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1 INTRODUCTION

1.1 This annexe describes the theories of harm and gives an estimate of the scale of potential detriment in the high-cost credit sector. This estimate gives an indication of the potential scale of benefit in the event that consumer harm could be addressed in full.

1.2 Chapter 2 of this annexe describes the various theories of harm which may apply within this sector, or within some parts of the sector.

1.3 Chapter 3 provides details of the methodology and an estimate of the scale of potential consumer detriment in this sector - that is the direct and theoretical financial loss experienced by consumers as a result of the markets not working well.¹ This analysis is based on aggregated data provided to the OFT by suppliers of high-cost credit.

1.4 Chapter 4 describes the nature of the limitations of this type of analysis and the manner in which the figures presented could be used.

¹ This means, for example, that we do not consider the opportunity cost of higher total repayments (for example, loss of interest on additional savings), or the damages a consumer may have incurred as a result of the high cost of credit (for example, disconnection of a utility because of missing bill payments, or eviction because of failure to pay rent).
2 THEORIES OF HARM

2.1 In this Chapter we set out the three theories of harm that may be relevant to the high-cost credit sector.

Consumers have a limited choice of credit

2.2 Some consumers may only have access to a limited set of credit products, because of their specific situation including area of residence, employment status, credit history and considerations around affordability of the debt.

2.3 These consumers could be at a disadvantage, as it can be reasonably expected that the cheapest credit options are the first to be precluded, leaving only more expensive credit products to choose from. This limited choice of credit enables suppliers to earn higher risk-adjusted margins on the limited range of credit products available to these consumers.

Consumers perceive themselves to have a limited choice of credit

2.4 Some consumers perceive that their choices are more limited than they are in practice. We examine three potential reasons for this below.

Lack of awareness of alternative options

2.5 Users of home-collected credit may be unaware that they may be able to borrow from cheaper sources such as credit unions. In this situation however, the competitive constraint that suppliers of alternative credit impose on each other is weak since the degree of substitutability between products is low in the eye of the consumer.
Lack of understanding of available options

2.6 Consumers with low levels of financial literacy are likely to struggle to compare products with different loan lengths or a different structure of fees, interest rates and other charges. In such cases, consumers are likely to attach little value to available information as they do not obtain significant benefit from it. Since their marginal benefit from gathering and processing information is low, they are unwilling to incur significant search costs.

2.7 Risk-averse consumers prefer to stay with a known supplier that has served them in the past, rather than trying to borrow from a new supplier. The resulting low level of switching lessens competitive pressures on lenders to provide low price or high quality credit products.

Lack of understanding of potential savings

2.8 Consumers may believe that savings available on small loans (by switching to competing suppliers) are negligible. In this situation, consumers have a distorted perception of the marginal benefit they may receive from additional search activity. For example, customer acquisition in the home credit market is based often on word of mouth and reputation. As consumers do not shop around much, they fail to drive competition between suppliers.

Suppliers do not compete effectively among each other

2.9 Limited competition between lenders of high-cost credit can result in high profits being earned by suppliers, irrespective of their level of efficiency. Lack of competitive pressure on the level of price does not force the least efficient players to become efficient or otherwise exit the market. Here we briefly consider the main factors which might sustain limited competition in the sector.
Barriers to entry and expansion

2.10 The existence of barriers to entry could be one explanation for a lack of effective competition in the sector. In the case of pawn-broking, for example, there appear to be economies of scope with retail jewellery (adequate premises, safe storage, ability to evaluate items and an established resale channel), which would put prospective non-retailer entrants at a disadvantage.

2.11 Similarly, in home credit, the prevailing business model based on word-of-mouth and the reliance on agents that live in the neighbourhood could act as a barrier to entry and expansion, as it is costly for a prospective entrant to set up such a network of agents, and to drive customers away from an incumbent lender.

2.12 An entrant in the high cost credit markets would likely face an adverse selection pattern, where it would attract mainly the highest risk customers from the incumbents. This increases the cost of business acquisition faced by entrants compared to established incumbents, and therefore deters entry.

Lack of consumers’ engagement

2.13 If consumers do not shop around and tend to rely on previous contacts and word of mouth when deciding on their borrowing needs, competitive pressure on suppliers is eased and lenders are likely to charge higher prices.
3 **ASSESSMENT OF CONSUMER DETRIMENT**

3.1 In this section we set out our assessment of consumer detriment according to the above theories of harm. In order to assess consumer detriment, we start by considering how much money (on aggregate) consumers could save, if they all used the best available product which was appropriate for their needs, and if competition among lenders was driving prices down. To estimate this, we look in turn at the savings achievable assuming that, holding other things equal:

- consumers are using the most appropriate product for their financial needs
- consumers are picking the best deal available within a product category, and
- lenders are competing more aggressively by offering prices below the current levels.

**The choice of the most appropriate credit product**

3.2 We define the most appropriate product for a consumer’s individual situation as that product which is available to the consumer and minimises the present value of the future stream of repayments, subject to a condition of affordability of such repayments. We examine how these elements affect consumers in the sections below.

**Access to the product**

3.3 We note that each product has specific access requirements that limit the choice of many consumers. For example:

- payday lenders require a proof of employment
- pawnbrokers require a valuable item to be pawned
overdrafts and credit cards require access to a premium bank account and hence a positive credit history, and

credit unions often have conditions, including a common bond (for example, members live or work in a specific area) and/or there may be a requirement that consumers save money, before being granted a loan.

3.4 Our review found that consumers of high-cost credit are less likely to meet these requirements than the average consumer (because, for example, they are more likely to be receiving benefit payments and/or to have a poor credit history)

3.5 Table 1 compares the cost of different products for a loan of £100, based on prevailing prices and use of these products. It shows that there would be potentially large benefits to be reaped, in terms of lower (present value of) overall payments, by allowing consumers the widest possible choice of credit products.

3.6 For example, in the short term, increasing access to mainstream personal current account products (such as arranged overdraft) or to credit cards can be cheaper than a pay day loan. From a slightly longer term perspective, access to credit unions or arranged overdrafts would

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2 The present value of a sum of money is the value today of a future payment or series of payments, discounted to reflect factors such as the time value of money. The present value is a function of the interest rate and the timing of repayments (for example, the length of the loan and the schedule of payments). For example, table 1 shows that full debt repayment via credit card in one month saved more than £10 pounds (in present value terms) compared to repayment of the £100 loan in 6 monthly payments with the same credit card.

3 Such as around four weeks.

4 Such as six to 12 months.
be cheaper than a home credit loan.

Table 3.1 Average cost of borrowing £100 with different credit products

<table>
<thead>
<tr>
<th>Type</th>
<th>Cost</th>
<th>Period (wks)</th>
<th>Pmts per month</th>
<th>Total payments</th>
<th>Present Value at 3 per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payday loan</td>
<td>£25 per £100 lent</td>
<td>4</td>
<td>£125.00</td>
<td>£125.00</td>
<td>£124.69</td>
</tr>
<tr>
<td>Arranged overdraft</td>
<td>19.9% APR</td>
<td>4</td>
<td>£101.52</td>
<td>£101.52</td>
<td>£101.27</td>
</tr>
<tr>
<td>Unarranged overdraft</td>
<td>19.9% APR + £35 in charges</td>
<td>4</td>
<td>£137.06</td>
<td>£137.06</td>
<td>£136.72</td>
</tr>
<tr>
<td>Credit card, short term</td>
<td>19.9% APR</td>
<td>4</td>
<td>£101.52</td>
<td>£101.52</td>
<td>£101.27</td>
</tr>
<tr>
<td>Home credit</td>
<td>300.0% APR</td>
<td>26</td>
<td>£23.16</td>
<td>£150.53</td>
<td>£149.13</td>
</tr>
<tr>
<td>Mail order¹</td>
<td>29.9% APR</td>
<td>26</td>
<td>£17.63</td>
<td>£114.59</td>
<td>£113.52</td>
</tr>
<tr>
<td>Credit card, debt paid over six month</td>
<td>19.9% APR</td>
<td>26</td>
<td>£17.38</td>
<td>£112.99</td>
<td>£111.93</td>
</tr>
<tr>
<td>Credit union loan</td>
<td>26.8% APR</td>
<td>26</td>
<td>£17.52</td>
<td>£113.89</td>
<td>£112.83</td>
</tr>
</tbody>
</table>

Note 1: The relevant comparison here could be based on borrowing a sum greater than £100 to account for the increased price mark-up applied to mail order prices.
Source: OFT analysis

3.7 The factors that limit access to other products are often related to the personal and professional situation of the consumer at the time of the application (and in the recent past, in the case of credit checks). Indeed, the existence of such restrictive access criteria lowers the risk profile of the customer base of products such as arranged and unarranged overdrafts, making them cheaper to provide than more specialist forms of high-cost credit, available to higher-risk consumers.

3.8 However, in other cases it appears that consumers forgo opportunities to borrow from cheaper suppliers (see, for example, the low membership
rate of credit unions, especially in England, compared to Scotland and other countries). Similarly, consumers sometime make genuine mistakes in managing their finances: for example, many customers who inadvertently incur unarranged overdraft charges\(^5\) could be better off with a payday loan (even a relatively expensive online loan).

3.9 The analysis above shows that there is potential for consumers to benefit from carefully selecting which credit product to use. Based on the information available to us, it was impossible to assess the proportion of customers who make a suboptimal choice. For the purposes of this section, we assume that all consumers did choose the most appropriate product for their needs. Whilst this is unrealistic, it minimises the risk of overestimating the detriment in this analysis.

**Affordability**

3.10 A major constraint on the choice of the most appropriate product for a consumer is the extent to which repayments are affordable on an ongoing basis. If the repayment schedule proves unsustainable, the consumer will have to sacrifice other expenditure to stay within budget, or will end up in a spiral of debt which will greatly increase the costs of borrowing. For example, mortgage lenders usually advise that overall debt should not exceed 30 per cent of disposable income. Therefore, a rational consumer will have to trade off affordability with higher overall payments. Table 3.2 below shows how the representative products we compared above have very different impacts on the monthly budget available to people on low incomes.

\(^5\) A survey from Ipsos Mori for the OFT found that only seven per cent of consumers who recently exceeded their arranged overdraft limit genuinely chose to do so. See: OFT, Personal Current Account in the UK: An OFT Market Study, July 2008, Para 4.65
Table 3.2 Affordability of a loan for £100 with different credit products, analysed by percentage of monthly income

<table>
<thead>
<tr>
<th>Annual Income</th>
<th>Monthly Income</th>
<th>Payday loan</th>
<th>Arranged overdraft</th>
<th>Unarranged overdraft</th>
<th>Credit card (short)</th>
<th>Home credit</th>
<th>Mail order</th>
<th>Credit card (6m)</th>
<th>CU</th>
</tr>
</thead>
<tbody>
<tr>
<td>£10,000</td>
<td>£833</td>
<td>15.0%</td>
<td>12.2%</td>
<td>16.4%</td>
<td>12.2%</td>
<td>2.8%</td>
<td>2.1%</td>
<td>2.1%</td>
<td>2.1%</td>
</tr>
<tr>
<td>£12,500</td>
<td>£1,042</td>
<td>12.0%</td>
<td>9.7%</td>
<td>13.2%</td>
<td>9.7%</td>
<td>2.2%</td>
<td>1.7%</td>
<td>1.7%</td>
<td>1.7%</td>
</tr>
<tr>
<td>£15,000</td>
<td>£1,250</td>
<td>10.0%</td>
<td>8.1%</td>
<td>11.0%</td>
<td>8.1%</td>
<td>1.9%</td>
<td>1.4%</td>
<td>1.4%</td>
<td>1.4%</td>
</tr>
<tr>
<td>£17,500</td>
<td>£1,458</td>
<td>8.6%</td>
<td>7.0%</td>
<td>9.4%</td>
<td>7.0%</td>
<td>1.6%</td>
<td>1.2%</td>
<td>1.2%</td>
<td>1.2%</td>
</tr>
<tr>
<td>£20,000</td>
<td>£1,667</td>
<td>7.5%</td>
<td>6.1%</td>
<td>8.2%</td>
<td>6.1%</td>
<td>1.4%</td>
<td>1.1%</td>
<td>1.0%</td>
<td>1.1%</td>
</tr>
<tr>
<td>£22,500</td>
<td>£1,875</td>
<td>6.7%</td>
<td>5.4%</td>
<td>7.3%</td>
<td>5.4%</td>
<td>1.2%</td>
<td>0.9%</td>
<td>0.9%</td>
<td>0.9%</td>
</tr>
<tr>
<td>£25,000</td>
<td>£2,083</td>
<td>6.0%</td>
<td>4.9%</td>
<td>6.6%</td>
<td>4.9%</td>
<td>1.1%</td>
<td>0.8%</td>
<td>0.8%</td>
<td>0.8%</td>
</tr>
<tr>
<td>£27,500</td>
<td>£2,292</td>
<td>5.5%</td>
<td>4.4%</td>
<td>6.0%</td>
<td>4.4%</td>
<td>1.0%</td>
<td>0.8%</td>
<td>0.8%</td>
<td>0.8%</td>
</tr>
</tbody>
</table>

Source: OFT analysis

3.11 There is some anecdotal evidence that consumers of high-cost credit are sometimes over-optimistic and struggle to meet repayments. Consumers would benefit if they could better predict their ability to repay and so choose the appropriate product, and if they better understood the costs that they would face over the lifetime of the product.

Search for the best deal

3.12 In order to find the best deal available within a product category, we created a database of a sample of high-cost credit deals available in 2008. This included information about the characteristics of the product (loan period, frequency of repayments, APR, charge per £100, etc.) and the take-up by the market (number of loans issued and amount lent).

3.13 We analysed pawnbroking, payday lending and home credit individually to assess the potential scale of detriment. We calculated the total
amount of money consumers would have to pay over the lifetime of the loans. We used conservative assumptions (for example, that pawned items are redeemed after only three months, that 100 per cent of payday loans are repaid within the first month, and that there are no delayed payments for home credit loans).

Potential benefits from switching

3.14 We also constructed a counterfactual scenario by picking what we considered to be the best deal available (that is one with the lowest APR or lowest charge per £100) and, holding all other things equal, calculated the potential savings that would result if all consumers had chosen the best deal available (or, if all lenders had priced at the minimum price available). For this counterfactual to be meaningful, the best deal needed to be widely available to a significant number of consumers. Therefore we decided that only products that had a reasonable take-up (specifically, at least 10 per cent of the sample, in value of the loans issued in 2008) could qualify as best deals.6

3.15 We considered that by comparing actual data with the counterfactual we would get an indication of potential benefits from remedies aimed to increase consumer awareness and attitudes towards comparing/switching products, or remedies aimed at reducing search costs.

3.16 Under the above mentioned assumptions, we calculated that consumers could have saved more than £120m (out of £1.68 billion loans in our sample) in 2008 by choosing the best deal price. These savings amount to about 5 per cent of total repayments made by consumer for loans

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6 Given lack of detail information about product availability and access criteria, we considered that non-marginal take-up by consumers is a reasonable proxy for widespread availability.
issued in 2008, or more than 13 per cent of the aggregate charges and interest paid in respect of these loans. If we scale this figure up according to the estimated size of the market, we reach a figure of around £150 million.

Table 3.3 Minimum APR scenarios (£ million)

<table>
<thead>
<tr>
<th>2008</th>
<th>Pawnbroking</th>
<th>Payday loan</th>
<th>Home credit</th>
<th>total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total amount borrowed (OFT sample)</td>
<td>£105.0</td>
<td>£473.5</td>
<td>£1,102.8</td>
<td>£1,681.3</td>
</tr>
<tr>
<td>Total payments (based on APR or Charge x£100, OFT sample)</td>
<td>£127.7</td>
<td>£565.2</td>
<td>£1,899.7</td>
<td>£2,592.6</td>
</tr>
<tr>
<td>Total payments if all loans were min APR (OFT sample)</td>
<td>£127.6</td>
<td>£543.6</td>
<td>£1,800.3</td>
<td>£2,471.5</td>
</tr>
<tr>
<td>Total potential savings (OFT sample)</td>
<td>£0.1</td>
<td>£21.6</td>
<td>£99.4</td>
<td>£121.1</td>
</tr>
<tr>
<td>Savings as % of total repayments</td>
<td>0.1%</td>
<td>3.8%</td>
<td>5.2%</td>
<td>4.7%</td>
</tr>
<tr>
<td>Savings as % of cost of loans (excl. principal)</td>
<td>0.4%</td>
<td>23.5%</td>
<td>12.5%</td>
<td>13.3%</td>
</tr>
<tr>
<td>Estimated market size (value of loans)</td>
<td>£600.0</td>
<td>£900.0</td>
<td>£1,260.0</td>
<td>£2,760.0</td>
</tr>
<tr>
<td>Estimated savings size for the whole market</td>
<td>£0.5</td>
<td>£41.0</td>
<td>£113.6</td>
<td>£155.1</td>
</tr>
</tbody>
</table>

Note: Values are rounded. Individual values may not sum to the total value, due to rounding. 
Source: OFT analysis

Potential benefits from more price competition

3.17 To estimate potential benefits from greater price competition we built on the above exercise and introduced the notion of a new product that undercut existing deals (as a proxy for additional competition).

Switching to a notional undercutting entrant

3.18 The above analysis risked falling prey to a version of the 'cellophane fallacy': there could be no or limited benefits from switching, if all

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7 In its original context, the cellophane fallacy refers to a failure to recognise that an existing monopolist has no incentive to raise the price above the prevailing level, as this is already the profit maximising price. This shall not be interpreted as lack of market power on the monopolist,
players priced at similar, potentially very high, levels. To account for this, the analysis looked at the benefits that a new product which undercut the existing best deal by a small but significant amount could bring about.

3.19 Table 3.4 shows that a five per cent undercut factor increased our estimate of achievable savings to around £190 million when scaled up according to the estimated size of the market.

**Table 3.4 five per cent undercut scenario (£ million)**

<table>
<thead>
<tr>
<th>2008</th>
<th>Pawnbroking</th>
<th>Payday loan</th>
<th>Home credit</th>
<th>total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total amount borrowed (OFT sample)</td>
<td>£105.0</td>
<td>£473.5</td>
<td>£1,102.8</td>
<td>£1,681.3</td>
</tr>
<tr>
<td>Total payments (based on APR or Charge x£100, OFT sample)</td>
<td>£127.7</td>
<td>£565.2</td>
<td>£1,899.7</td>
<td>£2,592.6</td>
</tr>
<tr>
<td>Total payments if all loans were 'min APR' (OFT sample)</td>
<td>£126.7</td>
<td>£540.1</td>
<td>£1,774.6</td>
<td>£2,441.4</td>
</tr>
<tr>
<td>Total potential savings (OFT sample)</td>
<td>£1.0</td>
<td>£25.1</td>
<td>£125.2</td>
<td>£151.2</td>
</tr>
<tr>
<td>Savings as % of total repayments</td>
<td>0.7%</td>
<td>4.4%</td>
<td>6.6%</td>
<td>5.8%</td>
</tr>
<tr>
<td>Savings as % of cost of loans (excl. principal)</td>
<td>4.2%</td>
<td>27.3%</td>
<td>15.7%</td>
<td>16.6%</td>
</tr>
<tr>
<td>Estimated market size (value of loans)</td>
<td>£600.0</td>
<td>£900.0</td>
<td>£1,260.0</td>
<td>£2,760.0</td>
</tr>
<tr>
<td>Estimated savings size for the whole market</td>
<td>£5.5</td>
<td>£47.7</td>
<td>£143.0</td>
<td>£196.1</td>
</tr>
</tbody>
</table>

Note: Values are rounded. Individual values may not sum to the total value, due to rounding.
Source: OFT analysis

4 INTERPRETATION AND LIMITATIONS TO THIS ANALYSIS

4.1 There are a number of practical difficulties in undertaking an exercise of this nature, and inevitably caveats must apply to the interpretation of the results of this analysis.

Interpretation

4.2 The partial equilibrium analysis above shows that it is reasonable to consider detriment from customers’ failure to actively engage with the market to be in the range of zero to £190 million per year.

4.3 We are not able to provide a more precise estimate, as it was not possible, for example, to assess the level of costs incurred by each supplier or the value to consumers of higher quality products (for example, better customer service).

4.4 We note from Table 3.1 that there is potentially substantial detriment occurring from sub-optimal borrowing decisions (that is, the decisions about which product to use). However, we do not account for this in the counterfactual scenarios, as under the partial equilibrium analysis any suboptimal choice would still be made (albeit at a lower price).

Limitations to this analysis

4.5 One of the most significant problems is the very limited availability of information about demand and supply elasticity for specialist credit products:

- Information on demand elasticity was very limited. Lenders who responded to our questionnaire were not generally able to estimate price elasticity of demand for their products. For this reason, it was not possible for us to model the demand curves.
Similarly, information on the supply curves was very limited. As a result, we did not model the supply curves and assumed that all suppliers would be able and willing (given their costs) to serve their 2008 demand levels even at the minimum APR price assumed in the counterfactual scenarios.\(^8\) We also implicitly assumed that, were some of the lenders forced to exit the market, the supplier of the benchmark product and any remaining lenders would be able to serve the whole market at the minimum APR price.\(^9\)

4.6 As a result of these difficulties, we could only carry out a partial equilibrium analysis, whereby actual quantities lent in 2008 by a sample of lenders are held constant in the counterfactual analysis, and only prices are allowed to change.

4.7 Other difficulties arise in assessing whether borrowers are rationally cost-minimizing agents.

- In particular, it was not possible to assess how search costs and bounded rationality affect the optimality of borrowing decisions, without resorting to unacceptably arbitrary assumptions on the likelihood and impact of such errors. For these reasons, in the assessment of detriment we assume, despite some anecdotal evidence to the contrary, that all consumers chose the optimal product for their financial needs (that is, the one which minimized the present value of repayments subject to a condition of affordability).

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\(^8\) We note from our financial analysis that some lenders are incurring losses at their (profit maximising) current prices.

\(^9\) This amounts to the assumptions that the marginal cost does not increase and that there are no capacity constraints for the relevant levels of demand.
• Furthermore, it was not possible to assess how customers value the quality of differentiated products, and in our counterfactual scenarios we implicitly assumed that customers see the benchmark product as a perfect substitute to their actual purchase.

4.8 While price information was ample and reliable,\(^\text{10}\) the choice of the benchmark product is inherently arbitrary. To limit such concern, we assumed that only products which proved substantially successful were eligible as 'minimum APR' products. As a result of this restriction, our benchmark products represented around 40 per cent of all loans issued by our sample of lenders in 2008.

4.9 As a result of the above difficulties, our approach throughout has been to base our estimates on available data and reasonable, conservative assumptions where that data is lacking. We have erred on the side of caution, by using assumptions that depict a world where customers repay their debt quickly (for example, in 3 months, for pawn-broking) and without delays (for example, no renewed pay-day loans, and no late payments in home credit). Whilst this may not always be the case in reality, it minimises the risks of over-stating consumer detriment in our assessment.

\(^{10}\) We have relied on data from the questionnaire we sent to a sample of specialist lenders for quantities and prices of loans issued in 2008, as well as publicly available price information from a variety of mainstream and specialist credit suppliers.