

Analysis of different ESR deferment regimes

1. In this appendix, we assess the fairness of the CC's proposed ESR remedy against current arrangements and against an alternative of removing lenders' ability to delay the settlement date at all.
2. Based on our assessment of the evidence submitted to us by Provident and of our own modelling (see Appendix 3.4), we have identified three quantitative approaches that may be used to assess the fairness of different ESR regimes:
 - The 'financial neutrality' of lenders that pay the minimum rebates may be evaluated by comparing the cashflows on loans that settle early and run to term, using the cost allocations underpinning the LEK model produced for Provident (as outlined in paragraphs 67 to 69 of Appendix 3.4).
 - Minimum rebates may be compared with estimates of costs avoided and margin unearned calculated using the CC's indicative range of scenarios (see paragraphs 75 to 82 of Appendix 3.4).
 - Minimum rebates may be compared with estimates of costs avoided and margin unearned calculated using the cost allocations underpinning the LEK model and the assumption that the profit margin is earned in proportion to all costs (see paragraph 90 of Appendix 3.4).
3. We consider all three approaches to be methodologically valid and do not consider any of these models to represent the single 'correct' approach to considering this issue. The first and third approaches have the benefit of being derived directly from the LEK analysis of Provident's cost structure—and so, for example, are able to take the approach of allocating bad debt and related costs according to Provident's actual profile of bad debt. The second approach enables us to consider some variation in cost structures—which we might expect to find among different lenders—and to allow for different views to be taken about the appropriate treatment of early settlement commission.
4. We use these three approaches to consider the overall fairness of three different ESR deferment regimes, by reference to a £400 loan taken out using Provident's 55-week cash loan product.¹ The regimes considered are:
 - the current statutory minimum ESR regime, in which lenders are able in practice to postpone the settlement date for calculation purposes by almost eight weeks;
 - the CC's proposed remedy, in which no home credit lender will be allowed to defer the settlement date for more than 13 days or to use actual repayments rather than contractual repayments as the basis for the calculation;² and
 - no deferment.

¹The average advance for this product in 2004 was £406. See provisional findings, Table 3.1. We chose this product as it is, by a substantial margin, the most popular home credit loan product.

²The CC's proposed remedies specify 13 days. However, the CC and LEK models have been developed on a weekly basis, so we will use two weeks to approximate the impact of the CC's proposed remedy.

- We have also conducted elements of this analysis on Provident’s 31-week PPC loan product which has a TCC £55 per £100, based on an advance of £215. This further analysis, which is not presented here, indicates that our assessment of the fairness of different regimes would not be materially affected by the loan product chosen for analysis.

Assessment of lenders’ financial neutrality using cash-flow analysis

- We repeated the cash-flow analysis described in paragraphs 67 to 69 of Appendix 3.4 for the three deferment regimes considered. Table 1 compares the profitability to the lender of loans that settle at different points in time using NPV (calculated at a weekly discount rate of 0.2 per cent) and IRR. We also present the cash margin on the loan—calculated as the cumulative cash flow on the loan once the loan has been settled—which is an intuitive measure of a loan’s profitability. This does not take account of the ‘time value of money’ to the lender and is therefore a less effective benchmark than IRR or NPV. The results of this further analysis are set out in Table 1.

TABLE 1 Profitability to Provident of a 55-week loan settling at different stages

Measure	NPV £			IRR %			Cash margin £		
	8	2	0	8	2	0	8	2	0
No of weeks’ deferment									
Loan runs to term	(
Loan settles at week 50									
Loan settles at week 40									
Loan settles at week 30									
Loan settles at week 20									
Loan settles at week 10									
Loan settles at week 1)								

Source: CC analysis of Provident data.

- With the current ESR regime, in which lenders may delay the settlement date by eight weeks for calculation purposes, lenders are better off under all three measures if loans settle early during the last 25 to 30 weeks of the loan (when most early settlements take place) than when they run to term. For loans settling in weeks 10 and 20, the expected NPV and cash margins would be lower—in part because of the payment of an early settlement commission (equivalent, in this case, to £[X]) for loans that settle immediately—but the IRR would be substantially higher. This analysis shows that the current deferment regime is beneficial to the lender, compared with the benchmark of ‘financial neutrality’.
- If no deferment were allowed, lenders would be close to being financially neutral on all measures, as between loans that run to term and loans that settle early after week 40. However, lenders would make a loss on loans that settle very early and would not earn a positive NPV on loans that settle before around week 10. In part, this is because of the ‘fixed cost’ element of Provident’s early settlement commission, but without a deferment, lenders would not be able to cover fixed costs for loans that settle very early.
- A two-week deferment leaves lenders slightly better off (compared with running to term) if loans settle within the last 15 weeks and mitigates the loss to lenders for loans that settle very early. Lenders would still make a loss on the very few loans that settle in the first week, if they paid an early settlement commission, but would be able to recover fixed costs.

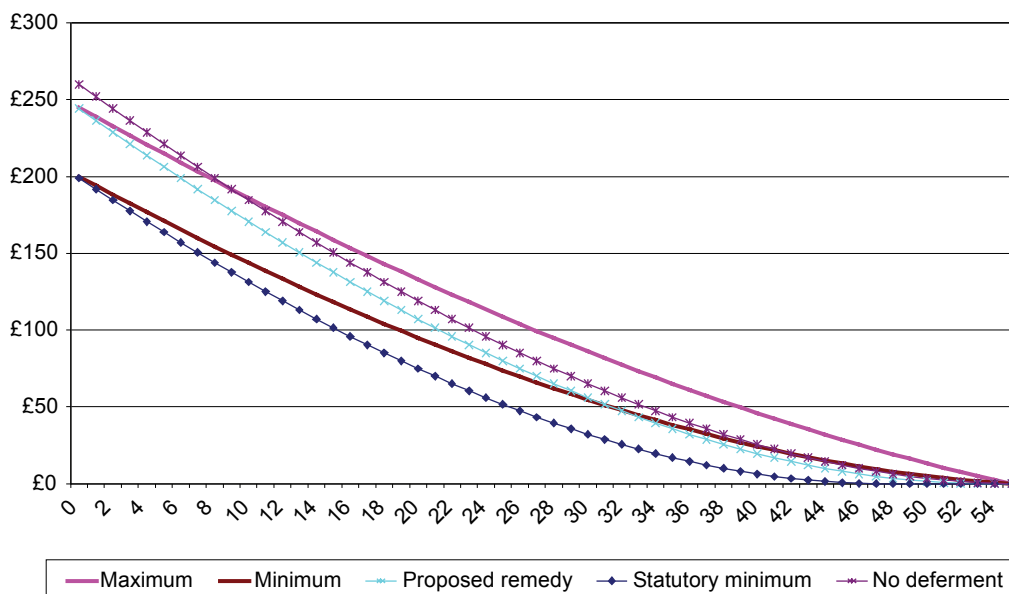
10. On the basis of the above analysis, we consider that the proposed remedy performs better in terms of financial neutrality than either the current statutory minimum or the removal of any deferment.

Comparison with CC range of indicative scenarios

11. Figure 1 compares the three rebates regime with the illustrative scenarios developed by the CC (see paragraphs 75 to 82 of Appendix 3.4). The maximum and minimum estimates of cost-based rebates generated by these scenarios are shown as bold lines.

FIGURE 1

Comparison of rebates regimes with CC scenarios



Source: CC.

12. Figure 1 shows that the current statutory minimum rebate falls below the CC's indicative range of cost-based rebates for any early settlement. A rebate regime with no deferment is above the range for settlements that take place very early on, then within the range thereafter. The proposed remedy falls within the indicative range up to week 32 and is then between £0 and £5 below the minimum estimate of cost-based rebates thereafter.

Evaluation using LEK model and revised margin assumptions

13. As discussed in paragraph 90 of Appendix 3.4, we adjusted the LEK model so that any extra profit margin (in addition to funding costs) on the loan was considered to be earned in proportion to *all* costs incurred up to the point of settlement. This approach takes the underlying cost analysis in the LEK model as given.
14. Using this adjusted model, we calculated a cost-based rebate as the Total Charge for Credit (£260) *less* the costs incurred up to settlement date *less* the margin earned up to the settlement date. Figure 2 compares these cost-based rebates against the statutory minimum rebate, the proposed remedy, and a rebate in which no deferment is allowed.

FIGURE 2

Assessment of ESR regimes using adjusted LEK model



Source: CC analysis of Provident data.

15. The cost-based rebate thus calculated is persistently above the statutory minimum rebate for any early settlement. This indicates clearly that the current statutory minimum rebates operate in favour of the lender. It is worth noting that this calculation has been made using the LEK/Provident assumption that early settlement commissions should *not* be rebated to customers. This reduces the estimates of cost-based rebates, particularly for loans that settle during the early stages of the contractual term. If an alternative view were taken of this matter, then the current statutory minimum rebates would appear more favourable to lenders.
16. If no deferment were allowed, this analysis indicates that rebates would be higher than cost-based rebates for loans that settle before week 36 and slightly lower thereafter (when most early settlements take place). The LEK/Provident assumption about early settlement commissions is partially responsible for this conclusion, but even if the view were taken that early settlement commissions should not be rebated, the presence of other fixed costs means that lenders would make a loss for loans that settle very early unless there was some deferment.
17. The proposed remedy produces an intermediate outcome. The proposed remedy gives rebates above a cost-based estimate for loans that settle up to week 30, and rebate that are below cost-based estimates for loans that settle early after this point.
18. The distribution of early settlements is not uniform over the contractual term. Most early settlements take place during the second half of a loan. Figure 3 shows the distribution of by settlement week for Provident's 55-week loan product.

FIGURE 3

Loan settlement profile for Provident's PPC 55-week loan



Source: CC analysis of Provident data.

19. To evaluate the overall balance between lenders and borrowers of different rebates regimes, we have taken this distribution of early settlements into account. To do this we calculated the difference between rebates payable under each regime and cost-based estimates (as shown in Figure 2), weighted by the distribution of early settlements by settlement week (as shown in Figure 4). Using this method, Table 2 summarizes the overall balance between lenders and borrowers of the three regimes.

TABLE 2 **Difference between average rebates payable under various regimes and cost-based estimates using the adjusted LEK model**

<i>Rebates regime</i>	<i>Amount by which average rebates are higher (lower) than cost-based estimates</i> £
No deferment	5
Proposed remedy	(1)
Statutory minimum	(15)

Source: CC analysis of Provident data.

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20. We find that the current ESR regime operates substantially in favour of lenders, with rebates £15 lower on average than cost-based estimates. A regime with no deferment would operate in favour of borrowers, with rebates £5 higher on average than cost-based estimates. The proposed remedy produces rebates that are in line, on average, with cost-based estimates.

Conclusions on fairness of different deferment regimes

21. By reference to Provident’s 55-week loan product, we have used three methodologies to assess the fairness of minimum rebate levels under the current regime (using contractual repayments) and minimum ESRs under two alternative regimes: the CC’s proposed remedy and the removal of lenders’ ability to delay the settlement date at all for the purposes of calculating an ESR. Where we have used the cost data underpinning the LEK model produced for Provident analysis—including the assumption that early settlement commissions are not costs that it is legitimate to rebate to customers—we consider the approach we have taken is conservative, in that it is likely to provide a lower estimate of a cost-based rebate than if an alternative view were taken of this matter.
22. As set out in Appendix 3.4, all three methodologies indicate clearly that the current minimum ESRs operate to the benefit of lenders when loans settle early. This supports the conclusion that minimum ESRs are low and the prices paid by customers when they settle early are high. Removing lenders’ ability to delay the settlement date produces a fairer outcome under all three methodologies for loans that settle during the later stages, but appears unfair to lenders for the minority of loans that settle early on.
23. We conclude that, based on the above analysis, the CC’s proposed remedy provides a fairer balance between borrower and lender than either the current regime or the total removal of lenders’ ability to defer the settlement date.