

# **Regulatory Impact Assessment**

## **1. Title of proposal**

### **The Consumer Credit (Early Settlement) Regulations 2004**

## **2. Purpose and intended effect of measure**

### **(i) The objective**

The aim of the reform is to increase efficiency in the credit market by reducing barriers to competition, and to create a fair and balanced market between lenders and consumers by ensuring costs are reasonable and transparent. In the market for consumer credit, early settlement fees can be used to either discourage borrowers from paying their loan off early, or from switching to a more competitive lender. The reform aims to achieve a fair and balanced outcome between lenders and consumers.

**Devolution:** The changes will apply in the UK.

### **(ii) The background**

The current method of calculating early settlement figures used by many lenders (the Rule of 78) is considered to be unfair – as set out in Chapter 2 of the White Paper. It is to be replaced by an actuarial formula, set out in detail in the accompanying consultation document.

### **(iii) Risk assessment**

As consumers are often unaware of early settlement charges when they sign credit agreements there is a risk that some lenders exploit this information gap by charging low APRs to gain customers but recoup returns through early settlement fees, once consumers are locked into an agreement.

The result of this is a distortion of competition, as APR is cross subsidised by early settlement fees. This increases switching costs, reducing competition by tying consumers to their current supplier.

The Rule of 78 is still widely used when calculating redemption figures for the early settlement of loans. It has been estimated by Datamonitor that around 70% of credit agreements are settled early<sup>1</sup>. A report by Egg plc estimated that consumers were paying hundreds of millions a year above a fair solution:

“UK borrowers will collectively pay £332 million in early repayment penalties as a reward for being financially conscientious.”<sup>2</sup>

## **Options**

### Content of the regulation

**Option 1:** Do nothing and continue using the current Rule of 78.

**Option 2:** Change the regulations to prescribe a fairer method when calculating an early settlement figure for all new agreements. In doing so, under each of the following implementation options we propose to allow lenders to charge a month's interest towards early settlement administrative costs, and to allow them to defer the settlement date by 28 days.

**Option 3:** Get the industry to voluntarily agree to use a fairer method when calculating an early settlement figure.

**Option 4:** Completely remove the early settlement charge.

### Implementation options.

**Option 5:** Apply the new regulations to new loans with immediate effect and, to all existing loans after a two-year transition period.

**Option 6:** Implement the new regulations to both new and existing loans immediately.

**Option 7:** Apply the new regulations to all new loans from April/May 2005. Allow lenders to have a 5 years transition period for early settlement, until May 2010, for longer term loans (those over 10 years term), and keep to a two years transition, until May 2007, for loans under 10 years in term.

There is a small risk with options 2,3,5,6 and 7 that the revised formula used to calculate early settlement fees will not be a true representation of cost. If fees are

---

<sup>1</sup> Datamonitor (Sept and Dec 2002). This figure was supported by two major lenders in their replies to the DTI's Aug-Nov 2002 consultation but disputed by the Consumer Credit Association who estimate that in their doorstep loans sector under 50% early settle. DTI's Sept 2003 MORI research, "Consumer Awareness of Credit Issues", reported that 53% of Personal Loan borrowers were considering settling early.

<sup>2</sup> Redemption Racket, <http://journalist.egg.com/aboutegg/newsreleases/news2003/2003-06-23/2003-06-23.pdf>

set too high then the current situation will persist. However, if the fees are set too low there is a danger that lenders will have to raise APR to compensate. This will lead to a price cross subsidisation whereby those consumers who do not settle early are paying towards the cost of those who do.

#### **4. Benefits**

**Option 1:** None.

**Option 2:** The DTI have estimated that this would result in a direct transfer of £60 million per annum in unfair early settlement charges from lenders to consumers if applied to all unsecured lending.<sup>3</sup> However, in the first few years under this option the benefits will be slightly lower because existing loan holders are excluded. Benefits may also be lower if lenders increase APRs to compensate for the reduction in early settlement costs.

With the removal of excessive early settlement charges we estimate that borrowers will also derive £74 million in benefit because reduced switching costs will allow them to make savings by obtaining cheaper credit elsewhere or paying their loans off early. Again this will be slightly lower in the short to medium term until existing loans expire.

Consumers with existing loans cannot benefit from lower switching costs, and are deterred from borrowing more wisely or paying their loan off early, they are therefore at a relative disadvantage to borrowers taking out new loans.

Competitive lenders will benefit as more confident consumers are ready to take on new loans or switch to more suitable products under the new fairer system. Some lenders have already said that they would relish the new environment believing that their own products are market-leading and will generate much new business to benefit their bottom line. At present early settlement charges act as a barrier to switching and make it harder for competitive lenders to attract consumers.

**Option 3:** This would only deliver benefits to consumers whose lenders chose to adopt the new recommendations. This would typically be lenders who are members of trade associations such as the FLA (who, incidentally, do voluntarily cap extreme Rule of 78 charges currently). However, there are around 100,000 credit license holders and, since the largest trade associations have only several hundred members,<sup>4</sup> the vast majority are not members of any trade association, and would therefore be less likely to adopt the recommended code of practice.

---

<sup>3</sup> Estimated as the difference between the rule of 78 and an actuarially fair premium on the 70% (estimated by Datamonitor) of loans that are settled early.

<sup>4</sup> The FLA have 188 members. The CCTA have 500 members. The CCA have 500 members. The BBA have 295 members. CML have 144 members. Some of these will be duplicates and not all will offer Consumer Credit Act regulated loans.

**Option 4:** All the benefits would accrue to early settling consumers if the lenders made no attempt to retrieve their early settlement costs through higher interest rates or set up fees etc. This is doubtful.

#### Implementation options

**Option 5:** This would deliver the benefits of the new Regulations to those taking out new loans and those with existing loans following a two-year transition period. This should greatly increase the benefit to consumers in the first year of application to existing loans. However, since most loans naturally mature after only a few years,<sup>5</sup> and many others are settled early every year (around 24% p.a. is consistent with an overall figure of 70% never making it to maturity), it will not take long before the loan pool of existing policies has shrunk to a negligible size<sup>6</sup> Under this option consumers are likely to be more willing to switch existing debt into new loans. Any lenders with more attractive competitive products will benefit from such new business.

**Option 6:** Superficially, this would introduce the benefits of Options 2 and 5 immediately but it would be a practical impossibility because of the transition time needed for lenders to make software and accounting system changes for existing loans.

**Option 7:** This would deliver the benefit of the new regulations to those taking out new loans from April/May 2005 and those with loans with duration less than 10 years within two years time. Benefits from loans of duration exceeding 10 years would not benefit from the new regulation until May 2010. This option is included since lenders with hedged loan products will be hit more than others by the new regulations. It is noted that hedged loans tend to be for longer terms.

#### ***Business sectors affected***

The impact would fall on those license holders who are lenders. These businesses provide credit of hundreds of billions (overall debt stands around £954 bn. (February 2004) according to the Bank of England). There would also be benefits to any businesses borrowing using a regulated agreement, though these are relatively small number.

---

<sup>5</sup> FLA's 23/7/3 Press Release estimates that only 4% of loans are for over 5 years. Egg's Redemption Racket report estimates that the average loan has a term of four years and four months (page 4).

<sup>6</sup> e.g. if on average each year 20% of loans mature, and 24% settle early, then after three years only 28% of the original stock would remain. By five years the figure is around 10%.

## ***Issues of equity and fairness***

The current rules stifle competition by increasing switching costs that tie consumers to their existing suppliers. A report by Egg estimates that 65% of borrowers would reconsider moving their debt, or paying it off early, if they knew that a penalty fee would be levied. This inhibits both new entrants and existing lenders from gaining market share through more competitive loans. The current rules favour lenders and our intention is to achieve a better balance between lenders and borrowers, with lenders charging a fair premium for early settlement as opposed to any excessive fees. -

## **5. Costs**

**Option 1:** None

**Option 2:** The transitional costs depend to some extent on the period at which the regulation comes into effect. Costs would be higher under option 6 than under option 5 and 7. Based on information on transitional costs from consultation with industry and assuming a reasonable period of transition we estimate total costs to be in the region of £180 million which consists of staff training, IT system changes, management time and legal costs.

Similarly, initial compliance costs (transfer from lenders to consumers) will be lower than the annual £60 million under options 5 and 7 than under option 6, as firms will not lose revenue on early settlement fees on existing loans.

In addition to the transitional costs it is anticipated that there will be ongoing administration costs to business from dealing with an increased number of early settlements. These are assumed to total nearly £2 million a year. However, under this option they will be slightly lower in the medium-term (£1.5 million) where existing loans are not included.

The transition cost per lender can be reduced substantially by allowing for a suitable lead in time so that the necessary changes can be coordinated within each firm, and perhaps integrated into annual update processes.

**Option 3:** If this option were effective the costs would be 50% of those under option 2, assuming a 50% sign up to the voluntary codes.

**Option 4:** Lenders incur costs from the early settlement of loans. If lenders were to abandon early settlement fees altogether, without recouping the costs elsewhere, they would incur substantial costs expected to total hundreds of millions of pounds.

**Option 5:** Under this option, firms incur a direct transfer cost of £60 million per annum which represents unjustified early settlement charges, but over the two

year transition period the direct transfer is lower because existing loans are excluded. Similarly, some of the additional IT and staff training costs incurred as a result of applying the legislation to existing loans will also be staggered by incorporating changes into forthcoming update/training procedures over the two year transition period, reducing costs somewhat.

**Option 6:** This option would incur a huge cost for lenders as they struggled to cope with new regulations brought in immediately to apply to existing loans with immediate effect as well. Manual systems would need to be introduced before software could be rewritten in the initial year or so and existing loans transferred across; firms would incur far higher management, administrative, and staff training costs as a result. Processes would be less efficient and therefore more costly in the short-term, and business risks would also be higher – reflecting human error and the impact that the immediate introduction of the legislation could have on the company balance sheet.

**Option 7:** Under this option, firms costs are tiered as the introduction of new regulation is phased. Final direct transfer cost will be £60 million per annum which represents unjustified early settlement charges though these costs will not all be incurred initially.

In particular, allowing long term loans (those over 10 years in term) to be excluded from regulation until May 2010 will mean that lenders do not lose out as a result of charging decisions taken prior to the introduction of the new regulations. These charges tend to be particularly significant for loans over 10 years in term that are more likely to be hedged and hence more expensive.

**(ii) Other costs**

None

**(iii) Costs for a typical business**

The one off (transitional) costs included that of IT, staff training relating to the new early settlement fee structure, and management and legal time in designing the new fee policy and internal implementation process. The FLA noted transitional IT costs both in terms of amending systems to calculate the new early settlement charges, and also the cost of running old IT to cover R78 contracts until they all expire or are replaced by the new regime following a two year transition period.

The British Bankers' Assoc. reported one member as estimating amended IT as costing £300,000. A further consultation response suggested that average one-off IT systems installation will cost around £120,000. Assuming a reasonable transition period and based on additional information gained through the responses from industry consultation we estimate that IT transition costs are likely to total approximately £160m.

One off costs associated with administration e.g. printing new contracts (this cost would be substantially reduced in that it will be introduced alongside the form and content regulations which will necessitate the redrafting and reprinting of agreements and is taken into account in the RIA) were estimated at £60,000 by the FLA. We believe costs can be made negligible by a suitable lead time for introducing changes so allowing businesses, and trade bodies, to reschedule their routine expenditure on updating in these areas. Indeed, the Consumer Credit Association commented that, overall, they felt that administrative costs would amount to £2.4m when account was taken of both their large and SME members and their entire customer base of 3m.

Other transitional costs include costs associated with one off staff training. Again, we believe that costs could be reduced significantly by a suitable lead time for introducing changes so allowing businesses and trade bodies, to reschedule their routine staff training courses to incorporate these areas.

Ongoing administration costs of the new regulation are unlikely to be higher than the costs that lenders currently incur. This view is supported by the findings from one survey where only 11% of lenders expect an increase in the costs they incur. We would expect some administrative cost associated with an increase in the number of customers settling early and assume this to be around £2 million a year once the legislation comes to affect all loans.

## **6. Consultation with small business: the Small Firms' Impact Test**

Liaison has and will continue to be undertaken with the Small Business Service and SME lobby groups such as The Alliance of Independent Retailers and Businesses; The Association of Independent Businesses; The Federation of Small Businesses; The Forum of Private Business; The Independent Food Retailers Confederation and The Union of Independent Companies. They have not raised any particular problems that the possible changes will impact adversely on SMEs.

The Consumer Credit Association have commented that it is unfair that their (mostly SME) members' loans of under one year's term will not benefit from the ability to charge a month's interest on top of the early settlement figure to contribute towards early settlement costs. However, they do not currently defer loans for an immediate 28 days after an early settlement written request (because their clients verbally ask to early settle). Since we will allow all lenders to defer the settlement date by 28 days, Consumer Credit Association members will be

able to do this in future. They could then still action an immediate transaction on request – if both parties wanted – but could merely add the theoretical extra amount onto the settlement amount required on the very day of the request.

The Consumer Credit Association have estimated that there would be new administrative costs of calculating early settlement figures where consumers wanted to roll into a larger loan.<sup>7</sup> They fear that the cost would typically be more than the interest rebate element to be deducted from the outstanding debt. Their members currently only allow customers to roll into a new loan in the last eight weeks. They then use their ability to defer settlement for two months to remove the need to calculate any interest rebate. By reducing this period to 28 days they will have to administer calculations for those rolling into new loans in the final 8-5 weeks. However, we note that some Consumer Credit Association lenders already restrict rolling into new loans to the final 4 weeks because they fear consumers will get into too much debt if they do this beforehand. Such lenders will not be affected by the revised rules.

With regard to any fear that our new rules might limit manoeuvre by consumers in the last 8-5 weeks of their loan, when they confront an emergency, we have been told by the Consumer Credit Association that their market is a very competitive one and many of their customers use three of their members to borrow from. This means that consumers who are not allowed to roll into a new loan could always get another from a rival lender and then use their statutory right to early settle their “unrollable” loan.

Turning to specifics, the Consumer Credit Association have provided their estimate of the new additional administrative costs of calculating early settlement in a figure that also included the policy transfer costs. They have suggested that the latter would account for 4/5th of their £2 million p.a. figure and the administrative costs would account for 1/5th or £400,000. With 500,000 customers for their SME members, we think this is a reasonable price for a fairer system of early settlement.

The Consumer Credit Association have expressed concern about set up costs not being retrieved fully in early settlement. However, since most of their members' loans are early settled by being rolled into new loans this becomes far less of a worry in reality.

## **7. Competition Assessment**

The competition filter was carried out on the market for the provision of consumer credit and our proposal was found to be unlikely to raise competition concerns. The market is characterised by a multitude of lending firms of different

---

<sup>7</sup> CCA report many of their customers habitually confront an urgent need for money in the last few weeks of a loan and will ask to increase their existing loan rather than take on an additional new one. This keeps their weekly payment the same albeit on a very extended time path.

sizes and we do not envisage that the changes will impact disproportionately on any particular firms. Similarly, the changes are unlikely to affect the market structure as costs will be related to the number of accounts a firm has. Whilst we do realise that smaller firms may have slightly higher transitional costs, given the fixed cost nature of IT infrastructure, we do not expect this to be large enough to influence their operations. Indeed, we expect the changes to have a positive effect on competition as new entrants and products are encouraged by the new market for them from liberated, and better informed, switching consumers.

## **8. Enforcement and sanctions**

Enforcement of Regulations made under the Consumer Credit Act is largely a matter for local authority Trading Standard Departments. The Office of Fair Trading also has an enforcement role and a duty to monitor the working of the Act.

The consequence of any lender trying to impose more onerous early settlement terms upon a borrower to a regulated agreement than the legislation permits is that the agreement becomes void.

There will be a non-recurring introductory cost as the OFT, local authorities and Citizens Advice Bureaux train their staff in the new regulations. With such fundamental legislation being changed it is likely that most staff will require some training. The publicity around the time of the changes may also generate an increased demand for advice. With suitable forward planning, the changes can be explained during routine training exercises.

Recurring costs should be capable of being absorbed within existing budgets given over to providing early settlement advisory services.

## **9. Monitoring and review**

Feedback will be obtained – during, but mainly after, a few years of “bedding in” - from Trading Standards, CABs and business over the effectiveness of the new method of calculation and whether avoidance or evasion has been attempted. Corrective measures can then be pursued, if necessary.

## **10. Consultation**

### ***Within government***

Her Majesty's Treasury  
Office of Fair Trading  
Government Actuary's Department

## **Public consultation**

Proposals were subject to 12 weeks public consultation between August and November 2002. The Response/Summary document, including our proposals, was put on the DTI website in July 2003. In December 2003, there was a 14 week consultation which contained a draft statutory instrument. Throughout these periods there have been meetings and on-going communications with lenders, consumer representatives and trade associations to discuss the impact of proposals in more detail. The policy will be implemented by means of secondary legislation which will be laid in June 2004.

## **11. Summary and recommendation**

The proposed changes should make it possible for consumers to settle their loans early without confronting unfair charges that come as a complete shock. This will help minimise the possibility of antagonistic discussions taking place between lenders and borrowers. The abolition of R78 will also end an inequitable method that always favoured the lender.

By prescribing a formula, a level playing field will be created and fairness will be encouraged both amongst lenders and between lenders and consumers. The ability to defer a settlement date for 28 days and to charge a month's interest will be a fair way of compensating lenders. Lenders will also benefit where more confident and empowered consumers prove ready to switch loans to more competitive lenders.

The proposed changes are a proportionate response to the early settlement issues raised in our consultation and take account of the valid concerns raised by the stakeholders, particularly regarding the transition timetable. The benefits should be delivered in proportion to the costs. On this basis, we recommend that option 7 is implemented, please see the cost-benefit table below:

<b>Option</b>	<b>Total cost per annum</b>	<b>Total benefit per annum</b>
1	Nil	Nil
2	<p>Total transitional costs are estimated to be £180 million. This consists of staff training, IT costs, management and legal time.</p> <p>Compliance costs are estimated to total £62 million annually, of which:</p> <p>£60 million in direct transfer to consumers a year, however will be lower in the first few years as existing loans are not covered.</p>	<p>Benefits are expected to total between £125-£130 million, of which:</p> <p>£60 million in direct transfer from lenders to consumers in the long-term, slightly lower for the duration of existing loans.</p> <p>£74 million in reduced credit costs, as consumers are more able to switch lenders to take advantage of better deals. Again, slightly lower for the duration of existing loans which</p>

	£2 million a year in administration costs due to the increased number of early settlements. This is expected to be marginally lower in the first few years as existing loans are not covered.	are excluded under this option.
3	50% of the costs under option 2 are expected owing to the lower sign-up rate to a voluntary code.	At most 50% of the benefits of option 2 could be expected. However, fair competitive lenders will not benefit as much as they would in option 2, as some lenders not signed up to the code would continue to charge excessive early settlement fees preventing consumers switching to cheaper products.
4	Costs would be far higher if lenders are unable to charge for early settlement. However, firms would most likely recoup the costs in higher interest rates or hidden fees elsewhere	Benefits would be low as consumers who do not settle early are paying towards the cost of those who do.
5	Total transitional costs are estimated at £180 million. This consists of staff training, IT costs, management and legal time. <sup>4</sup>  Total compliance costs of £62 million, of which:  £60 million annual transfer to consumers £2 million in increased annual administration costs	Total benefits are estimated at £134 million, of which: £60 million direct transfer from lenders to consumers £74 million in reduced credit costs for consumers.
6	Costs far in excess of option 5 owing to inefficient processes because there is no transition period.	Higher than under option 5 because consumers with existing loans can benefit immediately, though there could be negative effects in terms of errors, delays etc. leading to consumer dissatisfaction.
7	Costs to industry will be lower than under option five as firms are given an increased transitional period and will continue to be able to recoup early settlement charges on loans with terms longer than 10 years, where the hedging costs are	Total benefits are estimated at £134 million, of which: £60 million direct transfer from lenders to consumers £74 million in reduced credit costs for consumers. Given the implementation lag on

	often an important feature, up to 2010.	existing loans these benefits will not all be realised initially
--	---	--

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs

..... Date.....

Gerry Sutcliffe MP, the Parliamentary Under-Secretary of State for Employment Relations, Competition and Consumers, Department of Trade and Industry

**Contact point:** CCP5, Consumer Credit Policy Team.  
Department of Trade and Industry, 1 Victoria Street, London, SW1H  
Tel:02072153818

Consumer.Credit@dti.gsi.gov.uk