The case for an interest rate cap in the UK

A study based on Provident Financial plc

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About the author

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Richard has written on taxation and accounting matters for many years, both within the profession and now as a regular contributor to the Observer.

He campaigned for Oxfam in the 1980s and has been involved in new economics in some way since the first TOES. He now campaigns on international tax reform, pension reform, and monetary reform. He created the economic thinking behind the "People's Pensions" report published by NEF in 2003.

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Summary

This report looks at the financial performance of Provident Financial plc as indicative of the financial performance of the so called "sub-prime" lenders operating in the UK personal loans market . In doing so it seeks to establish whether there is a case for regulatory or other intervention in that market place for the benefit of consumers. The report finds that:

1. Provident Financial plc appears to have charged average APRs on its loan of in excess of 200% over a period of 6 years and at present charges about 185% APR on such loans.

2. Provident Financial plc appeared to charge an interest rate exclusive of charges of in excess of 100% per annum during this period.

3. Despite a falling trend in its average APR over this period, caused largely by lengthening the life and size of its average loan, Provident Financial plc increased the average revenue it earned for each £1 it advanced from 47.7p to 52.6p over the period 1996 to 2002.

4. Provident Financial plc has managed its affairs to appear to be a normal provider of loan finance for the purposes of stock market review, and that market has capitalised its extraordinary ability to make income of 77% of average loan balances outstanding in a year when compared with 6.9% for Lloyds TSB Group plc, for example. The result is that the market values each of them similarly. This will result in substantial stock market pressure against change in the trading environment in which Provident Financial plc operates.

5. There is evidence that Provident Financial plc might enjoy oligopolistic power within its market place. Such indicators include:

    a. the failure of other companies to enter the market place.

    b. the possible funding inefficiencies within the company suggesting it may not be maximising shareholder value.

    c. the apparent ability of the company to recharge for its operating inefficiencies might suggest a lack of competitive pressure.

    d. the ability of the company to hold its pay rates and to engage a substantial "freelance" workforce on terms that look worthy of investigation by the Inland Revenue for tax and minimum wage reasons suggest significant power within its employment sector.

6. There is evidence that the interest rates charged by this company are excessive when compared to those charged within the mainstream financial market. This suggests there is reason for an interest rate cap.

Having established these positions the report then makes recommendations in two sections. In the first instance it is suggested that:

1. The Department of Trade and Industry should investigate whether there has been market failure in this sector and whether as a result price exploitation of the consumer is taking place, since there appears to be evidence that this might be happening.

2. The Inland Revenue investigate the employment activities of the company with regard to its agents since it appears that these do not accord with current normal perceptions of self employment and that status may be disguising very low levels of pay, albeit that on average they appear to be above national minimum wage levels.

In the second group of recommendations the question of an interest rate cap is considered and it is recommended that:

1. Any cap must be on total finance charges, and not just interest rates.

2. Any change must be introduced over time to prevent market disruption.

3. The introduction of a cap is a necessity because:

    a) There is evidence of excessive pricing in this market.

    b) The company has charged these rates because it has had the opportunity to do so, and without compulsion it will continue to have that opportunity.

    c) The financial markets have welcomed the ability of Provident Financial plc to produce financial results that appear, on profit and loss indicators, to match those of other companies in the sector, albeit that it is clear that on balance sheet ratios it is aberrational. They are likely to resist changes to the business model that creates this result without compulsion.

4. The government must take an active part in solving this problem, and must in particular accept that it has a role to play in assisting cost effective debt recovery in this sector by way of repayment through benefit deduction at source or costs probably cannot be reduced to the level required to make any cap effective.

5. That any finance charge cap must take into account the variations in cost which arise as a result of differences in:

    a) base rates

b) loan amount

c) loan duration

d) repayment method (if collection were required it would have to be paid for).

This suggests that a simple percentage cap may be inappropriate and a formulaic approach may be required. It is recommended that more research be undertaken into the way such a formula should be constructed.

6. That the government should recognise that any new supplier in this market place faces problems of market entry and as such it should provide positive support to market entrants by of:

   a) The provision of capital and revenue grants to those who would wish to enter the market to facilitate their capacity to do so.

   b) The provision of training and expertise to those who wish to provide these services.

   c) The provision of funding for the development of standardised systems, software and hardware that will reduce the transaction costs of those involved in this market place.

   d) The provision of legal and technical support for the preparation of standard loan contracts and costing structures that will provide for fair charging.

   e) Negotiation of favourable direct debit arrangements for settlement of loans from basic bank accounts, including the avoidance of excessive charges in the case of default.

   f) The making of arrangements for access to bulk funding by those operating in this market e.g. through National Savings, so that expertise can be concentrated on the lending arrangements in areas where this is the clearest social issue (which it will not be in all cases).

These recommendations, when combined with a review of the sector as a whole, provide the opportunity for this market to become truly competitive. Since it is only financial markets that ever really have that potential this seems on this occasion to be what is needed to meet the needs of the consumer and to make them realise that what Provident Financial plc have to offer is by no means as good as it seems. That way the problem of excessive charging has best chance of being curtailed.

Methodology

The brief given for this case study was to determine whether there was economic justification for the imposition of a cap on the interest rates that might be charged by lenders active in UK financial markets.

It was decided to use Provident Financial plc as the basis for the case study because:

1. They are the largest of the so called ”sub - prime lenders” in the UK, being those whose activities are primarily identified as:

    a. providing loans for periods of less than one year
    b. handling their transactions largely in cash for the sake of the those consumers who do not use bank facilities and accounts
    c. charging flat fees for their services irrespective of delinquency in payment and other default
    d. being prior identified as charging interest rates reported to be in excess of 100% APR.

2. They are a member of the FTSE 100 group of companies (albeit, only just, in April 2003 ranking 97th in size in the UK in terms of market capitalisation, currently estimated to be £1,480 million).

3. They publish both half year and full year accounts as required by the Stock Exchange and have also published other data, primarily for the benefit of analysts, that allows substantial analysis of their financial performance to be undertaken.

Having made this decision it was also decided to benchmark some aspects of the performance of this company against other participants in the lending market. Those chosen were:

1. Lloyds TSB Group plc, chosen as the largest UK bank

2. Nationwide Building Society, chosen as a mutual organisation

3. First National Group plc, (part of Abbey National plc) chosen for its reputation as a provider of small value, asset based, finance.

The approach to the work was as follows:

1. A financial model capable of calculating reliable APR data on the basis of weekly repayment information was built, as none seemed readily available. The model was based exactly on OFT guidelines. It was tested against published (monthly) data by a range of financial institutions and product financiers and found to be reliable.

2. The financial data of Provident Financial plc for the years ended 31 December 1996 to 31 December 2002 was obtained and summarised, as was the financial data for the half year periods from 30 June 1996 to 30 June 2002 obtained and summarised.

3. Performance data for Provident Financial PLC as published on their web site for the benefit of analysts for similar periods was also extracted and summarised.

4. A substantial analysis of the resulting data took place. The intention was to identify the following:

    a. trends in financial performance

    b. trends in lending

    c. the value of the average loan

    d. average loan repayment periods

    e. average earnings per loan

    f. bad debt ratios, and trends in them

    g. marginal costs of loans

    h. an understanding of the financial dynamic of this company and the way it operated in the market place.

5. Having undertaken this work the results were then compared with those for other institutions to assist understanding.

6. Recommendations were then prepared.

Provident Financial plc

Summaries of the financial analysis used to produce this report are to be found in Appendix 1. As with all financial analysis referred to in this report these figures are:

- based exclusively on data published by the company either in print or on its web site in April and May 2003
- subject to the calculations shown in the appendices
- believed to be correct within normal parameters for error for calculations derived from published financial information using spreadsheets i.e. they are not absolutely accurate to a final decimal place, but are likely to be highly indicative of underlying performance and data assuming the company's own data is reliable.

The summaries show that over the seven year period Provident Financial plc has:

1. Increased turnover by more than 50%.
2. Increased profit by 37%.
3. Increased its asset worth by 45%.
4. Only slightly increased its number of home credit employees.
5. Significantly increased its overall employment due to extension of its insurance activities (the company also having significant activity as an insurance broker, mainly of motor policies, on which it also earns interest from supplying instalment payment options).
6. Has hardly changed the average pay to its employees (including benefits and related employment costs) despite inflation of 15% (RPI) over the period .

Appendix 1 makes clear that this is a company that is successful in the eyes of the market place. It has grown, as conventional wisdom dictates necessary. The reward from that growth has gone to shareholders through growth in profit and net assets. It has not been spent on enhanced rewards for those who participate in the business.

Appendix 2 provides additional data derived from that published by Provident Financial plc for the period. It shows:

1. A 37% increase in the credit issued over the period

2. A 27% increase in the number of agents (who actually issue loans, and then collect debts due and who work on a self employed basis) over the period, which increase is smaller than the increase in the value of business for reasons noted elsewhere in this report

3. A 23% increase in the number of customers over the period, but note that although Provident Financial do not specify this, it seems certain that this data is at a point of time and not over the period as results do not otherwise tally with other known data. This assumption has been reflected in subsequent calculations made.

4. An almost static number of customers per agent.

This analysis appears to support the claims made on Provident Financial's own web site, that its customer base is used as the basis for its marketing through a network of self employed agents who live and work in the same communities that the customers live in. This is one of the cheapest forms of marketing and is clearly contributing to profit growth over the period.

Appendix 3 is a suggestion of what Provident Financial actually spends its money on based, by extrapolation, on published information and reasonable guesswork (where nothing else is available, and which guesswork relates almost entirely to the split between "overhead" and "other" costs). It shows:

1. A business that is always more successful in the second half year than the first (a fact largely explained by the timing of Christmas).

2. Has suffered increasing bad debt charges over the period, starting at 10.6% of income in 1996 and rising to 17.3% on 2002. This failure to control debt recovery is a recurring feature of all reports on Provident Financial plc.

3. Fairly static salary costs.

4. Overhead costs that are also assumed to be fairly static, being equivalent to salaries in broad proportion (this is an estimate – and may be understated, but if it were the consequence would be that rewards to collectors would be less than referred to elsewhere in this report).

5. Modest financing costs. Provident Financial plc funds itself largely out of shareholder reserves, not bulk borrowing. This is unusual in the lending market. It would appear to have reduced shareholder reward as a result when compared to other companies in the financial sector. This does not appear to have attracted adverse comment in the financial press, even though a higher degree of gearing would have been expected if shareholder reward was being maximised.

6. An underlying trend of increasing "other costs", much of which is believed to relate to the cost of collection of debt.

Appendix 4 is an elaboration of the methodology used to calculate the average life of debt over the period, and is calculated by period. Four methods were developed (A, B, C and D) and then averaged to suggest a likely age of date in each period. The resulting averaged information, rounded to the nearest number of weeks, is as follows:

Year	Average length of loan (weeks)
1996	33
1997	33
1998	34
1999	35
2000	37
2001	41
2002	45
Average	36.7

If this data is then used to suggest the likely number of contracts issued in each year, by extrapolation from data on customers at a date to data on customers in a year, these figures are (within reasonable tolerance for error):

Year	Number of contracts issues (thousands)
1996	2,082
1997	2,229
1998	2,291
1999	2,334
2000	2,242
2001	2,057
2002	1,897
Average	2,162

It will be noted that as the average length of a loan has increased the number of loans has fallen. It would seem that there has been a policy of increasing average loan balances and reducing the number of loans, possibly by consolidating multiple loans to one individual, which is known to be a fairly common occurrence. Average loan advances on the basis of this data are:

Year	Average loan advance £
1996	322
1997	329
1998	351
1999	363
2000	394
2001	445
2002	486
Average	384

It would appear that average revenue per loan has been as follows over the period, when rounded to the nearest pound:

Year	Average revenue per loan £
1996	153
1997	157
1998	170
1999	181
2000	204
2001	226
2002	255
Average	193

It is interesting to note that this suggests yield per pound advanced has increased over the period:

Year	Earnings per £1 advanced (pence)
1996	47.7
1997	47.8
1998	48.5
1999	49.9
2000	51.7
2001	50.8
2002	52.6
Average	50.1

The data also suggests that the average weekly repayment has remained relatively static over the period as follows:

Year	Average weekly repayment £
1996	14.40
1997	14.75
1998	15.39
1999	15.63
2000	16.32
2001	16.49
2002	16.56
Average	15.65

Inflation as measured by the RPI over this period was 15%, almost exactly matching the increase in average repayment made. This would suggest that Provident Financial do not charge in accordance with normal market parameters such as interest rates, or costs, but do instead set their repayments in accordance with what they estimate consumers can afford to pay a week, and that charge levels might be a secondary consideration.

APR

Using the financial and debt data generated it was possible to then work out:

1. The average recovery from a contract.

2. The average income from that contract.

3. The average life of that contract.

This then allowed the average APR to be calculated for each year over the period. The model developed for this project was used for that purpose.

A key assumption in undertaking the calculations was that the average payment on the contract was made each week and no defaults occurred.

The resulting average APR for each period was as follows:

Year	Average APR %
1996	257
1997	260
1998	256
1999	257
2000	252
2001	204
2002	185

It is reiterated that this data is indicative and subject to limited amounts of error due to the inevitable interpretations that have to be made when interpreting published financial data. It is however believed likely to be highly indicative of actual average rates charged. In six of the seven years the average APR exceeds 200%. These calculations have been tested on software published by the Office of Fair Trading and have been found to be correct based on the data used.

As an indication of the credibility of this data it is useful to note that in May 2003 an enquiry made to the company for a 55 week loan gave rise to an offer at an APR of 177%. The company admitted that much higher APRs applied to shorter term loans, which were available to established customers. The rate offered on this loan is very similar to the current average rate noted above, and was based on a loan of not considerably dissimilar period.

It is apparent from this table that the impact of lengthening time periods, which always enhances the favourability of APR reporting over relatively short periods, has reduced APR in the final two periods when debt life increased significantly. These findings as to average APR are higher than those that some previous research has suggested likely.

It is reasonable to note that Provident Financial's argument in response to suggestions that they charge high APRs is that they do not just charge interest within their flat fee. They also charge for arranging the loan and for the debt recovery services of having an agent call to collect payment. It is important to note that the Office of Fair Trading do require such charges to be included in the calculation of the APR on a loan. But, the fact that this argument is put forward led to the attempt to identify pure loan data shown in Appendix 6. This data was developed because an unusual trait of Provident Financial's accounts became clear on analysing results between first and second half years (the latter never being published as such, and having been computed by deduction). The following is clear:

Year	Increase in turnover, second half year compared to first £ million	Increase in profit, second half year compared to first £ million
1996	23.5	23.9
1997	22.2	27.0
1998	22.2	21.7
1999	30.4	26.1
2000	32.4	26.3
2001	16.9	27.8
2002	20.3	28.5
Average	24.0	25.9

Surprisingly the increase in turnover in the second half year usually resulted in profit yields which on average where in excess of 100% of turnover. This implied the income stream in question was costless. This could be the case for Provident Financial as:

1. It has no effective costs of borrowing for the home credit business, the funds all being provided by the shareholders.

2. The number of contracts in issue in the second half year is never materially different from the first half year (49% of contracts are on average issued in the first half year and 51% in the second half year), but the value of each in the second half year is on average 38% higher than in the first half year.

3. All the additional revenue was therefore interest; the costs of collection, accounting and so on all being fixed as the volume of transactions is almost constant, only their value having increased. (Note that although it has been suggested above that weekly repayments are remarkably consistent that data is based on annual averages. This smoothes out seasonal cycles which hides the fact second half year repayments must always be greater than first half repayments, so allowing this conclusion).

Having allowed for volume efficiencies these assumptions do appear valid. The consequence is that this marginal business over a 26 week period can give an indication of the actual APR charged by Provident Financial plc on average, cost recharges having effectively been eliminated from consideration.

The process of undertaking this calculation has required a further range of assumptions to be made, especially as contracts are on average for longer than 26 weeks and the income variable is only measured over that period. It must be stressed that the process of "normalising" data to a 26 week period to undertake this calculation could produce distortions which could only be eliminated if more data were available. As a result it must be stressed that any calculation based on them is subject to a higher degree of margin for error than any previous calculation in this report However, using the reasonable estimates that can be generated from available information it appears that over this twenty six week period the average APR in the seven year period under review was 107%. This clearly falls within the range of expected APRs given the range of calculated APRs for average contracts during the period. Even if it is subject to parameters of error or plus and minus 20% (and more seems unlikely) it is suggested that this might be indicative of the APR charged by Provident Financial plc excluding costs.

What is clear is that this rate is extraordinary when compared to the prime personal loan market, whatever the parameters of calculation. This is particularly so as Provident Financial plc is, bad debt risk apart (which risk appears highly predictable), a low risk lender by the other normal criteria of lending risk within this market for the following reasons:

1. **Rate risk.** Provident Financial plc might lend at fixed rate, but its loan terms are short. There is very limited exposure over that period to risk with regarding to fluctuating interest rates. Cover for this risk does not need to be built into its rates.

2. **Status risk.** All loans carry the risk that the borrower might see a change in their status over the term of the loan e.g. someone with what appears to be a secure income loses their job or what appears to be a stable household collapses due to marriage failure. Due to the short term of Provident Financial plc loans this risk is low in their case and as such this factor, which is a substantial cause of risk for other companies in the personal finance market, is largely absent in their case.

On the basis of all this evidence there would appear to be no economic justification for the rate of interest charged by Provident Financial plc.

Inter-company comparisons

The accounts of Provident Financial plc were compared with those for other financial institutions to determine whether they are aberrational in terms of market performance, and therefore indicate the need for regulatory action. It is stressed that in this section of this report the accounts of the whole company are considered, and not just those of the Home Credit division, whose performance has been analysed in previous sections of this report, and some data may appear inconsistent as a result, but this is due to the different bases used.

It is also stressed that the three entities with which the company is compared report under rules with regard to banking institutions, but Provident Financial plc does not. As such some data for Provident Financial has had to be estimated for the sake of comparison.

The following points are apparent on the profit and loss account analysis:

1. The profit ratio of Provident Financial is quite close to that of both Lloyds and Nationwide if their turnover is stated net of interest paid, but with the two “banks” being more profitable that Provident Financial.

2. First National Group plc is much less profitable than Provident Financial on this basis.

3. Bad debt as a proportion of turnover is not as big a problem at Provident Financial as it is at First National, but Lloyds also face serious costs in this respect, and only Nationwide with a figure of 3% has limited risk in this area due to its loan largely being secured on property.

4. Provident Financial and First National have remarkably similar staff cost ratios based on net of interest paid turnover. Those of the “banks” are much higher, but this might in part be attributable to their deposit taking status and the greater complexity of some of their business.

5. Provident Financial administration costs appear low, but they do have aberrational levels of “direct costs” at 38% of turnover net of interest paid. This figure could be commission, and might include bad debt (in which case administration costs would be higher) but this is not clear from the accounting data published. It is also potentially distorted by the insurance business of Provident Financial. The other obvious explanation is that this cost includes collection and other fees paid, which could be categorised as commission as they are paid on a self employed basis, and these are abnormally high, even when compared to First National, who would appear to pay heavy rates of commission to retailers to procure financing business. If bad debt should be in direct costs this could cut commission costs to about the same level as First

National and increase the administration cost ratio to a point mid range in the table.

Whilst other points could be made the clear underlying message is that there is nothing about the profit and loss analysis that makes Provident Financial plc look particularly abnormal in terms of performance. It is producing results that look and feel like those of other financial institutions operating in the domestic credit market, subject to the vagaries of the way in which they work and the security of loan they offer. Given that much corporate analysis focuses upon the profit and loss account (because balance sheet analysis is much more complex) it is clear that the published figures are consistent with a performance the market might expect. It is unsurprising as a result that to an unquestioning investor their performance appears acceptable.

When, however, even limited balance sheet analysis is included (and this is harder to produce because balance sheets are not produced segmentally for types of business) the picture does begin to change:

1. The net investment (after deducting borrowed funds) in loans of Provident Financial is tiny in comparison to the sum invested by the other companies.

2. Provident Financial’s ratio of bad debts to loans is aberrational.

3. Provident Financial’s ratio of income to loans is six times greater than that of the nearest comparison company in this data set.

What is however clear is that it is closest in some ways to Lloyds TSB Group plc, the other directly quoted company in the group. Its market capitalisation ratio to issued capital is not dissimilar, their price / earnings ratios (a key market indicator of perception of value) are very similar and suggest they are perceived in the same light by the market, and their ratios of income to value are accordingly similar. This suggests:

1. The market believes what Provident Financial does is acceptable.

2. The market has over the years capitalised the ability Provident Financial has to make money from a very low loan base.

3. Provident Financial has itself exploited this by primarily using shareholder funds to grow its business rather than by borrowing, as opposed to the other institutions with which it has been compared.

4. There will be substantial financial market pressure to resist any change to the environment in which Provident Financial operates since there is a strong vested interest to resist such change. The company provides what that market wants, and has built its ability to extract high income out of small capital advances into the institutionalised perception of value of this company.

Provident Financial – an active oligopolist?

At this stage it would be possible to consider whether a case had been made for an interest rate cap or not based on the data now available, but this would mean that the chance to look more subjectively at Provident Financial plc within its market place would have been missed.

There is no doubt that Provident Financial plc is the largest company in its market sector. No other provider of short term, fixed price, cash loans has anything like the number of customers that Provident Financial has. But it certainly does have competitors, both within its own sector and from other types of product (e.g. pay day loans, cheque clearing arrangements etc.). It is not, therefore, possible to say that the company has monopolistic power.

It is however possible to speculate as to whether it has oligopolostic power. A number of factors suggest that this might be so:

1. This is a company with strong earnings and positive cash flow and which makes an extraordinary rate of return on loan sums advanced. Despite this other companies of good size and repute have not been attracted into its market, nor been attracted to buy it. The latter is particularly strange since it would appear that a bulk supplier of finance such as a bank could cut the cost of capital used by financing the operation through loans and not shareholder equity, so increasing returns whilst releasing funds for equity return. This suggests there is substantial market reticence to enter this market space, as has perhaps been indicated by the adverse comments made with regard to HSBC plc after it acquired a company operating in a not dissimilar market place in the USA. To put it another way, there appear to be substantial barriers to entry of both an economic and reputation nature for serious companies who might wish to compete with Provident Financial plc which are indicative of it having oligopolostic power within its market.

2. The company behaves as if there are barriers to entry within its market. It has appeared to make almost no attempt to automate the processes it uses. Despite pressure on almost every other banking sector that has led to substantial automation this does not appear to have been a feature of this company's operating behaviour. So, for example, doorstep collectors do not appear to use IT equipment to reduce data capture costs. Nor, despite the withdrawal of most forms of doorstep service, has it changed its practice in this respect. This would suggest it has suffered no price pressure to do so.

3. The company, and financial market appear to have accepted lax financial performance. This is perhaps best indicated by the increase in bad debt ratios in the period under review when no obvious external reason exists to suggest why such ratios should have risen. That they

have suggests a complacency towards this cost on the basis that it can be recovered out of increased prices. The result is that consumers have borne this cost, and this is indicative of oligopolistic power.

4. The company is an oligopolostic employer of a particular type of labour. It is notable that the company pays less in wages than other companies in its market place. It is also notable, as Appendix 5 shows, that on any reasonable analysis the reported claim that collectors earn the national minimum wage can only be supported with a small margin for error by their probable business performance. The business model used in this respect appears to have risk within it that it might be exploitative (these people are paid about national minimum wage, do not enjoy the benefits of employment although they work substantially all their time for one employer to whose operation they are integral and do have costs of compliance e.g. with tax law which might reduce their earnings below acceptable levels if they were to be employees). The model used is old fashioned, out dated in terms of current employment thinking, and it is surprising that the self employed status of collectors is tolerated by the Inland Revenue. The fact that it is should be the subject of investigation and is itself indicative of oligopolostic power. The number of people involved could be a disincentive as well as an incentive to Inland Revenue enquiry. What is clear is that at present this arrangement may be giving the company an unfair competitive advantage generated from the use of poorly paid quasi employees whose employment status is disguised as that of being self employed agents.

5. Whilst there are others in this market place they have no reason to price compete with Provident Financial when it can set price levels for the market place as a whole that guarantee good returns for those who do operate in it. As such prices above those that would appear to be justified by the costs of supply to the market place have been sustained across the market as a whole. This is not indicative of a fair and open market place.

These factors suggest that this company is not operating in a market where the normal rules of competition apply. In that case there must a question as to whether the operations of this company and those of the other companies that also operate within this sector need to be investigated by the Department of Trade and Industry, not so much on the grounds of being usurious but on the basis of:

1. competition policy

2. the existence of structured and uncompetitive pricing

It is recommended that the Department of Trade and Industry initiate such a review.

It is also recommended that the Inland Revenue should enquire into the employment and pay rate policies of this company, both with regard to taxation law and that relating to the minimum wage.

The case for a cap on interest rates

The question of whether an interest rate cap in the UK is appropriate, which is at the core of this report, is a complex one.

The analysis in this report shows that Provident Financial plc charges interest rates that are excessive when compared to those offered to people who enjoy financial inclusion. But, this is not sufficient reason of itself to justify imposition of a cap. There must be clear justification based on consumer protection for such a change.

Recommendation 1 – any cap has to be on total charges, not just interest

There should be no doubt about the fact that such a change will require strong will, and clear drafting of the necessary legislation if it is to be effective. It is vital that if a cap is to be effective it must cover all charges now included in the APR calculation and not just interest. Provident Financial plc would argue that their charges are not just made up of inertest but have at least three elements:

1. interest
2. arrangement fees for setting up the loan
3. collection fees.

There is nothing unusual about the second charge, although the third is definitely only commonly found in the markets which this and similar companies serve.

As a result it must be made clear that any change that is made must relate to the total fees charged for a loan facility, and not just the interest element. In this respect, the finding noted above that this overall charge has risen over the period reviewed by this report despite falls in interest rates is of relevance. Unless this was taken into account then the cap would simply be avoided by increasing one of the other fee elements.

Recommendation 2 – any cap has to be phased in

It is equally clear that if any cap is to be effective then the change process must be one that allows the market to adapt to a changed environment. There can be no doubt that consumer demand does exist for the products offered by Provident Financial plc. If those who now use such facilities were to be denied access to them because the company, and others less influential than it in its market place, were to be forced out of business almost overnight due to the inability of their business model to adapt to a cap within a short time period that would not be of overall benefit. Such a change would simply force many people into the hands of loan sharks, and that is a worse option.

Therefore, any change to be introduced into this market should be phased in over a period of up to five years, during which time any cap on total finance charges would be gradually reduced.

Recommendation 3 – a finance charge cap is needed

Having made background recommendations that are necessary pre-conditions for any cap to be considered, the third recommendation of this report is that such a cap is needed.

There are two key reasons. The first is that there is clear evidence that the market in which Provident Financial plc and its competitors are operating is not competitive in the conventional sense. A short survey of this sort suggests:

1. There is excessive pricing in this market as judged by notional APR calculated on total charges rendered which have exceeded 200% per annum on a regular basis.

2. The interest element of those charges appears to exceed 100% per annum and when compared with the rates available in the prime market for personal loans these rates are excessive to an unacceptable degree.

3. The company has charged these rates because it has had the opportunity to do so.

4. The financial markets have welcomed the ability of Provident Financial plc to produce financial results that appear, on profit and loss indicators, to match those of others in the sector, albeit that it is clear that on balance sheet ratios it is aberrational. They are likely to resist changes to the business model that creates this result without compulsion requiring them to do make such changes.

For these reasons the recommendations made in the previous section of this report with regard to the abuse of potential oligopolistic power by this company are repeated here.

The second reason for considering an interest rate cap is that it is clear that whatever the cost structure of Provident Financial plc, it can appear to charge interest rates of over 100% per annum on marginal lending and this is clearly unacceptable and an obvious indication of exploitation when it can borrow funds at little over base rate. This is clear indication of a need for action.

Recommendation 4 – government involvement in the process of change

What that action should be must be carefully considered, and this paper can only indicate possible changes. It must however be made clear that it is not the purpose of this report to suggest actions that would lead to the demise of Provident Financial plc or any other company. It is the intention to recommend change that exposes them to the consequences of market pressures from which it appears they have been immune to date. And, since that pressure cannot be created by the market itself it must be created by other means.

That pressure is inevitably expressed through pricing, and must have consequential effect upon the business model of Provident Financial plc and other such companies. In this respect it is worth taking another look at how the company makes money at this time, and how this might need to change.

On a topical loan of £486 in 2002 the company did at the calculated rate of 185% APR impose charges of £255 on its average borrower. Comparable charges at various other APRs would be:

APR	Total costs on £486 loan over same period
48%	£89
29%	£57
13%	£27

The various rates tested are:

1. Suggested possible interest rate cap, 48%

2. Typical credit card rate, 29%

3. Credit union rate, 13%

At this time any such level of charge would simply make Provident Financial plc uneconomic. At 48% interest the turnover of the company would fall from £484 million to £169 million based on 2002 results and a loss of about £163 million would have been sustained if a cap at this rate was imposed immediately. To move to an interest rate cap without allowing for change in its business model would therefore simply mean:

1. The loss of over £1 billion of value by pension and life funds (who will own most of the company)

2. The loss of almost 3,000 direct job and 10,000 agent jobs.

These are not desirable outcomes. This supports the view that a transitional period to a finance charge cap is needed.

What would have to happened in any such transitional period would be that:

1. The business model would have to be changed

2. The government would have to be willing not only to impose change but participate in it.

Both points need explanation:

1. As noted already, the current business model of Provident Financial plc appears inefficient. It is very labour intensive at all levels, and especially at the level of personal collection services, which although operated at about national minimum wage still impose enormous costs upon the company, and in turn upon the consumer without any obvious benefit in terms of improved debt collection ratios (indeed, it might even be that the opposite is true).

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2. The existing model appears to be unautomated when there is now ample cheap and simple technology available to substantially reduce the cost of data processing for simple transactions of the type undertaken by the company, even if performed by remote agents. There can be little doubt that this could substantially cut back office costs.

3. The bad debt probelm, which is growing in this company, suggests that radical action is needed to address the issue as it imposes a significant cost on all borrowers whether they are a good or bad credit risk.

The issues of debt recovery and systems development and bad debt are ones that the government should be willing to help tackle if it is serious about the issue of tackling financial exclusion. It is hard to see that the establishment of a fairer market could happen without that help. The reasons are:

1. First of all it has a duty to consider whether the current employment status of "agents" is acceptable in a 21st century tax and benefits system which is heavily biased against the self employed. It appears odd that such a status is accepted at this time since it is contrary to the general pattern of current employment status rulings. A change in this status might provide the necessary stimulus for change within the structure of this market place.

2. Secondly, it has to be recognised that many, if not most, of those who use the services of Provident Financial plc and similar companies are in receipt of benefit payments. All such recipients are now, by necessity, holders of some form of bank account and payment is made by way of credit transfer. In that case it is clear that the government is in these cases able to do what it asks private employers to do in many others, and that is facilitate economic provision of certain facilities by way of adjusting payments made at source through what are in effect payroll adjustments. It is a simple extension of the private-public

partnership concept in the face of social need that the government ensure the availability of repayment facilities for private loans through adjustment of benefit payments at source as a way of enhancing access to affordable credit. If it were to do so then the major cost obstacles to provision of such facilities would be overcome, namely:

a. Automatic recording of transactions
b. Virtual elimination of bad debt
c. Removal of the need for personal collection services without imposing alternative cost (whether of transport to a pay point, or banking) on the borrower.

Naturally, it would be appropriate for the government to seek recompense for providing such a service. Such recompense might come from integrating the Social Fund into part of the new, more affordable, loan arrangements, so enabling reduction or elimination of the cost of this fund (for which repayment at source arrangements of the type envisaged have already been created). Given that the government has used the financial services sector to achieve other social objectives, e.g. stakeholder pensions and basic bank accounts, this arrangement does not appear that different. Given the range of benefits now paid, and the fact that if a person took work most would still enjoy benefit payments at source that can be altered on instruction, this suggestion is not likely to create a “poverty trap” whereby only those on benefit will be offered credit.

Only by making such changes is it possible to imagine that a total finance charges cap could be effective. But with it, such a total cap can be easily envisaged.

If that cap were set at a level such as 48% then the approximate saving in cost to those who use such services from Provident Financial alone might amount to £315 million a year. The remaining income of about £169 million a year to that company should enable it to:

1. Pay agents who would grant loans

2. Account for loan repayments

3. Cover its own cost of capital.

If that were so, this is a fair business model so long as any cap mechanism took viability into account. This report has tested an interest rate cap of 48%, simply because of the historical precedent. But such a figure need not be an absolute. It is clear that within the market space for domestic borrowing smaller sums are advanced at lower rates on occasion, and there is no doubt that any ceiling must not be an absolute but must vary with:

a) Base rates

b) Loan amount

c) Loan duration

d) Repayment method (if collection were required it would have to be paid for)

Recommendation 5 – further work to establish a workable model for a finance charge cap is needed

Work to establish how these might be related has not been undertaken and will be a necessary next step for research. It is likely though that the result will be a formulaic approach to a cap that allows for variation in these cost elements.

Recommendation 6 – the market must be opened to competition

If, as thought likely, it an be shown that this market is oligopolistic, it is not enough to impose a charge cap upon it. Active steps must be taken to encourage the development of the market place. In that case it is vital that government support be given to new institutions that:

1. Lead to direct market pressure on Provident Financial plc and others to transform their performance.

2. Open this market to effective competition.

3. Themselves provide loans to the financially excluded within our society at reasonable cost.

In that case I recommend that active, government sponsored promotion of entry into this market should take place and that promotion should be by way of:

a) The provision of capital and revenue grants to those who would wish to enter the market to facilitate their capacity to do so.

b) The provision of training and expertise to those who wish to provide these services.

c) The provision of funding for the development of standardised systems, software and hardware that will reduce the transaction costs of those involved in this market place.

d) The provision of legal and technical support for the preparation of standard loan contracts and costing structures that will provide for fair charging.

e) Negotiation of favourable direct debit arrangements for settlement of loans from basic bank accounts, including the avoidance of excessive charges in the case of default

f) The making of arrangements for access to bulk funding by those operating in this market e.g. through National Savings, so that expertise can be concentrated on the lending arrangements in areas where this is the clearest social issue (which it will not be in all cases).

These factors, when combined with a review of the sector as a whole and the introduction of finance charge caps, provide the opportunity for this market to become truly competitive. Since it is only financial markets that ever really have that potential this seems on this occasion to be what is needed to meet the need of the consumer and to make them realise that what Provident Financial plc and others have to offer is by no means as good as it seems. That way the problem of excessive charging has best chance of being curtailed.