OXFORD ECONOMIC RESEARCH ASSOCIATES

FLA

REGULATORY IMPACT ASSESSMENT OF PROPOSED CHANGES TO THE CONSUMER CREDIT ACT 1974: SURVEY RESULTS

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Blue Boar Court
Alfred Street
Oxford OX1 4EH
Tel: +44 (0) 1865 253000
Fax: +44 (0) 1865 251172
Email: Enquiries@oxera.co.uk
www.oxera.co.uk

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Executive Summary

OXERA was commissioned by the FLA to undertake a regulatory impact assessment of the Department of Trade and Industry's (DTI) changes to the Consumer Credit Act 1974 (CCA), proposed in its December 2003 White Paper.[1] OXERA undertook a survey among credit providers with the objective of collecting quantitative evidence on the behavioural response of credit providers and the compliance costs they would incur in implementing the proposed changes to the CCA.

The CCA regulates consumer credit and consumer hire agreements for amounts of up to £25,000. Its protections apply to agreements between credit providers and individuals, sole partners, partnerships and unincorporated associations. The CCA lays down rules covering the form and content of agreements; credit advertising; the method for calculating the annual percentage rate of the total charge for credit; the procedures to be adopted in the event of default, termination, or early settlement; and extortionate credit bargains. It also requires that all credit providers that make regulated agreements obtain licences from the Office of Fair Trading (OFT).

This study focuses on the regulatory changes that are most likely to have a significant impact on credit providers and consumers. These include the changes to the extortionate credit provision, rules on early settlement, and financial limits, with particular attention paid to the impact on securitisation. Providers see significant costs resulting from the imposition of retrospective changes to the rules. These include the direct costs of making changes to extant agreements and the indirect cost of increasing the risk of lending, through the increased uncertainty caused by *ex post* regulatory intervention.

The majority of credit providers expect the changes to the rule on early settlement and the retrospective application of new rules on early settlement and unfair lending to have the most significant impact on their firm, followed by changes to the form and content of consumer credit agreements. Credit providers also expect the benefits to consumers from these changes to be limited. More than 65% of the respondents indicated that the proposed changes to the CCA would result in a reduction in availability of credit, particularly for consumers in the non-status segment of the market.[2] Furthermore, more than 50% indicated that the changes would impose a disproportionate burden on small credit providers.

Extortionate credit provision

The CCA reform proposals envisage changes to the current extortionate credit provisions (Sections 137–140 of the CCA). Broadening the scope of the provision of extortionate credit would bring it in line with unfair practices as within the meaning of Section 25(2) of the CCA (which deals with the licensing regime). The main proposal is to replace the existing definition of 'extortionate credit' with a wider test of whether an agreement is an 'unfair credit transaction', and extend the list of factors that the court should take into account to determine unfairness. In particular, the fairness of credit transactions would be assessed not just with respect to price, but also other terms and conditions of the agreement. Moreover, fairness could be assessed at any

[1] DTI (2003), 'Fair, Clear and Competitive—The Consumer Market in the 21st Century', White Paper, December; and DTI (2003), 'Establishing a Transparent Market—Early Settlement, Consumer Credit Advertising, Form and Content of Credit Agreements, APRs on Credit Cards, On-line Agreements', December.

[2] The non-status segment of the market is defined in line with the definition used by OFT (OFT (1997), 'Non-status Borrowing—Guidelines for Lenders and Brokers', November). There are two broad categories of non-status borrower. The first comprises borrowers with an impaired credit rating (eg, because of outstanding county court judgments or arrears). The second comprises borrowers with a low credit rating (eg, because of periods of unemployment or because income through self-employment is irregular or difficult to verify), or those who lack the supporting documentation necessary to obtain a loan.

time during the contractual period, not merely with respect to conditions at the time the agreement was concluded.

The DTI has stated that it aims to tackle loan sharks without changing the incentives of responsible lenders. However, it is not clear whether the proposals are well targeted and proportionate to the problems. The majority of the respondents indicated that the proposals expose the lenders to a significant and unnecessary degree of legal uncertainty that could make the provision of credit more expensive. Almost all (88%) indicated that a further, more specific, definition of 'unfair credit transaction', either in legislation or otherwise fleshed out in guidelines, is required in order to reduce legal uncertainty. If the proposals increase the risk of litigation and undermine lenders' confidence in enforcing a loan, they may result in greater difficulties for higher-risk customers in accessing credit, while the costs for average customers will rise.

Unless the provisions are adequately tightened and targeted, unintended disruption to the market may ensue. Lenders mentioned moving to fixed-rate contracts or restricting lending to non-salaried individuals.

This effect is particularly marked for lenders active in the non-status segment of the market. 58% of respondents expect loans to consumers in the non-status segment to become more risky and 25% indicated they would be less willing to provide credit to consumers in this segment of the market. Some credit providers highlighted that this may result in an unintended effect on these riskier borrowers. As licensed non-status lenders will have to comply with the new rules, which will be likely to increase their costs and restrict their provision of credit, non-status borrowers may be more vulnerable to loan sharks.

Around 22% of the credit providers surveyed currently use securitisations to fund part or all of their loan book. While the direct financial impact on investors in securitisations is probably limited, the proposals could have a significant impact on credit providers' ability to securitise new loan books. The retrospective application of rules introduces regulatory risk and therefore increases a provider's cost of obtaining funding through securitisation.

Financial limits

The CCA currently regulates credit or hire agreements of up to a value of £25,000 made to 'individuals—including a partnership or other unincorporated body of persons not consisting entirely of bodies corporate'. The proposals remove the £25,000 limit for consumer lending that is non-business. The limit is retained for business lending. Business lending that comes within the remit of the CCA is reduced to include only sole traders, small partnerships of up to and including three partners, and other unincorporated bodies.

In terms of the removal of regulation on large partnerships, the majority of the respondents do not expect any significant cost savings. This may be because they will not treat such credit differently once it becomes unregulated.

For the extended coverage of consumer protection, the relative costs and benefits depend, to a certain degree, on the amount of currently unregulated credit. Respondents to the survey indicated that, on average, approximately 1% of their credit agreements (weighted by number of customers) have a value above £25,000. While this seems small, around half of the respondents that provide both regulated and unregulated credit do operate a dual system, to reflect the different obligations due to regulation; the main differences in such treatment were attributed to

voluntary terminations and early-settlement clauses. As a result, it is particularly hire purchase and conditional-sale agreements that will be affected by the change to financial limits.

Under the CCA rules dealing with hire purchase or conditional-sale agreements, consumers have a right to terminate the agreement at any time before the final payment is due ('voluntary termination'). The asset will then be returned to the credit provider—the implication being that the credit provider bears the depreciation costs of the underlying assets. The consumer liability is capped at 50% of the loan. There is no equivalent provision for those who provide finance via personal loans.

Voluntary termination carries a significant cost and increases the risk to finance providers, which is priced into the finance provided. Removal of the financial limit could result in significant costs for hire purchase agreements due to the voluntary-termination clause in the CCA. The proposed change would particularly affect the provision of car finance. It benefits only a small proportion of consumers, but the costs are high and will be borne by all borrowers (through higher interest rates). Some credit providers indicated that they may decide to move away from hire purchase agreements towards personal loans. These potential unintended consequences of removing the financial limit do not appear to have been taken into account in the DTI proposals.

Furthermore, the rules on voluntary termination were introduced to enable those who are in financial difficulty to cancel their credit agreement without having to pay the early settlement sum based on the Rule of 78. Given the fact that the DTI is proposing changing the rules on early settlement in order to create a fairer system across the board, the need for rules on voluntary termination may no longer be relevant.

Early settlement

The DTI's proposals envisage four main changes to the CCA regulations with regard to early settlement:[3]

- to abolish the Rule of 78 in favour of an actuarial approach. The DTI plans to prescribe a calculation formula;
- to allow lenders to recoup their early-settlement administrative costs by claiming one month's interest beyond the settlement date;
- to allow settlement deferral for up to 28 days for all loans;
- to require lenders to provide consumers with pre-contractual information on early settlement.

The impact of the new rules on early settlement depends to some extent on the proportion of agreements that are settled early in general, and the extent to which credit providers currently use the Rule of 78. The survey results indicate that the average proportion of loans that are settled early is around 50% (weighted by number of customers); 50% of respondents use the Rule of 78 for all or almost all (95%) of their regulated loans; 23% for around three-quarters; and 16% for 50% or less of their loan book. The remaining 10% do not use the Rule of 78 at all. Typically, for higher-value loans, credit providers apply the actuarial principles method or the Rule of 78, whichever is the most beneficial to the customer.

Credit providers that currently use the Rule of 78 would incur costs to upgrade their internal systems, re-train staff, reprint standard credit agreements, change accounting practices, etc. The

[3] Proposals are described in the DTI White Paper and in DTI (2002), 'A Consultation Document on the Early Settlement of Credit Agreements under the Consumer Credit Act 1974', August.

survey indicates that most credit providers do not consider these costs to be significant for their firms. The larger credit providers indicates that the transitional implementation costs are likely to be between 0.5% and 1.5% of their annual operating costs. For smaller credit providers, the transitional costs are predicted by respondents not to exceed 2.5% of their annual operating costs. Once established, the ongoing administrative costs of the actuarial approach would be similar to the current arrangements.

The current rules enable credit providers to recover their costs of early settlement from those borrowers that settle early. Some credit providers indicated that they recover at least a significant part of their early-settlement costs in this way, while other costs related to early settlement are recovered through alternative means (eg, interest rates). The proposals tighten the existing regulation by shortening the period over which lenders can claim interest and by reducing the deferral period. The majority of respondents were of the opinion that the proposed one-month interest period after settlement would be too short to cover all costs—ie, the costs of administration, marketing, commissions and hedging. Credit providers indicated that under the new regime, some of the costs of early settlement would be recovered from all borrowers (through an up-front fee or higher interest rate) compared with the current situation, where most costs are directly recovered from only those borrowers who settle early. It could be argued that, by prescribing the use of actuarial principles and only allowing credit providers to charge one month's extra interest, credit products, such as personal loans and hire purchase agreements, become more similar to flexible credit products such as credit cards and overdrafts. The interest rates on personal loans may therefore also become more similar to interest rates on, for example, an overdraft.

The DTI has indicated that its aim is to bring new rules on early settlement into force for new loans from October 31st 2004, and for existing loans two years later—ie, from October 31st 2006. The majority of credit providers indicate that they need more time to implement the new systems, and that a period of at least two years would be appropriate.

Credit providers also expressed considerable concern about applying the new early-settlement rules retrospectively to existing contracts (as from 2006), as this is likely to result in high costs to the credit providers without significant benefits to borrowers. Whereas in the case of new loans, credit providers may be able to recover some of the costs of early settlement through higher interest rates or upfront fees, in the case of existing loans, the possibility for doing so is likely to be limited. In other words, the new rules on early settlement are likely to result in a cost to lenders. For loans that are securitised, these costs will be borne by the investors.

Contents

1. Introduction 1

1.1 Remit and objectives 1
1.2 Methodology and data sources 1
1.3 Structure of the report 3

2. Regulatory Impact Assessment 4

2.1 Overall impact of the proposed changes to the CCA 4
2.2 Disproportionate impact on some credit providers 7
2.3 Section 127(3) 7

3. Extortionate Credit Provision 9

3.1 Proposed changes to the CCA 9
3.2 Credit providers' views on the changes to extortionate credit provision 9
3.3 Impact on lending practices 10
3.4 The principle of responsible lending 12
3.5 Impact on securitisation 13
3.6 Conclusion 13

4 Financial Limits 14

4.1 Proposed changes to the CCA 14
4.2 Economic impact assessment 14

5. Early Settlement 19

5.1 Economic impact assessment 19
5.2 Costs recovered through the Rule of 78 21
5.3 Consumer benefits 23
5.4 Timing of application of proposed changes and 'retrospectivity' 24
5.5 Conclusion on early settlement 24

6. Retrospective Application of Proposed Changes and Impact on Securitisation 25

6.1 New rules on early settlement 25

6.2 New rules on extortionate credit 26

Appendix 1: OXERA/FLA Questionnaire 29

1. Introduction

1.1 Remit and objectives

OXERA was commissioned by the FLA to undertake a regulatory impact assessment of the Department of Trade and Industry's (DTI) changes to the Consumer Credit Act 1974 (CCA), proposed in its December 2003 White Paper.[4]

The CCA regulates consumer credit and consumer hire agreements for amounts of up to £25,000. Its protections apply to agreements between credit providers and individuals, sole partners, partnerships and unincorporated associations. The CCA lays down rules covering the form and content of agreements; credit advertising; the method for calculating the annual percentage rate of the total charge for credit; the procedures to be adopted in the event of default, termination, or early settlement; and extortionate credit bargains. It also requires that all credit providers that make regulated agreements obtain licences from the Office of Fair Trading (OFT).

In July 2001, Melanie Johnson, Consumer Minister, announced plans for a review of the CCA. The DTI has since engaged in an ongoing programme aimed at improving consumer credit regulation. Planned changes on which the DTI has consulted, or is doing so, include:

- protecting consumers more effectively against extortionate credit bargains;
- making provisions for the early settlement of loans clearer and fairer to consumers;
- simplifying credit advertising and making it more focused;
- modifying the form and content of agreements;
- abolishing the financial limit and the exempt agreements, thereby altering the scope of the CCA;
- reforming the licensing regime.

This study focuses on the regulatory changes that are most likely to have a significant impact on credit providers and consumers. These include the changes to the extortionate credit provision, rules on early settlement, and financial limits, and particular attention is paid to the impact on securitisations.

1.2 Methodology and data sources

In general, regulation of market activities may be justified from an economic point of view if the market fails to produce an adequate outcome without regulatory intervention. Potential market failures in the consumer credit market that may justify regulation include the following.

- *Information problems*—uninformed consumers are exposed to the risk of entering credit agreements on terms which they would not consider appropriate if fully informed.

- *Bargaining power*—credit providers may use their strength in the market to influence contractual arrangements at the expense of consumers, and consumers may be unable to bargain for adequate terms of contract.

[4] DTI (2003), 'Fair, Clear and Competitive—The Consumer Market in the 21st Century', White Paper, December; and DTI (2003), 'Establishing a Transparent Market—Early Settlement, Consumer Credit Advertising, Form and Content of Credit Agreements, APRs on Credit Cards, On-line Agreements', December.

- *Coordination problems*—these may occur in relation to consumer confidence and market reputation. There are many credit providers in the market, and the behaviour of one credit provider is likely to affect the confidence of consumers and the reputation of credit providers in the market at large. While a good reputation is of collective interest, individual credit providers may act in their own interest in a manner that fails to take sufficient account of the effect of their actions on other credit providers. Market forces may fail to function properly because the incentives of market participants are not aligned, and actions not coordinated.

If these problems are significant in the consumer credit market, the proposed changes to the CCA may be justified for consumer-protection reasons. However, any regulatory impact assessment must also consider the costs of implementing rules. In particular, regulation can impose costs on credit providers that may be disproportionate to the problems they seek to address. Moreover, regulation may have unintended side effects: it may be poorly designed and exacerbate rather than reduce existing market failures. It may restrict suppliers, thereby reducing choice, raising price, increasing barriers to entry into the market and conferring rents to incumbent firms. These considerations need to be taken into account when evaluating the impact of the proposed changes to the CCA.

Two broad categories of cost can be distinguished: direct compliance costs and behavioural responses of credit providers and consumers.

- *Direct costs*—these consist mainly of compliance costs (ie, the value of extra resources, including time, that would be used by firms and/or individuals to comply with a regulatory proposal). Economic theory suggests that incremental costs should be used—ie, costs that are not part of good business practice, and are not expected to become so. They will reduce the efficient operation of the credit markets, and can be considered a deadweight cost for the credit providers, and therefore, for the economy as a whole. The direct costs will be incurred by credit providers in implementing the new rules on, for example, early settlement, form and content of agreements, and financial limits.

- *Behavioural response of credit suppliers and consumers*—the proposed changes to the CCA contains elements that are likely to change the behaviour and incentives of credit providers and consumers. These changes in behaviour may directly affect the supply and demand for credit, and may also result in higher costs, thereby indirectly affecting the usage of credit. The proposed changes on extortionate credit provision, retrospective application of extortionate credit, and early settlement are likely to affect the behaviour of credit providers and consumers.

1.2.1 Principles of good regulation

The proposed changes to the CCA can be assessed against the principles of good regulation as developed by the Better Regulation Task Force, which identifies robust regulation as:[5]

- *transparent*—open, simple and user-friendly;
- *accountable*—to Ministers and Parliament, and to users and the public;
- *proportionate*—to the risk;
- *consistent*—predictable, so that people know where they stand;
- *targeted*—focused on the problem, with minimal side effects.

[5] Better Regulation Task Force (2003), 'Better Policy Making: A Guide to Regulatory Impact Assessment', January.

The DTI has stated that it aims to follow best practice at all stages of the regulatory process and that it firmly supports the five key principles of good regulation identified above.[6]

1.2.2 Information and data sources

This study is supported by various information sources, including the following:

- *Relevant public-domain documents*—the DTI's consultation documents on the CCA (including the White Paper and various documents published to its publication), and other documents, such as the CCA and a study undertaken by the OFT, were consulted to obtain an understanding of the proposed changes.

- *In-depth industry interviews*—these were largely conducted during the early stages of the study to obtain insight into the impact of the proposed changes to the CCA on the behaviour of credit providers.

- *A survey among credit providers*—OXERA designed a questionnaire for credit providers with the objective of collecting quantitative evidence on the behavioural response of credit providers and the compliance costs they would incur in implementing the proposed changes to the CCA. The questionnaire was sent to all credit providers that are members of the FLA (109 in total). Of these, 42% of the credit providers responded to the questionnaire. This sample of credit providers represents a large part of the credit market covered by the FLA membership. The members who responded represent approximately 51% of consumer credit covered by the FLA membership, around 61% of asset finance[7] covered by the FLA membership, and around 87% of motor finance covered by the FLA membership. Most of FLA members are medium-sized or large credit providers—the majority have a portfolio of at least £20m. The high market coverage means that the questionnaire results present a reliable picture of the consumer credit market covered by FLA membership. A copy of the questionnaire is provided in the Appendix to this report.

1.3 Structure of the report

The report is structured as follows:

- section 2 provides an overview of the overall impact of the proposed changes to the CCA;
- section 3 assesses the impact of the changes to the extortionate credit provision;
- section 4 examines the changes to financial limits;
- section 5 looks at the impact of the changes on early settlement;
- section 6 provides an analysis of the impact of changes to the extortionate credit provision and early-settlement rules on securitisation. Particular attention is paid to the retrospective application, and the impact on credit providers' ability to securitise.

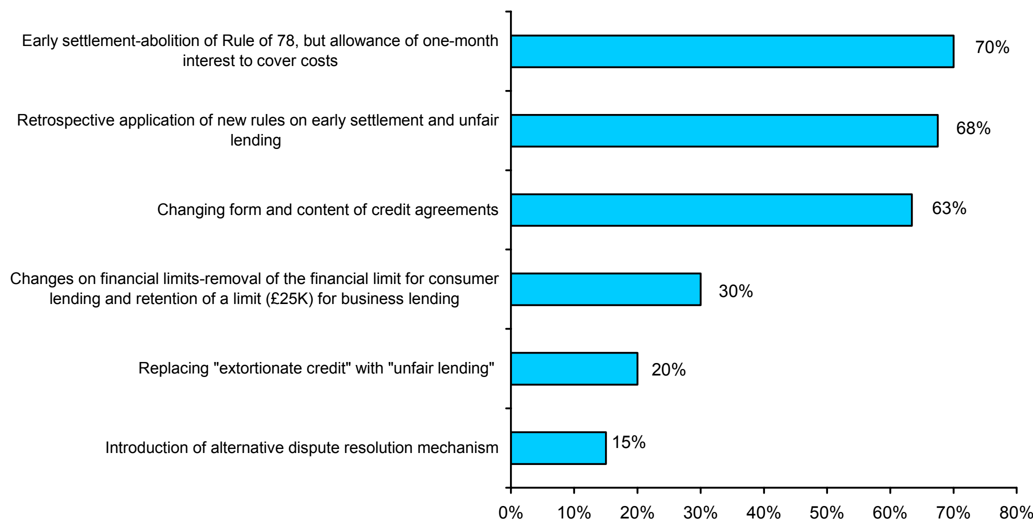
[6] DTI (undated), 'The Framework for Regulatory Risk Assessment in the Department of Trade and Industry'.
[7] This refers to transactions of less than £20m.

2. Regulatory Impact Assessment

2.1 Overall impact of the proposed changes to the CCA

Credit providers were requested to give their views in the questionnaire on what they consider or expect to be the most significant changes to the CCA in terms of impact on their firm. Figure 2.1 shows their responses.

Figure 2.1: Proposed changes that credit providers consider to be significant or very significant in terms of impact on their firm



Note: Credit providers were asked the following question: 'Please indicate the significance of the proposed changes in terms of their impact on your firm on a scale from 1 to 5 (1 = very significant; 5 = no impact at all).'
Source: OXERA/FLA questionnaire, 2003.

The majority of credit providers expect the changes to the rules on early settlement and the retrospective application of new rules on early settlement and unfair lending to have the most significant impact on their firm, followed by changes to the form and content of consumer credit agreements. The following specific issues were raised by the credit providers.

- The majority of the respondents to the questionnaire (65%) were of the opinion that the proposed rules on early settlement would not enable them to cover all the costs that they currently recover when consumers settle early—ie, the costs of administration, marketing, commissions and hedging. This is further explained in section 5.2.

- The DTI has indicated that it aims to bring new rules on early settlement into force for new loans from October 31st 2004. Credit providers interviewed indicated that they require more time to implement the new systems. This is discussed in section 5.4.

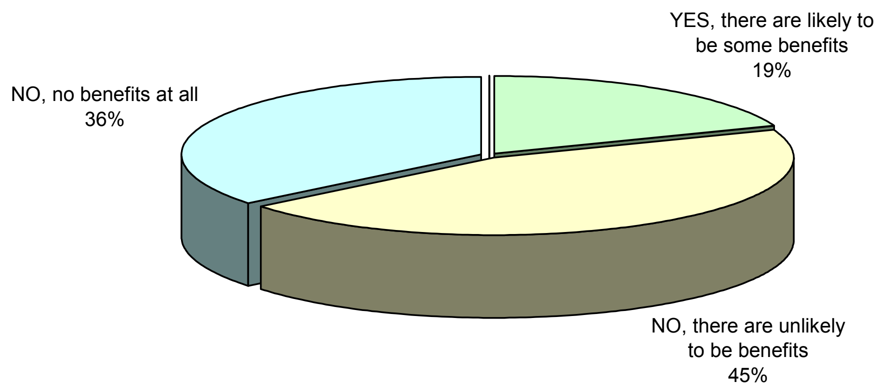
- Respondents indicated that the costs of retrospective application of the new rules on extortionate credit and early settlement are high, while benefits to consumers are likely to be small. Applying new rules to existing loans is not in line with good practice and basically

results in a regulatory risk. This may have an impact on credit providers' ability to securitise. This is explained in more detail in section 6.

The changes to financial limits are important to credit providers that currently have unregulated loans that will become regulated under the new regime (ie, loans with a value above £25,000). Almost all of these credit providers (30% of respondents) indicated that the removal of the financial limit would have a significant impact.

Some of the DTI proposals are intended to strengthen consumer protection while others are aimed at creating a more level playing field by reducing regulation where possible. However, a large proportion of credit providers indicated that there would not be substantial benefits to their firm from the proposed changes (see Figure 2.2)—19% of the respondents indicated that there are likely to be some benefits from the proposed changes, while 45% thought that there are unlikely to be benefits and 36% think that there will be no benefits at all. Benefits mentioned by respondents include greater transparency for the consumer, which should increase awareness of the terms and conditions of agreements, thereby contributing to borrowers' responsibility.

Figure 2.2: Do you expect any benefits to your firm from the proposed changes?

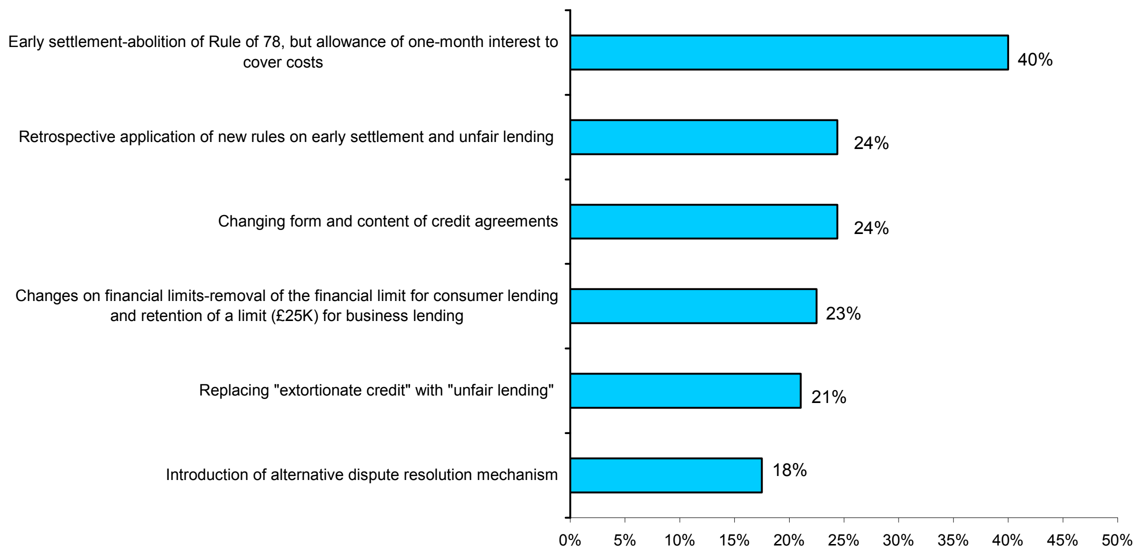


Source: OXERA/FLA questionnaire, 2003.

Credit providers also expect the benefits to consumers to be limited (see Figure 2.3). Of the respondents, 40% indicated an expectation that the changes to the rules on early settlement would affect consumers significantly, while the changes to financial limits and the replacement of extortionate credit with an unfair lending concept were considered significant by only 21%.

There may be a number of reasons for the fact that a limited number of credit providers suggested that the new rules on early settlement would result in significant benefits to consumers. First, the difference between the application of the Rule of 78 and actuarial principles is particularly significant for loans with high value, and less so for loans with low value. Second, as explained in more detail below, the new regime could result in a situation in which some of the costs of early settlement would be recovered from all borrowers (through an up-front fee or higher interest rates) compared with the current situation, where most costs are directly recovered from borrowers who settle early. If this were the case, the impact on consumers in general could be limited. Third, there are a limited number of credit providers that already use the actuarial principles method.

Figure 2.3: Proposed changes that credit providers consider to be significant or very significant in terms of their impact on consumers



Note: Credit providers were asked the following question: 'Please indicate the significance of the proposed changes in terms of their impact on consumers on a scale from 1 to 5 (1 = very significant; 5 = no impact at all).'
Source: OXERA/FLA questionnaire, 2003.

Figure 2.4 shows that credit providers appear to be concerned about increases in costs resulting from the proposed changes and do not expect significant benefits in terms of consumer protection. In other words, only a few respondents indicated that they consider the compliance costs to be justified and proportionate to the benefits resulting from the proposals.

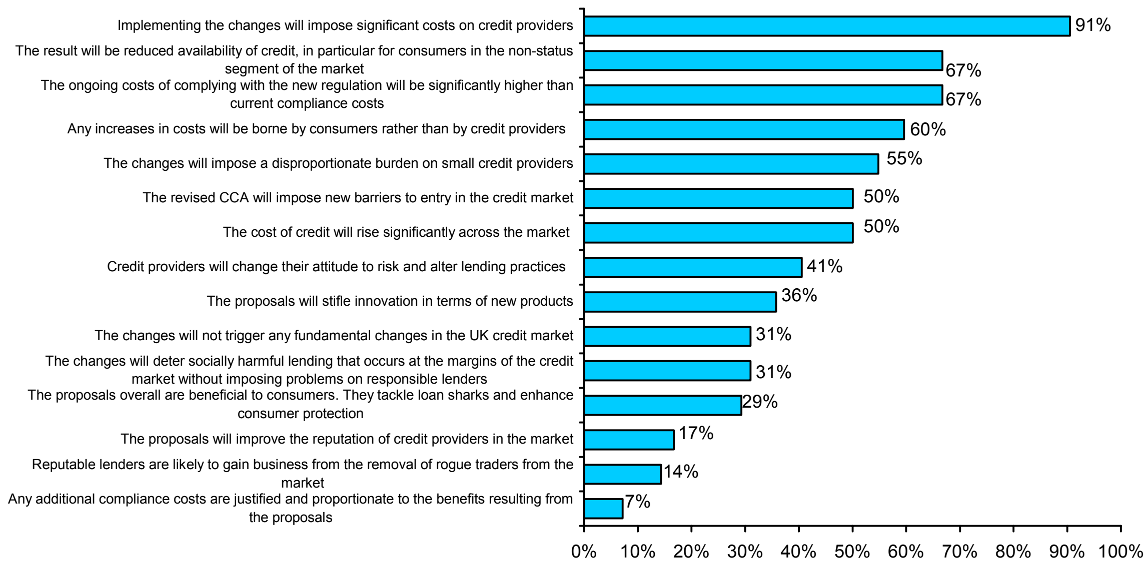
More than 65% of the respondents indicated that the proposed changes to the CCA would result in a reduction in availability of credit, particularly for consumers in the non-status segment of the market.[8] Furthermore, more than 50% indicated that the changes would impose a disproportionate burden on small credit providers.

Of the respondents, 31% were of the opinion that the changes would deter socially harmful lending that occurs at the margin of the credit market without imposing problems on responsible lenders. Only a small number (14%) expressed the view that reputable lenders are likely to gain business from the removal of rogue traders from the market.

The DTI has stated that the proposed changes are intended to tackle the issue of loan sharks. However, the questionnaire responses suggest that reputable lenders, and consequently, their customers, would also be affected to a significant extent.

[8] The non-status segment of the market is defined in line with the definition used by OFT (OFT (1997), 'Non-status Borrowing—Guidelines for Lenders and Brokers', November). There are two broad categories of non-status borrower. The first comprises borrowers with an impaired credit rating (eg, because of outstanding county court judgments or arrears). The second comprises borrowers with a low credit rating (eg, because of periods of unemployment or because income through self-employment is irregular or difficult to verify), or those who lack the supporting documentation necessary to obtain a loan.

Figure 2.4: Credit providers that agree or strongly agree with the following statements



Note: Credit providers were asked the following question: 'Please indicate whether you agree or disagree with the following statements, using a scale from 1 to 5 (1 =strongly agree, 5 = strongly disagree).'
Source: OXERA/FLA questionnaire, 2003.

2.2 Disproportionate impact on some credit providers

The proposals could affect some credit providers more than others, depending on their size and loan portfolio. Of the respondents, 25% indicated that they could be affected more than other credit providers in the market because of the small size of their firm. For example, the cost of altering agreements and providing additional documentation may be significant for them because of lack of economies of scale.

Of the respondents, 41% indicated that they would be affected more because of the types of product they offer. For example, certain elements of the proposals will, in particular, affect point-of-sale finance; examples are the new rules on early settlement and pre-contract information to be provided to consumers. One credit provider explained that it offers multiple products through multiple channels (ie, branch, telephone, internet, broker, and third-party retailer). It will therefore have significantly more changes to make (to documentation and related systems, etc) than a monoline lender, or lenders offering one product in multiple markets.

One credit provider with a relatively high proportion of loans with high value (mainly motor finance) indicated that the removal of the financial limit would increase its exposure to voluntary termination of agreements, leading to higher costs. Another respondent indicated that, for this reason, it would move away from hire purchase agreements to personal loans.

2.3 Section 127(3)

Some credit providers indicated in their responses to the questionnaire that any revisions to Section 127(3) of the CCA would have the greatest positive effect on credit providers of all the CCA changes proposed by the DTI. Under Section 127(3), a credit agreement which is not properly executed, because it does not contain all the prescribed terms, is unenforceable. Thus, even a minor

mistake in the contract terms may result in the loan becoming unenforceable, and the credit provider could lose both loan and security.

The DTI has proposed to make amendments that would reduce the consequences of making such an error in an agreement, but details had not been published at the time OXERA was undertaking this research.[9]

[9] OXERA has been informed that the DTI is proposing to repeal subsections (3) and (4) of Section 127 of the CCA, together with amendments to subsection (1) of Section 127, which gives the court discretion when considering applications for enforcement orders.

3. Extortionate Credit Provision

3.1 Proposed changes to the CCA

The CCA reform proposals envisage changes to the current extortionate credit provisions (Sections 137–140 of the CCA). The CCA currently states that a credit agreement is extortionate if the borrower is required to make payments which are 'grossly exorbitant', or if it 'grossly contravenes ordinary principles of fair dealing'. In these cases, the provisions allow the courts, on the borrower's application, to reopen the credit agreement 'so as to do justice between the parties'. In considering the matter, the court is required to take account of several factors (eg, interest rates at the time the agreement was made; debtor's age and experience; and the degree of risk accepted by the lender).

Broadening the scope of the provision of extortionate credit would also bring it in line with what are considered unfair practices within the meaning of Section 25(2) of the CCA (which deals with the licensing regime), and which could lead the OFT to take action against those involved. The two main proposed changes to the CCA regarding the extortionate credit provision are as follows.

- To replace the existing definition of 'extortionate credit' with a wider test of whether an agreement is an 'unfair credit transaction', and extend the list of factors that the court should take into account to determine unfairness. In particular, the fairness of credit transactions would be assessed not just with respect to price, but also other terms and conditions of the agreement. Moreover, fairness could be assessed at any time during the contractual period, not merely with respect to conditions at the time the agreement was concluded.

- To set up a dispute-resolution mechanism as an alternative to the courts. Alternative dispute resolution could, for example, be provided by the Financial Ombudsman Scheme or some other, new body, set up to deal with such disputes.

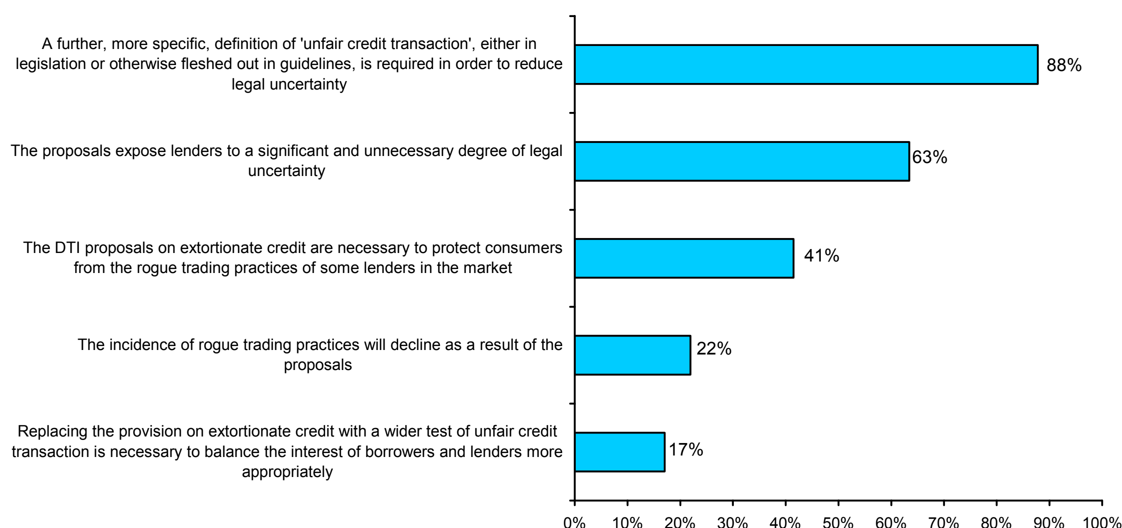
The DTI proposals regarding extortionate credit are, to a large extent, based on the recommendations of the OFT, published in its 1991 report, 'Unjust Credit Transactions'. In 1999, the DTI commissioned research from Kempson and Whyley[10] to follow up the issues raised by the OFT report, and, in 2000, the National Association of Citizens Advice Bureaux published a report on extortionate credit.[11]

3.2 Credit providers' views on the changes to extortionate credit provision

Credit providers were asked to give their views on the proposed changes to the extortionate credit provision. Figure 3.1 shows the responses.

[10] Kempson, E. and Whyley, C., (1999), 'Extortionate Credit in the UK', Personal Finance Research Centre, June.
[11] National Association of Citizens Advice Bureaux (2000), 'Daylight Robbery—The CAB Case for Effective Regulation of Extortionate Credit', December.

Figure 3.1: Credit providers that agree or strongly agree with the following statements



Note: Credit providers were asked the following question: 'Please indicate whether you agree or disagree with the following statements, using a scale from 1 to 5 (1 = strongly agree, 5 = strongly disagree).
Source: OXERA/FLA questionnaire, 2003.

In its White Paper, the DTI explains that most traders act in a responsible manner, but that there are some that engage in unfair practices, to the detriment of consumers, fair lenders, and society as a whole. Some of the proposed changes are therefore aimed at rogue traders. Credit providers were asked to give their views on the proposals on extortionate credit.

In so far as the proposals focus on rogue-trading practices, 41% of the respondents agreed that the DTI's proposals on extortionate credit are necessary to protect consumers from these practices (see Figure 3.1). Only 10% of the respondents indicated that they expected additional business from the removal of rogue traders.

Two credit providers claimed that, although they agree that consumer protection would be enhanced, they do not believe that the proposals seek to tackle loan sharks. They expressed the view that loan sharks are those lenders that operate unregulated and that they will continue to be active—indeed, that they may become more accessible under the regime than, for example, non-status lenders, which will have to comply with the new rules, which, in turn, are likely to increase their costs and restrict their provision of credit.

The majority of the respondents indicated that the proposals expose the lenders to a significant and unnecessary degree of legal uncertainty which could make the provision of credit more expensive. Almost all (88%) indicated that a further, more specific, definition of 'unfair credit transaction', either in legislation or otherwise fleshed out in guidelines, is required in order to reduce legal uncertainty.

3.3 Impact on lending practices

If the proposals increase the risk of litigation and undermine lenders' confidence in enforcing a loan, they may result in greater difficulties for higher-risk customers in accessing credit, while the costs for average customers will rise.

The DTI has stated that it is not its aim, under these proposals, to cause an impact on the activities of legitimate mainstream lenders. However, the survey indicates that the impact of the changes to the extortionate credit provision on lending practices could be significant. Unless the provisions are adequately tightened and targeted, unintended disruption to the market may ensue. In order to obtain an indication of the degree of uncertainty, credit providers were asked whether any of their current lending practices, terms and conditions, or certain characteristics of particular products would be at risk of being considered unfair under the new test of unfair credit transaction. 45% of the respondents indicated that some of the current lending practices would be at risk. In other words, by not clearly defining what is to be considered an unfair credit transaction, uncertainty has been created among even reputable mainstream providers.

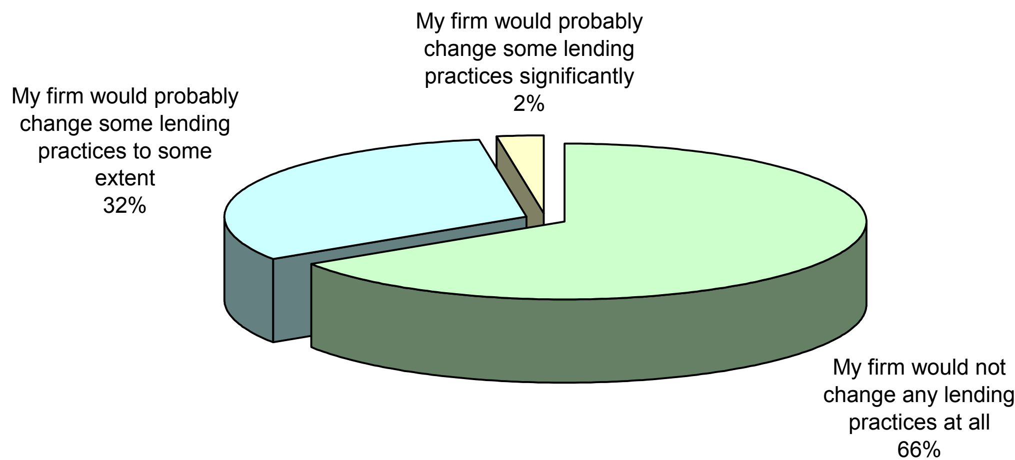
The fact that, under the new regime, consumer bodies will be permitted to initiate consumer class actions may also contribute to the uncertainty. It increases the probability of court cases, and also means that one court decision could affect a large number of credit agreements and credit providers.

The proposed changes to the extortionate credit provision could create legal uncertainty for credit providers active in the non-status segment of the credit market in particular. All respondents with 75–100% of their loan portfolio in the non-status segment of the market indicated that (part of) their practices would be at risk of being considered unfair.

Of all respondents, 58% indicated that they expect loans to consumers in the non-status segment of the market to become more risky. Respondents generally appear to expect certain aspects of credit products (eg, interest rates) to be subject to frequent (unjustified) challenges under the new concept of an unfair credit transaction. Of the respondents, 25% indicated that they would be less willing to provide credit to consumers in the non-status segment of the market, while 11% claimed that the rate of those being rejected for credit would increase.

Credit providers were also asked whether they would change their current lending practices (or terms and conditions, or certain characteristics of certain products), or cease to offer certain products that could be considered as unfair. The responses are similar to those on the impact on current lending practices; 34% would probably change some lending practices (see Figure 3.2). Uncertainty about how the new concept of unfair credit transaction would be interpreted is likely to be an important reason to change certain practices. For example, one respondent stated that it would reconsider its lending to non-salaried persons. Others indicated that credit agreements with variable rates would be reviewed and that linking them to an index or moving to fixed-rate contracts would be considered.

Figure 3.2: Impact of changes to extortionate credit provisions on future lending practices



Note: Credit providers were asked the following question: 'If the provision on extortionate credit were replaced by the wider test of 'unfair credit transaction', would you decide to change your current lending practices (or terms and conditions or certain characteristics of certain products), or stop offering certain products that could be considered unfair?'
Source: OXERA/FLA questionnaire, 2003.

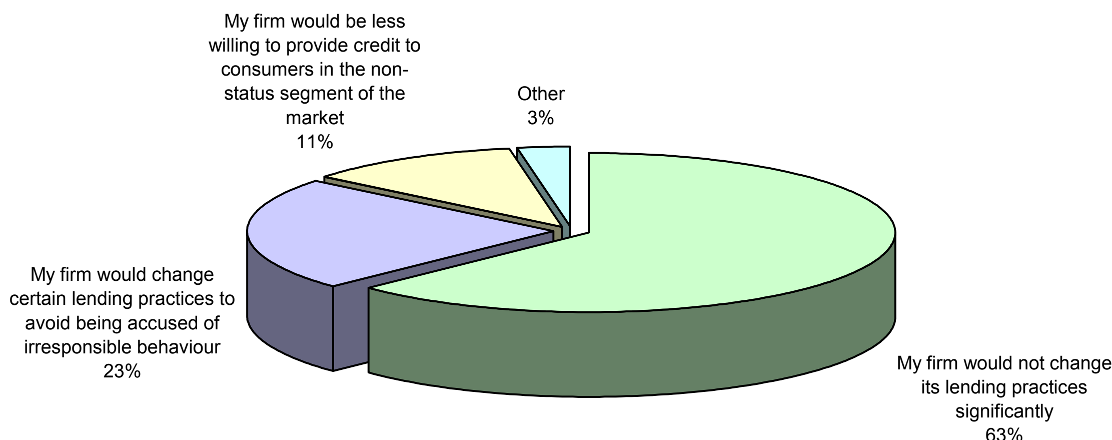
3.4 The principle of responsible lending

The DTI has consulted on whether the current legislation should be modified to ensure 'responsible lending', either by introducing an explicit provision on responsible lending (similar to the EC Consumer Credit Directive), or by making the issue of responsibility a factor that courts should consider in their decisions on whether a credit transaction is fair.

Responsible-lending provisions may increase the risks and costs to credit providers of lending, in particularly to consumers with low credit ratings.

Since FLA members already subscribe through the FLA's Lending Code to principles of responsible lending, only 18% of the respondents indicated that incorporating additional principles of responsible lending would definitely result in significant costs; 34% indicated that it would probably result in extra costs. The majority of the respondents would not change lending practices or activities as a result of the inclusion of such a principle (see Figure 3.3). 21% indicated that they would change certain lending practices to avoid being accused of irresponsible behaviour, while 9% would be less willing to provide credit to consumers in the non-status segment of the market.

Figure 3.3: Impact of incorporating a principle of responsible lending



Note: Credit providers were asked the following question: 'Would including the principle of responsible lending in the CCA change your lending practices or activities?'
Source: OXERA/FLA questionnaire, 2003.

3.5 Impact on securitisation

Around 22% of the credit providers surveyed currently use securitisations to fund part or all of their loan book. Most of these providers are not active in the non-status segment of the market.

The direct financial impact on investors in securitisations is probably limited. Only a few credit providers expect credit-rating agencies to review the rating of their firm's securitisations. This is explained by the fact that the majority of these credit providers (ie, those that use securitisations) indicated that they do not believe that any of their existing loans would be at risk of being considered unfair.

However, the proposals could have a significant impact on credit providers' ability to securitise new loan books. A large proportion of the respondents (55%) indicated that, going forward, the proposals are likely to increase their firm's cost of obtaining funding through securitisation and thereby reduce their firm's ability to securitise. Retrospective application of rules introduces regulatory risks and therefore imposes extra costs. This is further discussed in section 6.

3.6 Conclusion

The DTI has stated that it aims to tackle loan sharks without imposing problems on responsible lenders. However, it is not clear whether the proposed changes are well targeted and proportionate to the problems. The survey results show that the changes to the extortionate credit provision are likely to result in significant legal uncertainty and could result in a restriction in availability of credit among particular groups of consumers in the non-status segment of the market.

Furthermore, the DTI proposes to impose the new rules on the extortionate credit provision retrospectively for existing loans. The results of the questionnaire suggest that the benefits of this are likely to be small, while the changes themselves could result in unnecessary disruption in the market and, potentially, in costs to credit providers (see section 6).

4 Financial Limits

4.1 Proposed changes to the CCA

The CCA regulates credit or hire agreements of up to a value of £25,000 made to 'individuals—including a partnership or other unincorporated body of persons not consisting entirely of bodies corporate'. This extends the CCA beyond natural persons or consumers in the strict sense, and includes all borrowers/hirers except for corporate bodies such limited companies.

In considering the responses received by the DTI after publication of its consultation paper, the proposed changes to these rules are as follows:

- removal of the £25,000 limit for consumer lending that is non-business. The limit is retained for business lending;
- business lending that comes within the remit of the CCA is reduced to include only sole traders, small partnerships of up to and including three partners, and other unincorporated bodies. Larger partnerships will be excluded.

4.2 Economic impact assessment

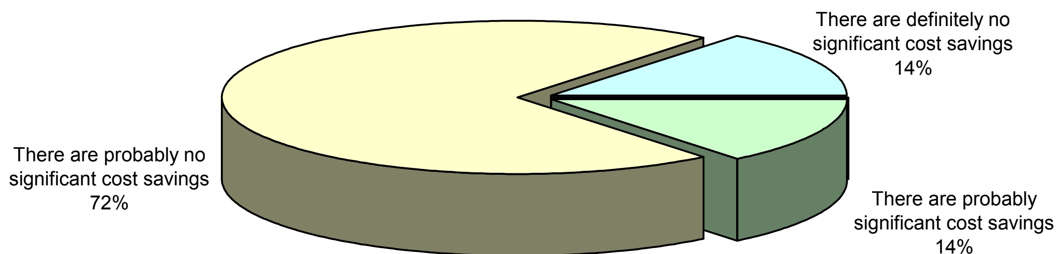
By removing the financial limit for consumer borrowing, the proposals increase the scope of the CCA and consumer protection measures. One motive for the change in regulation arises from the Financial Services Authority (FSA) assuming regulatory control of the first-charge mortgages of any value from the second quarter of 2004. However, second-charge mortgages and unsecured credit above £25,000 would remain unregulated, as they fall outside both the new FSA regulations and the CCA. In its consultation document, the DTI also points out that consumers are increasingly borrowing amounts above the current limit, and therefore fall outside the protection of the CCA. The DTI proposals ensure that most, if not all, consumer borrowing is regulated.

4.2.1 Large partnerships

Large partnerships as borrowers could benefit to the extent that the degree of current protection afforded by the CCA is excessive and inappropriate for these borrowers. As a result of the proposals, such borrowers may obtain easier access to credit and may benefit from a reduced cost of credit. Credit providers may be more inclined to grant credit to large partnerships, which, under the new rules, would be outside the scope of the CCA.

However, the impact will depend on whether credit providers are likely to adopt less-stringent rules for loans to large partnerships or to continue to treat credit for all partnerships as regulated credit agreements. Figure 4.1 shows the credit providers' responses.

Figure 4.1: Expected significant cost savings from lending to large partnerships as a result of the credit no longer being regulated under the CCA proposals



Note: Credit providers were asked the following question: 'Do you expect any significant cost savings from lending to these large partnerships as a result of the credit no longer being regulated under the CCA proposals?'
Source: OXERA/FLA questionnaire, 2003.

The majority of the respondents do not expect any significant cost savings. This may be because they will not treat such credit differently once it becomes unregulated—the regulation has set a certain standard which firms may continue to follow.

4.2.2 Consumer credit

While benefiting from increased protection, credit agreements that will come under the remit of the CCA as a result of the removal of the financial limit (ie, agreements above £25,000) may become more costly and less available.

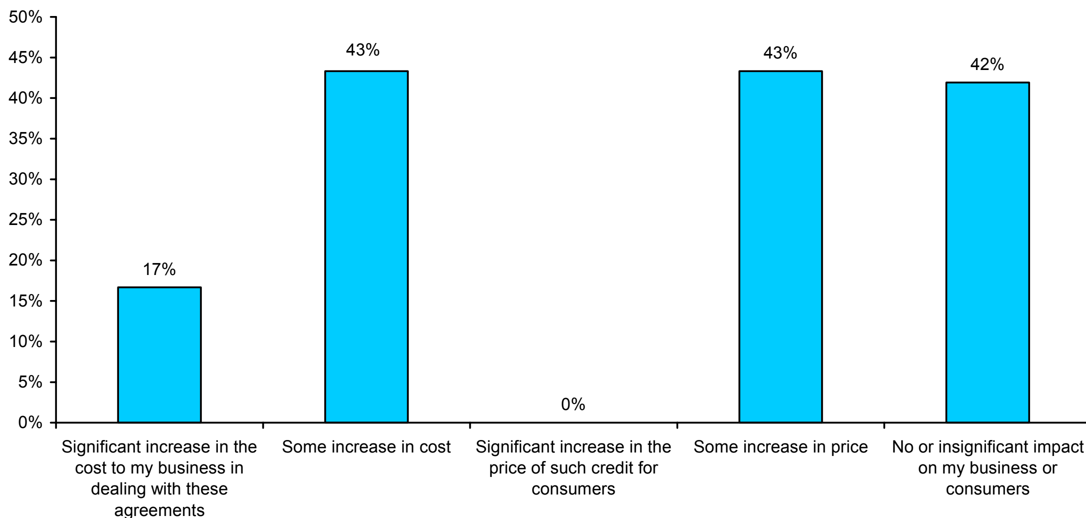
The relative costs and benefits of the proposals on financial limits depend, to some degree, on the amount of credit that is currently unregulated but that would become regulated (and vice versa), and the lending standards that apply to unregulated credit agreements. Credit providers were asked to indicate what proportion of their consumer loans is currently regulated (ie, below £25,000), and whether they treat unregulated agreements differently from regulated credit.

The questionnaire results suggest that the percentage of credit agreements with values above £25,000 is limited: 74% of the respondents indicated that all, or almost all, of their credit agreements are below a value of £25,000. In the other cases, credit agreements with values above £25,000 count for 10% of the total portfolio. On average, approximately 1% of the credit agreements (weighted by number of customers) have a value above £25,000.

Of the respondents that provide both regulated and unregulated credit, 56% indicated that they operate a dual system—ie, they treat unregulated credit differently from regulated credit. The main differences in such treatment were attributed to voluntary terminations and early-settlement clauses.

Credit providers were also asked to indicate the expected impact on the credit agreements that will become regulated as a result of the increase in the financial limit (see Figure 4.2).

Figure 4.2: Impact of the increase in financial limits on credit providers



Note: This figure shows responses to the following question: 'For credit agreements that will become regulated as a result of the increase in the financial limits, what do you expect the impact to be?'
Source: OXERA/FLA questionnaire, 2003.

Of the respondents, 43% indicated that they expect some increase in the costs to their business; 17% expect a significant increase; while 42% do not expect any significant impact on their business. Extra costs as a result of rules on voluntary termination (for hire purchase agreements) and early settlement were cited as examples.

In summary, for some credit providers, the DTI proposals relating to financial limits are thought to be costly in terms of compliance. Of particular concern was the impact on specific forms of affordable credit such as hire purchase. This is discussed below.

4.2.3 Hire purchase and conditional-sale agreements

Under the CCA rules dealing with hire purchase or conditional-sale agreements, consumers have a right to terminate the agreement at any time before the final payment is due ('voluntary termination'). The asset will then be returned to the credit provider—the implication being that the credit provider bears the depreciation costs of the underlying assets. The consumer liability is capped at 50% of the loan.

The original purpose of the voluntary-termination provision was to protect vulnerable consumers who are experiencing financial difficulty. There is no equivalent provision for those who provide finance via personal loans.

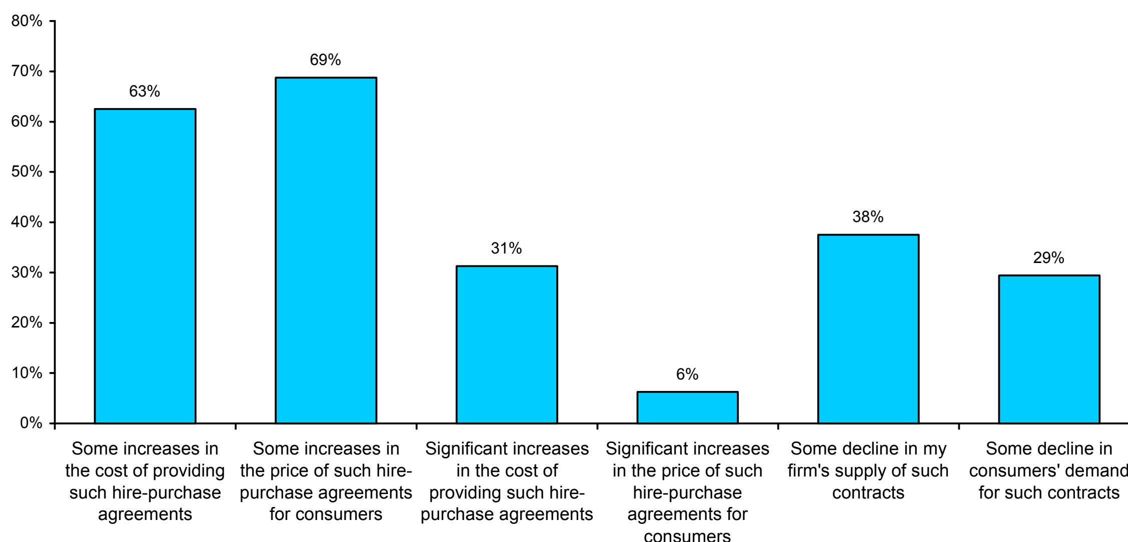
Voluntary termination carries a significant cost and increases the risk to finance providers, which is priced into the finance provided. Hire purchase agreements above £25,000 are currently not covered by the CCA, but, following the DTI proposals, consumers would be granted the right to terminate such agreements voluntarily. To the extent that finance providers currently do not offer voluntary termination on unregulated agreements, the proposed changes in the rules could present a substantial burden. Hire purchase agreements entered into by consumers on lower-value goods, such as home electronics, would not be affected. However, for loans with a high value, in particular in relation to car finance, the impact could be significant—higher costs and risks on the part of the

finance providers would ultimately be passed on to consumers in the form of higher credit prices or restricted finance availability.[12]

Of the respondents that provide hire purchase and conditional-sale agreements, 90% indicated that their unregulated agreements never contain voluntary-termination clauses. Of the hire purchase and conditional-sale agreements above £25,000, 15–70% are settled early—the average, weighted by number of customers, is around 50%.

Credit providers were asked to indicate the expected impact of the removal of the financial limit on hire purchase and conditional-sale agreements (see Figure 4.3).

Figure 4.3: Impact of the removal of the financial limit on hire purchase agreements



Note: This figure shows responses to the following question: 'If the hire purchase and conditional-sale agreements above £25k become regulated, what do you expect the impact to be?'
Source: OXERA/FLA questionnaire, 2003.

Between 63% and 69% of respondents indicated that they expect some increase in the costs or price of hire purchase and conditional-sale agreements, while 6–31% expect significant increases in the costs or price to consumers. Furthermore, 38% expect some decline in their firm's supply of such agreements—29% expected a significant decline.

These responses indicate that the removal of the financial limit could result in significant costs for hire purchase agreements due to the voluntary-termination clause in the CCA. It could be argued that this clause puts hire purchase agreements at a disadvantage compared with other credit products, such as personal loans. Furthermore, it benefits only a small proportion of consumers, while the costs are high and borne by all borrowers (through higher interest rates). Respondents to the survey therefore indicated that the costs and benefits of the retention of the voluntary-termination clause in the CCA need to be reassessed. Arguably, credit providers could possibly be

[12] In some cases, it may not be entirely clear whether a loan is consumer credit or business credit. For example, if a car is bought for business and personal use, the hire purchase agreement may be considered consumer credit in its entirety. In other words, in this way credit for business purposes could also be affected by the removal of the financial limit for consumer credit.

allowed to offer alternatives—ie, a hire purchase agreement with and without a voluntary-termination clause.

Some credit providers indicated that they may decide to move away from hire purchase agreements towards personal loans. Under the current CCA, hire purchase agreements cannot be offered at variable rates, which may give credit providers another reason to give preference to personal loans over hire purchase agreements under the new regime. These unintended potential consequences of removing the financial limit do not appear to have been taken into account in the DTI proposals.

Furthermore, the rules on voluntary termination were introduced to enable those who are in financial difficulty to cancel their credit agreement without having to pay the early settlement sum based on the Rule of 78. Given the fact that the DTI is proposing changing the rules on early settlement in order to create a fairer system across the board, the need for rules on voluntary termination may no longer be relevant.

5. Early Settlement

Consumers have a statutory right to settle loans early, and receive a rebate on some of the total charge for credit when they do so. These regulations are set out in Sections 94 and 95 of the CCA and in detail in the Consumer Credit (Rebate on Early Settlement) Regulations 1983. While many lenders calculate rebates on an 'actual cost' basis using actuarial approaches, others use the Rule of 78 for determining the settlement figure.

In addition to the use of the Rule of 78, the current regulations allow credit providers to defer the settlement date by two months for credit agreements with a term of less than five years, or by one month for credit agreements with a term of more than five years. This settlement deferral enables credit providers to recover some of the costs they face as a result of early settlement.

The DTI's proposals envisage four main changes to these regulations:[13]

- to abolish the Rule of 78 in favour of an actuarial approach. The DTI plans to prescribe a calculation formula;
- to allow lenders to recoup their early-settlement administrative costs by claiming one month's interest beyond the settlement date;
- to allow settlement deferral for up to 28 days for all loans;
- to require lenders to provide consumers with pre-contractual information on early settlement.

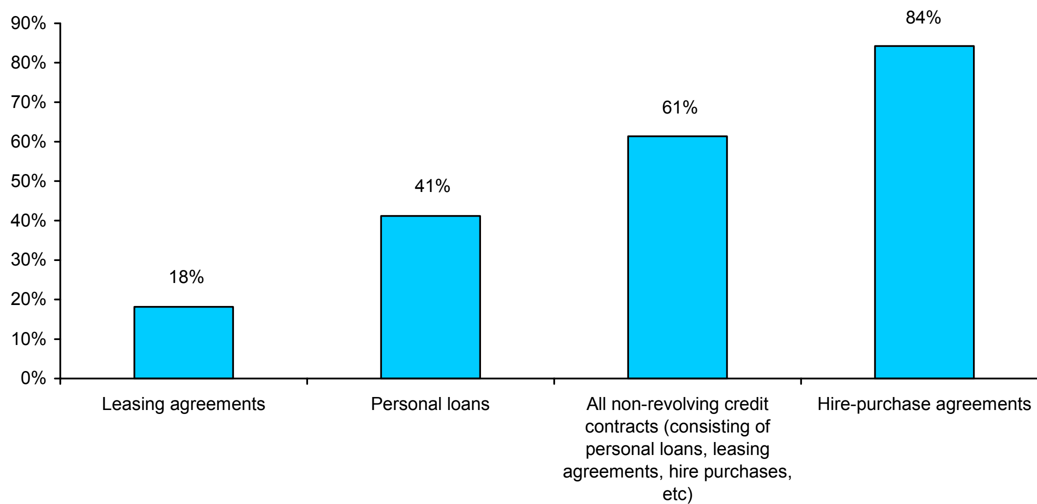
5.1 Economic impact assessment

The impact of the new rules on early settlement depends to some extent on the proportion of agreements that are settled early in general, and the extent to which credit providers currently use the Rule of 78.

The survey results indicate that the average proportion of loans that are settled early is around 50% (weighted by number of customers). Figure 5.1 shows that this percentage varies according to the type of loan.

[13] Proposals are described in the DTI White Paper and in: DTI (2002), 'A Consultation Document on the Early Settlement of Credit Agreements under the Consumer Credit Act 1974', August.

Figure 5.1: Proportion of loans settled early

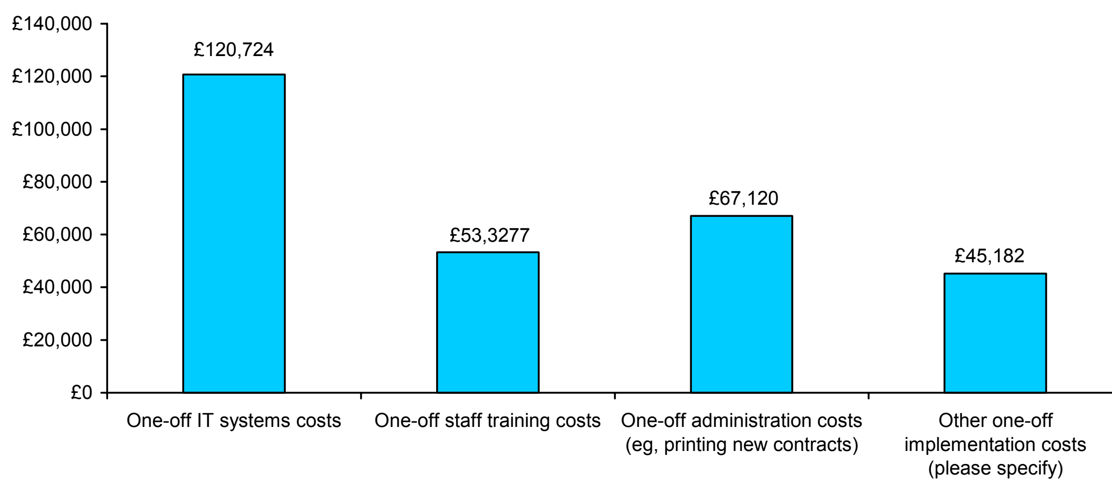


Source: OXERA/FLA questionnaire, 2003.

Of the respondents, 50% use the Rule of 78 for all or almost all (95%) of their regulated loans, 23% for around three-quarters, and 16% for 50% or less of their loan book. The remaining 10% do not use the Rule of 78 at all. Typically, for higher-value loans, credit providers apply the actuarial principles method or the Rule of 78, whichever is the most beneficial to the customer. A number of respondents stated that they do not normally use the Rule of 78 for loans above a value of £25,000 (ie, unregulated consumer credit) and for lease agreements.

Under the DTI's proposals, credit providers that currently use the Rule of 78 would incur costs to upgrade their internal systems, re-train staff, reprint standard credit agreements, change accounting practices, etc. The survey indicates that most credit providers do not consider these costs to be significant for their firms. On average, credit providers estimate the one-off implementation costs at £290,000. A more detailed breakdown is provided in Figure 5.2.

Figure 5.2: Average costs of implementing the actuarial principles method



Note: Some of the numbers provided by credit providers are based on rough estimates. Credit providers were asked the following question: 'If you currently apply the Rule of 78, please provide an estimate of the costs your firm would incur in implementing the actuarial principles method. Estimating these costs may be difficult, but please provide your best estimate.'
Source: OXERA/FLA questionnaire, 2003.

The larger credit providers indicates that the transitional implementation costs are likely to be between 0.5% and 1.5% of their annual operating costs. For smaller credit providers, the transitional costs are predicted by respondents not to exceed 2.5% of their annual operating costs.

The new rules on early settlement may also have an impact on credit providers that already use the actuarial principles method. First, the actuarial principles method is often used for only a certain proportion of the loan book—systems need to be updated and extended to the whole portfolio of loans. Second, the current rules allow credit providers to charge up to two months' extra interest while the new rules will only allow for one month. Third, some respondents indicated that their own actuarial principles are not entirely consistent with the DTI proposals. Respondents suggested that the DTI's formula is complicated.

Of the respondents, 89% indicated that they do not expect the ongoing administration costs (eg, IT, staff training, etc) of using the actuarial approach to be significantly higher than the costs they currently incur—only 11% expect an increase. This is consistent with responses from credit providers that use both the Rule of 78 and the actuarial principles method—most indicate that there are no significant differences in the costs of using the two methods.

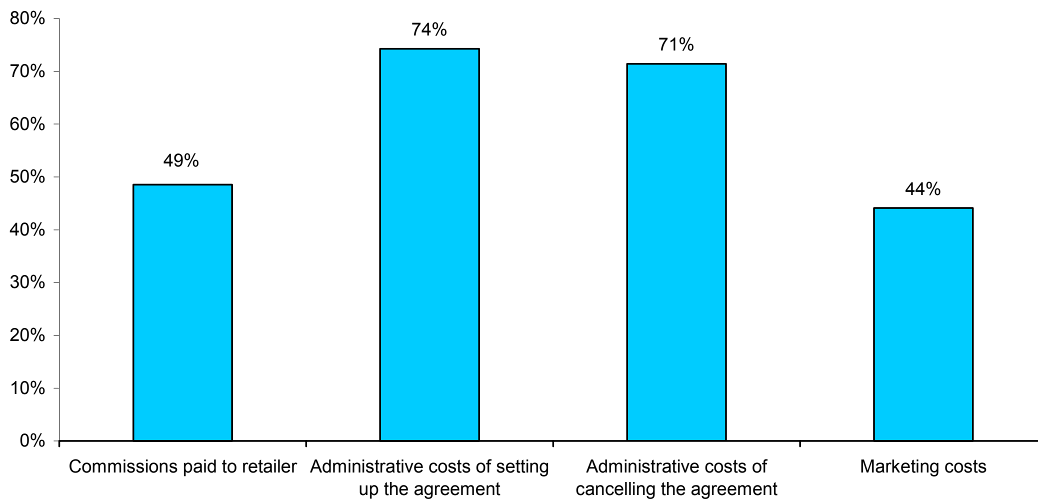
5.2 Costs recovered through the Rule of 78

The current rules enable credit providers to recover their costs of early settlement from those borrowers that settle early. Some credit providers indicated that they recover at least a significant part of their early-settlement costs in this way, while other costs related to early settlement are recovered through alternative means (eg, interest rates). The proposals tighten the existing regulation by shortening the period over which lenders can claim interest and by reducing the deferral period. The question is whether the new provisions will still allow lenders to recover a

significant part of their costs. Moreover, it could be argued that the provisions should result in early-settlement penalties that are sufficiently high to deter consumers from terminating certain loan contracts at little cost. Consumers who prefer to have the option of settling early can already purchase more flexible types of credit—eg, overdrafts and credit cards allow for settlement at any time at no extra cost. Credit products such as personal loans and hire purchase agreements, on the other hand, are generally based on a fixed-contract period but therefore attract a relatively low interest rate compared with the more flexible credit products. Allowing credit providers to recover costs, therefore, promotes product differentiation and increases consumer choice.

Figure 5.3 shows that the majority of respondents recover (part of) the administrative costs of setting up and cancelling the credit agreement. Furthermore, 49% of the respondents also recover commissions paid to retailers (or brokers/intermediaries) and marketing costs. Other costs cited by respondents include the costs of unwinding hedging arrangements in the case of fixed-rate credit products.

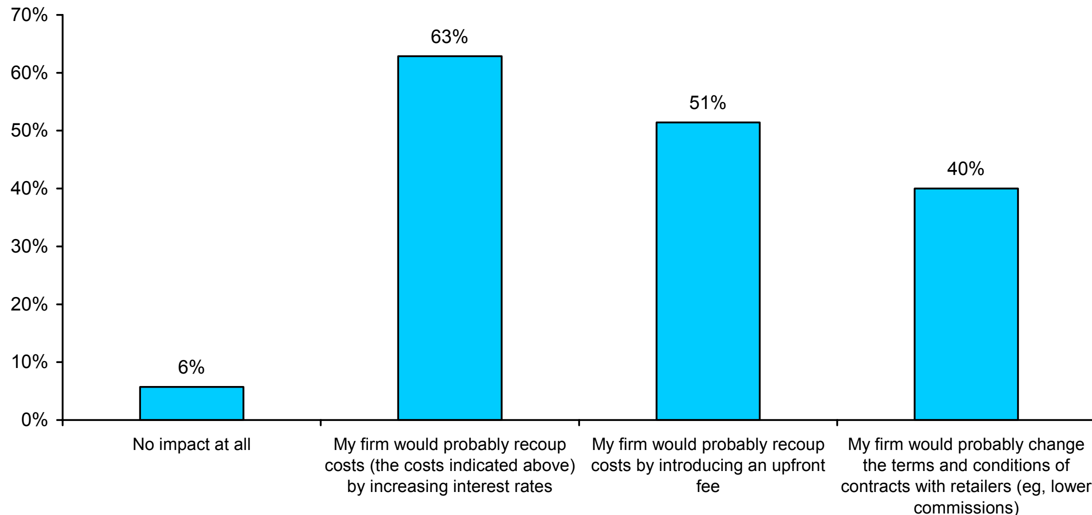
Figure 5.3: Costs recovered through the Rule of 78



Note: Credit providers were asked the following question: 'If you currently apply the Rule of 78, please indicate the types of costs you normally recover through the Rule.'
Source: OXERA/FLA questionnaire, 2003.

The majority of respondents (65%) were of the opinion that the proposed one-month interest period after settlement would be too short to cover all costs—ie, the costs of administration, marketing, commissions and hedging. When asked how they would recover the remaining costs after the introduction of the actuarial principles method, 63% said that they would probably recoup costs by increasing interest rates (see Figure 5.4); 51% would probably introduce an up-front fee; and 40% would probably change the terms and conditions with retailers (eg, they would charge lower commissions).

Figure 5.4: Likely response to the introduction of the actuarial principles method



Note: Credit providers were asked the following question: 'If you currently use the Rule of 78, please indicate your firm's likely response to the introduction of actuarial principles.'
Source: OXERA/FLA questionnaire, 2003.

In summary, under the new regime, some of the costs of early settlement would be recovered from all borrowers (through an up-front fee or higher interest rate) compared with the current situation, where most costs are directly recovered from only those borrowers who settle early. It could be argued that, by prescribing the use of actuarial principles and only allowing credit providers to charge one month's extra interest, credit products, such as personal loans and hire purchase agreements, become more similar to flexible credit products such as credit cards and overdrafts. The interest rates on personal loans may therefore also become more similar to interest rates on, for example, an overdraft.

5.3 Consumer benefits

In its White Paper, the DTI gives a regulatory impact assessment of the new rules on early settlement and estimates the direct benefits to consumers at £60m a year. This is estimated as the difference between applying the Rule of 78 and actuarial principles method on the 70% of loans that are settled early.[14]

This is likely to be an overestimate of the benefits. As explained above, the Rule of 78 enables credit provider to recover certain costs from those borrowers that settle early. Although under the new rules these costs may decrease (eg, due to the fact that some credit providers may decide to change the terms and conditions of contract with retailers, such as lower commissions—see Figure 5.4), it is unlikely that the costs will disappear. The survey indicates that, under the new regime, credit providers are likely to recover a large part of these costs from all borrowers through up-front fees and higher interest rates. This means that the new rules shift the cost of consumer protection from those directly affected to consumers generally.

[14] Datamonitor estimates that 70% of loans are settled early. The OXERA/FLA questionnaire gives an estimate of 50%.

5.4 Timing of application of proposed changes and 'retrospectivity'

To the extent that many credit providers are required to make adjustments to their systems and internal processes, they should be allowed sufficient time to optimise their transition to the new regime—the length of the transition period is likely to be inversely related to costs.

The DTI has indicated that its aim is to bring new rules on early settlement into force for new loans from October 31st 2004, and for existing loans two years later—ie, from October 31st 2006. The majority of credit providers indicate that they need more time to implement the new systems, and that a period of at least two years would be appropriate.

In its White Paper, the DTI discusses the benefits of a number of options and states that implementing the new rules to new loans from October 2004 is feasible, but that implementing the new rules to both new *and* existing loans from this time would be practically impossible because of the transition time required for lenders to make software and accounting system changes for existing loans. It is not clear how the DTI has reached this conclusion; although it acknowledges that credit providers need time to implement the systems, it appears to suggest that credit providers only need extra time for existing loans. It should be noted that both new and existing loans will require the same software and accounting systems. It is therefore arguable that it is illogical to give a transitional period only for existing loans.

Credit providers also expressed considerable concern about applying the new early-settlement rules retrospectively to existing contracts (as from 2006), as this is likely to result in high costs to the credit providers without significant benefits to borrowers. This is examined in further detail in section 6.

Credit providers would therefore like to have the option to continue to apply the Rule of 78 to existing loans. For some credit providers, this is the most important issue arising from the DTI proposals.

5.5 Conclusion on early settlement

Overall, abolishing the Rule of 78 may be justified by a cost–benefit analysis—an actuarial method is theoretically more robust and promotes cost-based pricing. Cost-based pricing also implies that credit providers should be allowed to recover all costs incurred as a result of early settlement. The survey indicates that the one-month interest and deferral period is likely to be too restrictive in this respect. The costs of adapting systems are unlikely to be of significance to lenders as long as they can be minimised by allowing a sufficiently long transition period and by applying forward-looking rather than retrospective legislation.

6. Retrospective Application of Proposed Changes and Impact on Securitisation

This section analyses the impact of the proposed changes to the CCA on credit providers' ability to securitise. Securitisations have become an important alternative to traditional on-balance-sheet financing for lenders. For some specialised lenders that do not have access to retail savings, securitisation is the only way to source funds. Furthermore, securitisation is a means of diversification for lenders that are otherwise mainly dependent on retail savings.

Securitisations use special-purpose vehicles (SPV) to segregate assets originated by lenders from the balance sheets. In a classic securitisation structure, the assets are transferred by the originator of the assets to the SPV pursuant to a sale—ie, a sale in law that constitutes a transfer of rights and property that would be upheld even if the originator were subsequently to go bankrupt. The lender almost always retains servicing rights and remains the principal point of contact for borrowers. In exchange for servicing the accounts, the SPV pays the lender a servicing fee.

6.1 New rules on early settlement

6.1.1 Impact on new loans

The proposals on early settlement tighten the existing regulation by shortening the period over which lenders can claim interest and by reducing the deferral period. The majority of respondents to the questionnaire were of the opinion that the proposed one-month interest period after settlement would be too short to cover all costs—ie, the costs of administration, marketing, commissions and hedging. They indicated that, under the new rules, they would have to recover a larger proportion of these costs through interest rates or upfront fees than under the current rules.

In other words, applying the new rules to early settlement on new loans may change the way credit providers recover their costs, and possibly the relative profitability of certain types of lending activities. These new parameters would be taken into account when new loans are securitised, and may affect the return on certain lending activities, but are unlikely to affect credit providers' ability to securitise.

The new rules on early settlement may result in an increase in the number of loans that are settled early, as settling loans early is more attractive for consumers under the new rules. This could have implications for the investors in the securitisation. When consumers settle early, they effectively 'buy back' the asset from the investors in the SPV, and the investors have to replace the security with another asset that may have a lower investment yield. In other words, the investors face a 'reinvestment risk'. Generally speaking, the higher the number of agreements that are settled early, the higher the reinvestment risk and the higher the return the investor will require for its investment into the securitisation. It is difficult to predict the increase in loans that will be settled early; however, the required risk premium is unlikely to be large.

6.1.2 Retrospective application of early settlement rules

It is proposed that the new rules on early settlement will also be applied to existing loans as of October 2006. Applying the new rules retrospectively is particularly likely to reduce the profitability of those loans that are settled early. Whereas in the case of new loans, credit providers may be able to recover some of the costs of early settlement through higher interest rates or upfront fees, in the case of existing loans, the possibility for doing so is likely to be limited. Charging an upfront fee is simply not possible given the fact that, when the new rules come into force, the credit contract will already have been agreed, and charging higher interest rates is likely to be an option only in the case of loans with variable interest rates, and then only for the remainder of the actual

lifetime of credit agreement. In other words, the new rules on early settlement are likely to result in a cost to lenders. For loans that are securitised, these costs will be borne by the investors.

It is difficult to estimate the exact amount of costs to the investors. The new rules will only affect existing credit agreements that are not settled or terminated before October 2006. The survey indicates that credit providers do not have strong views on the implications for securitisations.

However, although the financial impact could be limited, applying new rules retrospectively could result in a regulatory risk. This is discussed in more detail in section 6.2.2.

6.2 New rules on extortionate credit

6.2.1 Impact on new loans

Respondents to the questionnaire indicated that replacing the extortionate credit provision with the new concept of unfair credit transaction is likely to result in legal uncertainty about which practices are fair and which are unfair. Furthermore, certain credit agreements are likely to be challenged in court and may force lenders to change certain lending practices. The fact that consumer bodies will be allowed to initiate consumer class actions increases the probability of court cases, and also means that one court decision could potentially affect a large number of credit agreements and credit providers at the same time. Uncertainty about the interpretation of the concept of unfair credit transaction, and the possible increase in defaults and loans being considered as void by the courts, is likely to affect investors' appetite for securitisations. This in turn will affect lenders' ability to securitise in the short and medium term. Investors may require a higher return on their investment to offset the increased risks due to the legal uncertainty.

It could be argued that, over time, court decisions and guidance from, for example, the OFT, are likely to clarify what is considered fair and unfair, thereby reducing legal uncertainty and investor risks. When credit providers have adjusted their practices to the new rules, the new parameters, such as default rates and changes in lending practices, will be taken into account in new securitisations, and may affect the return on certain lending activities. However, they are unlikely to affect credit providers' ability to securitise in the long term.

The direct financial impact of the changes to the extortionate credit provision on the SPV in which the securitised loans are held will probably be limited. Only a small number of questionnaire respondents expect credit-rating agencies to review the rating of their firm's securitisations. This is explained by the fact that the majority of these credit providers (ie, those that use securitisations) do not consider that any of their existing loans would be at risk of being considered unfair.

6.2.2 Retrospective application of rules on extortionate credit

Although the direct financial impact of the changes to the extortionate credit on new loans may be limited, the impact of retrospective application of the new rules is likely to be more significant. 45% of the respondents that currently use securitisations indicated that, going forward, the proposals are likely to reduce their firm's ability to securitise.

Respondents to the questionnaire indicated that, under the new regime, some of the current lending practices, terms and conditions, or certain characteristics of certain products, would be at risk of being considered unfair. Allowing consumer bodies to initiate consumer class actions is likely to increase the probability of court cases concerning the fairness of both existing and new credit agreements. Furthermore, credit providers expect that some borrowers may use the new concept of unfair credit transaction to challenge existing credit agreements should they get into financial difficulty, thereby increasing default rates on existing loans.

This means that applying the new rules retrospectively on extortionate credit provision is likely to affect the return on current lending activities to investors in the securitisation. It is difficult to quantify the exact financial implications for the investors.[15] The survey among FLA members indicates that the proportion of loans that could be considered unfair under the new rules is relatively small and could be concentrated among loans to the non-status segment of the market—ie, a segment where securitisation is not as widespread as in the prime segment of the market.

However, even if the direct financial implications are not significant, the retrospective application of rules on extortionate credit may affect investors' attitudes towards new securitisations. Applying new rules retrospectively signals a change in the DTI's policy and is unlikely to be considered as being in line with good practice; it could also be seen to introduce a regulatory risk. It suggests that the DTI may do so again in the future, thereby creating uncertainty among investors. Investors will want to be rewarded for this regulatory risk, making securitisation relatively more expensive compared with the current situation.

The general rule is that all statutes are prospective and not retrospective. Retrospective legislation takes away existing rights. The legislature has the power to promulgate retrospective laws; however, there should be compelling evidence that making a retrospective amendment is in the public interest:

> In the absence of compelling reasons, courts may declare the law as arbitrary. The basic principle is that legislation is meant to deal with future acts and ought not to change the character of the past transactions, carried on upon the faith of the then existing law. Exception to this Rule may be seen in legislations which are merely declaratory or which relate to matters of mere procedure unless a contrary intention is manifest from the language of the statute or arises by necessary implication.[16]

This principle of prospective legislation is also reflected in the Better Regulation Task Force's five principles, which identify robust regulation as:

- *transparent*—open, simple and user-friendly;
- *accountable*—to Ministers and Parliament, to users and the public;
- *proportionate*—to the risk;
- *consistent*—predictable, so that people know where they stand;
- *targeted*—focused on the problem, with minimal side effects.

Applying new rules retrospectively on existing loans is clearly not in line with the principle of consistency—particularly in terms of the predictability of regulation. As explained in section 1, the DTI has stated that it aims to follow best practice at all stages of the regulatory process and that it firmly supports the five key principles of good regulation identified above.

Retrospective application of new rules is not in line with the principles followed by regulators and legislators. A recent example is the guidance provided by the FSA on the definition of 'mis-selling',

[15] If a credit agreement which is regulated by the CCA has not been executed in accordance with the provisions of the CCA, the CCA provides that such an agreement will be unenforceable without a court order being obtained and, in certain circumstances, will be completely unenforceable. Examples of improper execution in accordance with the CCA include a failure to comply with the provisions of the Consumer Credit (Agreements) Regulations 1983, which govern the form and content of agreements regulated by the CCA. Securitisation contracts may contain repurchase obligation clauses which means that the originator of the securitisation is obliged to buy back the asset from the SPV in case of non-compliance with the provision of the CCA. This liability may be limited to a specific amount. Securitisation contracts are unlikely to contain clauses which deal with implications resulting from changes to the CCA—it is unlikely that investors would have anticipated a retrospective application of new rules. This means that the risks of credit agreements being considered void on the basis of the new concept of unfair credit transaction is unlikely to be borne by the lenders, but by the investors.

[16] Halsbury's Laws of England.

clarifying what 'mis-selling' is and is not under its regulatory regime.[17] The note was addressed to the Association of Independent Financial Advisers, other principal trade associations and consumer bodies, and was prepared in light of industry concerns about the need for clarity about what kind of exposures can give rise to claims about the mis-sellings of investment products to consumers.

The FSA has made it clear that the new definition would not be applied retrospectively:

> Firms are rightly concerned that they should not be subject to retrospective redefinition of regulatory requirements, which could be coloured by hindsight. Retrospective redefinition is out of the question, given the need for the FSA ultimately to justify any proposed disciplinary action before the Financial Services and Markets Tribunal. The rules and standards to be enforced will continue to be those in place at the time of the sale and not some retrospective reconstruction.

[17] FSA (2003), 'FSA Advises Industry on Definition of 'Mis-selling', April.

Appendix 1: OXERA/FLA Questionnaire

OXERA/FLA QUESTIONNAIRE

IMPACT OF CHANGES TO THE CONSUMER CREDIT ACT 1974

The FLA has commissioned OXERA to conduct research into the impact of the DTI's proposed changes to the Consumer Credit Act (CCA).

You are invited to participate in this research by completing the attached questionnaire. The questionnaire seeks your views on the likely impact of the DTI proposals.

Some FLA members exclusively provide credit that is not regulated by the CCA. If your firm falls into this category, please answer only Part 1 of the questionnaire (and, if relevant, Parts 2 and 3, as explained in the questionnaire). All other members should attempt to answer the questions in all seven parts of the questionnaire.

Many questions require a considerable element of judgement. To enhance the credibility of the research results, please answer the questions as objectively as possible and provide the most reasonable estimate you can make.

Some questions require quantitative estimates, which may be difficult to obtain. We do not require exact quantitative data. Approximations or ranges of estimates are sufficient.

Part 1: Background Information

Name of firm: ....

Your name: ....

Your position:...

Contact details (telephone and email)

Tel: .... Email:...

1) Please indicate the types of credit business undertaken by your firm AND covered by your FLA membership. **The questions in this questionnaire refer to credit products that are covered by your membership of the FLA. This means that, when asked to express your answer as a percentage of your total loan book, this total loan book refers only to the business that is covered by your membership of the FLA.** (Put an 'x' in all relevant boxes.)

	Consumer finance		**Business finance**
	Unsecured personal loans		High-value finance (>£20m)
	Secured personal loans		Direct finance (< £20m)
	Revolving credit		Sales finance
	Credit cards		Finance leasing
	Leasing		Operating leasing
	Hire purchase (incl. conditional sale)		Lease/hire purchase
	Store cards		Other business loans
	Store instalment credit		Car finance
	Car finance		Commercial equipment finance
	Other (please specify)		Other (please specify)

2) Approximately, how many customers (consumers and businesses regulated under the CCA) does your firm currently have?

   Total number of customers ....

3) What approximate percentage of your customers (consumers and businesses regulated under the CCA) belongs to the non-status segment of the market? Please provide your best guess. Here, there are two broad categories of non-status borrower. The first comprises borrowers with an impaired credit rating (eg, because of outstanding county court judgments or arrears). The second comprises borrowers with a low credit rating (eg, because of a poor history of employment or because their income through self-employment is irregular or difficult to verify), or those who lack the supporting documentation necessary to obtain a loan.

   The number of customers in non-status segment as a percentage of all your customers %.......

   The value of loans to non-status customers as a percentage of your total loan book market

   % ....

4) Do you provide credit that is *not* currently regulated by the CCA? YES/NO

   If YES, do you *exclusively* engage in unregulated lending? YES/NO

   If NO, please provide an approximate percentage breakdown of the credit provided by your firm that is *not* currently regulated by the CCA?

   As a percentage of all credit agreements %.............

   As a percentage of total loan book %.............

   Credit providers that engage exclusively in unregulated lending should finish the survey here and not answer the questions in the remaining parts. (Credit providers that engage exclusively in unregulated lending under the current CCA, but would become regulated due to the proposed changes to financial limits, should answer the questions in Parts 2 and 3.)

Part 2: Overall Assessment of Proposed Changes to the CCA

1) This question seeks to obtain your views on what you consider or expect to be the most significant changes to the CCA. (A short summary of the proposed changes is provided in the Appendix to the survey.) Please give indicate the significance of the proposed changes in terms of their impact on (a) your firm, and (b) consumers, on a scale from 1 to 5 (1 = very significant impact, 5 = no impact at all).

	(a) Impact on your firm	(b) Impact on consumers
Replacing “extortionate credit” with “unfair lending”		
Early settlement—abolition of Rule of 78, but allowance of one-month interest to cover costs		
Changes on financial limits—removal of the financial limit for consumer lending and retention of a limit (£25K) for business lending.		
Changing form and content of credit agreements		
Introduction of alternative dispute resolution mechanism		
Retrospective application of new rules on early settlement and unfair lending Other (please specify)		

Please use this space if you want to expand on your answer or provide other comments.

....

....

2) Do you expect any benefits to your firm from the proposed changes? (Put an x in the box beside your choice.)

YES, the benefits are likely to be significant	
YES, there are likely to be some benefits	
NO, there are unlikely to be benefits.	
NO, no benefits at all.	

If YES, please provide details of the main benefits you expect.

....

....

....

3) How would you assess the overall impact of the proposed CCA changes? (Delete as appropriate.)

The cost increase to your firm is likely to be:

significant/insignificant/no change/don’t know

The benefits to consumers in terms of increased protection are likely to be:

significant/insignificant/no change/don’t know

The benefits to your firm are likely to be:

significant/insignificant/no change/don’t know

4) Please indicate whether you agree or disagree with the following statements, using a scale from 1 to 5 (1 = strongly agree, 5 = strongly disagree).

Statement	
The proposals overall are beneficial to consumers. They tackle loan sharks and enhance consumer protection.	
The changes will deter socially harmful lending that occurs at the margins of the credit market without imposing problems on responsible lenders.	
Implementing the changes will impose significant costs on credit providers.	
The ongoing costs of complying with the new regulation will be significantly higher than current compliance costs.	
Any additional compliance costs are justified and proportionate to the benefits resulting from the proposals.	
The changes will impose a disproportionate burden on small credit providers.	
Any increases in costs will be borne by consumers rather than by credit providers.	
Credit providers will change their attitude to risk and alter lending practices.	
The cost of credit will rise significantly across the market.	
The result will be reduced availability of credit, in particular for consumers in the non-status segment of the market.	
The proposals will stifle innovation in terms of new products.	
The revised CCA will impose new barriers to entry in the credit market.	
The changes will not trigger any fundamental changes in the UK credit market.	
The proposals will improve the reputation of credit providers in the market.	
Reputable lenders are likely to gain business from the removal of rogue traders from the market.	

Please use this space if you want to expand on your answer or provide other comments.

....

....

....

5) Do you expect the proposed changes to affect your business disproportionately more than other credit providers in the market because of:

the size of your firm? (Delete as appropriate.)

YES, definitely/YES, probably/probably not/definitely not

the types of product offered by your firm? (Delete as appropriate.)

YES, definitely/YES, probably/probably not/definitely not

If YES to either of these questions, please provide a short explanation.

....

....

....

Part 3: Financial Limits Proposals

The DTI is proposing to remove the financial limit (of £25k) for consumer lending. The financial limit for business lending to unincorporated bodies (sole traders, partnerships with three or fewer partners, and other unincorporated bodies) will remain at around £25k. Large partnerships will be excluded from the scope of the CCA.

If you *exclusively* lend to business rather than consumers, please go directly to Question 3.

1) If you lend to private individuals (ie, in their capacity of consumer), please provide an *approximate* breakdown of the consumer credit you provide according to whether it is currently regulated by the CCA (<£25k), and will become regulated (£25–£50k).

	< £25k	> £25k	Total consumer lending
Percentage of consumer credit agreements			100%
Percentage of consumer credit loan book			100%

If you currently provide both regulated and unregulated consumer credit, do you operate a dual system in the way you deal with such credit (ie, treat regulated credit differently from unregulated credit)? YES/NO

If YES, please describe briefly the main difference in the treatment of regulated and unregulated consumer credit.

....

....

....

For credit agreements that will become regulated as a result of the increase in the financial limit, what do you expect the impact to be? Please indicate the impact by putting an 'x' in all relevant boxes.

Significant increase in the cost to my business in dealing with these agreements.	
Some increase in cost.	
Significant increase in the price of such credit for consumers.	
Some increase in price.	
No or insignificant impact on my business or consumers.	
Other (please specify)	

If you expect significant increases in costs or prices, please briefly explain why.

....

....

....

2) Do you currently provide credit to private individuals (ie, in their capacity of consumer) in the form of hire purchase or conditional-sale agreements that are currently unregulated, but will become regulated under the proposals?

YES/NO

How often do these currently unregulated agreements have a voluntary termination clause (although this is not required)? always/frequently/infrequently/never

What **approximate** percentage of these agreements terminates early? %..................

If the agreements become regulated under the new proposals, what do you expect the impact to be? Please indicate the impact by putting an 'x' in all the relevant boxes.

No significant impact because my firm's unregulated hire purchase agreements already contain a voluntary termination clause.	
No significant impact because voluntary termination does not occur often in practice.	
No significant impact because voluntary termination does not impose costs on my firm.	
Some increases in the cost of providing such hire purchase agreements.	
Some increases in the price of such hire purchase agreements for consumers.	
Significant increases in the cost of providing such hire purchase agreements.	
Significant increases in the price of such hire purchase agreements for consumers.	
Some decline in my firm's supply of such contracts.	
Some decline in consumers' demand for such contracts.	
Significant decline in my firm's supply of such contracts.	
Significant decline in consumers' demand for such contracts.	
Other (please specify)	

3) Do you currently provide credit to large partnerships that is regulated by the CCA (< £25k)?

YES/NO

If YES, do you expect any significant cost savings from lending to these entities as a result of the credit no longer being regulated under the CCA proposals? (Please take account of whether your firm would treat such credit differently once it becomes unregulated.)

YES, definitely/YES, probably/probably not/definitely not

For the remaining parts of this survey, please answer the questions only with respect to credit agreements that are currently regulated by the CCA.

Part 4: Extortionate Credit

The DTI proposes to replace the existing definition of extortionate credit (CCA, Section 138) with the wider concept of whether an agreement is an 'unfair credit transaction'. This will ensure that as much account is taken of unfair practices as with the price of credit. The fairness of credit transactions would be assessed on several criteria, including market and behavioural factors. Unlike the current provisions, in determining whether a transaction is unfair, consideration will be given not just to how the agreement was concluded, but also to any subsequent events that may have led to unfairness.

1) Please indicate whether you agree or disagree with the following statements, using a scale from 1 to 5 (1 = strongly agree, 5 = strongly disagree).

Replacing the provision on extortionate credit with a wider test of unfair credit transaction is necessary to balance the interest of borrowers and lenders more appropriately.	
The DTI proposals on extortionate credit are necessary to protect consumers from the rogue trading practices of some lenders in the market.	
The incidence of rogue trading practices will decline as a result of the proposals.	
The proposals expose lenders to a significant and unnecessary degree of legal uncertainty.	
A further, more specific, definition of 'unfair credit transaction' either in legislation or otherwise fleshed out in guidelines is required in order to reduce legal uncertainty.	

2) If the provision on extortionate credit were replaced with the wider test of unfair credit transaction, would any of your current lending practices, terms and conditions, or certain characteristics of certain products be at risk of being considered unfair? (Please put an 'x' in the box, as relevant.)

NO, none.	
YES, some practices would be at risk of being considered unfair.	
YES, a significant number of practices would be at risk of being considered unfair.	

If YES, please give a number of examples of lending practices, terms and conditions or characteristics of products that could be considered unfair.

....

....

....

Please indicate the approximate proportion of your loan portfolio that would be at risk of being considered unfair. % ....

3) If the provision on extortionate credit were replaced with the wider test of unfair credit transaction, would you expect loans to consumers in the non-status segment of the market to become more risky (eg, due to higher default risk)?

YES definitely/YES probably/probably not/definitely not

If YES, please indicate what approximate proportion of your loans in the non-status segment of the market could be affected? % ....

4) If the provision on extortionate credit were replaced by the wider test of 'unfair credit transaction', would you decide to change your current lending practices (or terms and conditions or certain characteristics of certain products), or stop offering certain products that could be considered unfair? (Please put an 'x' in the box, as relevant.)

NO, my firm would not change any lending practices at all.	
YES, my firm would probably change some lending practices to some extent.	
YES, my firm would probably change some lending practices significantly	

If YES, please give a number of examples of lending practices that you would reconsider or change.

....

....

....

5) If the provision on extortionate credit were replaced by the wider test of 'unfair credit transaction', would that change your lending activities in the UK market, or in certain segments of the market? (Please put an 'x' in the box, as relevant.)

NO, my firm would be unlikely to change any lending activities.	
YES, my firm would *probably* be less willing to provide credit to consumers in general.	
YES, my firm would *definitely* be less willing to provide credit to consumers in general.	
YES, my firm would *probably* be less willing to provide credit to consumers in the non-status segment of the market.	
YES, my firm would *definitely* be less willing to provide credit to consumers in the non-status segment of the market.	

6) Do you anticipate any significant costs in terms of legal costs (drafting new contracts, etc), IT costs (adapting the current software), staff training or administration (publishing the guidance, contracts, etc) when changing to the new system?

YES definitely/YES probably/probably not/definitely not

If YES, please express the total cost in absolute terms and as a percentage of your total operating expenses. £ .... % ....

7) Do you currently use securitisations to fund part or all of your loan book?

YES, ...% of loan book is securitised/NO

If YES, please evaluate the impact of the changes to the extortionate credit provisions on securitisations by ticking all relevant boxes. Note that the DTI is considering applying the new rules on extortionate credit retrospectively (ie, to existing credit agreements as well).

Under current arrangements, the risk and financial consequences of the retrospective application of the legal change are typically borne by the investors in the securitisation vehicle	
Credit-rating agencies are likely to review their rating of my firm's securitisations. Some securitisations are likely to be downgraded	
Credit-rating agencies are unlikely to downgrade any of my firm's existing securitisations	
Going forward, the proposals are likely to reduce my firm's ability to securitise	
Going forward, the proposals are likely to increase my firm's cost of obtaining funding through securitisations	
Other, please specify	

8) Do you anticipate that you will gain additional business from the removal of rogue traders in the UK credit market? (Please put an 'x' in the box, as relevant.)

YES, my business will definitely gain more business.	
YES, my business will probably gain more business.	
NO, my business will probably not gain more business.	
NO, my business will definitely not gain more business.	

9) The DTI is proposing incorporating a principle of responsible lending in the extortionate credit provision. Credit providers will be expected to undertake enquiries that are proportionate, having regard to the type of agreement, their relationship with the customer, and the costs and risks involved. Would including this principle in the CCA impose any significant costs on your firm?

YES definitely/YES probably/probably not/definitely not

10) Would including the principle of responsible lending in the CCA change your lending practices or activities? (Please put an 'x' in the box, as relevant.)

NO, not at all.	
YES, my firm would change certain lending practices to avoid being accused of irresponsible behaviour.	
YES, my firm would be less willing to provide credit to consumers in the non-status segment of the market.	
Other (please specify)	

Part 5: Early Settlement

The DTI proposes to abolish the Rule of 78 for calculating early-settlement rebates in favour of an actuarial approach, which produces a ceiling on what lenders may charge when agreements are settled early. Lenders would be allowed to recoup costs by claiming one month's interest beyond the settlement date for loans over one year. Lenders would also be able to defer the settlement date for up to 28 days after a request.

1) Please indicate the approximate percentage of loans that settle early.

	Contracts settling early (as a percentage of all contracts)
All non-revolving credit contracts (consisting of personal loans, leasing agreements, hire purchase, etc)	
Personal loans	
Leasing agreements	
Hire purchase agreements	

2) For what approximate proportion of your business do you currently use Rule of 78?.... %

3) If you currently apply the Rule of 78, do you apply the Rule to all types of credit product?

YES/NO

If NO, please indicate the types of product for which you *do not* apply the Rule of 78?

....

4) If you currently apply the Rule of 78, do you apply it to all loans, irrespective of size?

YES/NO

If NO, please indicate for which size of loans you *do not* apply the Rule of 78.

....

5) If you currently apply the Rule of 78, please provide an estimate of the costs your firm would incur in implementing the actuarial principles method. Estimating these costs may be difficult, but please provide your best estimate. (*Please indicate whether the numbers you provide are rough estimates, or relatively accurate, based on an internal cost–benefit analysis.*)

	Total costs	As a % of operating expenditure
One-off IT systems costs		
One-off staff training costs		
One-off administration costs (eg, printing new contracts)		
Other one-off implementation costs (please specify)		

Once the implementation costs have been incurred, do you expect the ongoing costs of applying the actuarial approach to be significantly higher than the costs you currently incur? (*Please ignore the profit implications of possibly lower early-settlement rebates*.)

YES, definitely/YES, probably/probably not/definitely not

If YES, please provide an estimate of the *additional* costs that would be incurred in one year?

£..........

6) The DTI has indicated that new systems need to be in place within two years of the new CCA coming into effect. Please indicate whether, in your opinion, the implementation period of two years is appropriate or too short.

appropriate/too short

If you believe the period is too short, please indicate how many months you would need to get the required systems in place.

.... months

7) If you currently apply the Rule of 78, please indicate the types of cost you normally recover through the Rule, by ticking all applicable boxes.

Commissions paid to retailer	
Administrative costs of setting up the agreement	
Administrative costs of cancelling the agreement	
Marketing costs	
Any other costs (please specify)	

The DTI is proposing to allow credit providers to defer the settlement date for 28 days. In addition to the 28 days' deferral, credit providers will be allowed to charge one month's extra interest. Would this enable you to cover the costs of early settlement (costs as indicated above)?

YES definitely/YES probably/probably not/definitely not

8) If you currently use the Rule of 78, Please indicate your firm's likely response to the introduction of actuarial principles? (*Note that you can give more than one answer, as appropriate.*)

No impact at all.	
My firm would probably recoup costs (the costs indicated above) by increasing interest rates.	
My firm would probably recoup costs by introducing an upfront fee.	
My firm would probably change the terms and conditions of contracts with retailers (eg, lower commissions)	
Any other response (please specify)	

If you currently apply the Rule of 78 and use securitisations to fund (part of) your loan book, please evaluate the impact of the proposed changes to the early settlement provisions on securitisations by ticking all relevant boxes. Note that the DTI is considering applying the rules within 2 years of the CCA coming into effect to old and new loans.

Under current arrangements, the financial consequences of the retrospective application of the change in early settlement provisions would be borne by the investors in the securitisation vehicle	
Credit-rating agencies are likely to review their rating of my firm's securitisations because of the early settlement changes. Some securitisations are likely to be downgraded	
Credit-rating agencies are unlikely to downgrade any of my firm's existing securitisations	
Going forward, the proposals on early settlement are likely to reduce my firm's ability to securitise	
Going forward, the proposals are likely to increase my firm's cost of obtaining funding through securitisations	
Other, please specify	

9) If you currently apply actuarial methods, do you expect the DTI proposals to have any significant impact on your firm?

YES definitely/YES probably/probably not/definitely not

If YES, please briefly explain why.

....

....

10) If you currently apply actuarial methods, in which year did you switch from the Rule of 78 to actuarial principles? ....

How long did it take to get the systems for the actuarial principles method in place?

...........months

Please give any indication of the costs of switching to the actuarial principles method (IT costs, staff training costs, etc)?

£..........

11) Do you have any information that describes how you apply the actuarial principles? YES/NO. If YES: please attach a copy to this survey.

12) If your firm currently applies both methods (ie, Rule of 78 and actuarial) to calculate early-settlement rebates, are there significant differences in the costs of using the two methods? (Please ignore differences in profit implications of possibly lower early-settlement rebates.)

YES/NO

If YES, please explain the main differences. Please also provide a short explanation of why your firm is currently operating the two methods in parallel.

....

....

....

Part 6: Alternative Dispute-resolution Mechanism

1) The DTI is proposing an alternative dispute-resolution mechanism for consumer credit cases other than the courts. Please use this space if you want to comment on this proposal. ....

....

....