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Response to: FCA Assessing creditworthiness in consumer credit Consultation Paper CP17/27

Consumer Credit Policy
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Summary

Which? is concerned that the FCA understates the problem of unaffordable consumer credit – namely, how difficult it may be for a customer to repay credit – and the harm that this causes.

There is currently no explicit regulatory requirement for consumer credit firms to assess affordability, nor clear penalty for not doing so. Which? therefore greatly welcomes the FCA's proposals to change this. However, the FCA should go much further, specifying lending rules closer to the mortgage lending regime.

We are also concerned that rules governing the operation of the credit reference agencies (CRAs) are contributing to the problem of unaffordable (and high-cost) credit. These should be subject to competition review.

The FCA understates the problem of unaffordable consumer credit

Which? welcomes the opportunity to respond to the FCA's consultation[1].

Which? agrees with the FCA that consumer credit plays an important role in society and is a largely beneficial activity – enabling borrowers to purchase goods and services and spread repayments over time – but that there is a risk of potential harm to consumers when assessing affordability in consumer credit.

Which? is concerned though that the FCA understates the problem of unaffordable consumer credit. Unaffordable credit can cause large harm to consumers, including having to cut back on essentials, having to work longer hours, the prospect of default on financial commitments, potential bankruptcy, and associated distress, anxiety, and mental health impacts. Unaffordable consumer credit is also one underlying driver of macro-economic prudential and financial stability risk[2].

[1] Assessing creditworthiness in consumer credit: Proposed changes to our rules and guidance, Consultation Paper CP17/27, FCA, July 2017.

[2] Unaffordable credit to households (primarily, but not limited to, secured mortgage debt) was the underlying cause of the 2007-08 global financial crisis.

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The FCA's recently published Financial Lives Survey[3] highlights how widely consumer credit is held and many of the problems associated with unaffordable consumer credit:

- 75% of UK adults have had one or more consumer credit products or loans in the last 12 months;
- 46% of UK adults can be described as "paying for credit";
- 3.1 million UK adults have one or more high-cost loans now or have had one in the last 12 months;
- the FCA defines 4.1 million people as being in difficulty, because they have already failed to pay domestic bills or meet credit commitments in three or more of the last six months;
- 50% of UK consumers currently show one or more characteristics of potential vulnerability, and are twice as likely to have used high-cost credit in the last 12 months than other UK adults;
- 47% of those who rent say they would struggle to pay their rent if payments went up by less than £100 per month; and
- 24% of UK adults have little or no confidence in managing their money, and 46% of all UK adults report low knowledge about financial matters[4].

It is currently impossible to know what proportion consumer credit is unaffordable. However, Which? is concerned that much of the recent rapid growth in UK consumer lending has been driven by unaffordable credit, for example, on the basis of evidence such as:

- consumer credit lending growth, of 10% in the year to July 2017, being well above the rate of growth in household disposable income, driven by strong growth of motor finance, credit card debt, and personal loans[5];
- the Prudential Regulation Authority (PRA's) recent judgment that "the resilience of consumer credit portfolios is reducing, due to the combination of continued growth, lower pricing, falling average risk-weights, and some increased lending into higher-risk segments" and finding that "rising consumer indebtedness and its impact on borrowers' ability to repay their debt in the future was not always fully considered in firms' assessment of risk"[6]; and
- Andrew Bailey's recent statement that there is a "pronounced build up of indebtedness among younger people used for essential living costs"[7].

The FCA should therefore consider to what extent its current rules and guidance are contributing to the recent growth of consumer credit and concerns about indebtedness, and what reforms are needed to address this.

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[3] Understanding the financial lives of UK adults: Findings from the FCA's Financial Lives Survey 2017, FCA, October 2017.

[4] Executive Summary, Financial Lives Survey 2017, FCA.

[5] Bank of England Financial Policy Committee Statement from its policy meeting, 20 September 2017. Mark Carney has also stated separately that people are borrowing too much unsecured credit (BBC report,16 October 2017).

[6] PRA Statement on consumer credit, July 2017.

[7] BBC interview with Andrew Bailey, 16 October 2017.

There is currently no explicit regulatory requirement to assess affordability

The FCA's rules for consumer credit – the Consumer Credit (CONC) sourcebook, introduced in 2014 – states that "before making a regulated credit agreement the firm must undertake an assessment of the creditworthiness of the customer"[8]. Furthermore, the CONC sourcebook specifies:

> "In making the creditworthiness assessment […], a firm should take into account more than assessing the customer's ability to repay the credit. The creditworthiness assessment […] should include the firm taking reasonable steps to assess the customer's ability to meet repayments under a regulated credit agreement in a sustainable manner without the customer incurring financial difficulties or experiencing significant adverse consequences."[9]

However, the FCA's current Consultation Paper finds only that "most firms consider affordability in some form and appear to have implemented relevant processes", that "practices vary considerably", that "there is evidence of under-compliance with our rules", and that "some firms do not understand our current rules and guidance" [1.10, 2.17]. The FCA's Business Plan also states that "inadequate affordability assessments" are an issue in retail lending[10]. These findings are alarming. In accordance with the FCA's policy position outlined in the Consultation Paper, all consumer credit firms should assess credit affordability.

These findings are possibly unsurprising though given the absence of a definition of affordability in the FCA's rules. Indeed, the CONC sourcebook mentions affordability just once, and makes no distinction between assessing credit risk and assessing affordability.[11]

Only the current FCA Consultation Paper – and accompanying FCA Occasional Paper[12] – provide a clear distinction between assessing credit risk and assessing affordability, and explanation of why they differ. Namely, assessing *credit risk* and assessing *affordability* are distinct components of assessing *creditworthiness*. *Credit risk* is the ability of a customer to repay. *Affordability* is how difficult it might be for a customer to repay.[13]

Which? strongly agrees with these distinctions between credit risk and affordability. Moreover, we strongly agree that firms have good commercial incentives to assess credit risk, but little incentive to consider affordability (except to the extent that affordability overlaps with credit risk). Indeed, as the Consultation Paper and Occasional Paper show, just because a consumer is able to repay a loan, does not mean that the loan is affordable, i.e. that the customer can be repay without financial distress.

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[8] 5.2.1, Consumer Credit (CONC) sourcebook, Release 20, FCA, September 2017. The FCA took over responsibility for regulating consumer credit from the Office of Fair Trading (OFT) in 2014, following consultation on the FCA's new consumer credit rules.

[9] CONC 5.3.1.

[10] 2017/18 Business Plan, FCA.

[11] The FCA's subsequent document, "Creditworthiness and affordability: common misunderstandings" (2015) also provides no definition of what assessing affordability means, as distinct from assessing creditworthiness. The FCA's rules also makes no reference to the OFT's former consumer credit affordability guidance ("Irresponsible lending – OFT guidance for creditors: OFT 1107", Office of Fair Trading, March 2010 (updated February 2011)).

[12] Preventing financial distress by predicting unaffordable consumer credit agreements: An applied framework, Occasional Paper 28, FCA, July 2017.

[13] The Consultation Paper says that these definitions are "implicit" in the FCA's current rules [5.18 and Annex 2.5].

Hence, without a clear definition and explicit requirement for firms to assess affordability, then, as the FCA analysis shows, it should not be surprising that some firms may not do so voluntarily, and that this leads to consumer financial distress.

Indeed, the FCA's evidence in the current Consultation Paper shows that not all firms consider affordability nor understand the FCA's requirement to do so.

Which?'s other specific concerns from the FCA's research findings include that [4.20]:

- only 74% of firms always take account of individual income, and of these, only 74% verify it always or usually;
- only 69% of firms always take account of individual expenditure, and 36% household expenditure; and
- only 81% of firms use information about employment status.

Moreover, the FCA's research shows that less than half of motor finance providers take into account income and expenditure information in making creditworthiness decisions, compared to 75%-100% for almost all other consumer credit providers[14]. This is particularly worrying given the large recent growth in motor finance and that such loan commitments can be a large share of consumers' disposable income.

FCA says that these results "may also not necessarily evidence non-compliance by firms" [4.21] and "most firms believe they are compliant with CONC requirements but are looking for reassurance on this" [4.26]

Given the harm caused by unaffordable consumer credit, it is critical therefore that the FCA addresses the ambiguity in its current rules, as well as collecting more comprehensive evidence on the extent of unaffordable credit across the consumer lending market.

The FCA proposed changes do not sufficiently address the problem of unaffordable credit

Which? agrees with the outcome that the FCA is seeking, namely "for firms to make a reasonable assessment, not just of whether the customer will repay, but also of their ability to repay affordably" [1.18]. We agree that the FCA rules should promote responsible lending and enable responsible borrowing, and that this should promote sustainable well-functioning markets [3.18].

The problem of unaffordable credit applies in particular to high-cost credit or where customers are "non-prime" or vulnerable [2.1]. Unaffordable credit can nevertheless arise more widely than this and across all types of consumer credit, including high-cost credit, credit cards, personal loans, and motor finance.

We agree that firms must take into account a customer's wider financial situation, including essential expenditure and other commitments [2.9], and that the FCA must ensure an appropriate balance between, on the one hand, denying credit to those who cannot afford to repay and so are likely to suffer financial distress and, on the other, avoiding excessive

[14] Tables 18 and 31, Assessing creditworthiness in consumer credit: Summary of research findings, FCA, July 2017.

requirements which may lead some firms to limit lending unnecessarily or add unnecessary costs [2.29].

We therefore welcome that the FCA now proposes to require firms to consider affordability explicitly, especially in terms of whether repayments having a significant negative impact on the customer's overall financial situation [5.19], through changing the FCA's rules and guidance on assessing creditworthiness, including affordability, to clarify our expectations of firms [2.18], in particular:

- the distinction between affordability and credit risk;
- factors that firms should use; and
- the role of income and expenditure information [2.20].

However, Which? is concerned that these proposed changes still do not provide adequate guidance as to what firms must demonstrate that they have assessed, nor make clear the consequences of non-compliance. We have set out our alternative suggested approach in response to the Consultation Paper questions below.

Credit reference agency rules should be subject to competition review

Credit reference agencies (CRAs) have a significant role in the consumer credit market [1.16]. We are concerned though that the rules underlying the operation of the CRAs contribute to the problem of unaffordable (and high-cost) credit. In particular, the CRA reciprocity rules have the effect of restricting competition between bank and non-bank lenders. See response to Q7 below.

Which? is also concerned more generally that the FCA places does not place enough emphasis on the importance of promoting competition as a way to reduce the problem of unaffordable and high-cost credit. See response to Q10.

Consultation questions

Q1: Do you agree with our proposed changes to the scope of the creditworthiness rules and proposed transitional arrangements?

The consultation proposes only minor changes to the scope of the creditworthiness rules, on which we have no comments.

One concern is that unarranged overdrafts remain out of scope of the FCA's creditworthiness rules, especially as unarranged overdrafts can be a large contributor to unaffordable credit and financial distress.

Q2: Do you agree with our approach to the meaning of affordability and the factors that should be taken into account by firms?

Yes. The FCA should clarify that creditworthiness includes both credit risk to the lender and affordability for the borrower, and that the requirement to assess affordability must be made explicit.

The FCA should also provide clarification for what it means by "risk to the customer of not being able to make repayments without the repayments having a significant negative impact on the customer's overall financial situation" [5.19] as this requirement may itself be subject to considerable interpretation.

In particular, the FCA should provide quantitative thresholds as to whether a customer not being able to make repayments would have a significant negative impact on a customer's financial situation. Please see further below in response to Q4.

Q3: Do you agree with our proposals on the use of income and expenditure information?

We do not necessarily agree that in the majority of cases where the customer is "prime" and the amount and cost of the credit are relatively low, the firm may be able to satisfy itself on affordability without considering or verifying the customer's income and expenditure.

This is because an assessment of whether the amount and cost of the credit are relatively low itself is likely to depend on considering income and expenditure information. Even a small amount of credit will still have a large negative impact on a customer on a low (and/or uncertain) income and with other regular commitments. For example, even a "prime" customer may still have low income and relatively high expenditure.

We agree that where a customer is not prime, or the amount and cost of credit are not low (or the firm is unable to demonstrate it), then the firm must be required to take income into account in some way in the assessment, and that where a firm is required to establish or estimate income, it must also establish or estimate non-discretionary expenditure (i.e. disposable income).

A further important consideration is that lenders must also treat a consumer's ability to make regular savings as form of non-discretionary expenditure. The FCA's Financial Lives Survey 2017, among many other sources, highlights that the need for a large proportion of consumers to save more:

- many UK adults have very little in the way of cash savings (39% have no savings at all or savings less than £1,000); and
- one third of UK adults have no private pension provision.

Credit affordability assessment should therefore include the ability for consumers to make regular savings and pensions contributions, as a form of non-discretionary expenditure, especially where the relative amount of the credit is high[15].

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[15] This could follow the approach of the Standard Financial Statement (SFS) which includes a savings category, recognising the benefits of building financial resilience, helping develop savings behaviour and increase the capacity to withstand income shocks. See https://sfs.moneyadviceservice.org.uk/en/.

Q4: Do you agree with the factors which we propose that firms should have regard to when considering proportionality of processes for assessing creditworthiness including affordability?

No. Which? does not agree that firms should not be required to incorporate debt-to-income (DTI) ratios – or similar – into their assessments of affordability, in particular considering the FCA's own research that "our findings support the use of DTI ratio over other measures in affordability assessments, especially for higher-cost products"[16]. We recognise that DTI may not be a perfect measure, that an indicative DTI ratio for a particular sector may have limited relevance for another sector, or that lending to customers below a certain DTI threshold could necessarily be undertaken at lower risk.

However, a DTI ratio should be starting point for any affordability assessment, along with others ratios, such as repayment-to-income ratio, and discretionary/non-discretionary-to-total-income ratios. At minimum, a consumer's discretionary-to-total-income ratio (including any new credit repayments) must be sufficient to allow for reasonably foreseeable material changes in income and expenditure over the period of the credit, plus a margin for unexpected changes. Otherwise, consumers will undoubtedly face a high affordability risk and associated financial distress. Correspondingly, a high discretionary-to-total-income ratio should indicate a low affordability risk.

In contrast, the FCA's proposal that firms "should take into account, where relevant, when, for example, deciding on the types and sources of information to use in the assessment and whether and to what extent to verify information" a long list of factors including "type of credit", "amount and duration of the credit", "whether interest rates and charges are fixed or variable", and "other potential costs" [5.41] does not necessarily provide meaningful guidance or clarification, as almost all firms will likely say that this what they do already.

Instead, the FCA should provide some benchmark quantitative measures, based on research, such as a minimum acceptable disposable-to-total-income ratio, with a clear requirement to determine and apply this to affordability assessment, and requirement to report and explain any exceptions.

In this way, affordability requirements for unsecured consumer credit should reflect affordability for mortgages more closely[17]. The mortgage affordability test effectively sets a loan-to-income (LTI) cap for each borrower that depended on the term of the mortgage and the borrowers' other spending commitments. One option would be for the unsecured consumer credit affordability test to set a corresponding minimum disposable-to-total-income ratio (after all credit commitments). This is because unsecured credit can add substantial incremental debt service costs on top of mortgage payments (owing to higher unsecured interest rates) or correspondingly on top of consumer rental payments. This would be a particular concern if a consumer were already at their maximum mortgage LTI ratio. Correspondingly, as the FCA Financial Lives Survey shows, almost half of those who rent say they would struggle to pay their rent if payments went up by less than £100 per month.

The Consultation Paper also asks for comments on the various infographic and tables on how proportionality may affect the level of assessment required under our proposed rules (Tables 4-6). Which? agrees with the tables as a qualitative description of the necessary affordability

[16] Can we predict which consumer credit users will suffer financial distress? Occasional Paper 20, FCA, August 2016.

[17] The FCA's Mortgages and Home Finance Conduct of Business (MCOB) Sourcebook specifies detailed rules on requirements affordability assessment in mortgages.

assessment. However, they also appear to describe what most credit firms already do, hence, do not provide any additional guidance or clarification of the FCA's rules. As above, the FCA should develop quantitative thresholds for assessing consumer credit affordability.

Q5: Do you agree with our proposals for open-end and running-account credit, guarantor loans and peer-to-peer loans?

No. We do not agree that firms should make an assumption about how long an open-end agreement, such as a credit card, is likely to be for, as such an assumption is likely to be arbitrary and inaccurate in many cases.

Instead, firms should make a regular reassessment of the affordability of an open-end credit agreement. At minimum, this should be based on internal transaction data. For example, if a consumer uses a credit card for essential spending and only pays the minimum repayment for a given number of consecutive months, then this should raise affordability concerns. Likewise, if a consumer suddenly changes their transaction behaviour then this should also trigger an affordability review. Firms should also use external data to periodic affordability reviews, for example, every two or three years.

We agree with the FCA's approach to guarantor loans and peer-to-peer (P2P) lending.

Q6: Do you have any views on our proposals in relation to firms' policies and procedures for creditworthiness assessment?

The FCA must explicitly require firms to establish and implement clear and effective written policies and procedures to assess affordability, as distinct just from creditworthiness assessment.

Q7: Do you have any views on the use of CRA data and products, or other data sources, as part of an assessment?

Which? agrees that CRAs play a significant role in providing data, products and other analytics to inform lenders' assessments of credit risk and affordability, and that the system of reporting to CRAs through industry agreements has enabled the development of one of the most advanced credit reference markets in the world [5.79].

However, Which? is concerned that the principles that underly the operation of the CRAs – namely the Steering Committee on Reciprocity (SCOR) Principles of Reciprocity – are anti-competitive, in particular in the way that they limit data sharing with non-bank lenders.

As the FCA Occasional Paper notes "CRAs only allow lenders that report their own data (of the same kind) to access CRA data"[18]. While the stated purpose of this reciprocity rule is to ensure that there is no "free-riding" by individual firms and that there are incentives for firms to

[18] Page 34, Preventing financial distress by predicting unaffordable consumer credit agreements: An applied framework, Occasional Paper 28, FCA, July 2017.

contribute to the common goal of more accurate data, this rule has the effect of creating barriers to competition. In particular, the SCOR rules create a large competitive disadvantage for non-bank consumer lenders and other market entrants, relative to banks, thereby restricting competition and entrenching banks' incumbency advantages.

This means that it is more difficult for non-bank lenders to assess consumer creditworthiness (and affordability) than banks, and thereby face much greater *adverse selection* risk, i.e. risk of inferior credit quality through much greater asymmetric information between lenders and borrowers. Non-banks therefore may not be able to offer as competitive pricing as banks, or may not be willing to lend at all.

Which? does not believe that there is reasonable justification for such an anti-competitive restriction, for example, as required under the Competition Act 1998, and that the industry should therefore review the SCOR rules. In particular, the FCA should use its competition powers to consider the SCOR rules (and any potential anti-competitive effects).

Moreover, this situation contrasts with the position in SME lending, where regulations under the Small Business, Enterprise and Employment Act 2015 (SBEE Act), which came into force in 2016, requires the largest banks to provide information about SMEs to designated CRAs including a duty on such CRAs to provide information about SMEs to all lenders. This regulation was specifically intended as a way to reduce barriers to competition in the SME lending market. Similar provisions should also be considered for consumer lending.

We agree that the development of open-source application programming interfaces (APIs) in banking, as required under the revised Payment Services Directive (PSD2) and the Open Banking Standard, should help non-bank lenders [5.81]. Indeed, the Government has stated that "income and expenditure analysis, including affordability and credit rating or credit worthiness assessments" should be one of the services delivered by open-source APIs[19]. Moreover, the combination of PSD2, Open Banking, and the General Data Protection Regulation (GDPR) provide considerable opportunity for development of new products and services making use of consumer data.

However, such services do not yet exist and there is still much uncertainty as to how they will develop. The FCA should use its oversight role for Open Banking and regulatory responsibility for PSD2 to help ensure that the new APIs support credit affordability and creditworthiness assessment.

Q8: Do you have any other comments on our proposed changes to CONC in relation to creditworthiness including affordability?

No.

Q9: Do you agree with our assessment of the costs and benefits of the proposed changes?

Yes, we agree with the FCA's costs and benefits assessment.

[19] See para. 6.29, Implementation of the revised EU Payment Services Directive II, HM Treasury, February 2018.

Q10: Do you have any comments on the equality and diversity implications or other aspects of our proposals?

We have concerns that the FCA's proposals do not put sufficient emphasis on the FCA's duty to promote effective competition in the interests of consumers. In particular, the Consultation Paper says that the FCA has considered competition issues [2.11], but it does not say how it has considered them, except that:

> "The proposals also promote effective competition in the interests of consumers, by seeking to ensure that all relevant firms understand our regulatory requirements and expectations and offer credit fairly and responsibly." [Annex 3.8]
>
> "Competition is enhanced if firms operate on the basis of level playing fields and with a common understanding of the regulatory regime and regulatory expectations." [Annex 3.30]

In contrast, Which? would expect an assessment of how competition itself can impact creditworthiness assessment and propensity of firms to offer unaffordable credit (for example, through differential availability of credit data across market participants) and whether other regulatory changes could be made to make competition work more effectively.

Credit (and insurance) markets suffer in particular from problems of *adverse selection* and/or *moral hazard*, namely, where there can be a large degree of asymmetric information between borrowers and lenders (and between different market participants). Namely, borrowers will have better information about risk characteristics than prospective lenders. Borrowers' risks characteristics also a function of their behaviour, which may also change after entering a credit contract.

Hence, any competition assessment should include consideration of these credit market specific features, as well as general features of competition, such as barriers to entry and expansion, and ease of consumer price comparison and shopping around.

Which? would particularly welcome the FCA's current review of high-cost credit (including overdrafts) include a full assessment of competition, especially between alternative credit products. We note in contrast that the FCA's credit card market study[20] did not consider analysis of adverse selection and access to credit data, focusing chiefly on problem credit card debt rather than potential pro-competitive regulatory changes.

About Which?

Which? is the largest consumer organisation in the UK with more than 1.7 million members and supporters. We operate as an independent, a-political, social enterprise working for all consumers and funded solely by our commercial ventures. We receive no government money, public donations, or other fundraising income. Which?'s mission is to make individuals as powerful as the organisations they have to deal with in their daily lives, by empowering them to make informed decisions and by campaigning to make people's lives fairer, simpler and safer.

[20] Credit card market study: Final findings report MS14/6.3, FCA, July 2016.