

3. Findings on market outcomes

Introduction

- 3.1. This section sets out our findings on outcomes from the operation of the market for home credit. Specifically, it sets out the evidence that we have found on some indicators of the extent of competition which leads us to believe that there may be features of the market which prevent, restrict or distort competition.
- 3.2. The CC's guidance¹ indicates that the CC will look at several possible indicators of the extent of competition. This section is in four parts:
- the first considers the level of prices;
 - the second considers levels of profitability earned in the market;
 - the third considers efficiency, and in particular whether the costs incurred by home credit lenders are higher than they might be in a competitive market; and
 - the fourth considers other indicators of the intensity of competition, notably the extent of choice and innovation and levels of customer satisfaction.

It concludes with some general observations about possible explanations for what we have found. We then analyse key aspects of competition in more depth, and seek to assess the reason for what we have found. Specifically, in Section 4 we consider what constraint other forms of lending impose on home credit lenders, in Section 5 we consider the nature of the threat of entry or expansion and in Section 6 we assess the nature and extent of competition among home credit lenders.

- 3.3. Throughout this section we assess the supply of home credit in isolation, without prejudice to whether the relevant market for home credit is broader or narrower than home credit itself. Section 4 considers in more detail whether the constraints on the behaviour of home credit lenders from other sources of credit are sufficient for us to believe that the relevant economic market for analysis is broader than home credit, and presents our formal findings on product market definition.

Price levels

- 3.4. In this section we consider the evidence on the level of the prices paid for home credit.
- 3.5. The NCC supercomplaint which gave rise to this investigation asserted that prices for home credit loans are high, even when the cost of home collections is taken into account. 'Taken together, the evidence suggests home credit customers are paying an unacceptably high price for this form of credit.' Much research and public comment on home credit has focused on price levels, and some on the impact that loan repayments have on the household budgets of poor families. Independent research over time has found that while some customers consider home credit to be more expensive than other credit options, they do not know by how much. Most commentators (including, for example, Debt on our Doorstep) recognize that the risks

¹CC3, paragraphs 3.78 to 3.90.

borne and the costs incurred by home credit lenders are greater than for other forms of lending, but have questioned whether the additional risks and costs justify the differences in price.

Price measures

- 3.6. The price of a home credit loan can be expressed in several different ways:
- The *APR* is designed to be a standard measure of a loan's interest rate (incorporating some defined non-interest payments made by the borrower) which allows a customer to compare, before taking out a loan, the costs of different types of loan with different terms.
 - The *TCC* indicates how much more than the amount borrowed is to be paid back to the lender.
 - The *weekly repayment* is the amount collected every week, and is generally cited alongside the *term of the loan* (in weeks).
- 3.7. The Consumer Credit (Advertisements) Regulations 2004 described in paragraphs 2.43 and 2.44 require lenders to state the 'typical APR' in any advertising which refers to the terms of the loan in any way, makes particular claims about price or offers particular incentives. The regulations governing the form of agreements (see paragraph 2.47) require them to state all three measures of price.
- 3.8. Table 3.1 shows the 24 largest products in terms of the total amount advanced in 2005, according to information supplied to us by the lenders. Of these 24 products, 19 were cash loans and 5 were for vouchers. All the products in the table were issued by the five largest lenders (counting PPC and GPC as one company) and excluding Park, which was unable to supply data for this year.
- 3.9. For short- and medium-term loans, up to 55 weeks, TCCs are generally between £40 and £80 for a £100 loan; APRs vary from around 150 per cent to nearly 500 per cent. Weekly repayments for a £100 loan in most cases vary between £1.50 and £5.00, depending on the length of the loan. The two most popular loans in the market are for around a year and half a year respectively, although there has been a noticeable trend in the market over the last couple of years towards longer-term products. These two most popular cash loans, which together represent 62 per cent of the total amount advanced by these five largest lenders' leading 24 products, have a very similar average weekly repayment of £11.89 and £11.79 respectively, despite a wide variation in their APRs. Cattles' and S&U's loans of similar length also have similar average weekly repayments.

TABLE 3.1 Large lenders: principal products, 2005

Lender	Weekly payment £	Term (weeks)	TCC £	APR %	Number of advances	Average advance £	Total advanced £'000	Average weekly payment £
<i>Cash loans</i>								
PPC	3.00	55	65.00	177.0	⌈ ⌋	396	⌈ ⌋	11.89
GPC	5.00	32	60.00	399.7		236		11.79
PPC	1.80	105	89.00	102.7		1,077		19.39
Cattles	3.40	52	76.80	246.5		401		13.64
Cattles	5.30	30	59.00	440.3		230		12.19
PPC	2.25	80	80.00	132.5		914		20.56
PPC	5.00	31	55.00	365.1		220		10.99
S&U	4.00	41	64.00	281.0		359		14.34
LSB [†]	4.70	34	59.78	353.8		299		14.06
PPC	6.40	23	47.20	497.4		202		12.94
Mutual [†]	1.52	102	55.04	59.2		-		-
LSB [†]	3.25	50	62.48	194.7		739		24.01
S&U	3.33	50	66.67	213.0		483		16.10
S&U	5.00	32	60.00	399.0		255		12.77
Mutual [†]	2.75	51	40.25	104.9		-		-
LSB	2.14	100	114.41	149.7		944		20.19
GPC	3.20	53	69.60	206.8		407		13.04
LSB [†]	5.22	20	17.72	76.6		143		7.48
S&U	2.50	70	75.00	148.0		1,047		26.17
<i>Vouchers</i>								
PPC	5.00	25	25.00	152.3	112	5.61		
Cattles	3.00	50	50.00	148.1	223	6.69		
PPC	2.70	50	35.00	90.5	241	6.51		
PPC/GPC	3.00	45	35.00	104.3	232	6.95		
GPC	5.00	27	35.00	222.7	96	4.78		

Source: CC from company data.

*This cash loan product was offered in 2005 through Morses.

†Mutual confirmed that the prices of its products did not change in 2005. However, it was unable to supply updated volume data. The value of loans advanced by product is therefore from 2004. Mutual could not supply any figure for the number of loans advanced for each of its products as it does not record this information.

Note: The weekly payment and TCC are per £100 advanced. The average weekly payment is based on the average advance.

- 3.10. Table 3.1 also shows that the length of the loan term has a significant impact on the APR. Very short-term loans typically have very high APRs. A £100 loan repaid at £10 per week for 14 weeks—a loan offered by home credit lenders in some localities—has an APR in excess of 1,000 per cent but a TCC of £40 on £100. Longer loans typically have lower APRs but higher TCCs. The three most popular loans in the market, all offered by Provident, illustrate this point. A relatively short-term Provident loan over 32 weeks has a higher APR (399.7 per cent) but a lower TCC (£60 per £100 lent) than Provident's longer-term product over 105 weeks (with an APR of 102.7 per cent and a TCC of £89 per £100 lent.) Provident's most popular product over 55 weeks is in the middle of this range with an APR of 177 per cent and a TCC of £65 per £100 lent.
- 3.11. Table 3.1 illustrates that as loans get longer, different suppliers' APRs decline at different rates (and their TCCs change at different rates). Moreover, there is a wide range of prices available (especially for longer loans). For example, among loans of around a year the prices offered by the larger lenders vary from a TCC of £40.25 per £100 lent (APR of 104.9 per cent—Mutual's 51-week product) to a TCC of £76.80 per £100 lent (APR 246.5 per cent—Cattles' 52-week product). We consider the implications of this further in Section 6.
- 3.12. Table 3.1 also illustrates the challenge of finding a single good measure of the cost of a home credit loan. Small differences to the period of the loan can have a dramatic effect on the APR. For example, the Cattles 30-week loan and the GPC 32-week loan have similar TCCs of, respectively, £59 and £60 on £100, but APRs of 440.3 per

cent and 399.7 per cent respectively. More detail on the impact of different variables on the APR calculation is shown in Appendix 3.1.

- 3.13. We consider the APR alone to be a poor measure of the price of a home credit loan. Because of the relatively short period of some home credit loans, the reinvestment assumptions inherent in the APR calculation (see Appendix 3.1) can give rise to some very high figures, and magnify differences between similar products. It is therefore hard to use as a basis for comparing different loans, simply because it is hard for a customer to know what to make of a difference in APRs between two loans.
- 3.14. For a rational borrower considering whether to take a home credit loan (and if so which one), the TCC appears to us to be a more appropriate basis for comparison for comparing the value for money of different loans. Where quoted as a figure per £100 borrowed (as it generally is), it is readily comprehensible. It is less sensitive than APR to small differences in the period over which the loan is offered. And over the relatively short period (less than two years) of most home credit loans, it approximates to the net present value (NPV) of a loan to the borrower. We recognize that for a borrower on a fixed budget the affordability of the loan (represented by the level of the weekly payment) will also be an important consideration.
- 3.15. The TCC is, however, a less good basis for comparison of home credit loans with other, longer-term loan products. That was the purpose for which the APR was designed. In the rest of this document, we therefore seek to use both measures for comparison of prices where possible, on the grounds that for home credit loans we believe TCC to be the most appropriate measure of price, but recognize that across consumer credit more broadly the APR can provide a basis for comparison (albeit an imperfect one) and is the most frequently cited measure.

Price comparisons

- 3.16. We said in our Emerging Thinking that ‘home credit is a model of lending which meets the requirements of its customers well ... However, it does so only at a high cost. Customers ... bear that cost in the price they pay for home credit’.
- 3.17. Home credit lenders told us that it was inappropriate simply to state that prices were high without an appropriate comparison. We consider that most people would share our view that, say, £60 in charges on £100 lent for half a year seems like a high price in relation to the amount advanced. However, we recognize that certain other comparisons also provide a good basis for making such a judgement. We therefore considered the price of home credit:
 - by comparison with the price of other forms of credit (paragraphs 3.18 to 3.31);
 - by comparison with prices in the Republic of Ireland (paragraphs 3.32 to 3.43); and
 - by comparison with the costs of provision (paragraphs 3.44 and 3.45).

Comparison with prices of other forms of credit

- 3.18. Simple comparison of APRs² shows that APRs for home credit loans are generally higher than APRs for other forms of credit. For example, Capital One's 'Classic' credit card (which is designed for the sub prime market) carries a typical APR of 34.9 per cent. Personal loans are available from a range of providers; typical APRs for loans available from the Post Office, for example, range from 7.9 to 12.5 per cent. Although comparison of different products is one of the purposes for which the APR was designed, home credit lenders told us that such comparisons are misleading, both because the product, and especially the service provided, is different, and because the APR calculation does not reflect all charges which may be paid on other credit products, so it is not a good measure of the price of other credit products.
- 3.19. Elements of the home credit product (notably the home collection service and the ability to miss contractual payments) contrast with the lending models of most lenders (which involve remote processing and underwriting and automated regular collection with, in most cases, no facility to miss contractual payments without penalty³). Lenders told us that these were important features of the product to which customers attached considerable value. Thus a customer seeking to compare any measure of price between them is not comparing like with like, and we do not consider that a straightforward comparison of APRs (or even TCCs) is likely to be particularly helpful in this context.
- 3.20. Lenders also told us that all charges payable on a home credit loan are included in the APR calculation, so a customer should never pay more than the APR. Moreover, where a borrower makes some payments late, the actual interest rate paid, which can be calculated once the loan is paid off (and which we term the 'effective interest rate'), would be lower than the APR. By contrast, late payment or other penalties applied by other lenders are not included in the APR calculation. So, home credit lenders told us, the APR on a home credit loan was a better guide to what a borrower was likely to pay than the APR on other credit products. It was quite possible for a user of a credit card or remotely collected personal loan to incur additional charges for missing contractual payments and thus pay an effective interest rate in excess of the quoted APR. Home credit lenders argued that this made the pricing of home credit simpler and more transparent than the pricing of other credit products, in that all charges were included in the published APR.
- 3.21. Despite these claims, we found that some home credit customers do pay more than the posted APR, if they choose to settle the loan early. Where a loan is settled early, in practice the borrower still pays most of the charges originally payable on the loan (this is discussed in more detail in paragraph 3.49). So a borrower with a good payment record who settles a loan early will be likely to pay an effective interest rate higher than the quoted APR. The number of customers affected by this is hard to assess, since the impact depends on the number and pattern of any missed payments prior to the early settlement, but since around half of all loans are settled early (see paragraph 3.47), we suspect that a substantial minority of customers may pay an effective interest rate higher than the quoted APR. Provident showed us evidence⁴ that around [X] of a sample of Provident customers who had taken out a

²Despite our concern about the APR as a measure set out in paragraphs 3.13 to 3.15, in this section (paragraphs 3.18 to 3.31) we compare APRs because APR comparisons are those most commonly cited by commentators, because they are the quoted comparable figures, and because they were the rates used in the analyses on which we comment. In practice, for the purpose of these analyses, comparisons of TCCs would have yielded the same results.

³Two providers of mainstream credit products told us that they offered products which allowed customers to miss some payments, and that the added cost of this facility was 'minimal'.

⁴As part of the analysis summarized in Appendix 3.2.

certain loan product in 2000 had in fact paid an effective interest rate in excess of the APR.⁵ The implications of this for the cost to the customer when a loan is renewed are considered in more detail in paragraphs 3.46 to 3.57.

- 3.22. By contrast, a home credit customer who misses some payments and completes paying off the loan at or after the contractual completion date will pay an effective interest rate lower than the quoted APR. As indicated in paragraph 2.21, there is no direct penalty for missing payments (or for paying less than the contracted sum in any week). Customers do not, however, know for sure how many payments they can miss before their access to further credit may be jeopardized, though the agent may give them some indication, if only as an encouragement to pay. The same analysis as we cited in paragraph 3.21⁶ showed that the headline APR advertised by Provident is close to the median effective interest rate (implying that roughly as many customers pay an effective interest rate lower than the APR as pay an effective interest rate higher than the APR).
- 3.23. Provident submitted an analysis which, it told us, demonstrated that once effective interest rates were taken into account, the price difference between home credit and other products narrowed considerably for customers with certain characteristics. The analysis sought to show that, for a borrower with an uneven payment pattern typical of a home credit customer, price differences between home credit and other credit products are considerably diminished, once all the additional charges to which they might be exposed were taken into account.⁷
- 3.24. The analysis calculated what a customer with a typical payment pattern on a Provident loan would pay had they borrowed the same sum of money in a variety of other ways. This analysis (set out in more detail in Appendix 3.2) highlighted the difference, for forms of lending other than home credit, between the headline APR and the effective interest rate a customer with that repayment pattern would pay. Effective interest rates paid by a customer with this payment pattern rose for all the other lending products analysed (for example, to between 50 and 90 per cent for a credit card with a headline APR of between 20 and 30 per cent). The most expensive of the unauthorized overdraft rates exceeded the headline APR for the home credit loan (which, as discussed above, may be higher than the effective interest rate).
- 3.25. Home credit lenders quoted to us research by Policis for the DTI into the impact of interest rate caps in other countries, which found that 'under uneven repayment conditions, sub prime models can be cheaper than mainstream models, confirming the rationality of consumer choice'. This analysis is also summarized in Appendix 3.2. However, Policis told us that its analysis was seeking to illustrate the impact on the actual cost to the consumer of the behaviours typically associated with different products and pricing structures, rather than making a direct comparison between the prices of different credit products, as such an exercise would not in its view be legitimate.
- 3.26. We recognize that comparison of headline APRs can be misleading, and tends to overstate the gap in price between home credit and other options. However, in our view these analyses do not demonstrate that the prices of different forms of credit are similar. Even on similar repayment assumptions (which we consider an unrealistic assumption since customers miss more payments on home credit than other credit

⁵As a result of early settlement, rather than of additional charges.

⁶See Appendix 3.2.

⁷The OFT issued a decision on the levels of late payment and other charges on credit cards in April 2006. This decision and subsequent developments are outlined in Appendix 1.2.

products—see paragraph 3.29) the credit cards with the highest effective interest rates were still considerably cheaper than the home credit loan. When presented as a comparison of weekly payments, the comparable payment on a credit or store card would be around 25 per cent less than on a home credit loan. For authorized overdrafts the price difference is even more striking, and even most unauthorized overdrafts (the most expensive form of credit analysed and a somewhat different product to home credit) have an effective interest rate lower than that of the home credit product.

- 3.27. In our Emerging Thinking we said that ‘the price of home credit, whether expressed by APR or TCC, appears to be high in comparison to other forms of credit’. None of the evidence we have seen has significantly altered that view. We therefore continue to believe that home credit is more expensive than other credit products.
- 3.28. However, this does not mean that where the customer has the choice of other products it would always be rational to take the lower-priced product. The characteristics of home credit (notably home collection, the facility to miss payments without penalty and the absence of hidden charges) are very different from those of any other credit product, and may be of considerable value to some customers. For example, we consider that it would be rational for a customer who expects to have an uneven repayment record not to choose a product which imposes charges for missed or irregular payments. A customer who does so and suffers unexpected penalty charges is unlikely to do so more than once, given alternative options. We further consider that people living on limited budgets have a strong incentive to avoid the risk of unexpected additional calls on their weekly budget.
- 3.29. All home credit lenders who could provide data told us that over 90 per cent of customers missed at least one payment in the life of a loan and that over three-quarters ‘often’ or ‘usually’ missed payments (see Table 2.2).⁸ Provident told us that [X] of the customers of its one-year loan missed at least [X] payments over the life of the loan. Mainstream lenders’ experience of missed or late payment of interest varied; some told us that less than 5 per cent of customers missed payments on credit cards; the highest figure we saw suggested that just under 30 per cent of one lender’s credit card customers did so.
- 3.30. We accept that many of the characteristics of the home credit product are attractive to customers. Customers value available credit with a weekly repayment schedule which they consider they can afford from their weekly budgets. They also value the certainty that they will incur no further charges. Provident told us that its customer tracker data indicated that three-quarters ([X] per cent) of customers agreed that ‘the ability to miss payments occasionally’ without penalty was an important feature of home credit, and the vast majority ([X] per cent) agreed that ‘no hidden charges’ was an important feature of home credit. The value they place on these characteristics may help to explain why they pay what appear to be high prices and still secure what they consider to be value for money. Whether that enables the home credit lenders to charge higher-than-justified prices, and if so to what extent, are key issues of this investigation.
- 3.31. For the purposes of this section, we consider that the balance of evidence suggests that customers and observers alike recognize that the price of home credit is high by comparison with other credit products. We reach no conclusion, however, on the relative value for money of different credit products. We would expect that to vary

⁸As noted in the second footnote to paragraph 2.22, few ever fell as much as a month in arrears.

between customers according to their perception of the value of attributes of the products.

Comparison with relevant overseas comparator

- 3.32. We considered to what extent prices charged for home credit in other countries might serve as a useful comparison. Comparisons of prices of goods or services in different countries are often difficult, given differences in currency, regulatory regimes and other aspects of the market. In the case of credit products the exchange rate difficulty is overcome by the fact that prices are quoted in percentage or units per hundred.
- 3.33. Home credit exists in several other countries in Europe. Provident alone operates in five European countries (Poland, the Republic of Ireland, the Czech Republic, Hungary and Slovakia). In most cases the regulatory regime and structure of the financial markets are sufficiently different to make comparison difficult, and we have not been able to study most of these markets in sufficient detail.
- 3.34. We were able, however, to look at the market in the Republic of Ireland in some detail. Our consideration of the market there is set out in Appendix 3.3; our conclusions from it are summarized here.
- 3.35. We found that there were some similarities between the UK and the Republic of Ireland markets:
- Approximately the same proportion of the population uses home credit as in the UK (approximately 6 per cent as against 5 per cent⁹).
 - Provident is a substantial lender; there are many smaller lenders, many of whom confine their activities to one geographical area; most lenders are members of the CCA.
 - The CCA told us that the way its members conducted business, and in particular the nature of the agent-customer relationship, was 'virtually identical' in the two markets.
- 3.36. We also observed some differences between the UK and Republic of Ireland markets:
- There is a different regulatory regime. This has three key components:
 - an effective APR cap of 200 per cent which was introduced in 1996 following the 1995 Consumer Credit Act (the moneylender¹⁰ can charge for collection, which is not included in the APR cap as the customer can elect to pay at the moneylender's office);
 - moneylenders have to apply and pay for a licence to operate annually; and
 - a regulatory prohibition on reducing the advance given to a customer on a new loan to pay off an existing loan.

⁹Mintel estimated that 5 per cent of UK households use home credit (*Sub-prime Lending: Entering the Mainstream. Finance Intelligence, September 2002*); figures from Lexecon for the CCA suggested that there are 2.9 million customers—approximately 5 per cent of the total population.

¹⁰Any company or individual charging an APR in excess of 23 per cent which is not a credit institution or mortgage lender as defined in the Consumer Credit Act 1995 (as amended) must apply to the Financial Regulator for a licence to act as a moneylender. The majority of moneylenders are home credit companies.

- Credit union penetration in the population is much higher (over 100 per cent in the Republic of Ireland compared with around 1 per cent in the UK¹¹). A recent study of clients of the Money Advice and Budgeting Service (MABS)¹² suggests that 57 per cent of moneylenders' customers also have a credit union loan, while Provident told us that 42 per cent of its customers had savings with a credit union compared with 3 per cent in the UK.
- This is in part offset by lower penetration of mainstream credit products; only [x] per cent of Provident's Republic of Ireland customers have a credit card against nearly [x] per cent of UK customers, for example.

3.37. We found that prices in the Republic of Ireland were somewhat lower than in the UK. Table 3.2 summarizes the maximum prices charged (in APR terms); Table 3.3 compares the prices charged by Provident (the only major UK lender which operates in both markets) in the UK and the Republic of Ireland.

TABLE 3.2 Maximum prices (by companies belonging to the CCA) in the Republic of Ireland, 2006/07

	Number of companies	Duration weeks	Average		
			APR (excluding the collection charge)* %	Collection charge† %	TCC per €100 (including the collection charge) €
Companies charging APRs greater than 175%	8	24.4	175–200	4.4	32.03
Companies charging APRs between 150% and 175%	11	28.3	150–175	4.9	33.94
Companies charging APRs between 100% and 150%	11	29	100–150	5.0	31.45
Companies charging APRs between 50% and 100%	2	35.5	50–100	5.5	27.26

Source: The Financial Regulator (calculations by the CC).

*The maximum APR charged by each company. As in the UK, if a customer pays off a loan early they will face a considerably larger effective interest rate.

†The collection charge is usually calculated with reference to the loan rather than the amount collected and is outside the 200 per cent cap.

TABLE 3.3 Provident's prices in the UK and the Republic of Ireland (cash loans)

	Duration (weeks)	APR %	Collection charge	TCC per €/\$100 (incl collection charge)
<i>Republic of Ireland</i>				
26-week loan (home collection)	26	187.2	-	€30
51-week loan (home collection)	51	150.3	-	€53
26-week loan (office collection)	26	163.9	-	€27.40
51-week loan (office collection)	51	138.8	-	€49.94
<i>UK (PPC)</i>				
Short loan (home collection)	31	365.1	-	£55
Medium loan (home collection)	55	177.0	-	£65
Long loan (home collection)	80	132.5	-	£80

Source: Provident Financial.

¹¹The figure of over 100 per cent is expressed as a proportion of the economically-active population, which suggests that a high proportion of the population are members of at least one credit union; credit union penetration in the UK is calculated on a slightly different basis but not sufficiently different to invalidate the comparison.

¹²A Government agency established to address problems of moneylending and over-indebtedness.

- 3.38. Provident told us that there were two principal reasons for prices being lower in the Republic of Ireland than in the UK:
- First, costs had until recently been considerably lower because the customer base had been characterized by better paying customers (from 2001 to 2003 bad debt and other expenses had both been lower as a percentage of revenue than in the UK, though this was no longer the case).
 - Second, profitability and economic returns in the Republic of Ireland were [redacted] declining. An expansion of Provident's business since 2003 had been associated with a decline in the quality of debt and increase in expenses. Current lower levels of return had caused Provident [redacted]. We note, however, that Provident's Republic of Ireland turnover has nearly doubled in the last five years (from €[redacted] million to €[redacted] million) though much of this may have been a result of its expansion.
- 3.39. Provident and the CCA also cited the existence of the regulatory price cap as an influence on pricing and other behaviour. They told us that:
- The cap at the current level has led to an absence of very short-term provision—no loan of less than 20 weeks is offered in the Republic of Ireland; the NOP survey estimates that 10 per cent of UK loans are for this period.
 - Many lenders had left the industry in response to the cap, and returns were becoming unsustainable for those who remained.
 - Indications from the Financial Regulator's office that price increases would be unlikely to be granted (and that price cuts might be imposed) had effectively led to a price freeze.
- 3.40. We found that there had indeed been more exit from the industry than entry since the regulation was put in place. There were 74 registered moneylenders in 1996; in August 2005 there were 46 (though these numbers disguise significant churn—there were 22 new registrations in that time). Though the CCA cites the price cap (alongside other regulatory burdens) as a reason for exit from the industry, none of the five companies that left the market when the cap was brought in charged an APR over 159.4 per cent, so presumably all these companies could have raised prices if they believed they were uneconomic.
- 3.41. Similarly, the Financial Regulator's moneylenders register¹³ indicates that four moneylenders have increased the APR charged on their most expensive products by more than 20 percentage points, seven companies have increased the collection charges on their most expensive products, and six companies have decreased their APR by more than 20 percentage points on their most expensive products since 1997. It is thus not clear to us that the price cap has led to a price freeze.
- 3.42. We found the Republic of Ireland parallel instructive. Despite the apparent similarity in demographic profiles, Republic of Ireland customers' default rates appear to have been lower than their UK counterparts. It appears to have been possible for home credit lenders to survive while charging rates which are on average somewhat lower and in some cases appreciably lower than in the UK. Provident itself appears to have been able to operate at lower price levels [redacted], and as recently as 2003 saw the Republic of Ireland as a sufficiently attractive market to seek to expand its presence

¹³Money Lenders in Ireland Register 2004–2005.

there. The decline in the quality of debt it has experienced since may have been in part a result of that expansion (see our analysis of adverse selection as a barrier to expansion in Section 5) rather than a wider trend. We also note that any change to longer-term products in the Republic of Ireland may be a result of new customers, after a period of expansion, proving their creditworthiness and hence becoming able to take out longer, larger loans.¹⁴

- 3.43. We cannot be sure of the reasons for prices being lower. It is not, for example, clear whether credit unions impose a greater competitive constraint on lenders in the Republic of Ireland than in the UK. Nor can the impact of the regulatory regime be assessed in isolation. But the combination of factors which make the Republic of Ireland market different do appear to give rise to prices which are, and have consistently been, lower than in the UK, but which nonetheless appear to enable at least some lenders to operate profitably.

Comparison with costs

- 3.44. We considered whether prices reflected the cost of delivering the home credit service.
- 3.45. We considered conducting a more detailed analysis of costs and prices. However, any comparison of prices against costs would need to take account of the appropriate return to be earned on the company's capital base in order to reach a conclusion. This issue lay at the heart of our consideration of profitability (see paragraphs 3.60 to 3.144). We therefore did not pursue a detailed analysis of margins in addition to that analysis.

Prices paid when loans are settled early

- 3.46. In the light of our finding in paragraph 3.21 that customers who repay loans early pay a higher effective interest rate, we considered the level of prices paid when loans are settled early.
- 3.47. Over three-quarters of loans which are settled early are renewed. We found (see Appendix 2.3) that renewals were relatively common (around 40 per cent of all loans involve the refinancing of a previous loan from the same lender) and are popular with customers, and we found no evidence that they were being sold by agents in a way which was detrimental to customers' interests. Customers clearly value the opportunity provided by renewals to secure more credit without, in many cases, increasing the weekly repayment.
- 3.48. We observed in our Emerging Thinking that this opportunity comes at a high cost. In a simple example developed in Appendix 2.3 the customer appears to pay over £10 more per £100 borrowed if the loan is renewed with unchanged weekly repayments than if a parallel loan (which would provide the same cash advance, but which would temporarily increase weekly repayments because the original loan is not yet paid off) is taken out.
- 3.49. The reason for this is that when a loan is settled early (whether or not it is renewed) the customer still pays most of the charges due on the loan (less a rebate—issues relating to the rebate are discussed below). It is thus not the renewal loan (the second loan) itself which is expensive, but the early settlement of the original loan

¹⁴We identified a trend towards longer loans in the UK in paragraph 4.88.

which gives rise to the additional cost to the customer. Since it is the early settlement which gives rise to the additional cost, all loans which are settled early (not just renewals) are expensive.

- 3.50. The minimum level of the rebate paid by lenders when a loan is settled early is governed by The Consumer Credit (Early Settlement) Regulations 2004 (the ESR regulations) which apply to most forms of consumer credit and came into force in the course of our investigation. The rebate is designed to ensure that the borrower does not compensate the lender for costs which, as a result of the early settlement of the loan, have not been incurred by the lender. The minimum rebate is calculated according to a formula prescribed in the ESR regulations. The calculation of the rebate is described in detail, and issues related to it discussed, in Appendix 3.4. Though lenders can pay higher rebates, we found that few do so.
- 3.51. Our calculations suggest that for home credit, the statutory minimum rebate may not strike a fair balance between the interests of the borrower and the lender. We calculated rebates based on the costs we considered lenders to have incurred under a variety of assumptions, and found that the statutory minimum rebate fell below what we consider an appropriate rebate on any plausible cost-based estimate. Our calculations are set out in more detail in Appendix 3.4. We consider that this is likely to be a result of the particular circumstances of home credit, in which a high proportion of costs (for example, the cost of collection) are variable, and the fixed costs, both of loan initiation and of early settlement, are a relatively small proportion of overall costs.
- 3.52. The implication of this is that, as a result of the low level of the rebate, the price paid by customers when loans are settled early for any reason (not just when a loan is renewed) is high.
- 3.53. Home credit lenders told us that our conclusion was wrong and that the rebate formula was indeed fair to both borrower and lender. Provident submitted a detailed analysis on this issue, which is discussed in Appendix 3.4. Appendix 3.4 shows that the principal difference between Provident's analysis and ours lies in the treatment of the profit margin in the analysis of costs avoided by the lender when a loan is settled early (and thus forming part of the calculation of a fair rebate). There are some other differences which, in our view, do not materially affect our conclusions. Provident also argued that our conclusion was not based on the actual costs of a range of lenders.
- 3.54. We concluded from the analysis described in Appendix 3.4 that, for a home credit loan, the minimum rebate calculated in line with the statutory formula does not give rise to a fair balance between the interests of borrower and lender (and thus does not appear to meet the aim set out for it in the legislation). Specifically, it allows the lender to retain more of the total repayments than can be justified by the costs incurred. It does not leave the lender indifferent as to when the loan is settled; rather it creates an incentive on the lender to see loans settled early. The analysis was based both on Provident's actual costs and on a broad range of assumptions about the costs of home credit lenders more generally. The scenarios we used were designed to encompass all realistic cost structures. We are therefore confident in our conclusion that the minimum statutory rebate is too low. Thus most home credit borrowers who settle their loans early are paying a higher price than they would if the legislation was achieving its intended effect, and a price in excess of the cost of provision of the service.
- 3.55. Some lenders also told us that the current rebate formula had only recently been determined by the DTI, following extensive consultation, to be appropriate for all

forms of consumer credit, and it would not be appropriate for us to second guess that conclusion, least of all before the new arrangements had had time to establish themselves.¹⁵ Some lenders also gave us estimates of the impact on their business of the new regulations to date.

- 3.56. We do not consider it particularly surprising that legislation enacted to govern all consumer credit (of which home credit forms only a very small part) should not deal adequately with the peculiarities of that small sector. Nor do we consider the impact of recent legislation on the market we are investigating to be beyond our scrutiny. The DTI told us that it was entirely possible and legitimate for a detailed investigation into home credit specifically to find different cost structures or other considerations from those applying in consumer credit more generally.
- 3.57. We consider in paragraphs 6.168 to 6.176 the implications of the level of rebates for competition, specifically whether the level of rebates might be either a cause or a symptom of a lack of competition.

Conclusions on price levels

- 3.58. We conclude that the prevailing prices of most home credit products in the UK:
- are higher than the prices of alternative forms of credit; and
 - are higher than in the Republic of Ireland, an overseas market which has some parallels with the UK.
- 3.59. We further conclude that the price paid by customers when they repay loans early (including when they renew loans) is high, as a result of the low level of rebates paid when loans are settled early. We analyse whether or not prices of home credit loans more generally exceed the costs of provision in the light of our analysis of profitability of home credit lenders below.

Structure of prices

- 3.60. We would normally expect to look at the structure as well as the level of prices as an indicator of the extent of competitive pressure in a market. Our analysis of the structure of prices (including the history of price changes over time and the extent of variation in pricing) is set out in paragraphs 6.10 to 6.35 as part of our analysis of the nature and extent of price competition.

Profitability

- 3.61. Our guidance¹⁶ treats the level of profits of the firms in a market as one among several indicators of the extent of competition in that market. A competitive market is likely to generate significant variations in profit levels between firms as supply and demand conditions change, but with an overall tendency towards levels commensurate with the cost of capital of those firms. At particular points in time, the profits of some firms may exceed what might be termed this 'normal' level. Reasons for this could include, for instance, cyclical factors, transitory price or other initiatives, the fact that some firms may be more efficient than others and the fact that some firms may

¹⁵Some went on to argue that any variation in the rebate calculation between different forms of lending would create a distortion of competition between them. We consider this argument in paragraph 9.122.

¹⁶See CC3, paragraphs 3.78 to 3.90.

be earning profits gained as a result of past innovation. However, competition should put pressure on profit levels, so that they move towards the cost of capital in the medium to long run. A situation where, persistently, profits are substantially in excess of the cost of capital for firms that represent a substantial part of the market could be an indication of limitations in the competitive process.

- 3.62. As the home credit market is a mature market which has been in a steady state for many years, we considered that a period of five years would be sufficient to demonstrate whether, if there have been profits substantially in excess of the cost of capital across a substantial part of the market, these profits have been achieved 'persistently'. We recognized that we must also consider costs incurred by the business prior to this period which have been invested for a later return.
- 3.63. We therefore sought to assess the profitability of home credit lenders for the years 2000 to 2004. Subsequent to the analysis published in our provisional findings, we also requested financial data for 2005 from the medium-sized and larger home credit lenders in order to establish whether there were any changes to either the performance of the industry or an individual lender which would affect our findings.

Cost of capital

- 3.64. In order to estimate a weighted average cost of capital (WACC) for a large UK home credit business, against which to compare the profitability of home credit lenders, we used data from and relating to the five largest lenders, which are all UK listed companies. We recognized that the WACC calculation relies on several variables that cannot be calculated with complete accuracy and therefore did not express the cost of capital as a single figure, but rather as a range to compare against business returns. The detail of our cost of capital calculations is in Appendix 3.5. Our results found that, between 1999 and 2004, the nominal pre-tax cost of capital for a large home credit lender was between 8.4 and 11.2 per cent, with a mid-point estimate of 9.8 per cent. The real cost of capital for a large home credit lender for the same period was estimated to be between 6.0 and 8.7 per cent.¹⁷
- 3.65. Cattles' and LSB's own estimates of their cost of capital fell within this range. Provident's estimates overlapped with this range and S&U's estimates were outside it. The differences are examined in detail in Appendix 3.5; the most significant difference relating to the assumed financing structure of the business.¹⁸
- 3.66. Recognizing that gearing levels may change over time as companies are not usually able to optimize their capital structure in the short term, we used a gearing ratio of between 60 and 70 per cent in our calculations, which was ten percentage points lower than the optimum range identified for the three largest home credit lenders. S&U's figures showed a much lower proportion of debt, between [X] and [X] per cent, which S&U explained demonstrated its cautious attitude, not wishing to be 'at the mercy of its bankers' in the event of an economic downturn. However, for our purposes, the appropriate cost of capital against which to compare returns is the typical cost of capital for a large home credit lender, which will consider the most efficient capital structure available. S&U's behaviour is not indicative of the optimal capital

¹⁷The real WACC is calculated by discounting the nominal WACC by the average annual RPIX between 1999 and 2004 of 2.28 per cent.

¹⁸Provident made several other criticisms of our calculations, though none of them would have materially altered our conclusions. We consider the calculations set out in Appendix 3.5 to be well founded on reliable data from a variety of sources.

structure. From the evidence of Provident, Cattles and LSB, it was clear that the optimal capital structure involved a much higher proportion of debt.¹⁹

- 3.67. Following our provisional findings, Provident argued that if we were to use an optimum level of gearing, rather than one based on the observed gearings of the listed lenders, then the observed betas²⁰ must be adjusted to reflect the different financial risk of an optimally geared lender. We agreed with this view, and so amended our calculations. The results of our cost of capital calculations now show a slightly higher range than the results which we presented in our provisional findings.

Appropriate measure of profitability

- 3.68. We considered various approaches for measuring the profitability of the large home credit lenders over this period. We believed that for measuring the profitability of the ongoing home credit businesses, two possible approaches were appropriate: a truncated internal rate of return (IRR), which considered the cash flows of the businesses over the five-year period and calculated an asset value at the start and end of the period;²¹ or a return on capital employed (ROCE), which considered the return of each business against its capital employed in each of the five years in the period. As the majority of the large home credit lenders are in a steady state, such that neither the returns nor the value of their capital employed appears to vary significantly between periods, we considered that these two approaches would yield approximately the same result. We also considered that, by valuing the assets appropriately, both would take appropriate account of prior investments in the business. Of these two methods, we did not see any advantage to undertaking a truncated IRR analysis. In contrast, we considered ROCE a more readily understood calculation, which has also been adopted by the CC in several previous inquiries. We therefore decided to undertake an analysis of the lenders' profitability by assessing their ROCE over each of the most recent five years.
- 3.69. We recognized that, when measuring the profitability of a project, whether before the project has been undertaken or afterwards when reviewing the actual outcome, the non-truncated, full lifetime IRR of the project²² will usually give the best theoretical measure of the project's profitability. Where the full lifetime IRR of a project is greater than the cost of capital of the business undertaking it, the project is profitable. However, we did not believe that the full lifetime IRR is a suitable approach for measuring the profitability of a business for our purposes, for two reasons: first, the full lifetime IRR measures the return to the business over its full lifetime, rather than over a specific period which we wish to assess in order to inform our judgement of the competitiveness of the market in that period;²³ and second, it is difficult to calculate a full lifetime IRR when the cash flows of the business are still ongoing, due to having to know or make assumptions about historic cash flows and having to make various assumptions about future cash flows.

¹⁹As long as the default risk of debt is low, equity typically bears a higher risk than debt and is therefore more expensive. S&U's capital structure was sub-optimal in that it chose not to use debt which would have been available at cheaper rates than its equity capital. For our purposes, in order to compare returns against the cost of capital, we assume an optimal level of efficiency in both operations and financing, discounted in recognition of short-term factors.

²⁰The beta (or β) coefficient measures the asset's non-diversifiable risk or can be considered as the sensitivity of the asset returns to market returns.

²¹The truncated IRR was advocated in the book entitled *The Economic Analysis of Accounting Profitability* by Edwards, Kay and Mayer (OUP, 1987), which argued that with appropriate opening and closing valuations, the truncated IRR answers economically meaningful questions.

²²The IRR is the discount rate which produces an NPV of zero for a stream of cash flows.

²³*The Economic Analysis of Accounting Profitability* by Edwards, Kay and Mayer (OUP, 1987) explains that 'The internal rate of return concept ... has little to say about how evaluation over a finite segment of a firm's life should be made', pp6-7.

3.70. We also considered, for the home credit lenders, what the appropriate capital base against which to compare their returns should be. In particular, we considered whether a return on equity (ROE) calculation was a more appropriate measure of profitability than the ROCE, as this had been used in other inquiries into financial products and services.²⁴ However, we felt that home credit lenders showed different characteristics from other financial institutions. In particular, they had less highly-g geared capital structures than banks and related financial institutions providing credit,²⁵ and a greater amount of non-interest costs as a proportion of total costs. In these respects, the structure and funding of home credit lenders resembled non-financial companies more closely than banks or store card providers. We therefore felt that ROCE was a more appropriate measure than ROE for the purposes of this inquiry.

Approach to measuring profitability

3.71. We initially reviewed the rates of return earned by lenders, calculated as their unadjusted profit before interest and tax (PBIT), as a percentage of their unadjusted capital employed for each of the most recent five years. This calculation generated the lenders' unadjusted ROCE. The data provided by the lenders had been prepared in accordance with generally accepted accounting practice in the UK and, at a high level, had been independently audited, though not in all cases the specific data for the home credit activities of the lenders in which we were interested. However, there were no significant issues in identifying the relevant revenue streams and, on the whole, we accepted the lenders' own cost allocation methods and accounting practices in allocating corporate overhead costs to their home credit businesses.

3.72. Following this initial analysis, we then adjusted the analysis for investments which the home credit lenders have made in their intangible assets, which we determined should be considered for our purposes but which are not usually recognized by generally accepted accounting practices. We also adjusted the PBIT for any exceptional items so as to gain a 'normal' level of profit which the businesses are achieving. This adjusted ROCE analysis was presented in our provisional findings. Although, in this provisional analysis, we only estimated a single figure of ROCE for each lender for each of the five years, we undertook significant sensitivity analysis to ensure that our findings were robust to a plausible range of error which might exist.

3.73. Some lenders criticized this analysis. In the light of these views, we reviewed the analysis in our provisional findings and reconsidered the sensitivity analysis we had performed. Following submissions from Provident in particular, we undertook a revised analysis, but only for those lenders for whom we had provisionally found evidence of profits substantially and persistently in excess of the typical cost of capital for a large home credit lender. In contrast with our previous analysis, this revised analysis sought to ascertain what we believe the maximum possible value of the lenders' intangible assets could be and therefore the maximum possible adjustments which should be applied. This revised analysis therefore effectively replaces our previous sensitivity analysis and, we believe, gives a more reliable basis on which to calculate the minimum possible ROCE which we believe these lenders are plausibly achieving. The results of our provisional analysis are in paragraphs 3.113 to 3.126 and the results of our revised analysis are in paragraphs 3.127 to 3.137.

²⁴For example, ROE was used in the Store cards and SME banking inquiries.

²⁵Banks are usually set a minimum equity ratio by the Financial Services Authority. This ratio varies between banks but is usually below 15 per cent equity. In our estimate of the cost of capital for a typical large home credit lender we use a gearing ratio of between 30 and 40 per cent equity.

Profitability of small and medium-sized lenders

3.74. Ideally, we would have sought to conduct similar analyses across all home credit lenders. But this would have entailed significant practical difficulties. We were unable to secure financial information from all lenders. Many of the smaller lenders do not publish accounts and, among those who do, accounting policies vary in a way which makes it difficult to compare financial measures, including measures of profitability, on a consistent basis. Almost two-thirds of lenders who provided us with data are either sole traders or partnerships, which poses several problems:

- Cash may be withdrawn from a business as a salary (and so deducted before net profit) or as drawings (and so, generally, deducted after net profit); the apparent profitability of the same business could be very different depending on which approach is used.
- Salary levels for the proprietor and sometimes for family members employed in the business may be higher (or lower) than appropriate market values.
- Some personal expenses (eg use of cars) may be recognized as business expenses.

All of these issues (which are not unique to home credit) make reliance on financial data from small businesses for this purpose difficult.

3.75. We nonetheless conducted a simple analysis of returns among these groups based on the data they could give us but we regard the results as indicative rather than conclusive.

3.76. Our findings from this analysis are set out in Table 3.4.

TABLE 3.4 Profitability of small and medium-sized lenders, 2004 data

	<i>Turnover</i> £	<i>Net profit</i> £	<i>Capital employed</i> £	<i>Net margin</i> %	<i>ROCE</i> %
<i>Small businesses</i>					
Unweighted average	107,631	40,955	146,961	38.1	27.9
Unweighted median	70,869	26,260	83,643	37.1	31.4
<i>Sample size: 179</i>					
<i>Medium businesses</i>					
Unweighted average	1,698,591	201,599	2,878,849	11.9	7.0
Unweighted median	800,331	120,000	1,252,000	15.0	9.6
<i>Sample size: 11</i>					
<i>Small and medium businesses</i>					
Unweighted average	222,264	49,965	325,426	22.5	15.4
Unweighted median	76,243	27,790	89,669	36.4	31.0

Source: Responses to CC's financial questionnaire.

3.77. We found that small lenders appeared to be earning net profit margins which averaged 37 or 38 per cent, and ROCE which averaged 28 or 31 per cent. Medium-sized businesses, for which the data is probably more reliable and prepared on a more consistent basis but for which our sample size was smaller, appeared to be earning net profit margins which averaged 12 or 15 per cent, and ROCE which averaged 7 or 10 per cent. However, these averages mask considerable variation among the lenders we surveyed. Indeed, the CCA told us that, given the difficulties we had in gaining consistent data across the various small home credit lenders, we could not draw reliable conclusions about their profitability.

- 3.78. Subsequent to this analysis, we sought to update the data from medium-sized businesses for a more recent financial year but many of the businesses which responded to our information request were different from the businesses which responded to our original request so direct comparisons were not possible. Moreover, due to the small sample size, the results were inconclusive. Some of the medium-sized lenders submitted to us that their profitability had decreased between 2004 and 2005 and there was some indication in the data that this was so.
- 3.79. We recognize that our results in this area may be subject to quite wide margins of error. However, even if we apply a sensitivity of 20 per cent to the average capital employed figure for small lenders, the average ROCE of these lenders only falls from 27.9 to 23.2 per cent. We believe that these results indicate that small businesses may generally be more profitable than medium-sized ones, and that at least some small home credit businesses are earning returns which are in excess of the cost of capital.²⁶

Profitability of larger lenders

- 3.80. The six largest home credit lenders were able to supply data which enabled us to conduct more rigorous profitability analysis.
- 3.81. Most of the home credit lenders raised no concern with our use of a ROCE approach, using accounting profits as the starting point. Two lenders raised concerns.

S&U's objections to adjusted ROCE and alternative proposals

- 3.82. S&U submitted an analysis of its price/earnings yield compared with the specialist finance sector and the London Stock Exchange All Share Index. This analysis showed that S&U had traded at a discount to both the sector and the All Share Index for a number of years, which, S&U argued, provided an indication of the risk inherent for home credit lenders. We considered this evidence but concluded that it provided no information on the profitability of S&U compared with its cost of capital and so we ascribed no weight to it.

Provident's objections to adjusted ROCE and alternative proposals

- 3.83. Provident also disagreed with our approach. Provident submitted papers from its economic advisers and from Sir Bryan Carsberg²⁷ and Professor Colin Mayer²⁸ in support of some of the arguments put to us, and both attended meetings with us.²⁹

²⁶We consider that the appropriate cost of capital for a small business is the (opportunity) cost of investing in a business with comparable risk, which we took to be a typical large home credit business. So we compared small and medium lenders' returns with the same cost of capital as large lenders' returns (see paragraphs 3.64 to 3.67).

²⁷Sir Bryan Carsberg was Director General of Telecommunications 1984–92 and Director General of Fair Trading 1992–95. He was a member of the Accounting Standards Board 1990–94 (Vice Chair 1990–92) and Secretary-General of the International Accounting Standards Committee 1995–2001. In 2002 he advised HM Treasury in a review of the methodology used to measure profits, and its application, by the CC in the SME banking monopoly inquiry.

²⁸Professor Mayer is head of the finance department in the Said Business School at Oxford University and became Dean of the school in October 2006. He is also head of the Oxford Financial Research Centre (OFRC). Professor Mayer is one of the founders of OXERA and was on the advisory panel for the report prepared by OXERA for the OFT: 'Assessing Profitability in competition policy analysis—Economic Discussion Paper 6', dated July 2003. He has written widely on corporate finance and other issues and is co-author of *The Economic Analysis of Accounting Profitability* (OUP, 1987).

²⁹Both Sir Bryan Carsberg and Professor Mayer have put forward arguments supporting the approach taken by Provident. They have each made clear that, though they are familiar with the principles underlying Provident's model and approach, they have not reviewed Provident's calculations in detail.

- 3.84. Provident argued that a full lifetime IRR method is not only appropriate for calculating the profitability of a project but, as the home credit business model was, in its view, one of those rare situations in which it was possible to consider the business as an aggregation of individual projects, the full lifetime IRR method was also an appropriate approach by which to assess the profitability of a home credit business. Provident told us that a home credit business was composed of agents, which were the core unit of profitability. Each agent, or her agency, could be assessed as a 'project' by analysing the cash flows associated with the agent, or her agency, over her time as an agent. Provident submitted that 'Provident's business comprises both its agent network and its central infrastructure ... Provident's model assumes only that the agent network—which does not include central overhead costs—can be treated as the sum of a series of agent projects'.³⁰ Provident submitted a letter from Sir Bryan Carsberg which endorsed its view.³¹
- 3.85. We agreed with Sir Bryan Carsberg that cash flows, assuming all are necessarily incurred, can be considered as the essential measure of business performance. An approach to assessing profitability which focuses on cash flows, as the IRR approach does, may therefore in some circumstances be preferable. However, as we stated in paragraph 3.69, we believe it is only preferable where full lifetime data of the project is available.
- 3.86. We did not agree with Sir Bryan Carsberg that the home credit business model is significantly different from the financial models of many other financial lenders, or doorstep retailers, such that it can be considered as an aggregation of individual agent projects. We considered that, though the agent is a significant driver of profitability, in that successful agents can significantly increase the profitability of the business, the agent is no more the unit of profitability which can meaningfully be aggregated than the typical salesman for another product. Agents come and go and their contracts start and finish but the business continues throughout. In the same way, though much of a home credit business may be considered as the aggregation of its individual agencies or rounds, we observed that most large home credit businesses also have a central operation which must be considered. The presence of these central overheads demonstrates that most large home credit businesses are more than just their agencies. Further, even if the sum of Provident's agencies did equate to its total business, both the customers and the cash flows of these individual agencies continue indefinitely, despite the turnover of their agents. Indeed, the presence of many sole traders in the industry supports the assertion that individual agencies are more like small ongoing businesses than discrete terminating projects. Where an agency, or a group of agencies which together represent a business, are still ongoing, full lifetime cash-flow data is simply not available.
- 3.87. Further, Sir Bryan Carsberg did not dismiss an accounting-based approach completely. Rather, he stated that there were 'circumstances in which a procedure based on discounted cash flow analysis is as reliable as a conventional accounting approach, with adjustments to remove distortions'. He continued that if accounting-

³⁰Source: Provident's most recent submission to the CC (received 14 November 2006), repeating the explanation in its submission on 10 October 2006.

³¹Sir Bryan Carsberg submitted (29 November 2005):

For the whole of a business, the discounted cash flow approach is normally possible only after the business has come to the end of its life and been wound up, because only then can the cash flows be assessed with sufficient reliability; and such a calculation, if it were carried out, would produce a number that represented an average return over the whole life of the business, not distinguishing variations from period to period.

He continued:

The assessment of Provident's profitability is one of those rare cases in which the use of discounted cash flow modelling can be expected to produce good reliability. This is because, to a substantial extent, the activities of the Company can be divided into a number of 'projects', in such a way that all cash flow effects are included in some project, and each project is similar, having the same expected rate of return.

based measures were used, consideration must be given to the appropriate valuation of assets, both tangible and intangible, for two reasons. First, some important assets, particularly intangible assets, are not included in statutory accounting data. Second, accounting data uses irrelevant measures of assets, generally based on historic cost, and calculates depreciation of assets in a way that distorts measurements of profitability. We entirely agreed with these two cautions when applying a ROCE approach and we have included all appropriate adjustments in our adjusted ROCE calculations.

Provident's application of its proposals

3.88. On the basis of its arguments above, Provident submitted a model which calculated a full lifetime IRR for a business, using Provident's 2004 data and prices, of 13.6 per cent.³² This model is not a truncated IRR of Provident's actual recent cash flows or a full lifetime IRR of Provident's actual historic and projected future cash flows but rather is 'a calculation of the rate of return that would be earned by a business entering the market currently to take the place of Provident, accepting the prices faced by Provident and achieving the same level of efficiency'.³³ Provident compared this level of profitability with its real pre-tax cost of capital, which it calculated to be 9.3 per cent in 2004.³⁴ Provident submitted that the difference between the full lifetime IRR of the scenario it modelled and its estimation of its cost of capital can be explained by Provident's superior level of efficiency.

3.89. Provident's model was constructed using data from two principal sources:

- Provident's agency data, for its 11,860 agencies; and
- Provident's statutory accounting data for its UK home credit business.

3.90. Provident's model considers a hypothetical scenario where Provident is deprived of all its agents. The model assumes that Provident immediately recruits all necessary new agents, all of whom display the characteristics in terms of profitability of Provident's actual 2004 new agents, and immediately acquires all necessary new customers, again at the actual costs incurred by Provident of new customers in 2004. Though the business is therefore assumed to return Provident to its current 2004 scale immediately, it is with all new agents and all new customers and so at a much lower level of profitability. The model then assumes that agents leave and are replaced according to the attrition rates of Provident's actual agents in 2004. For those who stay, their profitability increases according to the profile of the profitability of Provident's agents by tenure in 2004.³⁵ Costs and revenues are allocated to the beginning and end of annual periods and all outstanding loans are called in and reloaned as agents leave and are replaced. Overheads, as extracted from statutory accounting data, are apportioned to individual agencies. Eventually, the business is returned to its current steady state, where the average agent or agency achieves the same level of profitability as the average agent or agency in Provident's 2004 business. The model considers a 50-year period, which effectively represents the full

³²There were actually various versions of the model submitted by Provident. This report refers to the version submitted to us on 11 January 2006.

³³Source: Sir Bryan Carsberg's most recent submission to the CC on behalf of Provident (received 14 November 2006). Sir Bryan Carsberg stated in the same submission that 'accepting that the IRR for the whole business life cannot be calculated and would not be relevant to the objectives of the Commission even if it could be calculated, one has to consider some other IRR calculation'.

³⁴The model used a single year of data and this data did not include the effects of price inflation. Therefore the correct comparator is the real cost of capital for the year from which the data was taken.

³⁵The model gained this profile of tenure by cross-sectional analysis in 2004 but Provident subsequently demonstrated its reliability by providing a longitudinal analysis which demonstrated similar results.

lifetime of the business being modelled, as any cash flows beyond this time have negligible effect on the resulting IRR. In fact, the time to reach a state which is very close to Provident's 2004 steady state is actually much shorter, approximately 15 to 20 years. The model thus calculates an estimated expected full lifetime IRR for both an individual agency and the agent network as a whole.

- 3.91. Provident explained its model to us in many meetings and over several months, providing us with a very thorough and comprehensive understanding of the model's assumptions, how it is built and what it demonstrates.
- 3.92. However, while we understand what Provident's model seeks to do and how it does it, we do not believe it provides any useful answers to the questions of interest to us, for two reasons.
- 3.93. First, the model is inappropriate for our purposes for the same reason as the full lifetime IRR approach generally is inappropriate for our purposes. The full lifetime IRR approach is only appropriate for a project which has finished and not for an ongoing business. Provident's full lifetime IRR model, which produces one rate of return 'that would be earned by a business entering the market',³⁶ cannot show the recent level of profitability of the Provident business.
- 3.94. Second, the business profiled in Provident's model is not a faithful representation of Provident's actual business. Provident's model presents the profitability of a business in a scenario where it is suddenly deprived of all its experienced agents and established customers and relies on the assumption that Provident's business can be considered as an aggregation of agent or agency projects. We do not believe it can, for the reasons set out in paragraph 3.86.
- 3.95. Moreover, even if we were to accept the appropriateness of the modelling approach, we do not believe that the data used in the model is the right data in order to be consistent with the scenario the model seeks to represent. Provident's model considers a scenario in which Provident is suddenly deprived of all its agents and customers. It then seeks to re-establish its business in a context in which the Provident business does not exist. However, the data it uses for the average new agent and new customer is taken from Provident's actual 2004 data, where the recruitment of new agents and the acquisition of new customers takes place in the context where Provident and other home credit lenders do exist, and around 2 million home credit customers' needs are already met. Provident's model thus implicitly assumes that the current cost to recruit a 'marginal' agent or acquire a 'marginal' customer is a good proxy for the cost of recruiting an average agent or acquiring an average customer. Though we recognize that these proxies may be the best available to Provident for its purpose, their unreliability does cast doubt on the appropriateness of Provident's approach. We cannot establish whether the data Provident uses will overstate or understate the costs involved in recruiting and training its new agents or acquiring its new customers in the scenario its model seeks to represent³⁷ but, either way, we cannot rely on the data it uses as reliable for Provident's purpose.³⁸

³⁶See paragraph 3.88.

³⁷Provident submitted that the actual costs incurred in this scenario would be greater than the 'marginal' 2004 costs used in its model.

³⁸It is worth noting that, though we use the same 2004 'marginal' data in our approach using ROCE to assess Provident's profitability, we apply this data to a very different purpose. Our approach is to seek to value the cost of replicating an individual unit of asset in the normal course of business, which is then aggregated for Provident's total number of similar units; Provident's approach is to replicate its entire business after a sudden deprival of all its assets, putting it into a very different context to that which it is in today, where the 'marginal' data applies.

- 3.96. As a result of these substantial reservations over the validity of Provident's proposed full lifetime IRR approach and its model, we did not consider it appropriate to use Provident's assessment of its profitability derived from its analysis within our assessment of the profitability of the large home credit lenders. Provident told us that our reservations were misplaced and that we were wrong to dismiss both its approach and its model.
- 3.97. Following our insistence that we would like to undertake an assessment of profitability using adjusted ROCE, Provident responded that the same data presented in its model could be used to calculate the value of its intangible assets on a deprival value basis. Provident argued that the model considered what would happen if Provident were deprived of all its intangible assets (experienced agents and established customers), suggesting that the cash flows in the model represented both the outflows required as an investment to replicate Provident's assets and the reduced cash inflows which would be achieved in the period in which such replication took place compared with Provident's current steady state. Provident calculated that the total value of its capital employed was £[~~£~~]. Provident submitted that as, on its calculations, £[~~£~~] is accounted for by tangible assets, the value of its intangible assets is £524 million.
- 3.98. We agreed that the deprival value, which measures the minimum loss a firm would suffer if deprived of an asset, provides an appropriate approach to value lenders' intangible assets. The deprival value is the lower of an asset's replacement cost or economic value, where the economic value is the higher of the NPV of the cash flows which can be generated by the asset or its net realizable value on disposal. Allowing that most profitable businesses acquire or build assets in order to generate a profitable return from them, the NPV from these assets will usually exceed the replacement cost. Hence, for our purposes, the relevant deprival value of an asset will usually be its replacement cost.
- 3.99. However, we did not believe that Provident's model provided any useful insight into the replacement cost of Provident's intangible assets, for two reasons.
- 3.100. First, the model considers the replacement of Provident's assets as a sudden event, where the net cash flows achieved by the business while it returns to its steady state take into account not only the cash outflows of replicating the business but also the lower cash inflows as a result of a gradual replication. Provident submitted that 'if Provident were deprived of an average existing agent it would be deprived of a substantial revenue stream, which would take several years to re-establish following the recruitment of a new agent'.³⁹ Provident submitted that unless we take these reduced revenues into account, our ROCE calculation will not be recognizing all the effective costs incurred on the deprival of an asset and its subsequent replication.⁴⁰ Provident's approach, which estimates the deprival value by considering a sudden event requiring replication over a period of time, during which period there are reduced revenues, is in contrast to our approach, which estimates the deprival value by considering replication in the normal course of business, where assets are continually replaced at normal cost, the business continues throughout and there are no reduced revenues. The costs that Provident has actually incurred to build and

³⁹Source: Provident submission to the CC on 4 September 2006, Annex A, p5.

⁴⁰Provident and its advisers sought to explain this difference between Provident's cash-flow approach (using its full lifetime IRR model) and our cost-based ROCE approach using various terms in its submissions over many months, such as 'reduced revenues', 'start-up losses', 'earnings shortfall', 'insufficient returns' or 'returns below the cost of capital'. In the 'start-up' scenario which Provident has modelled, there are reduced revenues which affect the net cash flows and resulting returns. These reduced revenues do not occur if assets are replaced in the normal course of business and therefore did not arise in our approach, which sought to value individual units of assets at their normal replacement cost.

acquire its assets have been entirely in the normal course of business. For example, when an experienced agent leaves and a new agent starts, the new agent will typically be less profitable than the agent she replaces but, as all the agents who stay become more profitable, so the steady state mix of agents and their aggregate profitability remain unchanged. Provident argued that the deprival value methodology requires the inclusion of these reduced revenues in the period in which the asset is replaced, but we do not believe it does. Rather, we believe that the relevant replacement cost is the cost that is normally incurred when the asset is replaced. The replacement cost does not require the inclusion of any reduced revenues.

- 3.101. Provident, supported by Professor Colin Mayer, also argued that, theoretically, the full lifetime IRR of a project should be equivalent to the weighted average of the ROCEs throughout the period of the project and that, without including the reduced revenues in the period, equivalence would not be achieved. We accepted the theory of this argument, that the full lifetime IRR of the cash flows of a project can be calculated from the weighted average of the annual ROCEs achieved throughout the lifetime. However, we did not believe a non-truncated, full lifetime IRR approach as used by Provident is appropriate for a continuing business, as stated in paragraph 3.69. Hence we did not believe equivalence to be relevant for our purposes.⁴¹ The cash flows in Provident's full lifetime IRR model, considering the replication of Provident's intangible assets, and the cash flows which we consider should be capitalized as investments which Provident has actually incurred over time, are not the same and the two approaches will not produce the same result. We therefore did not accept that the reduced revenues included in Provident's full lifetime IRR model is part of the relevant replacement cost of either acquiring or building its assets.
- 3.102. Second, irrespective of the first objection, a model can be sense-checked to consider whether its results accord with reality. We have not seen any evidence from our observations and analysis of the home credit market which corroborates the results of the Provident model. The model suggests that the average agency is worth £44,000 (calculated by dividing a total intangible asset of £524 million by 11,860 agencies), which was split by Provident into the average agent being worth approximately £33,000 and the average round of customers being worth approximately £11,000. As around a third of Provident's agents leave each year and consequently around [X] per cent of Provident's agencies at the end of 2004 either had no agent or an agent of less than one year's tenure, the average value of the experienced agent suggested by the Provident model will be much higher still. These numbers do not appear consistent with other evidence we have found. An agent's value to a company can be split between that element which is generic and potentially of value to all home credit lenders, and that which is proprietary and not transferable. The value of the generic element can be observed from the price of an agent in an effective market, while the value of the proprietary element can be estimated by identifying the internal costs incurred in generating the asset. For the generic element, we have seen market evidence that lenders have sought to attract experienced agents at a cost of approximately £1,000. Provident disagreed with this sense check. Provident argued that the markets for agents and customer rounds are small and that the quality of those agents and rounds which are available is low, requiring significant additional internal training, meaning that any market indication of their value is very poor. For the proprietary element, we have seen no evidence that the costs incurred by Provident, or by any other lender, as it invests to develop its

⁴¹Though we equally accepted the theory that the truncated IRR of a series of cash flows within a project or business can be calculated from the weighted average of the annual ROCEs of the cash flows achieved in the period, allowing for appropriate opening and closing asset values, this truncated approach is not what Provident proposed. We considered using this approach but, as stated in paragraph 3.68, we considered it to be no better for our purposes than a ROCE approach.

experienced agents are anywhere near £33,000 per agent. Though we recognized that an external sense check of proprietary assets is difficult, we considered what element of an agent's value is proprietary and did not believe it to be close to this value (for our estimation of the maximum plausible valuation of this asset, see paragraphs 19 to 33 of Appendix 3.7).

- 3.103. A further consideration is that Provident's estimate of the value of its intangible assets is indirectly derived from its IRR calculations. Provident's results can be contrasted with our direct estimate, which sought to value Provident's intangible assets using a 'bottom-up' cost-based approach. Our maximum total valuation of Provident's intangible assets is £130 million (see paragraph 3.132), which includes a £[~~30~~] million valuation for the cost of recruiting and developing Provident's experienced agents and permanent employees, and which we consider to be at the top of a plausible range of values. Yet our total valuation is significantly below Provident's total valuation of £524 million.
- 3.104. Part of the explanation for the disparity between our 'bottom-up' valuation and Provident's valuation is explained by our first objection to Provident's deprival value calculation outlined above: that Provident's asset values include reduced revenues. Our bottom-up valuation, which seeks to observe market values in order to estimate the value of generic assets and considers internally generated costs incurred in the normal course of business to estimate the value of proprietary assets (and in some cases generic assets where an effective market in the asset does not exist), does not include any reduced revenues. We do not consider it appropriate to include reduced revenues in the costs of acquiring and building an asset for the reasons set out in paragraph 3.100.
- 3.105. For these reasons, and because of our concerns over the validity of the representational faithfulness of Provident's model and the appropriateness of the data it uses, which are stated in paragraphs 3.93 to 3.95, we did not consider it appropriate to use the value of Provident's intangible assets derived from its model in our calculations. Provident again told us that our objections were misplaced and that we were wrong to dismiss both its model and the results derived from it.

Calculation of profitability based on ROCE—approach

- 3.106. We therefore conducted an analysis of adjusted ROCE for the six largest home credit lenders. In order to perform this analysis, it was necessary to adjust the ROCE derived from accounting data so as to include all economic assets and returns. As indicated above and highlighted by Sir Bryan Carsberg, audited financial statements are prepared for a specific purpose and audience, which adhere to accounting principles. These principles include prudence, ie taking a cautious view in the measurement of assets: if there is great uncertainty as to whether an asset exists or has value, the asset will be omitted or given a low valuation. Traditional accounting values may therefore not reflect the underlying economic value of the assets in a business, in particular the intangible assets which are often harder to quantify. For our purposes of retrospective profitability analysis, an adjustment to recognize the economic value of these assets is often required.
- 3.107. We first considered the appropriate economic value of the tangible assets of a home credit business. Between 80 and 100 per cent of the total tangible assets (fixed and current) on the balance sheets of the large home credit lenders is accounted for by the net value of loans outstanding (net of bad debt provision). We initially took the view that the appropriate economic value of the loan book was this net value. Provident submitted that the relevant value of its loan book for our purposes should

be its gross value, rather than its net value. Provident argued that, if it had to replace all its outstanding debts, it would have to reissue the gross value of all the loans, which therefore represented its deprival value. We did not agree. We assessed the value of tangible assets using a deprival value approach, as set out in paragraph 3.98. We believed that loans should be looked at individually, rather than considering the loan book as a single asset, and that the relevant deprival valuation measure for each loan (ie the lower of its replacement cost or economic value) would depend on the impairment of the loan. We looked at the replacement cost and economic values of both impaired and unimpaired loans. We found that, while unimpaired loans should be valued using replacement cost (which approximates to the capital outstanding on the loan or the gross book value of the loan), most impaired loans should be valued using economic value, as this would reflect the impairment of the loan and would be lower than the loan's replacement cost. We looked at Provident's bad debt provisioning policy and found that the book value net of provision for an impaired loan was a reasonable approximation to its economic value. Therefore, the aggregate deprival value of impaired and unimpaired loans was close to the book values net of provision (though it was not possible to estimate this with any precision). We concluded that the value of Provident's loan book and its other tangible assets was appropriately recognized in their net book value (ie net of bad debt provision), as stated in Provident's audited accounts, though in the knowledge that this risked slightly underestimating the true economic value.

- 3.108. We did agree that it was necessary to make adjustments to accounting values in order to include the value of Provident's intangible assets. We considered how we might identify and value these assets. Given that our purpose in measuring profitability in this context is to identify whether there is evidence of any excess profit, we needed to ensure that any methodology used for measuring intangibles was not based on stock market values (ie by reference to the excess of stock market value over the book value of equity) or determined by an assessment of the NPV of the business's future net cash flows. Either of these methods could incorporate the expectation that the business will make excessive profits in the future.
- 3.109. The approach we used to identify and value intangible assets followed the approach in the CC's inquiry into banking services for small and medium-sized enterprises⁴² (the SME banking inquiry). In that inquiry we explained that:

We believe it is normally correct to use depreciated replacement cost as the basis for valuation of intangibles. We do not recognize any circumstance where a basis higher than depreciated replacement cost is appropriate. Exit values may fall below this level in which case exit values should be used.

This definition concurs with the deprival value methodology. We considered the principles adopted in the SME banking inquiry, which was subsequently reviewed by Sir Bryan Carsberg (the Carsberg report),⁴³ and considered to what extent they were relevant to our inquiry.

- 3.110. The Carsberg report stated that 'the framework adopted by the Commission [in the SME banking inquiry was] sound and would be accepted as appropriate by most

⁴²*The supply of banking services by clearing banks to small and medium-sized enterprises: a report on the supply of banking services by clearing banks to small and medium-sized enterprises within the UK*, The Stationery Office, Cm 5319, March 2002 (also available on our website).

⁴³*Report on certain issues arising out of the report by the Competition Commission on the supply of banking services by clearing banks to small and medium-sized enterprises*, by Sir Bryan Carsberg.

independent experts'.⁴⁴ However, though Sir Bryan Carsberg endorsed the CC's approach in the SME banking inquiry, he submitted to us that the current inquiry was different and not all of the previous approach would be appropriate. We believe that it is generally accepted, as reflected in the SME banking report, that an asset is 'the right of access to future economic benefits as a result of a past transaction or event'.⁴⁵ As in that inquiry, we consider that the appropriate approach by which to identify an asset is to consider the expenditure incurred by home credit lenders and to identify that expenditure which generates a future economic benefit for the business. These expenditures may have been treated as a cost to be expensed and therefore not included in the balance sheet figures calculated for normal accounting purposes but should nonetheless be capitalized in our calculations. In most cases, this cost that has previously been incurred, after taking account of depreciation, can be used to estimate the asset's depreciated replacement cost, which is the minimum cost required for the business to replace the asset with one of a similar age and condition, ie with the same economic generating potential. In some cases, a lower value may be appropriate where the asset was either inefficiently acquired or built or where there are new cheaper ways by which to acquire or build the same asset.

3.111. We identified what types of expenditure we thought might generate intangible assets for all or some lenders. We again considered the approach adopted in SME banking, but adapted this approach to the specific circumstances of home credit. We identified four possible categories of intangible asset:

- (a) an experienced and trained workforce;
- (b) the customer base;
- (c) knowledge of customers' creditworthiness; and
- (d) IT systems.

Our reasoning behind selecting these categories, and our consideration of potential intangible asset values and lives, is set out in more detail in Appendix 3.6.

3.112. We informed the six largest lenders of the categories we had identified and asked them both for comments on the categories and for the figures needed to calculate the intangible assets which might have been created. We invited the lenders to propose any further categories which they thought should be considered:

- Provident principally argued against the methodology of our approach, insisting that we should also include in our calculation the reduced revenues in the period of replication, as considered above.
- Cattles and Park said that there were no further categories of intangible asset they wished us to include in our calculations.
- S&U said that we needed to take into account the value of the customer relationship, which we therefore ensured we either considered as part of the experienced agent workforce asset or as part of the lenders' knowledge of their customers' creditworthiness. S&U said that it did not consider there to be any further categories of intangible assets beyond those we had proposed.

⁴⁴Carsberg report, paragraph 38.

⁴⁵This is very similar to the International Accounting Standards Board (IASB) definition of an asset as 'a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise'.

- Mutual said that it did not propose for us to include any intangible assets in our calculation of its ROCE.
- LSB made no comment.

Calculation of profitability based on ROCE—provisional analysis

3.113. Having considered the parties' comments on our proposed approach and made amendments as necessary, we then analysed the figures that had been submitted to us in order to value the large lenders' intangible assets. The full provisional analysis of our adjusted ROCE calculation is presented in Appendix 3.6.

3.114. The analysis was conducted using the lenders' most recent financial data available at the time, in most cases from 2004. Usually we would seek to track ROCE through a series of years, to see if there are persistent high profits in excess of the cost of capital. However, in our previous analysis of unadjusted ROCE, a limited version of which was published alongside our Emerging Thinking, we demonstrated that, between 2000 and 2004, revenues and profits for four of the five publicly quoted home credit lenders (Provident, Cattles, LSB and S&U) are reasonably consistent over time, suggesting that it is appropriate to assume that lenders are operating in a 'steady state'. Given the steady state assumption, any intangible asset to be included in capital employed in 2004/05 can be assumed to be very similar in previous years.

3.115. Table 3.5 re-presents the results of this earlier analysis but with an additional column demonstrating that the assumption of the steady state still holds in 2005. It can be seen that:

- Provident and S&U, in particular, have both achieved very consistent levels of profitability over the five-year period.
- Cattles and LSB have both demonstrated some volatility in PBIT and profitability.
- Comparing the start to the end of the period, from 1999 to 2005, PBIT increased for Provident and S&U, though unadjusted ROCE, as a measure of profitability, declined for all of the profitable lenders.

TABLE 3.5 Profitability analysis, using unadjusted ROCE

	2000	2001	2002	2003	2004	2005
<i>Provident</i>						
Revenue						
PBIT*						
Average unadjusted capital employed						
Unadjusted ROCE (%)						
<i>Cattles†</i>						
Revenue						
PBIT						
Average unadjusted capital employed						
Unadjusted ROCE (%)						
<i>LSB</i>						
Revenue						
PBIT						
Average unadjusted capital employed						
Unadjusted ROCE (%)						
<i>S&U</i>						
Revenue						
PBIT						
Average unadjusted capital employed						
Unadjusted ROCE (%)						
<i>Park‡</i>						
Revenue						
PBIT						
Average unadjusted capital employed						
Unadjusted ROCE (%)						

Source: Provident, Cattles, LSB, S&U and Park (as analysed by the CC).

*Provident's PBIT has been adjusted for its pension deficit, such that PBIT has been reduced in each year from 2000 to 2004 by £[redacted]. Though there are many possible treatments of Provident's pension deficit, this treatment represents the maximum reduction to annual profit which we consider reasonable—see paragraphs 119 to 122 of Appendix 3.6.

†Cattles' capital employed and PBIT have been adjusted to exclude goodwill and the corresponding amortization charge.

‡Park's capital employed and PBIT have been adjusted to exclude goodwill and the corresponding amortization charge.

3.116. We then considered how this earlier analysis is affected by adjusting the capital employed and PBIT for intangible assets and other abnormal items. The details of our approach and our provisional calculations are in Appendix 3.6. The previously uncapitalized intangible assets which we identified as requiring an adjustment to the capital base for each of the six largest lenders of home credit are summarized in Table 3.6.

TABLE 3.6 Intangible assets to be capitalized in 2004

	£ million					
	<i>Provident</i>	<i>Cattles</i>	<i>LSB</i>	<i>S&U</i>	<i>Park</i>	<i>Mutual</i>
Staff acquisition and training costs						
Customer acquisition costs						
Knowledge of customer base						
IT costs						
Uncapitalized intangible assets	<u>33.103</u>	<u>4.851</u>	<u>1.811</u>	<u>0.529</u>	<u>0.692</u>	<u>0.039</u>
Company estimate of intangible asset	525.2	Not provided	Not provided	11.0	Not provided	'Very little'

Source: Provident, Cattles, LSB, S&U, Park and Mutual (as analysed by the CC).

3.117. From this valuation of the lenders' intangible assets, we then calculated a provisional estimate of the lenders' adjusted ROCE (2004 for Provident, Cattles, LSB and S&U; 2005 for Park and Mutual) as shown in Table 3.7.

TABLE 3.7 Profitability analysis, using adjusted ROCE

	£ million					
Source	Provident 2004	Cattles 2004	LSB 2004	S&U 2004	Park 2005	Mutual 2005
PBIT						
Adjustments to PBIT*						
Adjusted PBIT			✂			
Average capital employed						
Intangible assets not capitalized	<u>33.1</u>	<u>4.9</u>	<u>1.8</u>	<u>0.5</u>	<u>0.7</u>	<u>0.0</u>
<i>Intangible assets as % of tangible CE (%)</i>						
Total capital employed						
ROCE (PBIT/capital employed) (%)			✂			
ROCE (without intangibles) (%)						

Source: Provident, Cattles, LSB, S&U, Park and Mutual (as analysed by the CC).

*Adjustments to PBIT result from removing capitalized expenditures but instead recognizing an amortization charge for the intangible assets which have been created. In a perfectly steady state, no adjustment would be necessary. Provident's adjustment also includes its pension deficit adjustment—see paragraphs 119 to 122 of Appendix 3.6.

3.118. The additional, previously unrecognized intangible asset to be capitalized as a percentage of the previously recognized capital employed ranged from 0.1 per cent (~~1.8~~) to 5.3 per cent (~~1.8~~).

3.119. In this provisional analysis, three of the six largest providers of home credit appeared to be earning returns (measured by adjusted ROCE) substantially in excess of the typical cost of capital for a large home credit lender (estimated to be between 8.4 and 11.2 per cent) in their most recent year of data: Provident (24.5 per cent), S&U (17.7 per cent) and Cattles (15.5 per cent).

3.120. As we recognized that we had necessarily made many assumptions and used various estimates in deriving these provisional intangible asset values, we considered it important to consider the sensitivity of our results to changes in these assumptions and estimates. Three sensitivity scenarios were considered:

- for each lender, we increased the intangible assets as a percentage of the tangible capital employed to the highest level calculated for any lender (5.3 per cent [~~1.8~~]) (we termed this scenario 1);
- for each lender, we increased the intangible assets to 10 per cent of its tangible capital employed (we termed this scenario 2); and
- for each lender, we increased the intangible assets to 20 per cent of its tangible capital employed (the percentage uplift used as the upper band of the sensitivity analysis in the recent CC inquiry into store cards—we termed this scenario 3).

The results of these three scenarios are demonstrated in Table 3.8.

TABLE 3.8 Profitability analysis, using adjusted ROCE—sensitivity analysis

£ million

	<i>Provident</i>	<i>Cattles</i>	<i>LSB</i>	<i>S&U</i>	<i>Park</i>	<i>Mutual</i>
Scenario 1 (apply top end of range of intangibles as a per cent of CE to all lenders)						
Intangible assets as % of tangible capital employed (%)	5.3	5.3	5.3	5.3	5.3	5.3
Total capital employed	⌈					
ROCE (%)	✂					
Scenario 2 (apply 10% of intangibles as a % of CE to all lenders)						
Intangible assets as % of tangible capital employed (%)	10.0	10.0	10.0	10.0	10.0	10.0
Total capital employed	⌈					
ROCE (%)	✂					
Scenario 3 (apply 20% of intangibles as a % of CE to all lenders)						
Intangible assets as % of tangible capital employed (%)	20.0	20.0	20.0	20.0	20.0	20.0
Total capital employed	⌈					
ROCE (%)	✂					

Source: CC analysis.

3.121. In all three scenarios, the resulting adjusted ROCE for Provident, S&U and Cattles remained substantially above our estimate of the typical cost of capital for a large home credit lender of between 8.4 and 11.2 per cent.

3.122. In our provisional analysis, we then allowed for the sensitivities above in order to consider a range of possible returns for each of the lenders in 2004:

- Provident appeared to have been earning returns between 21.5 and 24.5 per cent;
- S&U appeared to have been earning returns between 14.9 and 17.7 per cent;
- Cattles appeared to have been earning returns between 13.4 and 15.5 per cent;

[✂].

3.123. As this provisional analysis used 2004/05 financial data alone, we then wished to determine the persistence of excess profits and so we applied our findings on the intangible assets of the five largest public home credit lenders back to previous years' results. We assumed that the percentage of tangible capital employed which was represented by intangible assets had remained approximately constant over the period 2000 to 2004, and so derived the total capital employed and calculated the adjusted ROCE for each year. We again tested the sensitivity of these assumptions by applying scenario 3 of the sensitivity analysis shown in Table 3.8 to each of the previous years. Apart from adjusting for Provident's significant pension deficit as an abnormal item which applied back to each of the previous four years,⁴⁶ we did not make any further adjustments to PBIT. As 2005 data is now available, we have since updated this table to include the results on the same bases for 2005, without further adjusting for Provident's 2004 pension deficit. The results are as shown in Table 3.9.

⁴⁶Consideration of the treatment of this pension deficit is set out in Appendix 3.6.

TABLE 3.9 Profitability analysis, using adjusted ROCE—time series

	2000	2001	2002	2003	2004	2005
Provident						
Adjusted PBIT						
Average capital employed				✂		
<i>Intangibles as % of capital employed</i>						
Intangible assets not capitalized	<u>28.7</u>	<u>30.7</u>	<u>32.3</u>	<u>32.4</u>	<u>33.1</u>	<u>33.2</u>
Total average capital employed						
Adjusted ROCE (%)						
Adjusted ROCE (%)—using scenario 3						
Cattles						
Adjusted PBIT						
Average capital employed						
<i>Intangibles as % of capital employed</i>						
Intangible assets not capitalized	<u>5.5</u>	<u>7.0</u>	<u>7.4</u>	<u>6.4</u>	<u>4.9</u>	<u>3.6</u>
Total average capital employed						
Adjusted ROCE (%)						
Adjusted ROCE (%)—using scenario 3						
LSB						
Adjusted PBIT						
Average capital employed						
<i>Intangibles as % of capital employed</i>						
Intangible assets not capitalized	<u>1.9</u>	<u>1.8</u>	<u>1.9</u>	<u>1.9</u>	<u>1.8</u>	<u>2.1</u>
Total average capital employed						
Adjusted ROCE (%)						
Adjusted ROCE (%)—using scenario 3						
S&U						
Adjusted PBIT						
Average capital employed						
<i>Intangibles as % of capital employed</i>						
Intangible assets not capitalized	<u>0.4</u>	<u>0.4</u>	<u>0.5</u>	<u>0.5</u>	<u>0.5</u>	<u>0.6</u>
Total average capital employed						
Adjusted ROCE (%)						
Adjusted ROCE (%)—using scenario 3						
Park						
Adjusted PBIT						
Average capital employed						
<i>Intangibles as % of capital employed</i>						
Intangible assets not capitalized	<u>0.1</u>	<u>0.2</u>	<u>0.2</u>	<u>0.4</u>	<u>0.6</u>	<u>0.7</u>
Total average capital employed						
Adjusted ROCE (%)						
Adjusted ROCE (%)—using scenario 3						

Source: Provident, Cattles, LSB, S&U and Park (as analysed by the CC).

3.124. The results of this provisional adjusted ROCE analysis suggested that, given a nominal pre-tax cost of capital for a large home credit lender of between 8.4 and 11.2 per cent, in the period 2000 to 2005:

- Provident made returns of 24.4 to 27.4 per cent, with a trend of declining profitability over the period, but stabilizing more recently.
- S&U made returns of 16.5 to 22.3 per cent, with no clear trend in profitability over the period.
- Cattles made returns of 11.0 to 24.6 per cent, with profitability declining between 2000 and 2002 but increasing in both 2003 and 2004 and remaining stable in 2005. Cattles argued that the years of lower profitability represented the ‘normal’ performance of its business. However, we disagreed. We believed that the lower returns in 2002 and, to a lesser extent, 2003 resulted from higher costs arising from an unsuccessful expansion strategy and subsequent retrenchment but we were not able to separate the results of this expansion from the underlying

profitability of the remaining business. As we did not consider the profit in 2002 and 2003 to be excessive, we therefore did not believe that the evidence for Cattles' underlying level of profitability was conclusive, though we did note that profits were high in some years.

[X]

- 3.125. We noted that, even if we applied what we considered to be the highest reasonable level of sensitivity and allowed the intangible assets not previously capitalized to represent 20 per cent of the formerly recognized capital employed for each lender, the results did not change significantly.
- 3.126. Lastly in our provisional analysis we considered whether the firms making returns above the cost of capital represented a substantial portion of the market. On most measures, Provident had a market share of over 60 per cent and S&U had a market share of approximately 5 per cent (the market shares of the large lenders are set out in more detail in Table 2.4). We considered that, as the two companies represented at least two-thirds of the market on most measures, and that profits in excess of the cost of capital, while greatest in Provident's case, were not confined to Provident, we could safely conclude that, in the words of our guidance, 'profits are substantially in excess of the cost of capital for firms that represent a substantial part of the market', and have been so persistently.

Calculation of profitability based on ROCE—revised analysis

- 3.127. Following the publication of the analysis above in our provisional findings, Provident responded by arguing that, even considering our most extreme sensitivities, we had still underestimated the value of its intangible asset base and the adjustments which are necessary to calculate its ROCE. Though we did not agree with Provident's estimated value of its intangible assets, derived from its full lifetime IRR model, we did review our previous analysis. Given that the identification and measurement of profitability for our purposes is a difficult area, we sought to undertake a substantial robustness check on our previous findings. The full revised analysis of our adjusted ROCE calculations is presented in Appendix 3.7.
- 3.128. The actual value of a lender's intangible assets is very hard to estimate precisely and we therefore still wished to consider a range. However, in our revised analysis, rather than seek a best estimate of the middle of the range of plausible values for a lender's intangible assets, as we did before, we sought to estimate the maximum value of the range of plausible values, above which we considered it highly improbable that the actual valuation would lie. This estimate should not therefore be compared with our 'best estimate' in our provisional analysis, but should be compared with the top-end sensitivity analysis which we previously performed. From this revised maximum estimate of the value of a lender's intangible assets we sought to derive a minimum estimate of the lender's ROCE, representing the minimum level of profitability which we believed the lender is at least achieving.
- 3.129. In our provisional analysis, we found substantial and persistent profits in excess of the typical cost of capital for a large home credit lender for two companies: Provident and S&U. As our provisional analysis did not result in an adverse profitability finding for any of the other companies, we did not perform our revised analysis on them.
- 3.130. The focus of our revised analysis was to determine the maximum plausible intangible asset value for Provident and S&U in 2004. As we had previously demonstrated that profits were substantially and persistently in excess of the cost of capital for a typical

- 3.136. Provident also argued that many of the assumptions in our revised analysis are 'arbitrary'. Though we would agree that there are many assumptions in the analysis which are broad estimates, the purpose of this revised analysis was to estimate a maximum plausible value for Provident's intangible assets so all the estimates we used in the analysis were the maximum we believed could be plausible. We believe that by including all plausible costs we may have significantly overstated the actual valuation of Provident's intangible assets but we are very unlikely to have understated it.
- 3.137. In both cases, the revised and more detailed estimate of the maximum plausible value of Provident's and S&U's intangible assets does not change our provisional findings, that profits are substantially and persistently in excess of the typical cost of capital for a large home credit lender across a substantial part of the market. As we have found profits substantially in excess of the cost of capital even at a maximum plausible intangible asset valuation, we consider our findings to be robust.

Conclusions

- 3.138. The assessment of profitability in competition inquiries necessarily requires some estimation and reliance on assumptions. In this case we have used accounting information, recognizing its limitations and making necessary adjustments, such as including intangible assets not recognized under traditional accounting methods, to attempt to overcome these limitations. We have used principles that have been used in previous market or monopoly inquiries, including one (the SME banking inquiry) where most of the elements of the CC's approach were endorsed by an independent review. We therefore believe that our approach to assessing the profitability of the large home credit lenders in this inquiry has been reasonable and, by seeking to determine the maximum of a plausible range of intangible asset values, has also been robust.
- 3.139. While it is difficult to be certain of the value of the intangible assets employed in the business, and therefore to calculate a reliable estimate of the actual ROCE that has been achieved, we are confident that, over the past five years, Provident has achieved a ROCE which has been at least 21 per cent a year and S&U has achieved a ROCE which has been at least 16 per cent a year.
- 3.140. In S&U's case, we note that the difference between its profitability and actual cost of capital is relatively small. We also accept that S&U's choice of capital structure, with a low level of debt, though relatively expensive is not unreasonable, particularly in a market context where a couple of large businesses have recently exited. However, we regard the typical cost of capital for a large home credit lender as the appropriate comparator for the reason that, in a competitive market, competitive pressure could be expected to force companies to adopt the most efficient capital structure available. The difference between S&U's profitability and the typical cost of capital for a typical large home credit lender is both substantial and persistent.
- 3.141. From our analysis, we therefore conclude that both Provident and S&U have, during the period under review, been earning returns substantially and persistently in excess of the typical cost of capital for a large home credit lender. As we indicated in paragraph 3.79, we consider that some smaller lenders may well also have been earning returns in excess of the cost of capital.
- 3.142. We therefore conclude that, in the words of our guidance, 'profits are substantially in excess of the cost of capital for firms that represent a substantial part of the market', and have been so persistently.

- 3.143. As stated in our guidelines,⁴⁷ we believe that profitability remains just one indicator of the extent of competition in a market and we therefore do not draw firm conclusions from our profitability analysis alone. Indeed, we have not sought to do so in this case. Rather, we have considered the evidence on profitability, the evidence of a comparison against prices of other credit products and the evidence of a comparison against prices of home credit in the Republic of Ireland. As a result of these various analyses, we believe that prices are higher than they would be in a competitive market.
- 3.144. We consider more evidence on the level of prices in Section 6, and consider the level of customer detriment caused by these high prices in Section 7.

Customers' perception of prices

- 3.145. We sought evidence from home credit customers on their perception of price. Relatively few contacted our freephone line. Of those who did, most observed that the prices they paid for home credit were high; some described the price as poor value for money. None said that prices were low or represented good value. We place only limited weight on this evidence alone; the numbers involved were small and self-selected and might be expected to contain a disproportionate number of customers with a grievance to air.
- 3.146. Qualitative research by AIA⁴⁸ found that most of the customers interviewed (and some agents) perceived prices as high. No evidence was reported of customers describing prices as low, but some customers highlighted positive aspects of home credit alongside the price. 12 per cent of customers interviewed by MFS⁴⁹ who had stopped using home credit cited high price, unprompted, as a reason for having discontinued their use of home credit. This was substantially fewer than those who said that they did not want or need more credit, and also than those who said they had found other sources (over 20 per cent said that they had found cheaper sources of credit). Provident also provided evidence that over three-quarters of its current and paid-up customers thought that its product delivered value for money, and that, of those who did not want to use home credit again, fewer cited price as a reason than cited other reasons such as 'Don't need it' or 'Don't want to be in debt'.
- 3.147. All the banks and providers of mainstream credit that we spoke to told us that they would be unlikely to charge an APR of over 30 per cent—substantially lower than the interest rates currently charged on home credit loans. Some told us that they would be reluctant to be associated publicly with higher rates.
- 3.148. The fact that some customers perceive that prices are high does not necessarily mean that they consider them poor value for money. Provident showed us evidence that home credit borrowers could look beyond price when assessing the value for money of different products. However, we also saw some market research evidence that customers' view of value for money was somewhat conditioned by the measure of price used; many fewer customers thought a home credit product good value when told the APR than when its price was described in other terms.

⁴⁷CC3, paragraphs 3.78 to 3.90.

⁴⁸AIA Research Report, April 2005, page 24.

⁴⁹Mori Financial Services Survey, slide 6.

Efficiency

3.149. Our guidance⁵⁰ says that we will consider the efficiency of firms as an indication of the extent of competition. In this context we considered principally the level of costs incurred by home credit companies, recognizing that this is only one measure of efficiency.

3.150. We were told that home credit is a model of lending which entails high costs for the lender, which give rise to prices to customers which are high by comparison with lending models which do not incur these costs. We recognize that the cost of agent collections and the cost of the infrastructure needed to support agents are not incurred by lenders with different business models, and that many home credit lenders' experience of bad debt is higher than that of other lenders because of the nature of the business and of some of their customers.

3.151. We sought to assess whether costs are higher than they might be, which might be an indication of a lack of competition. Unlike in some other inquiries, where there are some standard measures of cost efficiency recognized across the industry, we have not found a good basis for comparison of cost structures between companies, nor a good benchmark for cost efficiency. Provident told us that:

- a report prepared by Lexecon for the CCA suggested that it was more efficient than most home credit companies; and
- this was the result of conscious efforts to improve its efficiency rather than of economies to national scale.

We consider it unrealistic to claim that there are no economies to scale in the ability to spread the cost of head office overheads over a customer base and a loan book over three times the size of its nearest rival. However, we recognize that these are not large components of the cost base of a home credit company, and that many of the more significant elements of cost are less susceptible to economies of national scale.

3.152. We also found that it was possible for smaller home credit companies to earn good returns (see paragraph 3.79). We have little good evidence on which to judge why this might be. We were told that small businesses tend to have a good understanding of their customers and that they are often very cautious in recruiting new customers (and thus have better-quality debt). It may also be the case that they do not incur some of the overhead costs necessarily incurred when a business grows beyond one or two rounds which can be easily managed by the proprietor and a small number of close family or associates. We have also been told that smaller businesses can benefit from economies of local density where their customers are concentrated within a small area, making it possible to serve them efficiently. This may contribute to good returns. We consider the broader existence and significance of economies of local density in the context of entry in paragraphs 5.36 to 5.39.

3.153. We were told of some efforts by home credit companies to reduce costs in recent years. However, attempts to operate with a lower level of local management overhead (by [redacted]) resulted in a decline in the quality of the debt which, we were told, outweighed the cost advantages, and were reversed. Several companies (including Cattles through its Welcome brand) have developed a separate line of business issuing loans without a home collection service. We were told that such a model has

⁵⁰CC3, paragraph 3.90.

largely been targeted at customers other than home credit customers (though LSB, for example, has offered such a model to some home credit customers acquired with the Morse's business from Littlewoods in 2004), and that it has yet to prove itself viable for many current home credit customers.

- 3.154. We have noted some instances where efficiency improvements seem to us to have been introduced more slowly than we might expect were the companies under intense competitive pressure to reduce costs. For example, we note that only in recent years has Provident apparently moved to secure some of the benefits from integrating the back-office operations and customer data of PPC and GPC, which was acquired in 1978.
- 3.155. We conclude that the home credit model requires lenders to incur costs not incurred by other lenders in order to meet the needs of their customers. These costs (notably the costs of collection and of the local management scrutiny which we were told has been essential to control bad debt) are particularly high in relation to the size of the loans issued. We believe that, like all businesses, home credit lenders must have some potential to reduce some elements of cost. Lenders told us that the evidence of attempts to reduce costs showed that it was hard to do so while still meeting customers' needs.
- 3.156. We cannot be sure that costs are at a level which could be sustained under competitive pressure. But we have not seen strong evidence of inefficiency, and therefore cannot reach a conclusion that costs are higher than they should be.

Other indicators of competition

- 3.157. We considered several other indicators which may give some insight into the level of competitive pressure in the market.

Market share stability

- 3.158. We have found little evidence of change in market share. Section 2 showed that the changes to market shares since 1999 which we have been able to identify have been very modest. Even the (temporary) existence of an ambitious new entrant (Park) had little impact on the broad patterns we have observed. Provident remains the largest lender by a significant margin, and neither its market share nor that of any of the other larger lenders has changed significantly in recent years. The one possible exception is Park, whose share first rose (though never exceeding a few per cent) and was then taken over by Cattles. If Cattles continues to provide home credit products to those customers, we would expect Cattles' share to increase by a small amount as a result of this acquisition.
- 3.159. In response to our Emerging Thinking, Provident said that we had underestimated the extent of change in market shares (including the increase and subsequent decrease of Cattles' share, the growth of Park and the turnover of smaller businesses), and that the completeness of our data on smaller lenders was not sufficient for us to draw any robust conclusions. We recognize the developments cited by Provident (and that our data on smaller lenders is incomplete, though we think it is more comprehensive than any other survey of the industry of which we are aware) but do not think they invalidate the broad conclusion in paragraph 3.158.

Customer satisfaction

- 3.160. Lenders told us that customers' levels of satisfaction with home credit were not only very high, but high by comparison with other financial service products. Provident told us that over 93 per cent of its customers reported themselves satisfied with the service they received and 66 per cent reported themselves very satisfied.⁵¹ Our own research also found evidence of satisfaction. The AIA survey found evidence of satisfaction with the service received by existing customers. The NOP survey found that 90 per cent of those expecting to use home credit again would use their current or recent lender (three-quarters of these would use only their current or recent lender). 97 per cent of these customers cited their satisfaction with the service they received as a reason.
- 3.161. There was some evidence pointing to lower levels of satisfaction. Research we commissioned from MORI shows less satisfaction among those who have left home credit than those who are still customers. This and the AIA research show some evidence of dissatisfaction with the agent. But there was no evidence that such dissatisfaction was widespread. Provident's data on paid-up customers showed that, while a higher proportion of paid-up customers than of current customers were dissatisfied, the proportion even of paid-up customers who were dissatisfied (less than [x] per cent) was still small.
- 3.162. We indicated in our Emerging Thinking that we thought it possible that these customer responses indicated that customers were satisfied with whether the service provided met their expectations, rather than any more objective measure. The survey instruments used by lenders, while entirely suitable for tracking satisfaction over time, were less likely to enable any conclusions to be drawn about absolute satisfaction levels. A high level of customer satisfaction with the extent to which a business meets expectations, while no doubt useful and reassuring for business managers, may not enable us to draw any very robust conclusions about the extent of competition in the industry.
- 3.163. In response to these points, lenders told us that there was no basis for believing that home credit customers had low expectations. We make no such suggestion. Rather, we consider that the fact that most customers appear satisfied with the service they are receiving does not in itself imply that the market is competitive. It would be possible for customers to be satisfied with a poor product or poor service if they were familiar with it, had no good basis for comparison with other products or services, or if there were no alternative. In all such cases their satisfaction might be consistent with a lack of competition, and might give rise to a degree of customer inertia. If satisfaction inhibited customers from seeking cheaper or better alternatives, that might itself mute competitive pressure in the market.
- 3.164. We have no reason to doubt the evidence we have seen that most customers are satisfied with the service they receive from home credit lenders and agents. It is consistent with the findings of independent researchers over the last decade. Together with the research evidence that the service is one which is valued by many customers,⁵² we consider that it helps to explain why home credit lenders have continued to provide a product the essentials of which have remained largely unchanged for a long period in which other areas of financial services have seen more dramatic change. But we consider it only one among many indicators of the level of competition.

⁵¹These figures relate to 2004.

⁵²See our summary of pre-existing research and the AIA survey.

Customer turnover and switching

- 3.165. We discussed levels of customer turnover in paragraphs 2.30 to 2.34. We considered to what extent this turnover was attributable to switching, which might be evidence of competition for customers.
- 3.166. We found modest levels of switching between lenders. We identified three different forms of switching:
- *Balance transfers*—where, during the term of a loan, customers repay a current loan in full and take up a new loan with a different supplier.
 - *Switching at the margin*—where customers have loans with more than one lender (multi-sourcing) they could adjust the balance of their loans between the two from time to time, and/or vary the level or frequency of repayments to favour one lender over the other. Thus customers who multi-source have the potential to switch at the margin at any time.
 - *Serial switching*—where, after paying off a home credit loan with one lender, the customer obtains the next loan from a different lender.
- 3.167. We found very low levels of switching by balance transfer. We found that around 40 per cent of all home credit loans involve the refinancing of a previous loan (see paragraph 3.47). The NOP survey found a smaller percentage than this (around 15 per cent) but data from the parties themselves, which we consider more likely to be accurate and on which we therefore thought it safe to rely, suggested that the figure was nearer 40 per cent. However, we found that of all these loans that are settled using money from other loans, less than 3 per cent were settled by borrowing from a home credit lender other than the existing one. All the rest were renewed with the same lender.
- 3.168. We found higher levels of multi-sourcing, by which we mean the practice of having loans outstanding with more than one lender. Data from NOP suggested that nearly half of all borrowers normally use more than one home credit supplier.⁵³ Suppliers' impressions broadly confirmed this pattern. Estimates of the numbers of customers currently using another lender (generally based on companies' own market research) varied from around a fifth (Provident) to 90 per cent (S&U). Estimates of those who had used another home credit lender in the past year were substantially higher, ranging from about two-fifths (Provident and Cattles) to two-thirds (Park) to 90 per cent (S&U).
- 3.169. Multi-sourcers appeared to be more likely to be experienced users of home credit. The NOP survey found that, as a group, they are more likely than those who use only one source to have been using home credit for longer periods, more likely to consider more brands and to shop around between them, and more likely always to consider home credit when they need money. They may also be heavier borrowers (their loans were of slightly higher value, and they were more likely to use other forms of credit as well as home credit). NOP also found that those who used more than one lender were more likely to report having missed payments in the last two months. Given their pattern of borrowing, we do not consider it surprising that some of these borrowers, in juggling multiple commitments, might miss more payments than others.

⁵³This figure includes those who have loans with both PPC and GPC; Provident told us that about 5 per cent of PPC customers also had loans with GPC.

- 3.170. Although customers who multi-source have the ability to switch between home credit lenders at the margin, we found it difficult to identify to what extent this actually took place. This was not a behaviour which lenders could easily observe. However, if it were widespread we would have expected survey or other evidence to have shown it. Although we were told that customers behaved in this way, we saw little clear evidence.
- 3.171. There is some evidence that customers consider switching at the end of a loan. The NOP survey found that, of those who said they were likely to or might use home credit again in the next two years, 9 per cent said that they would switch to another lender. A further 23 per cent said that they would be likely to use both their existing lender and another lender. Of those who said they would choose their current or most recent lender, the second and third most frequent reasons (both cited by three-quarters of respondents or more) were that 'It saves you having to find another lender you can trust' and 'It saves you having to build up a good credit record with another lender'.⁵⁴ The most commonly cited reason for choosing a lender in the NOP survey was 'It's easier to borrow from my usual lender'—30 per cent of respondents expressed this view.
- 3.172. We found little evidence of trends in the pattern of switching or multi-sourcing over time. Data from Provident's customer tracker showed that the number of PPC customers with loans from other home credit lenders had not changed significantly between 2000 and 2003.
- 3.173. We discuss the reasons for the pattern of switching we have found in Section 6. We find it hard to be sure of the extent of switching. We have seen little evidence of switching at the margin, but we recognize that it is possible for customers who multi-source. And we have seen very limited evidence of serial switching or switching by balance transfer. In the light of the absence of evidence of it, we do not consider the level of switching to be particularly high. Lenders told us that this was attributable to the level of customer satisfaction with the product and service provided, and that it did not indicate an absence of competition. We recognize that relatively low levels of switching do not necessarily indicate a lack of competition. The NCC drew our attention to some recent research it had conducted which suggested that in some other consumer markets, including some financial service markets, switching was somewhat more prevalent than we found in home credit, and had shown a discernible increase since 2000, though this increase was not universal.⁵⁵

Choice and innovation

- 3.174. Competitive markets are characterized by extensive choice of products or product terms for customers, and also often by innovation, as suppliers seek different ways to attract and retain customers.
- 3.175. We found that the choice available to customers was determined by the number of lenders active in the locality and the variety of products they offered. The principal features on which these products differed were the length of the loan and the price charged (as indicated in Table 3.1). Longer loans were not always available to all customers; lenders told us that new customers were generally given smaller, shorter-term loans initially and longer loans only became available to them once they had proved their creditworthiness.

⁵⁴The most commonly-cited reason was satisfaction with service from the current lender—see paragraph 3.160.

⁵⁵*Switched on to Switching*, NCC (December 2005).

- 3.176. In our Emerging Thinking we observed that we had seen little evidence of product or process innovation; that the core home credit product was little changed in many years; and that home credit appeared to have changed less than most other financial services industries.
- 3.177. In response to this observation, home credit companies made two main points. First, they cited the high levels of satisfaction quoted in paragraph 3.160, and argued that in a market where customers were so satisfied with the product and the service they received there was little incentive for lenders to vary it. Second, they provided some evidence that we had underestimated the degree of innovation in the market.
- 3.178. Specifically, Provident told us that, while it had not changed the elements of the basic home credit product which had proved themselves popular with customers, it was in the process of promoting longer, larger loans to those customers for whom they appeared appropriate. It had also introduced several related product innovations. These included a Visa Electron card piloted in 2003 and subsequently extended, retailer cards as a development on traditional vouchers, and catalogue products. As could be expected, not all of these had been successful (the catalogue experiment was discontinued in 2003), but they were indicative of efforts to innovate. Provident also cited a number of process innovation initiatives which it had taken in its own business, including the consolidation of some branch activities into larger service centres and the development of a sophisticated IT-enabled behavioural scoring system.
- 3.179. Other lenders told us that these and other product innovations at the margins of home credit, for example the introduction of non-home-collected loan products, were in part attempts to hold on to customers threatened by competition from mainstream sources of credit.
- 3.180. The CCA likewise told us that it was neither surprising nor a concern that there was little evidence of innovation in a mature product which met the needs of its customers as well as home credit. It, and some other lenders, told us that some of the innovations we had drawn attention to in other financial services markets had in fact operated to the detriment of consumers, and that we should see the ability of home credit to maintain its existing business model despite cost increases and competitive pressure was in itself innovative.
- 3.181. We recognize that, while the basic home credit product has been largely unchanged in recent years, this is not necessarily indicative of an absence of competition, but may simply indicate the maturity and popularity of the product. We also accept that there has nonetheless been some associated innovation, both of products and processes.

Summary of findings on indicators of competition

3.182. In this section we have reported our findings that:

- The prices of most home credit products are high by comparison with alternative forms of credit and appear higher than in a broadly comparable overseas market.
- The price paid by customers when they repay loans early, including when they renew loans, is high, as a result of the low level of rebates paid when loans are settled early.

- Profits substantially in excess of the typical cost of capital for a large home credit lender have been earned persistently by firms that represent a substantial part of the market.
- The prices of home credit products are perceived to be high by many customers and observers.
- We are not able to reach a view on whether or not costs are higher than they would be in a competitive market.
- Most customers are satisfied with the service they receive from home credit lenders and agents.
- There was little evidence of customer switching.
- There has been some innovation, both of products and processes, in recent years.

3.183. As we might expect, not all of this evidence points the same way. Some of these findings, particularly the level of prices and profitability, may be regarded as evidence of weak or limited competition. Other evidence (for example, on customer satisfaction and innovation) may be thought to point the other way. We therefore need to make a judgement on whether the balance of the evidence indicates a lack of or weaknesses in competition in the market for home credit.

Possible explanations of these findings

3.184. Home credit lenders told us that we should not regard these findings as evidence of weak or limited competition. Rather, they were the outcomes that could be expected from a competitive process in this market that had, over time, refined the product to one that met customers' needs and set prices at a level which provided good value for money and acceptable, but not excessive, returns for lenders.

3.185. In particular, lenders told us that customers were financially astute, and well able to assess the relative value for money of different loan products, and to make rational decisions. Provident presented market research evidence which it said showed that when presented with full details of alternative home credit and other lending products, home credit customers were as able as other groups to distinguish good-value from poor-value products. Customers valued the service offering which formed part of a home credit loan and regarded the loan as good value for money. Moreover, they valued the simplicity and transparency of prices offered by home credit lenders.

3.186. We recognize these arguments, and that the evidence does not all point in the same direction. However, on balance, the findings set out in this section led us to the view that prices for home credit are higher than would be the case in a competitive market. This in turn leads us to believe that it is likely that there are shortcomings in the competitive process in the market. We consider that for this belief to be correct, it would have to be the case that there is little constraint on home credit prices:

- from other forms of lending;
- from the threat or reality of market entry; and
- from competition among home credit lenders.

3.187. We therefore consider in the following sections whether these findings are consistent with a market characterized by effective competition. Specifically, we assess:

- whether the threat or reality of customers switching to other forms of lending imposes a competitive constraint on home credit prices—the evidence for this is set out in Section 4;
- whether the threat or reality of entry to the market for home credit or of substantial expansion by smaller participants within it imposes a competitive constraint on home credit prices—the evidence for this is set out in Section 5; and
- whether competition among home credit lenders imposes downward pressure on home credit prices—the evidence for this is set out in Section 6.