loaf

Fairer credit. On fairer terms.

Submission to Competition Commission's investigation into payday lending

December 2013

Introduction

loaf is a fintech start-up. Our innovative technology platform allows us to extend short-term credit to UK consumers at approximately a third of the equivalent cash price of established incumbents (and an APR[1], on a like-for-like basis, that is approximately 90% cheaper). We believe there is scope to reduce our price further once we have operating experience. Our better price is driven by a combination of efficient operating platform, less costly client acquisition and proprietary risk management software, all aligned with a business objective that is interested in building long term brand rather than short term profiteering.

However, bringing our innovative solution to market has been frustrated by the UK banking industry. Numerous banks we approached to open a standard business account[2] cancelled our application upon learning the sector in which we plan to operate. There are many other issues that we could raise with the competition commission[3] but we have focused purely on this because we believe that it is a major impediment to encouraging new, independent and small firms to deliver a better deal for UK payday lending consumers.

It is our belief that anti-competitive behaviour by the UK mainstream banking oligopoly is a significant barrier to small and independent new entrants providing better value payday solutions to UK consumers. We believe that it could be in the interest of banks to act in this way 1) as they wish to safeguard profitable relationships with existing payday lenders, and 2) they fear long-term competition rising from innovative companies in the alternative finance and fintech space.

By not providing access to business banking services for new payday entrants (irrespective of business model) banks de-legitimise new businesses, neuter new competition from entering the broad financial services market and create problems that cause new and small businesses unnecessarily high costs and more complex or lower quality relationships with other essential service providers that is then reflected in the end price that consumers pay. This reinforces the position of established large payday operators (whom the major banks do provide banking facilities to) and reduces the commercial incentive to those players to provide a better price to UK consumers.

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[1] APRs are very sensitive to input assumptions and can change significantly with relatively small changes in inputs.

[2] To be clear, the service that is being restricted is a standard UK business bank account with no borrowing or overdraft requirements.

[3] For example, a wider market definition of short term credit for the purposes of this investigation would be better, taking in overdrafts (particularly unauthorised), credit and store cards (including debt entrapment through credit and store cards), home credit and other forms of credit would. Payday lending is not a service that takes place in a vacuum as current political and media coverage implies and customers do make comparisons across products. The fairness and price of access to data from credit reference agencies (CRAs) is also an issue. CRAs are private companies that provide a form of essential public utility and their services could be better tailored to the needs of payday customers as, presently, the costs of performing a full credit and affordability check for all applicants is costly relative to the size of the loan. CRA costs for all failed applicants must be borne by successful applicants so, the more universally a CRA's services are used, the more costly the product is to the 'good' borrower. The role that lead generators play and the costs that they add to the price of some loans should also be an area of investigation and regulation. But by far the most egregious abuse we have seen connected to payday lending are reports that payday customers are refused mortgages - this is simply scandalous!

It may be the case that there is no overt collusion or anti-competitive behaviour by the banks but, even then, it is highly inappropriate in such a narrowly banked country that mega-banks should be able to frustrate non-bank competition in a vital consumer market such as short-term credit. The default should be that such economically dominant banks must provide basic business banking to all legitimate new entrants (loaf had already acquired all the required licenses before approaching the mainstream UK banks).

Payday has a price problem worthy of Competition Commission investigation

We agree with those that question some of the practices of current players in the payday industry. Specifically, there is a conspicuous lack of price competitiveness in the payday market - a situation that shouldn't arise if the competitive landscape is good for a commodity consumer product like a short term loan. When the largest player charges 1% per day interest but only has a 2-3% problem loan book[4] there is self-evidently a price and competitiveness issue. Innovation in a market takes on many forms but for a commodity product innovation must primarily lead to better price if that product market functions well. Why do new businesses not step in and disrupt the incumbents?

When formulating the plan for our business we believed that the price problem was a function of poor operating and technology platforms, excessively high marketing and client acquisition costs, excess profiteering from a successful few businesses and the regulatory demands that come with consumer finance. However, we have discovered that there is one major external factor negatively impacting competitiveness - UK banks - and we believe this is the most significant current obstacle to innovation and better pricing in the sector (irrational, ill informed and partisan political and media comment is the other major deterrent). Banks have restricted banking services to any new entrant wishing to launch a competitive product into the payday market. The price impact of this could be, in extreme, as high as 5.6 - 8.0%[5] of each loan and generally higher operating costs.

This extra 5.6 - 8.0% cost to the consumer is calculated from two key components: (1) payment processing fees from merchant acquirers and (2) the price of participation in the UK faster payments service (FPS). In relation to (1), not having a mainstream UK bank can add up to 5% to these fees as a lack of mainstream bank account by default makes the new entrant a 'high risk merchant'[6]. On point (2), only UK mainstream banks can facilitate participation in FPS. A

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[4] This is a guess based on various informal sources and inferences from Wonga. The figure is not publicly disclosed by Wonga and may therefore be wrong.

[5] 5% interchange fee and £3 faster payment service fee. Percentage range is based on a loan of £100 to £400

[6] loaf is not a high risk business in terms of payment processing and should not be priced as such - we are well capitalised, have developed valuable proprietary technology and have extensive financial and business experience. A high risk company for payment processing is one where a high number of chargebacks will occur or where there is a long lag time between payment and delivery of a good or service. Of course, loaf is a business at high risk of commercial failure like any new and innovative venture but this is not the fact that drives the 'high risk merchant' fee discussed above. Merchant acquirer and payment processor companies insure themselves against loaf's commercial vulnerability by charging upfront set-up fees, ongoing service fees and maintaining a high level of rolling reserve on our account (i.e., delaying transfer to our bank account of full payment from customers).

bank that permits the new entrant to use this service directly to pay loans to its customers significantly reduces its cost per loan. Using an alternative FPS service (that then links into a UK bank to execute the service!) adds additional cost due to payment service fees. We have assumed £3 based on our research but it can be higher or lower depending on the volume of transactions. Independent new entrants to a market will tend to have low volumes so lack of access to FPS at a decent price is a significant barrier to their ability to compete against established incumbents. The underlying cost of a FPS payment is much less than £3 so payday consumers are experiencing significant additional cost for making use of this service.

We agree with the OFT/FCA that price and not quick payment should be the most important factor influencing consumer choice and that there is a market distortion if this is not the key factor for a commodity like a loan. However, FPS is essential to payday lending as it has become the expectation of customers that payments will be quick and it would be fatally damaging for any new entrant wishing to compete with the established players not to offer this service to their customers.

Even where a new entrant could reduce the immediate direct cost of lack of a mainstream banking facility the fragility of not having a mainstream bank account would jeopardise the sustainability and competitiveness of the business as it effectively confers a 'de-legitimised' status upon it. Alternative banking facilities can be found but they are more expensive and tend to be limited in volume of transactions they will accommodate[7].

Anti-competitive action of mega-banks damages consumers

We believe that the Competition Commission should focus urgent efforts on a major cause of the market failure in payday lending - anti-competitive behaviour by banks. Consumer interest and viable new business models which could bring positive price competition to the market are being damaged by the indiscriminate prejudice of banks. In loaf's experience the mainstream UK banks have been by far the most significant impediment encountered in seeking to launch a better product in payday.

The role that banks must play

Payday is rightly being investigated as an industry due to its price and the fact that it interacts with some quite vulnerable consumers at times[8] but it is not an illegal activity and there should be no presumption from oligopolistic banks that new entrants into the market are fatally undermined by coming regulatory change, are a 'reputational' threat to the bank or are involved

[7] There are many 'electronic-money' institutions (a very wide range of businesses) that provide banking 'lite' services alongside other payment processing or card services (usually pre-paid cards). There are many good and innovative firms in this space but ultimately a business like loaf needs mainstream banking services if it is to succeed.

[8] However, most payday customers should not be viewed as vulnerable and we agree with other respondents that payday is being excessively maligned. The service payday provides should be compared to a range of credit products. For example, a consumer that maximises their balance on a credit or store card pays a lower APR but can pay much more in cash terms, partly as this sort of borrowing encourages overspending (and can be a route to debt entrapment for the vulnerable or ill-disciplined). Deciding to borrow short term through a payday loan rather than add it on to a credit or store card may show financial maturity by a consumer.

in illegal activities (we actually experienced being verbally denied an account by one bank on the grounds that we are a likely perpetrator of fraud or money laundering!). The OFT and the FCA are the industry regulators. An entity that has secured the requisite licenses and regulatory clearance to its proposed business from the regulators should not face an additional hurdle to legitimate operation from the banking sector. All indications from the OFT and FCA are that the short term credit market will continue to exist in coming years and will not be 'regulated out of business'. The individual businesses in the sector must adapt to the changes that regulators (or legislators) demand and banks should not set themselves up as gatekeepers to the industry. The status of banks and the choices they are currently making means that they effectively govern who the UK consumer has access to when they need non-bank short-term credit. This is clearly undesirable.

It is incumbent on the very narrow group of powerful UK banks to facilitate the banking needs of all new businesses that are adequately capitalised, have a sound business plan (the banks should do very little judging of the merit of the business plan if it is legal and no borrowing is required) and run by people who are not known to be incompetent or dishonest. This is as true in financial services as is it is for other industry sectors.

Banks are actively entrenching the position of current market leaders in payday lending and damaging consumer interest in the process. This is not the role that they should play in this sector and they must remain neutral and facilitate competition by enabling new and legitimate businesses to enter the market and take the risk of competing against established players. Neither is it the role of banks to take a view on the morality of payday lending particularly as some of the demand in the sector can be viewed to be a function of poor or limited services by banks to certain segments of society and, where those consumers are fully banked, their tight financial situation can make them vulnerable to high charges from their banks (for overdrafts or problem payments).

Banks must not stifle innovation and the delivery of better loan prices to consumers. The simple truth is that there are customers that mainstream banks do not want as they are not profitable for them. The banks should not be allowed to stand in the way of innovators providing financial services to those consumers. However, without appropriate regulatory oversight the banks will seek to prevent competition: it is well known that competitive sectoral disruption in any industry usually comes from new companies that innovate a way to profitably serve the more basic needs of currently less profitable customers.[9] At loaf we believe that the banks are deliberately seeking to suppress future competition by using their current power.

Innovation and competition is the best solution to improve payday market

For all that established payday players may talk about innovation, there is only one innovation that really counts for a commodity like a short term loan - price. Incumbents have very low incentive to reduce prices as, like most established and currently successful businesses, the

[9] 'The Innovator's Dilemma', Clayton M. Christensen, 1997

emphasis is on profit maximisation for current owners from the current focus of operations.

Long term consumer interests are best served by competition and innovation by private businesses. The potential for detriment to consumer interest in financial services is well known and appropriate regulation is also necessary. However, the focus of regulators and other industry oversight bodies must also be to facilitate competition and innovation in the interest of consumers and not to permit the current extended industry structure to block this with anti-competitive practices. Restricting access to a standard UK business bank account for new entrants is directly stifling competition and innovation in the UK payday market.

Paul Lavin
Director, Lean on a Friend Ltd

Tom Brammar
Director, Lean on a Friend Ltd

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About loaf

We are a start-up fintech business seeking to offer a new and different product to disrupt the current payday market. We wish to compete on a platform of significantly lower price to consumers than current well known operators through:

1. More domain appropriate risk management approach (proprietary technology)
2. Efficient operating platform (that rivals industry's best)
3. Effective client acquisition strategy but at significantly lower cost than is typical in industry currently
4. Building brand, loyalty and referrals on basis of quality, fair and well priced service

At launch we will have a dual price structure depending on the level of engagement a customer chooses and this will dictate price. Our innovative technology platform allows us to extend short-term credit to UK consumers at approximately a third of the equivalent cash price of established incumbents (and an APR[10], on a like-for-like basis, that is approximately 90% cheaper). Note, we reduce the APR without extending the payback period of the loan like many payday companies are now doing as this often pushes up the cash cost for the customer and, in our opinion, can be a form of debt entrapment by either encouraging customers to increase their level of borrowing or increasing the likelihood that they miss a payment[11]. Also, when payday provides a loan to a financially less secure individual, a 3-12 month horizon can be much less certain than 1 month. However, most customers are not 'financially insecure' and they will likely have a choice of many forms of credit.

With the lower engagement route customers of loaf will still get a price that we think is best in the industry (approximately 50-60% of established incumbent cash cost and an APR, on a like-for-like basis, that is approximately 80% lower than their representative APRs). Our aim is to encourage as many of our customers to go the lower cost higher engagement route as possible. This reduces our immediate profit but we believe builds the long term commercial success of loaf.

At heart we are a technology focused business using data and new media in a way that we think can significantly improve outcomes in the short term credit market. We do not claim to use massive amounts of data like some established players do (we are skeptical of the genuine value of some 'big data' claims) but we aim to be smart in our use of data, technology and customer interaction so as to assess and manage total risk better. Both founders have worked

[10] APRs are very sensitive to input assumptions and can change significantly with relatively small changes in inputs.

[11] Common political and media suggestions that payday customers should be encouraged to use credit unions should be tempered with this fact in mind. Credit unions are important credit institution, particularly for the most vulnerable, but we believe that often the simple bullet payment nature of pure payday is more appropriate for low sum credit. loaf is confident that it can compete on price against any credit union offering a true like-for-like credit service even though the credit risk these businesses take are often subsidised (i.e., they can lack credit discipline as they do not need to eat the losses in the same way a private enterprise does).

in emerging markets before and some of the methods we saw used for consumer interaction and assessment in financial services there with people who are unbanked or lack financial depth and history were a significant catalyst for our business idea in the UK (of course greatly adapted to make appropriate to UK).

Our aim is to prove a hypothesis that many 'poor' borrowers (not all people that use payday are poor) are honest and reliable and it is this 'good character' that should form the basis for pricing very short term credit (asset or job wealth is much more important for longer term loans). As our hypothesis proves itself we aim to reduce the cost of borrowing still further. We believe loaf's approach is innovative and differentiated from all other players in the market. Importantly, we believe we have a commercial and scalable solution. Some of the alternatives being touted in the media to current payday are neither scalable or commercial (cost and risk management problems). Regulation alone will not provide an optimal solution.

Directors

Tom Brammar:

Tom is a proven technology entrepreneur who has also performed global senior management roles, most recently as CEO of the Financial Times' Emerging Markets news service. He founded his first technology business in 2003, raising $6.4m in venture funding before selling to a Private Equity fund in 2007. Identified by venture capital research group Library House as one of the UK's under 30 'high-fliers' he is an advisory board member for a number of high-profile finance technology businesses in Europe and the US and is retained as an advisor to Bank of New York Mellon on how best to leverage digital technology.

Tom leads the technological development of loaf.

Paul Lavin:

Paul has 17 years financial industry experience starting in actuarial consultancy and then moving into fund management. Until February 2013 he was a managing partner and global equity fund manager at Goodhart Partners (FSA approved), an institutional asset management boutique he co-founded with the aide of $6m raised from private equity backers. Goodhart managed $1bn, primarily for UK pension funds, and was recognised through industry awards for its innovative products. His greatest achievement at Goodhart was making positive returns for clients during the 2008 global financial crisis by identifying credit market problems in advance. He has been a member of the Chartered Financial Analyst Institute since 2002.

Paul leads business process and financial management at loaf.