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COMPTROLLER AND
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Office of Fair Trading

# Regulating consumer credit

# 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 |
| --- | --- |
| Advertising of credit products must not be misleading. | Consumers could sign up to credit agreements without fully understanding the contracts. |
| 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. |

**How the OFT can address non-compliance**

The OFT can:

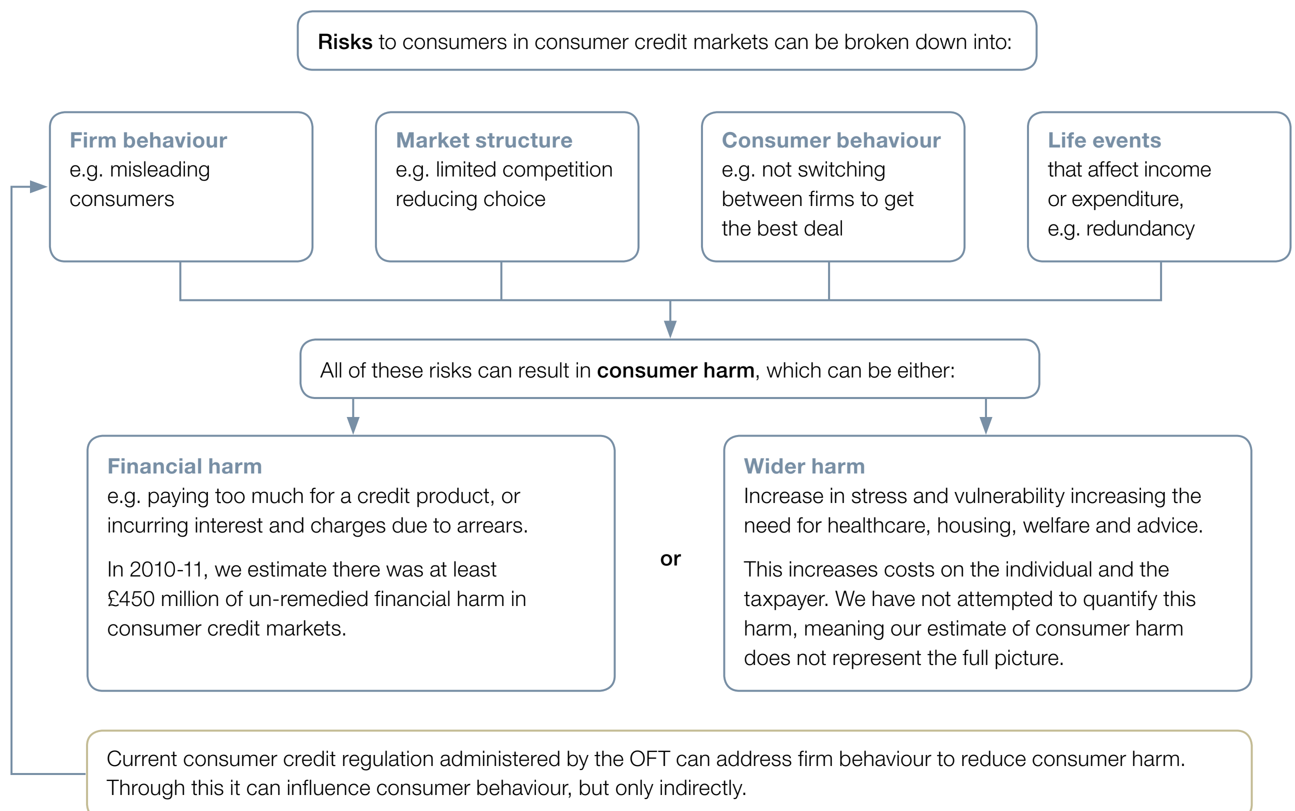
- refuse to issue a licence;
- issue a licence in different terms from those under which the application was made;
- issue warnings;
- place requirements on a licensee that affects what credit activities the firm can undertake. For example, the OFT found a payday lender was treating students unfairly 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.

*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.