Title: REFORM OF THE CONSUMER CREDIT REGULATORY FRAMEWORK **IA No:** BIS 0389 **Lead department or agency:** DEPARTMENT FOR BUSINESS INNOVATION AND SKILLS **Other departments or agencies:** HM TREASURY	**Impact Assessment (IA)** **Date:** 06/06/2013 **Stage:** Final **Source of intervention:** Domestic **Type of measure:** Secondary legislation **Contact for enquiries:** John Wright 020 7215 3507 Matt Bowhill 020 7215 6445

Summary: Intervention and Options

RPC Opinion: Green

Cost of Preferred (or more likely) Option				
Total Net Present Value	**Business Net Present Value**	**Net cost to business per year** (EANCB on 2009 prices)	**In scope of One-In, One-Out?**	**Measure qualifies as**
£353m	-£336m	**£32m**	Yes	IN

What is the problem under consideration? Why is government intervention necessary?

Consumer credit is regulated by the OFT under the Consumer Credit Act 1974 (CCA). Other retail financial services are regulated by the FCA under the Financial Services and Markets Act 2000 (FSMA). There are two issues to be addressed. First, the CCA is insufficiently flexible to keep pace with a rapidly evolving market and tackle consumer detriment. Second, the lack of a single regulatory regime for retail financial services can lead to a lack of coherence in consumer protection and market oversight, and to duplication for firms and consumers. Replacing the current basis of consumer credit regulation with the FCA's rules-based approach will allow rapid intervention in problem practices, products, firms and individuals.

What are the policy objectives and the intended effects?

The intended effect is to deliver a regulatory regime that keeps pace with developments in the market, is more flexible and contains stronger powers for the regulator to tackle detrimental practices and root out rogue firms. This can best be achieved by transferring responsibility for consumer credit regulation from the OFT to the new Financial Conduct Authority (FCA) which will have a wider range of tools to tackle consumer detriment, including the ability to make binding rules on firms and their activities, stronger controls on market entrants, and powers to secure redress for consumers where firms cause detriment.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

Three options have been considered.
The "do nothing" option 1 was ruled out as Ministers have confirmed that the OFT will cease to exist from April 2014, leading to a gap in the regulation of consumer credit and exposing consumers to harmful practices.
Option 2, to enhance the existing CCA regime, was ruled out because it was considered unlikely to deliver the flexible, rapid intervention of a rules-based regime.
Option 3, moving consumer credit regulation to the FCA - is preferred as the FCA will have a wider, stronger and more responsive range of tools to tackle consumer detriment than those available to the OFT under the

Will the policy be reviewed? It will be reviewed. **If applicable, set review date:** 2019

Does implementation go beyond minimum EU requirements?			N/A		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	**Micro** Yes	**< 20** Yes	**Small** Yes	**Medium** Yes	**Large** Yes
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:** NA	**Non-traded:** NA	

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister .... Date: 25/06/13

Summary: Analysis & Evidence

Policy Option 3

Description: Transfer of Consumer Credit Regulation to FCA

FULL ECONOMIC ASSESSMENT

Price Base Year 2013	PV Base Year 2013	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: -48	**High:** 945	**Best Estimate:** 353

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low	65	3	31	**256**
High	111		50	**416**
Best Estimate	88		40	**336**

Description and scale of key monetised costs by 'main affected groups'

Firms that wish to be authorised by the FCA will (a) pay one-off authorisation and ongoing fees and (b) incur administrative costs for authorisation and supervision compliance. These vary by size of firm. Minimum capital rules are proposed to apply to debt management firms. The net **total one-off costs** for the 3 year interim permission regime and authorisation are approximately £65m-111m (including 3 years of exit costs at £1.8m pa) and the net **annual costs** (fees + admin + exit cost) are approximately £31m-50m (all costs net of OFT costs).

Other key non-monetised costs by 'main affected groups'

The more intensive regulatory FCA regime involves increased authorisation and supervision costs, differentiated by firm size and risk profile. Some firms may choose not to incur these costs and exit the consumer credit market, as quantified above. In addition to the quantified direct costs of lost revenue, firm exits may lead to non-monetised risks, in the short term, including the risk of a small reduction in the supply of consumer credit to some high risk consumers and small businesses.

BENEFITS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	128	3	43	**368**
High	418		140	**1,201**
Best Estimate	240		80	**689**

Description and scale of key monetised benefits by 'main affected groups'

Benefits for consumers: detriment in consumer credit is estimated at £166m-£450m a year of which evidence and assessment suggests a realistic estimate of £43m-£140m per year at least could be addressed by FCA. The FCA will improve consumer protection through an enhanced regulatory gateway to prevent rogue firms entering the market and more intensive supervision, using a broad enforcement toolkit and flexible rule-making powers, to address actual and potential consumer detriment and facilitate

Other key non-monetised benefits by 'main affected groups'

Benefits for industry: Consumer credit firms may benefit from reputational benefits of a better regulated market where poor practices and rogue firms are proactively tackled. Firms may benefit if FCA regulation improves their lending decisions, risk management and strengthens firms' financial stability. There may be wider benefits to the economy if consumers are more willing to engage in the market and both consumers and firms behave more responsibly.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

Increased regulatory costs may cause firms to cease consumer credit activity. The volume of exit has been estimated based on existing trends and survey evidence on whether firms intend to carry on consumer credit business, given the additional regulatory costs. While the aggregate supply of consumer credit in the economy is unlikely to change significantly, if some firms exit there may be a reduction in consumer credit options in the short term for a small proportion of consumers.

BUSINESS ASSESSMENT (Option 3)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: 32	**Benefits:** 0	**Net:** -32	Yes	IN

Evidence Base

Background

1. In December 2010 the Government launched a consultation on transferring responsibility for the regulation of consumer credit from the Office of Fair Trading (OFT) under the Consumer Credit Act 1974 (CCA) to the Consumer Protection and Markets Authority (now known as the Financial Conduct Authority (FCA)) under the Financial Services and Markets Act 2000 (FSMA)[1]. A summary of consultation responses was published in July 2011[2].

2. In January 2012, the Government announced its intention to proceed with the transfer, subject to the design of an FCA regime that was proportionate and suited to the different segments of the consumer credit market[3]. The Government also committed to maintain the core consumer rights and protections afforded by the CCA under any new FCA regime. The Financial Services Act, which received Royal Assent in December 2012, includes provision enabling the transfer of consumer credit regulation.

3. In its response to the March 2012 BIS Select Committee report into debt management[4], the Government indicated in May 2012 that, subject to a proportionate regulatory regime being designed, the transfer to the FCA would take place in April 2014[5].

4. In March 2013, the Government confirmed its intention to proceed with the transfer and published a detailed consultation document, which set out the proposed design of the new regulatory regime and explained the draft secondary legislation that will effect the transfer.

5. This final impact assessment (IA) builds on the previous consultation stage IAs published in December 2010 and in March 2012.

6. The Government used the March consultation exercise to gather further evidence to support the analysis of the impact of the transfer. Changes which have been made in light of stakeholder views and evidence are highlighted in subsequent sections of this document.

7. This impact assessment also draws on a cost-benefit analysis (CBA) published by the FCA (then the Financial Services Authority) in March and on independent analysis and research commissioned by the FCA to support its CBA, principally a report by Europe Economics (EE) [6] 'Transfer of the Consumer Credit Regime: Compliance - Costs and Firm Behaviour'. The evidence base for this report includes a quantitative survey of over 100 consumer credit firms and over 60 qualitative in-depth interviews (both carried out by Policis). EE developed models of the drivers of cost compliance and profit impacts to assess the incremental compliance costs and understand the behavioural response of firms given the regulatory change. See annex A for the EE explanation of their approach to costs and impacts.

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[1] http://www.hm-treasury.gov.uk/consult_consumer_credit.htm

[2] http://www.hm-treasury.gov.uk/consult_consumer_credit.htm

[3] http://www.hm-treasury.gov.uk/consult_financial_regulation.htm

[4] http://www.parliament.uk/business/committees/committees-a-z/commons-select/business-innovation-and-skills/news/debt-management-chairmans-comments/

[5] http://news.bis.gov.uk/Press-Releases/Better-help-for-consumers-in-financial-difficulty-from-payday-loans-67a77.aspx

[6] http://www.europe-economics.com/publications/europe_economics_final_report_6-3-13.pdf

Current Regulatory Responsibilities

FCA

8. The FCA is the UK's main financial services regulator with responsibility for most retail financial services, including insurance, investments, deposits, payment services, and first-charge residential mortgages.

9. The FCA's remit, functions, objectives[7] and powers are set out in the Financial Services and Markets Act (FSMA). To carry on FSMA regulated activities, firms must usually become authorised by the FCA (or become the Appointed Representative of an authorised person), in so doing showing that they satisfy 'threshold conditions' required of all authorised firms. Firms must comply with the rules set out in the FCA's Handbook, which are subject to cost-benefit analysis and consultation and have the force of secondary legislation.

OFT

10. The OFT is the UK's consumer and competition authority, with a broad remit covering the whole of the UK economy. The OFT does not have rule-making powers. The statutory requirements with which firms must comply are set out in the Consumer Credit Act (CCA) and secondary legislation.

11. The OFT is required to issue guidance setting out how it will exercise its functions under the CCA on the practices that would call into question a firm's fitness to hold a licence. The CCA also confers rights on consumers, for example the right to withdraw from a consumer credit agreement within a specified time-period.

The OFT is to be replaced as part of the Government's wider reform of the competition and consumer landscape. The Government will establish a new Competition and Markets Authority (CMA) that will operate the combined OFT and Competition Commission markets regime.

Issue

12. Concern regarding how the current regulatory regime functions centres on two main issues:

1. The limitations of the CCA regime, namely:
    - 1a. the limitations of CCA powers;
    - 1b. the time it takes to change primary legislation to react to the rapidly changing and diversifying market; and
2. The split in regulatory responsibilities between the OFT and FCA.

1. Limitations of the CCA Regime

13. Concerns have been raised that the consumer credit licensing system has not worked sufficiently well to protect consumers from abuse by some consumer credit providers[8]. The OFT is not empowered to outlaw emerging unfair practices. It relies, to some extent, on the deterrent effect of individual enforcement cases - which can be subject to a lengthy appeals process. Its

[7] http://www.fca.org.uk/about
[8] http://www.publications.parliament.uk/pa/cm200607/cmselect/cmtrdind/591/591we10.htm

enforcement powers are very limited, particularly when compared with the FCA's broad suite of powers and sanctions over other financial services sectors.

14. Amending and making changes to the CCA requires Parliamentary approval and can therefore entail substantial delays between identification of problems in the market and enactment of additional legislation to address them. The FSMA regime, in contrast, has broad rule-making powers to address new problems as they arise.

1a. Limitations of CCA powers

15. Under the current regime, permanently revoking a firm's consumer credit licence (the principal sanction available to the OFT) can be a lengthy process which in some cases has taken up to two years. For example, the OFT first imposed requirements on Yes Loans in 2009, but it was not until 2012 that a decision was taken to revoke their consumer credit licence after the OFT found that the company had not complied with the previous requirements imposed on it[9]. The OFT found that the company was harming consumers by (among other practices) using high pressure sales tactics to persuade consumers to provide their debit or credit card details on false premises, and deducting brokerage fees without making it clear that a fee was payable, and/or without the consumer's consent.

16. There are two main limitations in the OFT's regulatory powers that can cause problems for consumers. Because the OFT has limited control over the individuals running consumer credit firms, should the OFT identify areas of consumer detriment or non-compliance, it is possible for a firm to establish another consumer credit firm, perhaps with a different colleague applying for the licence, and then operate as before using the same detrimental business practices. In addition, other firms in the market might be able to continue the same detrimental practices, but the OFT would have to take action against each one separately, including court action where necessary.

17. The CCA requires the OFT to issue guidance on behaviours and practices which it considers may call into question a firm's fitness to hold a consumer credit licence. For example, it has issued guidance in relation to irresponsible lending[10], debt collection[11] and debt management[12]. This requirement to issue guidance is intended to ensure that the OFT makes clear what behaviours it views as unacceptable - but there are significant limits on the OFT's ability to require specific behaviours or actions because it has no rule-making powers.

[9] http://www.oft.gov.uk/news-and-updates/press/2012/15-12
[10] http://www.oft.gov.uk/about-the-oft/legal-powers/legal/cca/irresponsible
[11] http://www.oft.gov.uk/OFTwork/publications/publication-categories/guidance/consumer_credit_act/oft664
[12] http://www.oft.gov.uk/shared_oft/business_leaflets/credit_licences/oft366.pdf

Box: Criticism of the current regulatory arrangements

Consumer representatives

A number of consumer organisations are critical of the current regulatory arrangements. For example, in a submission to BIS, Citizens Advice set out views that current consumer protection regulation as under-resourced, too slow to respond to problems in the market and too reactive[13]. In sum, Citizens Advice felt that the current regime does not ensure adequate protection for consumers, and Citizens Advice would prefer a consumer credit regulator to have rule-making powers.

BIS Select Committee

The BIS Select Committee carried out an investigation into Credit and Debt in 2011/12[14]. They concluded that improvements needed to be made to the regulation of the debt and credit industry. Amongst their recommendations were that higher-risk credit businesses should be charged higher consumer credit licence fees, a fast-track procedure to suspend credit licences should be introduced and the regulator should be given the power to ban harmful products[15].

National Audit Office

The National Audit Office (NAO) has recently conducted a review of the value for money of the current consumer credit regulatory regime. Among their initial conclusions was that the OFT has a low level of resources to regulate credit: the OFT spends £1 on regulation for every £18,000 lent.

The NAO found that the OFT has a good working relationship with consumer organisations and business, and the level of OFT knowledge of credit regulations and the credit landscape was valued.

However, it also found that there are real issues with the lack of information about the market and individual firms, meaning that OFT enforcement action was not properly targeted and that there was a lack of understanding of levels of consumer detriment for the different credit sectors. It also identified a key weakness in the current regime in that the OFT has inadequate regulatory powers for such a complex market.

1b. Changing primary legislation

18. The fast pace at which the UK credit market has developed in recent years, combined with the dynamic nature of product development, has not always been matched by changes to the legislative and regulatory framework. The 2006 reforms of the CCA, which significantly reformed the 1974 Act, was the first major overhaul of consumer credit legislation for 32 years. Since the 2006 reforms the consumer credit market has changed markedly with innovations such as instant loans via the internet or text message, and the increase in the availability and provision of payday loans as an alternative to mainstream credit.

19. Many requirements of the consumer credit regime are enshrined in the CCA itself, meaning that primary legislation can be needed even to make relatively small legislative changes. Under FSMA, in contrast, the FCA has access to a range of powers delegated from legislation

[13] http://www.citizensadvice.org.uk/print/bis_credit_and_debt_review_-_initial_indication_of_strategic_issues-2.pdf
[14] http://www.parliament.uk/business/committees/committees-a-z/commons-select/business-innovation-and-skills/inquiries/parliament-2010/debt-management/
[15] http://www.oft.gov.uk/news-and-updates/press/2012/95-12

(including powers to make and enforce rules), allowing a more flexible and quicker approach to regulation in this rapidly evolving market.

2. The split in regulatory responsibilities between the OFT and FSA

20. Because of the split in regulatory responsibility there are overlaps in the population of firms regulated by the FCA and the OFT[16] and across financial products. For example, a firm may be authorised and regulated under FSMA for the provision of mortgage advice and arranging insurance and also licensed under CCA to carry on the business of consumer credit, debt adjusting and debt counselling. This can lead to duplication of compliance costs and burdens for firms and differences in regulatory approach, which may lead to uncertainty for business as well as consumers.

21. Accountability for some objectives relating to retail financial services is split between the OFT, FCA, Local Authority Trading Standards Services (LATSS)[17], specialist Illegal Money Lending teams, the Department for Enterprise, Trade and Investment in Northern Ireland (DETI), the Department for Business, Innovation and Skills (BIS) and HM Treasury. This can be made to work most of the time, helped by concordats between the relevant organisations, and can indeed deliver benefits. However, the split in responsibility makes it difficult for regulators to take a strategic view of priorities across the entire retail financial services sector. Decisions are driven by the different legal duties and powers of individual regulators.

22. Overall, respondents to the Government's December 2010 consultation on consumer credit regulation balance favoured a single regulator for consumer credit and other retail financial services.

23. In addition to overlaps in the regulated population, there are also regulatory overlaps in relation to particular financial services products which may be confusing for consumers. For example, a current account is regulated by the FCA but the overdraft facility is regulated by the OFT under the CCA. Mortgage products with unsecured loan elements span both regimes, as do credit cards (because the use of credit cards as payment instruments is regulated by the FCA, but the underlying credit agreement is regulated by the OFT). Examples of the sort of boundary issues that have concerned both regulators include the right of set-off, unfair bank charges and product bundling and the treatment of consumers in financial difficulty (e.g. where consumers have both mortgage and unsecured debts).

Rationale for Intervention

24. The consumer credit market shares many common features with other financial services markets but with specific issues in relation to vulnerable consumers, including:

- Information asymmetry – given the complexity of consumer credit contracts, consumers often have access to insufficient or imperfect information about the product or firm with whom they are transacting. This is compounded by the fact that financial capability is low, and that consumers may seek credit infrequently, and often in times of crisis, when they are particularly vulnerable.
- Imbalance in bargaining power – often, the information asymmetry is compounded by consumers' circumstances in a way which tilts the balance of power further towards the

[16] The FSA directly authorise around 19,000 firms of which around half also hold a consumer credit licence. In addition there are around 83,000 Appointed Representatives of which around 11% also hold a consumer credit licence. Of the 47,600 active OFT Consumer Credit licence holders, around 10,000 were also directly authorised by the FSA, 9,000 were appointed representatives and 26,000 were OFT licensed only.

[17] For example, Trading Standards Services currently have powers to prosecute under the CCA (and take enforcement action under the Enterprise Act 2002) and consequently collect evidence on the activities of licence holders (which contributes to market oversight), provide local advice to businesses on credit matters, supply intelligence to OFT for licensing purposes and monitor compliance with OFT sanctions.

lender; for example, consumers who may find themselves unable to access traditional sources of credit due to a poor credit history or because their income is simply too low may resort to illegal money lenders.
- Financial stress - Bristol University research into the impact of proposals for a cap on the cost of credit suggests that over half of consumers of certain high cost credit products, pawnbroking, retail payday and online payday loans, had experienced financial stress in the previous 12 months.[18]

25. Regulation should ensure that a market functions well: that there is a thriving, competitive industry which serves consumers' needs and where consumers are treated fairly. The Government believes that the market is not functioning as well as it should and the regulatory regime cannot keep pace with the market. The nature of the credit marketplace – where consumers are often, by definition, at a disadvantage – and evidence of considerable unaddressed detriment in the consumer credit sector has confirmed the Government's view that there is a strong argument for a new regulatory approach, which should seek to ensure that firms treat consumers fairly.

26. The Government also wants to reap the benefits of bringing regulation of how retail financial services firms conduct business with their customers under a single regulator and of a unified, coherent regulatory approach.

27. The Government's ambition is to create a world-class regulatory regime that keeps pace with a dynamic consumer credit market; responds to actual or potential gaps in consumer protection; and places a proportionate regulatory burden on business.

Description of options considered

28. Alternatives to regulation were ruled out early in the process as it was clear that in identifying potential options for reform, non-regulatory options are unlikely to satisfactorily achieve the objectives set out above. Member States are also obliged by the Consumer Credit Directive to ensure that creditors are supervised.

Three options were therefore considered:

- Do nothing;
- Retain and enhance the CCA to ensure better consumer protections and leave enforcement in a separate regulatory body; and
- The preferred option:Transfer regulation of consumer credit to the FCA under a FSMA-based regime.

Option 1: Do Nothing

29. 'Do nothing' would leave the regulation of consumer credit with the OFT or its successor body. On 14 October 2010 the Secretary of State for Business, Innovation and Skills announced major reforms to the consumer landscape[19] with far reaching implications for the future of the OFT. BIS consulted in June 2011[20] as part of a wider review of consumer empowerment and protections. The Government response[21], published in April 2012, set out that in future, responsibility for each aspect of consumer advice, representation and enforcement should rest

[18] University of Bristol (2013) the Impact on Business and Consumers
[19] http://www.bis.gov.uk/consumer
[20] http://www.bis.gov.uk/assets/biscore/consumer-issues/docs/e/11-970-empowering-protecting-consumers-consultation-on-institutional-changes.pdf
[21] http://www.bis.gov.uk/assets/biscore/consumer-issues/docs/e/12-510-empowering-protecting-consumers-government-response.pdf

mainly with one of three key institutions: the Citizens Advice Service, LATSS and the proposed new Competition and Markets Authority (CMA). The OFT will be abolished on 31 March 2014.

30. In March 2011, BIS published a consultation[22] on proposals to merge the competition functions of the OFT and the Competition Commission to create the CMA. The Government responded[23] in March 2012 confirming that it intended to create the CMA with the aim of improving markets and helping consumers and businesses by providing greater coherence in competition practice and a more streamlined approach to decision making.

31. There were a number of concerns raised by stakeholders should responsibility for consumer credit move to the new CMA. There was a risk that consumer credit would not be a natural fit with the CMA's competition responsibilities, which would impact the ability of the CMA to deliver credit regulation satisfactorily in the future. There would also be a risk of distracting the CMA from building the core competition functions of the new organisation.

32. In light of the above, doing nothing and leaving the regulation of consumer credit with the OFT would be impossible to achieve once the OFT is formally abolished. However, this option remains the counterfactual to compare to the other options.

Option 2: Establish a new regulatory body with enhanced powers under the CCA

33. Option 2 would involve setting up a new regulator for consumer credit. Establishing a new dedicated credit regulator would require a new body to be set up with consequential governance costs. It was estimated that the new body would require an additional board and some additional administrative staff (the Consumer Credit Group within OFT already pays for its proportion of OFT overheads, rent etc via the consumer credit licence fee so such costs would not be additional to this option).

34. Two options for the new regulator were considered – transfer consumer credit regulation to the new CMA or establish an entirely new, dedicated consumer credit regulator.

Benefits of Option 2

35. Benefits of this option include a high degree of continuity in terms of regulatory processes (including the licensing regime and enforcement powers), as well as consumer protections and business requirements, with retention of well-known and understood requirements on firms. It would also allow a targeted approach, addressing specific issues known to give rise to consumer detriment, while minimising additional costs to business.

36. A package of measures was considered as a means to enhance the CCA to allow a new CCA-based regulatory approach to prevent consumer detriment before it arises and to tackle rogue firms. Measures include:

- Expanding current supervision and enforcement activities by classifying more licensing categories as high-risk and undertaking more sectoral compliance reviews;
- Undertaking new supervision and enforcement activities, by undertaking a one-off relicensing of firms in high-risk categories; and
- Giving new powers to the regulator including a power for the regulator to be able to apply to the courts for compensation orders and increasing the fines limit.

37. However, the measures considered in Option 2 do not address all the issues raised during the 2010 consultation in relation to limitations of the CCA regime. Principally they are not likely to

[22] http://www.bis.gov.uk/assets/biscore/consumer-issues/docs/c/11-657-competition-regime-for-growth-consultation
[23] http://www.bis.gov.uk/Consultations/competition-regime-for-growth

provide the flexibility that the regulator needs to keep up with changes in the credit market so that as new drivers of consumer detriment emerge they are addressed quickly. The ability of the FCA to develop new rules (following consultation) will allow the FCA to make prompt and tailored responses to product and service innovations that are harmful to customers.

38. In addition the FCA does not rely solely on detailed rules prescribing behaviour in the way that under the CCA the OFT relies on the detailed provisions in primary legislation. The FCA also requires that firms comply with 'Principles for Business' such as the principle that a firm must conduct its business with due skill, care and diligence; that it must treat its customers fairly; and that it must deal with regulators in an open and cooperative way. This helps ensure that firms comply not just with the letter of the rules but the spirit of the wider regime. Examples of high-level conduct standards include, for example, rules on having appropriate systems and controls in place to ensure that risk within a firm is properly identified and managed.

39. Also the enhanced CCA option would continue to rely on statutory requirements which can, in isolation, lead to firms taking a 'tick box' compliance approach. Other disadvantages to this approach include no improvement in coherence of the regulatory landscape and no market oversight for all retail financial services.

Costs for Option 2

40. Option 2 would be funded by a variable fee for credit licensees. The OFT consulted in December 2009 on the possibility of introducing a differentiated fee structure to take account of the different costs arising from its risk-based approach to regulation, to ensure that fees were fair and proportionate and to enhance the regulator's financial sustainability during periods of change in the size of the credit market.

41. It set out a preferred option for a system which defined applications as straightforward, moderately complex or complex, to be further refined with a scaling factor to include size of credit business and/or overall size of business. The proposal received a mixed reception, with approximately half of respondents opposed. At the time the OFT estimated that it would take around two years before a differentiated fees system could be implemented.

42. This option would mean a considerable increase in the licence fee to fund the increase in authorisation and supervision costs. The table below gives an indication of the potential cost to business of introducing an enhanced CCA regime.

Enhanced CCA (BIS estimates)	**£m**
Pre Transfer	
Transfer costs, IT, Staff moves[24]	2.5
Transition one–off costs	**2.5**
Relicensing – costs to regulator[25]	5-7
Reporting[26]	4.7
Total Transitional/one-off (approx.)	**14-17**
Ongoing annual costs	**£m**
Periodic and authorisation fees[27]	11.6-12.6
Reporting[28]	1-3.5
Total ongoing annual costs	**12.6-16.1**

[24] See annex B

[25] Cost to regulator of authorising firms = 47,000 firms * 4 hours * £17 (hourly rate of HEO)

[26] Admin cost to firms of authorisation form = 47,000 firms * 7 hours * £25 (hourly rate of director)

[27] Existing OFT licence fees of £10m + £1 to £2m for additional market reviews + £0.6m for additional board members for new regulator's board

[28] Additional annual reporting by firms to regulator = £43,000 * 3 hours * £25 (hourly rate of director)

43. An enhanced CCA-based approach would provide additional scrutiny at the gateway to the market (to ensure rogue firms were not given licences). We assume this would involve additional reporting costs for firms and additional scrutiny costs for this new regulator.

44. We assume that additional ongoing supervision would involve additional market reviews (which the OFT has estimated at up to £1m in cost to them) and other information requests by OFT, which would create additional reporting costs for business.

45. The increase in fees and admin costs to pay for the enhanced regulation would have an impact on the licence holders' willingness to remain licensed and therefore lead to some exit. This is a relevant point to consider when comparing options but is a non-monetised cost. The change in fees is possible under the existing Consumer Credit Act and does not involve a change in regulation i.e. OFT could change fees now.

46. At this stage we believe that all the changes to supervision, licensing and fees in this option are possible under the existing Consumer Credit Act; thus these costs are not associated with a change in regulation (and so not in scope of OITO), but with administrative change of establishing the standalone body. However, the costs are useful as a comparison to the transfer to the FCA.

Option 3 Transfer responsibility for regulation and supervision of consumer credit from the OFT to the FCA

Background

47. The Government wants to bring about a step-change in regulation of consumer credit, achieved through the FCA's wider range of tools and powers, increased resources and greater flexibility to tackle detriment and respond more quickly to market changes. It also wants to establish a regime which is suited to the consumer credit market, that the requirements placed on firms are proportionate and which helps to support a thriving and competitive marketplace that meets consumers' needs.

48. The Government and FCA have developed a two-tier regime which takes a differentiated approach to authorisation and supervision, reflecting the highly diverse nature of the consumer credit market. Firms undertaking lower risk activities such as offering loans where no interest or charges are applied or firms whose credit activity is secondary to its main business will be eligible for the 'limited permission' regime, under which they will have to meet a modified set of conditions to enter the market and will subject to an appropriate and proportionate degree of supervision. Not for profit debt advice providers will also come under the limited permission regime, with specific tailored regulatory arrangements.

49. The core regime will deliver a rigorous approach to consumer credit regulation and supervision. It is proposed to have the following features:

- A robust authorisation gateway appropriate to the risks of the activities carried out by the firm;
- Proactive supervision;
- Annual reporting of key information; and
- For debt management firms, requirements to hold capital to support consumer redress and wind-down in the event of liquidation – in order to protect client money held by these firms.

As outlined above, the 'limited permission' regime is a bespoke approach targeted at firms who are deemed to be lower risk. The regime for lower risk firms is proposed to have the following proportionate features:

- A shorter, tailored list of threshold conditions;

- Reactive supervision, primarily responding to intelligence about crystallised risk;
- Annual reporting of basic information; and
- A lower assessment fee.

50. As an alternative to authorisation, firms (except most lenders) may instead make arrangements with an authorised firm to become their appointed representative. The authorised firm (the principal) will take responsibility for assessing the suitability of the appointed representative for providing regulated consumer credit activities and will be responsible for the appointed representative's ongoing compliance.

Transition

51. To ensure a smooth transition for all firms from the OFT regime to the FCA regime, there will be a transitional period up to April 2016. OFT licensees will have the opportunity to register for an interim permission to continue the consumer credit activities for which they are licensed. At April 2016, interim permissions will expire[29], requiring firms to be authorised or to be appointed representatives. The compliance costs and burden for firms of applying for an interim permission will be minimal.

Consultation responses

52. Some industry respondents to the March 2013 consultation stage IA raised concerns regarding risks such as the impact on small lenders at point of sale and lending to small business (where these fall under the legal definition of "consumer"). Some industry respondents also argued that costs had been underestimated and total detriment overestimated. We explain below where we made alterations in this final IA to take account of evidence-based comments.

[29] There may be instances where the authorisation process is in train but not complete although the intention is to have most firms authorised by April 2014

Benefits of the Preferred Option[30]

Earlier sections set out the evidence supporting the need for an overhaul of consumer credit regulation and a fundamentally different approach. The key difference in approach is that the FCA will be able to tackle potential as well as actual consumer detriment in the following ways:

- **it will strengthen scrutiny at the gateway to the market**, especially of higher risk firms, preventing firms who do not meet its new and more stringent standards and requirements from entering the market. It will also, with LATSS and, in Northern Ireland, DETI, police the regulatory boundary, taking enforcement action against illegal lenders and firms offering credit services without appropriate authorisation;
- **it will require higher standards of firms,** for example, through more scrutiny of the integrity and competence of individuals in key positions in all firms and the application of high-level conduct standards;
- **it will supervise and monitor firms' behaviour** on an ongoing basis, focusing its resources on areas which could result in greatest consumer detriment,
- **it can make rules to address product and service innovations that are harmful to consumers** promptly and responsively and **it can put restrictions on products** and take action on advertising (financial promotions);
- **it has a broader and more flexible enforcement toolkit**, including the power to make unlimited fines and to take action against individuals in firms. These enforcement powers will act as a strong deterrent for non-compliance; and
- **it can ensure that consumers get redress** – the FCA will have the power to require firms to provide redress. This will bring benefits to consumers where redress is given, and should also incentivise firms to take due care when dealing with consumers.

53. The Government's view therefore is that the transfer of consumer credit regulation to the FCA will bring significant benefits to both consumers and industry through the regulatory approach described above.

In particular, the FCA's more effective regulatory tools and framework discussed above will be effective in tackling known consumer detriment occurring in the non-mainstream lending market such as: payday loans[31], credit brokerage[32], debt management[33] and home collected credit[34].

54. Issues identified in the non-mainstream market include:

- High default charges and fees
- Lack of competition leading to excess profits
- Customers failing to engage effectively with the high cost credit market
- Loans being continually rolled over with new loans being given on top of old
- Widespread non-compliance with OFT Guidance
- Misleading advertising
- Making false claims about the nature of the business
- Lack of competence amongst debt advisors.
- Unauthorised debiting of customer accounts
- Failure to pay refunds when they are due.

[30] See Government consultation from March 2013, table 1A page 9 for a comparison of both regimes.

[31] http://www.oft.gov.uk/OFTwork/credit/review-high-cost-consumer-credit/

[32] http://www.oft.gov.uk/news-and-updates/press/2011/62-11

[33] http://www.oft.gov.uk/about-the-oft/legal-powers/legal/cca/debt-management#named4

[34] http://webarchive.nationalarchives.gov.uk/+/http://www.competition-commission.org.uk/inquiries/current/homecredit/

55. Underlying problems have been highlighted in some parts of the market, including the lack of competition identified by the Competition Commission in the home collected credit market [35] and the excess profits identified by the OFT[36] being made in some sectors.

56. Unmanageable debt can then cause significant consumer harm including stress. A better regulated credit market should tackle poor practice on the part of consumer credit firms (e.g. inadequate assessment of the consumer's ability to afford credit) that may exacerbate over indebtedness and the personal, social and health problems associated with over indebtedness.

57. Furthermore some consultation responses pointed out that credit can itself be a contributor to unsustainable levels of indebtedness in consumers. While debt problems are often triggered by shocks to household expenditure, overexposure to credit can also provoke unmanageable debt problems. Information provided by Stepchange (a debt advice charity) estimates that of the £3.6bn in outstanding debt owed by their 190,000 clients; £2.15bn is owed by clients with contractual payments that are more than 50% of their net household income. This suggests that some of this credit is harmful in that it is contributing to an unsustainable situation for individuals. Stepchange estimates that there are nearly six million households that are either in or at risk of financial difficulty so the figures cited above are likely to be a small proportion of the overall picture.

Monetised benefits to consumers

58. In order to estimate monetised benefits, the Government has taken both 'top down' calculations (i.e. estimating the total detriment currently and then estimating what proportion the FCA will be able to address) and also a 'bottom up' calculation (i.e. estimating how much detriment the FCA will be able to address based on current estimates of the impact of the OFT regime).

59. We added the bottom up approach as a result of the consultation and RPC opinion. While we believe that the top down methodology provides a robust estimate of aggregate detriment from consumer problems, it requires informed assumptions about the proportion of detriment the new regime is expected to tackle. The bottom up approach, on the other hand, is based upon NAO analysis of actual interventions by the OFT. Therefore the expectation of effectiveness of the new regime is more closely linked to a recent assessment of the current regime's effectiveness - as a baseline, we assume that the FCA will be as effective as the OFT. We believe that this is a conservative assumption, given the transformation in approach and the wider and powerful regulatory tools and powers of the FCA regime compared to the OFT (as described earlier).

60. We also requested in the consultation and searched for further evidence of aggregate consumer detriment but did not find anything in addition to the two sources already discussed. Consultation respondents did not propose any other sources of evidence of consumer detriment. Various organisations have carried out case studies of problems in consumer credit in specific credit types but these are not suitable for monetising or aggregating to the whole market.

61. As set out in the summary sheet of the costs and benefits of the preferred option (page 2), the Government has put forward a best estimate of monetised benefits for consumer credit consumers at £80m per year on average. The following sections explain how the Government arrived at its estimates for monetised benefits.

Top-Down approach based on consumer detriment estimates

Consumer detriment estimates

[35] http://webarchive.nationalarchives.gov.uk/+/http://www.competition-commission.org.uk/inquiries/current/homecredit/

[36] http://www.oft.gov.uk/OFTwork/credit/review-high-cost-consumer-credit/

62. There are two main sources for recent estimates of consumer detriment in the consumer credit market: 1) the Consumer Focus Consumer Detriment Report 2012 and 2) the recent NAO report into OFT's regulation of consumer credit. These are used as the high and low estimates of consumer detriment. The reports use different sources of data and methodologies to assess detriment in consumer credit and so provide two alternative approaches to estimating the same figure – improving the overall robustness of the analysis.

Consumer Focus consumer detriment survey

63. The Consumer Focus estimate uses a survey of consumers specially designed to estimate the prevalence of consumer problems in the UK and the associated detriment. It is representative of the UK population. It builds on a methodology designed by the OFT specifically to define and measure consumer detriment. The measurement of consumer detriment includes the readily recordable costs of remedying the problem, such as telephone calls to the business, travel costs and legal advice. Detriment also includes the less easily measured psychological effects for the consumer including stress and anger as well as knock on effects such as reduced confidence to engage in the market effectively or even, for vulnerable consumers, to live alone. This data used in the IA for the detriment uses the readily quantifiable cost of resolving the problem only and so can be considered a conservative estimate.

64. Data from the 2012 Consumer Detriment survey indicates that there were around 237,000 consumer problems in 'ancillary credit business, hire and unsecured credit' market over the 'last 12 months' for the UK. This data source, which is representative of the UK population, is used as a proxy for the kind of detriment that consumers experience in consumer credit. The detriment these consumers experienced can be quantified by using a) the cost of resolving the problem and b) the cost of lost personal time spent resolving the problem.

- The cost of resolving the problem includes respondents' estimates of lost earnings, travel costs, expert advice and sundry costs. The mean cost of consumer detriment from consumer problems was £660. This is multiplied by the number of problems to yield £156.4m.
- Lost personal time spent trying to resolve these problems totalled 870,000 hours, according to respondents (across the 237,000 problems, i.e. an average of around 4 hours per incident). Multiplying these hours by the 2011 median wage of employees of £11.14 per hour as a proxy for the cost to consumers yields a total cost of lost personal time of £9.7 million.

65. The sum of these two figures yields an estimate of £166 million for consumer detriment in the consumer credit market. The confidence interval for the survey gives a range of £109m to £220m for the upper and lower bound. These figures are used as the LOW estimate of (remedied and unremedied) detriment in consumer credit. Respondents to the consultation did not challenge this low estimate.

NAO estimate of un-remedied consumer detriment in the consumer credit market based on Consumer Direct complaints data

66. As an alternative to using consumer survey data, it is also possible to estimate consumer detriment by using complaints information. This was the approach used in a recent NAO investigation of the consumer credit market.

67. The NAO estimated that the total unremedied financial harm in the consumer credit market was at least £450m in 2010/11. This was based on the Consumer Direct (CD) database of complaints[37] about consumer credit products.

68. From the sample of cases the NAO looked at, it estimated the average value to a complainant of resolving a consumer credit problem to be around £200, with varying averages by credit product. This was derived from a survey of CD complainants (OFT 2009[38]) who reported the value of the payments associated with the problem product and the value to the complainant of resolving their problem.

69. The NAO also used the OFT estimate that, for every 1 CD complaint about financial services, 59.3 problems were not reported to CD. Complaints about consumer credit products to CD were multiplied by 59.3 (to capture hidden complaints) and by the average consumer detriment for each credit product to yield a total estimated consumer detriment of £450m in 2010/11.

70. £450m per year is treated as the HIGH unremedied detriment estimate. Therefore the Government has estimated that the consumer detriment range is £166m-£450m per year.

71. We received consultation comments that the high consumer detriment estimate was an over estimate as it uses 2008 data which may be out of date and did not reflect changes in consumers likelihood to complain, the value of detriment of unreported complaints and the role of the Financial Ombudsman Service (FOS). Although we did not receive alternative evidence, methodologies or relevant data from respondents, we introduced the bottom up approach (for the benefit estimate below). The bottom up approach, rather than estimate total detriment and make informed assumptions about who much could be tackled, uses evidence on actual OFT interventions and therefore is closely linked to real cases and intervention.

Consumer benefit estimates

72. To assess the likely consumer benefit of the new regime, the following steps were applied to the high and low detriment estimates. We have also introduced a new best estimate using a bottom up approach.

HIGH consumer benefit estimate

73. We reviewed the CD database of 2011 consumer complaints and assessed which categories of detriment on the database are likely to be addressed by the proposed FCA regime. This assessment identified that 63% of reported detriment type could potentially be addressed by the FCA regime (see Annex C). Even so, it is not realistic to expect that the regulator would be able to tackle all reported detriment falling into these categories. We have assumed that of the 63% of reported detriment only 50% would be resolved. We believe that this is a realistic

[37] This data is used to help quantify consumer detriment in consumer credit. It is not intended to exactly reflect they way consumer detriment is tackled. For example neither the OFT nor the FCA necessarily responds as such to individual complaints. Rather detriment as a whole is considered (which includes evidence from complaints) and powers and tools are used to intervene in the market as a whole or by firm.

[38] Office of Fair Trading (2009) Trading Standards impact. An evaluation of the impact of the fair trading of local authority Trading Standards Services in the UK. OFT1085

assumption, given the proposed extent and the nature of the FCA's regulatory regime. Consultation responses did not challenge this assumption.

Applying these assumptions suggests a high estimate for consumer benefit of (£450m * 63%) * 50% = £139.5m per annum.

LOW consumer benefit estimate

74. The same 50% assumption was applied to the Consumer Focus survey estimate of (remedied and unremedied) consumer detriment of £166m per annum. This yields £83m per year.

75. However, the Consumer Focus survey (unlike the NAO estimate) includes problems that were remedied under the current regime. Therefore the impact of OFT intervention needs to be netted off. The best estimate for the impact of the OFT work is the NAO's cost effectiveness analysis. The NAO estimated the benefit to consumers of a set of OFT enforcement actions (using data as described for the NAO consumer detriment estimate above, as well as analysis of complaints about firms where the OFT intervened). This yielded a (low) cost benefit ratio of 7.9 (benefit) to 1 (cost)[39]. This analysis was based on a small sample of OFT cases to provide an indication of the cost-effectiveness. However, using this as the best available estimate of impact suggests that the impact of the OFT enforcement work is around £40m per year (£5.1m cost * 7.9). This £40m is subtracted from the £83m to yield £43m.

Best Estimate - Bottom up approach based on assessment of current OFT impact

76. In order to provide an additional check on the robustness of the benefits estimates set out in the consultation stage IA, we have considered an alternative approach based on the estimated impact of the current OFT CCA regime. This approach is also consistent with the FCA's own published cost-benefit analysis[40].

77. The NAO estimates that for every £1 spent on consumer credit enforcement by the OFT in 2011/12, consumers saved on average £8.60[41]. For the £4.5m spent on enforcement by the OFT, the NAO estimates that consumers benefitted by about £40m over the year 2011/12.

78. The transfer to the FCA will increase resources devoted to regulating consumer credit. From the estimated FCA fee revenue of about £30m per annum it is expected that the overall resource devoted to consumer credit regulation will approximately treble that of the OFT. As a very simple estimate of benefits, where one assumes that the FCA would have treble the resource on enforcement, one would expect (assuming the average benefit to consumers from enforcement action stays unchanged from the transfer) that the FCA would add another £80m in benefits from its enforcement actions annually.

79. Ordinarily one might expect some diminishing returns to additional spending on enforcement (for example, if OFT were given additional resources under the current regime). However, factoring in the FCA's new approach and powers to intervene in the consumer credit market as described above, the Government considers that this bottom-up estimate of £80m is in fact likely to be a conservative estimate of additional benefits.

80. As this £80m uses actual interventions and is close to the mid point (of the high and low top down estimates) we use this as the 'best estimate'. The different estimates of consumer detriment and consumer benefit are included in the table below.

Table: Summary of detriment and benefit estimates (per year)

[39] 7.9 to 1 is the NAO's low estimate.

[40] http://www.fca.org.uk/static/fca/documents/consultation-papers/fsa-cp13-07.pdf ANNEX 3

[41] http://www.nao.org.uk/wp-content/uploads/2012/12/1213685_tech_paper.pdf

Name/source	Consumer detriment estimate £m	Consumer benefit estimate £m	Notes
1 Consumer Focus survey **LOW**	166	43	Uses a survey of consumers
2 NAO top down **HIGH**	450	139.5	Uses complaints to Consumer Direct with multiplier to capture unreported complaints
Average of 1 and 2	391	91	
3 NAO bottom up **BEST**	Not applicable	80	Uses complaints to Consumer Direct and evidence on actual OFT interventions

Other Benefits - Benefits to Business

81. The Government has not attempted to monetise potential benefits to business of the new regime. However, we anticipate some positive qualitative impacts, as outlined below.

Proportionality

82. The Government is committed to ensuring that the new regulatory regime places proportionate burdens on firms. The Government recognises that the credit market is diverse, the current regulatory model is light-touch and therefore low cost, and that excessive new burdens on consumer credit firms could lead to some firms, especially those firms for whom offering credit is not the main driver of their business, leaving the market and reducing access to credit for consumers. The Government has worked with the FSA to design a regime where the regulatory burdens on firms are proportionate. Consumer credit firms will pay lower fees than other FCA regulated firms and will be subject to fewer regulatory burdens compared with other FCA regulated firms.

83. The approach will be tailored to in the following ways:

- establishing a new regulatory approach differentiated by firms' risk profile, where lower risk firms will pay lower costs and compliance burdens will be lower;
- setting fees which reflect the size and type of firm and reducing costs of the FCA regime where possible;
- applying only FCA requirements which suit the credit market; some elements of the FCA regime which apply to other financial services sectors will not be applied to consumer credit – for example, prudential requirements will not apply to credit firms (apart from debt management firms), reflecting that, in general, lenders rather than consumers bear capital risk in the consumer credit market; there will be proportionate application of approved persons requirements and firms will not be required to be covered by the Financial Services Compensation Scheme; and
- limited reporting requirements, especially for those firms with lower risk profiles.

Reputational benefits of a Better Regulated Market

84. The FCA's more proactive approach to consumer credit regulation will benefit the whole sector: rogue firms will find it more difficult to operate in the market and so firms that behave responsibly and treat their customers fairly should avoid the reputational tarnish caused by disreputable firms in the market that cause harm to consumers. This point was made qualitatively by IA consultation respondents in the debt advice and pawn broking sectors, for example.

Better Lending Decisions

85. Debt write-offs are high despite creditors showing increased levels of forbearance in recent years. In the 4 quarters to Q2 2012 £5.3 billion was written off in the UK. The FCA will have better market oversight and will proactively supervise firms to enforce responsible lending requirements and support an improvement in the quality of lending decisions.

Improved resilience

86. The FCA will put in place requirements which will help firms manage risk better and support increased resilience. For example:

- The FCA's approved persons regime and greater scrutiny of business models will ensure that there is appropriate governance and certain standards required of those occupying key roles in a firm, resulting in greater financial resilience for firms;
- FCA supervision will promote better standards in risk management, leading to fewer or lower losses (such as 'bad debt' or fraud) and in general lead to a more stable financial position for firms; and
- The appointed representatives regime will allow firms acting as principal to maintain improved oversight and control of their intermediaries.

More responsive approach

87. Firms will be able to benefit from a more responsive approach to regulation too. Where requirements in rules are no longer appropriate, the FCA can more easily remove these unnecessary burdens from firms than if regulation continued to be underpinned by primary legislation.

Dual-regulated firms

88. As discussed above, firms who are already regulated by the FCA will gain from the greater coherence and reduced compliance costs associated with dealing with a single regulator.

Costs to business of the Preferred Option

a) Cost drivers for continuing consumer credit providers

89. The new regime is expected to impose some additional costs on consumer credit providers, compared with the existing OFT regulatory model. This section sets out, at a high level, the nature of the proposed costs for firms of the FCA's regulatory approach. Further detail of these costs can be found in the FCA's CBA and the Europe Economics' report.[42]

Interim permission

[42] http://www.europe-economics.com/publications/europe_economics_final_report_6-3-13.pdf see pages28-64

90. OFT licence-holders will need to apply for an interim permission to carry out the regulated activities that are included on their OFT licence from April 2014. This will be a simple process: firms will need to provide basic information confirming their contact details and activities undertaken.

The FSA has consulted on the fee charged to cover the administrative costs of the application process for interim permission (proposed to be in the region of £350). Firms will also incur their own administrative costs in completing the application form, although this cost is anticipated to be low. The OFT charges sole traders a lower licence fee
than other firms and the FCA proposes to maintain that distinction during the interim regime with a proposal to charge them £150. In the longer term the FCA intends to differentiate fees on the basis of risk.

Authorisation and Variation of Permission

91. Firms will pay a fee with the levels differentiated according to the size and risk level of the activities undertaken. Further information on the approach to fees can be found in the FCA consultation on their high level rules[43] and will be subject to further consultation by the FCA later this year. Firms will also incur administration costs in completing the application pack (existing FCA authorised firms will complete a 'Variation of Permission' application to add consumer credit activities).

Approved persons

92. Firms will incur administrative costs in completing the application pack for approved persons, approved persons will carry out activities, e.g. data reporting, not required under the existing regime and costs will be incurred through any training required.

Reporting requirements

93. Authorised firms will be required to report key information to the FCA at least annually (such as turnover, transaction numbers). Firms with limited permission will report certain basic information (contact details and type of consumer credit activities carried out). Firms will therefore have some set up costs to establish processes for reporting and will incur an annual administrative cost in completing the reporting return. These are anticipated to be low.

Conduct review

94. Firms will need to ensure that they meet conduct standards under the new regime, especially where these are additional to existing CCA requirements or OFT guidance, or where CCA requirements have not been precisely replicated in FCA rules. In particular, firms will have to satisfy themselves that they meet the FCA's new high-level conduct standards and prepare for the change in approach of the FCA compared to the OFT. Firms will also be subject to the new standards relating to the FCA Financial Promotions Regime (current CCA requirements on advertising will become part of the financial promotions regime). This will incur some compliance costs including IT system costs in some cases.

[43] http://www.fca.org.uk/static/fca/documents/consultation-papers/fsa-cp13-07.pdf

Complaints

95. It is expected that firms that receive complaints over a threshold (such as 500 per annum) will have to publish complaints received. and therefore incur costs related to any changes to their current arrangements for dealing with complaints.

Annual Fees

96. It is expected that all firms regulated by the FCA will pay an annual fee, covering all the FCA's costs of regulation. The annual fee will recover, amongst other things, the cost of supervision, operating the customer contact centre, enforcement, any unrecovered authorisation costs, policing the perimeter to ensure that only authorised firms are carrying on regulated activities, information technology costs, policy and legal work and firm communications. It also includes recovery of the costs of establishing the consumer credit regime such as the costs of transferring staff from OFT to the FCA.

97. The FCA will consult on annual fees, including minimum fees later this year. The minimum fee is proposed to be additional to any fee already being paid by a firm for other FSMA regulated activities.

Additional rules for debt management firms

98. The FCA has proposed certain prudential requirements for debt management firms and client asset requirements for larger firms. These are only likely to be additional for larger firms when compared to the existing OFT guidance.

Appointed representatives

99. Appointed representatives may incur costs in entering into arrangements with principals and reporting data to the principal.

b) Estimated costs

100. The estimated costs[44] are estimates of the additional costs incurred by firms of the transfer compared with the current regime, and are based on estimates about the number of firms who will be carrying out consumer credit activity at the time of the transfer in April 2014 and the proportion that may exit the market following the increase in admin and fee costs.

101. Consultation respondents commented that 1) the individual cost categories may not have captured the aggregate or cultural impact of changing regulatory approach and 2) the Approved Person one-off and Authorised Representatives ongoing costs may have been underestimated. Discussion with the FCA's consultants Europe Economics regarding their detailed study confirmed that point 1 had been taken account of in discussion with businesses. We have incorporated point 2 in the high estimate cost.

102. The **net total one-off costs** for the interim permission regime and authorisation are approximately £65m-111m and the net **annual costs[45] for firms are approximately** £30m-49m

[44] The costs estimates show the costs to firms transferring from the OFT regime. They do not explicitly show the costs for new firms entering the market. However, the market exit assumptions are based on a balanced assessment of firms entering and exiting the market.

[45] The staff element of FCA licence fee (estimated by FSA to be 70%) are uplifted up 2% pa which is the OBR's forecast of labour productivity growth.

(an element of annual costs increases with productivity hence the summary sheet present value is slightly higher).

AGGREGATE COST TABLE Source: Europe Economics report to FSA with BIS addition to high estimate

Type of costs	**Low £m**	**High £m**	**Best £m**
Interim one-off costs			
Fess and administration	14.11	17.40	15.76
Authorisation one-off costs			
Authorisation	37.3	48.50	42.90
Approved Persons	3.3	9.90	6.60
High-level Principles and Conduct Standards	2.0	3.30	2.65
Client Asset Requirements for DM firms	0.0	0.30	0.15
Prudential Standards for DM firms	0.2	0.8	0.50
Supervision and Regulatory Reporting	7.4	9.9	8.65
Complaints and Redress	0.2	6.5	3.35
Financial Promotions	4.6	7.4	6.00
Appointed Representative Regime	5.4	6.6	6.00
Retail conduct review	15.5	25.30	20.40
(Sub total authorisation one-off costs)	(75.90)	(118.50)	(97.20)
Total one-off costs (interim + authorisation)	90.01	135.90	112.96
Cost of existing OFT regime (3 year period with annual cost of £10m)	-30	-30	-30
Exit costs (3 year period with annual cost of £1.77m)	5.31	5.31	5.31
Net total one-off costs (interim + authorisation – OFT regime)	65.32	111.21	88.27
On-going costs			
Annual fees	28.30	33.30	30.80
Approved Persons	0.50	0.80	0.65
High-level Principles and Conduct Standards	0.10	0.30	0.20
Client Asset Requirements for DM firms	0.00	0.40	0.20
Prudential Standards for Dm firms	0.20	1.10	0.65
Supervision and Regulatory Reporting	2.30	3.30	2.80
Complaints and Redress	0.10	2.40	1.25
Financial Promotions	3.90	8.80	6.35
Appointed Representative Regime	3.20	7.00	5.10
Exit costs	1.77	1.77	1.77
Total on-going costs	40.37	59.17	49.77
Cost of existing OFT regime	-10	-10	-10
Net total on-going costs (total on-going costs – OFT regime)[46]	30.37	49.17	39.77

- To support the **population estimates**, the FSA commissioned a third party company Critical Research to survey a sample of OFT licence holders. They estimate that around 47,600 firms are active.[47]

[46] The annual figure will increase in line with labour productivity.

- To estimate **additional costs** the FSA commissioned Policis and Europe Economics to undertake in-depth conversations with firms of various category and size to estimate the costs of the proposed regime (see methodology in annex A). These estimates are used in this IA.
- The ongoing FCA costs, where they reflect staff costs, may be expected to rise in real terms. We use the OBR's forecast of productivity growth of 2% per annum as the growth rate of staff costs. FSA estimates that 70% of the fees that it is required to recover is to account for staff costs.

c) Costs of exit

Estimate of how many firms are likely to exit

103. The Government believes that the risk that consumer credit licence holders will find the new admin and fee costs too burdensome has been significantly mitigated by the design of a proportionate regime which includes the option for certain firms to become authorised under the limited permission regime or become Appointed Representatives. However, some firms may choose not to seek authorisation to continue to carry on consumer credit activities and therefore exit the market. To estimate this impact the FSA commissioned Policis and Europe Economics to undertake an independent and robust analysis of profitability and possible exit (see annex A for the Europe Economics approach)

104. Policis interviewed 120 firms/trade associations of various consumer credit categories and sizes to discuss the impact of the proposals. The discussions also included data on profitability and revenue which Europe Economics used in a profitability model. Combining businesses' views and the model Europe Economics estimated exit by consumer credit category. The impact varied from negligible for a large bank to significant for a small credit broker. This exit includes both 'natural wastage' and exit as a result of the transfer of regulation. For natural wastage Europe Economics considered both the long term trend of a falling consumer credit licensed population (to 70k from over 200k in the last 10 years alone) but also the current environment of moderating aggregate demand for consumer credit. This analysis yielded natural wastage of 12%. Exit as a result of the transfer was estimated at 8%.

105. Therefore in total the analysis yields an estimated exit of around 20% of active firms or a change from 47,600 active firms to 38,600, but only 8 percentage points of the 20% exit is a due to the policy change.

106. Europe Economics found that, "The more marginal participants will be affected most. This is particularly evident in the credit broker and ancillary intermediary (i.e. motor and other retailer) segments where the involvement of a number of firms is currently low-scale (e.g. intermediating low volumes of low value loans). This means that a large number of exiting firms will not have significant consequences for the consumer credit market as a whole."

Impact on firms that chose to exit

[47] An active firm is defined as one that used its consumer credit licence in the previous 12 months and intended to do so in the next 12 months, as at the time of survey in May to July 2012.

107. Where firms exit the market as a result of the new regime, they could be expected to incur costs in terms of lost earnings from their current consumer credit activities.

108. As noted above, Europe Economics have estimated that around 8% (or around 3500) of active firms might leave the market following a change in the regime. By definition these are the marginal firms that will tend to be currently earning little from consumer credit activities, and for whom the additional costs of the new regime make continuing these activities unprofitable.

109. Firms can be expected to leave the market if the anticipated increase in costs of regulation is greater than their current earnings from consumer credit activities. Therefore, for each firm, the cost of lost earnings from exit can be expected to lie between zero and the additional cost of the new regime. We know from the EE cost estimates that if the 3500 did not exit then they would incur admin and fee costs of £8m as an EANCB (calculated as the proportional increase in cost based on the proportional increase in population). So £8m per annum is the maximum returns that those exiting firms will lose (if they had higher returns they would remain in the market). And if firms' returns were uniformly distributed, one might expect the average impact on firms to be half of the maximum, suggesting a cost of around £4m.

110. However, we know from the Critical Research survey that there is a long tail of firms with very low earnings from consumer credit activities – so earnings are not uniformly distributed for those firms that exit. For example, in response to the survey, 14% of active firms[48] stated that they earned zero from consumer credit activities, which is consistent with firms holding licences for precautionary reasons and because the OFT licence is relatively low. Applying the estimated distribution of actual earnings to the additional cost of the regime to the exiting firms (if they had sought authorisation) produces an estimate of the cost to business of exit to £1.8m per year.

111. Furthermore stakeholders noted in discussions during the consultation period that, while some businesses would exit consumer credit related activities, it was more likely that businesses that choose not to become FCA authorised or an appointed representative would alter their business model or consolidate with other businesses. So the impact of exit may be more moderate than the initial numbers suggest.

Risks

112. There are two main risks accompanying the transfer of responsibility for consumer credit from the OFT to the FCA. The first is that the **timescales** for the transfer may not give business and consumer organisations sufficient time to come to terms with the new regime and the second is on the impact that the transfer may have on the **supply of consumer credit**.

Timescales

113. The transfer will take place in April 2014, when the OFT ceases to exist.

114. To address concerns about the speed of the transfer the Government has announced that there will be a two year transition period (April 2014 - April 2016). Prior to April 2014, existing consumer credit licence holders will be able to obtain an 'interim permission' from the FCA to continue trading until they become FCA authorised or appointed representatives. To get interim permission, OFT licence holders are only required to notify the FCA that they want to continue carrying on their regulated activities and therefore will not need to meet the higher test of the FCA's authorisation process. From 1 April 2014 the FCA will be able to use all the powers in its toolkit.

[48] Firms are considered active if they had used or expect to use the licence in the past/next 12 months.

115. The FCA intends to adopt OFT guidance into its own guidance or rules; it will also consider taking the most effective elements of the many voluntary codes developed across the market and translate these into binding rules or formal guidance. To give firms time to get used to the new framework of rules and guidance, the FCA has proposed a six-month transitional period, during which, if firms can demonstrate that they are acting in accordance with a corresponding rule or guidance from the OFT regime which is the same in substance as the FCA's, they will not take action against them. The Government has, in response to respondents' concerns, also given the FCA the power to designate certain CCA secondary legislation, which will have been revoked, as rules.

116. The FCA will need to respond and adapt as new issues emerge. Subject to the outcome of the consultation exercises, there is, however, no intention to alter the proposals for the FCA model in the medium-term (i.e. the next 3-5 years). However, as the FCA understanding of the risks in the market increases during this period, it may determine that some aspects of the model are not proportionate to the risks faced by consumers and changes need to be made. If the FCA decided any significant changes to the model were necessary, it would work closely with the industry and consumer groups, and where further changes affect FCA rules and guidance, they will be subject to consultation in the usual way.

Impacts on the Supply of consumer credit

117. The Government acknowledges that the transfer of regulation is likely to lead to increased costs for firms which may ultimately reduce access to credit for consumers through any market exit that may occur. Therefore in designing the regime Government has sought to ensure that the new regime should not impose excessive burdens on business. To achieve this Government and the FCA have taken into account the particular nature of this market and tailored the FCA's approach to authorisation in the consumer credit market. This is principally through design of a two-tier approach, with a 'core model' of full authorisation and a 'second tier' of limited permissions which is designed for specific types of credit business whose activities are lower risk and/or secondary to the firm's main business. Certain firms will also be able to take advantage of the appointed representatives' regime and therefore will not be directly authorised by the FCA. This approach is intended to minimise the impact of the transfer and minimise the extent of any market exit.

118. Government is also providing continuity for firms in basing the new regime on the conduct rules enshrined in the current regime. There is also no intention to alter the FCA's proposed approach in the medium term (the next 3-5 years - see paragraph 120 above)

119. Overall the Government believes that the transfer is unlikely to affect the aggregate supply of credit. This is because the majority of consumer credit in the UK is supplied by large financial institutions that are already regulated by the FSA. The transfer will lead to an increase in costs for these firms, but this increase in compliance costs is likely be marginal given that they are already being regulated under a FSMA-based regime. Furthermore the potential exit estimated from the transfer is low (8%) after taking into account exit expected in the normal run of business.

120. The main risk of a reduction in credit supply results from the possibility of market exit by small non-bank lenders and credit intermediaries not currently regulated by the FCA.

121. There could be a number of other potential effects on the market and/or the supply of credit, as discussed below:

Competition and innovation

122. There is a risk that some small brokers may exit the market due to the higher cost of the FCA regime and, similarly, potential small entrants may be deterred from entering. This could affect competition in some local areas and associated benefits such as innovation or price. Consultation responses and discussions with stakeholders confirmed that in most consumer credit sectors, with one exception (point of sale credit, see below), the impact on competition would not be significant compared with existing levels of competition. EE analysis suggests that uncertainty in the approach of the FCA to regulation could delay innovation but was unlikely to lead to innovation forgone or lost permanently and they conclude that 'it does not appear that the new regime will have a notable effect on competition'.

Point of sale credit

123. As indicated in the introduction to this section, the risk of exit from credit markets is likely to be highest in the point of sale market for non-bank lenders and ancillary credit brokers. A number of industry consultation responses have concurred with this view citing compliance costs and regulatory uncertainty as key issues. Here we draw more fully on the EE research and consultation responses for a discussion of the risk.

124. Firstly as mentioned above, it is important to note that Government and the FCA have taken a bespoke approach to applying the FSMA regime to the credit market. One of the main beneficiaries of this bespoke approach are likely to be secondary credit brokers i.e. motor dealers and furniture or white goods retailers that introduce consumers to a finance provider. They will fall into the limited permission regime and therefore will be subject to lower authorisation fees and will meet threshold conditions that are tailored to the nature of their business and the risk level of their credit activities and as a result their compliance costs are anticipated to be lower than for other credit firms.

125. EE modelling of the likely costs of the new regime indicate that fee and administrative costs will be the most significant cost increases for point of sale secondary brokers. For non-bank lenders the authorisation costs are relatively significant.

126. The impacts in terms of possible exits are estimated to be greater for small firms. EE estimate that 5-15% of small secondary credit brokers (motor and non-motor) may exit credit markets as a result of the transfer with no projected exit of the larger providers.

127. For non-bank lenders EE estimated approximately 7.5% exit for small lenders and 2.5% for large firms49. It should be noted however that of the sample of five lenders they spoke with, the firm which was most likely to exit stated it would be able to withstand a 5% costs increase and the actual cost is estimated to be below 1%.

128. Government believes the picture to be nuanced in terms of how the cost increases might impact here, for example:

- For motor secondary credit brokers the findings in the EE report suggested some polarisation of views. Six of the 11 firms interviewed indicated that cost increases of less than 2% pa might mean it is no longer worthwhile for them to stay in the credit market. At the same time 4 of the 6 said that remaining in the consumer credit market

[49] The figures for non-bank lenders include figures for consumer hire firms.

was so business critical that almost any costs would be worth paying. The other five firms assessed the likely costs necessary for them to consider withdrawing from the credit market would be 10-25%. This clearly suggests significant incentive and appetite for some firms to develop strategies to remain in the consumer credit market.

- Feedback from the consultation also indicated that some consumers will be able to substitute other credit products if a chosen retailer ceases to provide credit (although there may be issues for consumers whose choices are already limited - see below for a discussion of this issue).
- Government also considers that despite some industry feedback that the current trend is for bank lenders to reduce relative exposure to this market, it is likely that banks may pick up some of any slack caused by market exit of non-bank lenders or intermediaries.
- Government believes it is reasonable to expect some consolidation in the market. Should smaller firms exit those that remain can benefit from economies of scale where they can distribute costs across a wider range of customers and sales.
- As a final consideration it was noticeable in consultation feedback and in some of the EE and Policis findings that regulatory uncertainty may be important in contributing to decisions to exit. In the context of uncertainty the EE report suggests that firms are likely to adopt a 'wait and see' policy in assessing this risk. This is therefore an area where Government and FCA (and indeed industry bodies) can have an effect by helping firms prepare for the changes and correcting any misconceptions firms may have over the FCA's likely approach under the new regime.

Lending to business

129. Two or three industry consultation responses suggested that the Government IA should address the risks to business lending from the transfer. One specific concern was whether non-bank lending to small business would be at significant risk from the transfer due to the increase costs of the FCA and change in approach to regulation.

130. A proportion of business lending falls within the scope of the Consumer Credit Act and Consumer Credit Directive. Partnerships with 3 or fewer partners and unincorporated bodies are within scope if they enter into a credit agreement of £25k or less. The FLA estimates that total business loans outstanding (the stock) within scope of the CCA was £50bn in 2010. Ninety per cent of which is provided by banks leaving £5bn of loans outstanding from non-banks. In comparison total loans outstanding to SMEs by the big four high street banks only is estimated by BIS at £93bn in 2012. So lending by non-banks within scope of the consumer credit market is, at most, about 5% of total lending to SMEs. According to the BIS SME Finance Monitor 15% of micro businesses used leasing/hire purchase in 2012 and 6% used invoice finance.

131. Taking into account the fact that non-bank lenders constitute a small part of the total and given that banks are already regulated by the FCA the impact of the transfer is not expected to be significant in terms of lending to business.

132. In addition feedback from the non-bank sector was not uniform and there was further evidence that participants are adopting a wait and see approach.

133. Government also considers that the potential downside risk here should be understood in the context of the benefits of enhanced protection for the, often very small, business borrowers in scope of the consumer credit regime. Some, albeit historical, poor business lending practice was raised with us during the consultation exercise. Therefore we consider that there is an upside from providing enhanced protection to small firms, in scope of the definition of 'consumer', to reduce the risk that contracted credit agreements drive them into unsustainable levels of debt.

134. Government also has a wider range of activities designed to promote access to finance that should strongly mitigate the risks here. Most notably Government has recently expanded the Funding for Lending Scheme explicitly so that non-bank lenders are in its scope. This provides

greater incentives for mainstream banks to provide finance for non-bank lenders to in turn lend to lend to small and medium-sized businesses.

Lending to high risk consumers

135. Some respondents suggested that lenders may have less appetite to lend to more risky consumers if the FCA regime is interpreted as making this more difficult and/or costly. So some lenders that are providing for the high risk market could exit or reduce their exposure. The EE analysis does suggest this is a possible outcome as high risk consumers may be affected by a reduction of access to credit at the point of sale (see below). Some substitution is likely to occur but those that already have limited choice of credit products will find that more challenging. The picture is far from clear cut however as the analysis indicates that the regime design will drive little market exit of payday lenders, for example.

136. Government also believes that lending to high risk consumers should be viewed in light of the detriment that can arise if poor lending decisions lead to unaffordable debt and associated consumer detriment. Although research evidence suggests that there are a range of drivers of indebtedness e.g. key life events or macro-economic factors, there is evidence that the availability of credit is of itself an important contributory factor, particularly for those on lower incomes[50]. The box below illustrates the issue from an analysis of one debt charity's client data.

Evidence from Step change Debt Charity Client Data
Stepchange provide free debt advice to over 190,000 clients. Their analysis of their client database for 2012 suggests that unsuitable and unaffordable credit is a key contributor to their clients' debt problems. For example:

- Of the £3.6 billion in outstanding debt owed by Stepchange clients in 2012, £2.15 billion is owed by clients with contractual debt repayments that are more than 50 per cent of their net household income.
- Contractual credit repayment liabilities of these clients totalled £134 million in 2012
- Clients with debts that were more than five times their annual net household income owed over £615 million in 2012.
- 31,775 clients had unsecured debts over £30,000, 16 per cent of all the 2012 clients. But their total unsecured debts were £1.9 billion or 53 per cent of all the unsecured debt owed by StepChange Debt Charity clients in 2012.
- In contrast, 93,469 clients owed less than £10,000 in unsecured debt; around 4 8 per cent of all 2012 clients. But these clients owed a total of £420 million, or about 12 per cent of the total unsecured debts of StepChange Debt Charity clients.

137. Therefore it seems reasonable to conclude that rather than simply a downside risk of the transfer there could also be benefits through any restriction of some borrowing to the most overindebted households.

138. Furthermore, mitigating action has been taken to address this risk of limiting access to credit. This includes the design of a proportionate credit regime where secondary credit brokers will be able to apply for limited permission that will reduce their likely fee and compliance costs and make it less likely that point of sale credit supply decreases. Government is also working to ensure that consumers with debt problems can get help with their debts and seek alternative, more sustainable sources of credit: the Government provides support for debt advice, principally via the Money Advice Service, as well as support to grow the lending of credit unions as a source of sustainable credit for lower income households.

50 http://www.bristol.ac.uk/geography/research/pfrc/news/pfrc1301.pdf

139. The Government supports efforts to improve consumers' understanding of financial issues. This is crucial to promoting a culture of financial responsibility, and empowering consumers to ensure they are fully equipped to engage with the market. Debt advice is provided free by a number of charities, consumer groups and user groups. The Government announced in July 2011 that the Money Advice Service (MAS) would take over coordination and funding of all free debt advice from April 2012. MAS' debt advice co-ordination role is about working with all stakeholders, including, importantly over-indebted people, to build a better advice sector. In 2012 / 2013, MAS are spending £27m on debt advice provision and aims to help around 150,000 people. The Government has also tasked the Money Advice Service with researching and developing a more effective service which will build on existing good quality provision and reach more people in a more appropriate way, including the additional support needed by vulnerable consumers.

140. The Government has committed to further investment to March 2015 to support the credit union sector to provide financial services, including affordable credit, for up to one million more consumers on lower incomes in a way that will enable credit unions to modernise expand and become financially sustainable, and save low income consumers up to £1 billion in loan interest repayments by March 2019. The Government's aim is to enable credit unions to become more stable over the long term giving low income consumers greater access to reliable, affordable credit, without having to resort to more expensive means, such as home credit or payday lenders, or worse, illegal lenders.

Off shore lending

EEA lenders

141. Firms that provide their services entirely at a distance by electronic means from an EEA Member State under the E-commerce Directive (ECD (2005)) do not need to be authorised in the UK. Such lenders are therefore outside the scope of FCA regulation. This possibility has existed since 2005 and therefore already exists under the CCA. Consultation responses suggested that at the moment all lenders from outside the UK have a UK base and are therefore in scope of the CCA. To the extent that the transfer increases costs to business it may make it more attractive for some more firms to operate outside the UKregulatory perimeter. However, the Government argues that this is not a significant risk because such lenders would still be subject to the many European Directives which regulate business behaviour.

Non-EEA lenders

142. To lend to a UK consumer from outside the EEA, the lender would have to have a base in the UK and therefore be regulated by the FCA. We do not consider this a significant risk.

Illegal Money Lending

143. A small number of consultation responses suggested that a fall in credit volumes and/or an increase in risk aversion on the part of some lenders may change firms' appetite to serve certain customers where it was no longer profitable to do so. It is also suggested that these consumers, where their ability to substitute in other products is perhaps already limited, may resort to firms that are operating outside of the law.

144. The Europe Economics study recognises that any cost change does have the potential to generate negative outcomes for particular individuals but goes on to conclude that there does not seem to be a case that any structural detriment can be attributed to the move to the new regime. Clearly resorting to illegal money lenders is likely to cause severe financial distress and this has long been a concern. There is however a robust approach to clamping down on illegal lending in the new credit regime and wider interventions to help people access alternative, legal sources of credit that will enhance mitigation of this risk.

145. In the regime design there is an important new protection for consumers in that local authority Trading Standards (LATSS) and DETI in Northern Ireland have been given the new role of policing the regulatory boundary with the FCA to take action against illegal loan sharks and other firms operating without authorisation. The FCA will work with these Illegal Money Lending Teams in LATSS to agree a memorandum of understanding to underpin co-ordination of enforcement effort. Furthermore FSMA has been amended to create an offence where authorised persons undertake credit activities that are outside of their permissions.

146. More widely, recent Government intervention, designed to stimulate the development of alternative sources of finance for people on low incomes and ensure access to debt advice, is detailed above, will help to mitigate the impact of this risk on consumers

Wider Impacts

Devolved issues

147. Financial services matters are reserved in Wales, Scotland and Northern Ireland and FSMA applies to the whole of the UK. Consumer credit matters are reserved in Wales and Scotland but consumer credit is a devolved (transferred) matter in Northern Ireland. However, the key consumer credit legislation which is relevant to this consultation (the Consumer Credit Acts 1974 and 2006 and associated regulations) applies to the whole of the UK.

148. The Minister of Enterprise, Trade, and Investment for Northern Ireland agreed that Northern Ireland should be included in the December 2010 consultation with a view to ensuring that Northern Ireland consumers can be consulted on any changes that may impact on their consumer credit legislation. Any new or amended legislation passed will only apply to transferred areas if the consent is given by the appropriate devolved authority.

One in Two Out (OITO)

149. The policy is in scope of OITO. The net total one-off costs for the 3 year interim permission regime and authorisation are approximately £65m-111m (including 3 years of exit costs at £1.8m pa) and the net annual costs (fees + admin + exit cost) for firms of approximately £30m-49m (all costs net of OFT costs). On the mid point this yields an EANCB IN of £32m.

Small to Medium Businesses Assessment

Small to Medium Businesses in the Consumer Credit Market

150. The consumer credit market has a very large number of small firms. Market research for the FCA in 2012 estimated there were around 47,600 active consumer credit licence holders[51] of which 34,800 had turnovers of up to £250k (FCA's definition of a small business) and almost two-thirds (64%) of no more than £50k. Measured by staff numbers, almost half (49%) had fewer than five employees, and a similar proportion (47%) had one or fewer full-time equivalent staff involved specifically in the activities covered by their consumer credit licence. These firms are also reasonably evenly distributed across the full range of consumer credit activities.

Cost Impacts of the Transfer

[51] http://www.fca.org.uk/static/documents/consumer-credit-key-findings.pdf

151. Europe Economics considered small and large firms in all aspects of its analysis. All costs were estimated separately for small and large firms. Both small and large firms should expect higher costs under the new regime but they will be felt in different ways.

152. In terms of one-off costs smaller firms will be more affected by the costs of seeking authorisation whereas large firms are more likely to need to incur costs through enhancing their systems for complaints given the requirement to publish them when they reach a certain number. Both small and large firms will be affected by the need for a retail conduct compliance review. Some large and small firms which are already regulated by the FCA for other financial services activity will face much reduced compliance costs.

153. The FCA is currently preparing a consultation document on their fees proposals that will be issued in October. It is likely that they will propose variable annual fees for firms that require full authorisation. These are likely to be set at thresholds related to the firm's consumer credit turnover. For firms with limited permissions there will be a separate lower fee scale.

154. The impact of on-going costs will also be felt slightly differently, with smaller firms affected more by on-going reporting requirements (whether authorised or appointed representative) and large firms will be more affected by the cost of collating and publishing complaints data and the costs to debt management firms of increasing the capital they hold to meet the proposed prudential standards for debt management firms.

155. Overall the Europe Economics' analysis estimates a market exit of 8% as a result of the transfer. Smaller firms are expected to be over-represented in this figure although some consolidation can be expected in certain sub-sectors e.g. 'Home Credit' and 'Bricks and Mortar' lenders. See the section starting at paragraph 106 above for a further discussion on exit.

Consumer Detriment in the Credit Market

156. Considerations of the options for small business exemptions in the consumer credit market have to be seen in the context of the objectives of the transfer i.e. a regulatory regime that ensures consumers are protected while applying proportionate burdens on firms.

157. A recent report by the National Audit Office (NAO)[52] identified the main drivers of consumer detriment in the consumer credit market as firm behaviour, market structure and consumer behaviour. The main drivers from firm behaviour were:

- Undue pressure placed on consumers - a particular risk when credit is offered in people's homes

- Providing unaffordable loans - if affordability checks are not through people may be granted a loan they cannot afford to pay

- Payroll structures incentivise staff to sell unsuitable products - where commission is paid for securing specific loan or debt solutions this may lead to people be sold products that are not right for them

- Misleading information provided to consumers - If consumers are given misleading information about a product, they could make poor decisions. The NAO cite advertising for high-cost credit which focuses on accessibility rather than cost which may mislead some consumers.

- One firm acts on behalf of another but not in their best interests

[52] http://www.nao.org.uk/report/office-of-fair-trading-regulating-consumer-credit/

158. It is the Government's view that the risks described above can apply to any size of business and potentially in a wide range of credit activities especially lending, broking and debt management. A review of recent enforcement action by OFT gives a flavour of the range of activities that have given rise to concern and action.[53] It is the Government's view therefore that an exemption by size of business would undermine a key policy objective of the consumer credit transfer and is therefore not appropriate in this instance.

Mitigation

159. As part of the transfer to the FCA regime, firms carrying out consumer credit business will move from being regulated under the CCA to a framework underpinned primarily by FSMA. This will not simply involve applying the existing FSA approach designed for the regulation of banking, insurance and investment products to consumer credit, but rather a bespoke model designed to fit the particularities of the sector. The Government is proposing a tiered and risk-based bespoke approach to authorisation in the consumer credit sector.

160. Key aspects of the tailoring of the regime that will help mitigate the impact on small firms include:

- Not applying minimum capital requirements for consumer credit firms under the FCA regime, except for debt management firms,
- Fees tailored to the credit sector, and differentiated according to size and risk level of the activities undertaken,
- The option for firms to become an appointed representative i.e. a firm which is not authorised itself, but is allowed to carry on certain regulated activities under a contract with an authorised firm (its 'principal'). This is a way for smaller firms to operate without having to shoulder the burden of direct authorisation and regulation. The regime will be available for all credit related activities except for lending and credit referencing services.
- Self-employed agents are individuals who liaise with consumers on behalf of another firm. The current exemption from authorisation will be continued for agents of mail order firms and home credit firms.
- In charging firms for an 'interim permission' a key aspect of the transition to the new regime, the FCA will charge a lower fee for sole traders.
- Currently companies that specialise in finding or tracing individuals are required to hold a consumer credit licence. Under the new regime this requirement will be removed where these Third Party Tracing Agents are not carrying out a financial business.

[53] http://www.oft.gov.uk/OFTwork/credit/enforcement-action/#.UbtOgvn4hsk

List of Annexes

Annex A –Europe Economics cost and exit estimates. Compliance Costs and Firm Behaviour

The following is an excerpt from Europe Economics report to FSA "Transfer of the Consumer Credit Regime: Compliance Costs and Firm Behaviour" [1]

Introduction

In this section we consider the impact of the policies described previously upon each of the segments that we have identified within the consumer credit sector.

For each segment we quantify the incremental compliance cost impacts by proposal and in aggregate, and also show separately how these divide between one-off and on-going costs. We describe the underlying assumptions of our analysis, and identify the key cost drivers. We also describe the interaction between these estimates and the assumptions made about firm behaviour, particularly market entry and exit.

Modelling Approach Adopted for each Policy Proposal

This section describes briefly how we have modelled the compliance cost impacts of each policy proposal. Where applicable we differentiate between the top down and bottom up approaches below.

Interim regime

All firms (including those that would opt for appointed representative status) — other than not-for-profit debt advisers — remaining within the market are assumed to pay the interim registration fee (being £350, or a reduced rate of £150 for sole traders).

In contrast to the other administrative tasks that we describe below, there is no evidence available on the likely time duration to deal with the interim permission form, because no one has yet used it. We took as our reference point the least onerous task of those where we had information, i.e. completing an approved person application (0.5 days). The level of information involved in the interim application is expected to be qualitatively different, however we note that most business interactions (including form-filing) with government or regulatory bodies tend to consume more time than anticipated and — more importantly we consider that any extra time here contributes to the pool of time available to firms to consider the new regime and its implications.

We have split the time taken 20:80 between senior management staff and compliance/ finance or IT staff (except in the case of sole traders). This balance is similar to what we have used in previous studies: e.g. in our work on the introduction of FSA-authorisation to general insurance and mortgage intermediaries we assumed that for large firms 10 per cent of the time was from management-level staff, with the balance from compliance or other staff, whereas for very smallest firms as much as 70 per cent of the time was allocated to management.[2]

Full authorisation and limited permission

Firms identified by the FSA as lower risk, such as consumer hire firms and secondary credit brokers, have been assumed to pay a £500 fee for a limited permission, regardless of size. This applied in both the

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1 March 2013 - Europe Economics - http://www.europe-economics.com/publications/europe_economics_final_report_6-3-13.pdf

2 Europe Economics (2002), "The Costs and Benefits of Mortgage and General Insurance Authorisation".

bottom-up and top-down models. In the latter case secondary intermediaries have been modelled as discrete segments. About one third of the non-bank lender and consumer hire category were taken to be lower risk, based upon our interpretation of Critical's population research.

For other firms there are three levels of authorisation fee depending on the sum of their consumer credit related turnover:

- Up to £250k per year: £1,500 (consumer credit related turnover of up to and including £250,000 per annum is the FSA's working definition of a small firm in this context);
- £250k to £5m per year: £5,000; and
- Over £5m per year: £15,000.

In the bottom up model, these fees were allocated based upon the firm's reported level of consumer credit revenue. Where a variation of permission was applicable — because the firm self-identified as being already FSA-authorised — these fee levels were halved.

In the top down model we used our estimates of the distribution of the population to assess the proportion of firms expected to be in each of these categories and used that as the basis of the calculation. The proportion of each segment, between 0 and 100 per cent, taken to be already FSA authorised so that a variation in permission would be relevant, was based upon our analysis of the Critical research and other sources (see Section 8).

Our analysis of the data generated in the Policis survey indicated 1–2 days as being the typical time spent on preparing the OFT's licence application. The reference point for the administrative aspects of authorisation was also taken from responses to the survey run by Policis, albeit in case using data only from those firms with actual experience of being supervised by the FSA, being an average of 3–4 days in total. The incremental administrative cost assumed in both models for preparing the authorisation pack was therefore taken as two days. The administration around a variation of permission has been taken as half this level, which was again in line with the data gathered by Policis.[3] In the "bottom up" version we also considered whether a business plan, or additional supporting materials, might be required by the FCA which would complicate the authorisation process. This additional cost was incurred where a firm had consumer credit turnover above £10 million per annum, but had identified its business planning as incomplete or limited (which was in fact rare in the Policis sample).

The annual fee was taken to be £1000, subject to a variable element applicable to firms above a certain size threshold. The latter was calculated as 0.02 per cent of the firm's stated consumer credit turnover (i.e. firms with consumer credit turnover up to and including £5 million per annum would pay £1000; those with turnover above this level would pay more). The administrative side of paying the annual fee was taken to be equivalent to annual average time spent relating to renewing the OFT licence.

Approved persons

The responses to the quantitative survey identified the number of senior management in each firm and also how many of these — if any — were already approved persons by the FSA.[4] The net of these has been taken as the number of senior managers requiring approval under the new regime. To these were added an individual to take responsibility for the oversight of anti-money laundering activity or of compliance where that has been built-in as a requirement of the new regime (see Section 3).

[3] There is no doubt that some firms will take significantly longer on this, particularly larger, more complex firms. Then again, smaller, less complex firms — of which there are significantly more — are likely to spend rather less.

[4] A substantial minority of firms actively using an OFT licence are also registered with the FSA with respect to another part of their business, such as variously mortgage lending, insurance intermediation, etc. These firms are modelled as having a slight advantage in adapting to the new regime over those firms without such experience of the FSA.

This approach has been over-ridden in the case of secondary credit brokers where a single person only will be required to take responsibility for apportionment and oversight.

In consideration of the time taken to obtain the approval we have used the research data as our reference point, specifically the estimates from firms that are already FSA authorised (i.e. we have not relied upon estimates from those without experience of the processes involved). These estimates averaged about 0.5 days per approval. This is slightly above past estimates. The time has been allocated 80 per cent to compliance (or finance staff where no compliance staff were in situ), with the balance allocated to senior management.

In the top down approach we drew upon earlier research conducted by Critical, as well as the results from the Policis survey. Those small (below £250,000 consumer credit revenues) and larger lenders (i.e. above this level) without prior experience of the FSA (e.g. those in home credit), and excluding sole traders, were assumed to have two and five persons respectively each requiring pre-approval. The approach in other segments was fundamentally similar except that small and large firms were assumed to have one and two persons respectively each requiring approval.

Sole traders were excluded from this requirement.

Appointed representatives

The Appointed Representative (AR) regime has the potential to lower costs by substituting a principal, with whom the AR has a pre-existing business relationship, for the FCA. A key restriction here is that the qualitative feedback and quantitative survey data indicated very clearly that the firms who might act as principals had little enthusiasm for this and we have therefore kept participation in the AR regime to a relatively low level.

We have assumed that a principal would seek full compensation for its activities in training and bolstering the control environment from ARs (e.g. by adjusting other pricing arrangements between the parties). We have assumed that an AR would, as a minimum receive two days additional training and be subject to external costs of £825 (e.g. to cover additional IT support). In the credit broker segment, where many firms are already ARs in other business areas these estimates were halved to reflect prior knowledge of FSMA-style requirements. These one-off costs of being an AR are below those from authorisation.

In terms of on-going costs, monitoring and continuing support would be necessary: we have estimated these at £750 per annum. This is below the cost of being directly authorised for a small firm, but comparable — even slightly above — the likely cost of a limited permission. A trade-off between the upfront saving and such an on-going additional cost may still mean that the AR regime is economically advantageous for firms with the option of a limited permission. On the other hand, we do not see the AR regime as purely as numbers-based decision by firms: some firms are likely to well prefer dealing only with their already established commercial partners rather with than the FCA. Nevertheless this may change the relative appeal of the appointed representative regime in those areas where limited permission is the comparator (see the discussion of secondary credit brokers in the main document).

High-level standards

The FSA’s intention is to map across conduct standards broadly unchanged. We focus here on the “nuts and bolts” changes that we believe are implied (but consider the likelihood and scale of firms reviewing their retail conduct below, at 0).

On PRIN, we considered the requirements for record-keeping and for adequate risk management to be a potential driver of process change and hence cost. Those firms indicating that they were not fully confident in risk management were considered as requiring additional training. The time duration and likely cost of this was with reference to desk-top research into relevant training vendors.

In terms of record-keeping we distinguished between adequate record-keeping for the OFT regime and what we deemed the qualitative shift in requirement necessary for the FSA/FCA. Firms currently have an obligation to have satisfactory records (not just to satisfy the OFT's needs) so those firms that were not confident in their own record-keeping were deemed examples of non-compliance (i.e. by having inadequate financial records) so that the cost of these becoming adequate should not be reflected in the compliance cost numbers.

However our view is that when firms look ahead to life with the FCA they will readily identify a supervisor that is more pro-active, requires regular reporting and also seeks ad hoc reporting: the effect being that some firms will need to upgrade their systems in order to cope. For example, in the bottom up model, a firm reliant on manually prepared accounts or on external accounts preparation was assumed to acquire a simple financial management system.

On SYSC, the treatment of financial crime oversight was taken as a key cost driver. This has the following elements. First we have data from the survey on whether there is an MLRO or not already in place (we have assumed that firms without an MLRO will need to incur additional training costs). Where there is not one, and the firm is not a sole trader, this can be treated as either a pay-grade difference, e.g. the gap between the cost of a compliance person and, say, a manager (with that uplift reflected as an extra on-going cost) or as a requirement to have training on financial crime (as a one-off cost) to transition someone into that role. We have taken the latter approach. This is not low cost: such training is likely to consume at least two days and may involve external costs of at least £1,000.

Second, where the relevant MLRO is required to be an Approved Person then an extra person has been added to the Approved Persons costing calculations. We have not assumed that those firms currently without a system for reporting suspicious transactions in place would need to acquire one: implicitly this assumes that such firms are broadly coping with the money-laundering regulations now.

In the top down model we assumed that:

- Half of sole traders would require additional investment in financial management or compliance software at a cost per firm of £205. This cost is based on entry–level quotes from vendors of financial management software. This affected about 12 per cent of the firms in the top down model, against about 10 per cent in the bottom up variants.
- Twenty-five per cent of small firms, and five per cent of other firms, would need additional training or other remedial action in terms of financial crime (if there was no prior contact with the FSA) at a one-off cost of £1400. This cost is based upon estimates from vendors of relevant training. About 22 per cent of the firms in the Policis sample required such training.
- Ten per cent of small and five per cent of large firms were assumed to require remedial risk management training (this was about 15 per cent in the Policis sample).

Financial promotions

The market research indicated what processes firms typically adopted with their promotions — e.g. obtaining prior sign-off from a compliance officer or lawyer. For those firms whose current processes were lacking to some degree we assumed a one-off training cost and an incremental time cost attached to each new advert, the latter being applied to each of the declared number of new promotions used. Where it was indicated by a firm that web-based advertising was used we assumed that this was updated weekly by larger firms and monthly by smaller ones. The average time taken to approve an advert was taken as one hour: this was a judgement.

In the top down model data on the number of promotions and firm-level approaches were not available to us. We assumed that those small and large firms without prior contact with the FSA would seek one and two days training respectively to familiarise themselves with the new requirements, and with an on-going time commitment of one day for small firms and five days — on average — for larger ones. At one hour per approval, this can be interpreted as 7–8 adverts per annum for a small firm and 40 for a larger one.

Supervisory reporting

The new regime involves firms reporting data to the FCA, at least once per annum, to support supervisory analysis. In the former case the data set is expected to be readily available for the vast majority of firms (turnover, customer numbers). However in most cases — where more data are required — this may be more onerous, although as we have noted already the contents of the data sets remain undefined.

For these firms we have modelled the following costs:

- Training to adapt the firm's Financial Management system, e.g. to develop new reporting modules to capture the required data.
- GABRIEL (the FSA's reporting engine) training if the firm is not already FSA-authorised. This has been taken as a half-day and is drawn from the results of the quantitative research run by Policis.
- Time-related costs in which actually to file the necessary report, based upon one day. This was reduced to half a day for lower risk firms, which will have a lower key reporting obligation. This is drawn from the results of the quantitative research run by Policis.

Complaints publication

Where complaints exceeded 500 per annum and a firm lacked a system capable of publishing these it was assumed in the first instance publication would be a manually-driven process, with a time cost allocated to each complaint. If complaints exceeded this level it was assumed that an IT system to handle this would be additionally necessary, with one-off and on-going support costs based upon the past experience of market participants with such systems already (an upgrade to publishing was assumed to cost £15,000 where a reporting system was already in place). Those firms with a system already in place able to publish complaints were assumed to suffer no additional costs.

In the top down model we assumed that one per cent of firms would be affected and that each of these would incur one-off costs of over £1,000 and on-going costs a little below that (these estimates are based on the FSA's own experience, as set out in CP 09/21).

Prudential standards for debt management firms

We have based our calculations on a proposal whereby the capital requirement would be equal to 2.5 per cent of turnover, subject to a minimum of £5,000, to the currently available capital and identified any shortfall firm by firm.

In our top down approach we have taken four per cent as a likely cost of raising such capital, which would cover legal fees and any fees charged by external share-holders as well as any internal administrative costs of actually raising the capital.[5] It can be argued that — given the extent of the advance notice in the prudential regime, and the likely small scale of the additional capital required in most cases — that many firms will seek to adjust capital levels through profit retention and so avoid these external costs of raising capital. To this extent our estimates can be viewed as conservative (although increasing profit retention can be argued to increase a firm's cost of capital). In our bottom up model we were able to match the requirement to the individual balance sheets of the firms responding to the survey, with three from 12 needed to raise additional funds based on this work, with one needing to raise a substantial sum (about £1m). The costs of raising capital were calculated with reference to the sums being raised and the disclosure within the survey as to shareholder composition (e.g. whether the firm was quoted, an unlisted PLC, etc.)

We were also provided with financial reporting data on a larger sample of debt management firms by the FSA. This included 35 firms with turnover and net assets data to enable a calculation of the capital requirement. We compare the outcomes of these different approaches in the main document.

There is an important distinction between the one-off cash costs associated with raising additional capital and the on-going opportunity cost of holding that additional capital on the firm's balance sheet. With respect to the latter we estimated the cost of capital — specifically the cost of equity capital — for quoted debt management firms within a CAPM framework. The sample available for this work was extremely small — there are currently just two quoted debt management firms (two more de-listed in the recent past). The results indicated a cost of 4.5–6 per cent. These are post-tax figures, with the equivalent pre-tax return being about 5.9–7.9 per cent.[6] We have assumed that this extra capital would be invested, e.g. in government bonds, and, after deducting the returns on this, our estimated on-going cost of holing any additional capital raised to meet the initial shortfall is 4.4–6.1 per cent. We used the mid-point of this range, about 5.25 per cent.

We note that this money can still be used in the business such that additional profits may be available on such capital. On the other hand, bearing in mind that these firms have not seen fit to inject such capital already, we must assume that such opportunities are limited or else the firms prefer alternative ways of accessing them.

In the top down model we assumed that 80 per cent of small firms would need the minimum value and that half of the full sum of the capital required by larger firms would need to be raised. These are highly conservative assumptions. On the other hand we have not made any adjustment for any on-going need to raise additional capital each year, e.g. because the debt management is growing).

Client asset requirements for debt management firms

Again, this policy relates only to the debt management segment — indeed to just the largest firms (in terms of client assets held) within that segment.

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[5] For instance Hennessey (2007) estimated a marginal cost of fund-raising of 5-11 per cent for quoted firms and Kaserer (2008) estimated 9-12 per cent for UK-based firms. Since firms raising extra capital from retained profits will not incur any cash costs. Four per cent can be seen as a blended rate (if you like, 40 per cent of funds raised are from external shareholders at 10%, the rest is from retained profits).

[6] Whilst the sample is very small, this is in fact close to the long-run range of stock market return data.

One practical problem here is that the threshold for this has yet to be set. From October 2011 £1 million in client assets has been the threshold for treatment as a medium-sized firm under CASS and we have adopted this as the threshold in this case: where a firm has indicated that it held over £1 million in client assets at least at one moment in time during the past twelve months we have assumed that the client asset requirements would apply to them.

The Policis research indicated what each firm currently did (e.g. whether it used annual external audits). This was used to model whatever remedial strategies would be required to become complaint with the new regime. The costs of these, such as a new IT system, were based upon evidence from those firms with such a system already in place. Where processes changed additional training was also assumed to be necessary. On the other hand where a firm was already — by its own estimation at least — compliant with the requirements of the new regime no incremental costs were calculated.

In the top down model we assumed that around ten large firms would require one-off and on-going expenditure both in excess of £30,000 in order to comply. These estimates are drawn from the FSA's CP12/20, considering client money rules and their impact on insurance intermediaries.

Retail conduct review costs

We have reviewed in the main document some of the issues around the transfer in regime from the OFT to the FCA.

The calculation of the cost of the conduct review has two parts: a *de minimis* period in days and a variable component linked to the estimated number of customers. Once combined these provide estimates that reflect the restricted nature of the review (i.e. no need to re-paper existing contracts and no major system changes because the conduct rules are remaining broadly the same — as described in the main document — such that implied change may be arguably classified as due to current non-compliance with those conduct rules).

Provided that the FCA will be concerned only with the application of the new regime to post-transfer contracts, then it can be argued that there is no obligation on firms to do anything about the pre-transfer paperwork (assuming that client contact in the normal course of business is enough to deal with rolling contracts). If participants believed there to be any ambiguity here or some residual exposure to FCA action then they might re-paper at least some pre-existing contracts: this could be expensive. This contingent cost might result in a level of cost attributable to this area several times that represented here. For example, the banks' stated experience with the CCA can be used for comparative purposes. Taking the numbers provided to us (£5-£10m per large bank) at face value and noting that the largest banks have 5 million to maybe 12 million contracts (some customers will have multiple contracts) implies a cost per customer of 40 pence up to £2, depending on how you slice it. This level of cost incorporated re-papering and also system and process change, however: given the intention of not changing conduct requirements, then even with such ambiguity this level of costs should not be fully replicated for re-papering alone.

Clear — and early — guidance from the FCA on the details of the policy framework would help keep such costs down, e.g. identifying where the CCA will still apply, etc. Limited permission firms will only have a fraction of the FSA rule book to assess and think about, but in most cases these will have little or no prior exposure to it: therefore the more pointers that the FSA/FCA can provide to what firms need to look at (or indeed, avoid looking at) the better in order to reduce any regulatory culture-shock. Equally, more guidance in user-friendly language will be valuable.

EXIT ANALYSIS: Approach to Modelling Firm Behaviour

We describe here how we have approached the modelling of firm behaviour, and the analytical framework within which that model has been constructed. The modelling uses the data on revenue, costs etc collected in the survey of firms.

Direct Impact of Compliance Costs for Existing Suppliers

We take profitability to be the baseline criterion that drives business decisions. When faced with multiple possibilities, firms will choose the option that would lead to the highest profits.

In their simplest form, profits equal revenue minus costs. Firms' decisions typically affect outcomes in multiple time periods. In that case, firms must consider the present value of the profits of all future periods, discounted by the appropriate factor (i.e. their cost of capital). In addition, firms have often multiple revenue streams. When firms engage in various activities, the total revenue is the sum of revenues from each separate product or service.

To conduct this analysis and construct our model for the behavioural analysis, we have made some simplifying assumptions. Specifically we have assumed that:

- If in profit the firm would not exit the market (even if could earn greater return on investment elsewhere).
- If making a loss and in the long-term and the business cannot be made profitable, the firm will always exit the market.

We focus here on the impacts of the completed shift to the FSMA regime. However, there will be a transitional period, between April 2014 when the OFT closes and April 2016 when the FCA will be ready to introduce its full new consumer credit regime.[7] Firms will be likely to incur different costs during the transition period and after the transition period.

Revenue

Revenue for a specific product is equal to the price times the volume of sales. The price that a firm can charge depends largely on consumers' willingness to pay and the prices of competitors and substitutes. In a perfectly competitive market, firms would have no power to influence the market price. Most real world markets, however, allow firms some degree of discretion to choose their prices. The second element that determines revenue is the volume of sales.

Firms can operate in more than one business, resulting in multiple revenue streams. For example, retailers might not only receive revenue from mark-up on prices, but also from the financial services or intermediation they offer their customers.

Costs

For economic decision purposes, costs consist of accounting (or out-of-pocket) costs plus opportunity costs. The latter are defined as foregone revenue of using resources in alternative activities and include

[7] Proposals for this are currently still being developed but are expected to include the following features:
- Firms with OFT licences will be given interim permissions to continue doing consumer credit activities until they obtain FCA authorisation (or a variation of permission if they are already FCA authorised) or become appointed representatives of authorised firms;
- Any prudential and reporting requirements will then come into effect; and
- During the transitional period firms will be required to comply with the new conduct standards but supervision is likely to be less intense than it will be when the full regime comes into effect from 2016 onwards.

the cost of capital (even if it is owned by the firm) and the wage of the owners, if the firm is owner-managed.

In the short-run, costs are classified into fixed and variable costs. Variable costs are the ones that depend directly on the volume of output and can be avoided if the firm decides to cease operations. Fixed costs, on the other hand, have to be incurred independently of the level of output. Examples of fixed costs include property taxes and insurance payments. These costs are sometimes referred to as overhead costs.

When a new regime is introduced, firms will typically bear incremental costs. These additional costs can also be classified into one-off and on-going costs. It is important to understand how these costs map into fixed and variable costs. While one-off costs are fixed costs, on-going costs can be either fixed or variable, depending on whether their amount varies with output. For example, renewing a license every period would be an on-going fixed cost. On the other hand, training new employees in regulatory compliance could be considered an on-going variable cost, as the number of new employees would depend on the volume of sales. Such variable costs also have greater scope to be absorbed into "business as usual" costs.

Acquiring new customers

If markets were perfectly competitive and consumers had perfect information, firms could rely exclusively on the price to influence the total volume of sales of a particular. However, typically both firms and consumers must incur search costs to complete a transaction. In particular, firms use advertising and intermediaries to secure new customers. The extent to which firms use such methods depends on factors such as the profitability of a particular segment and/or the amount and quality of information available to consumers in the market. When market conditions change, the incentives for acquiring this type of information could be affected.

Risk

In the presence of uncertainty, firms must rely on their assessment of their expected profits. Firms consider various possible scenarios and estimate their profits in each of them. The expected profit incorporates these estimations together with the probability of each scenario.

The extent to which firms are willing to trade off profits for reduced levels of risk will depend on their risk aversion. A firm that is risk averse will prefer not to have large variability across scenarios. Consequently, firms might be willing to reduce their expected return in exchange for lower risk.

In corporate finance theory all agents are framed as risk averse. However, the risk appetite of an organisation can vary depending on its ownership and debt structure. A 100 per cent debt financed firm will have a lower risk appetite than a firm with 100 per cent equity debt.

This is because a 100 per cent debt-funded organisation will be disciplined only by its lenders (as opposed to shareholders). Lenders want to be repaid. So the lender's concern is to minimize downside risk – there is no upside risk for a lender. By contrast, an organisation with equity will have shareholders that experience upside as well as downside risk. Such shareholders will want to maximise enterprise value, which includes upside risk. The consequence is that the organisation will have a higher risk appetite if it has shareholders.[8]

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8 This is purely from the capital structure risk management side, ignoring the cost management side for now.

Scenario 1: Costs have increased, but can be passed on to consumers

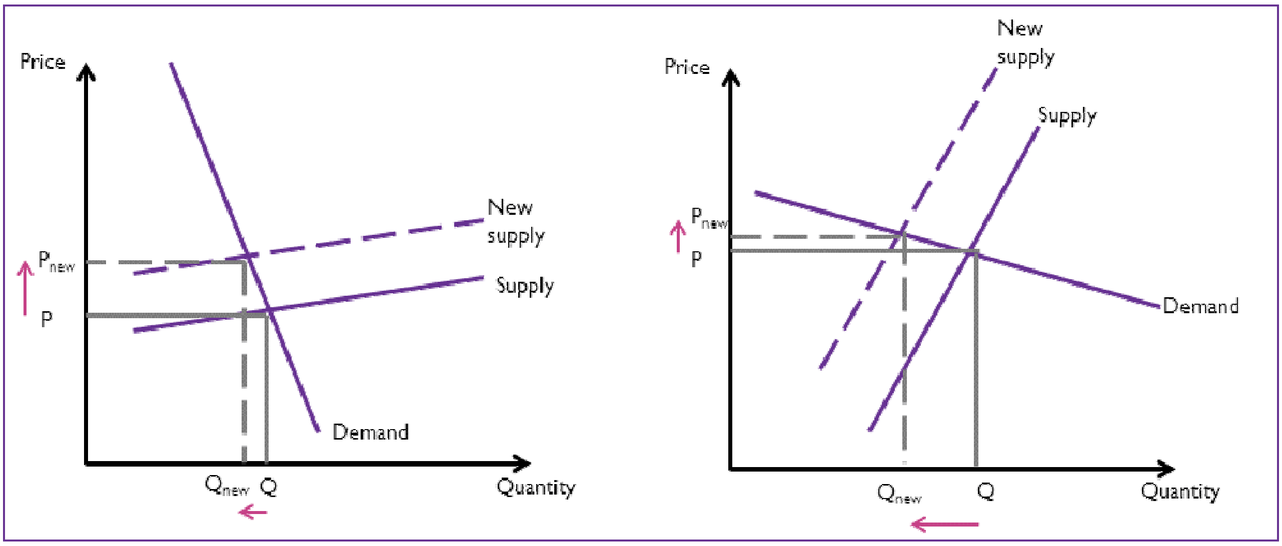
In the event that the change in the regulatory regime would imply increase compliance costs the first question to ask would be whether or not such costs could be passed on to consumers. This will determine the impact on the firm's profitability.

In a competitive market firms can only charge the customer the marginal cost of providing the service. To the extent that the additional compliance costs represent fixed cost (e.g. authorisation fee) these would not be passed on to consumers but borne by the supplier. Where the compliance cost represents a variable cost (e.g. reporting of individual agreements) we would assume that this would be passed on to consumers.

In competitive markets, the pass-through rate is determined by the relative price sensitivity of consumers and firms. If consumers are very price sensitive (relative to firms), it would not be possible to increase prices without a significant drop in demand. Therefore, in the short term at least, firms are likely to pass-through a lower proportion of any increase in the cost, rather they would reduce the supply of credit. In the opposite case, when the firm's supply is more sensitive to changes in price than consumer demand is to changes in price, the firm would be less able to continue supplying the market if they absorb a large fraction of costs and therefore, the pass-through would be greater and the reduction in supply smaller.[9]

The charts below offer a simple illustration of these dynamics. In the left hand diagram demand is less sensitive to changes in price than supply; consequently the reduction in supply (Q to Q_{new}) is comparatively less than the increase in price (P to P_{new}). Conversely in the right hand diagram consumer demand is relatively more sensitive to changes in price than the supply of credit, as such the reduction in supply (Q to Q_{new}) is larger than the price increase (P to P_{new}).

Figure 7.1: Extent of Pass-Through with Different Degrees of Price Sensitivity



Source: Europe Economics

The rate of pass through would also be affected by the persistence of any cost increase. The less persistent the increase in marginal cost is expected to be the lower the pass-through rate will be to consumers.[10]

9 To note we have assumed here that markets are competitive, and as such inelastic demand matched with perfectly elastic supply would result in 100 per cent pass through. In contrast, a monopoly would only pass through 50 per cent of the cost increase. See for example Donghun Kim and Ronald W. Cotterill (2008), "Cost Pass-Through in Differentiated Product Markets: The Case of U.S. Processed Cheese", *The Journal of Industrial Economics*, Vol. 56, No. 1, pp. 32-48, March 2008.

10 See for example John Taylor (2000), "Low inflation, pass-through, and the pricing power of firms", *European Economic Review*, 44 (2000), 1389-1408

Where the firm is able to pass cost increases on to consumers this would represent a change in its strategy. Where the cost increases are temporary and consumer demand is thought to be relatively sensitive to price changes compared to supply, we would not expect the firms' pricing strategy to change dramatically.

In contrast, if the cost increases are more permanent in nature and consumer demand is thought to be relatively insensitive to changes in the price of credit, we would expect the pricing strategy of the firm to change. Specifically we would expect prices charged by the firms operating in the market to increase. This would have implications for consumers (Refer to section 4 for a discussion of the impacts on consumers).

Where cost increases cannot be passed on to consumers, we would need to consider whether bearing these additional costs would undermine the firm's profitability.

Scenario 2: Profits have decreased, but are still positive

In the event that any increases in the costs of compliance created by the changes to the regulatory regime cannot be passed on to consumers but do not undermine the firm's profitability, we assume that firms would not, as a direct consequence of this, alter their business strategy.

In order to determine the impact on profitability both the incremental one-off and on-going costs of compliance must be considered. Depending on the nature of the one-off costs these would need to be spread over an appropriate period of time. Current guidance from the UK Government requires that certain types of expenditure are spread over a specified number of years. According to the guidance, staff costs, such as recruitment, training, or external advice, would all be written off immediately. In contrast, for software and capital expenditure (such as new computers and/or premises) the cost is spread over a number of years (between two and five years depending on the nature of the expenditure and the expected life of the capital stock). Since the main sources of one-off compliance costs are likely to be related to staffing and advice and investment in software (which according to the guidelines is written off after two years), we have — for simplicity — applied an amortisation rate of 25 per cent to one-off costs incurred when comparing them with profitability.

Scenario 3: Short run losses as a consequence of one-off costs, but the on-going business is still profitable

When the long run profitability is not threatened, firms might choose to continue operating despite losses in the short run. For example, a one-off investment to set up required compliance systems may cause the firm to incur a loss in the short-term, while relatively small increases in on-going costs do not undermine the continued profitability of the business. This decision is inter-temporal in nature: it would depend how current losses compare to the present value of future benefits. This calculation would be affected primarily by the ability of firms to access capital in the short-run and the cost of doing so.

Firms might decide to stay in a particular market at the expense of short term negative profits for different reasons. In particular, if a firm decides to exit the market, it would incur a loss equivalent to its fixed costs.[11] If the loss in profitability that a firm incurs as a result of the regime change is smaller than its fixed costs, it is still more profitable not to exit.

11 These represent sunk costs – once incurred, sunk costs cannot be recovered. Money invested in sunk costs is effectively lost on exiting the market. As indicated by Friedman: "While the same costs are often both fixed and sunk, they need not always be. Fixed costs are costs you must pay in order to produce anything. One could imagine a case where such costs were fixed but not sunk, either because the necessary equipment could be resold at its purchase price or because the equipment was rented and the rental could be terminated any time the firm decided to stop producing." Here we assume here that all fixed costs are sunk costs.

Scenario 4: Profits become consistently negative

Where the impacts of an increase in cost are permanent and result in negative profits in the long-term, the firm has various options.

Where such losses are not tenable, we consider four possibilities:

- the firms change their strategy
- the firms expand the business, either through growth or merger
- the firms exit the market
- the firms over to grey market

The first point to establish is whether or not the profitability of all product lines/consumer groups served would be affected, or whether only certain revenue streams would become unprofitable.

Change Strategy

If only certain revenue streams are affecting the overall profitability of the business, if the firm can distinguish between these streams, the firm could address any fall in profitability via a change in their business strategy. In particular, firms can offset cost increases by altering their pricing and marketing strategies. For example, if firms are able to price discriminate (i.e. charge different prices depending on the characteristics of the customers), they might be able to adjust prices charged to certain groups to restore the profitability in each of them.

Such strategies would not be feasible if the firms cannot differentiate between the different revenue streams, the losses would run across all revenue streams, and/or the firm cannot distinguish between different consumers (and so would not be able to adopt separate strategies for the unprofitable groups).

Pricing strategies

There are various forms of price discrimination, each of which requires different information to achieve. These are generally referred to as follows:

- First degree price discrimination — charging each consumer their willingness to pay;
- Second degree price discrimination — offering discounts for different quantities demanded; and
- Third degree price discrimination — charging different prices to different types of consumers.

The more common forms of price discrimination relate to quantity discounts (i.e. reduced prices for bulk purchasing) and charging different prices for different types of consumers (e.g. elderly, businesses, etc.). In order to price discriminate in this way it is important that the firm can distinguish between the relative price sensitivity of different groups. For example, to be able to price discriminate effectively a firm needs to have sufficient information on its customers or be able to structure their products in such a way that consumers are self-selecting, that is they select themselves the products most suited to their own willingness to pay.

In the consumer credit market access to customers’ credit ratings and income can facilitate this type of pricing strategy, similarly setting credit agreements of different lengths and with different penalty structures can allow self-selection by consumers. It is likely that pricing strategies would be easier in certain segments than others, for example credit rating information may allow price discrimination in the credit card or store-card segment, while the scope for such pricing strategies would be less feasible in pawn.

If price discrimination is not possible the firms marketing strategy may become more relevant. For example, firms may choose to focus their business efforts into attracting the customer base that is most valuable while neglecting other market segments.

Marketing strategies

Firms could also alter their marketing strategies. Where the additional costs render the business unprofitable, firms may decide to change the way in which they target consumers, and/or the types of consumers that they target.

Assuming that these firms are profit maximisers, it is not unreasonable to assume that they currently employ the most efficient (or optimal) method of acquiring customers. As such, in the absence in any change in the cost of acquiring consumers via the various methods, we would not expect their behaviour in this respect to change in this context.

However, if the cost of serving certain types of consumers increases more than for others firms may have an incentive to change the types of customers they serve (and thus target). For example, if certain types of customers become disproportionately less profitable, firms may choose to either stop serving them completely, or reduce the supply of credit to those groups in order to free up credit for more profitable customers. Ultimately firms will aim to maximise their expected return.

This may have a knock-on effect for the way in which they acquire customers, if different types of customers are targeted in different ways. The implications for credit intermediaries would need to be considered here.

Expand or Merge

Where such strategies are not feasible firms may attempt to make the business profitable by expanding their operations, including the possibility of merging with other firms. There are typically incentives for expansion/consolidation when economies of scale are present (i.e. when the cost per customer decreases as the volume of sales increases). An increase in fixed costs due to regulatory compliance would be such an example. For instance, if the cost of renewing licenses is independent of the volume of sales, small firms will suffer as they must divide this cost among fewer customers.

Exit

Firms may be willing to bear continued losses if:

- they operate in several markets and are able to cross-subsidise across revenue streams and providing the loss-making service offers some benefit (e.g. allows the company to offer a package of products/act as a one-stop shop); and/or
- the losses are offset by benefits obtained in a complementary activity.

In the absence of such benefits to their business as a whole, and without the scope to change their business strategy or take advantage of any economies of scale, the firm would ultimately exit the market.

Market exit could take a variety of forms. A firm could:

- sell the business on in its entirety;
- sell part of the business; or
- close down the business.

Whichever approach is adopted, the impact on market concentration would be the same unless new firms enter the market.

Model for Assessing Impact

Based on these dynamics and the factors underpinning business decisions we have developed a model to determine how a firm may react to an increase in the cost of compliance. In particular the model considers likelihood of:

- No change in the business;
- A change in the business strategy — including the potential for a firm to increase prices and/or reduce supply, to specific customers or across the board, and to change the range of products/services it offers;
- Expansion of the business;
- Consolidation (i.e. merger); and
- Market exit.

To construct this model we have made some simplifying assumptions. Specifically we have assumed that:

- If profits remain non-negative (after accounting for the cost of capital) the firm would not exit the market (even if it could earn greater return on investment elsewhere).
- If profit becomes negative in the long-term and the business cannot be made profitable, the firm will always exit the market.
- Non-SMEs will be able to cover any short-term costs
- That incremental compliance costs represent increases to on-going fixed costs
- If fixed costs increase by more than 10 per cent post regulatory change there will be an economies of scale effect
- If firms can pass through the costs to consumers they will just change their prices, if not they will change the consumers they target but not their prices to those consumers

The outputs of the model have allowed us to assess the impact on:

- competition in market
- prices
- consumers served

Competition in the market

The extent of competition will be determined largely by any change in the concentration of firms operating in the market. In particular the extent of any market exit, and expansion and merger activity will have important implications for the competitive environment. Any reduction in the number of firms and increase in the concentration of the market would potentially reduce the competitive pressure between the firms operating in the market.

Aside from such changes in firm behaviour, any impact on the scope for firms to enter the market and changes in demand side behaviour for different credit products will also be important in determining the competitive dynamics in individual markets. These are considered in Sections 3 and 4 respectively.

Prices

Prices may be affected via two mechanisms:

- a change in the business strategy of the firm; and/or
- a change in the competitive pressure in the industry — a reduction in competitive pressure may be accompanied by a rise in prices.

The extent to which a change in the competitive environment would result in a change in prices would depend not just on the scale of any change in the competitive dynamics, but also any changes in the quality of the service offered.

Consumers served

Any changes in the numbers or types of consumers being served will be driven primarily by any changes in the business strategies of individual firms as well as the extent of any market exit. If firms decide to alter supply to certain consumer groups, and/or the types of firms exiting the market tend to serve particular groups then there may be a shift in the types of consumers served by lenders. (An important part of any overarching analysis of the impacts on consumers, however, would also need to consider the extent and supply of alternatives available to affected consumers.) This feeds into our analysis of the impacts on consumers.

Annex B - Standalone option

Standalone option - Additional costs

Ongoing
Management
Chief Exec £120k
Head of Corp Services £80k
Operation Director £70k
Strategy and Consumer £70k

Board
Chair £125k
Dep Chair £75
6 Board members £25k * 6

Transition
Move staff
£500 * # staff

Back office
Branding, web £500k
IT £2m

Annex C - Consumer Direct Complaints about consumer credit products 2011

	% of all complaints	proportion FCA could tackle
(01) Defective goods	4.1%	0%
(02) Substandard services	33.1%	0%
(03) Credit	1.6%	100%
(04) Prices	3.0%	100%
(05) Delivery/Collection/Repair	0.7%	0%
(06) Cancellation	3.3%	100%
(07) Selling practises	8.7%	100%
(08) Misleading Claims/Omissions	16.8%	100%
(09) Offers of inadequate redress	2.0%	100%
(-1) Unknown	0.0%	NA
(10) Terms and Conditions	1.3%	100%
(11) Problems pursuing a claim	1.6%	100%
(12) Business Practices	23.5%	100%
	100.0%	62%