



**Consumer
Focus**
Campaigning for a fair deal

Consumer Focus response to BIS on managing borrowing and dealing with debt: consumer credit and personal insolvency review

December 2010

About us

Consumer Focus is the statutory consumer champion for England, Wales, Scotland and (for postal consumers) Northern Ireland.

We operate across the whole of the economy, persuading businesses, public services and policy makers to put consumers at the heart of what they do.

Consumer Focus tackles the issues that matter to consumers, and aims to give people a stronger voice. We don't just draw attention to problems – we work with consumers and with a range of organisations to champion creative solutions that make a difference to consumers' lives.

Consultation response

Q1 Should the Government extend regulations on advertising for credit products beyond the cost of credit?

Behavioural economics shows that consumers frequently buy products that are not in their own long term interests – so-called ‘*behavioural biases*’.¹ Consumers:

- a. over value instantaneous benefits against long term costs
- b. are over-optimistic, about their future ability to act rationally
- c. struggle to assess the value of complex products²

Credit providers design products and adverts to take advantage of these biases.

Many adverts for credit products do not advertise the actual cost of the credit but instead promote the concept of borrowing, exploiting the first two of these flaws. In particular, MasterCard and Visa advertise by setting out the benefits that spending brings.³ We do not believe they comply with the spirit of responsible lending. We believe it is appropriate only to promote the specific value or quality of a particular credit product and not the concept of credit in general.

Credit products and adverts also use complex products and consumers’ over-optimism to promote the value of their product. Headline figures such as Annual Percentage Rate (APR), Annual Equivalent Rate (AER) inform judgements with ‘demand less responsive to longer term product cost, which in many cases is quite difficult to calculate’.⁴ Headline APR figures may make the consumer believe they are applying for an excellent deal. However, they are later caught out as the complexity means credit products do not perform as consumers expect.

As an example of how complex products interact with marketing, we can look at the issue of balance transfers. The marketing material for many credit cards advertises ‘0 per cent APR’ on balance transfers over a certain time period. Yet, in the small print there is often a ‘*handling fee*’ upward of 2.5 per cent.

This can have the effect of misleading consumers about the real costs of transferring balances from other credit cards since it is the headline ‘0 per cent APR’ they see in marketing material and on price comparison sites. These offers are inherently misleading. Where there is a handling fee it should be included in the APR percentage advertised in order that consumers can better comprehend the cost of the transaction.

Where other charges are levied these should be clearly stipulated in a standardised format across advertising, marketing and personnel statements. Introductory deals should be clearly identified, alongside the length of the deal, the end point of the deal and how the terms can vary. Furthermore, all other ancillary charges must also be brought to the attention of the consumer within this box.

¹ A full discussion of the importance of framing, both in marketing and as part of designing information remedies can be found in Iain Ramsay, *From Truth in Lending to Responsible Lending*, p8

² CFEB do a complete analysis of behavioural biases as part of starting their work on financial education. <http://bit.ly/h4ir3x>

³ For example, ‘*There are some things money can’t buy. For everything else there’s MasterCard*’

⁴ Paul Johnson, Frontier Economics, for Consumer Focus, Focus on Finance lectures 2009 *Free or Fee: Are ‘free’ products good for consumers?*, p.2

As well as having varied APRs on different types of debt there are also differing classes of charges – APR, handling fee on transfers, and a percentage charge for taking out cash (with a high minimum charge) and various charges for foreign currency exchange. There are also differing interest free periods across purchases, foreign exchange and balance transfers. These need simplification.

As it stands the credit card market is simply too complex for informed assessment. Evidence shows four in 10 '*find it hard to know what's best for me when it comes to loan and credit agreements*' rising to 55 per cent among lower income groups.⁵

With such a complicated market structure consumers inevitably use shortcuts and assumptions in decision making. To have real value, choice must operate in a market that is not unduly complicated.

Q3 What would be the impact of a 7-day cooling off period for store cards on (a) consumer behaviour and (b) store card providers?

a. Consumer behaviour

Most sales approaches for store cards start with an offer of a discount on a product a customer wishes to buy (either a percentage off or an amount). We fear customers who sign up maybe blinded by the instantaneous offer of a discount and do not assess the long term implications to their finances.

Recent evidence suggests the number of store cards may be falling from a peak in 2007 and it seems likely that without the incentive of the instant discount this trend would accelerate.⁶ Many department stores are already moving into the provision of broader credit cards which receive special discounts, points or bonuses at the home department store. If store cards alone underwent a cooling off period it is likely to hasten the migration of store cards onto department store credit cards.

Yet, the problem of incentivised sales staff selling uncompetitive products remains. These new entrants to the credit card market, far from increasing quality and value, may in fact be worsening the value for consumers since anecdotal evidence suggests the typical APR remains above those of the high street lenders.

Consequently, the problems as set out in our response to the last BIS review into credit⁷ would remain. We would suggest all store cards or credit cards that are sold from stores as a discount as part of another purchase should be subject to a seven day cooling off period.

What appears of continuing importance to consumers is the sales approach by incentivised staff without training in selling financial products. This covers both credit and store cards. We would like to see greater emphasis on enforcement action ensuring those who sell credit and store cards comply with the legislation currently in place, Consumer Credit Act (CCA), and from February 2011 the rules under the Consumer Credit Directive (CCD) in particular under chapters 7 - 9 (credit worthiness, appropriate information and pre-contractual information).

b. Lenders

As stated above we believe lenders would migrate to selling more credit cards with discounts at the home store. We believe such cards sold by department store sales staff should also be subjected to the cooling off period since the same problems would apply.

⁵ OFT, A Factual Report prepared for OFT by Ipsos MORI, December 2009 *A Survey of consumers of unsecured and high cost credit*, Annex, p55

⁶ Mintel *Credit and Debit cards*, 2010, p82

⁷ Consumer Focus, *Response to the Credit and Store card review*, 2010

Q4 We would in particular welcome your views on the following OFT recommendations:

Before commenting on the specific OFT recommendations, we would like to draw attention to the fact these recommendations should be seen in the light of the OFT's overall view that the problems in the high cost credit sector were such that 'the likely effect of these remedies in the markets will probably be small. Addressing the more deep-seated concerns would require fundamental changes in approach'.⁸

Suggestions from the OFT⁹ about how these deep-rooted issues might be addressed included: either subsidising or requiring mainstream financial suppliers to offer loans in markets that meet consumers needs at reasonable prices, making a substantial increase in the direct provision of credit to consumers in these markets, eg through a substantial increase of the Social Fund, significantly improving financial capability among those with below average educational achievement and achieving a cultural change in social and individual attitudes to credit.

We agree with the OFT that without social policy measures, changes to improve the functioning of the market are likely to have only a marginal effect. Our responses to the recommendations below should therefore be seen in that context.

Recommendation (a): That the Government works with lenders to provide information on high cost credit loans to consumers through price comparison websites.

We broadly agree that for some users of high cost credit, it would be useful to have price comparison websites available. Our research has shown that although consumers are aware that these products are more expensive than others, they are rarely in a position to compare them with more mainstream alternatives.¹⁰

However, our own research and that of our predecessor organisation the National Consumer Council (NCC) has found that price is not the key driver for consumers using these products. For example, users of home credit tend not to focus on the total cost of the loan, but on the affordability of weekly repayment amounts. They also value the ability to borrow small amounts of money quickly and the lack of penalty charges for default on loans.¹¹ Payday loan consumers are often looking for a quick, easy to access, 'no questions asked' and easy to understand form of finance; price is a secondary consideration.¹² Other research we conducted with low income consumers in Wales found that these consumers were aware of the high prices they had to pay for credit, but felt they had few other alternatives.¹³ The OFT High Cost Credit review also found that consumers of high cost credit did little shopping around and tended to focus on the speed of arrangement (43 per cent), rather than the cost of the loan (25 per cent). This indicates that, as we have found in our research in this area, many consumers are using high cost credit under considerable financial pressures, with immediate credit needs and only limited options to meet those needs.

⁸ OFT Review of High Cost Credit, Final Report, p8

⁹ As above

¹⁰ *The Cost of Cash*, Consumer Focus Wales, November 2009, *Keeping the plates spinning: Perceptions of payday loans in Great Britain*, Consumer Focus, August 2010

¹¹ *Home credit: an investigation into the UK home credit market*, NCC, July 2004

¹² *Keeping the plates spinning: Perceptions of payday loans in Great Britain*, Consumer Focus, August 2010

¹³ *The Cost of Cash*, Consumer Focus Wales, November 2009

Furthermore, it is important to recognise that users of high cost credit are not a homogenous group and a solution that may be useful for some will not be suitable for all. The OFT High Cost Credit review found different consumer demographics for different types of credit products. For example, due to the nature of the loan, payday loan users will be employed and will have a bank account, whereas the same is not always true of pawnbroking and home credit customers, who may be unemployed and/or not have a bank account (OFT, Review of High Cost Credit, Final Report, Annexe E p15). As a result of this, the OFT Review found little substitutability in terms of the demand for payday lending, pawnbroking and home credit (OFT Review of High Cost Credit, Final Report, p18).

The usefulness of comparison websites to consumers in this market is also limited by a lack of access to the internet. The 2010 edition of the ONS Family Spending Report, based on the 2009 Living Costs and Food Survey found that in the lowest income decile 30 per cent had an internet connection and 35 per cent in the second income decile had an internet connection. The OFT consumer survey found that 7 per cent of home credit users used the internet as a source of information prior to taking out their loan (NB: the sample size was very small at 82 people and should be viewed as indicative only). The 'lenderscompared' website is a positive initiative, but these figures suggest it is unlikely that it is being used by many home credit users. Home credit users tend to use personal recommendation and word of mouth to choose lenders, so comparison information of this nature may only have a limited impact on their decision-making in any event. Our research indicated that many consumers are taking out payday loans online, thus there may be more scope for a price comparison website to be used by consumers in this area, provided it is marketed appropriately and brought to their attention.

In terms of the practical issues of creating a high cost credit website, it should be noted that the 'lenderscompared' website is the product of a legislative order. It is compulsory for all home credit providers to publish details of their loans on this website and include the website address in advertisements and payment books. The development and maintenance of the site is paid for by the major lenders in the home credit industry. We consider that the co-ordination and co-operation required to create a single website that would enable consumers to compare home credit, payday loans and pawnbroking as well as credit unions and community-based social lenders is unlikely to emerge through a voluntary solution.

Recommendation (b): That the Government explores whether there is scope under the European Consumer Credit Directive for a requirement that high-cost credit suppliers must include 'wealth warning' statements on advertisements for high-cost credit.

We agree that it is useful for consumers to have information about products presented to them in a clear and obvious format and a wealth warning is one way of ensuring that this happens.

However, a wealth warning should be only one aspect of the process of selling a product to a consumer. All lenders must comply with the OFT Irresponsible Lending Guidance and the forthcoming requirements of the Consumer Credit Directive, which require lenders to provide borrowers with adequate explanations of the product, including any features which may make the product unsuitable for particular types of use and in particular whether the borrower can afford the loan and understands the key risks (p19-21, OFT Irresponsible Lending Guidance). A wealth warning on advertisements can never be a substitute for an adequate explanation of the product to the individual consumer at the point of sale.

Moreover, our own research¹⁴ has indicated that consumers are aware that they are paying over the odds for this type of borrowing, but they do so for a variety of reasons. As stated above, there are features of these types of credit that suit the needs of low income consumers and they therefore have to pay the additional cost in order to be able to use the types of products that are suitable for their personal circumstances. Some consumers also felt they did not have any other options, due to low income or poor credit history.

In our view, therefore, the issue is not so much that high cost credit products need a wealth warning, but that consumers should have affordable products available to them from mainstream financial providers. There should also be greater promotion of alternative lenders, such as credit unions and Community Development Finance Institutions (CDFIs).

Recommendation (c): That the Government works with credit reference agencies to explore ways in which payday lenders and rent-to-buy suppliers could provide suitable information to credit reference agencies about the payment performance of their customers, in turn allowing those with good payment records to use mainstream lenders more easily in the future.

We understand that the purpose of this recommendation is to enable consumers who are using high cost credit to be able to build up a credit history which will enable them to move to mainstream borrowing in due course. We appreciate the intention behind the provision, but, as many consumers turn to high cost credit products because mainstream products are not suitable for them, we wonder how likely it is that a consumer will be able to move to the mainstream as a consequence of this measure. Until mainstream providers make available products that are suitable for low income consumers, they will remain in the high cost credit market, regardless of their credit history.

Enabling consumers to build up a credit history was one of the remedies that was imposed on the home credit industry by the Competition Commission and we would be interested to see any data on whether, and the extent to which, it has had the desired impact in relation to consumers in that market in terms of allowing them to move into mainstream borrowing.

There must be transparency about the type of data collected from these consumers and how any data collected will be used. We believe that decisions about credit should be made on affordability and ability to pay. Criteria for lending should be clear and should not be made on the basis of arbitrary judgements about lifestyle choices. It is essential that the fact of having used a high-cost loan should not in itself be viewed as a negative factor in a lending decision. Any data collected must be accurate and it must be easy for consumers to check and challenge the data that is held.¹⁵

One area where credit reference agencies would be able to help improve the situation is in relation to consumers taking out multiple payday loans. Our recent research into the usage of payday loans¹⁶ found that consumers who took out more than one loan, either over a period of months or simultaneously, or who rolled over a single loan from one month to the next, were more likely to experience difficulties. We have recommended that the number of loans or rollovers permitted should be limited to a maximum of five per household per year in order to prevent consumers getting into a 'debt trap'.

¹⁴ *The Cost of Cash*, Consumer Focus Wales, November 2009; *Keeping the Plates Spinning: Perceptions of payday loans in Great Britain*, Consumer Focus, August 2010

¹⁵ This issue is explored further in our answers to questions 5 and 6.

¹⁶ *Keeping the Plates Spinning: Perceptions of payday loans in Great Britain*, Consumer Focus, August 2010

It is our aim that we should avoid the position in the US, where an estimated five million consumers a year are caught up in a 'cycle of debt'.¹⁷ Currently, credit checking in this industry is inconsistent and tends to be carried out by specialist providers. Clearly, if there was comprehensive and timely credit checking in this market, it would be possible to monitor the number of loans being taken out by a family and reduce the likelihood of consumers becoming over-indebted.

Recommendation (d): That the OFT collects essential information on the high-cost credit sector, such as the volume, value and pricing of credit, levels of repeat business and defaults among customers as needed. This will help OFT understand the effect of its recommendations and provide better evidence for future policy making.

We agree with the proposal that the OFT should collect more information on this sector. We also believe that the OFT should make this information publicly available. At the moment, there is a dearth of information about this sector and the consumers that use it.

In our research on payday loans, our estimates on the size and nature of the market were based on discussions with the industry and a review of the data that exists in the public domain, for example, through the company accounts of the main lenders. This was also the case for our estimates of the consumer profile, as, due to the small proportion of payday loan borrowers within the wider market, it was not possible within reasonable cost to undertake a consumer survey of payday loan borrowers.

There are currently a number of organisations calling for an interest rate cap on high cost credit products. There is a lack of conclusive evidence that this necessarily helps consumers. One of the reasons why we have not supported a cap is that in the absence of other viable alternatives for low income consumers, we are concerned that a ban may push them towards illegal lenders. We believe that if the OFT collects information on this sector, it will in future be in a better position to judge the impact of policy decisions on the products in this market, including the effect of an interest rate cap or an outright ban.

Recommendation (e): That the relevant trade associations for home credit suppliers, payday lenders and pawnbrokers establish a code or codes of practice covering best practice policy including on: complaints and advice to customers, policies on rolling over of loans, limits for amounts to lend to consumers, avoiding misleading consumers through advertisement and ensuring that consumers are aware of the ultimate owners of brand names

We believe that there is a need for better practice within this area. With regard to payday loans, the consumers in our study found that the rigour of the application process varied between lenders. Some of the borrowers felt that their lender would lend to 'almost anyone'.¹⁸

Our payday loan research suggested a number of ways in which the current situation should be improved to protect borrowers from the problems associated with payday loans. These included:

- **Limiting the number of rollovers or repeat loans to five per household per year by clarifying the OFT Irresponsible lending guidance**
- **effective affordability checks (for first and additional loans)**

¹⁷ Center for Responsible Lending, Ernst K, Farris J and King U (2003, revised 2004), *Quantifying the Economic Cost of Predatory Payday Lending*

¹⁸ *Keeping the plates spinning: Perceptions of payday loans in Great Britain*, Consumer Focus, August 2010

- limiting loan values by income (for first and additional loans)
- information sharing between lenders to prevent multiple loans

At a roundtable event convened by Consumer Focus, involving industry, regulator and consumer representatives, it was agreed that all parties should work together to try to formulate a Code of Practice for the payday loans market. We are now participating in that process, which is being taken forward by the Consumer Finance Association, and we hope that it will produce a Code that is of benefit to consumers.

Nonetheless, while Codes of Practice can be useful in terms of setting out product and market standards, we remain doubtful that the measures we would like to see put in place will be achieved by a voluntary Code. We believe that it is a positive step for providers, regulators and consumer representatives to be working collaboratively in this area, but we consider that consumers are only likely to get the full level of protection they need from regulatory measures.

Q5 Is there a need for greater sharing of data between the consumer credit industry and other bodies, including utility companies, local authorities and HMRC?

The Irresponsible Lending Guidance requires lenders to lend ‘in a sustainable manner’ which is about looking at all a consumer’s debts rather than just the debt they are applying for. In our response to the Irresponsible Lending consultation we referred to affordability being about the impact of the loan on the borrower’s ‘overall financial well-being’¹⁹. This assessment should look at the following variables:

1. Lenders to be required to obtain evidence on the consumer’s income and expenditure to show they could repay the loan at the current rate and under a stress test scenario
2. Whether the consumer has any other loans, or liabilities
3. Any county court order, defaults or insolvency records
4. Finally, a more thorough analysis of a consumers credit behaviour

The first three only require the provision of the most basic information by credit reference agencies (CRAs). The fourth one, in essence, is trying to understand the consumer and their attitude towards borrowing, beyond credit defaults. Most consumers buy multiple banking products from one provider and rarely switch.²⁰ The lender can therefore use their own records to understand whether the consumer has the necessary attitude and behaviour to merit a good credit score.

It is only when a consumer has no, or a limited, track record with that bank that additional data and analysis by the CRA is justified. In essence, the CRA is attempting to provide analysis to determine the consumer’s mindset or behaviour. The lender will then use their own matrix to weight certain variables. Any assessment by the CRA, or indeed the lender, should not be given undue emphasis when put alongside the other three variables that detail both affordability and attitude towards repayment.

Consumer Focus supports the idea that a lending decision should be fully informed by the borrower’s financial situation. Therefore, if other data, from local authorities, utility companies etc., could more fully inform the lender about the borrower’s financial situation, their ability to repay and also their attitude towards repayment, then that it is a positive step.

¹⁹ <http://consumerfocus.org.uk/g/4m5> P7

²⁰ Mintel, *Retail Banking Overview*, 2010, p5

Yet, we have two caveats about this that will be explored further in question 6. Firstly, it must be remembered the vast majority of the information required to assess credit worthiness can be made simply with the information a consumer provides the bank and this additional information should at best be marginal in a lending decision.

Secondly, it is essential that any new data sharing from other institutions is sufficiently robust to be fair to consumers. They must make sure any data shared on consumers is up-to-date, accurate and any debts outstanding are not disputed by the consumer. As the next question will show, we already have serious concerns about data quality currently in the system. Prior to any extension of data sharing, institutions and processes must be proved to be accurate.

In terms of utility companies, Consumer Focus understands that credit reference information is already accessed and used by utility companies to varying degrees. However there is much discrepancy in the way that energy suppliers collect use and share this information, and the varying levels of consumer credit information that they pay to access via the credit reference agencies. We are aware that some energy suppliers are beginning to explore how they can access and use this information to better segment and understand their consumers spending and payment behaviour. This information will be used to 'tailor' communications with consumers, including the content, style and type of communication that each consumer will receive. Our work on energy debt and disconnection²¹ highlighted the need for tailored approaches to debt collection and repayment: we welcome the use of credit reference information by the energy industry that will enable suppliers to provide a better, individualised service to their customers, and ensure they are communicating with them in the most appropriate way.

However we do have concerns about the potential for errors and misuse of data. Energy suppliers already hold substantial information about their customers and it is imperative that this data is used responsibly. Currently if a customer is disputing a bill the supplier can put a 'hold' on their account so that it does not go through the system and result in demands for payment and ultimately disconnections. However, Consumer Focus' predecessor organisation energywatch, often received cases where the supplier had not put a 'hold' on the account despite agreeing to. If suppliers begin to share more information with credit reference agencies it is important that the systems in place are more accurate, as these incidences could potentially have a very detrimental impact on consumers if negative marks are made unfairly to their credit file.

We have recently begun work on the use of credit reference information by the energy industry to give us a better understanding of how individual suppliers are using, and plan to use, information about consumers. We are also eager to understand whether the widespread use of credit referencing data could have an impact on the level of competition and choice offered to consumers with poor credit reference histories. There is growing concern that this group of consumers may come under increasing pressure from suppliers to sign up to prepay tariffs. Furthermore, there may be moves by suppliers to introduce differential pricing policies for credit customers, influenced by their credit history. These two issues may become increasingly important ahead of the roll out of smart meters and the introduction of the Green Deal.

We are keen to learn from the work that BIS has already begun with the industry and cross-Whitehall working group on credit data sharing.

²¹ <http://bit.ly/fRADvf>

Q6 It has also been suggested that there needs to be greater transparency around credit scoring and the impact of credit scores on charges. Do you agree?

In recent years CRAs have extended their business model beyond the provision of the basic information – as set out in points 1-3 in question 5. CRAs unique selling point is now to provide lenders with huge amounts of analysis of consumer behaviour that attempts to determine a consumers ability to repay, and more fundamentally the nature of their character (trustworthiness to repay) using a range of sophisticated analysis of data held on consumers (so-called *white data*).

These variables do not have anything to do with their credit history but refer to wider socio-economic characteristics they display. Assumptions are made about a consumer's future repayment behaviour based on associated characteristics of those who have proved to default in the past. The CRAs weight that data alongside repayment history. In policing, this is referred to as '*profiling*'. These associated variables have now become crucial to the CRAs business model. Although each lender will vary on which exact variables it gives most weight to, their decisions to lend are all formed on the basis of the data and analysis collected on consumers by the three main credit reference agencies, and all include the use of the same variables.

It is in the provision of this analysis that the CRAs '*add value*' with '*sophisticated analysis*'. With so many of life's decisions and opportunities reliant on the ability to access credit, the credit scoring criteria of the CRAs now has a crucial role in a consumer's life.

We have several criticisms of CRAs practices and the regulatory framework in which they operate which we believe fails to ensure accurate credit scoring and unfairly discriminates against certain groups of consumers.

1. The CRA's analysis is only of limited use in assessing the likelihood of consumers entering repayment difficulty.

CRAs power to analyse consumers' wider data in determining credit worthiness has grown beyond all value that their analysis provides in ensuring responsible lending. As was pointed out in question 5, the consumer's credit score is the least important of the four variables of a credit worthiness assessment that lenders should use to inform lending decisions. In many cases, the CRAs are not necessary to ascertain the consumer's past behaviour if the lender itself has a record of their behaviour.

There is little evidence that CRAs analysis is more accurate at predicting defaults than affordability assessments. In its response to the BIS Credit and Store Card Review, the UKCA provided evidence that in its view demonstrated the efficacy of complex, mathematical analysis to predict borrower behaviour.²² The UKCA's response states: '*credit card issuers' credit scoring models are highly predictive and provide strong indicators*'²³.

To prove its point it showed that those consumers who asked for a credit limit increase themselves defaulted more frequently than those whose limit was increased unilaterally by the lender (so-called unsolicited credit card increase – UCLI). Yet, this evidence does not show the value of a CRA check. Firstly, it does not compare a CRA check with a basic affordability assessment and the relative value of each in predicting default. Research that is able to consider what benefits the added value CRA checks bring using 'white data' is extremely limited.

²² <http://bit.ly/gjB0SI>, p12

²³ *ibid.* p89

Secondly, those consumers who do ask for an increase in their credit limit (14 per cent ever have²⁴) are more likely to be in financial difficulty in the first place. As the UKCA response admits consumer inertia is profound. It is likely those who find themselves in financial difficulty will ask for an extension, but their credit score has not yet reflected this. It is therefore predictable that they are more likely to default than those whose credit limit is increased by the lender.

Thirdly and perhaps more fundamentally, defaults are mostly the result of unexpected economic shocks to consumers – either personal or due to wider economic conditions and therefore CRA scores do not predict such future behaviour.²⁵ In 2009, a record £4.12 billion was written off by credit card lenders, amounting to about 10 per cent of all money lent on credit cards.²⁶ Default here is mostly not about attitude or willingness to repay but an external, uncontrollable factor which CRA checks have proved incapable of predicting. History of past borrowing behaviour and attitude are far less important than having sufficient financial resources in changing times.

Finally, our research with consumers has illuminated cases where credit scoring has caused consumers to be rejected from a credit application even though a narrow affordability assessment would suggest otherwise.

a. CRA credit scores discriminate those who are poor even if the loan is affordable and they have a good repayment history

From our work in this area it has become clear that many poorer consumers are extremely good money managers but judged high risk on the basis of income alone.²⁷ We believe that this is not fair. Low credit scores should be reserved for those with a poor credit repayment history and whose overall circumstances would continue to present a real and present risk of default. The poor should not be categorised as high risk simply on the basis of wealth instead the basis must be their ability to repay taking into account their income and expenditure and track record of money management.

b. CRA credit scores do not reflect a consumers changed financial situation

In our recent Payday Lending report²⁸, some of the interviewees referred to feeling that it was unfair that they should be unable to get mainstream credit because of a credit rating that was based on their previous rather than their current situation.²⁹ A credit reference should reflect the updated situation in which the consumer finds themselves and should be judged solely on their ability to repay the loan.³⁰ As stated above, most defaults are to do with wealth, payment shocks and not behaviour. If a consumer's finances have changed then so should the likelihood of lenders responding favourably to a credit application. Yet, since credit scores are a) slow to respond to changed financial circumstances and b) given too much weight by lenders, consumers are unfairly excluded.

c. Lenders make significant profits by over-valuing risk

The gap between the Bank of England base rate (0.5 per cent) and the interest on credit cards (now averaging over 16 per cent) has reached never before seen levels and credit card companies 're-priced' the debt of many consumers upwards.³¹

²⁴ Ibid. p91

²⁵ <http://www.berr.gov.uk/files/file38667.pdf>, page v

²⁶ Mintel, *Credit and Debts Cards in the UK*, 2010

²⁷ *Opportunity knocks, High Cost Credit Review, On the margins*

²⁸ <http://consumerfocus.org.uk/g/4t>

²⁹ Ibid.p32

³⁰ Consumer Focus, Response to High Cost Credit review, p4 <http://consumerfocus.org.uk/g/4m4>

³¹ <http://bit.ly/eY9RR5>

The average credit card APR is more than 33 times higher than the BoE base rate, with several major credit card companies including Barclaycard, MBNA, Egg and NatWest, having increased their interest rates in recent months.³²

However, the contingent losses they expected to make, last year and this, have been written back into their profits since the extent of these losses did not materialise³³. For example, HSBC announced its profits had soared by 121 per cent to more than £38 million a day between January and June 2010, as fewer customers defaulted on their loans³⁴.

The level of loan write offs has grown since the start of the recession, and there have been two particularly bad quarters (Q3 2009 and Q2 2010) but the increase is far less pronounced than might be expected, given the length and the severity of the recession.³⁵

Yet, those consumers who behaved prudently, avoided default and struggled on paying have in no way been compensated nor have consumers more widely for the increased borrowing costs, through for example higher loan costs or credit card re-pricing. There is simply no mechanism, procedure or institutional checks to hold banks to account for over-valuing the cost of credit based on inaccurate or unfair assessments of risk.

It appears the CRA information was of little help in accurately predicting risk either prior or after the crisis and in one way or another it is the consumer who has paid.

2. CRAs analysis does not adequately determine consumers' repayment attitude when they do enter payment problems

Default history provided by the CRAs does not differentiate consumers who enter insolvency between those who aim to repay (through IVAs, Debt repayment plans) against those who default through bankruptcy.³⁶ It would appear the mark on the credit record is the same. Yet, the risk to the lender due to the attitude of the borrower is markedly different for these two scenarios and thus a consumer's credit access and pricing should differ accordingly.

3. CRAs analysis and scoring criteria has public policy consequences

Consumer Focus believes that the criteria that informs credit worthiness assessments needs to be subject to oversight.

The collection and analysis of an array of data needs to be democratically legitimised and consulted on with society more widely. There are huge consequences for consumers that need to be considered and weighed against other public policy goals.

A recent decision by the ICO prohibited CRAs from using defaults or bad credit scores on small businesses against the personal credit score of those involved in the small business.³⁷ This sets an interesting precedent since it is undeniable that the credit history of small businesses (such as sole traders) will impact on the likelihood of default on a personal credit card held by the same person. Despite that, the ICO has set rules that prohibit that information being passed to the personal credit score. Thus, a precedent has been set that restricts the private actions of CRAs and lenders to share certain information even where such information is predictive of future default.

³² Mintel, *Credit and Debit Cards*, p15

³³ Mintel, *Retail Banking overview, 2010* p18

³⁴ <http://bit.ly/eCLrN6>

³⁵ Mintel, *Retail Banking overview, 2010* p18

³⁶ This point was recently made by Damon Gibbons at a round table event 'Insolvency and Debt Management Roundtable' | Friday 26th November run by the Centre for Responsible Credit.

³⁷ The ICO was enforcing the Data Protection Act 1998 which separates data between business and personal records.

The ICO thus interpreted the DPA which establishes that wider social/economic or political considerations limit the ability of CRAs to share data.³⁹

However, there are wider issues around data sharing that are beyond the scope of the ICOs powers. Currently, the only forum to discuss data sharing practices is the Steering Committee on Reciprocity. This has a poor track record on consumer representation and engagement. We believe the following examples prove greater engagement is needed to ensure the public policy implications of data sharing are fully explored.

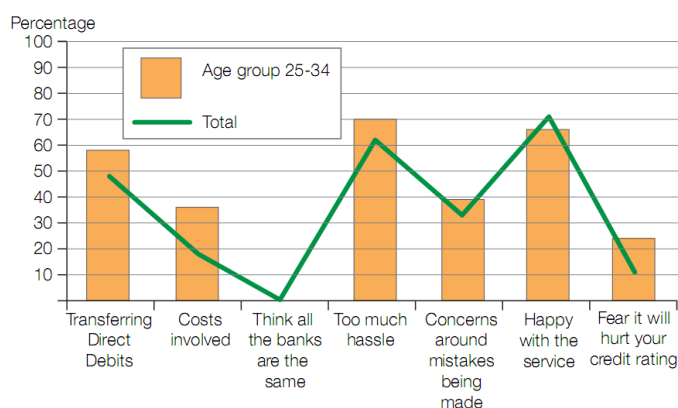
a. Switching current accounts

Consumer Focus recently investigated switching in the personal current account market to look at whether it was likely to influence competition among banks and affect unfair charges. Our research shows that 11 per cent of those who had thought about switching current accounts decided not to, due to fears about the effects on their personal credit rating.

This supports other consumer research in the current account market including the Competition Commission’s research into the importance that consumers’ fears of switching in the current account market had in Northern Ireland.⁴⁰

The fears are predictably strong for younger consumers who rely on a good credit score in order to obtain mortgage credit. The graph below shows that among those aged between 25-34 who have thought about switching, 24 per cent decided not so switch due to fears about how it would affect their credit rating.

Graph 6 – Have you not switched for any of the following reasons?



Our investigations have confirmed that one of the variables in determining credit scores is the length of time a consumer has held a current account with a bank.

We have serious concerns about the fairness of including such a variable in an assessment of credit worthiness as it is not clear that it is relevant. CRAs state it is only one variable among many and each lender has the ability weight this information according to how they see fit.

Yet, we simply do not accept this as a valid variable in determining credit worthiness. There are many reasons why one might switch, a consumer may be attracted by a marketing offer, wish to move to a bank with a better quality service, or may wish to have access to a closer local branch if they move. We do not believe CRAs should analyse this as meaning default is more likely.

³⁹ This point was recently made by Damon Gibbons at a round table event ‘*Insolvency and Debt Management Roundtable*’ | Friday 26th November run by the Centre for Responsible Credit.

⁴⁰ Competition Commission, *Qualitative Inquiry into Personal Current Account in Northern Ireland*, January 2006, p14

Competition in the retail current account market is an explicit policy goal of Government, most notably through the OFT's on-going work on personal current accounts.⁴¹ Our research clearly indicates this variable in determining credit worthiness undermines efforts to increase switching in the current account market. Following our report, we have identified the lack of any institutional framework, either through democratic organs or through stakeholders groups that includes consumer representatives to express concern about the operation of the credit scoring system.

b. Multiple loan searches

Similarly shopping around for loans can have an impact on credit ratings. Yet many products are *rate-for-risk*, so without applying you cannot know the rate. Consumer Focus wrote to the '*standing committee on reciprocity*' to make clear our concerns.⁴² Following our letter the Treasury select committee opened an investigation. It found the following:

'There is clear evidence that some consumers do not shop around because they fear that to do so will affect their credit score. Indeed, industry advice suggests that multiple applications "may lower your [credit] score". We consider there are likely to be serious flaws in a market in which consumers are discouraged from shopping around, either because of unfounded fears or because of industry bias against multiple searches...'

*'We believe the ability to shop around is not only an important means for consumers to assess the market, but also provides a key discipline on providers. We recommend that the OFT investigates the impact of multiple applications on the availability and price of credit.'*⁴³

Consumers need to have the guarantee that sharing more of their data does not mean they are scored down because they search for the best deal. We are aware the OFT has undertaken an investigation but as of yet we are unaware of its outcome.

Moving to quotation searches, which do not leave a footprint, as a default across the industry rather than as a rarely exercised option is an obvious solution. Following the Treasury select committee investigation we are aware that may now be a possibility for lenders. Yet, we have no knowledge about whether they do indeed use this option, under what conditions or whether consumers are aware about which search method lenders use.

c. Unfairly sharing contested information where a debt is disputed

The current Lending Code states that a lender can pass on information when the amount owed is not being disputed by the customer, but says that dispute must be 'genuine, reasonable and unresolved'. We are concerned there are few checks or processes that restrict firms sharing such data, or informing the consumer about the sharing of this data and its likely effects.

It should be the case that if the amount owed is disputed by the customer there can be no notification to the CRAs. In these circumstances the matter should be referred through the firm's complaint procedure and/or attempt to be conciliated. We fear that if other information is shared – from utility companies, local authorities, etc. there will also arise cases where disputes are passed on inappropriately. Since few consumers check their credit score they remain unaware about the consequences to their ability to access credit. Unless we are sure that their processes are sufficiently robust, we believe it is difficult to yet propose sharing data from these bodies.

4. Consumer control about the sharing of data

⁴¹ <http://bit.ly/ex5hul>

⁴² Alongside Money Saving Expert see <http://bit.ly/e9I2er>

⁴³ Treasury Select Committee report, Credit Searches, 2009/2010 <http://bit.ly/cbOBUX>

Consumers are not given sufficient control over the sharing of their information, nor to the uses to which such information will be put. Under the current Lending Code guidance if the customer does not give permission to share information about the day-to-day running of their account, there are 11 other ways of permission being implied on the basis of the Information Commissioner's guidance, including through the terms and conditions in an opening pack. That is not sufficient protection or choice from the consumer's perspective and it needs amending. Permission must be sought in relation to each disclosure and how that data will be used.

5. Consumers ability to see, understand and challenge the data (or analysis) on their credit worthiness.

Under the Data Protection Act 1998 and the Lending Code lenders have a duty to inform consumers of all information used in the credit together with notification of the assessment.

The borrower should then have the opportunity of providing evidence to dispute any information in the assessment and the assessment will be reconsidered.

Currently, lenders are failing in their duties. The Lending Standards Board (LSB) reviewed compliance with the Lending Code's provisions on credit assessment. It assessed lenders explanations of credit rejections to consumers where a CRA check has failed them. The LSB found subscribers were giving template responses when credit applications were rejected⁴⁴. It states:

'the explanation given to customers generally provides little information other than a recommendation to check their file at the CRA. In some cases this appears to be used as a stock response even when it is clear that the account history is the main reason for rejection'.

The report goes on:

'However, in some of the cases we reviewed, it was clear that the account behaviour and trends were probably significant factors'.

Consumer Focus agrees that consumers are not being informed what information is being taken into account, how they can challenge it or improve their credit score. According to the LSB, to remedy this failing the British Bankers Association is

'proposing to issue guidance to ensure that when asked, firms provide clear information to consumers about the reason for credit being refused, rather than simply stating credit had been refused "because of CRA data".'

We would welcome such measures but we remain sceptical about the willingness of lenders to review their procedures under voluntary schemes.

Q7 Which of these stakeholder proposals do you consider would bring benefits to industry or consumers and what would these be? Please provide evidence in support of your view.

Stakeholder recommendations: Decision to borrow

It is unfortunate that no information is provided about sources and aims of the recommendations in the appendix on 'Decision to borrow'. This has meant we are not able to comment in specific terms.

⁴⁴ Lending Standards Board, ***Themed review of compliance with the Lending code's provision on credit assessment***, <http://bit.ly/fyl7Vw>

In general terms, Consumer Focus is supportive of the principles of better regulation: unnecessary red tape places a burden on industry and costs can be passed on to consumers in terms of higher prices and lack of innovation.

However the Financial Services Sector in general is not an area which has suffered from excessive regulation – in fact it is the light touch approach which has led to the financial crisis affecting the banking system as well as the financial wellbeing of ordinary consumers. Where regulations are to be removed it is important that an assessment of impacts is carried out to mitigate any unintentional consumer detriment particularly on vulnerable consumers.

Stakeholder recommendations: What happens when things go wrong?

Again the recommendations set out below in the appendix section on ‘what happens when things go wrong’ are short on detail and further explanation would have been helpful. We make some comments below:

- requirement for banks to identify and act quickly on snowballing penalty charges/unmanageable debt

Our research into the unbanked shows that many consumers have turned away from the banking products because of often justified fears of mounting fees if they go overdrawn or miss payments. A swift and more proportionate, non-punitive approach to consumers getting into debt would enable more consumers to stay within the banking system

- provision of emergency borrowing facilities with limited duration and capped interest rates

In our research into payday loans we found that often people used this product because they liked the short term nature of the loan. These consumers intended to repay the loan at the next payday and did not want to have the temptation of a longer term lending facility.

In our report into this market we recommended that banks should investigate whether they could provide a short term lending facility for their customers so that they did not have to resort to high cost loans. This facility could be available to customers who had a regular income and would aimed to be paid off in full at the next payday. We recommend that customers only be able to use this facility two or three times a year to avoid it becoming a longer term lending facility. Given that the overheads and risks would be lower for banks providing this facility to customers they already know and provide accounts for it we expect that interest rates could be far lower than those charged by payday loan companies.

- ban on orders for sale except in exceptional circumstances and for all unsecured debts below £25,000

- minimum debt thresholds for charging orders (at least £25,000)

We deal with these issues later in this response

- rationalise role of Financial Ombudsman Service (FOS)

It is unclear what is meant by ‘rationalise’ the role of the FOS. Consumer Focus would welcome a strengthening of the role of the FOS and supports it remaining free to use for complainants. We consider that the FOS has worked effectively in dealing with the huge number of complaints it receives from consumers but that it is constrained by three main factors:

- a. the banks’ inability or unwillingness to deal properly with complaints thus forcing greater numbers of consumers to take their concerns to the FOS

- b. lack of prompt action from the regulator to prevent poor practice from continuing – for example action was only recently taken to prevent banks “bundling” PPI into loan sales
- c. inability to rank bank brands and products in terms of number of complaints received and upheld complaints according to market share

Consumer Focus would like to see:

- financial institutions resolving complaints at source and not letting matters drag out until they go to the Ombudsman
- lessons being learnt from the complaints data and a commitment from companies to improve with a concrete plan to do so over the next year
- companies priding themselves on dealing well with consumer problems and promoting their success in resolving problems
- a properly functioning ‘wider implications’ referral system so that systemic complaints involving unfair or unsafe business practice are picked up and dealt with before it becomes an entrenched part of an institution’s business model
- consistent complaints information across the FOS, the companies and the FSA so that, when they shop around, people can easily ascertain which firms receive the most complaints proportionate to their market share and how well they deal with them. There needs to be more clarity about firms’ performance across differing products
- greater visibility of the FOS on banking statements and in branch office etc so that consumers are aware of the service provided and are empowered to continue to pursue their complaint until it is dealt with satisfactorily. This would include mentioning the FOS in the banks’ acknowledgment of a complaint so the consumer is aware of their options if they remain unhappy at how the bank has handled the complaint.

Q8 Do you believe that the current voluntary, market-driven initiatives to address concerns about unarranged overdraft charges (UOCs) are delivering, or will deliver, sufficient improvements for consumers? If not, what would the wider implications of limiting bank charges be? Please provide evidence in support of your views.

Regulatory action on the banks

The OFT took legal action on ‘unauthorised overdraft charges’ to see whether it could assess bank charges for fairness when the charging structure was not transparent. The Supreme Court ruled on the test case on unauthorised overdraft charges in November 2009. It ruled that the fairness of these charges could not be challenged on the basis proposed.

While the Supreme Court decision did leave room for the OFT to take a different legal route it choose not to pursue the case. Without the legal route to judging the fairness of charges, the OFT has relied on voluntary action by the banks to ensure improved market competition eradicates consumer detriment.

OFT efforts to drive reform to eradicate consumer detriment through voluntary action with the banks

The OFT has sought to create a ‘virtuous circle’ of transparency of charges, greater consumer control and efforts to improve the consumer experience of switching. This sits alongside efforts to reduce the barriers to new competitors.

It is important to measure performance of the specific initiatives the OFT has co-ordinated under the auspices of voluntary action from the banks. Yet, an analysis of specific initiatives must be tempered with a strategic look at the big picture, at how effective those reforms have proved to be to date in the market place.

That means looking at how overall revenue for UOCs has shifted in recent years and how willing consumers are now to vote with their feet. When looking at the market from this perspective the evidence is clear; the reforms have not increased competition for those who pay UOCs, nor reduced the annual revenue raised from UOCs. The OFT's reforms have failed to adequately transform the current account market and it is vital that the Government introduces its coalition pledge to end unfair bank charges as we recently recommended in our switching report, *Stick or Twist?*.

1. Improved switching process to encourage consumers to 'vote with their feet'.

The OFT has facilitated wide ranging reforms of the current account market following its 2008 report. Reforms included improving the consumer experience in switching; most notably on ensuring Direct Debit transfers do not incur errors. Additionally, in 2009 the BACS working group established a guide for switching, a Direct Debit help centre, a consumer website with tools and advice for switching and template letters for consumers to use. It also introduced an 'originator education strategy' to ensure those firms who use Direct Debits have adequate systems in place to amend them.⁴⁵

In addition, in December 2009, BACS promised that no consumer would lose out financially by errors in the switching process from the bank or a Direct Debit originator. As consumers shift payments more and more to Direct Debits it is vital that these reforms radically reduce problems in order for trust in the switching process increase. The OFT has recently suggested some progress on this.⁴⁶ The OFT reported a 20 per cent reduction over the past year in the number of Direct Debits being sent in error to consumers' previous bank accounts.⁴⁷ The OFT also referred to a BACS survey suggesting consumer satisfaction was improving. The BACS survey found satisfaction was 85 per cent of those who had switched between June 2009 and June 2010.

Consumer Focus also recently investigated switching in the personal current account (PCA) market to look at whether it was likely to influence competition among banks and affect unfair charges.⁴⁸ Our report examined consumers experience of switching in the last two years (February 2008-2010) and also the impressions of switching held by those who had not switched. That covers a time period subsequent to the OFT current account study and just passed the introduction of the OFT led reforms mentioned above.

Our survey showed that consumers' experience of switching had actually declined since the 2008 OFT market study report. It must be noted that the period our research covered included time before the reforms were in place and it cannot yet judge the success of the BACS/OFT reforms but it is a significant concern that our research showed a significantly lower level of satisfaction than the BACS survey. We found one in four of all those who had switched still had problems in the Direct Debits process, an increase since the last survey by the OFT in 2008.⁴⁹

⁴⁵ <http://bit.ly/c4Bonx> p49-51

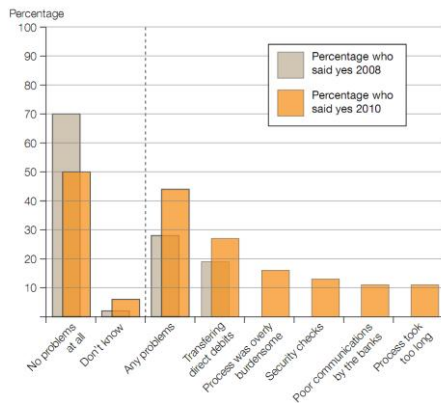
⁴⁶ OFT, *Personal Current Account, Progress report*, September 2010

⁴⁷ OFT, *September 2010*, p14

⁴⁸ <http://consumerfocus.org.uk/g/4mf>

⁴⁹ *Stick or Twist*, p24

Graph 10 – When transferring your current account from one provider to another, did you have problems with any of the following?

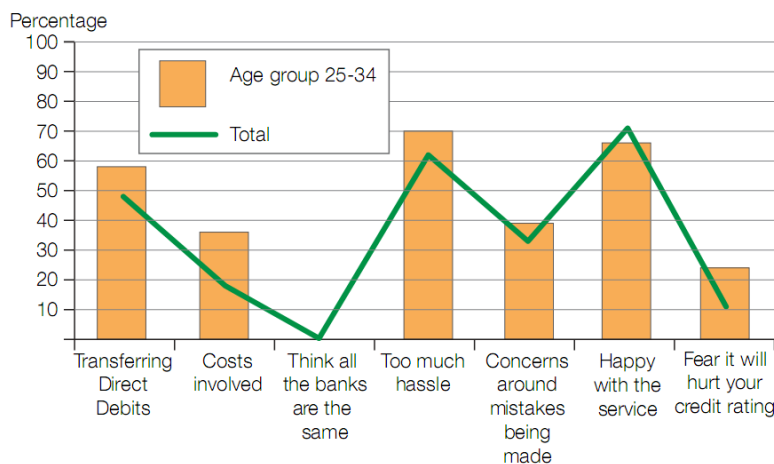


We concluded: ‘Our research showed that there is still a great reluctance among consumers to switch account providers. There also appear to be real problems with the switching process. This undermines efforts to improve switching as a way of driving competition in the banking sector. Until people are prepared to ‘vote with their feet’, competitive pressures on banks will be weaker than they should be’.

We have not been able to investigate the discrepancy between our results and the BACS data as we have been informed the research report is not publicly available.

Leaving aside the actual quality of the switching process what is equally as important is the question of public perceptions. Our report captured a deep suspicion about the switching process that will impede efforts for improved competition to drive consumer value. Over eight million people (17 per cent) have thought about switching but not done so and this is often due to concerns about the costs of switching. Of those who had thought about switching but not done so, nearly half (48 per cent) were put off by their fears around transferring Direct Debits. A third also expressed a general fear of mistakes being made. Many simply choose to give up and stick with their current bank. The graph below details the concerns of all consumers and also the age group 25-34 who had not switched but thought about it. We can see many were put off the process by fears about the process.

Graph 6 – Have you not switched for any of the following reasons?



Mintel has also recently found similar results.⁵⁰ Mintel’s focus groups confirmed the importance of the ‘hassle factor’ when considering switching banks:

⁵⁰ Mintel, *Retail Banking overview 2010*, p66

'Wouldn't switch accounts now as there are too many things that could go wrong with moving all the standing orders/direct debits etc.'

The BACS effort to promote switching as safe and secure therefore has work to do. In the long run its success in changing minds will depend on actual consumer experience, which as we note above, is far from clear. Trust in the process can also be helped if consumers were confident that if things did go wrong they would be adequately compensated.

Consequently, in our report we recommended the OFT or the banks offer compensation as well as restoration of any money lost by a consumer who has suffered an error. That would encourage businesses to improve their performance and it would fairly compensate consumers who have had to chase up mistakes. This would build on the OFT's finding in its response to our super-complaint on cash ISAs that: *'providers should think more broadly about whether there is asymmetry in their relationships with consumers if they levy fees when consumers miss a payment date for example, but are not prepared to offer redress voluntarily, without being asked, when their own processes are delayed or go wrong'*⁵¹.

We do not see any prospect that the banks would be willing to introduce such provisions under the voluntary regulatory framework currently in place. A good model to follow would be the FSA's approach to complaint handling where it has undertaken significant research, mystery shopping and testing the processes of firms. This has led to enforcement action as well as the current consultation on forcing firms to reform their complaint handling processes.⁵²

Furthermore, the promotion of switching could be better undertaken than under the current voluntary approach. The *'switching service'*, is only on the BACS website, which is largely aimed at industry not consumers, – so unsurprisingly just 7,000 people have looked at the site in the past 12 months.⁵³ We found many banks' websites do not refer to this website and nor is the documentation available in many branches. Many banks do have dedicated switching services but the last time the OFT examined these, in 2008, it found error rates were higher for the consumers who used these sites than those who did not.⁵⁴

Tools to encourage and support switching need to be accessible and crystal clear, with easy-to-read scenarios that consumers can relate to their own circumstances. In reality, it is unrealistic to expect consumers to research the BACS website, download various forms and send them off – consumer apathy is likely to be too strong. We would like to see the switching service disseminated in a consumer friendly way. It should be made available to all customers, on banks' websites and in branches

The OFT, or whatever the future regulator of the current account market will be, needs stronger teeth and a greater will to challenge industry. Tough action is needed to restore consumer faith so that competition can go at least some way to applying pressure on the banks to treat customers fairly.

Yet, even an improved switching process will not provide the transformation needed for those consumers hit by UOCs. Our report shows that consumers are deeply apathetic about switching PCAs when compared to other products⁵⁵.

⁵¹ OFT, Cash-ISAs: Response to super-complaint by Consumer Focus. June 2010.

⁵² <http://bit.ly/crFrCh>, p.86

⁵³ <http://bit.ly/eiNKPE>

⁵⁴ OFT, September 2010

⁵⁵ Of, 2008, p103

⁵⁵ *Stick or Twist*, p12

We stated: *'fewer than one in five consumers have ever even considered switching. Most consumers rarely even think about switching current accounts and this applies across age groups, gender and differing socio-economic classes. For most consumers, switching simply does not enter their mind. This confirms the conclusions of the OFT's survey in 2008 and the NCC's survey in 2005 and suggests there are limits to what effect making switching easier will have on the current account market. The majority of consumers are either not interested in switching or there are other impediments to them exercising a choice'*.

Our research is one of many that emphasises consumers continued reluctance to switch in this market. For example, the BACS research quoted by the OFT found the rate of switching had decreased.⁵⁶ According to Mintel, *'Relatively few people are seriously considering switching their current account. While churn in the general insurance market and, to a lesser degree, savings and credit card markets is high, people tend to stick with their current account provider'*.⁵⁷

Indeed, OFT research for its barriers to entry paper suggests consumers are less willing than before the economic crisis to switch. It found some 41 per cent of current account holders say that they are less likely to move providers compared to three years ago, compared to 11 per cent who would be more likely to switch.⁵⁸

In *Stick or Twist* we found those most reluctant to think about switching also appear to be those most likely to suffer UOCs.⁵⁹ To reduce the detriment suffered by consumers who pay UOCs requires action on pricing which we believe requires the Government to end 'unfair bank charges'.

2. Greater Transparency and clarity over pricing

a) Simplified charging structures and reduced UOCs

The OFT expects that transparency initiatives will *'lead to an increase in the transparency of costs of PCAs to consumers, which in turn will lead to consumers both using their PCAs more efficiently (for example, by avoiding charges) and being more aware of the benefits of shopping around for a better PCA. Together these outcomes will help drive competition in the PCA market, which will lead to PCA providers needing to offer better value products to retain and attract consumers'*.⁶⁰

Consumer Focus supports the goals behind the OFT's initiative on transparency. Across all products and industries we call for simple, comparable and transparent pricing structures in order for informed consumer choice to drive value and competition in markets. However we have two major concerns that means we differ from the OFT's approach:

- Charging structures within UOCs have proliferated. The OFT states this allows consumers to find an account that best suits their specific lifestyles
- The OFT states the recent migration of charges to authorised overdraft charges (AOCs) is more transparent for consumers allowing more informed choice and this should lead UOC charges to reduce as a consequence

⁵⁶ OFT, *Personal Current Accounts in the UK, a progress report*, September 2010 p15

⁵⁷ Mintel, *Retail Banking*, 2010, p7

⁵⁸ OFT, *Barriers to Entry*, September 2010

⁵⁹ *Stick or Twist*, p15

⁶⁰ <http://bit.ly/eXYkT5>

UOC have proliferated

In its March 2010 paper the OFT claimed that, in light of its efforts to improve the clarity of costs of current accounts, banks have lowered unpaid item charges since its original report in 2008, falling from £34 to £17 on average in three years⁶¹.

However charges have shifted from unpaid item charges to a whole host of more complicated penalty charging structures. Such variables include: days beyond the limit per month; amount beyond the limit; payments when overdrawn; and percentage of transactions that bounce. As elaborated further in the final section, the overall revenue from UOCs remains largely unchanged in terms of revenue earned and as a percentage of total revenue. Thus, the regulatory efforts on transparency have not reduced UOC charges in total but only worsened the complexity and confusion consumers experience when trying to comprehend the PCA market.

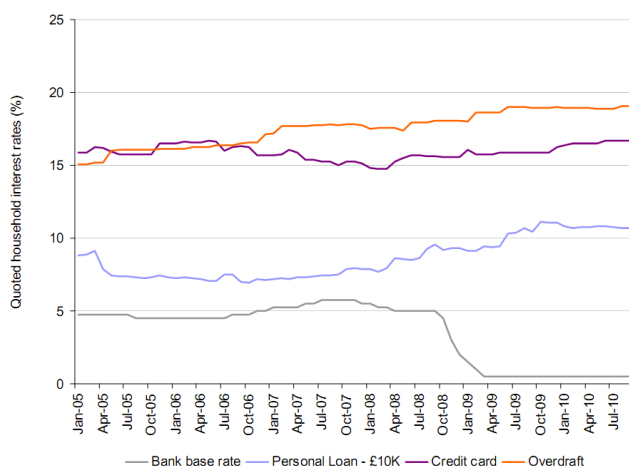
Our evidence shows that of those who had not considered switching, 39 per cent suggested all the banks are the same.⁶² Equally Mintel has found “*Three fifths agree that high street banks are pretty much the same as each other*”⁶³. This suggests for those not actively engaged in searching the market, a large percentage believe that there is nothing to be gained from switching. This is particularly worrying for those who face penalty charges. These consumers could gain a great deal by switching. Yet, the presumption the banks are all the same comes from the extreme difficulty for this group in assessing the relative value of differing accounts.

With such an overly complicated pricing structure it is very difficult to fathom and compare the actual expense of different accounts, since it is based on their future behaviour they may not be able to predict. This prevents their engagement with the market.⁶⁴

Charges have increased on AOCs

The OFT believes ‘*downward pressure on UOCs may lead to increases in other, more visible charges such as the cost of using arranged overdrafts. Since such charges are more transparent, consumers will have incentives to switch away from providers that do not offer value-for-money, thereby exerting a competitive pressure on these costs.*’⁶⁵

FIGURE 23: AVERAGE QUOTED CONSUMER CREDIT RATES, 2005-10



SOURCE: BoE/MINTEL

⁶¹ <http://bit.ly/dbIVcg>

⁶² *Stick or Twist*

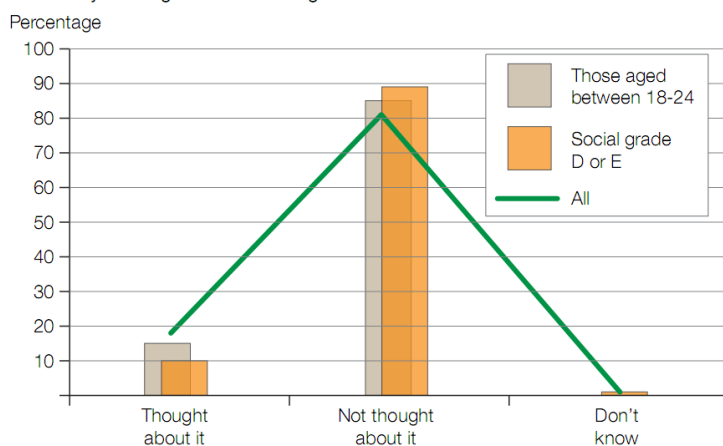
⁶³ Mintel 2010, p8

⁶⁴ *Stick or Twist*, p22

⁶⁵ OFT, September 2010, p27

As the above graph shows the interest charged on AOCs (overdraft in the above graph) has indeed increased as the Bank of England base rates have fallen, massively increasing their income stream on this form of credit. However, Consumer Focus does not believe consumers choose their current account based on the headline overdraft charge. As the graph below from our research demonstrates those who are more likely to switch are wealthier and older consumers which are also the least likely to suffer UOCs, or indeed use their overdraft at all.⁶⁶

Graph 3 – Have you thought about switching?



The marketing campaigns of those PCA providers looking to expand their market share focuses on wealthier consumers who form part of the 77 per cent who do not pay UOCs⁶⁷ (to gain the offer consumers often have to pay a minimum amount each month). Evidence suggests PCAs are used to then cross-sell more other products.⁶⁸ Richer consumers are more likely to purchase a wider selection of financial products and therefore provide future revenue. Consequently, banks are willing to offer PCAs on very attractive terms to such customers.

To support this we need only look at the marketing campaigns of the various high street banks. The nature of competition in the PCA market means banks compete to attract custom by offering teaser rates of a cash reward or high interest on deposits for a certain time period.⁶⁹ Others offer additional bundled products for free or at a discounted rate.⁷⁰ Adverts rarely mention the charges for AOCs or UOCs. Furthermore, economic research shows demand in the PCA market does not respond to longer term cost that can be difficult to calculate.⁷¹

This has socio-economic consequences meaning more than ever the costs of supplying the PCA infrastructure are placed on consumers who suffer overdraft charges and are likely to be poorer. In its 2008 report, the OFT noted a significant source of income for PCA providers was '*net interest income from credit and debit balances*' not passed on to consumers (£4.6 billion).⁷² This was nearly double the income gained from UOCs (£2.6 billion). With the decline of base rates to 0.5 per cent this source of interest has reduced placing strain on the business model of the PCA providers considering few consumers are willing to pay upfront costs for their PCA (unless bundled with extras).⁷³

⁶⁶ Consumer Focus, *Stick or Twist*, p15

⁶⁷ As reported in 2008 by the OFT <http://bit.ly/i1GJmh>, p5

⁶⁸ Mintel *Retail Banking overview*, 2010, p5

⁶⁹ For example, HSBC, First Direct, Santander, Halifax

⁷⁰ Co-operative Bank, Lloyds TSB

⁷¹ Paul Johnson, in Consumer Focus, Focus on Finance seminars *Free or fee: Are 'free' products good for consumers?*, Consumer Focus, <http://bit.ly/fbOMf0>

⁷² <http://bit.ly/i1GJmh>

⁷³ As the OFT accepts in *Barriers to Entry*, 2010, p36 footnote 51.

It would appear PCA providers have substituted this source of income with increased margins on AOCs.

It means those in deposits now pay next to nothing at all for their PCAs (whereas before they risked paying in terms of opportunity cost of not putting their income in an interest earning account). Additionally, they are given money or extras to encourage them to switch. The increase in AOCs is not likely to impact on them but instead on poorer consumers.

As was made clear in our 'Focus on Finance' seminar what was a charge on wealthier consumers has now been passed on to poorer consumers, who subsidise the teaser offers marketed to entice richer consumers.⁷⁴

The increasing profitability of AOCs has not been accompanied by a decrease in the revenue or complexity of UOCs as the OFT hoped in its above quote. Instead, UOC revenues are stable⁷⁵ but even more complex than before. The sheer complexity of charging structures means that it is very hard for consumers who require their PCA for access to temporary credit to know what best value is for them.

Meaningful comparisons are difficult on future behaviour that you do not predict (see section b below for further details) so transparency has not improved. Determining value at the lower end of the market is so confusing consumers are not increasing their propensity to switch. Our recent report has found those most likely to suffer from charges appear the least likely to switch.⁷⁶ Our report is one of many recent reports to dampen the idea that switching rates are increasing in general or for this group specifically. Consequently, the current voluntary led arrangements are not making the necessary reforms to make current account charging fair and action from the Government is needed to follow through on its commitment to end '*unfair bank and financial transaction charges*'⁷⁷.

b) Greater consumer information to compare and choose PCA based on costs

As part of its wider efforts to reform the current account market the OFT has tried to ensure consumers are given greater transparency over the cost of their account, from potential charges if they switch (scenario testing). Consumers will also soon receive an annual summary of all charges. Clearly as these measures have recently or are yet to be fully implemented it is too early to assess either the success of the implementation or gauge the impact of them on the market.

However we do not believe they are likely to transform the market place for consumers who suffer UOCs. As noted above, those most likely to suffer UOCs (23 per cent of the market according to the OFT in 2008⁷⁸) are least likely to switch generally and remain disengaged from the market place. Our evidence strongly expressed the real and consistent failure of those who suffer from UOCs to engage with the market at all.

This only confirms the findings the OFT first discovered in its market study that consumers stubbornly refuse to engage with pricing in the PCA market even when repeatedly facing UOCs since pricing remains so opaque.⁷⁹

⁷⁴ <http://bit.ly/fbOMf0>

⁷⁵ OFT, *Personal current accounts in the UK Progress update*, September 2010 p27

⁷⁶ *Stick or twist*

⁷⁷ Coalition agreement, *Our programme for Government*, June, 2010, p13 <http://bit.ly/aRcqqg>

⁷⁸ <http://bit.ly/i1GJmh>, p5

⁷⁹ *Ibid.* p5

Secondly, the changes since the 2008 market study have only worsened complexity. Charging structures have grown more complex so engagement with the market becomes more difficult even with the assistance of charging scenarios. The 2008 OFT report highlighted that *'although over half of the interviewees had experienced insufficient funds charges, almost none had anticipated going overdrawn, having payments rejected, or paying bank charges. The conclusion of the psychological analysis was that some consumers are overconfident when it comes to their finances and probably underestimate the cost of banking'*⁸⁰.

When the consumer is so poor at anticipating their use of UOCs, is so overconfident and fails to engage with the market it appears unlikely that they would switch banks based on variables they do not yet know. Thus, it appears unlikely that those who do face these charges are able to calculate which account suits their needs best using these scenarios because they simply do not plan to suffer from them.

We have concerns about both scenario testing and annual summaries which we will outline below. It must be born in mind these points do not negate the above points that information provision as a whole is only likely to have a marginal effect on the market.

The OFT notes in its September report that the scenario testing documents are difficult to find on the banks' websites.⁸¹ There is also the related issue of the quality of the information provided to consumers.

We have yet to see any evidence from the OFT, Consumer Direct or the banks about how many consumers have used the charging scenarios either on the web, phone or face-to-face to inform switching decisions and their views of its usefulness. We believe to assess whether the scenario testing is working there should be an evaluation with consumers.

We welcome the banks agreement to *'pre-notify all fees and charges'* and offer an annual summary of charges to consumers in 2011. The OFT hopes this may make consumers reflect on the cost of their PCA and encourage switching. We believe the notification could have been made more powerful. Inertia is so high among consumers (see competition section) that their right to switch needs constant reinforcement.

One way to keep *'plugging away'* would be to include a reminder that consumers have the right to switch on the upcoming annual summary of charges and interest. This proposal has already been recommended by the Competition Commission following its investigation into the current account market in Northern Ireland.⁸² A similar reminder has been implemented in the energy sector which already has higher rates of switching than in the PCA market.⁸³

3. Improving consumer control

a) Faster Payments

In September 2010, the OFT produced its most recent progress report with regards the current account market including progress on the introduction of faster payments.

We believe the OFT report shows the introduction of the faster payments scheme is unacceptably slow and as a result consumers are experiencing detriment. Payments were highlighted as an issue of consumer concern in the Cruickshank Report in 2000. The OFT Payment Systems Taskforce was established, on which our predecessor body

⁸⁰ OFT, 2008, p70

⁸¹ OFT, September 2010, P19

⁸² *Stick or Twist*, p12

⁸³ Ofgem, 2009, Retail Remedies

the NCC played a lead role. In May 2005 it reported that it had reached agreement with the industry to establish a greatly improved system for electronic payments, involving a multi-million pound investment by industry. This "*faster payments*" service came into operation in May 2008.

On 6 September 2010, the ceiling for one-off payments using Faster Payments was increased to £100,000. Arguably this is still not high enough, given that one-off payments may include major items such as house sales/purchases, but it is a significant increase on the previous ceiling of £10,000. The ceiling for standing order payments is also £100,000.

No bank has yet implemented the £100,000 limit – the highest level remains £10,000. But most disappointingly, given the years of work and investment that has gone into this system, a number of banks are not allowing their customers to access it in any meaningful way. For example Santander customers can only make a payment of up to £300, and even then only by phone and not using internet banking. Alliance & Leicester customers can pay £300 by phone or internet, Nationwide customers £1000 and Co-op Bank customers £2,500.⁸⁴

Furthermore, banks seem to offer differing payment amounts depending on the method of payment. The maximum standing order payment by HSBC customers is just £50. For Lloyds TSB and Nationwide it's £1,000 and Santander £2,000. Alliance & Leicester does not offer this facility at all.

The 2009 FSA Financial Risk Outlook (FRO) highlighted their concern that '*firms might seek to reduce costs and under-resource key controls, such as complaint handling, as a result of revenue pressures*'.⁸⁵ Subsequently, the FSA has devoted significant regulatory resources into ensuring that banks do not reduce their funding in the complaint handling area.

Instead it would appear, as banks seek to reduce their costs, they have decided to cut back investment in the technology of payments systems. The issue would appear to be that there is not a great competitive advantage to invest in payment systems because they are just one aspect of the overall consumer offer within the current accounts market ie it is an example of market failure.

As Consumer Focus's recent report on current account switching (*Stick or Twist*) and the OFT's own analysis in its work on barriers to entry make clear the current account market has weak competitive pressure. Furthermore, Consumer Focus has undertaken some limited ad-hoc mystery shopping on the question of faster payments with both HSBC and Santander. When calling these banks, their staff seem unaware of the differing Faster Payments thresholds that are available. For example, one Santander staff member said there was no limit for Faster Payments on any payment method, and another HSBC staff member quoted £10,000 across all payment methods. It is of deep concern that those consumers who do enquire may be misled.

Finally, we are worried that without the introduction of Faster Payments, banks continue to make money out of slow and unpredictable payment systems.

As the OFT states: '*The increased use of Faster Payments contributes to greater consumer control as consumers can more quickly rectify a mistake by transferring money to their PCA. If consumers rectify mistakes more quickly they are likely to incur fewer and / or lower unauthorised overdraft charges (UOCs)*'.⁸⁶ Yet with the OFT unable to assess

⁸⁴ OFT, *Personnel Current Accounts in the UK: Progress Update*, September 2010, p30

⁸⁵ FSA, *Review of complaint handling in banking groups*, p9

⁸⁶ OFT, *Personnel Current Accounts in the UK: Progress Update*, September 2010, p29

UOCs for fairness following the Supreme Court judgment in November 2009, there appears to be a moral hazard here where the banks own revenue model incentivises ineffective and slow payment systems.

In the absence of competitive pressure we believe the OFT (or future Consumer Protection and Markets Authority) needs to take action to ensure a basic minimum functionality with regard to faster payments from all banks. In its September update it stated that: *'The OFT expects that those providers which currently have low limits will increase them in the future so that all PCA customers are able to send and receive large value payments via Faster Payments'*. However there appears no clear time line, or penalties for failure to do so.

We would like to see all major high street banks offering a £10,000 floor across all payment methods as well as clear plans to meet the maximum threshold moving forward.

b) Opt-out

'As the market evolves, the OFT expects customers to be offered a real choice about whether or not to have an unarranged overdraft facility and be given better information to keep track of real-time balances.'

This is likely to become an area across which PCA providers will compete, enabling consumers to reward those providers that offer greater control and provide the best customer service by moving their account to them.'

We have strong reservations about the extent to which these measures will be effective in improving the situation for consumers with regard to UOCs. In the first instance, we consider that there should be bank accounts offered which do not have an automatic unauthorised overdraft facility, thus requiring the consumer to decide to have an unauthorised overdraft facility on their account (an 'opt-in' product).

What is being proposed is an 'opt-out' product, where the consumer must choose not to have an unauthorised overdraft on their account. In addition, lenders will not be obliged to offer opt-out products in any event.

The effectiveness of these measures is also limited by the fact that charging and pricing cannot be considered as part of this initiative, yet these would seem to be central to any issues faced by the consumer. It is also a significant concern that there are a number of transactions that it will not be possible to stop from resulting in an unauthorised overdraft. This includes point of sale transactions on debit or contactless cards where automated or on-line authorisation is not sought. This applies to a substantial proportion of shop-floor transactions and very few consumers appreciate the extent of this. There seems considerable scope for consumers who believe they have opted out of unauthorised overdrafts to go into unauthorised overdraft without realising it.

Our research into consumers without bank accounts⁸⁷ and consumers using payday loans⁸⁸ has shown that the risk of overdraft charges are a significant factor in the decision making of these consumers. Marginalised consumers without bank accounts were wary of opening accounts because of the perceived risk of spiralling debt as a result of unauthorised overdraft charges, particularly due to the lack of control over Direct Debits. Over half of those interviewed had previously had bank accounts and their experience of getting into debt through bank charges meant they were extremely nervous about having another account.

⁸⁷ *On the margins: Society's most vulnerable people and banking exclusion*, Consumer Focus, June 2010

⁸⁸ *Keeping the plates spinning: Perceptions of payday loans in Great Britain*, Consumer Focus, August 2010

In addition, recent research for the Financial Inclusion Taskforce⁸⁹ has shown that the majority (six in 10) of people currently without a bank account have had a bank account in the past. Often, they have closed it, or had it closed, because of incurring penalty charges and getting into spiralling debt. This research also showed that fear of penalty charges was a reason given for not having account among three in ten of this group. Thus the fear of incurring unauthorised overdraft charges is a barrier to consumers entering mainstream banking.

It is also the case that the fear on the part of these consumers is likely to be justified in many cases. The research for the Financial Inclusion Taskforce also found that penalty charges considerably reduced the level of savings achieved by consumers as a result of getting an account: 'For those on the lowest incomes, the gains in access to cheaper credit are outweighed by unauthorised overdraft fees, often disproportionate to borrowings'.⁹⁰

Payday loan users have a different demographic profile to the consumers without bank accounts in our study. As stated above, they must have bank accounts and jobs to qualify for this type of loan. In our research⁹¹ we found that many of those interviewed were not able to access or extend overdrafts because of a low income or a poor credit history. However, there were some consumers who were making a positive choice to use payday loans because they saw payday loans as more manageable and less likely to lead to long-term debt than overdrafts. Some consumers were aware that it could be more expensive for them to go into unauthorised overdraft for a short period. There was appetite among consumers for a short-term low value loan that would allow them to go over their overdraft limit without any charges and without a lengthy application process. Thus this is another instance of overdraft charges being a barrier to low income consumers exercising choice in financial services.

4. Big Picture

The proof of the efficacy in the reforms in the current account market is given in the September 2010 update paper. There are two potential tests for success:

a. Is competition growing?

The Herfindahl-Hirschman Index (HHI), a measure commonly used to assess the level of concentration in a market, rose from 1,410 in 2007 (as quoted in the PCA market study) to 1,736 in 2010, indicating that the PCA market is becoming close to being characterised as highly concentrated.⁹² Thus, in recent times the market has become even less competitive.

There are moves to differentiate providers. Many banks now offer enticing switching deals for consumers – either in money or bundled extras. The FSA and FOS now also publish data on complaint handling that now brings differentiation on the quality of service consumers receive.

Yet, despite these efforts our report also noted consumer apathy was deeply embedded within the sector. Just 7 per cent of consumers (equating to 3.3 million people) with current accounts have switched over the last two years, far behind other markets.

⁸⁹ *Realising banking inclusion: the achievements and challenges*, Financial Inclusion Taskforce, 2010

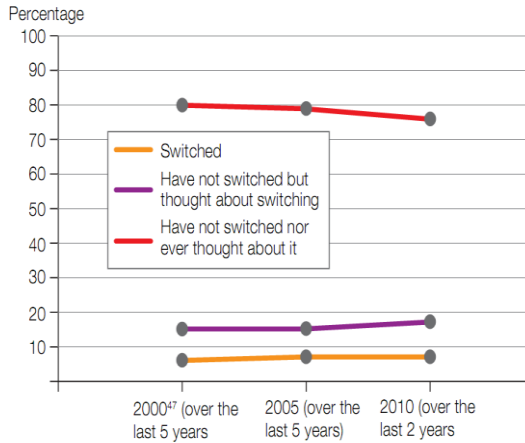
⁹⁰ As reference 13 above, p4

⁹¹ *Keeping the plates spinning: Perceptions of payday loans in Great Britain*, Consumer Focus, August 2010

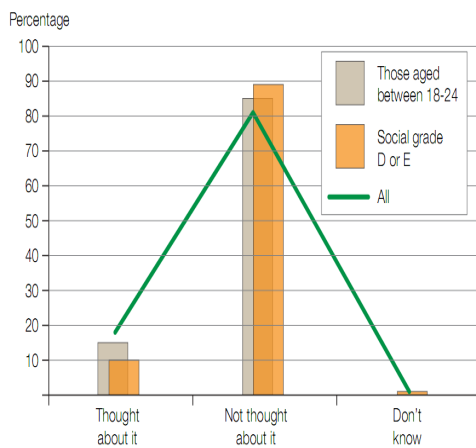
⁹² OFT, *Barriers to Entry*, 2010

Various reports have come in the last 12 months that all place the annual rate of switching as stable with little sign of any notable increase than that reported in the OFT 2008 study (6 per cent). Our report (see below graph) shows three quarters of consumers (75 per cent) have never even considered switching their current account provider. Consumers, in particular poorer and younger consumers who are more likely to pay UOCs⁹³, do not see sufficient value in switching.

Graph 4 – Have consumers switched or thought about switching?



Graph 3 – Have you thought about switching?



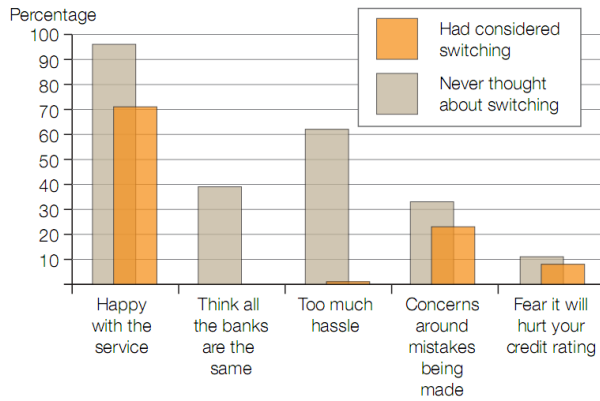
Despite all efforts, our research shows that a lack of differentiation means many consumers simply do not engage in the market place. Nearly two in five of those who had not considered switching felt the sector lacked real substantive differentiation between providers.

Mintel found three in five consumers felt all the banks were the same.⁹⁴ In reality, for those who do pay UOCs where comparison is based on difficult and unpredictable assessments of future behaviour, that is a fair assessment of the market offerings.

⁹³ OFT, 2008, p69

⁹⁴ Mintel, *Retail Banking Overview, 2010*, p8

Graph 7 – Which of the following describe why you have not considered switching the provider of your current account?



b. Is revenue from unfair bank charges declining?

The OFT stated that: ‘As UOCs become more subject to competitive pressures, we might expect these revenue figures to fall’. In its progress report of March 2010 the OFT highlighted the following two examples to exemplify its claim as expressed in its press release that ‘Significant improvements in unarranged overdrafts build on progress in PCA market’⁹⁵ namely:

- unpaid item charges, levied when a bank refuses to make a payment, falling from an average of around £34 in 2007 to around £17 in 2010
- per transaction paid item charges, levied when an unarranged overdraft is granted, falling from an average of around £30 in 2007 to around £22 in 2010

However, its most recent update suggests that the income derived from UOCs more generally has remained stable. The report states: “In 2006, the market study reported that UOC revenue represented around 30 per cent of all PCA revenue. In 2009, UOC revenue represented around 28 per cent of all PCA revenue.”⁹⁶

Not only is the percentage of revenue emanating from UOCs stagnant but so is the total revenue. From the below table also provided by the OFT we see the collective revenue from UOCs has remained remarkably stable over the last three years recorded, despite the legal case, negative publicity and consumers being exposed to the dangers of UOCs repeatedly. The only thing that has changed is transparency, which has worsened for consumers who suffer UOCs and may wish to switch (see question 2 – transparency of pricing).

Table 3: Estimated unarranged overdraft charges, revenue 2007 to 2009

	Revenue from UOCs
2007	£2.48 billion
2008	£2.76 billion
2009	£2.52 billion

Source: Information supplied by the major PCA providers who collectively represent over 90 per cent of the market.

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All this lends credence to the idea that voluntary based regulation simply has not succeeded in the PCA market. We strongly urge the Government to implement its coalition commitment and to strengthen regulation.

⁹⁵ OFT, March 2010, press release <http://bit.ly/dblVcg>

⁹⁶ P26, September 2010

⁹⁷ OFT, September 2010, p27

Consequences of ending unfair bank charges

The potential ending of unfair bank charges would have a profound impact on the PCA market place. This would largely reduce the £2.5 billion of revenue currently coming from this source of income. Many commentators have discussed the as yet unknown market consequences. Our Focus on Finance seminars discussed this issue in depth.⁹⁸ There is the possibility that there would be an extension of the number of PCAs that charge upfront fees. There is a concern that many consumers would balk at the idea of paying for their PCA. Currently, around 75 per cent of accounts do not have any upfront fee attached to their PCA⁹⁹.

Consumer Focus would like to see a diversity of offering on the market place. A fee and free model could sit side by side with differing functionality and benefits attached to the account. That in turn would offer consumers more choice, it would incentivise greater innovation by firms and it would drive competition which the current complexity of UOC charging and free-in banking model tend to eradicate.¹⁰⁰

Yet, it is clear there are also downsides for consumers who currently benefit from the free-in credit model. The difficulty in any fee model universally applied to PCAs would be that the poorest consumers might no longer be able to gain access to their money for free if they avoided UOCs or AOCs. Those who are currently prudent will suffer on already tight budgets. Such consumers may also withdraw from the PCA market altogether and return to a cash economy.

For low income consumers who use their free-in credit banking without facing charges there should be the continued provision of a PCA without charges.

If the market fails to provide this account then the Government should ensure basic bank accounts are more widely used for low income groups. This means ensuring their design and functionality is appropriate for low-income consumers and that banks appropriately market and offer them. Basic bank accounts are important as a potential entry level product and for those on low incomes. Their appeal might be more universal, and less stigmatised, if some of the shortcomings were addressed. These include practised and perceptual barriers to opening accounts, the gap between essential account features and the functionality some basic bank accounts offer (or don't offer) and the perceived and actual risks associated with operating such an account.

Consumer Focus has undertaken research on the design of a PCA that best suits the needs of low income consumers. We have suggested a proposal for a Post Office custom account which would offer improved functionality on the current Post Office Card Account (POCA), including the ability to receive all payments, the ability to take money out at all ATMs and a debit card, enabling payment for goods and services as well as cash withdrawals, together with a small (£10 - 20) interest free 'overdraft' facility.¹⁰² The report highlights also the progress that the introduction of a custom account through the Post Office, and reforms to the current POCA (and also existing basic bank accounts), could have towards greater financial inclusion. It would also ensure any market reforms that led to upfront charging did not unfairly exclude or penalise those consumers who currently do not pay under the free-in credit model.

⁹⁸ <http://bit.ly/dSOXo8>

⁹⁹ Mintel, *Retail Banking overview*, 2010, p35

¹⁰⁰ Mintel, *Retail Banking overview*, 2010, p48

¹⁰² Consumer Focus, *Opportunity Knocks*, p10

Finally, our research on low income consumers has found many are willing to pay for financial services if it removes the risk of larger charges in the future.¹⁰³ Transparency and simplicity are hugely valued by all consumers but especially those on the tightest incomes. That explains why many with a need for credit prefer to borrow from pay day loans companies with high APRs rather than pay the unknown and risky costs associated with credit under an UOC.¹⁰⁴

¹⁰³ Consumer Focus, *Keep the plates spinning*, 2010, *Opportunity Knocks* 2010

¹⁰⁴ Consumer Focus, *Keep the plates spinning*

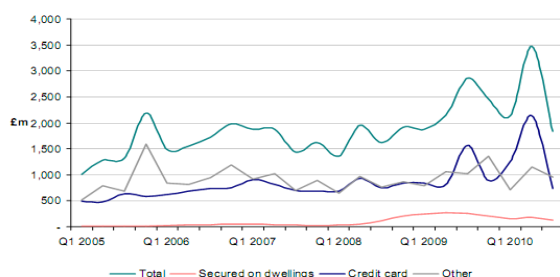
Q9 Should interest rates on credit and store cards be subject to a cap? If so, should this apply to all interest rates or only those which apply to existing borrowing?

It is clear that in recent years the cost of credit on credit cards has risen.¹⁰⁵ Credit card interest rates have increased over the last two years, despite the fact that the base rate has remained at a historic low of just 0.5 per cent for well over a year. This has to do with a combination of risk re-pricing, regulatory costs and write-off of defaults but also excessive profits. For example, pre-tax profits at Virgin Money have increased by 26 per cent to £34.3 million in its latest figures on the back of its booming credit cards business.¹⁰⁶ In its accounts, Virgin Money said that its credit cards division 'was the real driver of profitability' for the group in 2009. Its turnover grew by 11 per cent to £109.5 million. In no other mature industry are profits a third of turnover, and in the middle of a recession.

Lenders have used the fear of defaults to justify large rises in lending rates. Has this fear of defaults proved accurate? Well, not much is the answer as defaults have risen but far less than expected. The level has grown since the start of the recession, and there have been two particularly bad quarters (Q3 2009 and Q2 2010) but the increase is far less pronounced than might be expected, given the length and the severity of the recession.

Loan write-offs spike in Q2 2010

FIGURE 12: WRITE-OFFS OF LOANS BY BANKS AND BUILDING SOCIETIES, 2005-10



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Indeed, the banks admit as much in their annual or interim reports. HSBC announced its profits had soared by 121 per cent to more than £38 million a day between January and June, as fewer customers defaulted on their loans than expected.¹⁰⁸

Therefore, the gap between the base rate and APR unjustified. Action is needed to ensure the credit card market operates fairly and competitively. The question is what is the best method to ensure consumers get good value products yet credit is still forthcoming?

In our view there are significant dangers with a cap that could tighten the supply of credit even further to those currently deemed a high risk. Lenders have significantly tightened lending criteria and supply already. There is a danger a cap could further reduce the supply of credit. These consumers may then move to more expensive forms of debt such as pay day loans or even possibly lenders outside of the legal framework.

Currently, consumers on lower incomes can access credit without any cost if they operate their lending effectively. It would be undesirable to restrict their access to credit which they are able to handle.

¹⁰⁵ Mintel, *Retail Banking overview, 2010*, p31

¹⁰⁶ <http://bit.ly/hbqiaia>

¹⁰⁷ Mintel, *Retail Banking overview, 2010* p18

¹⁰⁸ <http://bit.ly/eCLrN6>

Q10 Are there any alternative measures which would reduce the scope for consumers to be exposed to higher interest rates on credit and store cards?

The credit card market needs radical simplification in order to make it easier for consumers to ascertain what is good value. As it stands, fathoming which card best suits your needs is overly complex.

Consumers face the problem of trying to assess value with three differing APRs on different types of debt with three differing interest free periods. There are also differing classes of charges – APR, handling fee on transfers, and a percentage charge for taking out cash (with a high minimum charge) and various charges for foreign currency exchange.

Due to ‘innovation’ in the sector even further complication has now arisen:

- a. Differing costs depending on the type of expenditure – eg petrol on the BMA visa card is charged at 0 per cent for five years, or a Barclaycard Breathe MasterCard charges a lower APR for expenditure on certain public transport¹⁰⁹
- b. Reward vouchers or cash-back schemes given based on a percentage of expenditure returned to the card user (usually around 1 per cent) or additional ‘free’ products tied onto the card. The aim is to offer an additional value to a credit card to entice customers. While some reward schemes may be good value other reward schemes offer luxury prizes that are extremely unlikely to be affordable for most card users. With high levels of purchasing required to gain these items one wonders if these rewards scheme are meant to be realistic purchasing options or for mis-leading marketing purposes. It would appear such prizes are meant to capture people’s emotions and desire thus diverting them from the dry maths required to assess whether the card is actually good value
- c. Larger reward points on expenditure at certain firms, usually associated with the credit card. For example, on the Marks and Spencer credit card 1 per cent is returned in M&S gift vouchers on any purchases, but 2 per cent of expenditure given in points for purchases within M&S stores

As it stands the credit card market is simply too complex for informed assessment. Evidence shows four in 10 ‘find it hard to know what’s best for me when it comes to loan and credit agreements’ rising to 55 per cent among lower income groups.¹¹⁰ Consumers notoriously struggle to assess long term value of complex products.¹¹¹ With such a complicated market structure consumers inevitably use shortcuts and assumptions in decision making particularly when facing large amounts of information.

In recent months, there has been more activity in the market, with an increasing number of cards now offering 0 per cent introductory rates, as well as reward/incentive schemes. What has failed to fall is the headline APR rate.¹¹² That means the areas of the market where competition has advanced is not the headline rate, that consumers can compare but bonuses and ancillary benefits.

Consumer Focus is of the opinion that unless simplification takes place consumers will not receive the maximum benefits possible from the provision of annual summaries, on-line comparisons and consumer empowerment initiatives.

¹⁰⁹ <http://bit.ly/fgbFZe>

¹¹⁰ OFT, A Factual Report prepared for OFT by Ipsos MORI, December 2009 A Survey of consumers of unsecured and high cost credit, Annexe, p55

¹¹¹ Paul Johnson, *Frontier Economics*, for Consumer Focus, Focus on Finance lectures 2009 Free or Fee: Are ‘free’ products good for consumers?, p.2

¹¹² Mintel, *Credit and Debit cards 2010*, p13

To have real value, choice must operate in a market that is not unduly complicated in order for consumers to be assured that their choice is effective at determining value.

Consequently, Consumer Focus recommends the following actions to the credit and store card market:

- Requiring all credit card companies to have only one APR rate for each form of lending (unless a good cost based rationale can be given for not doing so)
- Where other charges are levied these must be clearly stipulated in a standardised format across advertising, marketing and personnel statements to negate as far as possible the misleading consequences of 'framing'
- An investigation into the possibility of standardising or controlling charges on the other costs (particularly fees and charges) consumers face from their credit cards in order to promote competition and value
- An end to separate 'handling fees' for balance transfers. These should form part of the APR
- A simplified framework in which rewards schemes operate

Recent conclusions the OFT has drawn from the current account market showed '*banks can raise the level of the less visible fees without reducing their overall competitive position... We are not persuaded that profits earned from less visible fees are fully competed away in other areas*'¹¹³. These conclusions are equally as prescient in the credit card market.

We would also like some accountability and transparency about the operation of credit scoring which seems to be currently responsible for much of the current growth in profitability in banks. See question 6 for more details.

Furthermore, help is required for consumers who enter financial difficulty to ensure that their problems are not worsened by the continuing adding of debt interest and ancillary charges each month on their credit card. We suggest some ways which the credit card supplier can become alerted of a consumer's financial difficulty and how they can help the consumer avoid excessive interest increases in our response to the *BIS Credit and Store Card Review*.¹¹⁴

Q11 How effective have the Competition Commission's remedies been in improving prices for home credit customers? Is further action needed to ensure that consumers of home credit get a fair deal?

A super-complaint by NCC to the Office of Fair Trading led to a Competition Commission (CC) inquiry into the high-cost credit market, which confirmed that the home credit market was uncompetitive. A number of measures were proposed to introduce more competition to the market, including:

- a. A price comparison website for home credit providers
- b. Lenders to share data on customers' payment records
- c. Borrowers to be provided with clear account statements
- d. A fair rebate for the early repayment of loans

We have indicated above our concerns that a price comparison website is limited in the impact that it can have on the decision-making behaviour of home credit users, because of their preference for personal recommendation and in person contact.

¹¹³ OFT, 2008, *Personal current accounts in the UK: An OFT Study*, p.110

¹¹⁴ <http://consumerfocus.org.uk/g/4n1>, p8

They are also less likely to use the internet and those in the lowest income deciles tend to have lower levels of internet usage. Furthermore, they are more likely to have low literacy levels and some may not be comfortable using the internet.¹¹⁵

We have also raised above our interest in seeing information on whether data sharing has enabled home credit users to build up a credit history that has enabled them to access lower cost mainstream credit.

The OFT High Cost Credit Review carried out a detailed analysis of competition and profitability in this market (Annexe E p40 – p50). They found that this is a highly concentrated market: in 2007, there was a four firm concentration ratio of around 90 per cent and they believe that concentration has remained at this level. In fact, since the time of the CC inquiry, the number of large lenders in this market has reduced from six to four. As the consultation paper points out, the OFT found that there was little price competition and that competition in the market was limited and not very effective.

Provident Financial is the largest lender in this market. At the time of the CC inquiry, it accounted for 60 per cent of the market and since then the reduction in large lenders has enabled Provident Financial to consolidate its position in the market.¹¹⁶ In November 2010, the lender reported that for the 12 weeks since the beginning of September 2010 sales were up seven per cent on sales at the same time last year.¹¹⁷

We consider that these factors indicate that the Competition Commission's remedies have not been effective in improving prices for home credit customers. In terms of further action, we consider that market-based action is unlikely to result in a fairer deal for these consumers. The types of remedies that are needed to improve the situation are the social policy measures suggested by the OFT in the High Cost Credit Review, which we mentioned in response to Q4. As the OFT has said, it is those measures that are likely to deal with the major concerns about this market. Other steps are likely to have only a marginal effect.

In the meantime, improving the availability of alternative lower cost credit is a measure which would ameliorate the problems faced by low income consumers. We believe there should be continued investment in social lenders, such as credit unions and community development finance institutions (CDFIs). As a first step, we strongly recommend the continuation of the Growth Fund, which is a programme aimed at increasing the availability of quick affordable loans to people on low incomes and thus enabling people who might otherwise have used high cost credit to borrow from social lenders. This funding is due to end in March 2011.

What happens when things go wrong?

In this section of the response, we will highlight areas where we feel we are most able to comment on the issues in question, rather than going through each question in turn. Please note that for all of this section, unless otherwise stated, our comments refer to the situation in England and Wales only.

Legal Aid

We would like to register our deep concern about the recent Ministry of Justice (MoJ) proposals that consumers with debt problems will no longer receive free legal advice from legal aid.¹¹⁸

¹¹⁵ *Broadband minded? Overcoming consumers' barriers to internet access*, Consumer Focus, March 2010

¹¹⁶ OFT Review of High Cost Credit, Final Report, Annexe E, p47

¹¹⁷ Provident ups sales despite benefit cuts, City AM, 25 November 2010 <http://bit.ly/fc3kJw>

¹¹⁸ Proposals for the Reform of Legal Aid in England and Wales, MoJ, November 2010

We believe it is essential that people on low incomes should have access to legal advice and representation when they experience debt problems. People in debt are entitled to good quality advice about their rights. Furthermore, it is vital to fairness within the court process that people struggling to meet their debts should have adequate access to advice.

Enforcement mechanisms

Our recent research into consumers' experiences of the small claims court in England and Wales¹¹⁹ found that enforcement of an award remains a problem. The research found examples of consumers who had paid fees for enforcement processes that were ultimately unsuccessful. The report recommended a new approach to enforcement procedures. It was suggested that the MoJ should consider all judgements in small claims cases having an enforcement action automatically attached. Another suggestion was the possibility of the court paying litigants for awards that remain unpaid and then taking responsibility for enforcing the debt (to be paid for by a 'success uplift' on the award).

Similar problems with enforcement have also been found in Scotland, where a different enforcement regime operates. In 2007, the Scottish Consumer Council, one of our predecessor bodies, published the report of the Civil Justice Advisory Group, chaired by the Right Honourable Lord Coulsfield. The Group's report indicated that enforcement, and particularly whether enforcement of court judgments can or should be left to the parties or whether there should be some public role in ensuring that judgments are observed, was a key area that should be included within any review of the Scottish civil justice system. This recommendation was not unfortunately taken forward as part of the subsequent Scottish civil courts review.

Orders for sale

We responded to the MoJ's consultation on this issue. We would strongly support a minimum threshold of £25,000 for charging orders and orders for sale.

We are concerned about the significant increase in charging orders being sought and obtained by creditors. We believe that, in the same way as possession proceedings, charging orders and orders for sale should only be used against an individual's home as a matter of last resort, and only in circumstances where it has been impossible for the creditor to obtain repayment of the debt by any other means. In the same way as possession proceedings, there should be pre-action requirements to safeguard consumers from precipitative and unfair action on the part of lenders. These pre-action requirements should prevent charging orders from being available to creditors who have rejected reasonable offers for payment (taking into account the borrower's personal circumstances) or where there is a pre-existing arrangement for payment agreed with the lender.

In Scotland, the Home Owner and Debtor Protection (Scotland) Act 2010 provides greater protection for the borrower by introducing a range of pre-action requirements to prevent the lender from taking proceedings. These include: an obligation for the lender for to provide the borrower with certain information about the debt and information about sources of advice and assistance available for helping them to manage their debt. In addition the lender is required to make reasonable efforts to agree proposals for future payments with the borrower and not to take possession proceedings if the borrower is taking steps to pay off the debt in a reasonable time.

¹¹⁹ *Small claims, big claims: Consumers' perceptions of the small claims process*, Consumer Focus, October 2010

Similar pre-action requirements for social landlords before they can evict a tenant for rent arrears have been introduced within the Housing (Scotland) Bill, which was passed by the Scottish Parliament in November 2010 and is currently awaiting royal assent. We believe consumers in England and Wales should have similar levels of protection against losing their homes, whether this is due to possession proceedings or orders for sale.

We support the minimum threshold of £25,000, because it is disproportionate for consumers to be threatened with losing their homes for a low-value consumer credit debt, which is a fraction of the value of the property concerned. The instability and stress caused to a borrower as the result of the threat of a charging order or order for sale is so high that it justifies a minimum threshold being set. Furthermore, as the original debt would have been unsecured, the consumer will probably have paid a higher rate of interest on the loan. They are also unlikely to have been warned about the risk of losing their home when the debt was originally incurred. We consider that the figure of outstanding debt should not include default interest and charges (which may considerably add to the amount owed).

In addition, even where the debt is above the minimum threshold, the borrower should be shown to be in persistent default, given the remaining period of the loan and their payment history. There should be no presumption that a charging order or order for sale should be granted once the threshold is reached. The courts should continue to exercise their discretion to take into account the personal circumstances of the debtor, should an application be made.

In the MoJ consultation paper, it was suggested that a threshold could cause certain lenders to withdraw from the market, as they would be unable to enforce their debt by charging order 'if the worst comes to the worst'. We would be concerned by any business with a lending formula based on the availability of a charging order in the event of default. Lenders should make lending decisions on the basis of the affordability of the loan, not the potential to secure the loan in the case of default.

Debt advice

Please note that the situation regarding debt advice and legal aid in Scotland is different to England and Wales and the comments below are confined to the situation in England and Wales.

We agree that access to debt advice is essential for consumers struggling to repay their debts. Debt advice charities have seen a significant increase in the demand for their services over recent years.

With growing pressure on Government at the national and local level to cut costs, both telephone and on-line advice services are being increased. It is critical that funding directed at this type of service is not at the expense of face-to-face provision.

While telephone advice services are suitable for many consumers, for others, face-to-face provision is essential. It is well-recognised that face-to-face advice provision is often the most appropriate for addressing the needs of many low-income and vulnerable consumers (particularly those with literacy/numeracy difficulties, mental health problems and language difficulties). Many consumers facing financial difficulties are likely to have multiple debt problems; for those with additional needs there is often no substitute for discussing such complex issues face-to-face. Face-to-face services not only help to build up a degree of trust between the client and advice provider, they also enable the adviser to gain a better understanding of a person's personal circumstances.

We are concerned that the future of the face-to-face debt advice project paid for by the Financial Inclusion Fund (FIF) remains undecided. The Public Accounts Committee has commended the work of the project, which, by the end of September 2009, had delivered debt advice to 270,000 consumers since starting in April 2006.

The committee also pointed out that demand continues to outstrip the supply of debt advice available under this initiative.¹²⁰ We would strongly recommend the continuation of this funding.

It is particularly important that the FIF funding of face-to-face debt advice should continue, in the light of the green paper recently issued by the MoJ concerning the future of legal aid, as referred to above, where it is proposed that all legal aid funding for debt advice will be removed.¹²¹ Given the difficulties of the current financial climate, this is a measure that we do not support. Pressures on local authority budgets could also lead to reduced funding for local Citizens Advice Bureaux and other advice providers. This poses a considerable threat to the viability of local advice services at a time of escalating demand. We are aware of the financial constraints on public funding at the current time and would suggest that additional debt advice could be funded by a levy on the financial services industry.

Some consumers are able to use the services of fee-charging debt management companies, but for consumers on low incomes this is unlikely to be an option. Furthermore, research commissioned by the Money Advice Trust has raised concerns about elements of poor practice within the fee-charging sector, including some companies not informing clients of their fees until a late stage in the process and some companies paying creditors late or not at all.¹²²

Debt purchase and debt collection

We have reviewed the area of debt purchase and debt collection and found a number of areas of concern. A principal concern is the lack of publicly available data in this area, as there is no requirement for debt sellers, debt purchasers or debt collectors to report the amount of debt sold on or contracted out for third parties to collect. We would like to see debt sellers, purchasers and collectors subject to more detailed reporting requirements. The data from this would form the basis of proactive investigation into the debt selling and debt collection market to show the actual level of consumer detriment in this sector.

In the absence of such data, much of the evidence of current practice in this area is anecdotal. Our discussions with debt advice providers have indicated that debt purchasing may have reduced standards in debt collection, as some of the companies that have bought debt may be less likely to follow the OFT guidance on debt collection, since they have less reputational risk.

Another problem in relation to sold on debt is the accuracy of the data that debt purchasers are given, which results in disputes about the debt, including about the amount of the debt, whether it has been paid, whether the amount is uncollectable and whether a debt advice agency is involved. The accuracy of data would probably improve if financial sanctions (including compensation to the consumer) applied when businesses supplied inaccurate data to debt purchasers or debt collectors. Better training for debt collections staff could also improve practice in this area.

¹²⁰ The Committee of Public Accounts, UK Parliament, 31st Report of the Session 2009-10, The Department for Business, Innovation and Skills: Helping over-indebted consumers

¹²¹ MoJ, Proposals for the Reform of Legal Aid in England and Wales, November 2010

¹²² An independent review of the fee-charging debt management industry, Sharon Collard, Personal Finance Research Centre, University of Bristol, June 2009

However, we believe that that a range of problems would be significantly ameliorated if organisations selling on debt remained accountable for the debt collection practices of those purchasing debt from them. If this was the case, those selling on debt would be more likely to ensure their own data was accurate and would be more rigorous in monitoring the practices of debt purchasing agencies.



Consumer Focus response to BIS on managing borrowing and dealing with debt: consumer credit and personal insolvency review

If you have any questions or would like further information about our response, please contact Oliver Morgans, by telephone on 020 7799 7965 or via email oliver.morgans@consumerfocus.org.uk

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