National Audit Office

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL

HC 685
SESSION 2012-13

19 DECEMBER 2012

Office of Fair Trading

Regulating consumer credit

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Office of Fair Trading

Regulating consumer credit

Report by the Comptroller and Auditor General

Ordered by the House of Commons
to be printed on 18 December 2012

This report has been prepared under Section 6 of the National Audit Act 1983 for presentation to the House of Commons in accordance with Section 9 of the Act

Amyas Morse
Comptroller and Auditor General
National Audit Office

12 December 2012

HC 685 London: The Stationery Office £16.00

This report makes recommendations for the future regulatory regime based on an examination of the value for money of the current arrangements. Good value for money in consumer credit regulation means: minimising avoidable harm experienced by consumers, and doing so cost-effectively.

Printed in the UK for the Stationery Office Limited on behalf of the Controller of Her Majesty's Stationery Office

2530648 12/12 PRCS

Contents

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This report can be found on the National Audit Office website at www.nao.org.uk/oft-2012

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Key facts

£176bn	£4.5m	£8.60
was lent to consumers in 2011-12	was spent taking action against individual firms under the Consumer Credit Act in 2011-12	was saved for consumers, for every £1 spent on enforcement

65,000	licence holders are currently trading
At least £450 million	of potential financial harm to consumers is not currently addressed through the regulatory regime
£1,075	is the cost of a consumer credit licence for a partnership or company
£11.5 million	of licence fees were collected in 2011-12

Summary

1 UK consumers borrowed £176 billion in 2011-12 from credit providers such as credit card companies, small businesses offering hire purchase arrangements and payday lenders (this does not include mortgage lending). Consumer credit is important for the economy. It allows consumers to manage cash flows over time. The UK consumer credit market is made up of about 65,000 firms trading with licences to provide credit and related services, such as debt management and debt collection. Around 47,500 of these are defined as 'active' in the market, meaning they have both used their consumer credit licence in the past 12 months and expect to do so in the next 12 months. Of these active licence-holders around half offer financial services as their main business.[1] The others provide credit as an adjunct (for example, retailers offering goods on credit).

2 Many consumers use credit as part of their everyday lives without running into difficulties. However, for others, consumer credit can cause harm. Many consumers have relatively low levels of financial understanding, and may suffer harm if firms behave unfairly, for example by advertising products misleadingly or by withholding information on extra charges. Consumer credit firms are regulated, to protect consumers from harm arising from deliberate or accidental mistreatment by credit providers. If not remedied, mistreatment can result in consumers incurring financial harm, experiencing undue stress, and, in severe cases, can have a wider negative impact such as an increased demand for healthcare.

3 The Office of Fair Trading (OFT) regulates consumer credit in the UK in accordance with the Consumer Credit Act (the Act). Credit providers must be licensed and the OFT, working with agencies such as local Trading Standards services, aims to ensure that only those firms fit to hold or retain a licence do so, and can enforce licensing standards (**Figure 1** overleaf).

4 The OFT will cease to exist in 2014. Most of its activities, but not credit regulation, will be transferred to a new Competition and Markets Authority. The government wishes to change the way consumer credit is regulated and to transfer responsibility for it to the Financial Conduct Authority (FCA), one of the successor bodies to the Financial Services Authority (FSA). The FSA currently regulates other financial services, for example first charge mortgages, payment protection insurance policies and bank accounts.

1 Critical Research population figures (research conducted for the Financial Services Authority).

Figure 1
How the OFT regulates consumer credit firms

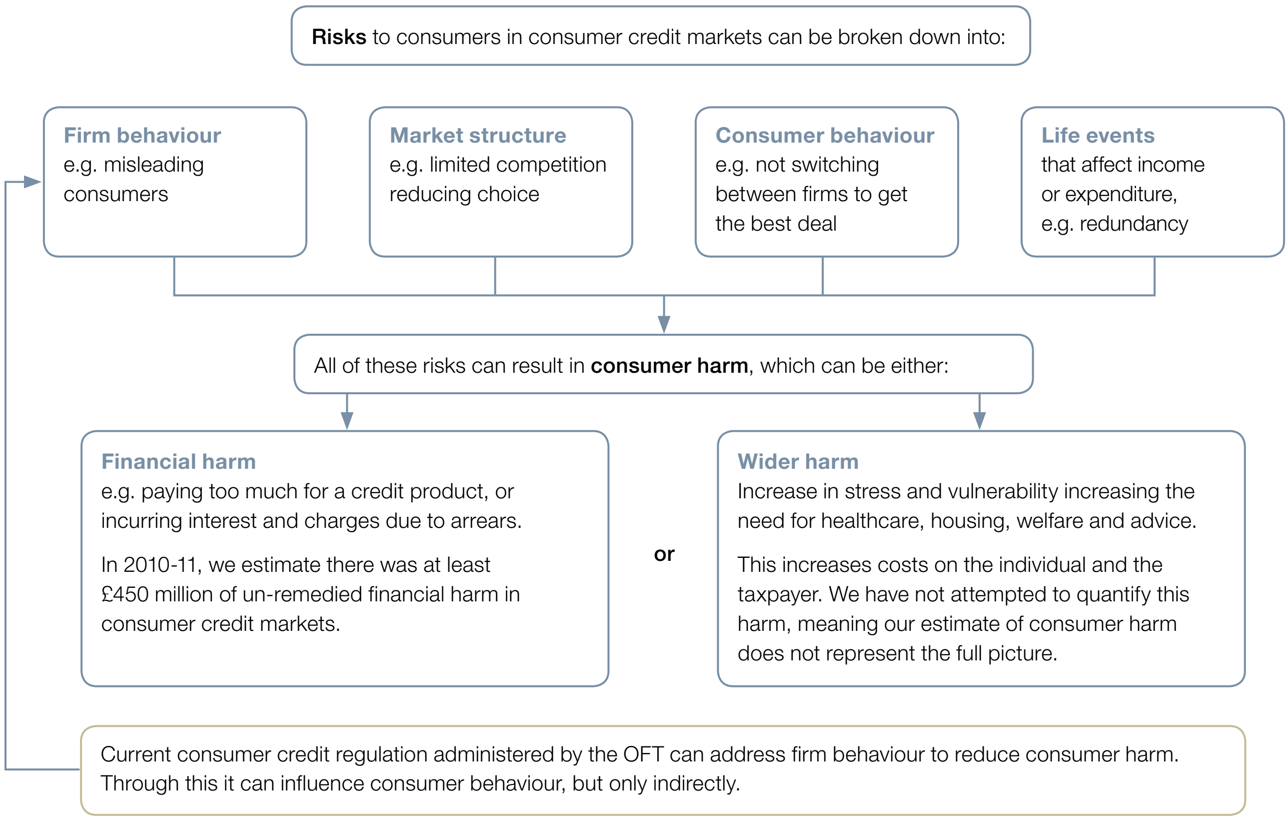
Protections provided by the Act	Risks to consumers if firms do not comply	How the OFT can address non-compliance
Advertising of credit products must not be misleading.	Consumers could sign up to credit agreements without fully understanding the contracts.	The OFT can: • refuse to issue a licence; • issue a licence in different terms from those under which the application was made; • issue warnings; • place requirements on a licensee that affects what credit activities the firm can undertake. For example, the OFT found a payday lender was treating students unfairly and imposed requirements on the firm; • issue a fine if requirements are breached; • revoke a credit licence. For example, a payday lender's licence was revoked for chasing people they should have known had not actually taken out loans; • conduct a compliance review of a sector of the market. The debt management industry and payday lending market have both been the subject of compliance reviews; • issue guidance to help firms become compliant. For example, the irresponsible lending guidance provides greater clarity on what constitutes responsible lending practices; and • if the firm is a member of a trade association the OFT can work with the association to help the firm – and the sector as a whole – become compliant.
Lenders must conduct thorough affordability checks before issuing loans.	Consumers could be given loans that they cannot afford to repay, leading to missed payments, charges and increasing debts.	
All information should be provided to consumers about the terms and conditions of the loan.	If consumers are unaware of all charges they may miss payments and accumulate more debt.	
Doorstep canvassing is prohibited and there is a five-day cooling-off period in which consumers are able to cancel the loan.	Doorstep lending may lead to consumers feeling pressured to take out a loan that they do not really want.	
If consumers have difficulty repaying, firms are required to make reasonable adjustments to help the consumer to repay the debt.	If, due to sudden changes in income, a consumer is unable to repay a loan, it can lead to a spiral of debt.	

Source: National Audit Office analysis

5 This report makes recommendations for the future regulatory regime based on an examination of the value for money of the current arrangements. Good value for money in consumer credit regulation means: minimising avoidable harm experienced by consumers, and doing so cost-effectively. **Figure 2** shows that regulation attempts to minimise harm to consumers resulting from firms' behaviour. It does not directly address risks resulting from consumers' behaviour, or market structure. Harm caused by life events is beyond the control of a regulator. Our report covers:

- the nature of consumer credit markets and risks for consumers (Part One);
- the current regulatory framework, its constraints, and considerations for the design of the new framework (Part Two);
- how the OFT has used its resources to target the areas where the greatest risk occurs (Part Three); and
- whether the OFT's enforcement actions have been effective at reducing financial harm (Part Four).

Figure 2
The relationship between risks, consumer harm and regulation in consumer credit markets



Source: National Audit Office analysis of consumer harm

Key findings

The consumer credit market

6 **The UK consumer credit market is one of the largest in Europe and is rapidly changing.** It includes a diverse range of products, ranging from mainstream credit, such as credit cards and personal loans, to high-cost forms of credit such as payday lending. In October 2012, total outstanding debt was £156 billion, the largest proportion of which was owed in personal loans (paragraphs 1.2 to 1.4 and Figures 3 and 4).

7 **We estimate that unscrupulous behaviour by firms in this market cost consumers at least £450 million in 2010-11, with the most vulnerable consumers potentially most at risk.** Our estimate is based on an analysis of complaints against firms in 2010-11 and only covers direct financial harm, not wider impacts such as increased stress. High-cost credit is the fastest growing sector of the market and is now estimated to account for approximately £8 billion of total lending annually. Consumers of high-cost credit tend to have lower than average financial understanding, lower than average incomes and poor credit ratings or no credit history. In 2009, 46 per cent of consumers of payday loans earned less than £15,499 annually (paragraphs 1.7, 1.9, 4.8 and Figure 8).

The current regulatory regime

8 **The OFT had £11.5 million in 2011-12 to regulate consumer credit, which is not enough given the size of the market and levels of consumer harm.** The OFT funds consumer credit regulation solely from licence fees. The fee structure is not linked to the size of lending provided by firms. A small firm may pay the same fee as a large bank: £1,075 for a consumer credit licence. Most licences awarded since 2008 have been issued indefinitely. A maintenance fee will come into effect from 2013 (paragraphs 2.5 and 3.3 to 3.5, Figures 16 and 18).

9 **The OFT is getting a good return for the money it spends on consumer credit regulation, although enforcement action is not yet minimising consumer harm.** We examined a sample of complaints against firms and estimate the OFT's actions (for example, issuing warnings, revoking licences and imposing requirements on non-compliant firms) benefited consumers by £8.60 for each £1 spent on enforcing regulations. The OFT has achieved a good return for a small outlay. But at least £450 million of harm to consumers remains unaddressed (paragraphs 4.8 and 4.9).

10 The current regulatory regime is not designed to provide a supervisory approach to addressing potential consumer harm. The OFT is not resourced to supervise firms and monitor compliance on a day-to-day basis. It monitors and takes action on firms when it receives information that provides reason to believe there is a particular problem of non-compliant behaviour. Consequently, in order for the regulator to prevent further loss to consumers, in many cases some harm must have already occurred. In 2011-12, 13 firms had requirements imposed on them and 27 firms had their licence revoked. The maximum fine the OFT can impose under the Act, in relation to a breach of a requirement placed on a firm, is £50,000. To date, there have been no cases in which the OFT has imposed a fine under the Act, however, serious breaches of requirements have contributed to decisions to revoke licences (paragraphs 2.3, 2.8 and 2.15 to 2.18, Figures 12 and 13).

11 The OFT has a broad understanding of the issues in consumer credit markets through interaction with key stakeholders but has not quantified levels of consumer harm. The OFT regularly engages with industry and consumer groups and has good working relationships with them. It has also made good use of more informal regulatory tools that do not impose large direct costs on firms, such as guidance to firms and approving codes of self-regulation. However, much better information is needed on levels of potential harm to consumers in credit markets, and how it breaks down by types of products and consumers (paragraphs 2.9 to 2.12 and 4.10 to 4.11).

12 The OFT does not collect information on the level of lending provided by each firm and therefore does not have a quantified understanding of the supply in the market. This, combined with the lack of information about consumer harm, means the OFT cannot provide assurance that its enforcement actions are targeted towards those areas which will have the highest impact, either in terms of number of consumers or level of harm involved. The model used by the OFT to determine the risk level of a credit activity has not been regularly updated since its development in 2007, despite a rapidly changing market over this period (paragraphs 3.9 to 3.11).

13 The OFT does not have an accurate picture of the proportion of its resources spent on different types of regulatory activities. Our analysis indicates that the OFT spent £4.5 million on enforcement actions in 2011-12, approximately £7,300 for each action (paragraphs 3.6 to 3.7 and Figure 19).

Conclusion on value for money

14 The OFT is to be commended for delivering a good return on a small outlay in regulating consumer credit. We estimate it saved consumers £8.60 for each £1 it spent on enforcing firms' compliance with consumer credit regulations in 2010-11. There is still room for improvement in how it delivers its regulatory activities, as weaknesses in its management information mean it cannot be sure it is targeting its limited resources to areas of greatest risk to consumers.

15 However, the regulatory regime under which the OFT operates is not delivering value for money, because it is not minimising harm to consumers from unscrupulous practices. We estimate that the cost to consumers from problems not addressed by regulation was at least £450 million in 2010-11. This is largely due to constraints on the regulatory regime. It has not had enough resources to enable it to regulate effectively, and it has not had all the powers it requires. The government is proposing a new regime. This must target resources to the areas of greatest risk to consumers, and improve on both the current benefit to cost ratio and the total amount of consumer harm prevented, to achieve value for money in future.

Recommendations

a **The risks associated with the transfer of consumer credit regulation to a new regime must be carefully managed.** The Department for Business, Innovation and Skills and HM Treasury must manage the transition between regimes in a way that ensures that through the transitional year of 2013-14 there is an appropriate level of protection for consumers from practices likely to cause them detriment, for example irresponsible lending from firms who are not intending to renew their consumer credit licence under the new regime. The regulator should also carefully manage the transfer of licences and credit agreements to the new regime, considering both the burden on industry and the effect on consumers, who will need to be aware of the protections under the new regime.

b **The new regulator should build on the areas where the OFT has established good working practices and delivered value.** The new regulator should take advantage of the knowledge and experience of OFT staff by retaining these staff after their transfer. The OFT has positive relationships with both consumer and industry groups, which have allowed it to better understand the issues affecting consumer credit markets. In some cases these relationships have allowed for the effective use of 'unofficial enforcement actions' such as industry codes and guidance. The new regulator should consider using these where it deems it appropriate.

c **The regulator should develop a proportionate licensing regime that takes into account the market share of firms when collecting data and licence fees.** This would ensure the regulator has an appropriate level of resources to regulate with. The new regulator should collect sufficient, regularly updated information about the firms that it regulates, including credit activities they supply, size of firm and levels of lending. More detailed information about the size of firms and the risks they pose to consumers could allow the new regulator to develop a licence fee system that would protect smaller firms from overly large increases in cost. This will improve the resources available for reducing consumer harm and maintain consumer confidence through the proportionate allocation of costs to firms according to size.

d **The new regulator should deal with risks to consumers before they occur, where possible.** In order for the regulator to be more proactive it should collect more information from firms on a regular basis. This would allow it to have a better understanding of market supply and to monitor the changing risks to consumers. The design of the new regulatory regime should also consider granting the regulator power to intervene at the product level, if necessary, to be more effective in minimising consumer harm by addressing risks associated with market structure.

e **The new regime should be held accountable for targeting its actions in the most cost-effective way.** The regulator should develop an evaluation framework to assess the impact of its enforcement activity. This should include an assessment of the costs of its different types of enforcement actions, including compliance costs to industry, a measure of potential harm across consumer credit markets, and how this is distributed between different groups of consumers.

Part One

Consumer credit markets and risks to consumers

1.1 This part of the report explains the structure of the consumer credit market in the UK. It shows the following:

- The UK has one of the largest levels of consumer credit as a proportion of GDP in Europe. The market is diverse and continually evolving.
- Many consumers have relatively low levels of financial understanding. Consumers may suffer harm if risks, such as unfair behaviour by lenders, are not properly monitored and addressed.
- Despite consumer credit regulation, we estimate that consumers may have suffered losses of at least £450 million in 2011-12 from problems that regulatory enforcement did not address.

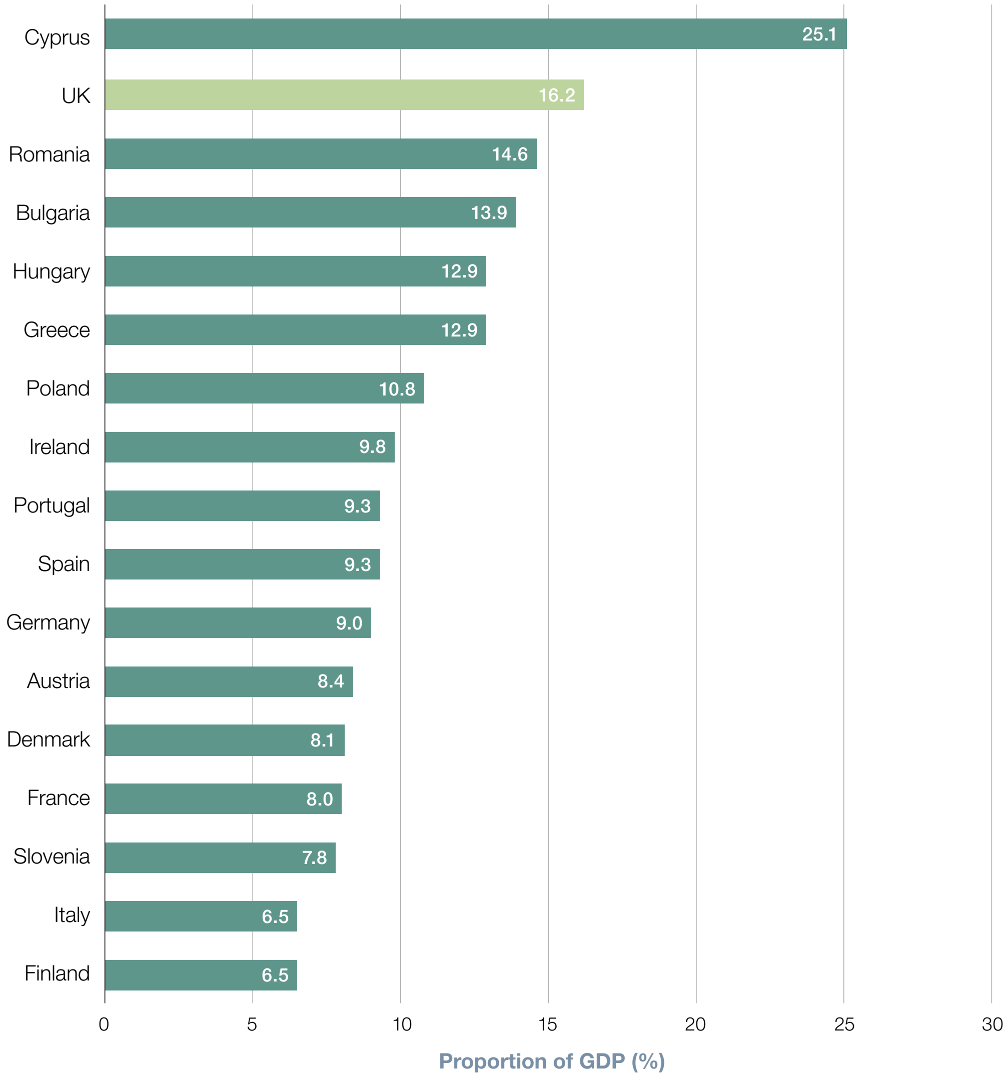
The UK consumer credit market

1.2 The UK has one of the highest levels of consumer credit as a proportion of GDP in the EU, standing at more than fifteen per cent in 2008 (**Figure 3**). Since 2008, consumer credit has fallen by 33 per cent as a proportion of GDP in real terms. In August 2012, the total value of debt outstanding on credit cards was £54 billion, and the debt outstanding on other credit products such as personal loans was £102 billion.

1.3 Different people use credit for different purposes. Many use it to manage their finances, for example by using credit cards to smooth variations in their income over time. Others use credit to purchase one-off items that they then wish to pay off over time, such as taking out a personal loan to purchase a new car. Different types of consumers participate in these markets in different ways. For example, consumers may participate in high-cost credit markets because they are unable to access mainstream credit due to a poor credit history or low income. These types of consumers may need to use credit to purchase everyday items rather than luxury goods. 'Consumer credit', therefore, covers a large range of products. **Figure 4** on page 14 shows the main consumer credit products and, where data are available, estimated values for each of the sectors.

Figure 3
Consumer credit as a percentage of GDP

The UK has one of the highest levels of consumer credit as a proportion of GDP in the EU



Source: Consumer Focus, Affordable credit: Lessons from overseas, 2008

Figure 4
Consumer credit in the UK

Consumer credit market

Mainstream credit	Non-mainstream credit Estimated to be £7.5 billion in 2008	Credit services
Overdrafts Money made available from a bank account resulting in the balance going below zero. Estimated £8.7 billion in outstanding overdrafts in July 2012. **Personal loans** A loan of money, granted at a rate of interest, usually not secured on an asset. Estimated £36 billion in outstanding loans in July 2012. **Credit cards** A payment card allowing the cardholder to purchase goods and services based on a promise to pay for them in the future. Total debt of £66.2 billion in 2011. **Store cards** As a credit card, however, issued by a single retailer and only usable with that retailer. In 2011 £1.83 billion was spent on store cards. **Hire purchase** A contract in which a person pays a monthly rent for goods over a specified time period. The goods can then be purchased at the end of the period for an agreed sum. **Goods on finance** A contract in which a person agrees to pay for goods in parts over time.	**Payday loans** Short-term unsecured loan. Estimated £1.9 billion in 2010. **Home credit** Unsecured loan in which the consumer's home is the point of sale. Home lending valued at around £3.5 billion per year. **Credit union loan** Loan provided through a member-owned finanical cooperative. Approximately £0.6 billion paid out in 575,000 loans to members. **Pawnbroking** Secured loans in which a consumer provides a personal item as collateral. Pawnbroking market worth around £0.5 billion. **Logbook loans** A loan secured on a consumer's vehicle.	**Debt adjusting** A company providing services to help consumers manage multiple debts. Commercial debt management companies (DMCs) make about £0.3 billion a year from fees. **Debt collecting** A company which collects debts on behalf of other firms. **Debt counselling** A company or charity that provides advice to consumers in dealing with multiple debts. **Credit brokering** A company that links a consumer with a company offering credit. **Credit information services** A company that collects and disseminates information about the credit history of consumers.

NOTES

1 Overdrafts: British Bankers Association, Table 6, Historical time series tables, July 2012. Available at: www.bba.org.uk/statistics/article/july-2012-figures-for-the-main-high-street-banks/high-street-banking/

2 Personal loans: British Bankers Association, Table 6, Historical time series tables, July 2012. Available at: www.bba.org.uk/statistics/article/july-2012-figures-for-the-main-high-street-banks/high-street-banking/

3 Credit cards: International Financial Law Review, Legal changes threaten credit card yield, 2006.

4 Store cards: Which?, Hold all the right cards, December 2011.

5 High cost credit: Office of Fair Trading, Review of High Cost Credit, June 2010.

6 Payday loans: Which?, The loan danger, October 2011.

7 Home credit: Consumer Credit Association, website accessed September 2012. Available at: www.ccauk.org/about-us/membership-statistics/

8 Credit unions: Association of British Credit Unions, website accessed September 2012. Available at: www.abcul.org/media-and-research/facts-statistics

9 Pawnbroking: The National Pawnbrokers Association of the UK, website accessed September 2012. Available at: www.thenpa.com/press-and-media/keyfacts.asp

Source: National Audit Office analysis

1.4 Credit cards account for most of the credit within the UK with more than 32 million card accounts active in 2012.[2] Following the financial crisis and a decrease in mainstream lending, other types of lending have increased. For example, payday lending has increased from approximately £100 million in 2004 to £1.9 billion in 2010,[3] with the number of customers increasing significantly to 1.9 million.[4]

1.5 Other types of lenders, such as payday and home credit, provide credit to consumers who are unable to access mainstream credit. **Figure 5** shows that these types of credit come at a significantly higher cost to consumers. For example, borrowing £100 from a mainstream credit card and paying back in full after making just the minimum payment in the first month would cost consumers £1.44. However, the same loan through a payday lender would cost the consumer approximately £37. Concerns have been raised over the business models of high-cost credit providers on the grounds that lending at this high cost is unfair because it does not accurately reflect the risk of default.

Risks to consumers in credit markets

1.6 There are four main areas of risk for consumers in credit markets: firm behaviour; market structure; consumer behaviour; and life events (**Figure 6** overleaf). Many consumers do not understand financial matters. For example, research has found that almost twenty per cent of consumers do not understand whether a higher or lower Annual Percentage Rate (APR) figure represents a better deal. They may be more vulnerable than consumers in other markets.

Figure 5
Cost of mainstream credit compared to other types of lenders

Lender	Cost of credit (£)	Approximate APR (%)
Short-term lending of £100		
Credit card – £100 for 60 days	1.44	17.9
Payday loan – £100 for 30 days	37.00	4,214.0
Longer-term lending		
Personal loan £1,000 for 12 months	120.00	23.9
Home lending £500 for 52 weeks	410.00	272.0

NOTES
1 The cost of credit for the credit card assumes the consumer makes only the minimum payment in the first month and then pays the full balance in the second month.
2 These prices are examples of lenders in UK consumer credit markets in November 2012.

Source: National Audit Office analysis

2 British Bankers Association, Credit Card Statistics, July 2012. Available at: www.bba.org.uk/statistics/credit-card-market/
3 Which?, Written evidence to Department for Business, Innovation and Skills Committee Inquiry into Debt Management, November 2011. Available at: www.publications.parliament.uk/pa/cm201012/cmselect/cmbis/1649/1649we35.htm
4 Department for Business, Innovation and Skills Committee – Fourteenth Report: Debt Management, February 2012. Available at: www.publications.parliament.uk/pa/cm201012/cmselect/cmbis/1649/164902.htm

Figure 6
Risks in consumer credit markets

Firm behaviour	
Undue pressure placed on consumers	This can occur when the loan is agreed in the consumer's home and can result in consumers taking on loans they do not need. This is a particular concern in **home lending**.
Providing unaffordable loans	Firms are required to undertake an affordability check before issuing a loan to ensure the consumer can repay. Affordability checks conducted by some **payday lenders** are not thorough, and additional checks are sometimes not completed for repeat customers.
Payroll structures incentivise staff to sell unsuitable products	If employees of firms are rewarded for issuing loans, consumers may be given unaffordable loans. **Credit brokers** may be incentivised to offer unsuitable products because they are paid by commission. They may also over-inflate the credit worthiness of an individual. Additionally, **DMCs** report that some companies offer high commissions to financial advisers who push a client into more expensive debt solutions.
Misleading information provided to consumers	If consumers are given misleading information about a product, they could make poor decisions. Consumers like **high-cost credit** because of the ease and convenience. Advertising for high-cost credit focuses on accessibility rather than cost. This can mislead some consumers.
One firm acts on behalf of another but not in their best interests	This is when one firm, although acting on behalf of a second firm, ensures that their own costs are covered ahead of the second firm. Some **DMCs** front-load fees to ensure they are fully paid before they begin to pay the customer's debt. This can lengthen repayment time and increase the total amount owed.
Market structure	
Information asymmetry	When the consumer has less information about options than the lender. Consumers find it difficult to compare **personal loans or credit cards** on a like-for-like basis as not all firms calculate interest in the same way, and firms tend to provide different types of information. APR is used as a standard measure of comparison, however this can often be confusing for consumers (see Figure 5).
Lack of information sharing with credit reference agencies	When firms do not share lending information with credit reference agencies it distorts consumers' debt history and impacts future credit. For example, not all **home or payday lenders** share their information with credit agencies.
Some barriers to entry exist, limiting consumer choice	When firms face large obstacles before entering a market this can reduce the level of competition in the market. In the **home lending** market a new entrant would need to have a large localised field force of agents in order to compete with the larger home lenders.
Reduced options for consumers preventing price competition	Little consumer choice reduces competition and the chance of a good deal. The use of exclusivity agreements between lenders and **credit brokers** may limit consumer choice. Brokers sometimes source their credit from only a few lenders, offering consumers less competitive credit deals.
Consumer behaviour	
Using 'rules of thumb' to choose products	Consumers take shortcuts to make decisions, resulting in poor choices. In 2010, the OFT estimated consumers could save up to £120 million if they looked for the best credit deals in **high-cost credit** markets.
Consumers tend not to switch	Staying with the same credit supplier can cost consumers money. For example, **loan and credit card** companies offer teaser rates to entice consumers before charging more.
Consumers can feel overconfident in their circumstances	Consumers can overestimate their ability to pay off debts on time, not looking at the cost of missing payments before taking out a product. **Credit card** companies therefore may under-price the cost of credit to sell more cards, and overprice penalties and charges to compensate.
Life events	
Income or expenditure changes	A reduced household income can lead to debt. Redundancy, a decrease in wages, unemployment or a relationship breakdown can affect income or costs of living. All of these events can lead to life no longer being affordable.

Source: National Audit Office literature review on problems facing consumers in credit markets

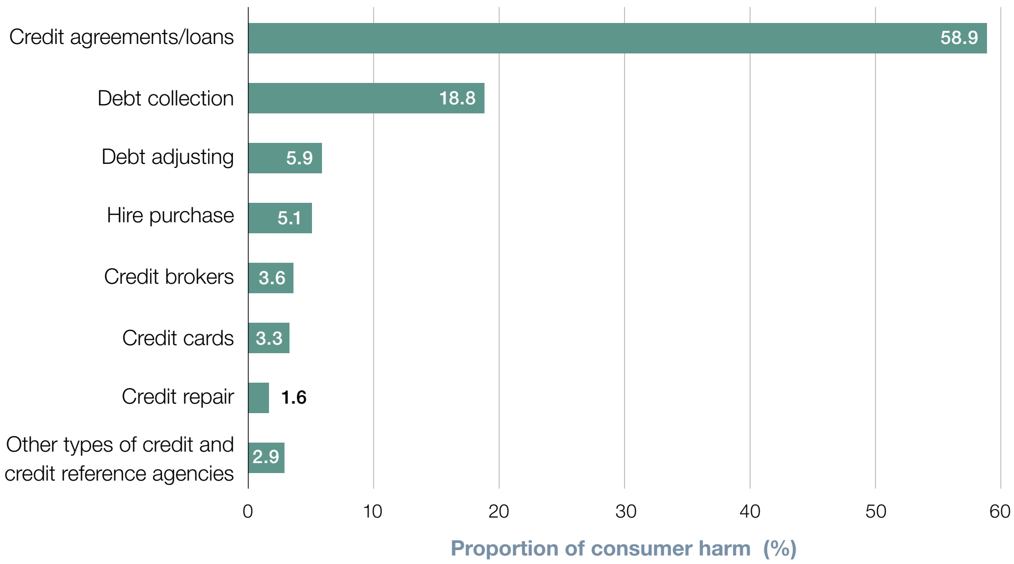
Levels of financial harm

1.7 Risks to consumers in credit markets can result in harm. We conducted our own analysis of consumer harm in credit markets, by quantifying financial harm to consumers. Financial harm includes, for example, paying too much for a loan, paying unfair late payment charges or facing unfair debt management fees. This is discussed in more detail in Part Four together with some of the impacts associated with wider harm. We estimate that in 2010-11, the Office of Fair Trading (OFT) saved consumers £8.60 for each £1 it spent on enforcement actions against unfair lending practices. Over the same period, we estimate consumers may have lost at least £450 million from problems not addressed by the OFT's actions.

1.8 **Figure 7** shows how potential financial harm to consumers breaks down across different market segments, in as far as it is possible to do so. More than half the total in 2010-11 occurred in the credit agreements and loans market, and about a quarter in the debt collection and debt adjusting markets.

Figure 7
Consumer harm in consumer credit markets

Consumer harm differs across different consumer credit markets



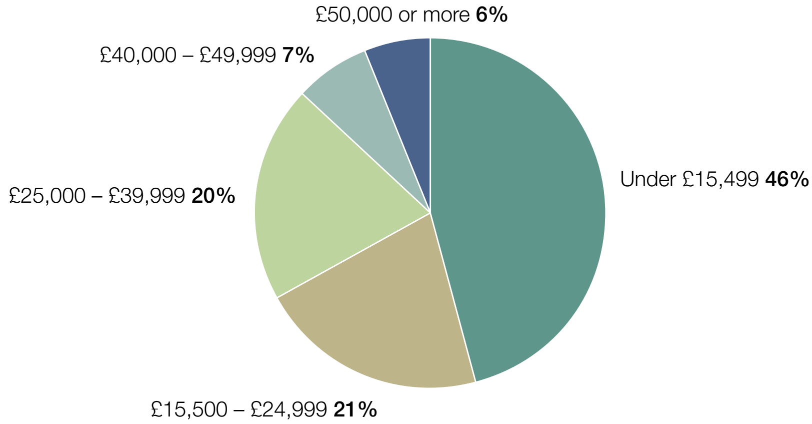
NOTE

1 See Technical Paper accompanying this report for calculations. Available at: www.nao.org.uk/oft-2012.

Source: National Audit Office analysis from Consumer Direct database

1.9 The most vulnerable consumers can be most at risk of financial harm as they can be forced to pay more for credit. The OFT's review of the high-cost credit market in 2010 found that there are a number of characteristics and behaviours exhibited by consumers of high-cost credit. For instance, they tend to have a lower than average income and educational background. Consumers of high-cost credit also tend to have poor or damaged credit ratings, or in some cases no credit history at all. **Figure 8** shows that in 2009, nearly half of payday loan customers have an income of below £15,499.

Figure 8
Proportion of payday loan customers in income groups



Source: Consumer Focus 2009

Part Two

How lending is regulated

2.1 This part of the report outlines how consumer credit is currently regulated in the UK, and the powers the Office of Fair Trading (OFT) has to carry out this regulation. It shows the following:

- How the OFT licenses providers of consumer credit.
- That the OFT must in practice react to intelligence to direct its enforcement actions, rather than monitoring firms on a day-to-day basis to ensure compliance with licence standards, as it does not have the resources to take a supervisory approach.
- How in some cases the OFT makes use of additional regulatory tools including guidance and self-regulation.
- How the regime for credit regulation will change in future, which presents opportunities, but also risks to be managed.

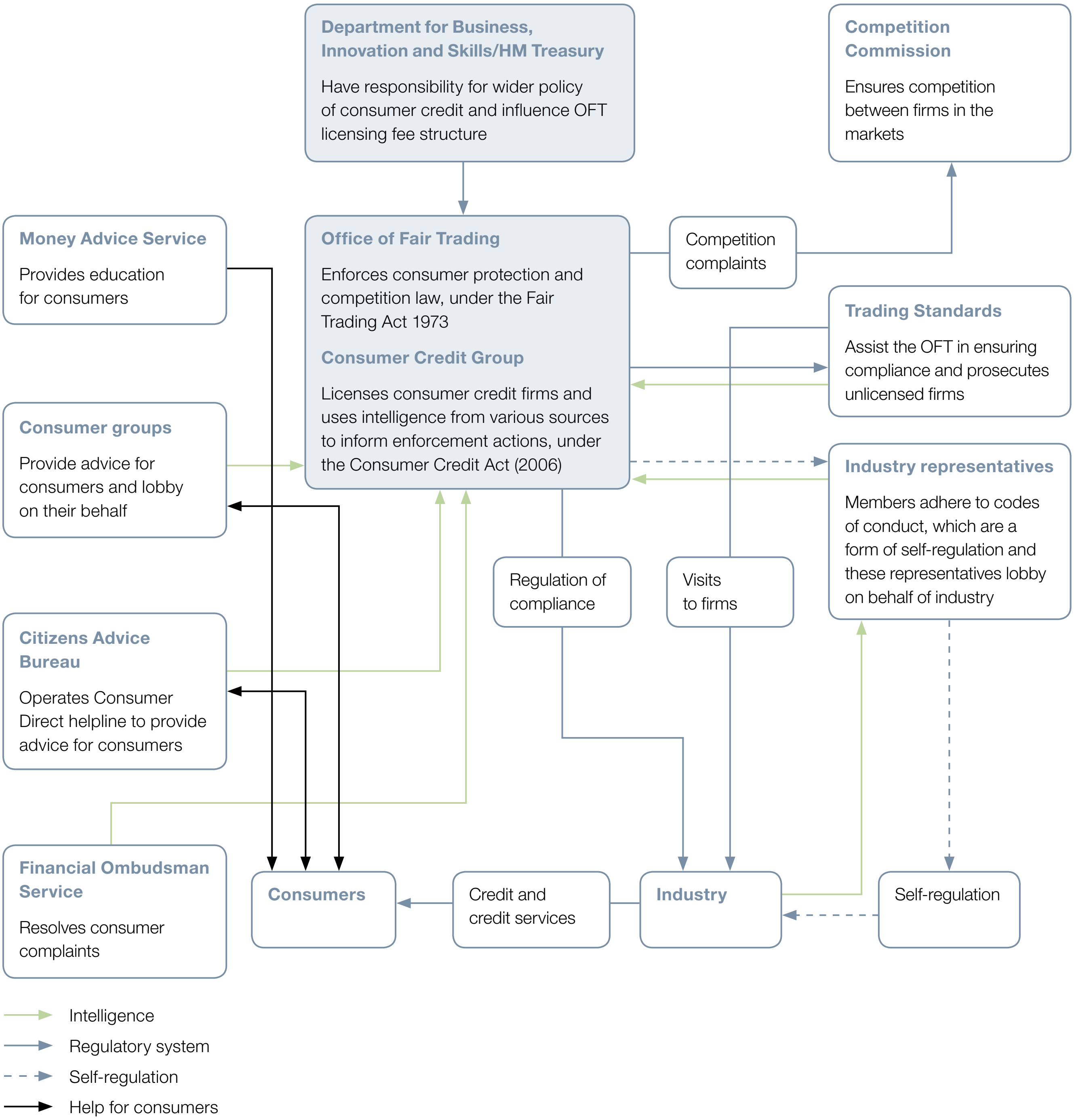
Regulating consumer credit

2.2 The Consumer Credit Act[5] (the Act) requires firms that lend money to consumers, or supply goods on credit, to hold a credit licence. The Act also regulates the way these firms conduct their business. Trading in credit activities without a credit licence is a criminal offence. Tackling illegal moneylending is in practice enforced by local Trading Standards services and regional illegal moneylending teams,[6] with the OFT taking occasional cases.

2.3 The OFT is responsible for issuing consumer credit licences and regulating the conduct of firms in accordance with the Act. The OFT has powers of investigation and enforcement and a duty to monitor licensed firms as it sees fit, coupled with a power to demand information from them. The current regime is not, however, designed to operate a supervisory approach to oversee the behaviour of firms. This means that the OFT is not resourced to monitor the behaviour of licensees on a day-to-day basis, but investigates when it learns that firms have not complied with the Act. It collects this intelligence from a number of sources including consumer groups and trade associations. **Figure 9** overleaf outlines the regulatory landscape.

5 Consumer Credit Act 1974, updated 2006.
6 See Comptroller and Auditor General, *Protecting consumers: the system for enforcing consumer law,* Session 2010–2012, HC 1087, National Audit Office, June 2011.

Figure 9
Consumer credit regulatory landscape



Source: National Audit Office analysis

Licensing consumer credit

2.4 Firms generally apply for a consumer credit licence through the OFT's online system. There are nine different categories of licensable activity a firm can apply for, depending on its activities (discussed further in Part Three). The OFT keeps an online register of firms who have applied for, and been granted, credit licences. **Figure 10** shows the number of current licences has been falling since 2008. This is due both to fewer new licences being issued and a declining rate of firms renewing existing licences.

2.5 Under the current licensing system, firms pay a fee for the consideration of their licence application and – for some, but not all applicants – a levy to the Financial Ombudsman Service, an alternative dispute resolution scheme that settles complaints between consumers and financial services firms. Prior to 2008, a consumer credit licence needed to be renewed every five years. However, following changes to the Act, the majority of licences awarded since 2008 have been issued indefinitely. A maintenance fee will come into effect from 2013.

2.6 Approximately seventy per cent of licence applications go through after the completion of preliminary checks for issues such as criminal records and insolvency. However, those licence applications that are for higher risk activities, or which pose some kind of problem, undergo further assessment within the Gateway (**Figure 11** overleaf), based on an analysis of information about their competence.

Figure 10
Consumer credit licences

Year	Applications received	Licences issued	Current licences
2004-05	15,400	16,600	
2005-06	14,900	14,100	
2006-07	16,500	13,900	
2007-08	15,200	15,400	
2008-09	10,600	10,600	113,700
2009-10	8,500	8,500	101,500
2010-11	7,600	7,100	91,200
2011-12	6,800	6,700	82,200

NOTE
1 No data available for total number of current licences before 2008-09.

Source: Office of Fair Trading

Figure 11
Gateway

Role of the Gateway team within the Consumer Credit Group

The Gateway team within the Consumer Credit Group is a dedicated team who hold responsibility for investigating the fitness and competence of firms and individuals applying for a consumer credit licence. This team aims to ensure that only firms with the necessary integrity hold a consumer credit licence. It is an important regulatory tool as it prevents those who are unfit from holding a consumer credit licence and potentially treating consumers unfairly.

Source: Office of Fair Trading

Enforcement actions

2.7 The enforcement team within the OFT takes action based on adverse intelligence received from various sources, including consumer complaints, the actions of other regulators and notifications about criminal records or bankruptcy. **Figure 12** shows the process that is followed.

2.8 There are a number of possible outcomes from the OFT's enforcement actions. Some of these are informal measures to assist firms in becoming compliant with the Act. Other actions, such as imposing requirements on a firm which are aimed at putting a stop to past poor practices, or removing a licence altogether, are formal measures. These can take longer to impose as due process must be followed, allowing firms the opportunity to make representations and appeal. **Figure 13** on page 24 provides examples of recent regulatory actions taken by the OFT against consumer credit firms.

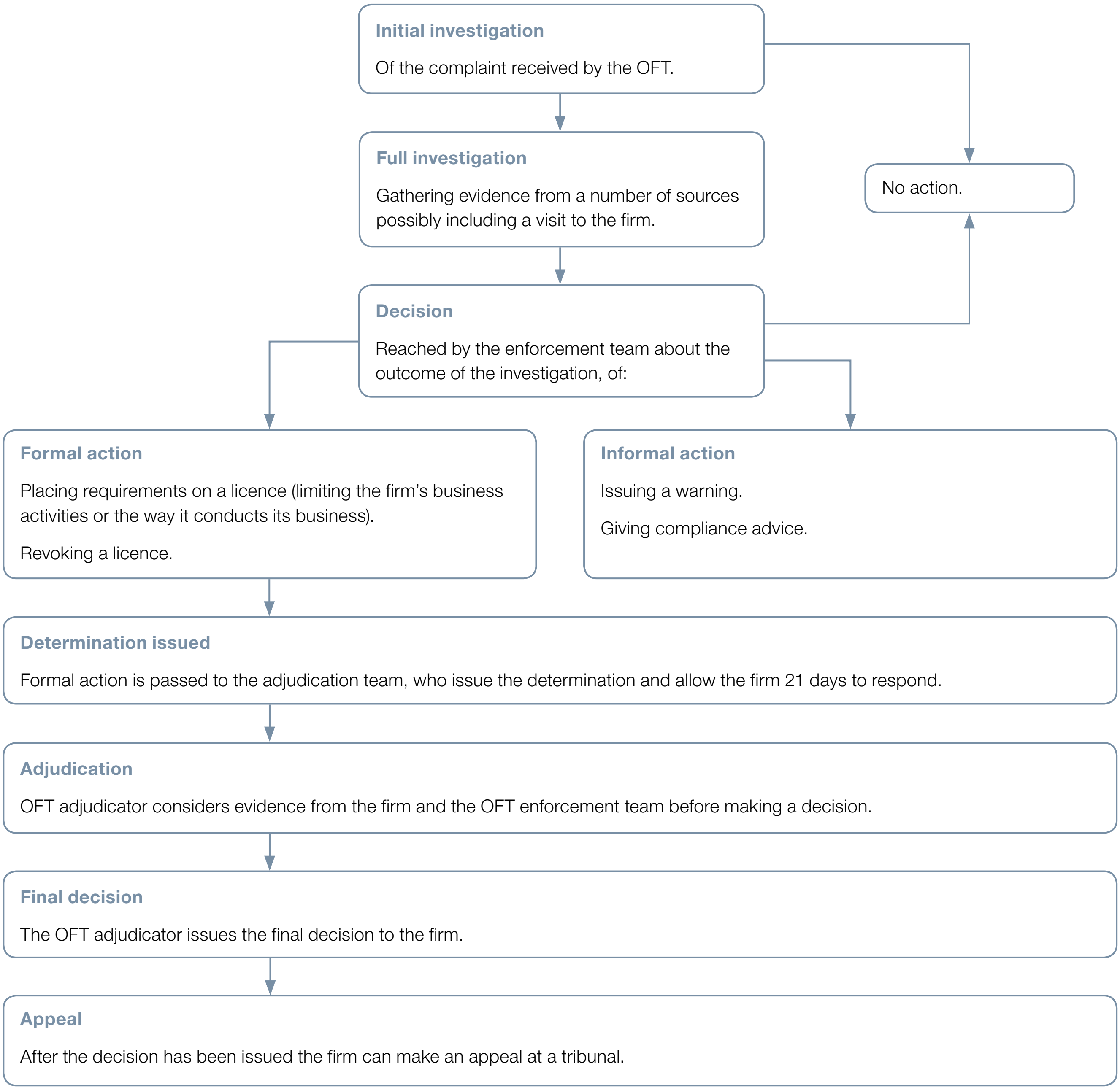
Additional regulatory tools

Guidance

2.9 The OFT issues guidance to improve compliance, by making the terms of the Act clearer to firms, setting out standards and explaining what constitutes non-compliance. Since the beginning of 2008, the OFT has written 14 pieces of guidance, ranging from specific guidance for credit brokers and intermediaries, to more general guidance about credit advertising. Compared with many individual enforcement actions, this is a low-cost method of helping to ensure compliance.

2.10 Industry representatives told us that guidance can cause confusion because its status is ambiguous, suggesting that it is inconsistent with the Act. In some cases the guidance has been received very positively due to the details and explanation included. In others, it was felt to be overly long and cumbersome.

Figure 12
Process of enforcement against existing licence holders



Source: National Audit Office analysis

Figure 13

Recent regulatory actions taken by the OFT against consumer credit firms

Unsecured credit broker had their licence revoked

A firm was found to be treating customers unfairly in a number of ways, including: using high-pressure sales tactics to persuade consumers to provide their card details on the false pretence that they were required for an identity and/or security check; deducting brokerage fees without making clear that a fee was payable; selling customers higher interest products compared with the ones they originally sought; misleading consumers into believing the firm was a loan provider rather than a credit broker; and not giving refunds in a timely manner. The OFT determined that treating customers unfairly, especially vulnerable people, meant the business was unfit to hold a consumer credit licence, and it was revoked.

Requirements imposed on second charge lender

A second charge lender (providing loans secured against a property already mortgaged) was not adequately checking whether customers could afford the loans being provided. They were not verifying customers' incomes and were not taking into account other financial commitments or personal circumstances. Furthermore, the lender was not explaining the charges that could be incurred for going into arrears, and failed to exhaust alternative options before taking borrowers to court. The OFT imposed requirements on the lender ensuring it must carry out proper affordability checks, be more transparent about late payment charges from the beginning, and only take steps to repossess a borrower's home as a last resort.

Source: Office of Fair Trading press notices

Self-regulation

2.11 When a sector or industry regulates itself through a code of conduct or a set of industry standards, it is said to be self-regulating. In consumer credit markets, trade associations or industry groups can require firms to sign up to codes of conduct in order to become members (**Figure 14**), and can expel and fine non-compliant firms. These associations can share best practice and provide members with compliance advice.

2.12 We found in some cases that the OFT was able to act more quickly by working with industry regulators to improve compliance, and industry representatives were very supportive of the use of self-regulation. Consumer groups reported more mixed views about self-regulation. Some groups expressed concerns that trade associations do not have suitable resources to monitor the compliance of their members. Moreover, self-regulation does not cover all firms, as they are not obliged to join a trade association in order to provide credit.

Figure 14
Examples of self-regulation in consumer credit markets

The Lending Standards Board

The Lending Code is a voluntary code of practice that sets out the standards required of banks and credit card issuers when lending money to consumers. The Lending Standards Board monitors and enforces compliance with this code, helps firms understand and comply and identifies any gaps in the code that could lead to consumer harm.

Debt Managers Standards Association (DEMSA)

DEMSA aims to encourage high standards within the debt management market and has developed a code of conduct, which members have to comply with. This code of conduct has been approved by the OFT.

Source: National Audit Office analysis

Compliance reviews

2.13 The OFT conducts compliance reviews to investigate potential problems across a whole market, rather than within individual firms. Compliance reviews may lead to a series of enforcement actions against a number of firms. For example, following a review of the debt management industry, 43 firms surrendered their licences, and a further 13 firms had their licences revoked. Currently, the OFT is conducting a review into the payday lending market, in part prompted by concerns that some payday lenders may be taking advantage of people in financial difficulty. The review is focusing on whether payday lenders are carrying out adequate affordability checks; whether they are inappropriately targeting vulnerable consumers; whether they are rolling over loans so that charges escalate; and whether they are treating fairly borrowers that get into financial difficulty. Compliance reviews are resource-intensive and the OFT needs to weigh up the cost of completing a compliance review against the benefits of individual enforcement actions.

Burden of current regulation

2.14 The burden of regulation on industry comprises both the direct cost of the licence fee, and the time and cost of complying with regulation. Industry groups reported that the current regime provides, overall, a low level of regulatory burden. Industry groups felt that the cost of a consumer credit licence was low. However, smaller firms reported some difficulty in understanding and completing all that was required for them to be compliant.

Constraints on the current regulatory framework

Investigating non-compliance

2.15 The OFT does not have the capacity to seek out non-compliance on the part of firms through day-to-day supervision. It monitors firms when it receives intelligence that gives it reason to believe there is a problem of non-compliance. In other words, the regulatory system is not geared to preventing problems arising from malpractice of existing licence holders, and for a problem to be resolved it must in practice have already resulted in consumer harm. The delay between non-compliance and action may also allow for further consumer harm to take place.

Revoking licences

2.16 Firms that have been issued with a notice that their licence is to be revoked are able to continue trading while they appeal. This appeals process has on occasion lasted for a number of years, allowing non-compliance to continue if the appeal is rejected. The government has granted the OFT additional powers of enforcement, allowing a licence to be immediately suspended, which will come into effect in 2013. These new powers are strongly supported by consumer groups, and a number of trade associations, as a valuable tool for reducing consumer harm and increasing trust in consumer credit markets.

2.17 If a firm's licence is revoked, the OFT has limited powers to prevent those running the firm from buying another licensed firm and continuing to trade. Although there is a legal requirement for licensed firms to inform the OFT of changes to their ownership or management, this relies heavily on the firm complying. In combination with the time taken to revoke a licence, as a result of due process, this may allow firms or individuals that are behaving badly to continue trading in licensable activity, with resulting consumer harm.

Fines

2.18 Fines can be imposed on firms who breach requirements the OFT has placed on them. The maximum fine the OFT can impose on licence holders is limited at £50,000 – much lower than the fining powers of the FSA, for example. Consumer groups argue that these fines do not act as a deterrent. To date, there have been no cases in which the OFT has exercised its fining powers under the Act. However, following instances of serious breaches of requirements the OFT has revoked licences.

The future of regulation

2.19 The government is proposing to alter the framework for consumer credit regulation, transferring regulatory responsibilities from the OFT to the Financial Conduct Authority (FCA), one of the successor bodies to the FSA. **Figure 15** summarises the options currently under consideration.

Challenges for the new regime

Cost

2.20 Both industry representatives and consumer groups told us that introducing a new regulatory regime created an opportunity for a simpler and more proportionate system that links licence fees to the size of firms or the potential risk to consumers of the credit activities the firm is providing. This could increase the level of resources available to the regulator. Consumer groups felt that a higher level of resources would allow for the regulator to detect and act on non-compliance earlier.

2.21 Industry representatives reported their concern that transferring consumer credit regulation to a new regime may result in an increased regulatory burden on small firms, which could lead suppliers of consumer credit to exit the market. This could reduce the availability of credit to people with lower incomes or poor credit histories, and could increase illegal lending. The cost of the new regime must therefore enable the regulator to provide an appropriate level of consumer protection in a proportionate manner and it is vital that the impact assessment for any change quantifies costs and benefits in a robust, evidence-based way.

Figure 15
Transfer to the Financial Conduct Authority

Financial Services and Markets Act (FSMA)

Currently, other financial products such as mortgages are regulated by the FSA under FSMA. The government proposes to develop a proportional regime for consumer credit under this legislation that still provides the protections to consumers that exist within the Consumer Credit Act.

Retaining the Consumer Credit Act (the Act)

However, if a proportional regime cannot be developed, the government retains the option to enhance the regulatory powers under the Act to improve consumer protection. The FCA will be empowered to regulate consumer credit under the Act.

Source: National Audit Office analysis of options

Consumer protection

2.22 Consumer groups were concerned that some of the consumer protections available in the Act may be lost in the transfer to a new regime. Therefore, the new regime needs to ensure that consumers are afforded at least the same levels of protection that the current regime provides. Examples of specific protections that consumer groups told us should be maintained include the following:

- Protections for consumers who experience difficulties repaying, such as:
  - Section 129: allows the court to make a time order giving the consumer more time to repay a debt.
  - Section 136: allows for the credit agreement to be amended as a consequence of a time order by reducing the interest rate or extending the term of the loan.
- Protections to ensure goods and services are fit for purpose, such as:
  - Section 75: provides equal liability, meaning that a consumer does not have to pay the debt on a product bought on credit that was not received, or was faulty, as the credit provider and the firm selling the product are both responsible.

Knowledge and expertise of staff

2.23 A concern expressed by both consumer groups and industry representatives was the possible loss of expertise in consumer credit by moving the regulation from the OFT. Consumer credit markets are very diverse and are made up of many small- to medium-size firms and sole traders, just over ninety per cent of active consumer credit licence holders have 100 employees or fewer. Providing financial services is the primary business activity of only around half of all active licence holders.[7] Therefore, retaining employees from the OFT in the new regulator would prevent expertise being lost and help to maintain the good working relationships with consumer and industry groups that are already established.

7 Critical Research population survey figures (research conducted for the FSA), based on those firms who are actively using their licence, i.e. have used it in the past 12 months and expect to use it in the next 12 months.

Risks to consumers during transition

2.24 During the transition period some firms may be aware that they will not continue to trade in this market and may seek to increase their profits in the time they have remaining. This could lead to irresponsible lending practices and harm consumers.

2.25 The OFT may also have reduced resources to regulate consumer credit during this period. The OFT is already losing experienced staff due to the uncertainty around the transition and is finding it difficult to replace them permanently. The additional work that the OFT is doing to support the transfer has not been supported by any up front additional budget and this means that resources are being diverted away from front-line credit work.

Legacy arrangements

2.26 If the new regime operates under different legislation, arrangements for consumers with existing credit agreements need to be considered. Industry representatives were concerned that many firms will need to operate under two regimes for a period of time, increasing regulatory burdens. Moreover, consumers who have existing credit arrangements and enter into new agreements will also need to be aware of any differences between these regimes.

2.27 Industry representatives emphasised that since all currently licensed firms may have to reapply for a new authorisation under the new regime, this process needs to be managed carefully.

Part Three

How the OFT uses its resources

3.1 This part of the report examines how the Office of Fair Trading (OFT) uses its resources to carry out its responsibilities for consumer credit regulation. It shows that:

- licence fee income provided the OFT with £11.5 million for regulating consumer credit in 2011-12. We estimate that, within this, the cost of licensing application investigations and enforcement actions against existing licence holders was £4.5 million;
- industry and consumer groups felt that this is a low level of resource; and
- the OFT has a good understanding of risks in consumer credit markets, but its risk model for licensing investigations does not fully reflect this. It has not linked cost and risk information to prove that it is using its limited resources to best effect.

Licence fees

3.2 The OFT funds consumer credit regulation solely through licence fees. **Figure 16** shows how the licence fee is structured. The fee for a sole trader differs from that of a partnership or company, but does not differentiate between the sizes of firms (a small firm pays the same fee as a large bank).

Figure 16
Cost of a consumer credit licence

	Sole trader (£)	Partnership/company (£)
Fee to apply for a new licence or to renew a licence	435	1,075
Fee to vary licence name or trading names	80 for first change 60 for each further change	80 for first change 60 for each further change
Fee to add or remove licence categories	80	80

NOTES
1 The OFT charges a fee once every five years for a licence.
2 Some firms may also pay the Financial Services levy of £140, which covers the Financial Ombudsman Service and the Financial Services Compensation Scheme.

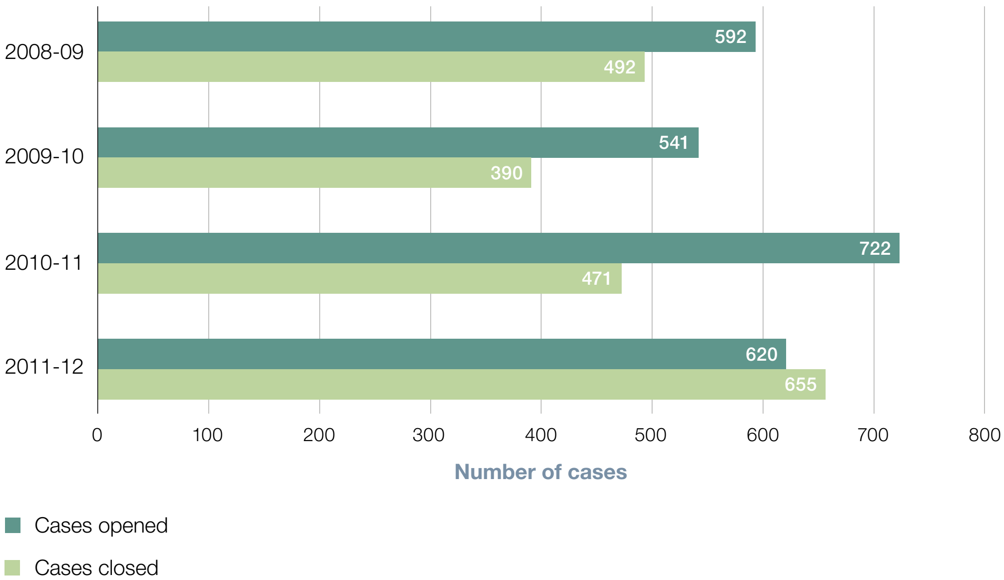
Source: Office of Fair Trading

The cost of regulation

3.3 In 2011-12, licence fee income totalled £11.5 million. Of this income, the OFT spent £2.1 million of staff costs on teams primarily involved in carrying out licensing application investigations and enforcement actions against existing licence holders. This does not include overheads, legal or other additional costs, such as visits carried out by Trading Standards services, which all contribute to enforcement and licensing costs. During this period the OFT employed 124 full-time equivalents on consumer credit regulation, processed 6,791 licence applications, 5,569 licence renewals, 3,156 variations on licences, 6,932 notifications and 540 voluntary licence surrenders, and produced five pieces of guidance. According to our analysis of the Case Management System (CMS) database, 620 new licensing application investigations and enforcement actions against existing licence holders were opened, and 655 cases were closed. **Figure 17** shows the OFT's performance over time in opening and closing cases. It shows that the OFT has performed well in 2011-12.

Figure 17
Enforcement cases opened and closed

During 2011-12, the OFT closed more enforcement cases than it opened



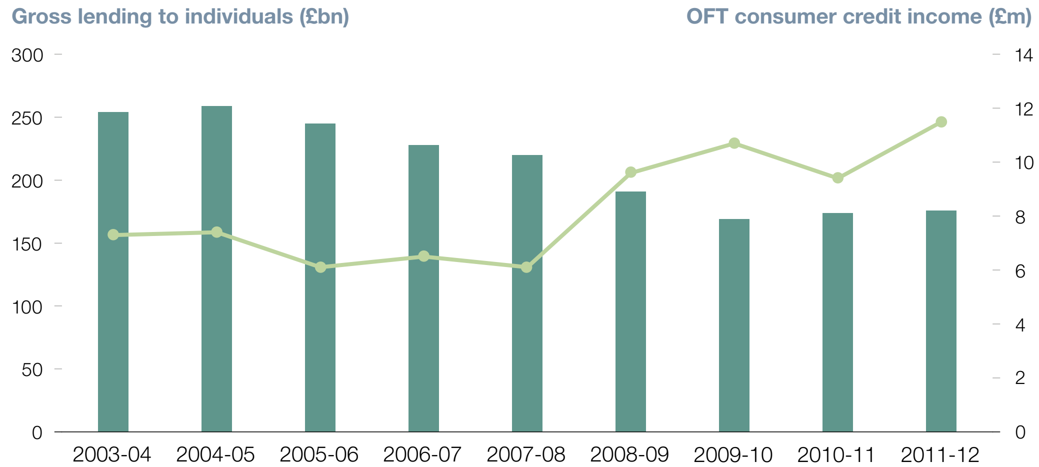
Source: Office of Fair Trading

3.4 Figure 18 shows the income from the licence fee compared with total gross lending to individuals between 2003-04 and 2011-12. For example, for every £1 spent on regulation in 2011-12, £15,000 was lent to consumers. In 2004-05, when lending to individuals was at its highest, at £259 billion, £35,000 was lent to consumers for every £1 spent on regulation. This is a low level of resource to spend on regulation given the size of the market.

3.5 Industry representatives and consumer groups felt this was a low level of resource. As net lending figures do not include the activities of consumer credit firms that are licensed by the OFT but who do not directly lend money to consumers – for example, credit brokers and debt collection firms, the size of the regulated sector is larger than the total lending figures in Figure 18.

Figure 18
UK consumer credit regulation spending against net lending

Between 2003-04 and 2011-12, gross lending to individuals has fallen and the OFT's consumer credit income has increased



	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
Gross lending to individuals (£bn)	254	259	245	228	220	191	169	174	176
OFT consumer credit income (£m)	7.3	7.4	6.1	6.5	6.1	9.6	10.7	9.4	11.5
Ratio (£000)	35	35	40	35	36	20	16	19	15

NOTE
1 Figures adjusted for inflation.

Source: National Audit Office analysis from: Office of Fair Trading annual reports and resource accounts and Bank of England net lending to individuals data

The OFT's understanding of its costs

3.6 The OFT records enforcement cases on its CMS. We found limitations in how the CMS was used as a source of management information. Records are often incomplete – for example, the dates on which cases were closed were sometimes missing. The Consumer Credit Group cannot easily run reports that separate consumer credit cases from other kinds of enforcement cases.

3.7 The OFT does not know the actual cost of their enforcement cases. We carried out our own costing exercise (**Figure 19**). We found that, depending on the type of case, the cost can vary widely. We estimate the average cost of an action is around £7,300 (around £6,800 for a licence application investigation and £9,900 for an enforcement action against an existing licence holder). We estimate the total cost of licensing and enforcement in 2011-12 was £4.5 million. The results achieved for this expenditure are discussed in Part Four.

Figure 19
Costs of licensing application investigations and enforcement actions

Cost type	Amount (£)
Input costs	
Average enforcement team staff cost per case	2,484
Average Trading Standards cost per case	378
Average legal cost per case	1,389
Average overheads cost per case	3,075
Calculated unit costs	
Average total cost per case for licence investigations	6,831
Average total cost per case for enforcement actions	9,924
Average total cost per case for all cases	7,326
Total costs to the OFT of investigation and enforcement	
Total case costs in 2011-12	4,542,396

NOTES
1 Total case costs are calculated by multiplying the number of cases opened in 2011-12, which is 620, by the average total cost per case of £7,326.
2 Overhead costs include accommodation and other costs of running the regime such as communications and senior staff.

Source: National Audit Office analysis

How resources are allocated

Licensing investigations

3.8 In deciding which licence applications to subject to a greater degree of scrutiny, the OFT has developed a risk model in which certain types of consumer credit activities are rated as higher risk than others (**Figure 20**). **Figure 21** shows how some of these high-risk activities can impact on consumers.

Figure 20
OFT credit licensing risk model

Licence category	Risk level	Exceptions
Consumer credit	Low	High risk if supplying secured and sub-prime or home credit
Consumer hire	Low	–
Credit brokerage	Low	High risk if broking secured and sub-prime or home credit
Debt adjusting	High	–
Debt counselling	High	–
Debt collecting	High	–
Debt administration	Low	High risk if administering secured and sub-prime credit
Credit information services, excluding credit repair	Low	–
Credit information services, including credit repair	High	High risk if commercial, low risk if non-commercial
Credit reference agency	High	–

NOTE
1 The OFT uses this risk model as a guide, enabling it to make firm-specific decisions about the possible level of risk to consumers where necessary.

Source: Office of Fair Trading

Figure 21
Examples of where consumers may be at risk

Debt collection

A female living with her partner and three children aged four, 14 and 21 stopped using her store card in 2002. It had no debt on it, and yet for the last two years the store has pursued her through three debt collection agencies, the last of which threatened her. This shows how debt collection agencies can cause harm by not having the right information.

Debt adjusting

A consumer has been with a fee-paying debt management company for four years paying off a debt of £24,000. She has been paying £171 per month and her debts have reduced little over the past four years. She contacted the company but they reassured her that they were managing her debts, although the creditors have continued to add interest and charges. This is an example of harm caused by a debt management company misrepresenting extra charges.

Home lending

An 85-year-old woman with Alzheimer's has been taking out multiple loans over the past two years from a doorstep lender and now has approximately £2,000 outstanding. She has no memory of taking these loans out and has found £45 per week is being taken from her state pension. Her family feel that she is being exploited. This is an example of how home lending can unfairly target vulnerable consumers.

Source: Citizens Advice Bureau database

3.9 A more rigorous application process applies for licences in higher risk categories, requiring firms to provide information about their knowledge, experience and skills. This allows the OFT to assess their competence to hold a licence. Firms applying for high-risk categories may be visited by either OFT officers or by Trading Standards officers under contract to the OFT. Trading Standards services generally receive a fee for carrying out a visit.

3.10 The OFT began developing its risk model in 2007, using its knowledge of the market, of the type of harm suffered and vulnerability of those targeted as well as the nature and number of complaints received from consumers about different sectors of the market. It is important that the future regulatory regime builds on this work to regularly reassess the emerging risks in the rapidly changing markets. It will need to combine cost and risk information to optimise resources. For example, Trading Standards officers reported to us that they felt some visits, especially those to larger established firms renewing their licences, were unnecessary. Focusing only on types of activity, rather than the way business is conducted, may miss firms that are causing consumer harm by conducting low-risk activities in high-risk ways.

3.11 The OFT could also use additional intelligence to further segregate its risk model and make more detailed decisions about which firms require visits. Resources could then focus on firms who need more help to comply.

Enforcement actions

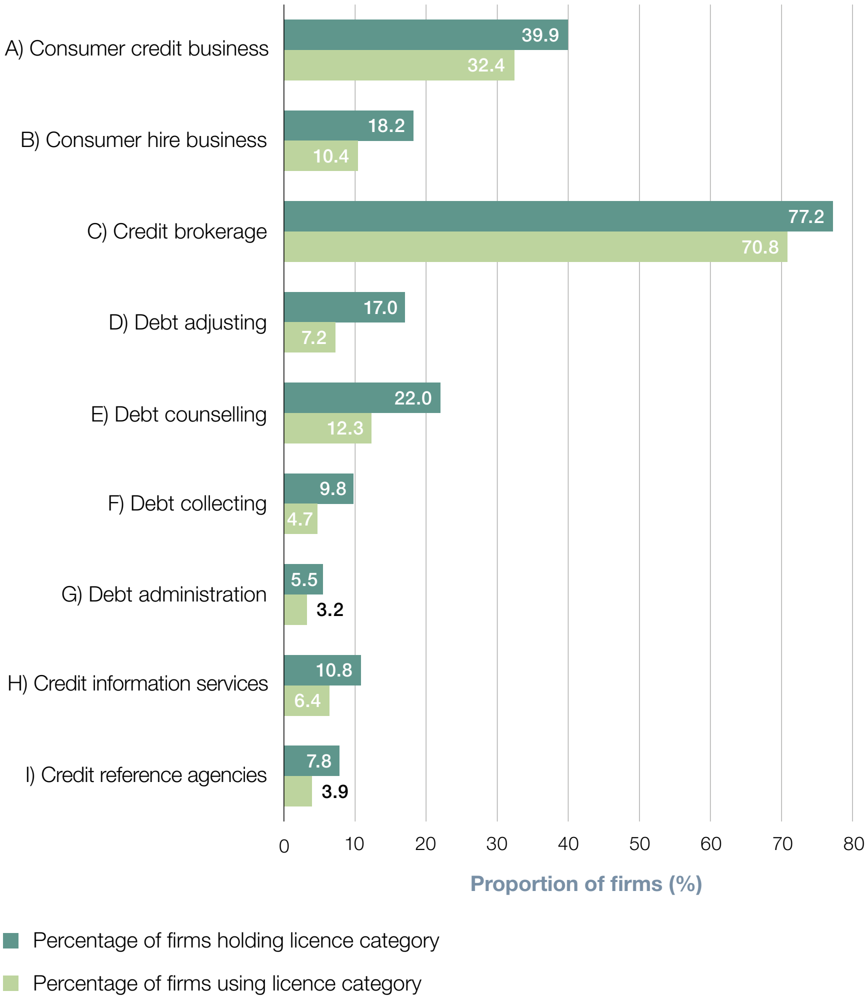
3.12 The OFT uses intelligence reports and its knowledge of consumer credit markets to determine where to target its enforcement activity. It collects information about firms through the licence application process. Before changes to the Consumer Credit Act (the Act) in 2008, firms were advised to apply for all categories of consumer credit licences regardless of whether they were active in that category. Firms now only apply for licences covering the activities they actually undertake, which means information on licences provides a better picture of activity in the market. However, although it is illegal for firms to undertake credit activities without a licence or to engage in activities not covered by an existing licence, there is no guarantee that this information will be updated. The information the OFT holds about licence holders does not include the number of people employed by the firm, or the levels of lending they provide. This means the OFT does not hold the information it needs to regulate effectively.

3.13 Furthermore, there is a significant difference between the number of licences held, according to the OFT's records, and the actual number of licences in use. The OFT database shows there are 80,000 firms who are holding a current consumer credit licence; however, research commissioned by the Financial Services Authority (FSA) estimates that only 65,000 who hold a current licence are actually trading, and that around 47,500 are using the licence actively, meaning that they have used their licence in the past 12 months and expect to do so in the next 12 months. **Figure 22** shows the proportions of these active firms holding each of the OFT licence categories, and the proportions that have used each category in the past 12 months.

3.14 The OFT has an intelligence function that produces daily, monthly and quarterly reports, based on media scanning, analysis of complaints data received from bodies such as the Financial Ombudsman Service and Citizens Advice, and trend analysis. These reports are used to identify potentially problematic traders and to assess whether markets are working well. Since the OFT is not resourced to take a supervisory approach and therefore does not monitor firms on a day-to-day basis, it tends to be dependent on receiving intelligence from third parties to identify non-compliant firms. Therefore, there may be a delay before it deals with problems in sectors where consumers do not know how to complain.

Figure 22
Use of consumer credit licence categories

Proportion of firms holding and using consumer credit licence categories



NOTES

1. This data includes only firms actively using their licence, meaning they have used it in the past 12 months and expect to use it in the next 12 months.
2. Firms holding licence categories refers to active licence holders who hold the current licence category.
3. Firms using licence category refers to active licence holders who have used this licence category within the past 12 months.

Source: Critical Research population survey figures (research conducted for the Financial Services Authority)

Part Four

Achieving good outcomes

4.1 This part of the report discusses the outcomes of the Office of Fair Trading's (OFT's) enforcement actions. It shows the following:

- Much better data are needed on levels of potential harm to consumers in credit markets, and the impact of regulation. On the basis of existing data on complaints, we estimate the OFT has saved consumers £8.60 in financial harm for every £1 spent on enforcing regulations.
- However, enforcement action is not yet minimising harm to consumers. Again, on the basis of the limited existing data, we estimate consumers lost at least £450 million from problems not addressed by regulatory enforcement in 2010-11.
- The harm consumers may suffer if unscrupulous practices are not detected and prevented goes further than losing money. The design of the new regulatory regime for consumer credit presents an opportunity to evaluate these wider impacts, and ensure that regulation and enforcement is proportionate and effective.

Measuring the impact of regulation

4.2 Although the OFT has evaluated the impact of its work in enforcing competition law, and investigating risks of market failure across different sectors of the economy, it does not routinely evaluate the effectiveness of its work regulating consumer credit. One notable example, however, is the work it did to clarify the law about consumer protection for payments made using credit cards overseas.[8] In 2009, a report for the OFT covering various aspects of consumer protection estimated that the OFT's intervention saved consumers £99 million annually.

Preventing financial harm to consumers

Licensing application investigations

4.3 One important way in which the OFT prevents consumer financial harm is through its licensing function in the Gateway. The Gateway team aims to prevent individuals who are unsuitable to run consumer credit firms, for example because they lack the necessary competence or have convictions for violence, from obtaining a consumer credit licence. This therefore prevents consumer harm from occurring, as these firms are refused licences and are not able to offer credit or related services. As these firms have

8 See Section 75 of the Consumer Credit Act. Available at: www.legislation.gov.uk/ukpga/2006/14/contents

never had consumers, no complaints will have been made against them and calculating the level of financial harm they might potentially have created is very difficult. We have focused our quantification of the level of financial harm prevented by the OFT on the enforcement action it takes against existing licensees. This measure does not include all benefits for consumers.

Enforcement

4.4 We analysed complaints about credit providers from consumers from 2008 to 2011, as recorded on the Consumer Direct[9] database, to provide some preliminary estimates of the impact of the OFT's enforcement actions. Further details of our analysis are provided in the technical paper accompanying this report, on our website.[10]

4.5 We examined how the numbers of complaints that consumers made about firms varied before and after the OFT took enforcement actions. Not all complaints reflect harm to consumers, and if a consumer has experienced mistreatment, it cannot always be measured in purely financial terms. However, using previous research by the OFT on the financial consequences for consumers who complain, we estimated the average losses associated with complaints in each type of transaction.

4.6 We found that enforcement action was associated with a reduction in complaints. Research has shown that only a small proportion of consumers who have problems with a credit product actually complain about it, so we scaled up our results to account for this to provide approximate figures for overall levels of financial harm.

4.7 We linked these results to the costing exercise discussed in Part Three to compare the cost of enforcement for the cases in our sample with the estimated financial harm prevented. We found that for each £1 spent on enforcement action, the OFT directly saved consumers about £8.60. This does not take account of the extent to which these actions are likely also to have prevented further harm by acting as a deterrent against other firms' misconduct.

Un-remedied financial harm

4.8 As discussed in Part One, however, this analysis also suggests that the level of un-remedied financial harm to consumers is at least £450 million. We estimated this figure by examining the financial harm resulting from the total number of complaints on the Consumer Direct database and scaling this up to provide an approximate figure covering losses from complaints not registered on the database.

4.9 More research would be needed to establish a definitive figure for overall consumer harm in consumer credit markets. As we have calculated this total on the same basis as our calculation of loss prevented by the OFT's enforcement actions, it allows an approximate comparison of levels of remedied and un-remedied financial harm. If the future regulatory regime is to reduce un-remedied harm, it will have to target the resources available for enforcement more efficiently (thus improving on the current 8.60:1 benefit to cost ratio), or devote more resources to enforcement – or both.

9 Consumer Direct was the OFT's telephone-based consumer advice service, now run by Citizens Advice.
10 Available at: www.nao.org.uk/oft-2012.

The direction for future analysis

4.10 This is an initial analysis based on existing data. We undertook it as a start towards filling the gap in information on potential levels of harm in consumer credit markets, and the extent to which regulation is achieving its objective of minimising harm from unfair practices. We would expect the design of the new regulatory regime to be informed by a broader and more detailed analysis of potential detriment, and which also takes into account the rapidly evolving nature of this market (as seen in, for example, the recent rapid growth in payday lending).

4.11 Future analysis could consider the distribution of harm across socio-economic groups, and across the different consumer credit markets, to enable the regulatory regime to focus on preventing harm in those areas which pose the greatest risks to more vulnerable consumers.

Wider harm experienced by consumers

4.12 In addition to financial harm, wider harm must also be considered. For some, harm in consumer credit markets results in unmanageable debt (**Figure 23**). Government research suggests that bills and credit commitments are a heavy burden for 15 per cent of households in the UK. The StepChange Debt Charity, one of the UK's largest debt counselling charities, estimates that the average level of household debt, excluding mortgages, in 2011 was £7,948. Regulation of consumer credit markets should work with the areas of government responsible for tackling these issues to reduce this harm.

4.13 **Figure 24** gives some examples of how the harm consumers can experience in consumer credit markets can have wider impacts. Consumers can suffer stress and in some cases this can result in an increased expense on the public purse, for example through additional healthcare requirements. The evaluation of an effective regulatory framework needs to consider not only financial harm, but the benefits from dealing with these additional impacts.

Figure 23
Examples of over-indebted consumers

Payday lending

A 23-year-old self-employed man's income fell and he was unable to pay off his monthly debts. They were consolidated into one new debt and an interest rate of 4,214 per cent APR was applied. He did not understand why this happened, despite reading the website, saying it was unclear. He feels trapped by the excessive interest rates.

A female in her early 30s was approved five payday loans, worth £1,812. She lives on benefits. The payday loan companies are taking the payments directly from her bank account, so she is behind on her rent and other bill payments. She feels overwhelmed and depressed with the spiral of debt.

Source: Citizens Advice Bureau database

Figure 24
Wider effects of consumer harm

Over-indebtedness puts an enormous strain on family life. One consumer told us, "My husband always had a good wage, but when it was taken away we couldn't cope. I was coming home late and we would argue and bicker over stupid things." Another consumer talked about the effect on his children, "The other day when me kids asked me could they have an ice-cream and I couldn't give them, I felt like crying."

Another over-indebted consumer said, "Some of the creditors just make you feel like crap. I can't afford food, how do you think I'm going to give you one hundred and fifty pounds over the phone right now?" This consumer was getting bothered by a debt collection agency even though she was paying off her creditors through a debt management plan because the debt had been sold on by the original creditor. "The debt had been sold on to another company. He phoned up and I ended up in tears… he said 'you're just faking it, and putting it on'. He was really rude, and really uncaring."

Another consumer tried to get their bank to freeze interest rate charges: "And with each one of them I was met with 'no they couldn't do that'. So it just seems that the stress is just mounting and mounting now and I don't know where to turn with it all."

Source: National Audit Office research on over-indebted consumers, 2009

Appendix One

Our audit approach

1 This study examines whether the OFT regulates consumer credit in a way that provides value for money for consumers and industry. To do this, we assessed the following:

- Whether the OFT regulates in line with the principles of good regulation.
- Whether the OFT has a good enough understanding of the consumer credit market in order for their risk-based approach to work.
- Whether there has been effective measurement of the impact of their regulation on consumers.

2 We developed our own evaluative framework to assess value for money, which considers what arrangements would be 'optimal' for regulation of the consumer credit market. By 'optimal' we mean the most desirable outcome possible given the expressed or implied constraints. A constraint in this context is the budget: the funding collected by the OFT through licensing fees that pay for regulating consumer credit.

3 Our audit approach is summarised in **Figure 25**. Our evidence base is described in Appendix Two.

Figure 25
Our audit approach

The objective of government

To ensure good outcomes for consumers and industry in the consumer credit markets by providing effective regulation.

How this will be achieved

The Consumer Credit Act 1974, updated in 2006, requires firms that lend money to consumers or sell goods on credit to apply for a consumer credit licence. The Office of Fair Trading (OFT) is responsible for issuing consumer credit licences and for carrying out enforcement actions where a firm has not been compliant with the Act.

Our study

The study assessed the value for money of the OFT's regulation of consumer credit.

Our evaluative criteria

Regulates in line with generally accepted principles of good regulation.

Sufficient knowledge of the markets to adopt a risk-based approach to regulation.

Effective measurement of impact as a regulator.

Our evidence

(see Appendix Two for details)

We assessed how the OFT regulates by:

- Interviews with OFT staff
- Reviewing OFT documents
- Conducting semi-structured interviews with stakeholders including:
  - Academics
  - Consumer groups
  - Industry representatives.

We examined the existing consumer credit evidence base by:

- Conducting an extensive literature review
- Secondary analysis of existing market research
- Building a market analysis framework.

We measured the impact of the OFT's enforcement actions on consumer financial harm by:

- Developing a process map of the OFT's enforcement actions
- Analysing OFT data
- Analysing consumer credit complaints data
- Developing a cost-effectiveness model.

Our conclusions

Our key findings are set out in paragraphs 6 to 13. Our conclusion on value for money is in paragraphs 14 and 15.

Appendix Two

Our evidence base

1 Our independent conclusions on whether the OFT's regulation of consumer credit is achieving value for money were reached following analysis of the evidence gathered between May and August 2012.

2 We applied an evaluative framework to consider the optimal arrangements to regulate consumer credit. Our audit approach is outlined in Appendix One.

3 We examined whether the OFT regulates in line with the principles of good regulation. To do this:

- We conducted interviews with the OFT.
- We reviewed existing evidence including OFT documentation, evaluations and academic literature regarding consumer credit regulation, to understand the landscape where the market has developed and currently operates.
- We undertook semi-structured interviews with stakeholders, including industry representatives, consumer groups and academics. We used qualitative techniques to identify recurring themes and triangulated these themes with other analyses.

4 We examined whether the OFT has a detailed enough understanding of the consumer credit market for a risk-based approach to be effective:

- We conducted a literature review, including:
  - academic articles;
  - reports written by the OFT and other departments;
  - trade association reports; and
  - consumer group reports.
- We analysed existing market data including:
  - data collected by Critical Research (for the FSA) – due to be published in February 2013;
  - Bank of England data;
  - data collected by trade associations and consumer groups; and
  - data produced by the OFT.

5 We carried out an analysis of costs and benefits of the OFT's enforcement actions to estimate the impact of these actions on reducing consumer financial harm in credit markets. To do this:

- We conducted a workshop with the OFT's enforcement officers to map the investigation and enforcement processes, to set out resource cost at each stage of the process and probability of outcomes.
- We developed a model to estimate the costs of different OFT enforcement actions and to cost each outcome.
- We matched the Consumer Direct complaints data with the OFT's Case Management System to estimate the benefits of different enforcement actions by comparing complaints received before and after OFT intervention.
- The costs were then combined with benefits to produce a quantified measure of the value for money of the OFT's enforcement actions.
- More detail on this work is contained within a separately published technical paper, available on our website: www.nao.org.uk/oft-2012.

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Design and Production by
NAO Communications
DP Ref: 010017-001

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ISBN 978-0-10-298057-8

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