

## Renewal loans

### Introduction

1. This appendix examines renewal loans. The term ‘renewal loan’ is used in the home credit industry to describe a loan taken out in the following circumstances. A customer is part way through repaying a loan to a home credit supplier. The customer then takes out a second loan from the same supplier, which is used to settle the balance of the first loan (net of any rebate payable for early settlement) and to provide a further cash advance. This type of loan has also been referred to as a ‘rollover’ loan or a ‘refinancing’.
2. The rest of this appendix is structured as follows. We start by examining how renewal loans work in practice, by describing and developing a simple worked example. We then examine the evidence on the extent of renewal loans and the circumstances in which such loans are taken out.

### A simple example

3. A customer takes out a 32-week loan of £200. The terms of this loan—which has an APR of 399.7 per cent—are as follows:

TABLE 1 Terms of initial loan

Total charge per £100	£60.00
Sum advanced	£200.00
Charges on £200 loan	£120.00
Total amount payable	£320.00
No of weeks	32
Weekly repayment	£10

Source: CC.

4. The customer makes their first 24 weekly payments of £10. At this point they discuss with their agent the possibility of borrowing more money. As a result of this discussion, the customer takes out a second loan of £200. This is used to settle the remaining £80 on the first loan and provides the customer with £120 cash-in-hand. A rebate of £2.96 is payable for early settlement, which the customer receives in cash. The customer repays this second loan in 32 weekly repayments of £10 a week.
5. Table 2 sets out how the two loans taken together appear from the customer’s perspective.

TABLE 2 Initial and renewal loans from customer’s perspective

Week 0	Initial cash advance of £200
Weeks 1–24	24 weekly repayments of £10, while paying off first loan
Week 25	Further net cash advance of £120 plus £2.96 rebate
Weeks 26–57	32 weekly repayments of £10 while paying off renewal loan

Source: CC.

6. Two points are worth noting at this stage. First, repayments are constant throughout the term of both loans. This is not always the case, but renewal loans do generally have the effect of smoothing repayments.
7. Second, the cost of borrowing for the two loans taken together is higher than for the initial loan. The customer pays total charges for credit on both loans of £237.04,<sup>1</sup> for which they receive £322.96 cash in their hand (including the rebate). This is equivalent to £73.40 for each £100 of cash in the customer's hand, compared with £60 charges for each £100 in the customer's hand on the first loan.
8. The annualized interest rate<sup>2</sup> for the two loans taken together is 415.2 per cent (after taking the rebate into account) compared with an APR of 399.7 per cent for both loans. The annualized interest rate on the first loan is higher than the APR because the loan is repaid early.<sup>3</sup> Assuming the second loan is repaid on schedule, and is not itself renewed, the annualized interest rate on the second loan is the same as the APR.

### Comparison with parallel loan

9. One way of exploring these two points further is to compare the renewal loan described above with a second scenario. The scenario has been constructed to illustrate another way in which the customer could borrow the same amounts in cash at both the start of the loan and at the point of renewal.
10. In this scenario, there is no difference up to week 24. At this stage, the customer takes out a second loan but continues to repay the first loan, rather than using the second loan to pay off the balance of the first loan. We will refer to this as a 'parallel loan', as the customer will be paying off both loans in parallel until the first loan has been paid off.
11. To provide the customer with £122.96 cash in their hand in week 25, they will have to borrow £132.96 to cover the £10 repayment that is due on the initial loan that week. The total amount payable on this second loan is £212.74, repayable in 32 weekly instalments of £6.65 each. Table 3 sets out how the two loans taken together appear from the customer's perspective.

TABLE 3 Initial and parallel loans from customer's perspective

Week 0	Initial cash advance of £200
Weeks 1–24	24 weekly repayments of £10, while paying off initial loan only
Week 25	Further net cash advance of £122.96, comprising new loan of £132.96 and £10 weekly repayment on first loan
Weeks 26–33	7 weekly repayments of £16.65 while paying off both loans
Weeks 34–57	25 weekly repayments of £6.65 while paying off second loan only

Source: CC.

12. The profile of repayments is less smooth than for the renewal loan. Repayments are higher for the first seven weeks of the second loan and then fall, once the initial loan has been paid off. The difference between customer repayments for renewal and parallel loans is illustrated in Figure 1.

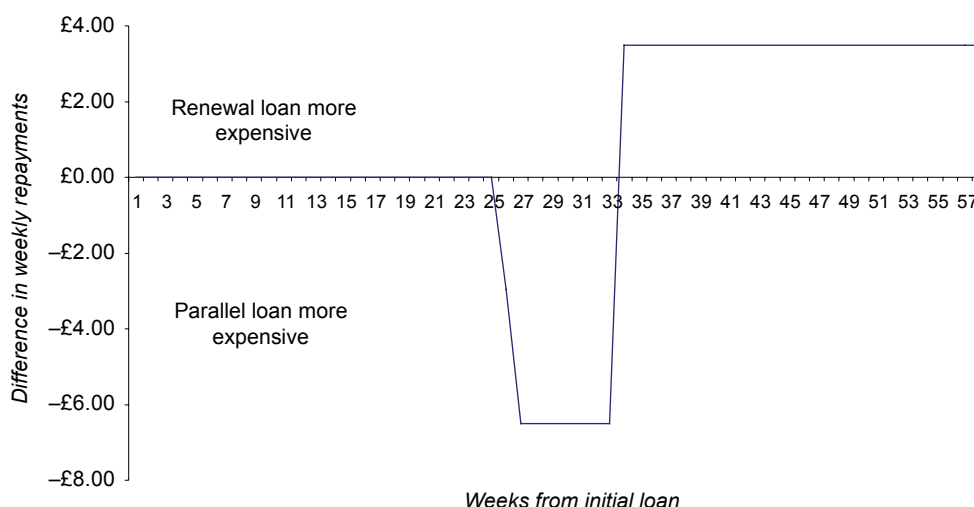
<sup>1</sup>This is calculated as the difference between total repayments of £640, less the sums advanced of £400 and the rebate of £2.96.

<sup>2</sup>The annualized interest rate is an ex post measure of the actual cost of a loan (or series of loans). It is calculated as the rate of return of all of the cashflows associated with the loan(s).

<sup>3</sup>Early repayment appears to be the only case in which the annualized interest rate of a home credit loan is higher than the APR.

FIGURE 1

**Comparison of repayments on renewal and parallel loans**



Source: CC.

13. Overall, the customer pays higher charges by renewing the loan compared with taking out a parallel loan. When renewing a loan, the customer is taking out a loan for a larger amount in order to obtain the same cash in their hand after repaying the first loan. The rebate payable for early settlement of the first loan (£2.96 in our example) is small compared with the extra charges associated with taking out a larger loan. Table 4 compares renewal and parallel loans.

TABLE 4 Comparison of renewal and parallel loans

	<i>Renewal loan</i> £	<i>Parallel loan</i> £
<i>Advances to customer</i>		
Cash in customer's hand	322.96	322.96
Total amount borrowed	400.00	332.26
<i>Repayments</i>		
Total repayments on both loans	640.00	532.74
<i>Of which</i>		
Repayment in week of new loan	80.00	10.00
Other repayments	560.00	522.74
<i>Charges</i>		
TCC on both loans	240.00	199.78
Rebate for early settlement	-2.96	-
Effective TCC on both loans (net of rebate)	237.04	199.78
<i>Measures of cost of borrowing</i>		
Contractual TCC per £100 borrowed	60.00	60.00
Effective TCC per £100 in customer's hand	73.40	61.86
Annualized interest rate on both loans %	415.2	399.7

Source: CC.

14. In this example, the customer pays an extra £37.26 in charges for renewing the loan, compared with taking out a parallel loan. In return for this, they make lower repayments over the following seven weeks and achieve a smoother repayment profile overall.

15. The smoother repayment profile associated with a renewal loan is likely to be attractive to some customers. In particular, it is likely to be attractive to customers on low or fixed incomes and customers with an immediate credit need who cannot easily find the money to make higher weekly repayments.
16. In thinking about the extra charges associated with renewal loans—and the choice that customers make when renewing a loan—it is helpful to separate a renewal loan into two components:
  - (a) a parallel loan for the cash sum advanced, assuming that the terms of this loan are the same as for the initial loan; and
  - (b) a ‘repayment smoothing product’ that enables customers to maintain their weekly repayments at a constant level.
17. In our example, the ‘repayment smoothing product’ would consist of seven weekly payments to the customer of £6.65 (a total sum advanced of £46.54), followed by 25 repayments by the customer of £3.35 (total repayments of £83.80). This equates to a charge for credit of £37.26, equivalent to a TCC of just over £80 per £100 advanced<sup>4</sup> or an annualized interest rate of 661 per cent.

### **Incentives for lenders and their agents to offer renewal loans**

18. The analysis in paragraphs 13 to 17 suggests that lenders have incentives to offer renewal loans rather than with parallel loans of the same amount. In our example, the company receives an extra £37.26 in charges from the customer on terms equivalent to offering a new loan with a TCC of just over £80 per £100. These extra charges are likely to exceed the additional costs associated with offering a renewal loan. Suppliers will incur some additional funding costs and will generally pay agents more commission in total for the renewal loan (see paragraphs 22 to 28).
19. Large suppliers told us that lenders do not incur any significant extra administrative costs in issuing a renewal loan compared with a parallel loan.<sup>5</sup> The costs of issuing both renewal and parallel loans are lower than the costs of issuing a loan to a new customer, as suppliers have already conducted their initial checks on the customer.
20. Furthermore, credit risks are likely to be lower for renewal loans than for parallel loans. The smoother repayment profile associated with a renewal loan means that customers are less likely to miss repayments, only make partial repayments or even default on the loan. This view was confirmed by large suppliers, although different views were expressed on whether a renewal loan had a lower risk of default than a parallel loan. Provident told us that parallel loans could result in increased bad debts and that a customer with a parallel loan always poses a higher credit risk than a similar customer with a renewal loan.<sup>6</sup> S&U, by contrast, considered that the likelihood of default would not be affected by whether a customer took out a renewal or a parallel loan.<sup>7</sup> All large suppliers agreed that the credit risks of offering a renewal or parallel loan were lower than for a loan to a new customer.

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<sup>4</sup>This is calculated by dividing the charges of £37.26 by the sum advanced of £46.54.

<sup>5</sup>Source: large suppliers' responses to further information request issued on 23 May 2005.

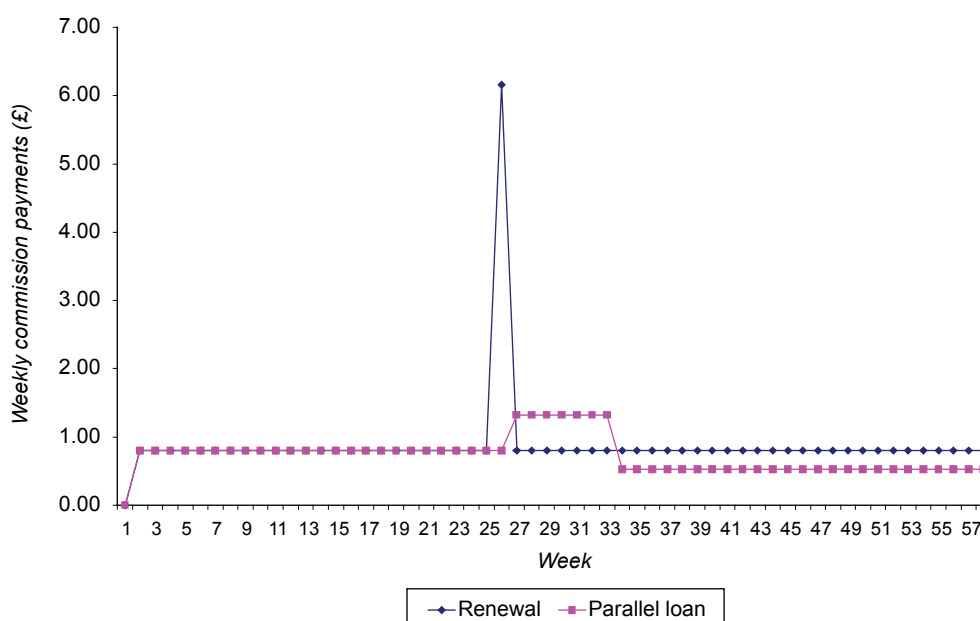
<sup>6</sup>Provident told us that where a customer requests a parallel loan than would result in higher bad debts and a greater credit risk, it would consider offering a renewal loan instead (or may not offer credit at all). This keeps the weekly rate manageable for that consumer.

<sup>7</sup>Source: Response to further information request issued on 23 May 2005.

21. In virtually any circumstances in which it is profitable for a supplier to offer a parallel loan, we would expect a renewal loan to be more profitable. Customers will pay additional charges for renewals that exceed any additional costs incurred by the supplier. In some instances, the cost to a supplier of offering a renewal loan may even be less than offering a parallel loan, yet the customer will still pay higher charges.
22. Agents can also have incentives to offer renewal loans.<sup>8</sup> When a customer renews a loan, repayment of the balance outstanding on the first loan may constitute a 'collection' for the purposes of calculating commissions. If so, the agent would be entitled to commission on the amount renewed less any rebate payable. If renewal takes place with several repayments still due, then the commission paid to the agent is likely to be higher than the normal weekly commission for this customer.
23. Figure 2 illustrates how commission payments would vary in our simple example, assuming that the agent is paid a constant 8 per cent commission on all repayments, including renewals.

FIGURE 2

### Commissions on parallel and renewal loans



Source: CC.

24. The sharp increase in commissions at week 25 corresponds with the renewal of the loan. Even without this one-off 'bonus', the agent receives higher commissions overall, because the customers' total repayments are higher. In the example provided, the agent would receive an overall increase in commissions of £8.34, of which £6.16 comprises the one-off payment at renewal.<sup>9</sup>
25. It should be noted that the main suppliers differ in their treatment of commission payments for renewal loans. For commission purposes, [X] treat renewal collections as ordinary collections and pay their standard commission rates on the outstanding

<sup>8</sup>This is recognized by some agents. See, for example, p56 of the qualitative research by Andrew Irving Associates.

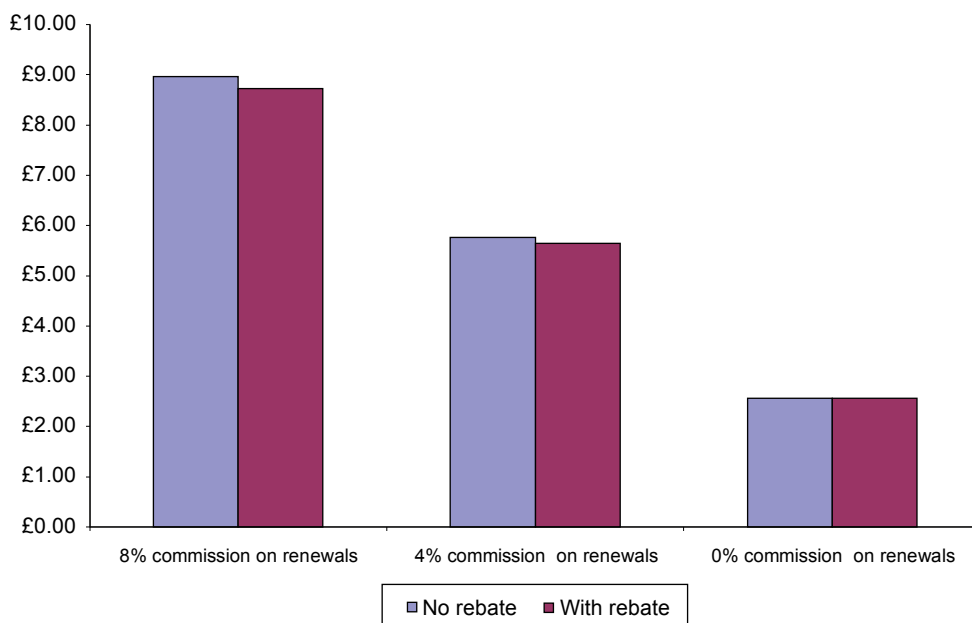
<sup>9</sup>The agent would have received 80p in the equivalent week of a parallel loan.

balance on the initial loan that is collected at renewal.<sup>10</sup> [X] offers a lower commission rate on the amount collected at renewal.<sup>11</sup> [X] collectors are not paid commission on the amount collected at renewal, though they are paid £[X] if they bring in a new loan lead which is converted into a loan (completed) and £[X] if they bring in a renewal loan which is completed. [X] does not pay commission on the amount collected at renewal.

26. Figure 3 (based on our simple example) shows the impact of different commission arrangements on agents' incentives to offer renewal as opposed to parallel loans. In all cases, a commission rate of 8 per cent is paid on normal repayments. Commissions on renewals are calculated at 0, 4 and 8 per cent. The impact of subtracting the amount of the rebate from the repayment made at renewal is also illustrated.

FIGURE 3

**Extra commission for renewal compared with parallel loan**



Source: CC.

27. With an 8 per cent commission on the amount collected at renewal, the agent is clearly better off with a renewal loan compared with a parallel loan. If commission payments on renewals are halved to 4 per cent, this dampens but does not remove agents' incentives to offer renewals. Even with zero commission payments on the amount collected at renewal, total agent commissions are higher for renewal loans than for parallel loans. This is because the customer's total repayments are higher for a renewal loan. Furthermore, if a commission is paid on early settlements, renewing a loan has the effect of bringing forward commission payments on the first loan and may reduce the likelihood of missed repayments on the subsequent loan.
28. It should be noted that, if commission payments to agents on renewals are less than on normal repayments the difference (less any rebate paid) is retained by the home credit company, which in effect collects the revenue from the loan but does not incur this element of costs.

<sup>10</sup>[X]  
<sup>11</sup>[X]

## Factors that determine the extra cost of a renewal loan

29. So far, we have considered a single example. While simple, this example highlights three important features of renewal loans, more generally:
- (a) a renewal loan increases the charges for borrowing, compared with a parallel loan;
  - (b) a renewal loans typically results in a smoother repayment profile, when compared with a parallel loan for the same cash advance in the customer's hand; and
  - (c) companies and, in many cases, their agents have financial incentives to offer renewal loans.
30. Annex A derives a general formula for estimating the extra charges paid by customers for a renewal, compared with a parallel loan. These extra charges comprise the additional charges on that part of the first loan which is renewed *minus* adjustments to the charges on the parallel loan for any rebate payable and the extra week's repayment.
31. Relative to the size of the initial loan, the additional cost to the customer of a renewal loan over a parallel loan is determined by three main factors:<sup>12</sup>
- (a) The TCC on the second loan. The cost to customers of renewal will normally rise with this factor. Conversely, the additional charges paid by customers will be lower, if the second loan has a lower TCC.
  - (b) The number of weekly repayments remaining compared with the original length of the loan. The extra cost to customers of renewals is higher, if more of the initial loan is renewed. Conversely, if customers have fewer repayments left to pay on the initial loan; this will reduce the extra cost to customers of renewals.
  - (c) The amount of the rebate on the first loan. The more generous the terms of this rebate, the lower the extra cost to customers of renewal. Conversely, if rebates are low, this will increase the extra cost to customers of renewal.

### ***Number of weekly repayments remaining***

32. In the absence of a rebate (see paragraphs 34 to 36), the earlier that renewal takes place within the initial loan, the higher the extra cost to customers. This is because more of the original loan (and its charges) is refinanced. By similar logic, a renewal with eight weekly repayments left on a 64-week loan will have proportionately less of an impact than a renewal with eight weekly repayments left on a 32-week loan, as the customer would have paid off more of the initial loan and charges. An example of a customer renewing a 55-week loan after 52 weeks is developed in Annex B, which also illustrates the impact of missed repayments.
33. If the customer in our simple example had taken out a renewal loan after making 20 weekly repayments of £10, the comparison between a renewal and a parallel loan

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<sup>12</sup>The length of the first loan is also relevant, but will only have a significant effect if the renewal takes place very near to the end of the loan, or if the initial loan is very short term. It should also be noted that these factors may be interrelated: for example, the rebate will be a function of the number of weekly repayments made.

would have looked as set out in Table 5.<sup>13</sup> After 20 weekly repayments, the customer would have paid off £200 and would have £120 outstanding on the first loan. The customer would be entitled to a rebate for early settlement of £10.22. The difference between the total charges for a renewal and parallel loan is £49.65 (compared with £37.26 for a renewal after 24 weeks). Renewing the loan also has less of a dampening impact on the profile of repayments. Because the second loan is larger than in our initial example (in order to provide the same cash advance while refinancing a larger sum), weekly repayments will rise with a renewal loan, though the short-term increase will be less than for the parallel loan.

TABLE 5 Comparison of renewal and parallel loans after 20 weeks

	<i>Renewal loan</i>	<i>Parallel loan</i>
Week 0	£200 cash advance	£200 cash advance
Weeks 1–20	20 x £10 weekly repayments	20 x £10 weekly repayments
Week 21	£120 new cash in hand. <i>Plus</i> rebate of £10.22	£120 new cash in hand <i>Plus</i> £10.22 equivalent to rebate
	New loan issued for £240	1 x £10 weekly repayment on first loan New loan issued for £140.22
Weeks 18–33	11 x £12 weekly repayments	11 x £17.01 weekly repayments
Weeks 34–57	21 x £12 weekly repayments	21 x £ 7.01 weekly repayments
TCC on both loans	£264.00	£204.13
Less rebate	£10.22	-
Effective TCC	£253.78	£204.13

Source: CC.

### **Terms of any rebate**

34. In some circumstances, customers are entitled to a rebate for early settlement of a loan. Where a rebate is paid, it reduces the impact of the extra charges associated with renewal.
35. With the exception of Mutual, all of the large suppliers offer rebates on the basis of the statutory formula set out in the ESR regulations.<sup>14</sup> Mutual offers a refinancing discount for customers who renew a loan. For a 102-week loan this discount is equal to 25 per cent of the balance outstanding adjusted for any arrears. This can be substantially more generous to customers than the statutory rebate. We are also aware of two smaller suppliers that offer rebates that go beyond the minimum statutory requirements, but this practice does not appear to be widespread.
36. We present our detailed analysis of ESRs and of the ESR regulations in Appendix 3.4.

### **How widespread are renewal loans?**

37. We used two sources of information on the extent of renewal loans:
  - (a) company records; and
  - (b) responses to customer surveys.

<sup>13</sup>This example is presented for illustrative purposes. A renewal at this stage of the loan might not be allowed under some suppliers' lending rules (see paragraphs 58 to 61).

<sup>14</sup>Provident told us that it considered these regulations to provide a fair balance between the interests of borrower and lender. S&U intends to keep rebate levels under review. Cattles has commented that there is no requirement to offer more generous rebates especially as the new regulations effective 31 May 2005 have increased the value of customer rebates.

## Company records

38. We asked the main suppliers to estimate the proportion of loans issued in 2004 that fell into each of the following categories.
- (a) a customer's first loan with the company;
  - (b) a follow-on loan to a previous customer who had paid off all of their previous loans;
  - (c) a parallel loan by an existing customer;
  - (d) a renewal loan; and
  - (e) any other form of loan.
39. Table 6 summarizes the responses received, relating to the number of loans issued by Park, Cattles, Provident and London Scottish. S&U and Mutual were unable to complete this table. S&U estimates that around [X] per cent of its loans are renewed. Mutual estimates that just under [X] per cent by number and [X] per cent by value of its loans were renewals. There were several definitional issues raised by this exercise, which are discussed in Annex C.

TABLE 6 Analysis of number of loans issued in 2004 by type

	Park	Cattles	Provident*	London Scottish	Average (weighted)	Average (unweighted)			
Customer's first loan with your company	(	)	)	)	15	18			
Previous customer, who had paid off all previous loans					6	8			
A parallel loan						X	32	25	
A renewal loan								40	47
Other						†		6	3
No of loans ('000)									

Source: CC analysis of data provided by suppliers.

\*See Annex C for basis of this estimate.

†For Cattles, 'other' includes renewals with fewer than four weeks remaining.

40. For all suppliers, repeat business accounts for the majority of loans issued—ranging between 77 and 87 per cent. Renewal loans are the largest category of repeat business overall (with a range between 26 and 64 per cent), followed by parallel loans (with a range between 12 and 35 per cent). Paid-up customers taking out new loans account for around 6 per cent of loans issued.
41. Table 7 repeats this analysis by reference to the value of new loans.

TABLE 7 Analysis of value of loans issued in 2004 by type

	Park	Cattles	Provident*	London Scottish	Average (weighted)	Average (unweighted)
Customer's first loan with your company	( )				9	10
Previous customer, who had paid off all previous loans			✂		6	5
A parallel loan					26	26
A renewal loan					52	56
Other			†		7	3
Value of loans issued (£m)						

Source: CC analysis of data provided by suppliers.

\*See Annex C for basis of this estimate.

†For Cattles, 'other' includes renewals with fewer than four weeks remaining.

42. Loans to new customers account for a lower proportion of loans issued by value than by volume. This indicates that loans to new customers are for lower amounts than loans issued to customers who have already built up a credit history with a company. By contrast, the proportion of renewal loans is higher by value (52 per cent overall) than by volume (40 per cent), indicating that renewal loans are for larger amounts than the average loan.

### Consumer surveys

43. Companies are likely to have the most accurate information about renewal loans. Customers will not necessarily always be able to recall the details of renewal. However, they may be able to recall whether they were paying off a loan when they took out a new loan and whether they used one loan to pay off another.
44. The NOP survey for the CC asked customers about their most recent loan. The results are shown in Table 8.

TABLE 8 Was your most recent home credit loan

	% of respondents
Your first home credit loan with any lender	11
Your first home credit loan with this lender (but you have used others)	9
A new loan after you had paid up all your loans with this lender	54
A new loan before you had finished paying off your loan with this lender	26
<i>Of which</i>	
Parallel loan	11
Renewal loan	15

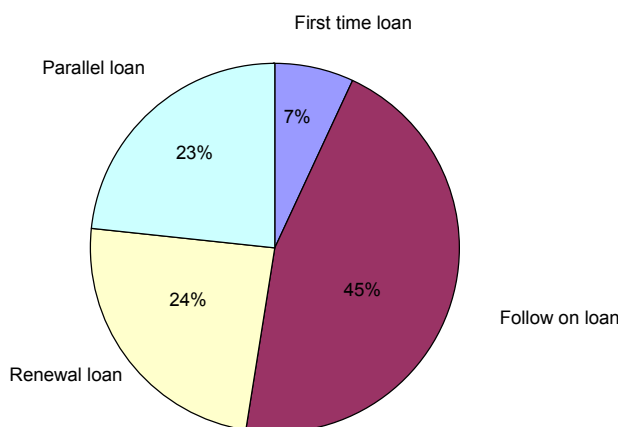
Source: NOP survey for CC. Effective base 775.

45. Figure 4 shows the findings of a recent survey of home credit customers by Policis that relates to this issue.<sup>15</sup> Policis found that just less than one-quarter of customers' most recent loans were renewals. A similar proportion of new loan sales were parallel loans.

<sup>15</sup>TNS survey of nationally representative sample of 1,444 18- to 64-year-old low-income (lowest quintile) and benefit-dependent consumers undertaken for Policis November 2004.

FIGURE 4

### Type of loan taken out



Source: Policis.

46. Compared with the evidence from suppliers, both surveys find a substantially higher proportion of loans that are taken out after the customer has paid off a previous loan (follow-on loan) and a lower proportion of loans that are renewed.

### Circumstances of renewal loans

47. In this section, we present the evidence that we received on four aspects of the way in which renewal loans are taken out:
- (a) the stage in a loan the renewal takes place;
  - (b) the balance outstanding at renewal and the amount of the rebate paid for early settlement;
  - (c) the role played by the lender in determining whether and when a loan is renewed; and
  - (d) the role played by agents in determining whether a loan is renewed.

### Timing of renewals

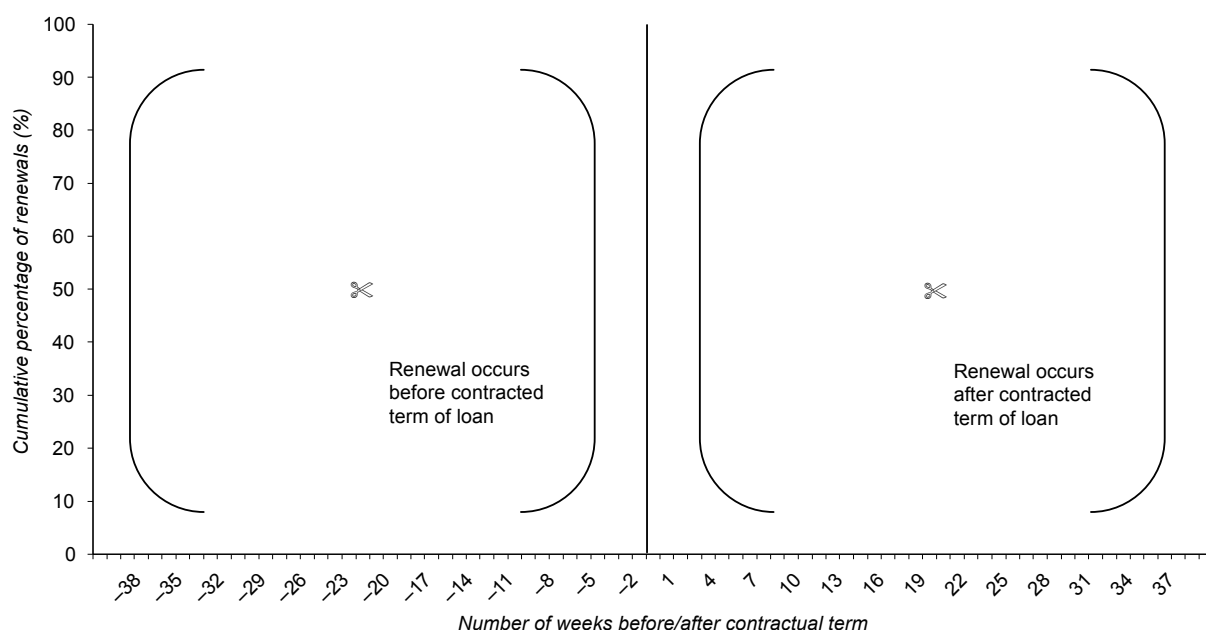
48. Other things being equal, the cost to customers of renewing a loan increases if it takes place earlier in the initial loan. As with the incidence of renewal loans, evidence on this issue can be collected from both suppliers and customers.
49. There are two ways of measuring when a renewal takes place during a loan:
- by reference to the contractual term of the loan; and
  - by reference to the number of weekly repayments remaining on the loan.
50. These will be the same if the customer has a perfect repayment record, but will differ if the customer has missed some repayments. In our example, if the customer had made 24 weekly repayments on time, but had missed three repayments, then the customer would have five weeks remaining relative to their contractual term of 32 weeks but would still have eight weekly repayments left to make.

*Timing of renewals relative to contractual term*

51. London Scottish and Provident provided information about the timing of loans relative to the contractual term. Provident estimated that [X] per cent of all renewals took place at or after the contractual term (ie the only repayments outstanding were repayments which had previously been missed).<sup>16</sup> In Provident's view, these were not true renewals. London Scottish provided a detailed breakdown of the timing of renewals relative to the contractual term of the loan. Figure 5 shows that [X] per cent of London Scottish renewals take place at or after the contracted term has expired (of which [X] per cent take place more than 40 weeks after the contracted term of the loan has expired), [X] per cent take place before the contracted term has expired (of which [X] per cent take place more than 40 weeks before the loan reaches its the contracted term).

FIGURE 5

**London Scottish cumulative number of renewals before/after contractual term**



Source: CC analysis of data provided by London Scottish

*Number of weekly repayments remaining at renewal*

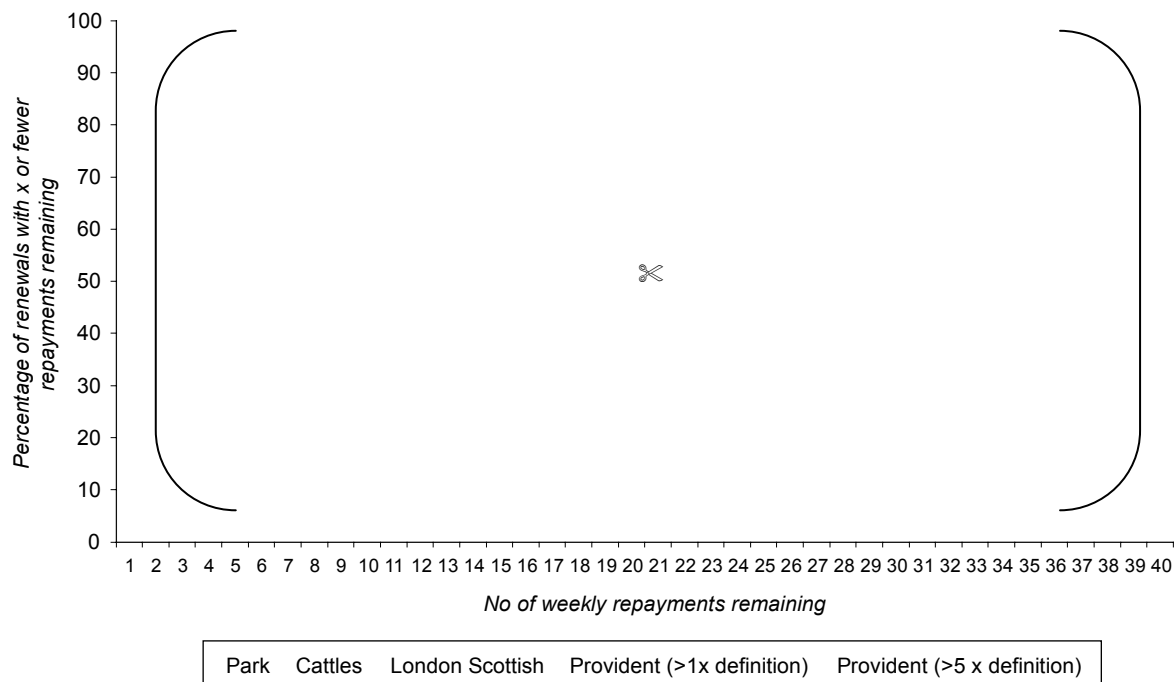
52. The extra charges associated with a renewal loan are a function of the number of weekly repayments remaining rather than the timing relative to the contractual term.
53. We asked the large suppliers to provide data about renewals, broken down by the number of weekly repayments remaining on the loan. Four companies (Provident, Park, London Scottish, and Cattles) were able to provide this information. There are some important differences between the bases on which this data has been supplied, which mean that these figures are not directly comparable with one another. These data issues are summarized in Annex C.

<sup>16</sup>Source: Provident response to market questionnaire question 56. These estimates are based on the cohort approach and the 5x weekly repayment measure (see Annex C for details).

54. Figure 6 shows the number of weekly repayments remaining when customers renew a loan.<sup>17</sup> The median number of weekly repayments is nine weeks—ie half of renewals occur with nine or fewer weekly repayments remaining.<sup>18</sup> London Scottish has a different time profile of renewals from the other suppliers. This is because it offers a higher proportion of loans with a term of one year or more than the other suppliers.

FIGURE 6

**Cumulative number of renewals by weekly repayments remaining**



Source: CC analysis of data provided by suppliers.

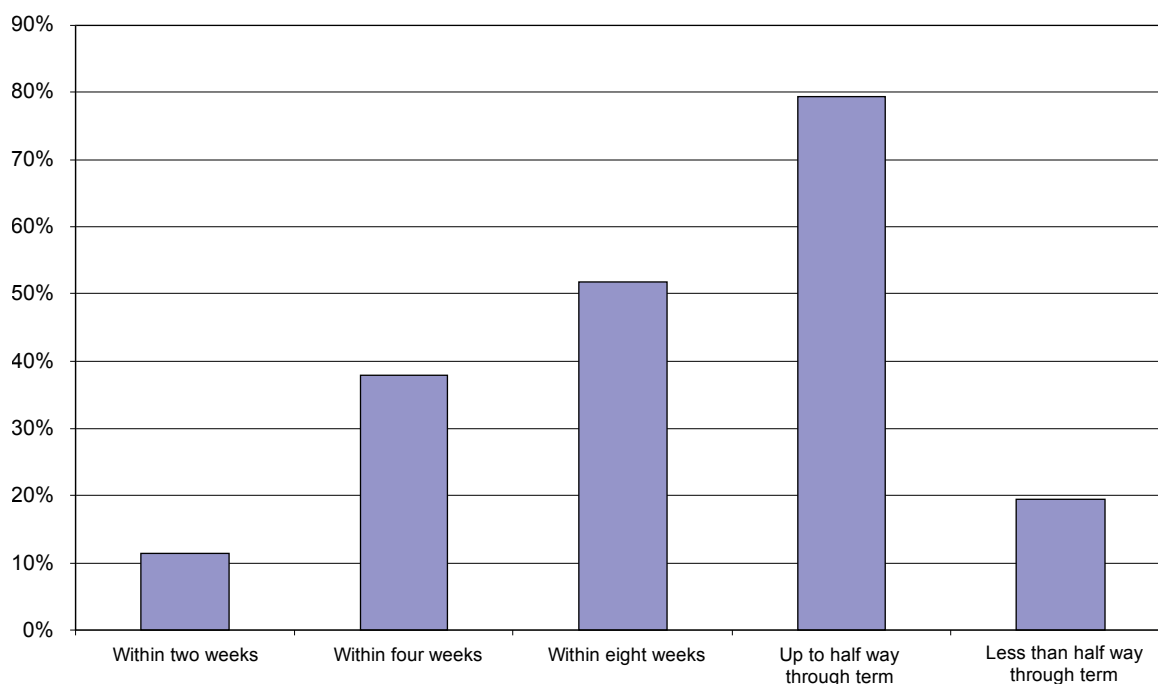
55. The figures from the other three suppliers are consistent with some further results from Policis presented in Figure 7. The base for this analysis is all customers who are taking on a new loan with an existing supplier. It therefore includes parallel loans as well as new loans. It is rare for customers to take on a new loan if they are less than halfway through repaying an existing loan. Around one-half of renewal and parallel loans are taken on with fewer than eight weekly payments to go. A small proportion of loans are renewed at less than halfway through. This is consistent with companies’ restrictions on issuing renewal loans (see paragraphs 58 to 61).

<sup>17</sup>Provident has provided this data on both a 1x weekly and a 5x weekly definition of renewals (see Annex C). Provident believes the 5x weekly definition to be most accurate.

<sup>18</sup>Provident data for this calculation was provided on a 1x weekly definition of renewals. If the data based on a 5x weekly definition was used, the median value would be just over ten weeks.

FIGURE 7

**Weeks remaining on existing loan for customers taking on new loan**



Base: Those with existing loans taking on new loans only

Source: Policis.

***Balance outstanding at renewal***

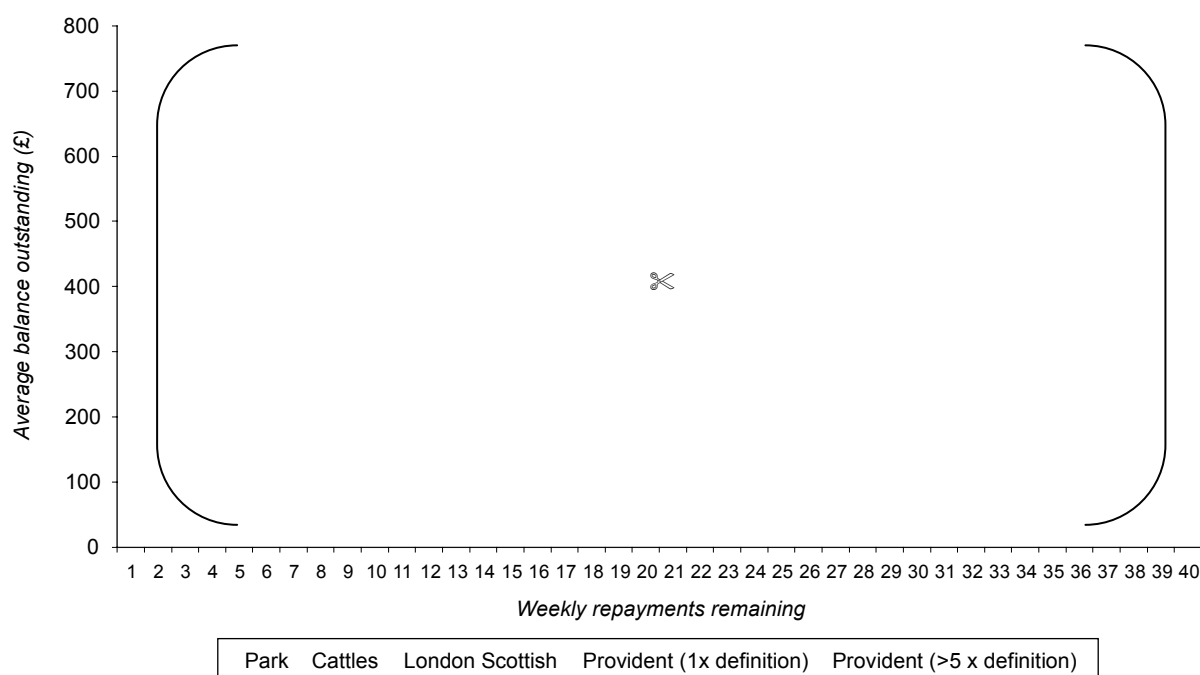
56. Figure 8 shows the average balance outstanding by week of renewal.<sup>19</sup> As would be expected, this increases with the number of weekly repayments remaining. The average balance outstanding across all renewal loans for all four suppliers is £134.<sup>20</sup>

<sup>19</sup>Provident has provided this data on both a 1x weekly and a 5x weekly definition of renewals (see Annex C). Provident believes the 5x weekly definition to be most accurate. Provident figures are calculated on the basis of contractual balances outstanding and hence will understate the actual balance outstanding, where customers have missed repayments.

<sup>20</sup>Provident data for this calculation was provided on a 1x weekly definition of renewals. If the data based on a 5x weekly definition was used, the average balance renewed would be £160.

FIGURE 8

**Average balance outstanding at renewal**



Source: CC analysis of data provided by suppliers.

**Role of lenders**

- 57. Lenders play two quite different roles with regard to renewal loans:
  - (a) regulating agents' behaviour to discourage irresponsible lending; and
  - (b) actively encouraging agents to make further loans to creditworthy customers.

**Regulating agents' behaviour**

- 58. As part of their management of credit risks, medium and large suppliers have internal guidelines that specify the circumstances under which agents can advance a loan to new and existing customers.
- 59. Like any other home credit loan, renewals will be governed by the companies' general lending policies. In broad terms, the amount that customers are allowed to borrow on any occasion—and the size of weekly repayments—will be a function of their past payment history and other information about the customer held by the lender. There will usually be some room for judgement by agents and their managers. Lenders will encourage renewal loans over parallel loans, where the agent or company believes that the customer could not afford a higher weekly repayment. In some such circumstances, lenders will not offer a parallel loan and will only allow customers to borrow more with them, if they take out a renewal loan.
- 60. In addition to these general lending controls, the larger companies also constrain their agents' ability to renew loans very early on in a loan. For example, Provident's policy is that 'a customer taking a loan must receive at least half of each loan issued

to them in their hand'.<sup>21</sup> Figure 9 summarizes information on this point contained in responses to the market questionnaire. It is our understanding that smaller suppliers also operate similar rules of thumb, in determining when it is acceptable to offer a renewal loan.

FIGURE 9

### Large suppliers' restrictions on issuing renewal loans

**Provident's** policy is to permit refinancing only where at least 50 per cent of the new loan will be available to the customer.

**Cattles** require all products to run to a minimum term, relative to the original length, before they can be renewed.

**S&U's** credit control rules state that 'it is not company policy to encourage refinancing at the earliest opportunity except on the customer's initiative'.

**London Scottish** will not offer a renewal unless it has received repayments equivalent to at least the total interest payable on the initial loan.

*Source:* Large suppliers' responses to market questionnaire, questions 52 and 54.

61. These policies will tend to discourage renewal until around two-thirds of the initial loan has been repaid. They appear to be driven by two concerns. First, a request for very early renewal might be a signal that the customer is in financial distress and may therefore represent a higher risk of default. Second, it appears important that customers should receive a reasonable part of any new loan in their hand.

#### *Encouraging further lending to good customers*

62. As well as discouraging agents from lending irresponsibly, suppliers can encourage agents to issue further loans to those customers who represent a good credit risk. A number of methods can be used to prompt agents to issue new loans to current customers and to prompt current customers to take them out. These may include discussions between managers and agents, messages left in the agent's collection books and direct marketing to the customer.<sup>22</sup>

#### **Role of agents**

63. The AIA research indicated that agents sometimes play a proactive role, both in suggesting a further loan to the customer and in proposing a renewal instead of a parallel loan. As a piece of qualitative research, AIA did not seek to estimate the proportion of occasions on which renewal loans are actively promoted by agents to their customers. There is, however, some quantitative evidence on this issue from the NOP survey for the CC and from Policis.
64. NOP asked those customers who renewed a loan, where the idea of renewing the loan came from. 64 per cent of respondents said that renewing the loan was their idea, 19 per cent said the idea came from the agent and 15 per cent said the idea came from someone else. It should be noted that the base for this question is small, as only 15 per cent of customers said that they had renewed a loan.

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<sup>21</sup>Source: Provident response to MQ 54. An exception to this general rule is where a new customer has been given a small initial loan on a trial basis and has demonstrated the ability to make repayments over the first few weeks.

<sup>22</sup>See, for example, Section 2.5 of the AIA report, headed 'The process of lending more money to existing customers'.

65. The Policis research cited earlier provides some further insight. Table 8 indicates that agents suggested a renewal in just over one-half of cases in which customers took out a new loan mid-term. The actual proportion of customers who renewed their loan was slightly less than this.

TABLE 8 Role of agent in suggesting renewal

	%
<i>Did agent suggest renewal loan?</i>	
Agent suggested renewal	55
Agent did not suggest renewal	45
<i>Did customer take out renewal loan?</i>	
Took out renewal loan	49
Kept new loan separate	46
Don't know	5

Source: Policis—see first footnote to paragraph 56. Base—Customers with existing loans taking on new loans.

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66. In summary on this point, agents suggest renewal loans to customers in some instances. Given the incentives to do so, it would be surprising if this were not the case. However, customers also instigate renewals and we have seen no evidence, from either customer research or customer complaints, that customers are coerced into taking renewals against their will.

## Conclusions

67. This appendix has looked at renewal loans. Renewal loans account for a substantial proportion of new home credit loans. From the information provided by suppliers, we estimated that renewals account for over one-third of new loans issued—around 1.5 million loans a year. In 2004, the average balance outstanding on loans that are renewed was £134, for those suppliers for whom we have this data. Our analysis suggests that £150 million to £200 million in outstanding balances on home credit loans are refinanced through renewal loans each year.
68. Renewal loans are clearly valued by some home credit customers. In particular, customers on tight budgets are likely to value the ability to borrow more, while maintaining weekly repayments at a relatively constant level. In home credit the demand for refinancing appears to be driven predominantly by customers' demand for more credit and the understandable desire—in some cases a necessity—to avoid sharp increases in weekly repayments.
69. However, the charges associated with refinancing a home credit loan through a renewal are high compared with taking out a parallel loan to obtain the same cash advance. In the example developed in this paper, the customer pays an extra £37.26 in charges for taking a renewal loan compared with taking out a parallel loan to obtain the same cash advance. The extent to which this represents a fair deal for home credit customers is essentially determined by the amount of any early settlement rebate received by the customer. This is discussed further in Appendix 3.4.

### What determines the extra cost of a renewal loan?

1. The repayments on a renewal loan may be compared with the repayments on a parallel loan offering an equal cash advance to the customer at the same time. The difference between the total repayments under the two scenarios gives an indication of the extra charges paid by customers in return for any smoothing of repayments. It also provides an indication of the additional profit for home credit suppliers from renewals, some of which may be shared with agents in the form of higher commissions.
2. To understand the factors that drive the difference in charges, consider the following scenarios.

#### First loan

3. A customer takes out a first loan with the following terms:

Sum advanced = A

No of weekly repayments =  $N_a$

Total charges/sum advanced =  $p_a$

Total amount payable  $TAP_a = A(1+p_a)$

Weekly repayment  $W = A(1+p_a) / N_a$

#### Second loan

4. After the customer has paid off after  $s$  per cent of this first loan, they need to borrow a further amount  $B$  in cash and therefore wish to take out a second loan with the same company, the terms of which are as follows:

No of weekly repayments =  $N_b$

Interest payable/sum advanced =  $p_b$

Total amount payable  $TAP_b = B(1+p_b)$

#### Parallel loan

5. If the customer is still repaying the first loan, the sum advanced for a parallel loan will need to be increased by one weekly payment, in order to give the customer  $B$  cash-in-hand.<sup>23</sup>

TAP for parallel loan =  $(B+W)(1+p_b)$

=  $B(1+p_b)+A(1+p_a)(1+p_b)/N_a$

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<sup>23</sup>This might not happen in practice, but is a necessary assumption to ensure that we are comparing like-with-like.

6. The total repayments for both loans will cover the whole of the first loan plus the whole of the second loan, including the extra week.

$$\text{Total repayments (parallel)} = A(1+p_a)+B(1+p_b)+A(1+p_a)(1+p_b)/N_a$$

7. Thus, the total repayments comprise the total amount payable on the first and second loans, plus an extra element to cover the repayment of the first loan, when the second loan was taken out. The total sum advanced on both loans is equal to  $A + B + W$ . This makes the total cost of credit for the parallel loan as follows.

$$\text{TCC (parallel)} = A(1+p_a)+B(1+p_b)+A(1+p_a)(1+p_b)/N_a - (A+B+W) \quad (1)$$

### Renewal loan

8. Again, this takes place after  $s$  per cent of first loan has been repaid. The terms of the loan are the same as the second loan. There is a rebate for early settlement,  $Z$ , which can be expressed as  $z \cdot A(1+p_a)$ , where  $z$  is the proportion of the TAP on the first loan that is rebated. As with the parallel loan, the customer receives  $B$  cash-in-hand.

9. The sum advanced is calculated at the new cash advance of  $B$ , plus the proportion of the first loan that had not been repaid less the rebate for early settlement.<sup>24</sup>

$$\text{Sum advanced on renewal loan} = B + (1-s)A(1+p_a) - z \cdot A(1+p_a)$$

10. The total amount payable on the renewal loan is equal to the sum advanced plus the interest on the loan.

$$\begin{aligned} \text{TAP on renewal loan} &= [B + (1-s)A(1+p_a) - z \cdot A(1+p_a)] \cdot (1+p_b) \\ &= B(1+p_b) + (1-s-z) \cdot A(1+p_a) \cdot (1+p_b) \end{aligned}$$

11. The first of these terms is the same as the costs of borrowing  $B$ . The second term comprises the extra payments that are associated with the renewal loan, taking into account any rebate paid.

12. In total the customer who renews a loan pay  $s$  per cent of the total amount payable on the first loan along with the total amount payable on the renewal loan.

$$\text{Total repayments (renewal)} = s \cdot A(1+p_a) + B(1+p_b) + (1-s-z) \cdot A(1+p_a) \cdot (1+p_b)$$

13. The total sum advanced on both loans is equal to  $A + B$ . This makes the total cost of credit for the renewal loan as follows.

$$\text{TCC (renewal)} = s \cdot A(1+p_a) + B(1+p_b) + (1-s-z) \cdot A(1+p_a) \cdot (1+p_b) - (A+B) \quad (2)$$

### Difference between cost of parallel and renewal loans

14. We can now compare the total cost of credit for a customer who renews a loan part way through, and another customer who takes out a second loan at the same time.

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<sup>24</sup>We assume here that the rebate is used to reduce the sum advanced on the renewal loan. For the purposes of comparing charges the renewal and the parallel loan, this is equivalent to increasing the amount borrowed on the parallel loan.

$$\text{Difference} = \text{TCC (renewal)} \text{ minus } \text{TCC (parallel)} \quad (3)$$

$$= s.A(1+p_a)+B(1+p_b)+(1-s-z)*A(1+p_a)*(1+p_b)-(A+B+W)$$

minus

$$A(1+p_a)+B(1+p_b)+A(1+p_a)(1+p_b)/N_a-(A+B)$$

15. While this looks complicated, several of the factors in this calculation are common to both renewal and parallel loans.<sup>25</sup> This means that after some algebraic manipulation, the difference between repayments reduces to the following formula.

$$\text{Difference in repayments} = \text{TAP}_a*(1-s-1/N)*p_b-\text{TAP}_a*z*(1+p_b) \quad (4)$$

16. The first of these terms corresponds to the extra interest paid on the amount renewed less the extra week. The second term comprises the adjustments made for the rebate.
17. The additional cost to the customer of a renewal loan over a parallel loan is therefore determined by four main factors.<sup>26</sup>
- The total amount payable on the initial loan ( $\text{TAP}_a$ ). The higher the initial loan, the greater the cost of renewal.
  - The proportion of the TAP on the first loan that is being renewed ( $1-s$ ). The cost of renewal is greater, if more of the initial loan is renewed.
  - The ratio of interest payable to sum advanced ( $p_b$ ). Unless the rebate is implausibly generous—or the renewal takes place very near to the end of the loan—the cost of renewal rises with this factor.
  - The proportion of the TAP on the first loan that is rebated ( $z$ ). The more generous the terms of this rebate, the lower the extra cost of renewal.

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<sup>25</sup>Under both scenarios the customer pays off  $\text{TAP}_a$  and  $\text{TAP}_b$ .

<sup>26</sup>The number of weekly payments on the first loan is also relevant to this calculation, but will only have a significant effect if the renewal takes place very near to the end of the loan, or if the initial loan is very short term.

### Example of a 55-week loan with missed repayments

1. A customer takes out a home credit loan of £200 on 30 November to spend over the Christmas period. The loan is repayable over 55 weeks and the terms of the product are as follows.<sup>27</sup>

TABLE 9 Terms of initial loan

Total charge per £100	£65.00
Sum advanced	£200.00
Charges on £200 loan	£130.00
Total amount payable	£330.00
No of weeks	55
Weekly repayment	£6

Source: CC.

2. The customer normally pays on time, but misses every tenth repayment. At the same time the following year (ie 52 weeks later, after 51 repayments have fallen due), the customer again wishes to borrow £200 cash-in-hand to spend over the Christmas period.
3. At this stage, the customer has nine weekly repayments remaining—the four contractual repayments and the five missed repayments—making a balance outstanding of £54. The customer has a good enough repayment record on the first loan for the lender to be happy to offer either a renewal or a parallel loan. No rebate is required under the new regulations, as the loan is for longer than one year, and the request for renewal would be made within the last eight weeks of its contractual term.
4. Table 10 shows repayments on the renewal and parallel loans.

TABLE 10 Comparison of renewal and parallel loans from customers perspective

	<i>Renewal loan</i>	<i>Parallel loan</i>
Week 0	£200 cash advance	£200 cash advance
Weeks 1–51	46 x £6 weekly repayments 5 missed repayments	46 x £6 weekly repayments 5 missed repayments
Week 52	£200 new cash-in-hand New loan issued of £254 No rebate or weekly repayment	£200 new cash in hand New loan issued of £206 1 x £6 weekly repayment on first loan
Weeks 53–61	8 x £7.62 weekly repayments 1 missed repayment likely	8 x £12.18 weekly repayments 1 missed repayment likely
Weeks 62–113	47 x £7.62 weekly repayments 5 missed repayments likely	47 x £6.52 weekly repayments 5 missed repayments likely

Source: CC.

5. Table 11 compares the total charges on the renewal and parallel loans.

<sup>27</sup>These terms are equivalent to Provident's 55-week home loan, which was the most widely used home credit product in 2004. It has an APR of 177.0 per cent.

TABLE 11 Comparison of charges on renewal and parallel loans

	<i>Renewal loan</i> £	<i>Parallel loan</i> £
<i>Advances to customer</i>		
Cash in customer's hand	400.00	400.00
Total amount advanced	454.00	406.00
Rebate for early settlement	-	-
<i>Repayments</i>		
Repayment in week of new loan	54.00	6.00
Other repayments	709.10	663.90
Total repayments on both loans	749.10	669.90
<i>Charges</i>		
Total charges on both loans	295.10	263.90
Total charges/£100 advanced	65.00	65.00
Total charge/£100 in customer's hand	73.78	65.98
Ex post interest rate on both loans % pa*	157.2	154.6

Source: CC.

\*Calculated on the assumption that the customer misses repayments in weeks 10, 20, 30 etc, through the course of both loans.

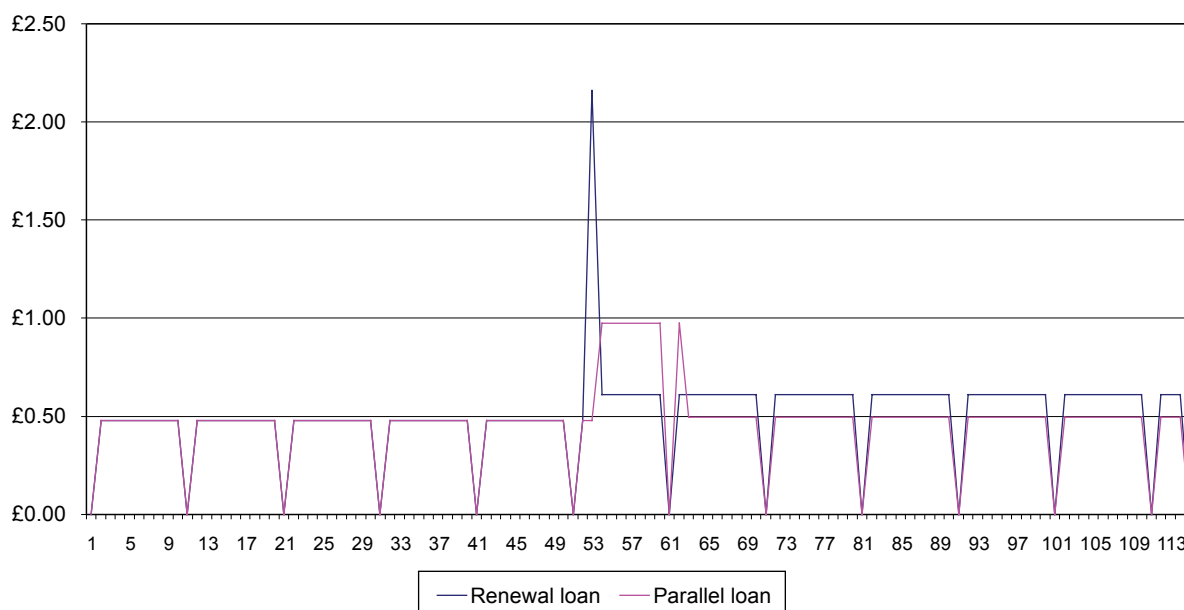
6. As with the example in the main text, the renewal loan may be thought of as comprising a parallel loan of the same amount and a 'revenue smoothing product'. In this example, the 'repayment smoothing product' would consist of eight weekly payments to the customer of £4.56 (a total sum advanced of £36.48), followed by 25 repayments by the customer of £1.44 (total repayments of £67.68). This equates to a charge for credit of £31.20, equivalent to a total cost of credit of £85.53 per £100 advanced<sup>28</sup> or an ex post interest rate of 212.3 per cent a year.
7. The agent in this example receives a commission rate of 8 per cent on normal repayments and 4 per cent on renewals. The agent receives no commission for missed repayments. Commission payments for the agent are shown in Figure 12. Overall the agent receives £57.77 in commission for the loan that is renewed compared with £53.59 if a parallel loan is chosen instead. In the week of renewal, the agent earns £2.16 for the loan that is renewed,<sup>29</sup> compared with 48p if a parallel loan is taken out.

<sup>28</sup>This is calculated by dividing the charges of £31.20 by the sum advanced of £36.48.

<sup>29</sup>The agent would have received £4.32 if a full commission had been paid on the amount renewed.

FIGURE 12

### Comparison of commissions for renewal and parallel loans



Source: CC.

8. Comparing this example with the one used in the main text brings out the following additional features:
- Missed repayments reduce the ex post annual interest rate on both renewal and parallel loans. The ex post annual interest rate on a renewal loan may be lower than the headline APR on the original loan.
  - However, missed repayments do not fundamentally affect the comparison of a renewal loan and a parallel loan. A renewal loan still attracts higher charges—and a higher ex post annualized interest rate—as the customer is borrowing more and rebates are small. Missed repayments also reduce the likelihood that the customer will receive a rebate.
  - The impact on charges of a renewal loan with a given number of repayments remaining will generally be somewhat less with longer-term loans. This is because the weekly repayments, compared with the amount borrowed, are typically lower than for loans of a shorter period.
  - Lower rates of commission for renewals will reduce the financial incentives for agents to renew a loan. However, commissions are higher for renewal than for parallel loans, both in the week of renewal (potentially providing a form of ‘Christmas bonus’ for the agent) and over the lifetime of the loan.

- Customers with regular annual spending patterns, who take out loans with a term of slightly more than one year, are likely to have several repayments remaining when they next require a loan.<sup>30</sup>

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<sup>30</sup>CC analysis of monthly data from large and medium suppliers suggests that one-quarter of new loans by value are issued in November and December.

### Note on definitions and data issues

1. We define a renewal loan as a loan which a home credit customer takes out before they have paid off a previous loan from the same supplier, part of which is used to settle the balance of the previous loan<sup>31</sup> and the remainder of which consists of a further cash advance. The following issues were raised by companies when attempting to provide data on renewal loans.
2. The first issue concerns the treatment of renewals that take place after the contractual term of the initial loan has expired (ie where the only repayments outstanding are repayments which had previously been missed). Provident has not included these in its renewal figures, as it does not consider these to be real renewals. These loans were included with a category of 'other loans' in the data submitted by Provident. Other suppliers have not made this distinction and have included renewal loans which take place after the contracted term as 'renewals'.
3. The second issue concerned companies' ability to provide information about the number of loans renewed. This varied considerably between suppliers. Park and London Scottish were able to estimate the number and value of renewals. Mutual was unable to provide this information and S&U has only been able to provide a rough estimate. Cattles was unable to separately identify renewals with fewer than four weeks to go and included these with hampers and rewrite loans in 'others' (estimated at [X] per cent of all loans issued by Cattles in 2004).
4. Provident does not track renewals directly and has estimated the number of renewals as follows. It first identifies those customers who take out a new loan within a three-week window of paying up an old loan that has not yet reached its contractual term.<sup>32</sup> For each of these customers, Provident then compares the amount repaid on the old loan with the normal weekly repayment. For its internal purposes, Provident defines a renewal as occurring when the amount repaid on the old loan is over five times the normal weekly repayment (5x weekly rate). Provident uses this definition because 5 to 10 per cent of its customers informally pay fortnightly or monthly. Using a definition of final repayment of less than five weeks will catch some monthly payers who are paying up a loan fully and then taking out a new loan. This will exclude renewals which take place with fewer than five weeks' repayments remaining, but Provident considers this nevertheless to be the most accurate figure.
5. At the CC's request, Provident also provided an estimate based on a broader definition, where the amount repaid on the old loan is more than one normal weekly repayment (1x weekly rate). As noted above, this latter estimate will include some customers who have informal arrangements to pay fortnightly or monthly and who are not, in practice, taking out a renewal loan—but may, for example, be taking out a loan back-to-back with another loan. All such monthly/fortnightly customers repaying normally and taking out another loan within a three-week window of their last repayment will be incorrectly allocated to renewals under the >1x weekly rate definition.

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<sup>31</sup>Net of any rebate payable for early settlement.

<sup>32</sup>The 'three-week window' comprises the week in which the repayment took place and the week before and afterwards. Using a three-week window will overestimate the level of renewals, since some customers that are taking out back-to-back loans will be captured erroneously by this definition.

6. Table 12 shows how the estimate of renewals as a percentage of new Provident loans is affected by these definitional issues.

TABLE 12 Impact of definitions on calculation of Provident renewals

Issue category	% of loans	% of value
Customer's first loan with your company	$\left( \begin{array}{c} \times \\ \times \\ \times \\ \times \\ \times \end{array} \right)$	$\left( \begin{array}{c} \times \\ \times \\ \times \\ \times \\ \times \end{array} \right)$
Previous customer, who had paid off all previous loans		
A parallel loan (including vouchers)		
A renewal loan (5x weekly definition)		
A renewal loan (>1 wk, <= 5 wks rate. Includes some weekly and fortnightly loans that are not renewals)		
Other (including renewal loans at term or late)		

Source: CC analysis of data supplied by Provident.

7. Taking Provident's internal definition (of 5x weekly rate), [x] per cent of loans issued by Provident in 2004 were renewals. If a 1x weekly rate definition were used, this would increase to [x] per cent of loans. If renewals at or after the contractual term were included, these proportions would increase further to [x] per cent of loans.
8. If we make an assumption that [x] per cent of the loans in the last two categories (1 to 5 weeks and 'other') are fortnightly or monthly paying customers taking out a back-to-back loan,<sup>33</sup> this would estimate the proportion of renewals by Provident at [x] per cent.
9. Third, Provident commented on the 'snapshot' approach, whereby we asked companies about loans issued in 2004. Provident preferred to take a 'cohort' approach—following through loans issued in 2002 and seeing whether they were renewed. Both approaches are helpful in understanding this issue. A snapshot approach provides information about the sources of new loans, a cohort approach provides information about the outcomes of old loans.
10. We did not ask all large suppliers to conduct a cohort analysis. However, Provident has provided its own estimates of the percentage of loans renewed on both bases (see Table 13). This shows that the methodology makes little difference to the calculation of the percentage of loans that are renewed by volume. However, the percentage of loans renewed by value is considerably lower on a cohort analysis than if a snapshot of loans is taken. This may be because a cohort analysis looks at the value of the *original* loan (ie the loan taken out in 2002), rather than the *most recent* loan (ie a renewal loan taken out in 2004). If renewal loans are of a higher value than the loans that preceded them (for example, because the lender is willing to lend higher amounts) then this could explain this difference.

<sup>33</sup>This would imply that 7.5 per cent of customers fall into the 'other' category. This is the mid-point of Provident's estimate of consumers who pay weekly or fortnightly. Not all of these customers will be taking out a back-to-back loan.

TABLE 13 Comparison of snapshot and cohort analysis

Methodology	Snapshot		Cohort	
	% of loans by volume	% of loans by value	% of loans by volume	% of loans by value
<i>Definition of renewal loan</i>				
A renewal loan (pre-term, more than 5 wks rate)	[		×	]
A renewal loan (pre-term, more than 1 wk rate)				

Source: CC analysis of data supplied by Provident.

11. In addition, we asked large suppliers to provide data about renewals, broken down by the number of weeks remaining on the loan. Provident, Park, London Scottish, and Cattles were able to provide this information. There are some important differences between the bases on which this data has been supplied:
  - (a) Cattles provided information about the number of loans and actual balance outstanding on loans renewed with four or more weekly payments remaining on the loan.
  - (b) Park provided information about the number of loans and actual balance outstanding on all renewal loans.
  - (c) London Scottish provided information about the number of loans and actual balance outstanding on all renewal loans.
  - (d) Provident provided information about the number of loans and contractual balances outstanding on loans renewed before the contractual term. Where customers have missed repayments, these will be lower than the actual balances outstanding on loans renewed.
  
12. As a result, the data are not directly comparable between companies. However, they do provide a useful insight into the timing of renewals and the balances outstanding when loans are renewed.