Financial Services Consumer Panel

AN INDEPENDENT VOICE FOR CONSUMERS OF FINANCIAL SERVICES

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Dear David,

Call for Input: High-cost credit and review of the high-cost short-term credit price cap

This is the Financial Services Consumer Panel's response to the call for input on high cost credit.

The Panel's mission is to make sure that individuals and small businesses benefit from financial services. In the short time that it has regulated consumer credit, the FCA has made significant progress in protecting some consumers from harm. However, the evidence published by the FCA in this Call for Input (as well as its Credit Card Market Study and CMA's personal current account study) identifies common practices in the credit market that result in consumer detriment for a significant minority of individuals and their families. This review is an opportunity for the FCA:

a) To ensure that it has a consistent approach to conduct risks regardless of the sector in which they occur. This should help minimise 'waterbed effects' that are potentially detrimental to consumers and time-consuming for the FCA to identify and supervise.

b) To focus more on measures to prevent people getting into unmanageable debt rather than on 'curative' measures that deal with detriment that has already occurred. Based on evidence from sources including the Credit Card Market Study and complaints about irresponsible payday lending,[1] the Panel wants the FCA to do more to improve the quality and consistency of lenders' affordability checks and creditworthiness assessments. We also believe lenders should carry out better surveillance of accounts in the interests of their customers and intervene earlier where they identify potential problems, such as credit card users with persistently high utilisation of their credit limit and persistent minimum payers. The Panel would also like the FCA to explore a single credit limit for consumers across all their non-mortgage borrowing.

c) To consider how a Duty of Care[2] could protect consumers from detriment in the credit market. There are numerous cases where the FCA Principle of Treating Customers Fairly (TCF) is failing consumers, but where firms have not been breaking FCA rules, for example:

  - If a customer tries to withdraw funds beyond their overdraft limit, banks can allow the withdrawal without telling the customer, at the point of making the decision, what charges will result. Under TCF, as long as the

[1] http://www.financial-ombudsman.org.uk/publications/annual-review-2016/ar16.pdf
[2] https://fs-cp.org.uk/sites/default/files/duty_of_care_briefing_-_jan_2017.pdf

customer has been told the charging structure, this is considered fair. Under a duty of care, the bank would be required to inform the customer of the likely charges before the withdrawal.

- Credit card companies exploit 'minimum payers', who are paying interest rates typically 15-20% above base rate. They offer increased credit limits without conducting affordability checks. And, as the result of just one missed payment, or breaching the credit card limit, firms can immediately withdraw an interest-free credit card offer, which is likely to result in high interest charges. Under a duty of care, firms would only offer appropriate products with affordable credit limits to consumers, and firms would only have transparent and proportionate fees and charges.

d) To consider the risks that might arise for consumers from providers of HCSTC (indeed any lender) misusing the Open Banking remedies to engage in aggressive collections activity or to penalise consumers who do not want to allow access to their transactional data.

Section 1: High-cost credit

Q1: Which high-cost products do you think our review should focus on and do you think a more consistent approach to high-cost products is feasible or desirable?

This review is an opportunity for the FCA to develop a consistent approach across consumer credit as a whole, not just to look at 'high-cost' products. The Panel believes that this is essential to avoid regulatory arbitrage. The review should include not only 'traditional' high-cost products (payday loans, rent to own, home credit, logbook loans, etc.) but also sub-prime credit cards; other forms of high-cost credit such as instalment loans and guarantor loans; and overdrafts.

The review should also examine the potential detriment from the use of Open Banking APIs by brokers and providers of credit.

Q2: To what extent is there detriment from high-cost credit products (other than HCSTC)?

There is risk of consumer detriment from many products. For example:

- The FCA's credit card market study, found that **'Low and Grow'** card users are much more likely to have exceeded their credit limit than the generality of card users (20% of Low and Grow users compared with 7% of card users overall). We appreciate this is a minority of Low and Grow card holders, but it nonetheless represents a sizeable and worrying number of consumers. While 'Low and Grow' cards may be useful products for consumers to build their credit rating and to smooth income and expenditure, this evidence indicates that such cards do not always work for consumers and risk damaging already fragile credit ratings.
- **Unarranged overdrafts** are supposed to be a 'last resort' for consumers who experience unexpected cash-flow problems, not a line of consumer credit. Lenders who repeatedly allow their customers to go into, or stay in, an unarranged overdraft are not lending responsibly. Unarranged overdrafts and the charges associated with them can be used to exploit financial difficulty and small errors from consumers that far exceed marginal cost. In some circumstances the cost of an overdraft can exceed the cost of a payday loan, which the FCA has capped at 0.8% interest per day. The analysis in the Call for Input shows a detrimental inter-relationship between overdrafts and payday loans.
- A number of HCSTC products have recently morphed into **products requiring small repayment instalments followed by a large final payment**, rather than spreading the cost of the loan across the loan period.

- There are a number of new products linked to bank accounts using screen scraping and Open Banking APIs that offer a **revolving line of high-cost credit**.
- There has been an increase in recent years in the use of **logbook loans** (bills of sale). We have supported the Law Commission's proposals to reform the law in order to include protections similar to those offered by hire purchase law. Borrowers in this market need greater protection.
- The work of the Illegal Money Lending Teams shows that there are significant risks of consumer detriment from the exploitative activities of **unauthorised lenders operating in local communities**.

Q3: Where there is detriment, do you consider that it arises from matters not addressed by our rules, or is it mainly caused by firms failing to comply with the rules?

Both, although we would emphasise that *any* form of credit, lent irresponsibly, causes detriment to some consumers.

Regulatory arbitrage means that some new products are not captured by the HCSTC rules, such as instalment loan 'bullet payments' and revolving credit designed to circumvent the rules. Other high cost products are excluded from the rules, of which unarranged overdrafts are the most glaring example.

Many lead generators are unregulated and so are able to attract consumers in ways that regulated firms can't. They avoid regulation because they avoid giving advice as defined by CONC. Consumers, however, can't differentiate between regulated and unregulated firms.

Insolvency Practitioners are exempt from FCA regulation provided that the advice they give is in "reasonable contemplation" of an insolvency appointment. If they buy packaged IVA leads from unregulated lead generators then the FCA has no oversight or control of those cases. By way of contrast an FCA regulated adviser is not only accountable for their own actions but for the activities of any lead generators they use too – effectively ensuring those lead generators work to FCA standards.

We also believe that some firms are also not complying with rules governing responsible lending and affordability assessments. According to a freedom of information request, the FOS received almost 7,000 complaints in the year until September 2016, relating to affordability. Of these, the FOS upheld 51%.

Recent StepChange research[3] reports that there are still issues with lending practices. Over a third of StepChange clients with HCSTC debts have three or more such debts and three quarters of clients surveyed said that they got a HCSTC loan when they already had outstanding HCSTC. StepChange also says that a quarter of its clients did not know or only had a rough idea of how much they would have to repay and just over a quarter said they did not think the lender took reasonable steps to assess their ability to repay a HCSTC loan.

While the LSB's new standards of lending practice add to the FCA rules in some respects, the standards are voluntary and LSB membership largely comprises large firms that are already closely supervised by the FCA. This means the LSB's impact in improving standards across the sector as a whole is likely to be limited.

Q4: If there is detriment arising from matters not addressed by our rules, what sort of interventions should we consider? What would be the impact?

We believe that protections equivalent to those applied to HCSTC should be applied across all forms of consumer borrowing where there is evidence of detriment. In addition, we believe there should be a single credit limit applied to individuals' non-

[3] https://www.stepchange.org/Portals/0/documents/Reports/Payday-loans-next-generation.pdf

mortgage borrowing. Firms and the FCA should aim to prevent detriment, not deal with it when it has occurred. Making it harder for people to borrow when they do not have the means to pay back the money would likely lead to a higher price and reduction in access for the riskiest borrowers, and (maybe) lower prices for low risk consumers. This is likely to happen anyway as more firms use big data to cherry pick or 'red line' customers, and the FCA needs to take this into account in developing interventions. The bottom line is, that if the FCA, or the Government, believes that everyone should have access to affordable loans, then they need to decide where the subsidy should come from.

Q5: Should some of the HCSTC protections be applied more widely? What would be the impact on the cost of or access to credit?

Yes, but see answers to previous questions. The FCA should take a broad view across all credit products.

Q6: To what extent do you think overdrafts are a substitute, or alternative, for other high-cost credit products?

The Panel believes the picture is more complex than consumers simply substituting overdrafts for other high-cost credit products. The analysis in the Call for Input shows an interrelationship between overdrafts and HCSTC loans: for both declined and successful HCSTC applicants, there was an increasing likelihood of them exceeding their overdraft limits post-application, regardless of the outcome (Annex 3). This is one reason why the Panel think the FCA should explore a single credit limit for consumers across all their non-mortgage borrowing.

Q7: What do you think are the key issues the FCA should consider on arranged and unarranged overdrafts respectively?

Unarranged overdrafts are supposed to be a 'last resort' for consumers who experience unexpected cash-flow problems, not a line of consumer credit. The Panel feels strongly that the emphasis should be on firms using their transaction data to identify and proactively contact consumers who risk drawing on an unarranged overdraft and incurring significant costs from the firm and potentially a bill originator as well. Banks should not put customers in a position where they are regularly paying charges for using an unarranged overdraft. Unarranged overdrafts are bad value for users, due to their high charges, but generally good for banks. The FCA should evaluate actual administrative costs incurred by banks when consumers use an unarranged overdraft or have a payment rejected. It is standard practice in many other sectors for contingent charges to be restricted to marginal cost. There is no rationale for banks to charge more.

Overdraft fees and charges have become more complex and difficult to compare over the past few years, as banks have moved away from charging interest to charging daily fees, monthly fees, interest or some combination of these. Unarranged overdrafts may also have paid and unpaid item charges alongside other charges. This makes it more difficult for consumers to understand which account offers them best value. Often, the answer as to which account is best for them will be "it depends" – it will depend on how often, how much and how long they use their overdraft. There is evidence that many consumers underestimate their usage of overdrafts[4] and they may be over-optimistic about their ability to avoid them in the future. In these circumstances greater transparency alone is unlikely to have the desired effect.

Unarranged overdraft fees can be seen as a type of discontinuous pricing strategy, used to exploit financial difficulty and small errors from consumers with charges that far exceed marginal cost. In some circumstances the cost of an overdraft can exceed the cost of a payday loan, which the FCA has capped at 0.8% interest per day. Which? research[5] comparing the cost of borrowing £100 for 30 days found that unarranged

[4] See, for example, OFT, *Personal current accounts in the UK: an OFT market study*, July 2008. page 159
[5] http://press.which.co.uk/whichpressreleases/overdraft-charges-could-cost-156-more-than-payday-loans/

overdraft charges at some high street banks were as much as 7.5 times higher than the maximum charge of £24 on a payday loan. Because bank overdraft charges apply to their monthly billing period, not the number of days the money is borrowed for, consumers who need £100 could pay up to £180 in fees if they borrow across two billing periods.

This difference in cost between payday loans and unarranged overdrafts, when banks face very low customer acquisition costs for their unarranged overdrafts merits closer examination. Unarranged overdrafts should also be lower risk as banks possess a significant amount of information about the consumer's financial circumstances.

Q8: What measures could be taken to address these and what would be the risks and benefits?

We do not have any confidence that the CMA's remedies will deal with the consumer detriment from overdrafts.

Giving consumers the ability to opt-out of an unarranged overdraft facility does not go far enough, as inertia will generally prevent them from doing so. We believe that consumers should actively opt-in.

If firms levy charges on consumers who have opted not to have an unarranged overdraft, these should be clearly justified and based on the marginal cost to the firm.

An alternative could be to require firms to offer consumers a sweep service that would automatically take funds from a linked savings account, rather than going into an unarranged overdraft or missing a payment. For consumers who do not have savings, firms should proactively contact consumers at risk of incurring charges for unarranged overdrafts, using the transactional data they hold.

A cap seems to be the only way to control the level of unarranged overdraft charges. There are 3 possible structures:

- Restrict the level of unarranged overdraft charges to those of arranged overdrafts;
- Apply the current level of the HCSTC cap to unarranged overdrafts; or
- Restrict unarranged overdraft charges to the net additional direct administrative costs which firms incur when consumers use their overdraft.

Precedent from other sectors includes:

- Mortgages - FCA rules require charges levied when a consumer is in mortgage arrears to only reflect a "reasonable estimate of the cost of the additional administration required as a result of the customer being in arrears"[6]; and
- Credit cards – In 2006 the OFT capped credit card default charges at £12 as charges in excess of that would almost certainly exceed the direct administrative costs incurred by the lender[7].

Section 2: HCSTC price cap review

Q9: Please provide evidence and/or views on:

– the reasons for the substantial reduction in applications from consumers for HCSTC and the reduction in acceptance rates by firms

This was expected. These effects are very well-evidenced from other countries that have introduced interest rate caps, as referenced in the final report of the CMA payday lending market investigation.[8]

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[6] MCOB 12.4.1

[7] OFT, Calculating fair default charges in credit card contracts: A statement of the OFT's position, 2006

The FCA should consider the extent to which firms have reduced their marketing activity and whether this has contributed to the decline. We believe that consumer demand for these products is, to a large extent, generated by the firms.

– the impact on loan duration and product development more generally of the structure and level of the price cap

There is good evidence from the UK and elsewhere that firms adapt to a cap by offering longer-term or other types of credit. Payday lenders now increasingly market three-month or longer instalment loans. This is both to generate more interest income and because of the rollover rules which only allow a loan to be extended twice.

Q10: Do you have views and evidence on the risks for consumers of using HCSTC post-cap? Do you agree with our initial assessment that risks of falling into arrears have reduced?

The biggest risks are likely to come from credit products that fall outside the cap.

Q12. Do you agree that consumers do not generally move to other high-cost credit products as a result of being declined for HCSTC?

The FCA's analysis indicates this is the case – this chimes with other evidence that shows the types of consumer credit that tend to be used in tandem. Home credit and loans from a pawnbroker, for example, are generally used by different customer segments than online payday loans.

The Call for Input reports that there has not been any increase in borrowing from illegal lenders operating in local communities post-cap, based on evidence from the Illegal Money Lending Teams. The Teams do not deal with all forms of unauthorised lending, however. As noted above, the Panel believes that any work on unauthorised lending being carried out by the FCA's Unauthorised Business Department should be linked to this work on consumer credit.

It is often anticipated that non-standard forms of lending from credit unions and other community lenders will increase when a cap is introduced. The Bank of England Credit Union Annual Statistics shows that the value of credit union lending increased between 2013 and 2015 although the number of loans outstanding[9] increased only slightly over the same period, having peaked in 2014.

	2013	2014	2015
Value of loans made during the year	£701,266	£757,286	£791,577
Number of loans outstanding at financial year end	506,727	521,050	516,710

Source: Bank of England Credit Union Annual Statistics 2015, published 2016[10]

Some of the increase in credit union lending since 2013 may be attributable to the HCSTC cap introduced on 2 January 2015, but will also relate to the credit union expansion project (begun in 2014), which aims to "achieve the modernisation and expansion required for the credit union sector to be close to achieving sustainability in the next seven to ten years" through a government investment of up to £38 million.[11]

According to a 2015 report[12] published by the CDFI trade body, Responsible Finance, in 2015 personal lending by CDFIs comprised £22m to 45,185 people. They report a 14%

[8] https://assets.publishing.service.gov.uk/media/54ebb75940f0b670f4000026/Appendices___glossary.pdf Annex C

[9] The Bank of England publishes statistics for the number of loans outstanding at financial year end but not the number of loans made during a financial year.

[10] http://www.bankofengland.co.uk/pra/Documents/regulatorydata/creditunionannualstatistics2015.pdf

[11] https://www.gov.uk/government/consultations/british-credit-unions-at-50-call-for-evidence/call-for-evidence-british-credit-unions-at-50

[12] http://responsiblefinance.org.uk/2015/12/responsible-finance-the-industry-in-2015/

increase in personal lending in 2015, compared to 2015; and that they helped 12,000 people avoid using a high-cost lender.

By way of comparison, one large home credit lender announced in 2013 that its lending volumes (pre-cap) had reduced by 0.3 million customers (from 1.8 million to 1.5 million); and in February 2015 that it had reduced its home credit numbers by a further 500,000 to just over 1 million.[13]

Q13: What are the implications for consumers of increasing loan duration for HCSTC?

The Panel is concerned that, while increasing loan duration is marketed as a positive way for borrowers to spread debt repayment, the use of 'bullet' payments can create difficulties for some in just the same way as a standard 30-day payday loan. Lengthening loan duration can also result in consumers being in debt for longer if they choose to roll-over the loan.

Q14: Do you have views or evidence that the HCSTC price cap has had an impact on other high-cost products: e.g. because consumers use those products as an alternative?

The FCA needs to monitor this over the longer term – borrowers (and declined applicants) may migrate to other credit products over a fairly long period of time, as they exhaust other options such as doing without or borrowing from friends and family.

Q15: Do you have evidence that the definition of HCSTC is providing opportunities for firms to evade the HCSTC price cap (and HCSTC regime more generally)?

Yes – see above about instalment loans. There is also the advent of firms offering revolving lines of credit at high cost.

Yours sincerely

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[13] http://www.carnegieuktrust.org.uk/carnegieuktrust/wp-content/uploads/sites/64/2016/02/pub14550114201.pdf