likely to benefit lone-parent households; two-parent families; families with a new baby in the past 12 months; and those whose income has both fallen and risen over the past 12 months. These are the groups that are the heaviest users of personal loans. Hire Purchase, on the other hand, is fairly evenly distributed among all socio-economic groups, therefore the benefits of these reforms relating to hire purchase products are likely to be fairly evenly spread.
- Charges will be fairer for borrowers, but will allow lenders to recoup reasonable costs when consumers settle agreements early.
- The abolition of Rule of 78, and its replacement with a new, actuarial method, will be easier for consumers to understand.
- Consumers will save around £60m a year.³³
- Lenders who offer better terms will increase their market share, while some uncompetitive products will be lost from the market mix.

Enforcement

2.53 While we are proposing significant reform of the regulatory regime, we will maintain the existing CCA enforcement arrangements in these areas. These consist of:

- criminal and civil sanctions;
- statutory powers available to the court in relation to the enforceability of agreements; and
- powers bestowed upon the OFT in relation to advertising for which local authority trading standards departments (TSDs) have day to day authority.

³³ Estimated as the difference between the Rule of 78 and an actuarially fair premium on the 70% of loans estimated by Data Monitor that are settled early.

- 2.54 At present, responsibility for the enforcement of the majority of these aspects of consumer credit law falls to the OFT – as the licensing authority – and to TSDs. This will remain the case.
- 2.55 However, the most serious consequence of breaching the provisions relating to the form and content of agreements can result in a consumer asking the court to declare their credit agreement to be unenforceable by the lender. In addition, the Enterprise Act 2002 now enables the OFT to seek undertakings or Enforcement Orders to prevent traders from breaching the provisions of the CCA in a way which will harm the collective interests of consumers. The lender will then be liable to a fine or imprisonment if he breaches an Enforcement Order.
- 2.56 However, the reforms should also be viewed in the context of the wider proposals set out elsewhere in this White Paper that focus on the conduct of credit business. In particular, we will achieve a general strengthening of enforcement through the proposed reform of the credit licensing regime; the introduction of new rules on unfair credit transactions; and the establishment of a system of alternative dispute resolution.
- 2.57 Reform of the licensing regime as set out in chapter three will mean that the OFT will continue to be able to assess frequent and/or severe breaches of the areas set out in this chapter specifically in the context of the fitness test to be applied to licence holders.
- 2.58 The details of our proposed consultation on the new ADR mechanism are referred to in chapter three (3.43 – 3.48). This will provide consumers with an additional form of redress and, depending upon the ultimate jurisdiction of the ADR body assuming responsibility, may cover the majority of the areas of reform set out within this Chapter [see 3.43 ff for discussion on ADR].

We are committed
to creating a fairer
consumer credit
framework

Chapter 3:

Creating a Fairer Framework



Introduction

- 3.1 Alongside work to create a fair framework that provides a level playing-field for businesses operating in the credit market, the Government is also committed to giving consumers greater protection and a more accessible means of redress. The proposals that follow have been formulated following extensive consultation over the past two years on reform of the consumer credit regime.³⁴
- 3.2 The CCA regime contains regulatory controls on traders,³⁵ credit agreements,³⁶ and ancillary credit activities to ensure a fair and competitive credit market. These are enforced, for example, through the licensing system, criminal sanctions, and the judicial control of agreements and their enforceability.
- 3.3 This chapter looks at ways of strengthening and improving existing controls and their application, to provide an effective regulatory response to the modern credit market. Areas for reform include:

Licensing Regime

We intend to:

- Strengthen the current ‘fitness test’ for licence-holders. This will enable the OFT to look forwards in assessing a trader’s competence to run a credit business, as well as considering their past conduct.
- Provide the OFT with more tools to enforce traders’ continuing compliance with the fitness requirements.
- Introduce new provisions on investigation and information, to enable the OFT to take a proactive approach to enforcement.
- Move to a system where licences are granted indefinitely. This will reduce the burden on licence-holders (as they will not have to renew their licences periodically), and will enable the OFT to focus its resources on monitoring traders who present a greater risk of not complying with the requirements of the licensing regime.

³⁴ Consultation on making the extortionate credit provisions within the Consumer Credit Act 1974 more effective, March 2003, CCP 007/03, <www.dti.gov.uk/ccp/consultpdf/extortcon.pdf>. Consultation on the Licensing Regime under the Consumer Credit Act 1974, March 2003 <<http://www.dti.gov.uk/ccp/consultpdf/credlic.pdf>>. Tackling loan sharks – and more...Consultation Document on Modernising The Consumer Credit Act 1974, July 2001. These consultation documents provide more detailed background on the licensing regime and its problems.

³⁵ This is primarily achieved through the licensing of businesses engaged in lending credit, hire and ancillary credit activities.

³⁶ Agreements control is regulated through a number of means including advertising, form and content and early settlement requirements. These aspects are outlined in detail within Chapter 2.

Extortionate Credit Bargains

The current provisions targeting 'extortionate credit bargains' have failed to address unfair practices in the credit market. We intend to:

- widen the existing provisions to encompass 'unfair credit transactions' to enable consumers more readily to challenge unfairness;
- provide access to an affordable and effective alternative dispute resolution (ADR) mechanism to help consumers seek redress;
- tackle the escalation of debt, by ensuring better information is provided to consumers, through annual statements that detail arrears.

Removing the Current Financial Limit of £25,000

- CCA regulation currently covers the supply to individuals (including sole traders and partnerships) of credit up to £25,000. We intend to remove this limit to widen consumer credit protection.

Reforming the Licensing Regime

3.4 Anyone who wishes to carry on a consumer credit, hire or ancillary business must have a licence. Licences are granted to applicants who satisfy the OFT they are 'fit' to carry on the type of business in question. In determining whether a person is fit, the OFT shall have regard to any circumstances appearing to be relevant and, in particular, any evidence that shows the applicant – or persons connected with that business – has been involved in four specific classes of activity:

- Certain offences – involving fraud, dishonesty or violence;
- Breach of the CCA or any other consumer protection legislation;
- Discrimination; or
- Business practices appearing to be deceitful, oppressive, unfair or otherwise improper – whether unlawful or not.

- 3.5 The test gives particular weight to the collection of information on evidence of past failings (a conviction for a crime or a failure to settle debts, for example) as evidence that the trader is not fit to hold a licence. However, it does not, at present, expressly take into account a trader's ability to conduct their credit business in a fit manner in the future (by ensuring staff are properly trained or adequate systems have been put in place, for example).
- 3.6 The problem is compounded by limitations on the OFT's powers to investigate ongoing activities of the licensee. If a trader behaves in a way, which, although undesirable, does not breach a specific provision of the Act, the OFT is powerless to gain the information it needs to consider properly whether the licence should be revoked. (Unacceptable methods of debt-collecting or sales practices which take advantage of the elderly are examples of such activities.) Currently, the OFT relies, principally, on the applicants themselves or complaints from the public or local Trading Standards Departments (TSDs).
- 3.7 A further weakness with the current system is its lack of flexibility in the imposition of intermediate measures to promote compliance. Currently, the OFT can only refuse, vary, suspend or revoke a licence. A refusal, suspension or revocation may put the licensee out of business and, therefore, is only used in the most serious of cases. The only alternative to this draconian sanction is to take no action at all, beyond informal warnings, which, in practice, means the OFT has no appropriate sanctions for a range of infractions.

A Strengthened 'Fitness' Test

- 3.8 **Through reform of the licensing regime the Government wants to ensure that the current test for fitness to hold a licence is strengthened**, so the OFT can equally look back, at a licence applicant's past conduct, and forward, to assess their preparedness for running their credit business. **We will also seek additional powers for the OFT to ensure that traders continue to *remain fit*.**
- 3.9 Better monitoring of the fitness of licence-holders will encourage lenders to behave in a fair manner. When asked about the important factors in deciding whether to take out credit, 85% said the reputation of the lender was the most important, followed by the advertised APR (84%).³⁷ The reform of the licensing regime, as set out in this chapter, will enable consumers to gain greater confidence in the credit market, thereby stimulating greater competition.

³⁷ Op. Cit. 14.

- 3.10 **The OFT will be given responsibility for producing initial guidance³⁸ on what it considers are the standards of fitness required for the conduct of credit businesses.** It will publish draft guidance in time for consideration alongside any Bill in Parliament. The OFT already produces guidance on fitness under the current test, both for the general licensed population and for specific sectors, such as the non-status lending market and debt collection.³⁹ Similarly, future guidance on fitness would give examples of appropriate conduct for a business to hold a consumer credit licence. The precise content of the new guidance would be the subject of formal public consultation before it is issued. The guidance would take account of current and relevant market practice. Whilst contravention of the guidance would not give rise to any consequences itself, it is intended that it would be used to support licensing representations and OFT determinations on fitness to hold a licence.
- 3.11 In view of the intermediate measures proposed below – which will enhance compliance and oblige licence-holders to report any changes which may affect their fitness to hold a licence – **the Government has decided to move from a system in which licences are renewable every five years, to one where the OFT is able to grant licences for an indefinite period, with periodic payments to maintain the licence.** This will reduce the current administrative burden on business significantly and enable the OFT to target those businesses and sectors which pose the greatest risk.

A Risk-based Approach

- 3.12 **The DTI's Consumer Credit Review has shown that the OFT should adopt a system of enforcement that aligns fitness monitoring with an objective assessment of the risks posed to the consumer.** This is an essential part of the move to ensuring compliance with the fitness tests, throughout the period of the licence. Traders who, because of the nature of their business or their past record, pose little threat, will be monitored with a light touch. Those whose past activities have given cause for concern or who operate in market sectors that raise specific concerns (such as debt-collection or non-status lending and brokering), will be scrutinised more closely. **We will consult with stakeholders to ensure that the package of reforms delivers a licensing regime that is proportionate and clearly focused on the worst offenders.**

³⁸ To replace the current guidance, "Consumer credit licences – Guidance for holders and applicants", OFT 329.

³⁹ "Non-status lending: Guidelines for lenders and brokers" OFT 192.

- 3.13 The licensing system needs updating to deal with the development of new categories of licensable credit activity as the credit market continues to develop and new activities, such as credit repair, which are not covered by current categories of licensable activity, appear. To this end, **the Government intends to introduce a new legislative power to support this risk-based approach, which will allow the Secretary of State for Trade and Industry to vary the activities for which a licence is required for ancillary activities.**
- 3.14 Although they may be working in diverse areas of the credit market, at present, traders are assessed in much the same way. By clarifying these different categories, and the levels of risk attached to them, the OFT will be able to target its resources more effectively (for example, more questions might be asked of a specialist finance broker than a high street retailer).

Powers of Investigation

- 3.15 To date, the OFT and TSDs have had only very limited powers when trying to establish whether a trader is unfit to hold a licence.
- 3.16 **The Government believes that it is appropriate to grant the OFT the power to seek additional information from licensees and third parties.** These powers may include the requirement to produce books, documents and records, along with powers to carry out compliance visits where there is particular concern.

Case Study⁴⁰

X, who ran a debt management agency, disappeared in 2003.

Around 800 customers, who had paid the firm to handle their debts, were left still owing millions of pounds to lenders.

It is understood the firm may not have forwarded this money to the lenders and the case has been under investigation by the local TSD, the OFT and the police.

Following the disappearance of X, the firm sent undated letters to clients, claiming the company had been put into voluntary liquidation. Trading Standards said there was no evidence to support this claim and the company's bank account was, until recently, still receiving direct debit payments from clients across the UK.

Police and customers called for tighter controls on people given consumer credit licences.

Detective Sergeant W, from the economic crime unit, said: "We referred the case to the Crown Prosecution Service, but they said it is unlikely to get convictions on any offences of dishonesty.⁴¹ Therefore, the police won't be taking any further action. The regulation, rules and laws are inadequate. The Office of Fair Trading is well aware of that. It is an issue that the Government should take action about."

Under the reformed regime, OFT staff would have new powers to carry out proactive, unannounced visits and request documents to show whether the trader was complying with the Act.

- 3.17 In order to ensure that the information held by the OFT is accurate and up to date, **the Government wishes to extend the duties imposed under S.36 of the CCA. This means licensees will have to notify the OFT of any material changes in their circumstances relating to their fitness to hold a licence.**
- 3.18 At present, this duty only covers a limited number of facts, including changes in the officers or partners of a business. **This will be extended to cover the other key information required at the time of application (or last renewal for existing licensees).** The relevant information will include: County Court Judgments, disqualification from acting as a director, bankruptcy or criminal convictions.

⁴⁰ Source: Office of Fair Trading, 2003.

⁴¹ Because the licensee was in America and fraud was difficult to prove over incompetence in the case (either way the licensee no longer had the money paid in).

- 3.19 In addition, S.166 of the CCA makes provision for the courts, if they think it is relevant, to notify the OFT of judgments or convictions. **We shall be discussing with the DCA, the Scottish Executive and Department of Enterprise, Trade and Investment for Northern Ireland how to ensure that these arrangements provide a more effective flow of information. We intend to have improved arrangements in place by June 2004.**

Intermediate Measures

- 3.20 Under the current system, the OFT has a lack of flexibility in the imposition of sanctions on licence-holders. It can only suspend, vary or revoke a licence, and such powers are generally only justifiable in the most serious contraventions. However, in many cases where traders have breached a provision of the CCA, it does not necessarily merit the refusal or withdrawal of their licence. While their conduct may fall short of the expected standards, and give cause for concern, often their behaviour does not warrant the potential loss of their livelihood, or that of their employees. Nevertheless there is a need for some censure if the licensing system is to remain credible and effective.
- 3.21 There is, therefore, a need for intermediate measures where there has been misconduct by a licensee, which does not, necessarily, merit revocation. **We intend to introduce powers for the OFT to impose special conditions on (or take undertakings from) licence-holders.** These special conditions would be specific to a particular licence-holder, to ensure that the business was meeting its fitness requirements (for example a training requirement, or a requirement to report specific information to the OFT). A breach of one of these conditions or undertakings by a licence-holder could lead to the imposition by the OFT of an appropriate financial penalty or ultimately the revocation, suspension, or variation of the licence.
- 3.22 Any decision to impose a condition or a financial penalty would be subject to the same procedural safeguards and rights as decisions to refuse, revoke or vary a licence. At present, there are two specific safeguards. First, an adjudication process whereby the OFT must inform an applicant of the reasons why a licence is not being granted (or only being provided on different terms to those requested). The applicant, then, has an opportunity to make written representations, or oral representations to the OFT at a personal hearing. Second, the applicant can appeal in respect of a number of determinations made by the OFT to the Secretary of State (see Appeals, below). The case for setting a statutory cap on the level of penalty will be considered. **The Government intends to require the OFT to issue guidance on penalties after consultation and subsequent approval by the Secretary**

of **State for Trade and Industry**. The OFT will issue draft guidance on penalties when the provisions go through Parliament.

Appeals

- 3.23 Under the current system, an applicant or licence-holder who is dissatisfied with certain licensing decisions made by the OFT⁴² has the right of appeal to the Secretary of State for Trade and Industry. Such appeals are by way of a re-hearing, heard on her behalf by a panel of suitably qualified independent people. The Secretary of State for Trade and Industry makes her decision after considering the recommendations of the panel. An appellant who is dissatisfied in point of law with this decision, has the right to appeal against such a decision to the High Court.
- 3.24 With the introduction of a strengthened fitness test, **the Government believes that it is appropriate to make the appeals process more transparent and bring it into line with the new Tribunal Service, being planned by the Department for Constitutional Affairs (DCA)**. This means that responsibility for appeals will pass from the Secretary of State for Trade and Industry to the new Tribunal Service under the DCA. It is envisaged that the appeals procedures would remain in a similar form to that under the current system.

Fees

- 3.25 Following the reforms proposed in this chapter we intend to consult in detail on a revised licence fees structure reflecting the new regime. It is intended that licence fees will be set according to the category of the activity undertaken and reflect the relative costs in each category. The Government's charging policy is that fees should normally be set to recover the full cost of administering the licensing system, and no more. The ongoing monitoring required to deliver an effective regime for business and consumers may require periodic maintenance fees to be paid by licence holders. We will work with HM Treasury and the OFT to ensure that the licensing system is delivered in the most cost-effective manner.

Impact Assessment

- 3.26 The proposed reforms will benefit both lenders and borrowers. Increased consumer confidence in the reputation of the credit industry can only

⁴² OFT decisions which may be appealed are set out in s.41 CCA.

- buoy the market – fair lenders benefiting from the gaps left by the removal of the rogue traders. Fair lenders will also benefit from a risk-based approach to enforcement and the move to indefinite licenses.
- 3.27 Rogue lenders tend to target the least well-informed. By preventing the unfit lenders from entering the market and exploiting the information gap, we will protect the most vulnerable – when entering into agreements, and when problems occur during the term of an agreement. Intermediate sanctions are a proportionate tool to ensure lenders continue to remain fit, offering protection to consumers, as well as fair lenders. New provisions on investigation and information provision will enable the OFT to take a more proactive approach to enforcement.

Extortionate Credit

The Need for Reform

- 3.28 Most traders act in a responsible manner. However, there are some who engage in unfair practices – to the detriment of consumers, fair lenders, and society as a whole. Those who have financial problems or are on low incomes are especially vulnerable and susceptible to exploitation.
- 3.29 The CCA already includes provisions designed to protect consumers against so-called extortionate credit bargains.⁴³ A credit bargain is deemed extortionate if it requires the borrower to make payments which are ‘grossly exorbitant’ or otherwise ‘grossly contravene ordinary principles of fair dealing.’ The Act already allows the court to re-open a credit agreement in these cases, so as to do justice between the parties. However, since the inception of the CCA only about 30 extortionate credit cases are known to have reached the courts and, of those, only ten were proven.
- 3.30 **The Government believes that these provisions have not operated effectively.** This conclusion is supported by responses to our consultation on extortionate credit,⁴⁴ discussions with a wide range of stakeholders, and evidence from a number of case studies. The existing law has not been effective in dealing with the margins of the market, in particular, regarding credit to consumers on low incomes. The existing definition

⁴³ Sections 137-140.

⁴⁴ Tackling Loan Sharks and more! A consultation document on making the extortionate credit provisions within the Consumer Credit Act 1974 more effective, March 2003.

should be replaced with a test that would make agreements easier to challenge.⁴⁵ Other research⁴⁶ supports this view, suggesting that there are up to a few hundred thousand people (often the most vulnerable in society) who have loans with costs, terms and conditions that could be considered extortionate.

3.31 A number of factors have been identified which demonstrate the need for reform:

- Few cases have reached the courts, primarily because the qualifying hurdles under the current law are too high. In particular, it has been argued⁴⁷ that the wording of the Act is imprecise, the courts consequently tending to give a restricted interpretation to the relevant provisions.
- The courts have traditionally focused on interest rates charged under the agreement. However, other terms such as the level of security required, default charges and lack of transparent information may also cause detriment to the consumer.
- In addition, unfair practices such as pressure-selling or the churning of agreements can cause detriment. New forms of lending have emerged where – whether through rogue trading practices or because of consumer ignorance or desperation – credit may be taken on terms (not necessarily high interest rates) that appear unacceptable.
- The courts have tended to examine only the terms of a credit agreement at the time it was entered into.⁴⁸ There may, however, be subsequent conduct by the lender that makes an agreement unfair – through changes to the rate of interest or the way in which default charges are applied, for example.
- Litigation in this area is complex and unpredictable and, as a result, may be very expensive for borrowers. Two reports⁴⁹ have emphasised that borrowers may face practical, psychological and cultural barriers to bringing court action and that those who are particularly vulnerable will feel intimidated by the court process and/or fearful of the lender.

⁴⁵ “Unjust Credit Transactions” 1991 – Report by the Director General of Fair Trading, “Daylight Robbery – The CAB case for effective regulation of extortionate credit” Citizens Advice 2000 (based on evidence from over 100 CAB’s), “Summing Up – bridging the financial literacy divide” Citizens Advice 2001.

⁴⁶ Report to the DTI by Kempson & Whyley of the Personal Finance Research Centre 1999.

⁴⁷ Kempson & Whyley, *ibid.*

⁴⁸ *Paragon Finance PLC-v-Nash and Staunton* [2001] 2 All ER (Comm) 1025 and *Broadwick Financial Services Ltd. v Spencer and another* [2002] 1 All ER (Comm) 446. In both these cases, the lenders had a discretion to vary the interest rates that were payable from time to time. The Court of Appeal, in both cases, decided that variations in interest rates were not to be taken into account in determining whether the agreement was an extortionate credit bargain.

⁴⁹ “Daylight Robbery – The CAB case for effective regulation of extortionate credit” Citizens Advice and Kempson and Whyley, *ibid.*

Reform Proposals

- 3.32 **We intend to make it easier for consumers (and third parties acting on behalf of the collective interests of consumers) to challenge unfair agreements and for individual consumers to be able to seek redress through an accessible, ADR system.**⁵⁰
- 3.33 The objective of reform will be to target any unfair credit transaction, widening the scope of the current 'extortionate' definition, to ensure account is taken of unfair practices as well as the cost of the credit. Any assessment must be flexible enough to accommodate all circumstances affecting the use of credit, while giving certainty to all interested parties about what is acceptable and what is not.
- 3.34 **Legislative factors and guidance from the OFT will give a clear message to businesses, the courts, and, if appropriate, ADR adjudicators in determining the fairness of credit transactions.** They will enable account to be taken of relevant practices in the current market and ensure that a balance is struck between the duty of the lender to behave fairly and responsibly and the need for borrowers to provide accurate information, borrow sensibly and take responsibility for their own financial decisions.
- 3.35 **We will consult informally on developing our definition of an unfair credit transaction through our stakeholder group (comprising industry, regulator and consumer representatives). We intend that the OFT will have initial draft guidance available by the time these legislative proposals are considered by Parliament.**
- 3.36 Unlike the current provisions, in determining whether a transaction is unfair, consideration should be given not just to how the agreement was concluded but, also, to any subsequent events that may have led to unfairness.
- 3.37 The factors in the legislation on what constitutes an unfair agreement may include:

Unfair practices

- Whether the lender or any broker has engaged in an unfair commercial practice such as: misleading, harassing, coercing or otherwise unduly influencing the borrower in connection with the transaction. This could

⁵⁰ Our proposals for ADR are discussed at the end of this chapter.

involve, for example, the mis-selling of products, unacceptable high-pressure selling techniques or the churning of credit agreements and aggressive debt-collection practices.

Case Study

In summer 2000, Mr and Mrs Z applied to a major finance house for an unsecured loan of £1,000 to carry out improvements to their property. A further £550, relating to PPI and arrangement fees, was added to the loan. The APR on the loan was 48.1%.

Both Mr and Mrs Z suffered from mental illness. Their combined weekly income was approximately £400.

Almost immediately, Mr and Mrs Z were contacted by the lender offering them a further loan of £6,900. This was agreed a week after their first loan application, and redeemed the earlier loan. It also included PPI at £2,057.50.

Three weeks later, the lender again approached Mr and Mrs Z and offered a loan of £16,464. This time, it was secured over their home and the advance was again applied to pay off the previous loan. This time the PPI cost £4,206.

Four further loans were completed between September 2000 and June 2001 – each loan replacing the previous one, and each including PPI. The final loan was for £74,162. And so, in the course of 12 months, the borrowers had received seven loans from the lender, each including PPI. The total of the PPI for all of the loans was £44,267. The borrowers' state of health was such that they were excluded from PPI cover in any event.

Despite representations from the CAB that the lender's conduct had not complied with its trade association's code of practice, the lender was only prepared to make only very limited concessions.

Source: Citizen's Advice

Unfair credit costs

- Whether credit payments substantially exceed market levels – having regard not just to the original cost of the credit, but also to the total sum that becomes due when a loan falls into arrears – including the level of default interest, charges and costs. However, it is important to note that high costs alone would not necessarily render the agreement

unfair. Transaction costs are not 'high' or 'low' in the abstract, but must be considered in the light of the nature and type of the agreement and circumstances in which it was made or how the lender has acted subsequently. For example, in the case of default, the amount demanded by the lender to be repaid – including fees, costs, and default interest – can be excessive and unfair compared with the amount of credit advanced and risk involved. Lenders must, of course, be able to recover debts and all their costs from those who default. However, such charges and costs should be set at a reasonable level in view of the lender's own costs and losses.

Case Study

Mrs J took out a secured loan in 1987 of £10,800, for debt consolidation. £1,800 comprised a broker's fee. The APR was 29.8% and she was to repay £240 a month, over 15 years. The total amount repayable was £43,200, which included interest of £32,400.

She fell into arrears and default interest was charged on the arrears at 29.8%. This was compounded monthly. Costs and charges were also debited to the account and default interest charged on them.

After 14 years, she received a settlement statement showing, to her shock, that she owed £95,000. At that time, the monthly instalments of £240 were up to date. However, the statement showed that interest was being debited to the account at the rate of £2,000 a month, and so the balance would continue to grow at an alarming rate. She had already paid £42,000 – nearly the full amount she would have expected to pay if there had been no default.

Seven months later, the lender issued possession proceedings. The 15-year term of the loan had expired and so the lender sued for the outstanding balance, which had grown to £118,600. By that date, she had paid £52,200. The lender was therefore claiming a total of £170,000 in respect of a loan where the borrower only received £9,000.

Under the present law, the agreement could be difficult to challenge, as the interest rate itself might not be regarded as extortionate. However, it was the manner in which the lender operated the account when Mrs J fell into arrears that led to such a huge debt.

Source: Mary Ward Legal Centre, London

Responsible lending

- The lender's care and responsibility in providing the credit – including taking reasonable steps to ensure a consumer's credit worthiness and ability to meet the full terms of the agreement at the time it was concluded. We acknowledge that different approaches to responsible lending are required for different sectors of the market. However, creditors should be expected to undertake enquiries that are proportionate, having regard to the type of agreement, their relationship with the customer, and the costs and risks involved. The obligation on the lender must also be balanced with an obligation on borrowers to provide true and accurate information about their financial circumstances.

Other relevant circumstances

- The circumstances of the borrower, including his/her age, experience, business capacity and state of health, and the degree to which he/she was under pressure and the nature of that pressure.
- Whether the borrower dealt honestly in providing accurate and full information to enable the creditor to assess the risk.
- The degree of risk accepted by the lender, having regard to the nature and value of any security.
- Whether the transaction involves an inflated cash-price, so that the true cost of the credit is hidden in the price of the goods.⁵¹
- Whether ancillary or linked transactions have been reasonably required (e.g. insurance policies).
- Any other relevant considerations that may have led to unfairness.

Better Information for Consumers About Debt

3.38 Chapter two dealt with the information consumers need to shop around for credit and fully understand the nature of the commitment they are entering. Information is also essential once an agreement has been concluded. A contributory factor identified in relation to the escalation of debt, has been the lack of ongoing information that many borrowers receive concerning their credit agreement. This is of particular concern to

⁵¹ Consumer groups have told us that insufficient use is made of the current provisions because the reference to the "colourable cash-price" is not properly understood.

consumers who fall into arrears, as they are often unaware of the consequences of charges on their account, default costs for missed payments, compound interest on the amount owed or underpayment on the accumulation of their debt. At present, although the CCA contains some duties on the lender to provide information, these are generally only triggered by a request from the consumer. There is no obligation on a lender to provide regular statements or, crucially, to inform consumers when payments have been missed.

- 3.39 **To ensure greater transparency for consumers, it is intended that creditors should provide regular statements – at no direct cost to the consumer – detailing prescribed information about the account.** The creditor will also be required to send statements to the debtor more frequently if the account falls into arrears. In particular, the creditor should notify the debtor on each occasion that charges have been debited to the account, together with information about their impact on the debt. It is envisaged that interest will not be charged on these charges for a period of 28 days after notification has been sent. However, provision will be made to reduce the frequency of such information where regular charges are incurred on a recurrent basis (e.g. monthly).

Existing Agreements

- 3.40 **We are considering the extent to which our proposals should apply to existing credit agreements and whether any transitional arrangements are necessary.** We will make a decision on this by the end of January 2004.

Representative Actions

- 3.41 In our consultation paper on the extortionate credit provisions,⁵² we proposed that named third parties could bring a group-claim against a trader engaged in rogue trading practices. **We intend to enable certain designated bodies to bring an action on behalf of the collective interests of consumers requiring a trader to refrain from engaging in conduct which constitutes an unfair credit practice, through the use of existing powers under Part 8 of the Enterprise Act 2002. Over the next two months, we will work with relevant Government Departments and key stakeholders to determine how best to implement the proposal.**

⁵² Tackling Loan Sharks – and more! A consultation document on making the extortionate credit provisions within the Consumer Credit Act 1974 more effective, March 2003.

Codes of Conduct

3.42 In addition to the reforms set out in this White Paper, **the Government believes that industry codes of conduct can play a vital role in effecting change within the lending industry.** OFT has identified the financial sector as a priority sector for encouraging approval of codes of conduct under the new powers given to it in the Enterprise Act 2002. The Government's expectation is that all creditors should be covered by, and comply with, principle-based codes of practice. The Government also encourages trade associations regularly to review their codes of practice to maintain industry standards. In particular, they should reflect best practice with regard to responsible lending, marketing and arrears management, and should seek to ensure compliance with the code. The case study below illustrates how Codes of Conduct can play a vital role in helping consumers in financial difficulty.

Case Study

Mr A took out a credit card with a finance company in February 2001. A year later, Mr A lost his job, but was re-employed within a couple of months at a much lower salary. This meant he was unable to maintain the minimum payment on his account.

Mr A owed money to a number of lenders to whom he made offers to reduce his payments (through a “financial statement”). He also requested that interest be frozen on his accounts in order to give him a chance to recover from the situation. All lenders agreed, apart from one who continued to charge interest at a reduced promotional rate of 7% pa.

The lender confirmed that as part of their terms and conditions, contractual payments should be made at either 2.25% of the outstanding balance each month, or the total of any fees and interest plus £5, whichever was the lower amount. Since Mr A’s offer in his financial statement was more than this minimum monthly contractual payment, the lender was at first reluctant to accept that Mr A was in financial difficulty. They did, however, continue to give Mr A the reduced promotional rate of interest until his account was up to date and within the agreed credit limit.

Mr A sought the help of the lender’s trade association. The association intervened, pointing out that under its code of practice, which went further than the legal protection offered to borrowers, its members must treat cases of financial difficulty sympathetically and positively. Following the association’s intervention, the lender agreed that as an exception to their general policy, they would freeze the interest on the account for three months in order to enable Mr A to make headway on reducing the balance outstanding on his account. Mr A was happy with this result.

Source: Finance and Leasing Association

Improving Consumer Redress

- 3.43 Most respondents to recent consultation⁵³ agreed that there should be a mechanism, other than the courts, to resolve disputes about consumer credit. Court action is perceived as being costly, complex, intimidating and lengthy. In respect of extortionate credit, there have only been approximately thirty court cases in thirty years of which ten were successful.

⁵³ Summary of responses to the consultation document on making the extortionate credit provisions within the Consumer Credit Act 1974 more effective. (CCP 007/03)

Other evidence, from Citizens Advice for example, suggests that extortionate, or unjust, credit is more widespread than the small number of court cases would indicate.

- 3.44 The introduction of an ADR system should make it easier to resolve disputes in a speedy, fair and inexpensive manner. This would benefit both firms and consumers. The Government believes that some form of ADR for the consumer credit industry should be established.
- 3.45 One possible ADR mechanism for consumer credit would be the Financial Ombudsman Service (FOS). The FOS was set up as an independent dispute resolution service under the Financial Services and Markets Act 2000 to help settle individual disputes between consumers and those firms which are regulated by the FSA. The FOS, which is free to consumers, already deals with disputes about mortgages, other loans and credit cards between consumers and firms which offer these services and also offer financial services regulated by the FSA.
- 3.46 In principle, it would be a good outcome for the FOS to become the ADR for disputes concerning consumer credit. We recognise, however, that there are a number of practical issues that would need to be resolved. These include, but are not restricted to: which aspects of lending should be covered by the FOS, what the relationship of the FOS should be to court or regulatory action on consumer credit, who should bear the costs, and what would be the impact on the other work by the FOS of the inclusion of all consumer credit? We will shortly be consulting publicly on whether the FOS should become the ADR for consumer credit disputes or whether a “stand alone” ADR dealing only with consumer credit would be a better alternative.

Impact Assessment

- 3.47 The proposed changes will produce the following improvements:
- It will be easier for consumers to challenge unfairness as the current provisions on ‘extortionate credit bargains’ will be widened to encompass ‘unfair credit transactions’.
 - Consumers will also be empowered to challenge unfair practices through an ADR process, instead of only having the option of the courts.
 - Greater transparency concerning annual statements and arrears accounts will alert consumers to possible problems caused by accumulation of debt.

- The use of Enterprise Act enforcement powers will enable the OFT to take co-ordinated action to stop those traders who engage in systematic, unfair practices, creating a fairer credit market for consumers and credit businesses alike.
 - These reforms will benefit consumers who are victims of an unfair credit transaction. They will be especially targeted to help lower socio-economic groups who are disproportionately susceptible to excessive costs and unfair practices.
- 3.48 We will shortly be consulting publicly on whether the FOS should become the ADR for consumer credit disputes or whether a “standalone” ADR, dealing only with consumer credit, would be a better alternative.

Interest Rate Ceilings

- 3.49 It has been suggested by some consumer groups that one mechanism for controlling the cost of credit is to limit the rate of interest charged. The overwhelming advantage claimed for this mechanism is its simplicity. Several other EU Member States and some of the States in the United States of America have ceilings. The UK, itself, had what was, in effect, a ceiling prior to the introduction of the CCA. The Moneylenders Acts provided that a rate in excess of 48% was *prima facie* excessive and the transaction harsh and unconscionable. However, the Crowther Committee concluded that, in practice, the protection accorded was largely ineffective.⁵⁴
- 3.50 The Government is not yet persuaded that the introduction of interest rate ceilings for the UK is the right approach to provide protection from excessive credit costs. While the Government acknowledges that there are some benefits from having a clear and simple-to-administer system, there are a number of problems associated with interest rate ceilings:
- The UK has a sophisticated and diverse credit market. There would be many practical difficulties in introducing a capping regime that would apply to so many different types of credit arrangement.
 - A high APR is not necessarily indicative of an extortionate or high-cost loan. For example, the amount of interest repayable for very short-term loans may appear relatively modest, and yet can result in a very high APR.

⁵⁴ Cmnd 4596 Consumer Credit, Report of the Committee, Lord Crowther, London, Her Majesties Stationery Office, 1971, section 6.6.3 – 6.6.4.

- Creditors could manipulate the APR by extending the minimum term over which credit can be taken. This would result in the APR being reduced, although the total interest repayable might actually increase.
- If creditors are required to reduce their rates to come within a rate ceiling, they could make the cost of credit to consumers more expensive in other ways. For example, many weekly doorstep lenders do not, at present, charge for missed or late payments, but could decide to introduce such charges.
- Rate ceilings could actually have the effect of encouraging rates to gravitate towards that ceiling.
- A rate ceiling may also result in some lenders withdrawing from the market. This, in turn, may lead to groups of consumers being denied ready access to alternative forms of credit, forcing them to resort to illegal moneylenders.
- EU Member States who have rate ceilings, tend to have a less diverse credit market.

3.51 **Therefore, the Government is not yet persuaded of the case for interest rate ceilings.** Our preferred approach is to address high-cost credit in a number of other ways (outlined elsewhere in this chapter). In particular, this will include measures to combat unfair interest rates and charges. In addition, protection will be provided by the increased transparency of agreements and changes to the rules on early settlement.

3.52 That said, **we have commissioned research into the way that interest rate controls have worked in other countries.** This research will also look at the differences in the environment between the UK and those countries, for example, in the level of availability of non-commercial sources of credit such as credit unions.

3.53 Whether or not an interest rate ceiling is the most appropriate mechanism, the Government is concerned that the cost of some credit is unreasonably high. The measures set out in this chapter are intended to deter and, if necessary, deal with those lenders who abuse the current system through unfair and excessive interest rates. **The Government will continue to monitor the impact of these measures and the cost of credit.**

3.54 Many of the consumer concerns raised relate to high interest-rate charges in the doorstep collection credit market. We are aware that the National Consumer Council (NCC) has launched a research investigation to explore the extent of competition in the market for home credit for low-income

consumers. The NCC is examining barriers that may stop consumers from switching between lenders; the structure of the market; whether there are barriers to new businesses entering the home credit market; and whether prices are kept consistently high.

- 3.55 The NCC is conducting this research to see whether there are sufficient grounds to submit a super-complaint, on behalf of low-income consumers, to the OFT. **The Government will consider any competition or other remedies the OFT proposes, should a market investigation into doorstep lending proceed.**

Abolition of Financial Limits⁵⁵

- 3.56 The current purpose of the CCA is to protect consumers when entering into small- to medium-value credit agreements. When introduced, it covered most credit agreements up to a financial limit of £5,000, but this was increased to £15,000, in 1985, and to its present limit of £25,000⁵⁶ in 1998; on both occasions to reflect inflation.
- 3.57 These protections are vital. Previous published reports⁵⁷ and feedback from financial advisors indicates that it is consumers requiring lower-value loans who are most vulnerable and least likely to seek independent financial advice.
- 3.58 However, more and more consumer agreements are no longer regulated due to an increase in borrowing on second-charge mortgages and unsecured loans above £25,000.
- 3.59 In particular, consumers are being encouraged to use secured loans to consolidate unsecured debt. This reduces consumers' monthly payments, but spreads their debt over a longer period of time, resulting in higher borrowing costs. In addition, once the borrowing is secured, they run the risk of having their property repossessed in the event of default.
- 3.60 The lack of protection is further highlighted by the fact that from 31 October 2004, the FSA will be given the power to regulate first-charge mortgages, for which there will be no financial limit. However, the FSA

⁵⁵ Consultation on these issues took place in March 2002: *Tackling Loan Sharks and More! A consultation document on the financial limit and exempt agreements of the Consumer Credit Act 1974. Summary of Responses published in November 2002.*

⁵⁶ It is important to note that, in contrast to other provisions of the CCA 1974, the court's powers to reopen an extortionate credit bargain are not confined to this amount but apply to all agreements of any value.

⁵⁷ Daylight Robbery – NACAB 2000 and Extortionate Credit in the UK – Elaine Kempson and Claire Whyley June 1999.

will not regulate second-charge mortgages, so those loans above £25,000 would therefore remain unregulated if the financial limit of the CCA is not amended.

- 3.61 **In the light of these developments, the Government has therefore announced its intention to remove the current financial limit and re-examine the current exemptions under the Act.** This will ensure there is consistent and transparent protection for consumers entering into credit agreements of any value.

Enforcing Credit Agreements

- 3.62 Importantly, any reform in this area will need to proceed in conjunction with reform of S.127 of the CCA. This is the section that governs the enforceability of agreements and sets out the powers a court has to enforce a regulated agreement. In cases where certain requirements of the Act, relating to the form and content of an agreement, have not been followed by the lender, the Court has discretion to consider whether to make an agreement enforceable. However, in certain instances, the Court is precluded from making an enforcement order if the agreement is not properly executed – because, for example, the documents were not in a certain prescribed form or signed.
- 3.63 The House of Lords judgment, in July 2003, in *Wilson and others v. Secretary of State for Trade and Industry (Appellant)*,⁵⁸ confirmed that, in these certain instances, the effect of a technical error on the part of the lender will render the whole agreement unenforceable.
- 3.64 The House of Lords found that this was a proportionate outcome, even in circumstances where the lender has acted in good faith and the error had stemmed from a mistaken understanding of the statutory requirements. However, it is clear from the judgment that their Lordships had in mind the current financial limit of £25,000, which confines the exposure of a creditor. It is not clear whether they would have found such adverse consequences to a lender acceptable on human rights grounds if there was a much higher, or no, financial limit.
- 3.65 **We therefore recognise that removing the financial limit could expose lenders to greater liability where agreements are held to be unenforceable.** A more proportionate approach to enforcement will therefore be sought which will seek to balance, on the one hand, the objective of ensuring that particular attention is paid to the inclusion of certain terms in documentation signed by borrowers, and on the other, the financial consequences of unenforceability for lenders.

⁵⁸ [2003] UKHL 40.

Business Lending

- 3.66 The CCA currently regulates credit agreements made with: ‘individuals including a partnership or other unincorporated body of persons not consisting entirely of bodies corporate’. Because the personal and business affairs of people running small businesses may be intermingled, they should receive the same protection in their business capacity as is afforded to them as consumers.
- 3.67 Removal of the financial limit would mean that all business lending to partnerships and sole traders would be caught by the CCA. This would be likely to result in the cost and access to high-value finance for small businesses being adversely affected in the following ways:
- The CCA contains a provision that allows Hire Purchase (HP) agreements to be voluntarily terminated and the goods handed back if a minimum of one half of the total sums due have been paid back. While this is relatively manageable for lower value goods, removal of the financial limit would expose HP providers of, often, bespoke equipment, to returned goods, which may then be of little or no re-sale value. Estimates suggest that in excess of 70% of business lending on HP terms is for specialist equipment above £25,000 and, therefore, currently unregulated. This represents a considerable risk to the credit provider.
 - The existence of cooling-off protections for agreements concluded away from trade premises could restrict the flexibility of business lending and the speed of access to finance. Concluding business transactions in this manner is common practice and such delays may result in the skewing of business lending to other forms of borrowing, which are neither regulated nor appropriate.
- 3.68 Following extensive consultation,⁵⁹ **the Government believes that some business lending below £25,000 should still be regulated to protect the most vulnerable business borrowers who do not have access to mainstream lenders.**
- 3.69 The £25,000 limit continues to be appropriate for this purpose as it provides a reasonable upper limit for vulnerable businesses. Borrowing above this figure is likely to be secured by a charge over the assets being purchased, which will entail both a higher level of advice (including legal advice), and recourse to the underlying assets.

⁵⁹ Through consultation document and responses as well as Stakeholder groups.

- 3.70 Retention of the limit provides suitable protection for the vulnerable, smaller businesses but, importantly, also facilitates ease and speed of access to vital business funding above £25,000, where its use is solely for business purposes.
- 3.71 **It is the Government's intention, therefore, to retain the £25,000 limit for all business lending to unincorporated bodies** (which will be defined as sole traders, partnerships – up to and including three partners – and other unincorporated bodies not consisting entirely of bodies corporate). Irrespective of the value of the loan, where any part of it is for a non-business purpose it will be regulated by the CCA.

Exemptions

- 3.72 Some categories of credit and hire purchase agreements were originally exempted from the Act because, either alternative safeguards already existed, or it was thought that to impose regulation might not be in the interests of consumers.
- 3.73 At present, many lenders offering secured loans are exempted under certain generic exemptions (banks, for example, as they are already covered under separate legislation). These provisions dictate that some types of lender have to be named in an order made under S.16 of the CCA for their loans to be exempt, while others do not. This imbalance mainly exists between bank and building society subsidiaries (subsidiaries of the former gain automatic exemption, whereas the latter have to apply for exemption). **While the responses to our consultation delivered a clear message that the current exemptions should be retained, the Government believes that further consideration of the issue is appropriate.** We will make a decision on this issue by February 2004.

Modifying Agreements

- 3.74 The removal of the financial limit has generated some concerns from the lending industry with regard to their increased exposure to liability when varying or supplementing existing credit or HP agreements. The CCA stipulates a number of formal requirements (S.82) should be followed, if the new agreement is to be enforceable.
- 3.75 The process of modifying an existing agreement is perceived by lenders as potentially complex and prone to error with the subsequent risk of the modified agreement becoming unenforceable. However, it is not clear whether concern regarding unenforceability is the sole concern for

lenders or whether they find the current provisions burdensome or unworkable for other reasons.

- 3.76 **We will work with stakeholders over the next two months on whether more wide-ranging reform is needed.**

Multiple Agreements

- 3.77 One of the objectives of the provisions relating to multiple agreements is to prevent lenders artificially combining distinct agreements together, in order to exceed the regulatory limit. The removal of the £25,000 limit will make this objective redundant for any borrowing with a consumer element.
- 3.78 The second objective of the provisions is to make it clear that an agreement, falling within more than one statutory category, must comply with the statutory requirement for each category. Difficulty has been caused when single advances are to be applied for two or more purposes, attracting different categories. In recent years, the introduction of more complex retail lending products – e.g. credit cards with different terms for balance transfers, cash advances and purchases – has led to uncertainty as to how the provisions apply to the different elements of the agreement. **Further discussion is needed with relevant parties to clarify how this area can be made more transparent for the consumer, while still making it possible for lenders to package together different credit products with legal certainty. We will aim to finalise these provisions by February 2004.**

Impact Assessment

- 3.79 The removal of the financial limit will result in the following benefits:
- The inclusion of all consumer lending within the CCA regime so that all consumers benefit from the regulatory provisions, rather than only covering consumers borrowing less than £25,000.
 - Proportionate protection for small businesses will be maintained by retaining the £25,000 limit for business lending, while recognising that higher value business lending does not require regulation through the CCA.
 - Greater clarity and certainty for creditors wanting to make use of the provisions on modifying and multiple agreements, and greater transparency for consumers.

We want a Europe
that creates business
opportunities and
enhances consumer
protection and choice

Chapter 4:

Europe



EU Strategy

- 4.1 **We want a Europe that creates business opportunities and enhances consumer protection and choice; a Europe that builds the confidence of consumers to shop across borders; a Europe where business can transact with certainty. We want to see a competitive, dynamic market in consumer credit that encourages entrepreneurship and growth.**
- 4.2 The UK has gone significantly further than the existing European legislation in its approach to regulating new types of credit agreement in this fast-moving sector. The 1987 legislation⁶⁰ only set the minimum requirements necessary for regulation across the EU. This has led to competitive distortions in its credit markets. Consequently, the scope for consumers to obtain credit in other Member States is restricted.
- 4.3 **The Government supports a single market in consumer credit, enabling businesses to work with legal certainty and consumers to shop confidently, across the EU.**
- 4.4 Since September 2002, the European Commission has brought forward two proposals, aimed at enhancing consumer protection and establishing a single marketplace: a revised Consumer Credit Directive⁶¹ (CCD), and the Unfair Commercial Practices Directive⁶². These proposals have an important impact on consumer credit regulation within the EU, including the UK.
- 4.5 **We expect UK regulation to be consistent with and complement European legislation.** The UK's consumer credit legislation provided European policymakers with many of the ideas for the existing 1987 CCD. Our experience as the largest, most dynamic credit market in the EU means that the UK has much to bring to developing regulation of this sector at a European level.
- 4.6 This paper sets out our vision for European-wide consumer credit provision.

⁶⁰ 87/102/EEC.

⁶¹ COM(2002) 0443.

⁶² COM (2003) 0356.

Consumer Credit Directive

- 4.7 The UK and other Member States have found the existing, 1987, CCD inadequate to regulate the EU credit market of the 21st Century.
- 4.8 The European Commission published its proposal for a revised CCD on 11 September 2002. There is a long way to go and many uncertainties as to how the final Directive will look.
- 4.9 A revision of existing law is an opportunity for the UK credit industry (worth 40% of the EU credit market which exceeds £500 bn⁶³) to expand with legal certainty and create an environment where consumers can cross borders to shop for credit with confidence.

UK Focus

- 4.10 For the UK to take full advantage of its place at the heart of the EU credit market, the Government's objective must be to secure a Directive that tackles the real barriers to a single market in consumer credit and provides an appropriate level of consumer protection.
- 4.11 While the Government recognises that significant barriers to the single market will be language and culture, a Directive must address barriers to:
- *the use of and access to data* – to ensure lenders have the correct credit reference information to assess the risk of lending to individual consumers.
 - *fair competition* – to enable UK credit companies to penetrate new markets by establishing high-level principles that create a level playing-field for lenders and protect consumers from misleading and unfair advertising.
 - *debt recovery and collection practices* – to ensure lenders are able to recover debts in other markets and operate under clear rules in all Member States.
- 4.12 The key building blocks for such a Directive are:
- Cross-border exchange of data on an equal and fair basis;
 - Common information requirements;

⁶³ Consumer Credit Directive proposal – explanatory memorandum COM(2002) 443 final.

- Common rules on approaching the calculation of the APR – essential for like-for-like comparison of different offers;
 - An effective licensing regime for lenders wanting to provide credit products cross-border; and
 - An effective out-of-court redress process to deal quickly and easily with cross-border consumer complaints.
- 4.13 **The Government will work closely with the Commission, other Member States and the European Parliament to ensure the proposals are in the best interests of the UK.**
- 4.14 The current reform process could be very influential on the European debate. Our analytical research into the key drivers for reform of the largest and most dynamic credit market in the EU means that our conclusions as to the right level of regulation and consumer protection will provide a clear direction for the UK at an EU level.
- 4.15 **It is the Government's intention to forge ahead with reform. We do not believe it would be right to hold it up until the CCD is agreed.**

Directive on Unfair Commercial Practices

- 4.16 On 18 June 2003, the Commission published a draft Directive concerning unfair business-to-consumer practices in the internal market (the Unfair Commercial Practices Directive). The proposed Directive will cover all business sectors, including consumer credit. It has two main objectives: to tackle rogue traders through prohibiting unfair commercial practices; and to create a more conducive environment for business and consumers who want to sell and buy cross-border by replacing the existing, outmoded rules currently regulating this sector.
- 4.17 **The Government is concerned about the possible impact of this cross cutting measure on already highly regulated sectors such as financial services. The Government's broad objectives in future negotiations will be to ensure that any Directive offers effective consumer protection, avoids duplication of regulation, and provides legal certainty for business, consumers and enforcement bodies.** The Directive should also complement the provisions of the CCD and the UK reform process through its coverage of marketing and selling practices. The Government has consulted separately on this proposal⁶⁴.

⁶⁴ <http://www.dti.gov.uk/ccp/consultpdf/unfaircon.pdf>

Over indebtedness
harms individuals,
fuels poverty and
social and financial
exclusion

Chapter 5:

Minimising Over-indebtedness



Introduction

- 5.1 Despite the dramatic increase in availability of credit since 1989, evidence suggests that the majority of households continue to manage their borrowing effectively, paying off their debts as they fall due.⁶⁵ However, there are a minority of consumers for whom over-indebtedness is a problem. Over-indebtedness fuels poverty, and social and financial exclusion, as well as having a real impact on the health and well-being of individuals. Tackling over-indebtedness is integral to the development of an effective, efficient and inclusive credit market, and to the achievement of DTI's PSA objective to 'place empowered consumers at the heart of an effective competition regime'.
- 5.2 While aimed at all consumers, the measures in this White Paper set out a new, transparent and fair framework for a modern credit market that will be of particular benefit to the most vulnerable. It is they who are most likely to suffer from the kinds of detriment we are seeking to prevent. Of particular importance are the measures aimed at improving information provision, strengthening the licensing regime to target rogue and unfair practices, putting an end to unfair selling practices and facilitating challenges to unfair credit agreements. This chapter builds on this with specific measures to tackle over-indebtedness.

A Strategy for Tackling Over-indebtedness

- 5.3 Addressing the specific problems of over-indebtedness requires partnership between the industry, the voluntary sector, the Government and consumers. **Working with these partners, we will develop an over-indebtedness strategy, by spring 2004.** Based on clearly defined principles and responsibilities this strategy will complement our proposed legislation. This chapter sets out the measures the Government is taking to tackle over-indebtedness and identifies areas that the over-indebtedness strategy will need to address.
- 5.4 Successful development and implementation of the proposals set out in this chapter will require co-ordinated action across Whitehall. A new Ministerial Group will oversee government action (discussed further below).

⁶⁵ Kempson, E (2002) "Over-indebtedness in Britain: A report to the Department of Trade and Industry", Department of Trade and Industry (www.dti.gov.uk/ccp/topics1/overindebtedness.htm)

The Current Situation

Defining Over-indebtedness

- 5.5 There is no generally accepted definition of over-indebtedness. For the purposes of this White Paper we use the criteria established in the Household Survey, carried out for the DTI in 2002,⁶⁶ namely, that a household is likely to be over-indebted if:
- 25% of their annual income is spent on repaying consumer credit (5% of UK households in 2002);
 - 50% of their annual income is spent on repaying consumer credit and mortgages (6%); or
 - They have four or more credit commitments (7%).
- 5.6 This definition presupposes all consumers have access to mainstream credit services. However, a number of the measures that follow are equally aimed at those consumers who simply have difficulties budgeting on a low income or do not use mainstream financial services – the ‘financially excluded’.

The Extent of Over-indebtedness

- 5.7 The majority of consumers use credit effectively, without getting into difficulties. There is, however, a significant minority who do suffer because of debt: some 7% of households fell into the criteria for over-indebtedness listed above, and 20% of households approached for the Household Survey admitted to having financial difficulties of some kind at the time of the survey.
- 5.8 Over-indebtedness is closely linked to low income, and financial and social exclusion:
- *Low income.* 35% of low/moderate income families are unable to meet repayments on at least one bill or credit commitment.⁶⁷ People on low incomes normally borrow relatively small amounts. However, as a proportion of their incomes the amount owed is greater than for higher-income groups.

⁶⁶ Op cit 65.

⁶⁷ Family and Children's Study, Department for Work and Pensions, 2000-2001.

- *Financial exclusion.* It is estimated that 7% of the overall population is excluded from the financial services market, and this figure rises to 14% where household income is between £150-200 per week.⁶⁸
 - *Social exclusion.* Over-indebtedness can be both a cause, and a result of social exclusion. Socially excluded groups are at higher risk of over-indebtedness, and some people who are over-indebted risk becoming socially excluded – for example, through becoming homeless, losing work or developing mental health problems.
- 5.9 In the event of a change in the current macro-economic climate – with its low interest rates and high levels of employment – there is the potential for a greater proportion of consumers to become over-indebted. Low-income groups and the young have the highest debt-to-income ratios and their ratios have increased most in recent years⁶⁹. Thus it is these households that are most vulnerable to sudden financial changes. (Vulnerability to over-indebtedness is discussed further in chapter one.)

The Causes of Over-indebtedness

- 5.10 Over-indebtedness is usually triggered by a major life event or change in circumstances. The most common triggers are: losing a job or constantly moving in and out of work, separating from a partner, becoming ill or developing a disability, or having children. For example, nearly one-in-five households in arrears or financial difficulties attribute this to redundancy.⁷⁰ In addition, approximately one-in-seven people cite living for long periods on low income as the cause.⁷¹
- 5.11 Following this trigger, some people fall into debt while others cope. A range of factors influence whether a trigger results in a debt problem, many of which in particular affect vulnerable groups. Such as:
- *Financial literacy.* DTI research⁷² shows that the lack of understanding and awareness of financial products is highest among the lower socio-economic groups (for example, 70% of the C2DE classification do not know what the APR stands for compared to 50% for the ABC1s classification).

⁶⁷ Family and Children's Study, Department for Work and Pensions, 2000-2001

⁶⁸ Department of Trade and Industry (1999) "Modern Markets: Confident Consumers" (www.dti.gov.uk/consumer/whitepaper/). The Social Exclusion Unit's Policy Action Team 14 (PAT14) on financial exclusion sets out evidence for the extent and causes of financial exclusion.

⁶⁹ Bank of England Quarterly Bulletin, Winter 2002, "Financial Pressures in the UK Household Sector: evidence from the BHPS".

⁷⁰ Op cit 65.

⁷¹ Op cit 65.

⁷² Op cit 14.

- *Availability of Debt Advice.* Advice services are seen as crucial in reducing both debt and its impacts.⁷³ As discussed later, free debt advice suffers from problems of capacity, confusion, co-ordination and funding.
- *Access to affordable credit.* Research among CAB debt clients⁷⁴ shows that those on low incomes often turn to more expensive forms of credit – such as, doorstep collection companies, mail order catalogues and pawnbrokers – than those with larger monthly incomes.
- *Irresponsible or illegal lending.* This can exacerbate the situation, and those in vulnerable groups are more likely to be at risk from extortionate credit and unfair practices or to be borrowing from illegal moneylenders.
- *Administration or entitlement difficulties.* Following a trigger, a lack of timely Government support can increase the likelihood of problem debt. For example, problems with Housing Benefit administration can exacerbate problems of over-indebtedness experienced by tenants.

5.12 In a minority of cases, irresponsible borrowing can either trigger or exacerbate over-indebtedness. Practices that sometimes indicate irresponsible borrowing include: borrowing to re-finance other credit, unplanned purchases and taking on new credit despite knowing that repayment will be a struggle.⁷⁵

The Costs of Over-indebtedness

5.13 The costs of over-indebtedness do not just fall on individual borrowers, they have a much wider impact, affecting financial institutions or creditors, and the State as a whole.

5.14 Over-indebtedness impacts heavily on borrowers' lives. Studies have found:

- Stress is a particular problem. The Citizens Advice report, 'In too deep: CAB clients' experience of debt',⁷⁶ found that a quarter of CAB clients are already seeking treatment from their GP for stress, depression and anxiety, at the time of seeking advice;

⁷³ Collard, Steele and Kempson, "Quality Assured? An Assessment of the Quality of Independent Money Advice" (2000).

⁷⁴ Information taken from CAB Evidence report "In too deep. CAB clients' experience of debt" (May 2003) and Financial Over-Commitment Survey: Research Study conducted by MORI for Citizens Advice (July 2003).

⁷⁵ Op cit 65.

⁷⁶ Citizens Advice (2003) "In too Deep: CAB clients' experience of debt" (www.citizensadvice.org.uk/docks/ln_too_deep.pdf)

- Mental health problems affect a higher proportion of those in over-indebted households than they do the general population;
 - Money problems have been associated with a large proportion of homicidal threats, violence and suicides;
 - Indebtedness may be a barrier to work;
 - Access to future credit is restricted due to the backwards-looking credit rating system.
- 5.15 The costs to financial institutions and creditors include:
- Coverage of bad debt and the level of contingency fund set aside for non-payment;
 - The cost of chasing bad debts through management and administrative time, debt collectors and court fees.
- 5.16 These costs are difficult to quantify, but analysis undertaken by the DTI suggests that the cost of recovering 2.5% of current, outstanding (unsecured) consumer credit would be approximately £600-800m.
- 5.17 The costs imposed on the State as a whole include:
- The burden on the NHS due to stress and related impacts on individual borrowers;
 - Debt problems result in evictions, which impose a direct cost on the Government's housing budget;
 - Public expenditure on debt cases in the legal system (for example, in 2002/03, the Community Legal Service spent £19.6m on legal aid for debt cases);
 - The impact on productivity from stress and absenteeism.
- 5.18 Over-indebtedness, particularly among low-income groups, also has a significant negative impact on a number of Government objectives – for example, on eliminating child poverty, welfare to work aims, health inequalities and neighbourhood renewal.
- 5.19 Further details of the extent, causes and costs of over-indebtedness are set out in Annex C.

Objectives

- 5.20 The Government seeks to create a fair and efficient marketplace where consumers can actively participate, making informed judgements and taking effective decisions about the use and management of their money. In doing so, the Government will work in partnership with the voluntary sector and the credit industry to empower those most at risk of falling into over-indebtedness, thus, minimising the costs of over-indebtedness to individuals, the financial sector, the Government and society as a whole.
- 5.21 In order to achieve this, the Government seeks to:
- **Minimise the number of consumers who become over-indebted; and**
 - **Improve the support and processes for those who have fallen into debt.**
- 5.22 The following sections highlight proposals to address these twin aims through: empowering and protecting consumers; facilitating the provision of affordable credit; assisting those in debt; and ensuring provision of accessible and usable legal processes for problem resolution. Policy proposals cover:
- Financial literacy
 - Debt advice
 - Sources of affordable credit
 - Irresponsible or Illegal money lending
 - Enforcement processes and problem resolution
 - Administration of entitlements
 - The way forward: co-ordination and monitoring
- 5.23 These proposals are not only designed to ensure that those facing the triggers identified above are able to cope, but also to ensure that when individuals cannot cope, there is sufficient support available.
- 5.24 The proposals have particular regard for vulnerable groups and will be taken forward in collaboration with government work on financial exclusion. The recommendations of the Social Exclusion Unit's Policy

Action Team 14 (PAT14) report on financial exclusion⁷⁷ have now broadly been implemented and the Government is developing a strategy for addressing financial exclusion going forward.

Financial Literacy

5.25 For consumers to make rational, well-informed choices about financial products, they need to have access to information, and the ability to understand that information (information provision and transparency are discussed in Chapter 2). The Moser report 'A Fresh Start'⁷⁸ identified that a significant proportion of consumers do not classify themselves as financially literate. The Citizens Advice report, 'Summing Up'⁷⁹ which brings together evidence gathered by Citizens Advice Bureaux in the course of providing debt advice, identified a number of detriments arising from poor consumer literacy and numeracy. These included the fact that such consumers:

- Find it immensely difficult to identify appropriate financial services;
- Can too easily become the victims of abusive practices from financial service companies; and
- Find it difficult to identify the welfare benefits and/or credits that would increase their income.

Financial Education

5.26 In addressing this, the Government, working in partnership with other organisations, is already doing much to improve financial education and literacy through a range of programmes, including:

- Citizenship and Personal, Social and Health education, which is part of the National Curriculum in schools in England;
- The Basic Skills Agency's 'Skills for Life' programme and the Department for Education and Skills' Community Finance Learning Initiative, both aimed at adults;

⁷⁷ National Strategy for Neighbourhood Renewal: Policy Action Team Audit (1998) "PAT 14: Financial Services" (www.socialinclusionunit.gov.uk/publications/reports/html/pat_audit/14.htm)

⁷⁸ Lifelong Learning (1999) "A Fresh Start: Improving numeracy and literacy" (www.lifelonglearning.co.uk/mosergroup/rep.htm)

⁷⁹ Citizens Advice (2001) "Summing up: Bridging the Financial Literacy Divide. A CAB evidence report" (www.citizensadvice.org.uk/pdfs/project.pdf)

- A range of financial education and advice materials produced by both the FSA and the OFT, along with a number of charitable, consumer and industry bodies.

Generic Financial Advice

5.27 As well as financial education, consumers may also require guidance and assistance in making financial decisions and managing their money. There are already a number of initiatives that offer consumers generic financial advice and help with budgeting, many of which are targeted at consumers at those points in the lifecycle when they are most vulnerable to over-indebtedness (such as losing a job, facing long-term ill health, or becoming a parent). These include:

- The FSA's 'Financial Health-check Tool' helps individuals understand their budgeting requirements and identifies those areas where they need to take action in planning for their long-term financial futures;⁸⁰
- The Department for Work and Pensions is developing a web-based retirement planner which will enable people to view their total projected pension income from both state and private sources, estimate the income they might need in retirement and calculate any savings shortfall;
- HM Treasury's Savings Gateway offers financial education to those participating in schemes linked to Community Finance Learning Initiatives;
- Credit unions and local authorities also offer generic financial advice and budgeting programmes.

Raising Financial Awareness

5.28 Increasing financial education, information and advice will go some way to achieving the objective of empowering consumers to participate actively and effectively in the consumer credit market.

5.29 **The FSA has published a statement of principles for the development of a national Strategy for Financial Capability⁸¹, for consultation.** Among other things, it proposes a co-ordinated approach across Government, the industry, the trade and consumer bodies and Non-Governmental

⁸⁰ Financial Services Authority Financial Healthcheck (www.fsa.gov.uk/pubs/press/2003/030.html)

⁸¹ FSA, "Towards a national strategy for financial capability" November 2003), http://www.fsa.gov.uk/pubs/other/financial_capability.pdf

Organisations in the provision of education, information and generic advice for financial services. The FSA has set up a steering group to establish, by 31st March 2004, a clear view of each party's role within that strategy.

Debt Advice

- 5.30 Despite measures to minimise the number of people who become over-indebted, there will inevitably be individuals who will fall into this situation. The Government is committed to improving support for those individuals and recognises that provision of free debt advice is crucial to that end.
- 5.31 There are a number of free debt advice providers, most of whom operate under the umbrella of the Community Legal Service. These include National Debtline, Citizen's Advice Bureaux, Consumer Credit Counselling Service and Advice UK members. Between them they offer a number of services, including general information and budgeting advice, support on managing and repaying debts, and specialised legal advice and casework. Some of these services can be accessed face-to-face, others by telephone, and some by both methods.

Case Study

Mrs X's husband lost his job due to ill health. This left them, and their two children, reliant on Mrs X's part-time wage, and his incapacity benefit.

Some 12 months later, having struggled to pay several loans and credit cards taken out while Mr X was in employment, things came to a head when they received a Court Summons for repossession of their mortgaged property. At this point Mrs X contacted a free debt adviser.

The debt adviser was able to help them prioritise their debts – so that all their essential expenditure could be met and priority arrears reduced – and helped them negotiate repaying affordable amounts on their mortgage arrears. As a result, they are now managing and in control of their finances.⁸²

⁸² Source: National Debtline.

5.32 However, the free debt advice sector faces a number of challenges:

- *Capacity.* There is considerable evidence that these services are over-subscribed. According to the 'Household Survey on over-indebtedness',⁸³ most free, debt advice services work to near capacity, while still only assisting a small proportion of households facing arrears.
- *Co-ordination.* The organisations involved in debt advice each have strengths in helping different individuals in different ways. However, there is currently little co-ordination between the providers to cross-refer clients to the most appropriate advisor.
- *Confusion.* An individual who becomes over-indebted is often unsure which advice provider most suits their needs. Many individuals are less aware of free debt advice and repayment services than paid-for alternatives.
- *Funding.* Free debt advice is funded primarily through a mixture of private and public funds. These funding streams are usually committed on an annual basis making long-term planning difficult.

Our Vision for Joined-up Debt Advice

5.33 In order to address these challenges, **the Government is working in partnership with advice service providers to develop a vision for joined-up debt advice. We want to instigate:**

- **A new telephone gateway;**
- **Formal referral agreements between telephone and face-to-face services; and**
- **Sign-posting from Government services.**

5.34 The aim of the new telephone gateway is to provide a high profile entry point for individuals who are currently uncertain how to access debt advice. The gateway would be an additional route, working alongside well established and trusted contact points already provided. The service would offer an initial diagnosis of the problem, provide access to emergency help, where necessary, and signpost the consumer to an appropriate specialist service (telephone or face-to-face).

⁸³ Op cit 65.

- 5.35 There is evidence that lower socio-economic groups, including the most vulnerable, are under-represented among callers to telephone debt advice services.⁸⁴ However, because user surveys of services, such as, National Debtline and the Consumer Credit Counselling Service (CCCS), only poll those who actually contact them, there is a lack of clear evidence as to the reason why this should be the case. **Along with the service providers, the Government is considering how debt advice organisations can better serve these, the most vulnerable groups. Progress will be reported in the over-indebtedness strategy to be published in spring 2004.**
- 5.36 In addition to the new gateway, formal referral agreements and mechanisms, between the various providers, would allow for greater efficiency – ensuring consumers are directed to the most appropriate advice, and providers focus their efforts on their core client groups.
- 5.37 At times when people need debt advice most, they are often already in contact with the Government ‘system’ for other reasons. We need to make best use of this opportunity. For example, Jobcentre Plus already funds debt advice for some of its clients through the New Deal programmes. An additional £3m was announced in the 2003 Budget to provide advice in situations where debt is considered a barrier to employment. We need to explore ways of encouraging other frontline workers similarly to signpost their clients to the appropriate debt advice channel.
- 5.38 Levels and certainty of funding are a major challenge for the debt advice sector. Service providers, often voluntary and community sector organisations, rely on combinations of funding streams to ensure continuity. There are a number of parties with an interest in funding these services, including the Government, the credit industry, local authorities and charities.
- 5.39 National debt advice models are a good example of services where a mixture of funding streams is appropriate. In partnership with the credit industry, Government is funding a telephone advice service provided by National Debtline. The Legal Services Commission, together with local authorities and others, funds debt advice through the Community Legal Service. CCCS gets funding from the creditors who benefit from repayments under the debt repayment plans it manages on behalf of its clients. Many in the industry already make a significant contribution to funding debt advice. However, sustainable funding will be key to achieving an effective service.

⁸⁴ B&W Deloitte (2003) “Evaluation of Money Advice Debtline pilot and business case for development of ‘National Debtline’”, Department of Trade and Industry.

- 5.40 **The Government will be working in partnership with the advice sector and creditors to agree the operational details of this vision and to secure contributions on a longer-term basis from a wider range of interested parties. Progress on this work will be reported in the over-indebtedness strategy to be published in spring 2004.**

Face-to-face Advice

- 5.41 Vulnerable consumers are more likely to have literacy difficulties, need detailed casework and representation, or lack the confidence to work through their debt problems independently. This indicates that face-to-face advice services are often the most appropriate means of addressing their requirements and providing advice to them.
- 5.42 The Government accepts that the current level of face-to-face advice provision is not sufficient to meet the need, especially in the most deprived communities. Improved co-ordination of advice services should release some face-to-face capacity to handle new cases, and identify where greater provision of face-to-face advice needs to be directed. **The Government will work with local government, the credit industry, the utilities and the voluntary sector to explore ways of addressing this shortfall; identifying and developing funding opportunities, and growing capacity. Progress will be monitored by the Ministerial Group.**
- 5.43 Face-to-face advice is best provided at a local level. Local authorities and the voluntary and community sector are best placed to target specific geographical areas of need and are able to operate economies of provision. Clearly, co-ordination of needs analyses and funding at a local level is the most effective way of addressing local shortages. For example, in the case of debt advice provided through the New Deal, DWP will be working through Jobcentre Plus districts to consider local analyses of need.

Research

- 5.44 At present there is limited quantitative evidence of the impact of debt advice on other social outcomes. This information would help to assess how much money might be saved by investing in debt advice services. **The DCA is commissioning research into the impact of debt advice on clients' financial positions, and a range of social outcomes and associated costs.**

Debt advice in Scotland

- 5.45 In Scotland, the position is rather different. The Scottish Executive already funds significant proportions of face-to-face money advice and has introduced new legislation which places a statutory duty on creditors to provide debtors with debt advice and information. Arrangements to link telephone advice and face-to-face advice will be examined separately in Scotland.

Sources of Affordable Credit

- 5.46 In order to achieve the objective of reducing the number of consumers who become over-indebted, affordable alternatives for credit provision need to be in place. This is of particular importance to those on low incomes and sub-prime consumers (for example, those unable to access mainstream credit because they have a County Court Judgment against them). High-cost credit can lead to over-indebtedness, or exacerbate existing debt problems. Sources of affordable credit include credit unions, Community Development Finance Institutions and other 'social' lenders. In many cases these organisations can offer more than just cheap loans, providing a range of financial services relevant to people on low incomes.

Social Fund

- 5.47 The Social Fund is an important source of support to people on low incomes. It provides a system of regulated payments, grants and interest-free loans aimed at helping with large, unexpected or occasional expenses (such as replacing necessary household items or covering funeral costs). Over 4.5 million awards were made in 2002/03, with a gross expenditure of £820.7m.⁸⁵ Loans from the Social Fund are intended for those in receipt of income-related benefits and are not designed for the whole of the market, nor to replace marketplace offerings.
- 5.48 The 2002 pre-Budget report announced a £90m cash-injection for the discretionary Social Fund. **The Department for Work and Pensions is working to improve Social Fund administration, guidance and training. It is also looking to see what further improvements can be made to enhance the ability of the Social Fund to help those on low incomes manage their finances.**

⁸⁵ Department for Work and Pensions (2003) "Annual Report by the Secretary of State for Work and Pensions on the Social Fund 2002/03".

Credit Unions

- 5.49 Credit Unions have an important role to play in providing greater choice and diversity in the financial services sector. The credit union ethos of thrift, financial planning and self-help, together with their ability to offer access to affordable loans, means they are well placed to make an important contribution to tackling financial exclusion.
- 5.50 The Government has been involved in a number of initiatives to help the movement grow and to enable credit unions to offer a greater range of services to their members. This has included the implementation of deregulatory measures to enable credit unions to compete more effectively with other depositors. And, through the Financial Services and Markets Act, credit unions have been brought under the regulatory supervision of the FSA, giving savers with credit unions the same protection as those with banks or building societies.
- 5.51 The credit union movement in Scotland is more developed than in much of the rest of the UK, having 139 credit unions, compared with 547 in the whole of England and Wales. The Scottish Executive has recently refocused and extended its financial support for the credit unions in Scotland to provide additional funding – where they are sustainable, and where their activities specifically address financial exclusion.
- 5.52 **HM Treasury is currently discussing with the credit union movement different approaches to facilitate further development in the sector. We will continue to work with the movement to identify options for reform.**

Other Sources of Affordable Credit

- 5.53 There is a wide range of initiatives that provide affordable credit, usually through partnerships between the private and community sectors. For example, there are partnerships between Housing Associations and banks or building societies that provide low-cost credit to tenants (e.g. Cambridge New Horizons). There are also schemes set up explicitly to provide loans to those who cannot get credit elsewhere (e.g. the Portsmouth Area Regeneration Trust).
- 5.54 Social enterprises of this type have a double bottom-line: economic output *and* social impact. Properly organised, low-income finance provision can be both fair and profitable. The Government will continue to explore ways of further developing this sector.

Illegal Money-lenders

- 5.55 Consumers who find themselves excluded from credit channels due to a poor credit history, an inability to manage finances or because their income is simply too low to provide reassurance, may resort to illegal money-lenders. (Illegal money lending is defined as lending without a credit licence.)
- 5.56 Responsibility for enforcing the law against illegal money lending rests principally with TSDs. (In principle, the OFT could also enforce the provisions, but it is more sensible for this to be tackled at a local level.) However, investigations and prosecutions are rare, as the offence is difficult to prove. It requires extensive undercover surveillance, carried out by enforcement officers unknown to the local money-lending community. Most local TSDs do not have the resources, few officers have the requisite skills, and generally, the police do not carry out investigations in these matters (though they will provide operational support when warrants are to be executed).
- 5.57 **The DTI will fund a two-year pilot to form special teams to deal with cases of illegal money lending.** Each team will consist of a mixture of experienced Trading Standards Officers and enforcement officers with a suitable background, such as recently retired police officers. The teams will be embedded in TSDs, but will be expected to operate across a region. **They will begin operating in April 2004.**
- 5.58 This work will need to be done in association with work being undertaken by the Government and voluntary sector organisations to ensure access to legal alternative sources of affordable credit (see paragraph 5.46 above).
- 5.59 Success measures for the pilot will include:
- Cases of illegal money lending being regularly brought to court as a result of the work of the teams during 2004/05 and 2005/06.
 - Obtaining a far clearer understanding of the scale and impact of illegal money lending.
 - Creating a climate where victims can come forward – confident that prosecutions will be undertaken, and convictions obtained, without fear of reprisals.

- 5.60 **We also plan to commission research to take place alongside the project to ascertain the extent of illegal money lending in the UK. This will help us quantify the deterrent effect of strong enforcement. We will publish our findings and the steps to be taken by autumn 2006.**

Case Study

Statistical information on illegal money lending is rare. But information from Strathclyde TSD's Taskforce to Tackle Illegal Money (which ran from the late 1980s to the early 1990s) indicates that, in the Strathclyde area alone, there were some 60 rings of illegal lenders operating. Where financial records were found, the annual income of the illegal lender was reckoned to be close to £100,000, meaning £6m was potentially being paid to illegal lenders.

One resident of a hostel for the homeless was being charged 1.3 million per cent. A gang working in a local community centre was charged with a number of offences (including illegal money lending, fraud and importuning a 15-year old to become a prostitute to pay off debts). Gang members were jailed for a total period of 12 months for illegal money lending, it having proved impossible to get witnesses to speak on the other charges.⁸⁶

Responsible Lending

- 5.61 It is up to individuals to make responsible borrowing decisions, and the measures described above are designed to ensure the Government does what it can to facilitate this. There is also a role for lenders, however, in preventing over-indebtedness through responsible lending practices.
- 5.62 The Household Survey identified certain lending practices which disproportionately affect people who are at risk of over-indebtedness and potentially make a bad situation worse. While it would be wrong to claim they cause over-indebtedness, they could be seen as being irresponsible. These practices include:
- The automatic raising of credit limits on credit and store cards and on overdraft facilities;
 - Encouraging people to transfer balances on credit cards, by offering low initial interest rates and higher credit limits;

⁸⁶ Source: Strathclyde Regional Council.

- Reducing the minimum payment on credit cards; and
 - Unsolicited issuing of cheques that can be used to draw on credit card accounts.
- 5.63 The DTI Taskforce on Tackling Over-indebtedness looked at ways of achieving more responsible lending and borrowing. It made recommendations for government, such as improving the transparency of agreements (covered in Chapter 2). It also made recommendations for industry, such as, ensuring appropriate credit checks before the granting of pre-approved loans and the increasing of credit limits. Some of these recommendations have now been implemented in industry codes of practice. **The Government will continue to encourage industry to implement the recommendations of the Taskforce. In addition, the OFT is encouraging trade associations to develop consumer codes of practice, and these must include provisions to protect vulnerable consumers. We will report on progress in the strategy for tackling over-indebtedness in spring 2004.**
- 5.64 The FSA's mortgage regime also covers responsible lending practices and is aimed at providing a clearer analysis of a consumer's ability to pay. Where consumers get into arrears on their mortgage, the FSA requires lenders to give consumers early information about remedying the situation.
- 5.65 The sharing of consumer data is important in the development of responsible lending practices. The Taskforce recommended that lenders should seek to share all currently permissible data, both positive and negative, with other lenders. This should include outstanding credit balances, credit limits, open credit lines, history of repayments and amounts borrowed. **The Government continues to encourage credit reference agencies and lenders to consider jointly whether any changes to data sharing could assist in more effective identification of over-commitment, especially on credit card limits, usage, and repayment behaviour.**
- 5.66 In a small minority of cases, extortionate credit agreements may contribute to over-indebtedness. The review of the CCA has specifically looked at this issue and Chapter 3 sets out the measures we intend to introduce. Of particular relevance to the over-indebtedness agenda are the measures designed to make it easier to challenge unfair credit agreements.

- 5.67 **Finally, at an EU level, we will support the inclusion of a duty on creditors to lend responsibly in the forthcoming Consumer Credit Directive. Government, industry, and the voluntary sector will look at how to deliver the requirements of the directive.**

Debt Collection

- 5.68 There will inevitably be those for whom over-indebtedness leads to court proceedings and, where this is the case, the Government has an important role in matters of debt collection and enforcement. A sensitive approach to debt collection distinguishes between those who can pay their debts over time, and those who genuinely cannot pay.
- 5.69 Consumer credit debt collection is a licensable activity under the Consumer Credit Act 1974, and traders are required to satisfy the OFT as to their fitness. The OFT published revised guidance on debt-collection practices in July 2003, setting out a number of practices that it regards as unfair and which could call into question fitness to hold a consumer credit licence.
- 5.70 Under the Enterprise Act, the OFT can approve codes of practice which meet core criteria relating to content, disciplinary procedures, redress and monitoring processes. **The OFT is encouraging the credit industry to develop approved codes of practice and we will report on progress in the strategy for tackling over-indebtedness in spring 2004.**
- 5.71 Court action is sometimes required to ensure repayment of debt. However, legal processes can increase costs, both to creditor and debtor, and should be avoided wherever possible. The DCA has commissioned research into the 'can't pay, won't pay' divide. This research sought to identify those consumers who wish to, but are unable to pay their debts, and those who have chosen not to pay.⁸⁷ **The DCA is working to develop pre-action guidance in debt cases, which will encourage creditors to engage in dialogue with debtors before entering the court process. This would help identify whether or not debtors are in a position to pay. Progress will be reported in the strategy for tackling over-indebtedness in spring 2004.**
- 5.72 **In addition, the DTI, DCA and Defra (for OFWAT) will work with Trade Associations and utility regulators to ensure that codes of practice encourage creditors to avoid court-based action, except where it is genuinely necessary.**

⁸⁷ Kempson, E (2003) "Can't pay or won't pay? A review of creditor and debtor approaches to the non-payment of bills".

Legal Processes

Time Orders

- 5.73 Two sections of the CCA have the potential to give particular benefit to those who fall into the trap of over-indebtedness. S.129 enables the court to make an order giving additional time to a debtor to pay what they owe under a credit agreement. S.136 provides courts with the power, when they make such orders, to amend the terms of the agreement, where it is just to do so – for example, by extending the term of the agreement or altering the rate of interest to be paid.
- 5.74 It is clear from consultation and discussion with stakeholders that little use is made of Time Orders, especially in relation to the additional powers the court has available to it under S.136. There seems to be a general lack of awareness of these sections and the way in which they operate, especially among borrowers.
- 5.75 **We are discussing with the DCA and the devolved administrations what may be done to encourage wider use of the Time Order provisions, including allowing a debtor to apply for a Time Order before notice of default has been served. We are discussing with external stakeholders what arrangements should be put in place, and will report the outcome in the strategy for tackling over-indebtedness, in spring 2004.**
- 5.76 Crucially, we are also discussing the most effective way to enable the court to take account of post-judgment contractual interest when determining cases.

Insolvency and Court Provisions

- 5.77 As well as providing advice, the market also offers solutions for consumers with some income to help them repay their debts, through debt repayment programmes, such as Debt Management Plans. Consumers without income have recourse to insolvency procedures as an option. However, there is a cost for the administration of insolvency schemes, which is typically borne by the consumer. This can act as a barrier to those most in need.
- 5.78 The individual insolvency provisions of the Enterprise Act 2002 (which apply for England and Wales), allow for proportionate treatment of bankrupts, having regard to the facts of their individual case.

- 5.79 **The Insolvency Service and the DCA are working together to consider whether these current statutory systems are sufficient. In particular, they are examining whether there is a need to provide a non-court-based resolution to debt problems for those who are unable, for whatever reason, to go through the existing channels. We will consult on viable solutions early in 2004.**
- 5.80 Personal bankruptcy in Scotland is an area of law devolved to the Scottish Parliament. This area covers individuals, sole traders and partnerships. **The Scottish Executive is currently considering the reform of personal bankruptcy legislation and a public consultation will be carried out in due course.**

Administration of Government Support

- 5.81 As well as responsible lending, we need efficient administration, particularly in connection with financial support from Government to consumers on low incomes.
- 5.82 For example, problems with Housing Benefit administration can exacerbate difficulties experienced by tenants through over-indebtedness. The Department for Work and Pensions issued a set of Performance Standards in April 2002. More than £200m will be invested over three years to help local authorities meet these new standards. These steps have already begun to make a real difference. The Local Government Ombudsmen for England has recently reported a further significant fall in the number of Housing Benefit complaints received, meaning a reduction of nearly 50% in the last two years.

The Way Ahead

Co-ordination of Government Policy

- 5.83 We are committed to tackling over-indebtedness. Successful development and implementation of the proposals set out in this chapter will require co-ordinated action across Whitehall, local government, the credit industry, the utilities and the voluntary sector.

- 5.84 **A cross-departmental Ministerial Group will oversee development, co-ordination and implementation of the programme of action. The Ministerial Group will be supported by an Officials Group, and we will work with industry and the voluntary sector through a new Advisory Group.** The Advisory Group will build on the important contribution made by the Taskforce on Tackling Over-indebtedness and will have reinforced representation from government, business and consumer groups.
- 5.85 **The first task of these groups will be to develop and agree specific proposals in response to the issues outlined in this White Paper. We will draw up a strategy based on clear principles and responsibilities. In particular, the strategy will set out proposals for financial literacy, debt advice, access to affordable credit, and improvements to insolvency and court provisions. The Officials Group will begin work by the end of the year, with the aim of agreeing the strategy by spring 2004.**

Monitoring

- 5.86 **We will establish indicators to monitor the extent of over-indebtedness in the UK and the profile of the over-indebted (who is affected, and what type of debt they have).** These indicators will be used to monitor the effectiveness of the policies and to inform the development and targeting of future work. Progress will be reported in the strategy for tackling over-indebtedness in spring 2004.
- 5.87 **The OFT will monitor the effect of the updates to the regulatory framework announced in the White Paper, with a view to advising the Secretary of State on the need for further changes. It will have particular regard to the position of vulnerable consumers.**

We will implement
our reforms in
consultation and
partnership

Chapter 6:

Implementation



- 6.1 We can only achieve our vision of a more competitive, fair and transparent consumer credit market if we implement the reform as set out in this White Paper in consultation and partnership with all our stakeholders in industry, consumer bodies and other government Departments.
- 6.2 This chapter summarises in the table below the commitments and timetable for consultation and implementation of the various reforms.
- 6.3 Annex A of this document sets out our success measures and how we intend to monitor them.

Implementation Plan

Measure	How implemented	Consultation	Timescale	Target date for implementation
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Chapter 2 – Establishing a Transparent Market

Credit advertising	Secondary legislation	Consultation document issued alongside White Paper	Comments by 15 March 2004	31 October 2004
Standardisation of APR calculations	Secondary legislation	Consultation document issued alongside White Paper	Comments by 15 March 2004	31 October 2004
Form and content of credit agreements	Secondary legislation	Consultation document issued alongside White Paper	Comments by 15 March 2004	31 October 2004 (Subject to consultation responses)
Early settlement of regulated agreements	Secondary legislation	Consultation document issued alongside White Paper	Comments by 15 March 2004	For new loans: 31 October 2004 (Subject to consultation responses) For loans made prior to 31 October 2004: 31 October 2006

Measure	How implemented	Consultation	Timescale	Target date for implementation
Online Agreements	Secondary legislation	Consultation document issued alongside White Paper	Comments by 15 March 2004	31 October 2004
Clarification and presentation of different interest rates applying on a credit card	To be decided	Discussion with industry and consumer groups	Approach agreed by end February 2004	To be decided in light of discussions
Standardising ways of calculating interest on a credit card	To be decided	Discussion with industry and consumer groups	Approach agreed by end February 2004	To be decided in light of discussions
Scope for giving different repayment scenarios on a credit card	To be discussed with industry and consumer bodies	Further discussions with industry and consumer bodies	Approach agreed by end February 2004	To be discussed with industry and consumer bodies

Chapter 3 – Creating a Fairer Framework

Chapter 3 provision which require primary legislation	Primary Legislation	Share draft legislation with stakeholders prior to the Parliamentary process	Prior to the bill being introduced into Parliament	Subject to Parliamentary Timetable
Strengthen consumer credit licensing system	Primary legislation	Consultation paper was issued in January 2003	Consultation closed 30 April 2003	As soon as Parliamentary time is available
Reform the law on extortionate credit	Primary legislation	Consultation paper was issued in March 2003	Consultation closed 6 June 2003	As soon as Parliamentary time is available

Measure	How implemented	Consultation	Timescale	Target date for implementation
ADR System	Primary legislation	Consultation document on the details of the provision in December 2003	Comments by March 2004	As soon as Parliamentary time is available
Extent to which proposals on unfair credit transactions should apply to existing loans	Primary legislation	Involve key stakeholders and relevant Government departments in detail of the proposals	Decision by end January 2004	As soon as Parliamentary time is available
Encourage wider use of Time Orders	Primary legislation	Involve key stakeholders and relevant Government departments in development of the proposal. Reflect outcome of the ongoing discussions in the strategy for tackling over-indebtedness	January 2004	As soon as Parliamentary time is available
How the Court should take account of contractual interest when making a default judgment	Primary legislation and through administrative arrangements with DCA	Involve key stakeholders and relevant Government departments in detail of the proposal	January 2004	As soon as Parliamentary time is available

Measure	How implemented	Consultation	Timescale	Target date for implementation
Removing the financial limit	Amendment to existing primary legislation	Consultation paper was issued in March 2002. Proposals to remove the financial limit on lending to consumers and reduce the scope of lending regulated by the CCA were announced in July 2003	Proposals will be published in Spring 2004	As soon as Parliamentary time is available
Whether changes are needed to the provisions on modifying agreements, multiple agreements and enforceability	Amendment to existing primary legislation	Involve key stakeholders and relevant Government departments in detail of the proposal	Spring 2004	As soon as Parliamentary time is available

Measure	How implemented	Consultation	Timescale	Target date for implementation
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Chapter 5 – Strategic Approach to Minimising Over-Indebtedness

Co-ordination of Government Policy on Over-indebtedness	Ministerial Group, supported by Advisory Group and Officials Group	Advisory Group (including representatives from Government, Consumer Groups, Industry and Voluntary Sector) to be set up. We will consult more widely as appropriate	Officials Group to begin work by end of year 2003. Ministerial Group and Advisory Group to begin work early in 2004	Action Plan for implementing proposals on over-indebtedness in White Paper – Spring 2004
Establish monitoring of over-indebtedness	Statistical Research	Working with OGDs, Consumer Groups and Voluntary Sector Organisations through Advisory Group to develop indicators	Approach to be agreed by Spring 2004	Report on progress in over-indebtedness strategy – Spring 2004 and annually thereafter
Strategy for Financial Capability	Strategy	The FSA has set up a steering group including representatives from Government, Consumer Groups, Industry and the Voluntary Sector to develop the strategy		Strategy to be published – 31 March 2004

Measure	How implemented	Consultation	Timescale	Target date for implementation
Joined up free debt advice services	1) Provision of new gateway and referral procedures 2) Signposting from Government Services 3) Development of sustainable funding strategy	Details of delivery of vision being developed by Round Table of providers of free debt advice and the industry in consultation with Government to develop joined-up debt advice	Delivery of Vision to be discussed with Ministers, January 2004	Implementation plans to be reported in Action Plan Spring 2004
Enforcement of law against illegal money-lending pilots	Funding of two-year pilot project	Evaluation in consultation with Stakeholders	N/A	Pilot implemented – April 2004 Initial Evaluation – June 2004 Final Evaluation – June 2006
Access to Affordable Credit	Informal Consultation	HM Treasury will continue to work with the credit union movement to identify options for further developments	N/A	Progress reported in over-indebtedness strategy – Spring 2004

Measure	How implemented	Consultation	Timescale	Target date for implementation
Pre-action Guidance in Debt Cases	Guidance (format to be decided)	Department for Constitutional Affairs led working group involving representatives from legal profession, OGDs, consumer groups, industry and voluntary sector. Consultation in New Year.	Consultation – January 2004	Progress reported in over-indebtedness strategy – Spring 2004
Access to Insolvency Arrangements	Consultation	The Department for Constitutional Affairs intend to consult early 2004.	N/A	Dependant on outcome of consultation
Promoting industry “good practice” on responsible lending and protecting vulnerable consumers	Codes of Practice and Industry Guidance	OFT and DTI working with OGDs, Industry, Consumer Groups and Voluntary	N/A	Progress reported in the over-indebtedness strategy – Spring 2004

Promoting Awareness

- 6.4 Given the scale of the reform envisaged, it is essential that those affected – consumers, advisers, lenders and their agents – are made aware and fully informed of the implications of the new legislative and other measures. The changes we seek to introduce already reflect the outcome of intense and wide-ranging discussion with the credit industry, consumer groups and regulators. This dialogue will continue with these stakeholders to ensure that knowledge of these changes is disseminated in a wide, timely and effective way.
- 6.5 In addition, in line with usual practice, **we will be evaluating the impact of the reforms to consumer credit legislation once they have been in force for two years.** The evaluation will be carried out in consultation with industry, consumer groups, regulators and others. It will look at whether or not the reforms are achieving the aims set out in this White Paper. **The results of these evaluations will be published.**
- 6.6 This is a major programme of reform. We are committed to acting quickly, effectively, and in partnership to create a framework in which consumers get a fair deal and business the certainty and freedom to continue to innovate.



A close-up, high-contrast photograph of a person's face, focusing on the eyes and nose. The person has dark hair and is looking slightly to the right. The image is set against a dark background, and the overall color palette is dominated by dark greens and blacks. The text "Annexes A, B, C, D, E" is overlaid in white, sans-serif font across the center of the face.

Annexes A, B, C, D, E

Annex A: Measuring the success of our reforms

- 1 We have set out our reform programme with a view to:
 - creating a consumer credit framework that is fair, transparent and competitive; and
 - minimising the number of people becoming over-indebted, particularly among vulnerable groups.
- 2 Whilst changes in the credit market will be influenced primarily by factors such as the overall state of the economy, changes to interest rates and cultural factors, we will monitor the specific measures set out below which in turn will provide important indicators on whether we are achieving our overall outcomes.
- 3 Having identified the areas of the current consumer credit regime which require amendment and set out our proposals in terms of changes, we intend to implement a process whereby we will assess on an ongoing basis the success of these changes.

Consumer Credit Advertising

- 4 *Risk*

There is a difficult balance to strike in ensuring the provision of simplified, yet more prescriptive information. One risk is that consumers will ignore the information provided to them. However, measures to improve financial education of consumers will mitigate against the risk and help to ensure that the improved information is both valued and utilised. Alternatively, regulators may find they receive too many complaints about illegal adverts to resolve them quickly. We will minimise these risks by ensuring that the new advertising regulations are both simple and transparent, so that they are easy to comply with for businesses and easy to understand for consumers.

Measures of success

- 5 We intend to assess:
- whether credit advertisements are clear, fair, balanced and not misleading;
 - whether enforcement authorities are more successful in enforcing compliance with the advertising regulations;
 - whether the costs to business of complying with advertising regulations have decreased.
- 6 The conduct of **annual opinion polls** will be a key way of assessing the success of the proposals. These polls will be aimed at obtaining consumer views on whether the changes implemented have achieved the desired result. The existing MORI poll, undertaken in August 2003, will be used as a benchmark for the first post-implementation poll and thereafter each year's results can be compared against the previous year.
- 7 We will also examine on an annual basis figures for complaints relating to consumer credit advertisements and numbers of advertisements withdrawn or amended as a result.

Form and Content of Credit Agreements*Risk*

- 8 The proposed changes to the form and content of credit agreements should result in a more efficient market, in which consumers are better able to select the products to meet their needs. There is a risk, however, that consumers may not utilise the new information to change the way they purchase products.
- 9 By ensuring the form and content regulations are simple and transparent, resulting in agreements which are easy for consumers to understand, we will reduce these risks significantly. In addition, measures to improve the financial education of consumers should help to ensure that consumers are in a position to understand and use the information provided to them.

- Measures of success*
- 10 The areas we intend to assess include:
- whether consumers have a better understanding of credit advertisements and of APRs;
 - whether consumers have a better understanding of the terms and conditions of their credit agreements, including early settlement costs;
 - whether better information has led to more consumers switching credit products.
- 11 The conduct of annual opinion poll (see 6.11)

Online Agreements

- Risk*
- 12 The question of whether to offer online completion of loans will be a business decision for each lender. The internet is a relatively low cost sales channel which should make it easier for smaller businesses, without a branch network, to enter this sector of the financial services market. On the other hand, some smaller firms may not have the capability to offer online completion of loans, particularly in view of an increased risk of online identity fraud.
- 13 The introduction of the completion of contracts online should result in a more competitive market. Lenders may offer special deals online which exclude those without access to the internet. We recognise this potentially discriminates against lower income, less educated classes and elderly people.
- 14 The conduct of annual opinion poll (see 6.11)
- 15 Furthermore, the Government has a target to ensure internet access for all who want it by 2005. The Office of the e-Envoy is leading work across Government to achieve this objective.
- Measures of success*
- 16 The key indicator of success will be the extent to which credit agreements are being concluded online.

Early Settlement of Existing Loan Agreements

Risk

- 17 The proposals relating to the early settlement of existing loan agreements will bring fees charged on early settlement in line with the actual costs incurred, but will not eradicate them entirely. However, survey data shows that 17% of consumers who repaid a loan early (22% for HP) said that they were unaware of any charge. As such, there is a risk that consumers may remain unaware of any early settlement fees. The requirement to highlight costs in agreements and statements should improve awareness of these fees. Where consumers continue to be unaware of the fees, the proposals will mean that any detriment suffered as a result will be at a lower level.
- 18 In setting the level of the fees to be charged, it will be important to strike a balance between ensuring that the fees are a true representation of cost, so the lenders do not recoup lost revenue through hidden charges or higher APRs, whilst ensuring that consumers do not suffer detriment. The emphasis of the reforms on making clear, comparable information available to consumers should ensure that new hidden charges are not imposed on consumers.

Measure of success

- 19 The key measures of success will include:
- Increased consumer awareness of early settlement fees; and
 - how much consumers have saved as a result of the new early settlement rules.
 - Evaluation of success of measures to improve transparency
- 20 We intend to continue to engage with lenders as part of our stakeholder panel and will actively seek feedback from them on the issues referred to above. In addition, industry trade associations will be able to provide statistics at an industry level from which we will be able to ascertain whether we have achieved our original goals. We will be conducting a poll to this effect two years after these regulations coming into force.

Licensing

Risk

- 21 The responsibilities of the new regime, along with the licence fee and other compliance costs, may act as a barrier to entry to the market. Existing lenders may also withdraw from the market. As a result the supply of credit may be reduced, leading to the possibility that vulnerable consumers could be denied legitimate sources of credit, turning instead to illegal moneylenders.
- 22 We will ensure the new regime strikes a balance between protecting consumers and placing requirements on lenders. In particular, OFT will consult in detail on a revised licence fee structure. The new regime will result in a more transparent and competitive market, encouraging other lenders and alternate providers of credit to enter the market.
- 23 The OFT will be taking a more proactive approach to weeding out unscrupulous licence-holders. It will be important to monitor the success of this approach, adjusting as necessary to ensure the OFT is able to take action against unscrupulous lenders.
- 24 The OFT will ensure guidance is well defined – in terms of when to take action against unfair practices. However, the OFT is reliant on businesses keeping it up to date with their details, if businesses fail do to so, it could make it difficult for the OFT to monitor compliance.

Measures of Success

- Whether OFT action under the new licensing regime has led to improved compliance in those sectors of the credit market which have given cause for concern; and
 - the impact on numbers of licence refusals/revocations and the imposition of licence conditions and penalties.
- 25 Through our ongoing relationship with the OFT we will be able to obtain feedback as to success of the two points referred to above. We will be conducting a review within two years of the legislation coming into force.

Consumer Redress

Risk

- 26 New opportunities for challenging unfair credit transactions may lead to a surge in the number of cases coming before the courts and/or an ADR provider. This may, also, lead to companies withdrawing from the market or, alternatively, increasing prices in order to cover costs. This is expected to be a particular risk for lenders in the sub-prime market. These lenders may have to charge higher prices in order to cover the risk premium, which, in turn, may make them more vulnerable to claims of extortionate credit. Again, there is a risk that vulnerable consumers will be forced to pay more for their loans as lenders withdraw from the market, restricting supply and causing them to turn to illegal moneylenders.
- 27 However these anxieties may overstate the case. One mitigating factor would be if the ADR was not available for existing loans. Additionally, the new standards the OFT will enforce are not likely to go beyond the requirements of the voluntary standards to which many firms, including those who lend to the sub-prime market, are already committed. We would not, therefore, expect to see a diminution in the supply of credit to sub-prime markets, as they are currently defined.
- 28 There is a risk that unscrupulous consumers might try to work the system by defaulting on loans at the point where it would cost the lender more to retrieve the sum than to write off the outstanding debt. This risk would not however be new; such behaviour would make it difficult for such consumers then to obtain credit in the future, but we do not expect this to be a widespread problem.
- 29 The decline in unfair credit transactions will increase consumer confidence in their dealings with lenders who in turn will benefit from a more competitive and transparent consumer credit market. An effectively regulated credit market will benefit both consumers and firms.

Measure of success

- changes in the causes of consumer complaints and how they have been resolved;
- cases on unfair credit transactions going to court or ADR;
- the impact on the number of cases going to ADR.

- 30 Statistics will be available from the body that will assume responsibility for consumer redress. These statistics can be analysed to assess whether the number of complaints has increased/reduced. Court cases can also be assessed. We will be conducting a review within two years of the legislation coming into force.

Over-indebtedness – Debt Advice

Risks

- 31 The telephone debt advice gateway could generate more demand than there is the capacity to handle and it may not be possible to increase capacity in line with demand. Agreement on operational details needs to be reached. The Money Advice Trust is chairing negotiations within the sector and is hopeful that agreement will be possible by the New Year.

Success measures

- growth in the awareness and use of debt advice amongst the over-indebted;
 - whether the formal referral service and new telephone gateway are addressing the lack of capacity, and more consumers are being helped;
 - how satisfied consumers are with the new gateway to telephone debt advice;
 - whether the most vulnerable consumers are being adequately served by debt advice services.
- 32 The Ministerial Group, with advice from stakeholders through the Advisory group, will identify whether there are any remaining gaps in the strategy on over-indebtedness and the steps needed to address those gaps. A progress report will be published in Spring 2004.
- 33 Measures are being developed as a part of the work being undertaken on building a unified debt advice service to monitor its impact on consumers. This will inform future Government policy determining requirements for debt advice services by spring 2004.

Annex B: Draft Regulatory Impact Assessment

1. Title of Proposal

Reform of the Consumer Credit Act 1974

2. Purpose and Intended Effect

(i) The Objective

A competitive and efficient financial sector, of which the consumer credit market is an important part, is essential to raise the level of economic growth in the UK economy. Our vision is to create an efficient, fair and open market where consumers are empowered to make fully informed decisions and lenders are able to compete on a fair and even basis. This framework must also be considered in the context of wider EU commitments.

Devolution

The CCA currently applies to the whole of the UK, with certain special provisions for Northern Ireland. These do not affect the substance of the statutory regime, and the OFT exercises its responsibilities under the Act across the whole of the UK. However, consumer credit is now a devolved matter with respect to Northern Ireland, so, we are discussing with the Northern Ireland Office how these proposed changes should best be reflected there. We are also consulting with the other devolved administrations, as it is intended that the proposed reforms should apply across the whole of the UK.

(ii) The Background

The CCA was introduced in 1974. Its main objective was: 'to provide for the small individual borrower the protection he unquestionably needs without setting up artificial barriers between one sort of credit and another'.⁸⁸ Through the licensing regime, and other targeted regulations, the Act protects borrowers in a number of ways. For example:

- It affords consumers a 'cooling-off' period, allowing the borrower to cancel the credit agreement within a certain period of time;⁸⁹
- A creditor cannot demand early payment, try to get the goods back, or end the agreement without, first, serving a written notice, 7 days before taking action;
- If the borrower has paid a third of the total price of the goods under a HP agreement, then the creditor cannot take the goods back without first getting a court order;
- If a credit agreement is 'extortionate', then the borrower can apply to the courts to ask them to look at the agreement;
- In the case where the seller of goods and the provider of credit are not the same, the borrower can make a claim against either party in the event of non-performance of the contract. For example, in the case of a faulty product, where the supplier is declared bankrupt, the borrower can make a claim against the supplier of credit;
- Certain written information must be provided to the borrower for the credit agreement to be enforceable, including the total cost of credit, the APR, and the cash-price for the goods.

Since the introduction of the Act, the credit market has been transformed – the average level of outstanding debt per person, in real terms, rising from £86, in 1969, to over £2,700, today. Thirty years ago £32m was owed on credit cards, now over £49bn is owed. The range and complexity of credit products and the sales strategies utilised by credit providers have also developed at an unprecedented rate. And the number of licences has increased by over 8,600% since the Act was introduced. The average credit card now has four different interest rates, depending upon usage, and credit is no longer simply sold on the basis of a face-to-face interview. A number of sales channels are now used, including phone, post and the internet.

⁸⁸ Crowther Report (1971).

⁸⁹ This cooling off period is limited to agreements signed away from trade premises, following face-to-face discussions.

Over the last two years we have reviewed the consumer credit market. Our investigations and consultations with a wide range of stakeholders have revealed problems in the consumer credit market, which the reforms outlined in this White Paper aim to address. These problems can be summarised as follows:

- **Informational problems pre purchase:** Consumers need clear consistent information to be able to make informed comparisons between the plethora of products currently available to them. Innovation and evolution in the credit market has benefited consumers through increase choice and flexibility. However many of today's products have become difficult for consumers to understand because they are so complex, and because there is a lack of transparency of standardised information, for example on the way the APR is calculated.
- **Undue surprises post purchase:** Often, problems arising from misinformation occur after a credit agreement has been signed and the consumer is committed. In this way, the widespread use of large early settlement fees and other hidden costs can cause under surprises post purchase.
- **Illegal money lenders:** Illegal money lenders, who are unlicensed and operate outside the CCA, are commonly referred to as loan sharks. These loan sharks not only take advantage of vulnerable lenders but also bring disrepute to legitimate lenders.
- **Over indebtedness:** Aggregate data shows that, while the majority of consumers do not experience any difficulties with borrowing, 20% of households who have credit, experience financial difficulties, while 7% have levels of credit use associated with over indebtedness or unmanageable debt. (Household Survey (op cit 1)).

Since 2001, various focus groups have been held, comprising consumer representatives, lenders, enforcement bodies and the legal profession. These groups have assisted in the first major review of the Act since it came into force.

Throughout the period of this review, we have sought to build a consensus between all the key stakeholders. So far, we have consulted six times on different aspects of the review and have received a total of 362 responses – from consumer groups, trade associations, enforcement bodies, the legal profession and individual lenders, including sole traders.

These formal consultations have been regularly supplemented by meetings of key stakeholders, which have assisted with the development of policy in areas such as advertising and early settlement.

Full details of our consultation strategy can be found in section 10.

(iii) Risk Assessment

Informational problems can result in consumers ending up with the wrong form of credit at the wrong price. It has been estimated that consumers could save £1.9bn a year in interest payments alone by switching to cheaper credit cards.⁹⁰ Assuming similar savings can be made across all unsecured borrowing, this implies an annual consumer saving of £6.1bn if consumers switched to cheaper products.

Hidden charges, large early settlement, and other post settlement surprises can result in over commitment and over expansion of the market. For example 58% of consumers who were unaware of early settlement costs said that, if they had been informed they would have gone to another lender. Hidden costs may also lead consumers into financial difficulty and over indebtedness.

Illegal moneylenders can not only take advantage of vulnerable consumers but also bring disrepute to legitimate lenders. Illegal money lenders often lock consumers into exorbitant rates of interest which can lead to escalating debt while failure to pay can lead to violence and intimidation.

The consequences of over indebtedness are often worse for the lowest income groups and can have serious repercussions, such as eviction, imprisonment, disconnection, or repossession. Overindebtedness in these groups is often linked to financial and social exclusion, and therefore has wider costs for society and the economy as a whole.

⁹⁰ It has been estimated that consumers could save £1.9bn a year in interest payments alone, by switching to cheaper credit cards. This is based on the £52bn outstanding credit card debt moving from the average interest rate of 15.3% to the average of the lowest quarter of 11.7%. (A similar exercise by Which? In June 2002 also estimated this saving to be in the region of £2bn). Assuming similar relative savings can be made across all unsecured borrowing, we estimate that if just 5% of borrowers switch to cheaper loans and credit cards this will generate a consumer benefit of £306m a year.

The challenge of this approach outlined in this White Paper lies in ensuring that any new regulations are able to reduce the risks to consumers posed by the current market, without unnecessarily restricting the supply of credit. The regulations will need to be flexible enough to deal with such a diverse and innovative market.

3. Options

Option 1: *Do nothing.* This option does not address any of the concerns with the current consumer credit framework.

Option 2: *Update the regulatory regime provided by the Act to improve the efficiency and fairness of the credit market.* The proposed regulatory reforms can be split into two broad categories:

A) Establishing a transparent market by refocusing regulation on:

- consumer credit advertising;
- the form and content of credit agreements;
- reducing hidden charges (such as early settlement);
- changes to pre- and post-contractual disclosure;
- ensuring the APR calculation is standardised;
- and aiding innovation by enabling agreements to be concluded online.

B) Reform of credit licensing to create a fair framework that ensures a proper balance between the needs of lenders and borrowers, by:

- providing better powers and sanctions;
- redefining 'extortionate' credit;

- encouraging responsible lending;
- enabling easier consumer redress;
- and abolishing financial limits.

The challenge of this approach lies in ensuring that any new regulations are flexible enough to deal with such a diverse and innovative market, without unnecessarily restricting the supply of credit. At the same time, these regulations must provide adequate protection for consumers.

Option 3: *Establish a voluntary code of practice that addresses the areas highlighted in Option 2.* The difficulty with this approach is that there are over 200,000 credit licence-holders in the UK, and the largest trade associations have only several hundred members.⁹¹ The vast majority of licence-holders are not members of any trade association. This means subscription to any voluntary code would, at best, be slow or, at worst, be minimal. It is reasonable to assume that the rogue traders these measures are designed to target would not be bound by a voluntary code of practice, anyway.

4. Benefits

Option 1: This option has no benefits over the current system, but avoids the risks of increased costs to industry and possible reduction in the supply of legal credit to the less well off associated with option 2.

Option 2: Addressing the weaknesses we have identified in the current regime will empower consumers and encourage competition in the credit market.

Increased transparency will enable market forces to operate more effectively, with both borrowers and lenders benefiting as a result. Those lenders offering the most competitive loan packages prosper, while consumers equipped with more comprehensive information will be able to make smarter choices and, ultimately, benefit from better deals.

⁹¹ The FLA have 188 members; the CCTA have 500 members; the CCA have 500 members; the BBA have 295 members; CML have 144 members. Some of these will be duplicates and not all will offer CCA-regulated loans.

We estimate that, in the long run, there could be a consumer saving in the region of **£381m per year**. This comprises:

- an estimated annual saving of around £306m from consumers obtaining cheaper credit products,⁹²
- a £60m per year saving on early settlement fees,⁹³
- and a £15m a year saving on consumer complaints,⁹⁴ as a result of better informed consumers making better decisions.

Then, there are also the unquantifiable benefits, which include: reduced stress from over-indebtedness, together with reduced time off work through stress-related illness; a more effective smoothing of consumption; greater efficiency driven by fair competition; and increased consumer confidence in the market as rogue trading practices are ended.

Honest, competitive businesses will benefit from reduced costs, saving in the region of £3m per year (although, this figure does not factor-in the industry set-up and ongoing costs detailed in section 5). Clearer advertising and form and content regulations will contribute to a reduction in legal fees, while freedom to complete applications online will help bring down administration costs.

Option 3: The consumer benefits of this option would be similar in nature to option 2. However, they would be on a smaller scale. As noted by the OFT, there is a natural limit to how tight a voluntary code can be, since tightening the code will exclude a large proportion of the market.⁹⁵ Given that a typical voluntary code will achieve 50% sign-up, at best, we could expect 50% of the consumer benefits in option 2. However, this is probably an overestimate as legal traders likely to engage in unfair practices are unlikely to sign up to a voluntary code of conduct.

⁹² It has been estimated that consumers could save £1.9bn a year in interest payments alone, by switching to cheaper credit cards. This is based on the £52bn outstanding credit card debt moving from the average interest rate of 15.3% to the average of the lowest quarter of 11.7%. (A similar exercise by Which? In June 2002 also estimated this saving to be in the region of £2bn). Assuming similar relative savings can be made across all unsecured borrowing, we estimate that if just 5% of borrowers switch to cheaper loans and credit cards this will generate a consumer benefit of £306m a year.

⁹³ Estimated as the difference between the Rule of 78 and an actuarially fair premium on the 70% (estimated by Data Monitor) of loans that are settled early.

⁹⁴ This is calculated as a 10% fall in the consumer detriment in the credit market. Consumer detriment for the industry is taken from the OFT Consumer Detriment (2000) Paper.

Issues of Equity and Fairness

The current system does not provide a fair deal, particularly for sub-prime borrowers who are more likely to suffer from interest rates which represent an exceptionally high risk premium, and other practices that are unfair. At present, it is very difficult for such borrowers to prove that a credit agreement is extortionate. The proposed changes to the Act will protect these consumers by removing unfair traders and better defining extortionate credit and unfair lending practices. Reforming the definition of extortionate credit on variable-rate loans to include the interest rate in later periods, as well as the interest rate at the starting date of the agreement, is a good example of the added protection built-in by the proposed amendments. This is intended to address the problem lenders increase interest rates when the base rate increase; but do not reduce it when the base rate falls.

The reforms proposed will increase competition by removing the possibility for unfair competition through the use of hidden pricing. At present, it is possible for traders to cross-subsidise their products by reducing the headline charge (APR) and regaining the capital on hidden costs, such as default charges, early settlement fees, late fees, administrative costs or alterations to the term.

The balance between lenders and borrowers will also be addressed, where necessary. Early settlement fees based on the rule of 78, which is always in favour of the lender, will be removed and replaced with a fair premium.

⁹⁵ OFT (1996), Voluntary Codes of Practice: A Consultation Paper.

5. Costs

(i) Compliance costs

Option 1: No additional cost

Option 2:

Transitional Costs

Costs for lenders making the transition to the new regulatory framework are estimated to be in the region of £127m. These costs reflect the regulatory reforms as set out in Chapters 2 and three.

These costs consist of IT development and installation, management time, staff training, legal advice (in re-designing contracts), administration costs and increased business risk.

Reforms to the way in which early settlement fees are calculated require businesses to make substantial changes to IT systems. There are also IT costs involved in redrafting the form and content of agreements. In addition, there will, inevitably, be IT costs for those lenders that choose to sell credit products online (in response to the reform to regulations governing online transactions).

General business risk will increase as consumers are empowered through a more effective means of redress, such as the ADR. This empowerment will lead to an initial increased cost to business as current practices are challenged. However, as rogue traders are forced out of the market and problematic practices are eradicated, we would expect the ongoing cost to business to fall. We estimate increased business risk to total £8 million in the first year after the reforms. This represents the cost to lenders of higher consumer complaints than anticipated in the ADR running costs. The transitional business risk is a third higher than the ongoing business risk, to reflect an initial surge in complaints once the service becomes available.

Training staff to use new systems will also impose a substantial transitional cost to business. However, this cost may be mitigated by lenders' staff turnover and ongoing training strategies.

These transitional costs will be mitigated by:

- Allowing lenders a period of preparation and adjustment before implementation is required. (The regulatory reforms of the CCA, as set out in this White Paper, will not come into effect before October 2004. The reforms that require primary legislation will be implemented significantly later.)
- Making the framework as flexible as possible (for example, the removal of the financial limits exemption, will remove the necessity for continual updating of the limit, which has increased from £5,000 to £25,000 since its introduction).
- Simultaneously introducing reforms on transparency (advertising, form and content, online agreements and early settlement), in October 2004, which means lenders will be able to make all the system changes and updates required, in one hit.
- The continued provision of clear guidance by the OFT to enable lenders to adapt to the new framework with minimal disruption.

Compliance Costs

The ongoing impact of the proposed changes to lenders' costs is estimated at £84.4m per year.

The compliance cost, estimated above, results from the licensing fee; introduction of the ADR system; increases in cases going through the ADR system; increased business risk; reduced revenue from early settlement fees; and administration costs from issuing regular statements and possibly dealing with an increased number of early settlements.

The new licensing regime will impose two costs on lenders: the direct cost of the licensing fee and, the indirect cost of complying with these powers. These are the same costs imposed on businesses by the existing licensing regime. The targeted nature of the new regime will need further calculation of the costs specific to different categories of business, and this will be a part of the planned consultation.

We estimate that the ADR system will cost £10m per annum, this is a conservative estimate, and will be reviewed in the forthcoming consultation. Increases in business risk owing to the ADR provision are expected to fall to £6m annually, after the initial transition. There will also be some increase in business risk by allowing the completion of agreements online (through increased exposure to fraud, such as, identity theft – i.e. applying for credit products in someone else's name).

Changes in the calculation of the early settlement fees will reduce business revenue by £60m a year.

Administration costs are expected to total £4.9m, annually.

Option 3:

The transitional and compliance costs of this option would be as option 2, but would only be borne by those lenders who have signed-up to the voluntary code. Assuming a 50% take-up, transitional costs are expected to total £63.5m, and compliance costs are expected to total around £42m. However, there would also be an additional cost of advertising the code of conduct. Ongoing advertising in the press and on radio would be around £500,000 a year.⁹⁶

(ii) Other Costs

We expect that this set of measures will have a negligible impact outside of the credit market. We do not envisage these changes impacting upon the size of the credit market, but do expect the composition of the market to change.

(iii) Costs for a Typical Business

Three types of lenders exist in this market – large lenders, SMEs which are members of a trade association, and SMEs that are not.

The regulation reforms should have a small impact on the costs of larger lenders because these lenders are routinely redrafting and re-printing material, and training staff. They also are likely to have legal and IT staff in-house, and can also recoup these costs more quickly. With an adequate transition period, their additional costs will be very small.

SME lenders who are part of a trade body have greater access to centrally provided advice. This will aid any transition and keep costs relatively low.

⁹⁶ This estimate of the cost is based on prior experience of the Quality Mark and Good Garage Schemes.

We acknowledge that transitional costs may disproportionately fall on SMEs without access to trade association resources. However, we do not envisage that SMEs will find these one-off costs unaffordable or that these costs will place them at any significant competitive disadvantage.

The costs vary substantially between activities. Costs for traders using licences solely for credit brokerage (the most common activity for licence-holders, constituting around 40% of all credit licence-holders) will only increase by the increased licence fee, though those advertising loans may incur some of the costs associated with the advertising regulations. Only licence-holders who engage directly in lending will face the full cost of the reforms.

Breakdown of estimated transitional and compliance costs	
<i>Transitional</i>	Costs
Business risk	£8m
Staff training ⁹⁷	£29.8m
IT	£54.3m
Management time	£9.3m
Legal costs	£11m
Administration costs ⁹⁸	£14.7m
Total transitional costs	£127.1m
<i>Compliance</i>	
Business risk ⁹⁹	£9.5m
Early settlement ¹⁰⁰	£60m annually
ADR	£10m
Administration costs ⁹⁸	£4.9m
Licensing fees	To be confirmed
Total compliance costs	£84.4m
TOTAL COSTS	£211.5m

⁹⁷ There were wide discrepancies in staff training estimates, ranging from £50 per member according to the CCA and £14,600 per member from the FLA. We applied an average cost per member of £7,300 to our estimated number of lenders.

⁹⁸ The CCA predicts administration costs per member of £4,800, we have applied this to our estimated number of lenders, and assumed that 75% of the £19.6m total is transitional cost and 25% is ongoing.

⁹⁹ £3.5m attributed to identity fraud associated with on-line completion (APACS state £25m in identity theft in 2003, we forecast an annual figure of £35m in the future, and attribute 10% of this to on-line completion.) The remaining £6m is ADR risk.

¹⁰⁰ Estimated as the difference between the rule of 78 and an actuarially fair premium on the 70% (estimated by Datamonitor) of loans that are settled early.

Breakdown of Cost by Firm			
TRANSITIONAL	Small	Medium	Large
Business risk	482	588	888
Staff training	1,797	2,190	3,308
IT	3,274	3,990	6,028
Management time	561	683	1,032
Legal Costs	663	808	1,221
Administration costs	886	1080	1,632
Total	7,663	9,340	14,110
COMPLIANCE			
Business risk	573	698	1,055
Early Settlement	3,617	4,409	6,661
ADR	603	735	1,110
Administration costs	295	360	544
Total	5,089	6,202	9,370
Assumed that 25% of lenders are small, 30% are medium-size, and 45% are large			

Risk Assessment

The risks of each individual policy measure are considered in more detail in the respective chapter of the White Paper and in the Regulatory Impact Assessments in the consultation on draft regulations on form and content, online agreements, advertising and early settlement which can be found at the end of this document.

There is a risk that the cumulative effect of the measures proposed in the White Paper could be that the cost of credit rises, especially in the sub-prime market. This, in turn, could make the credit business for small lenders unprofitable and drive them out of the market.

However, collectively, we think this package of policy measures will increase consumer confidence in the entire credit market, including the sub-prime sector. The spur to competition that this generates should allow the more competitive and innovative firms (both small and large) to gain market share, while less competitive lenders are forced out. This will provide benefits to the consumer through lower prices, higher quality, more innovation, as well as giving them the confidence that they are making like-for-like comparisons between products.

There is a small risk that a vacuum will still remain in the sub-prime market, however, there are already signs that larger credit businesses currently operating in the prime market, may branch into the sub-prime sector. A more credible risk is that the reforms increase the cost of lending to the sub-prime market, reflecting the uncertainty of an increased number of challenges to unfair agreements, combined with an already higher-risk premium. However, this should be mitigated over time as case law is developed, providing the average borrower in the sub-prime market with better and fairer agreements, as transparency allows the vacuum to be filled by fairer lenders, and alternate sources of credit such as credit unions, COFI's and other social lenders.

The most difficult issue surrounds extortionate credit provision. The issue of whether these measures restrict credit or not, lies within the nature of the test. If the new test would focus unduly on the cost of credit, this could introduce a de-facto rate ceiling. This, in turn, may have a particular effect on the sub-prime market. However we will bear this risk in mind and aim to avoid it when formulating the legislative factors and guidance to define unfair credit transactions to ensure a balance is struck between capturing unfair practices and not placing onerous burdens on the lender.

6. Consultation with Small Business: the Small Firms' Impact Test

Throughout the period of the review we have engaged with key trade associations whose membership predominantly comprises small businesses. We have also met with the owners of small lending businesses from southern Scotland, north Wales, the north west of England, Swindon, Hull and London. In addition, we have obtained advice from businesses that lend extensively to small businesses in sectors, such as, construction, and from businesses that act as consultants to a variety of small businesses inside and outside of the lending community.

On the basis of this, we have concluded that the reforms do not have a disproportionate impact on small business nor will it restrict the ability of small businesses to obtain credit.

7. Competition Assessment

The impact of the proposals on the consumer credit market was assessed in relation to the consultation responses, and was found to be unlikely to raise concerns about competition. In fact, we consider the proposals to be generally pro-competitive as transparency, certainty, and fairness in the market increases. Any change in the composition of the official lending market will be the result of competitive forces, but will affect small, medium and large firms equally. While smaller firms could incur slightly higher costs in some instances, we expect this to be offset by the benefits in terms of a more transparent, competitive market, with some consumers feeling more confident in approaching smaller lenders as a consequence.

We acknowledge that the transitional and compliance costs of these reforms will place a burden on all lenders. In particular, there is a small risk that this may raise barriers to entry into the market, particularly for small lenders. However, we believe that the compliance costs will be small relative to the vast sums incurred in successful entry into the market in terms of infrastructure, IT, skills, marketing etc and should not therefore represent a significant barrier to entry. At the same time, there are likely to be significant benefits as rogue traders are eradicated from the market and their market share is spread among the fair and honest lenders.

8. Enforcement and Sanctions

While we are proposing significant reform of the regulatory regime, we do not envisage any changes to the existing enforcement arrangements which include criminal and civil sanctions, statutory powers available to the court in relation to the enforceability of agreements, and powers bestowed upon the OFT in relation to advertising for which local authority trading standards departments (TSDs) have day to day authority.

The proposals on licensing will enable the OFT to take sanctions against lenders in a wider range of cases and will, therefore, lead to a larger number of appeals against these determinations. It is predicted, however, that after an initial peak, the number of cases should fall back to their current level as lenders' standards increase. Experience from the FSA shows that businesses raised their game before the introduction of new regulations.

The proposals on extortionate credit are designed to make it easier for the courts to intervene where borrowers are being exploited. It has therefore been estimated that the number of complaints and court cases will increase as the new system is implemented.

We have indicated that we intend to introduce an Alternative Dispute Resolution ('ADR') process for consumers seeking redress. This will provide consumers with an additional form of redress.

The recent DTI survey showed that people are generally unwilling to go through the court process, but would be more willing to challenge the terms of an agreement through some alternative route, such as a third-party intermediary or a financial ombudsman. Therefore, it is anticipated that the number of cases dealing with extortionate credit may increase. However, it is envisaged that these cases should be resolved at no cost to the consumer, although the costs to lenders and traders will increase on the assumption the number of cases increases compared with the number that currently go to court.

9. Monitoring and Review

The Government is committed to conduct a review within three years of any regulatory changes it introduces, utilizing the success measures outlined in Annex A.

10. Consultation

(i) Within Government

We have consulted the OFT, HM Treasury, the Cabinet Office, DCA, devolved administrations, Number 10, the Social Exclusion Unit, DWP, DfES and FCO.

(ii) Public Consultation

The review has been overseen by a board chaired by DTI and comprising representatives from:

- The Citizens Advice Bureau – to provide an understanding of the difficulties experienced by consumers;
- The Finance and Leasing Association – who represent a wide range of lenders;
- The Office of Fair Trading – to provide an overview of the role of the enforcement authorities; and
- An academic lawyer—to ensure that our work takes account of wider legal implications.

We have undertaken six formal consultation exercises:

- July 2001: an overview of the CCA and priorities for reform entitled: Tackling the loan sharks. We received 107 responses to this consultation.
- March 2002: increasing or removing the £25,000 financial limit in the CCA and reviewing the status of some exempt agreements, to which we received 55 responses.
- August 2002: making the regulations on early settlement fair and equitable to both lenders and borrowers, to which we received 38 responses.
- December 2002: we received 35 responses to a consultation paper on enabling lenders and consumers to be able to enter into and conclude credit agreements by electronic means.

- January 2003: we consulted on the reform of the consumer credit licensing regime and received 57 responses.
- March 2003: we received 70 responses to our consultation on the reform of the protections offered to consumers in respect of extortionate credit.

Each of these consultation papers has been issued for a minimum of twelve weeks and has been sent to interested parties, as well as being available electronically on the DTI website.

These formal consultations have been supplemented by a series of meetings with key stakeholders to generate proposals in areas, such as, advertising and the form and content of agreements, and understanding the wider impact of the proposals on lenders. We have also consulted with the FSA, a statutory regulator, and have other consultations planned for the future, as outlined in chapter 6.

Our understanding of the credit market has been supplemented by independent research on:

- Extortionate credit in the UK
- The US credit market
- The Cause, Extent and Effects of Over-indebtedness
- Consumer Credit Awareness survey

Wider social concerns about the rise in levels of consumer debt have been addressed by the Taskforce on Tackling Over-indebtedness, which was set up in October 2000. Its remit was to address concerns about consumer debt in the UK by considering ways of achieving more responsible lending and borrowing. It has reported twice to Ministers and many of their recommendations have been incorporated in this proposal.

Several members of the team have been seconded from major lenders to provide a detailed insight into how regulations are viewed and interpreted. Finally, members of the Civil Service have spent short periods shadowing staff of various lenders to gain a firsthand understanding of the way different sectors within the financial industry are involved in consumer credit.

11. Summary and recommendation

Option	Total cost per annum	Total benefit per annum
1	No additional cost over the current system. Consumer detriment will continue and fair lenders will continue to lose out to unscrupulous lenders.	
2	<p>Increase in ongoing costs estimated as £84.4m, of which:</p> <p>Reduced revenues to lenders from excessive early settlement fees of £60m.</p> <p>Business risk: £6m to allow for the increased risk of being challenged over agreements or practices through the ADR, and £3m for identity fraud, if companies opt for online completion.</p> <p>ADR system cost of £10m</p> <p>Administration costs of £4.9m include more frequent statements.</p> <p>Implementation costs of new regulations: £127.1m of which:</p> <p>IT costs £54.3m, the majority is allocated to early settlement system changes, with the remainder going on form and content and online contractual changes.</p> <p>Staff training: £29.8m</p> <p>Administration: £14.7m</p> <p>Approximately £10m allocated to both legal costs and management time. £8m in business risk has been allocated to account for the initial surge in demand for ADR.</p>	<p>Total benefits of £384m, of which:</p> <p>Consumers benefit from a direct reduction in unfair settlement fees of £60m.</p> <p>We also estimate that consumers will derive £306m in benefit through switching to more suitable loans.</p> <p>Greater competition will bring improvements in price, choice, quality, and innovation. This will benefit both consumers and lenders, with most competitive lenders gaining market share.</p> <p>Businesses will also derive benefit in the region of £15m from fewer consumer complaints, and £3m from lower compliance costs as a result of clearer legislation.</p>

Option	Total cost per annum	Total benefit per annum
3	Based on our assumption of a maximum 50% sign-up rate to voluntary codes of conduct, we estimate the costs to be half those of the above option, and quite possibly less, because, as already mentioned above, the requirements may be less strict.	At best we can expect 50% of the benefits under option 2.

12. Recommendation

It is considered that Option 2 would promote competition, a consistent and fairer deal for consumers and business, and allow confidence in the credit market to grow. These benefits, when considered together, provide a transparent, fair and adaptable framework that will allow the credit market to continue to develop and innovate. Option 2 is consistent with Government objectives to promote competition and empower consumers, while still providing protection for vulnerable groups. This option is expected to promote efficiency and allow savings for business, consumers and Government in the longer term.

ANNEX C: The Cost of Over-indebtedness

This Annex looks at some of the available data on the extent, causes and costs of over-indebtedness.

Extent and Profile

The Household Survey¹⁰¹ identified that some 20% of households were experiencing financial difficulties at the time it was carried out. Of these, 13% were actually in arrears.

It also identified three warning signs indicating that consumers are, either, already over-indebted, or are at risk of becoming over-indebted:

- Spending 25% or more, of their gross income on consumer credit repayments (5% of households surveyed);
- Spending 50% or more, of their gross income repaying their mortgage and other credit commitments (6% of households surveyed); and
- Having four, or more, credit commitments (7% of households surveyed).

Of those surveyed, more households were in difficulties with household bills compared with credit commitments. Household bills, for the purposes of the survey, included mortgages, rent, council tax and utility bills. Evidence from debt advice providers indicates that the majority of consumers are more likely to risk not paying household bills (roughly 4% having arrears in the 12 months prior to the survey, with the exception of mortgages or rent – less than 1.5% having arrears) than credit commitments (roughly 2% having arrears).

Of those people with credit commitments, most had been in arrears over the last 12 months on overdrafts (3%) and credit cards (4%), compared with store cards (1%), mail order (2%) and loans (2%).

This indicates that high levels of borrowing are problematic for only a small number of people. However, a far greater number would, potentially, be at risk of serious difficulties in an economic downturn or a period of sustained increase of interest rates.

¹⁰¹ Op cit 10 or 64.

Of those consumers who are, or are at risk of becoming, over-indebted, the Household Survey identified some particular groups who were more likely to be affected than others. Of those households who had been in arrears over the 12 months prior to the survey, perhaps unsurprisingly:

- households earning less than £10,000 per annum (37%);
- lone parents (48%);
- young householders (32%);
- the newly separated (52%);
- those having a new baby (42%);
- part-time workers (30%); and
- the unemployed (43%),

were disproportionately represented. This means that some of the most vulnerable people in society have a greatly increased risk of being, or becoming, over-indebted, with the consequent costs associated with it. Government policies need to pay particular attention to helping these people.

In comparison, the older the consumer, or the higher their wages, the lower the risk is of their becoming over-indebted.

Causes

Over-indebtedness is typically associated with the following reasons:

- An unforeseen change in circumstances due to unpredictable events, such as redundancy, illness, injury, divorce, family breakdown;
- Mismanagement of resources or over-optimistic future expectations. This includes cases where the consumer has received credit, which they are always unlikely to be able to repay. This can capture both irresponsible lending as well as irresponsible borrowing.

In addition it has been found that over-indebtedness is closely linked with social exclusion and low-income groups, with 35% of low-moderate income families being unable to meet repayments on at least one bill or credit commitment¹⁰². People on low incomes normally borrow relatively small amounts. However, as a proportion of their income, the amount owed is greater than that for borrowers in higher-income groups, and the burden has increased over the last 5 years¹⁰³, placing them at greater risk.

The survey on over-indebtedness¹⁰⁴ identified the following reasons for arrears on household bills and credit commitments.

	<i>Percentage</i>
Loss of income	42
<i>Redundancy</i>	18
<i>Relationship breakdown</i>	6
<i>Sickness or disability</i>	6
<i>Other loss of income</i>	12
Low income	15
Over-commitment	9
Increased/unexpected expenses	11
Overlooked or withheld payment	12
Third party error	6
Debts left by former partner	2
Other reason	3
Base: all in arrears in past 12 months	208

Despite low levels of unemployment, the largest, single cause of financial difficulty was still job loss.

Types of Debt

Results from the CAB evidence report 'In too deep'¹⁰⁵ suggests that 82% of the people seeking advice from CAB have a monthly income of less than £1,199. The table below gives figures (% of debt clients) for the distribution of types of debt by monthly income and how this compares to types of loan and credit which the whole population have.

¹⁰² Family and Children's Study, 2000-2001.

¹⁰³ Audit Commission (2003) "Local Authority Housing Rent Income".

¹⁰⁴ Op cit 2.

¹⁰⁵ Op cit 75.

Clients' Monthly Income				
Type of debt	Up to £399	£400 up to £799	£800 up to £1,199	Whole population
Bank loan	13.7	13.8	15.4	16
Bank overdraft	7.5	5.5	5.6	42
Catalogue	12.2	12.9	10.1	11
Council tax arrears	4.7	4.6	5.5	–
Credit card	14.5	15.6	22.3	54
Finance company loan	9.4	9.7	9.7	–
Fuel arrears ¹	4.7	3.0	1.7	–
Money-lender or home-collected credit ¹	3.5	4.1	3.2	–
Rent arrears ¹	2.4	3.7	3.5	–
Store card ¹	3.9	4.4	4.1	24
Telephone bill	3.9	5.5	2.9	–
Other	19.6	17.2	15.9	–
¹ Limited data in these categories.				
Information taken from CAB Evidence report "In too deep. CAB clients' experience of debt" (May 2003) and Financial Over-Commitment Survey: Research Study conducted by MORI for Citizens Advice (July 2003)				

The Costs of Over-indebtedness

The effects of over-indebtedness can generally be broken down into three categories: the costs faced by financial institutions or creditors; the costs imposed on the individual borrower; and the costs imposed on the State as a whole.

Financial institutions

The largest potential cost facing financial institutions is the increased cost of bad debts and the increase in the contingency fund set aside for non-payment of personal debt. Over-indebtedness may also increase the costs of chasing bad debts through management and administrative time, debt collectors and court fees etc.

These costs are difficult to quantify, though evidence shows that cost of collecting debt has substantially increased in the past five years. For example, in 1995 it cost £70 to start court proceedings for a debt of £1,000 whereas, now, it costs £115, an increase of almost 65%¹⁰⁶. The cost of collecting debts through dedicated collection agencies is in the region of 15-20% of the amount recovered¹⁰⁷.

Below a certain threshold, it is unprofitable for a bank to incur the costs of engaging debt collectors and court proceedings. Any mechanism that enables these lower levels of debt to be repaid will be extremely beneficial to financial institutions.

Individual borrowers

Over-indebtedness imposes various costs on individuals, such as higher stress levels, depression, divorce, health problems, lower morale etc. Many of these individual costs then impose a cost on society, which picks up the tab for dealing with health and housing problems, for example.

Recent research found that 62% of CAB clients were suffering from stress, anxiety or depression, and 43% were receiving medical treatment or counselling for these problems¹⁰⁸. Although it is difficult to isolate the cause of these conditions, debt was highlighted as a contributory factor by all those interviewed and, in just under half of the cases, it was felt to be the main factor.

In 1992, the CBI estimated the cost of mental health and stress-related problems to be in the region of £5bn through lost work days, alone – equalling the total annual losses through theft.

A study published in Finland, screened the mental health of approximately 250 over-indebted households in the City of Vantaa¹⁰⁹. The study concluded that over 70% of the target group suffered from mental-health problems, three times higher than the overall Finnish population.

¹⁰⁶ Op Cit 6.

¹⁰⁷ This charge is average between IDRS, FTS credit services, P & B collection services and VBS.

¹⁰⁸ In too deep: CAB clients' experience of debt (2003).

¹⁰⁹ Nykanen et al (1995), Economical peace in the eye of the storm, Report No 17, Helsinki.

A further study, in Sweden, sampled 500 over-indebted individuals¹¹⁰. This study also showed a marked negative effect on physical and mental health in the over-indebted sample.

Research also shows a clear link between stress and absenteeism, with an estimated 70% being linked to stress-related illness¹¹¹.

Finally, one other cost that may be felt by the individual, over the longer term, is access to future credit lines through falling into arrears or defaulting on debt. Credit rating systems are backwards-looking so penalise individuals for their past credit history, regardless of whether their current and future circumstances have changed for the better. Such a situation could result in the individual paying a higher risk premium over a longer period or time, if indeed credit lines are open at all.

Public expenditure costs

As mentioned above, debt problems that affect individuals, often have further repercussions on public expenditure, imposing direct burdens on services such as the NHS. These health problems will inevitably incur costs on society through healthcare, medication, loss of production (sick absences), rehabilitation, and so on. Similarly, debt problems that result in eviction in the UK, will impose a direct cost on the Government's housing bill. And, the number of people claiming insolvency would raise the legal aid bill.

The decline in productivity associated with over-indebtedness is conservatively estimated to be 30% of salary¹¹². The cost of its workers' financial problems to a company can be estimated by multiplying 30% of a workers' salary by the percentage of the workforce with such problems. The recent household survey on over-indebtedness by Elaine Kempson showed that about a quarter of households reported financial difficulties in the last 12 months and 7% of households had been in financial difficulty for more than a year. Using this estimate, the cost in terms of lost output could be as high as 1% of GDP.

¹¹⁰ Ahlstrom, R (1998), Health and quality of life in severe financial crisis. Preliminary Manuscript.

¹¹¹ Tang, T. L. & M. L. Hammontree (1992) The effects of hardiness, police stress and life stress on police officers illness and absenteeism.

¹¹² IBID.

The US Department of Defence estimates that employee money problems cost it \$1 billion annually. This is despite the military having the best financial counselling programme of any sector in American society. The costs of financial stress include: absenteeism, work time spent on financial matters, healthcare costs, job turnover, commitment to organisational goals, job stress, loss of customers and revenues, accidents and customer compensation claims, substance abuse, workplace violence and employee theft.

Conclusion

The costs of over-indebtedness do not just fall on individual borrowers, they have a much wider impact, affecting financial institutions or creditors, and the State as a whole. Over-indebtedness, particularly among low-income groups, also has a significant negative impact on a number of Government objectives – for example, on eliminating child poverty, welfare to work aims, health inequalities and neighbourhood renewal.

Annex D: Glossary

Term	Definition
ADR	Alternative Dispute Resolution
APR	Annual Percentage Rate
CAB	Citizens Advice Bureau
CCA	Consumer Credit Act 1974
CCD	Consumer Credit Directive
DCA	Department of Constitutional Affairs
DTI	Department of Trade and Industry
FSA	Financial Services Authority
HP	Hire Purchase
Illegal money-lenders	A person who engages in licensed credit activities without a consumer credit licence
NCC	National Consumer Council
OFT	Office of Fair Trading
PPI	Payment Protection Insurance
Rule of 78	Rule of 78 is a mathematical formula prescribed by the CCA governing the early repayment of loans and is based on the fact that borrowers do not pay off interest in equal instalments. At the start of a loan borrowers will be paying off more interest than at the end, even though monthly payments are the same.

Secured lending	Borrowing by a consumer over which the lender has taken a form of security. Over land this could be in the form of a mortgage, but security could also be in the form of an asset such as a car, where the lending is advanced to purchase that asset.
Unsecured lending	Borrowing that is not dependent upon security being provided by the borrower.

Annex E: Definition of Social Grades

The grades detailed below are the social class definitions as used by the Institute of Practitioners in Advertising, and are standard on all surveys carried out by MORI (Market & Opinion Research International Limited).

Social Grades			
	Social Class	Occupation of Chief Income Earner	Percentage of Population
A	Upper Middle Class	Higher managerial, administrative or professional	2.9
B	Middle Class	Intermediate managerial, administrative or professional	18.9
C1	Lower Middle Class	Supervisor or clerical and junior managerial, administrative or professional	27.0
C2	Skilled Working Class	Skilled manual workers	22.6
D	Working Class	Semi and unskilled manual workers	16.9
E	Those at the lowest levels of subsistence	State pensioners, etc, with no other earnings	11.7

Contacting Us:

The Government does welcome any comments and views from individuals and organisations. If you are responding on behalf of a representative group or organisation, it would be helpful if you could make this clear. If you have not already been part of the consultation process and would like to be involved in future consultations on consumer credit issues please contact us.

Please address any comments on the White Paper by **15 March 2004** to:

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Comments can also be sent by e-mail to:

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