RESPONSIBLE LENDING IN CONSUMER FINANCE

GETTING THE BALANCE RIGHT

HUNTSWOOD

THE FOCUS ON AFFORDABILITY

Affordability was already a major area of concern for the Financial Conduct Authority (FCA) and regularly landed in the FCA's risk outlook prior to the Coronavirus pandemic.

In the last few years, the regulator has made a number of high-profile interventions and introduced some fundamental rule changes and updates to guidance which have challenged profitability and sought to steer the industry towards more supportive relationships with consumers.

The global economic crisis caused by the Coronavirus pandemic has further highlighted the consumer need for access to credit and the important role the consumer credit sector has within society. However, it has also exacerbated the challenges for lenders. Lenders now need to not only consider issues of affordability, but also balance this with the UK Government's requirement to show forbearance to consumers around mortgages, overdrafts and other credit mechanisms, while still generating enough revenue to sustain business.

Those who are most vulnerable have always been at greatest risk of harm caused by poor lending practices, and it is this group that the regulator primarily seeks to protect. Vulnerability, however, is a fluid condition. In an unstable economic climate, the resilience of households to shocks is lowered and the number at risk of financial distress increases. Identifying those who are vulnerable, or at risk of vulnerability, becomes even harder.

A historic low in central bank interest rates, combined with a requirement for some to lend at reduced costs, a higher risk of default, and greater expectations from the public and regulator of forbearance, puts lenders in a testing position. Many have been stuck with the impossible choice of extending credit terms and worsening indebtedness, versus tightening credit and restricting access to cash to protect people from the debt cycle.

It is imperative for the survival of firms, not to mention the protection of consumers and the stability of the economy, that best practice is adopted when it comes to assessing affordability, managing debt and recognising vulnerability. The conduct of firms throughout the pandemic will make a lasting impression on customer sentiment and affect reputations for a long time to come. Those who get it right have the potential to establish newfound brand loyalty and integrity as a result.

WHAT DOES THE REGULATOR EXPECT FROM LENDERS?

Since the FCA began regulating the industry in 2014, its focus has been on delivering the best possible outcomes for consumers and introducing a raft of new legislation to support lenders in their adoption of fair lending practices. This includes an increasing focus on how to support customers who are vulnerable to any changes in their own circumstances, as well as the external economic environment.

In 2017, the results of a large-scale survey by the FCA found that

75% OF UK ADULTS HAD TAKEN OUT ONE OR MORE CONSUMER CREDIT PRODUCTS OR LOANS

in the previous 12 months and

4.1 MILLION PEOPLE WERE “IN DIFFICULTY”

because they had already failed to pay domestic bills or meet credit commitments in three or more of the previous six months. At the same time,

50% OF UK CONSUMERS ALSO SHOWED ONE OR MORE CHARACTERISTICS OF POTENTIAL VULNERABILITY.

As a result, the regulator updated its affordability rules in 2018, requiring firms to make a reasonable assessment of creditworthiness before making a regulated credit agreement or significantly increasing the credit limit.

Since then there have been multiple updates from the regulator across different lending practices, including the recent focus on credit cards, high cost credit, high cost short term credit and motor finance.

The FCA’s 2020 Sector Views report further highlighted that

OVER 39 MILLION PEOPLE HAVE OUTSTANDING BORROWING TOTALLING £1.66 TRILLION AS OF OCTOBER 2019.

The regulator has taken specific action, for example within the high cost short term lending space, and is now turning its attention towards enforcing responsible lending practices within firms.

When investigating why poor practice still occurs, it’s important to look at the guidance currently available to lenders. The issue with compliance, however, is that the handbook leaves many rules open to interpretation for lenders.

For example, there is often a lack of detail around the length that firms should go to in validating affordability assessments. Wording such as "proportionate checks" is open to interpretation, running the very real risk that businesses do not meet the regulator’s expectations.

STEPS TO ENSURE RESPONSIBLE LENDING:

1. Before entering into a credit agreement with a customer, lenders should make a reasonable assessment of the customer's creditworthiness and how affordable and sustainable the credit is.

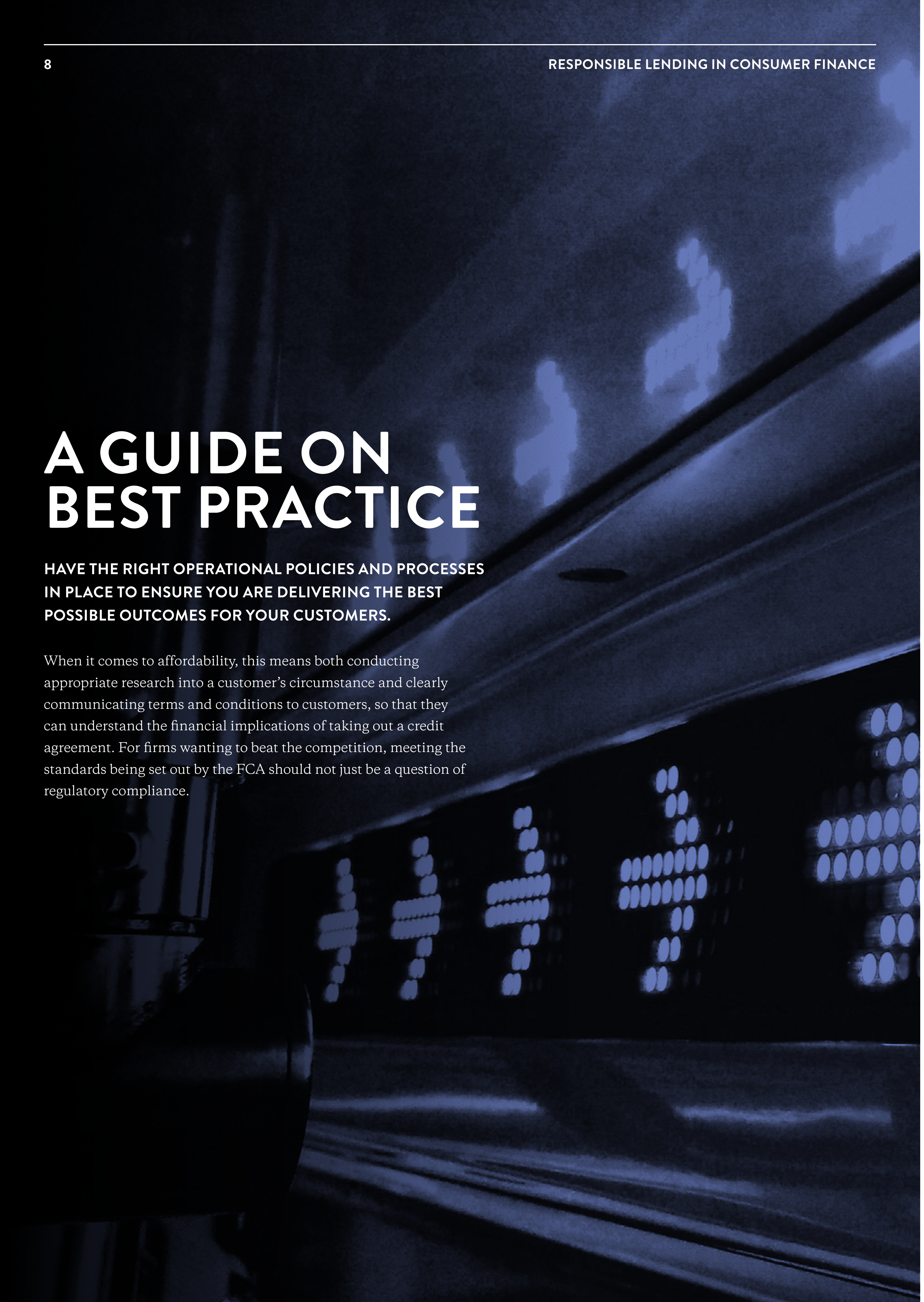
2. Lenders need to understand the drivers behind a consumer's decision to take on short-term debt and look at their credit history before extending credit. Will the customer be able to make repayments over the lifetime of the credit agreement?

3. An assessment should be undertaken and monitored to identify whether the situation changes and the customer shows signs of financial distress.

4. Any decisions that are published by the Financial Ombudsman Service (FOS), be that decisions against the firm or their competitors, need to be fed back into the business to enable changes to be made where

5. Firms should monitor, learn from, and amend policies or processes based on their own complaints experience.

WE BUILD ON THE STEPS ABOVE IN MORE DETAIL OVER THE FOLLOWING PAGES.



A GUIDE ON BEST PRACTICE

HAVE THE RIGHT OPERATIONAL POLICIES AND PROCESSES IN PLACE TO ENSURE YOU ARE DELIVERING THE BEST POSSIBLE OUTCOMES FOR YOUR CUSTOMERS.

When it comes to affordability, this means both conducting appropriate research into a customer's circumstance and clearly communicating terms and conditions to customers, so that they can understand the financial implications of taking out a credit agreement. For firms wanting to beat the competition, meeting the standards being set out by the FCA should not just be a question of regulatory compliance.

STRIKING THE RIGHT BALANCE

When it comes to lending, one thing firms should be confident in is the difference between credit and affordability checks. While a typical credit check is backward-looking, it does not consider possible future changes to a customer's circumstances. According to the FCA, firms must understand the potential for credit to adversely impact the customer's financial situation – in other words, whether the debt will be affordable for the entire lifetime of the agreement.

When assessing whether a customer can afford a product, the FCA sourcebook – CONC 5.2.3 – sets out the key factors that firms can check, including income and other commitments. The list isn't prescriptive or exhaustive because firms are expected to understand their business well enough to establish their own robust procedures.

Responsible lending includes weighing up whether your customer will be worse off in the long run by taking out credit. By considering the potential customer outcomes, firms can help their customers understand what their new financial obligations will mean on a day-to-day basis and build good habits that will last for years.

By ensuring the right affordability checks are carried out and all information is clearly relayed to customers at the start, lenders are likely to see fewer defaults and higher customer satisfaction levels. They will also experience lower mitigation costs, while removing the time and resource constraints associated with more complex complaints. This will allow firms to re-allocate the staff and resources currently being used to explain complicated terms and conditions to customers.

WHAT DOES “GOOD” LOOK LIKE WHEN IT COMES TO AFFORDABILITY?

In order to make an accurate assessment of affordability for any customer, a number of indicators need to be taken into account, and potentially challenged by the lender, in order to ensure that the ultimate decision is the right one for all involved. These include:

THE CONSUMERS EFFECTIVE DISPOSABLE INCOME AND LIKELY FUTURE DISPOSABLE INCOME

The FCA has said on a number of occasions that in most cases, self-declaration alone from customers is not likely to be compliant with their rules and expectations. Therefore, firms should explore a number of other options to arrive at an accurate disposable income, that will satisfy the regulator.

INCOME

Payslips or bank statements are likely to be the most effective and accurate means of verifying income.

Firms should be careful, however, when considering individual's paid varying amounts each month. For these customers, it is recommended firms look at a longer period of time. Bonuses and overtime can be complex. Again, an average could be used or a reducing factor.

Firms should always ask customers whether they foresee a reduction in income during the term of the loan/agreement.

EXPENDITURE

Bank statements are likely to be the most effective and accurate means of verifying customers' expenditure. Other options include verifying customers’ self-disclosed expenditure against external sources such as ONS data. However, firms should note this will not include credit commitments, so ONS data would need to be used in conjunction with external credit reference agency checks.

It's important that all expenditure is included, in particular, anything classified as “non-discretionary expenditure” such as mortgage or rent payments, credit commitments, and bills such as utilities and council tax. Firms should be particularly careful to capture all food costs and understand how expenditure is likely to be higher where there are dependents.

As with income, firms should always ask customers whether they foresee any change in their expenditure, and firms should take particular note of any expected increases.

Open banking is a facility favoured by some firms and is generally liked by the regulator, if used correctly. Open banking negates the need for customers to provide information such as bank statements, and it can be set up to make automated lending decisions by populating income and expenditure, taking away the administrative burden of manual reviews.

THE CONSUMERS CREDIT HISTORY AND THE SIGNS OF ANY DISTRESS

Assessing credit history using agency data is fairly common across the industry as it provides an up-to-date view of a customer’s credit soundness (e.g. credit score), their current credit commitments, as well as how well the customer has maintained their account by showing defaults, county court judgments (CCJs) and bankruptcy.

The data can be particularly complex to interpret, and warning signs are subjective to personal views and opinions. Firms should consider using set rules to identify warning signs that ultimately inform whether lending is accepted or declined.

The rules can be set against a number of areas. For example, not lending to customers with two or more defaults in the last six months, or not lending to customers with two or more CCJs in the last 12 months.

THE CHANGING VULNERABILITY OF THE CUSTOMER

It's important that firms understand what the customer's overall profile looks like. Using the data sources mentioned above: payslips, bank statements, credit reference data - firms will have lots of data to hand that will assist with the identification of a number of vulnerability factors, such as financial vulnerability, gambling addictions, and more.

However, customer vulnerability is fluid and may have changed as a result of external factors, such as the Coronavirus pandemic. It's crucial frontline staff are trained to spot these warning signs to intervene and take appropriate action. Ultimately, lending rules will be required that may lead to a decline in the amount that can be borrowed where a customer is identified as vulnerable.

In addition, firms should regularly ask customers at the start and throughout their relationship whether they need extra support, alongside the crucial questions about whether a change in circumstances is likely during the agreement. This information will allow firms to intervene at the earliest opportunity – for example, to refer customers to debt charities for further support – while it also informs the way in which firms communicate with customers throughout the remainder of the agreement.

GIVEN THE EVOLVING ECONOMIC CONDITIONS AND SIGNIFICANT UNCERTAINTY AT THE MOMENT, THESE DECISIONS NEED TO BE SIMPLY REINFORCED WITH CONTROLS THAT ENSURE THE OUTCOMES ARE UNDERSTOOD AND ANY RISKS ARE MONITORED, FOR BOTH THE LENDER AND THE CUSTOMER.

IDENTIFYING VULNERABLE CUSTOMERS

As we have discussed throughout this paper, the FCA is increasingly focusing on the potential for consumer harm, especially when it comes to vulnerable customers. In the context of affordability, looking after vulnerable customers – and taking proactive steps to support them – should therefore be a top priority for firms as they are likely to be hit hardest by financial pressures. Ensuring that customers in vulnerable circumstances are protected and receive fair outcomes is more than just a regulatory requirement.

To deal with the constantly shifting nature of vulnerability, frontline staff need to be upskilled in the identification and understanding of vulnerable customers and processes, which is what will ultimately make the difference between poor and good outcomes for vulnerable customers.

With 50% of UK consumers showing one or more characteristics of potential vulnerability prior to the economic shock of the Coronavirus pandemic, getting this right is a sure way for firms to stay ahead of the competition. By giving employees the tools to respond to vulnerability, firms can ensure that every customer receives the best possible outcome and experience, no matter what is taking place in their life at the time. The benefits will be seen in customer advocacy and greater loyalty.

VULNERABILITY FRAMEWORK

Firms must ask themselves how they will ensure effective delivery of these outcomes in a way that engages senior management; is aligned to the strategy, culture and business models; is tailored to the firm's customers and ensures that the key benefits are delivered.

BUSINESS MODEL AND STRATEGY

(INCLUDING CULTURE AND RISK APPETITE)

OVERSIGHT

- Clear view of the regulatory landscape
- Clear business requirements and interpretation of the obligations

POLICY AND PROCESS

- Review of Responsible lending policy
- Review of Vulnerability policy
- Review of Operating process
- Review of Business guidelines

CUSTOMER DEMOGRAPHICS

- Initial and ongoing customer interactions and identification:
  - Channels and access
  - Comprehension
  - Circumstances (including detailed assessment of financial circumstances)

OUTCOMES

- Product
- Communication
- Tailored approach
- Judgement
- Fair disclosure and information usage
- Tell once
- Proactive forbearance
- Vigilance
- Carers
- Third parties

MANAGEMENT INFORMATION (MI)

- Risk metrics (financial and non-financial)
- Risk-based outcomes testing
- Quality checks (QA)
- Customer insights
- Root cause analysis (RCA) key information extracted to provide evidence of:
  - Fair customer outcomes
  - Trends
  - Continuous improvement

BENEFITS

- CUSTOMER ADVOCACY
- EMPOWERED STAFF
- REDUCED OPERATIONAL LOSSES
- CUSTOMER CENTRIC CULTURE

HOW CAN HUNTSWOOD HELP WITH THE CHANGING EXPECTATIONS AROUND RESPONSIBLE LENDING?

Huntswood has extensive experience working in the consumer credit market, in particular on the issues surrounding responsible lending and affordability. In our capacity as a member of the FCA's Skilled Person Panel, we have gained significant insight into best practice, ensuring it aligns with the changing expectations from the FCA. We can support firms with:

- Guidance on what good looks like when it comes to affordability
- Undertaking reviews of conduct, including firms' approach to responsible lending
- Technical insight into what 'proportionate' means in the context of affordability
- The role of data when it comes to managing affordability
- Managing the risk of persistent debt and recoveries

WHAT HAPPENS IF YOU GET IT WRONG?

THERE HAVE BEEN A NUMBER OF HIGH-PROFILE CASES RECENTLY WHERE LENDERS HAVE NOT ALWAYS ACHIEVED THE RIGHT BALANCE WITH REGARDS TO RESPONSIBLE LENDING.

WONGA

Wonga is perhaps the most cited example of what can happen if firms don't properly assess their customers' ability to meet repayments. In Wonga's case, it had to write off the loan balance of its 330,000 customers who were in excess of 30 days in arrears, while also removing the interest charges for its 45,000 customers who were less than 30 days in arrears. The firm eventually collapsed in 2018.

QUICKQUID

The UK's biggest payday lender, QuickQuid first entered a redress scheme in 2015 when its lending criteria left a group of customers with loans they could not afford to repay. Following an investigation by the FCA, it was found that the customers were entitled to redress totalling £1.7 million. QuickQuid continued to trade after making changes to its lending strategy. Fast forward to 2019 and the company came under fire again and eventually fell into administration, leaving thousands of customers without answers and ineligible for compensation.

BRIGHTHOUSE

Rent-to-own retailer, BrightHouse, was told by the FCA to pay £14.8m to 249,000 customers in 2017 after the regulator said it had not acted as a "responsible lender". The ruling came after the FCA identified that the firm's lending applications, affordability assessment and collections processes did not always deliver good outcomes for customers, particularly those who were at a higher risk of falling into financial difficulty. After an influx of compensation claims, the firm finally collapsed in March 2020, with the closure of stores due to Coronavirus being described as 'the final nail in the coffin'.

WHAT CAN LENDERS LEARN FROM PREVIOUS CASES?

While such cases have been relatively rare, the FCA's increased focus on affordability means that more and more lenders could face harsh penalties if found to be causing harm to customers.

If the regulator has expressed concern over a firm's past operations, or it suspects a product or process may have led to unintentional consumer harm, it may call for a past business review to reveal exactly where an issue lies, allowing firms to make the steps required to remediate it. It is important that lenders can identify and quantify issues in terms of the level of detriment suffered and, subsequently, the extent of any remediation required.

However, this is an expensive outcome, as the firms mentioned above can already testify. To help remove the possibility of paying tens of millions of pounds in redress, firms would be well advised to establish their own exposure to legacy risk prior to intervention from the regulator.

By seeking specialist support, firms can review their past business from a regulatory perspective, providing either positive assurance, or recommendations for further action. Making the necessary changes to ongoing processes will avoid future punitive measures and allow firms to demonstrate to the regulator that they have understood affordability and taken proactive steps to improve their processes, policies and products and ensure the issue will not occur in future.

CONCLUSION

IT'S CLEAR THAT CONSUMER CREDIT LENDERS WILL CONTINUE TO FACE SCRUTINY FROM POLITICIANS, REGULATORS, MEDIA AND THE PUBLIC IN THE FUTURE.

However, if firms can adapt quickly to ongoing changes and pressures, the sector can drive positive change, increasing the potential for innovation, better consumer outcomes and improvements to the dynamics of competition.

Firms that don't want to be left behind should immediately review their current practices in regard to affordability. Investing the right time and resource into best practice now, rather than waiting for regulatory intervention, is a far more cost-effective approach in the long run.

Huntswood's knowledge, experience and resource capability makes it the ideal partner to review, advise on and deliver a robust strategy for the long term.

ABOUT THE AUTHORS

MATTHEW DRAGE

DIRECTOR OF CONSUMER FINANCE

Matthew is Director of Consumer Finance at Huntswood. Matthew also leads on the firm's external engagement strategy, to help position and support our brand and services within the marketplace.

Matthew has a background in conduct regulation and professional services having worked as a supervisor at the Financial Conduct Authority (FCA) and for two of the "Big 4" advisory firms, where he led and contributed to work in relation to Conduct Risk.

Matthew is a Fellow of the International Compliance Association (ICA) and is a member of the Chartered Institute for Securities & Investment (CISI).

PAUL DYER

HEAD OF REGULATORY ASSURANCE

Paul has over 25 years' experience in developing regulatory, risk, compliance and control solutions for regulators, banks, insurers, pensions providers, foreign exchange and investment firms.

Paul joined Huntswood from the FCA in October 2019. He has overseen a number of investigations as a regulator, consultant and at senior levels within regulated firms. Most recently, Paul led the FCA's Risk Review and Regulatory Failure teams, planning and delivering assured reviews on high profile regulatory matters to senior and executive sponsors, as well as the FCA Board.

Paul is an ex-CEO of the Association of Professional Compliance Consultants (APCC) and is a certified member of the Institute of Risk Management.

RICHARD BROWN

TECHNICAL ADVISORY SPECIALIST

Richard has over 20 years' experience in the retail financial services industry across consumer credit, banking, wealth management and insurance. Previous roles prior to joining Huntswood included Regulatory Compliance Advisor, and Product and Proposition Manager in a marketing function.

During his time at Huntswood, Richard has led a number of FCA Skilled Person reviews (s.166) in the high-cost short-term credit (HCSTC) market relating to responsible lending and complaint handling. In addition, Richard has also led numerous 'mock Skilled Person reviews' also in the HCSTC market. Richard also acts as a day-to-day advisor for a number of consumer credit firms, providing regulatory advice and guidance when required.

ABOUT HUNTSWOOD

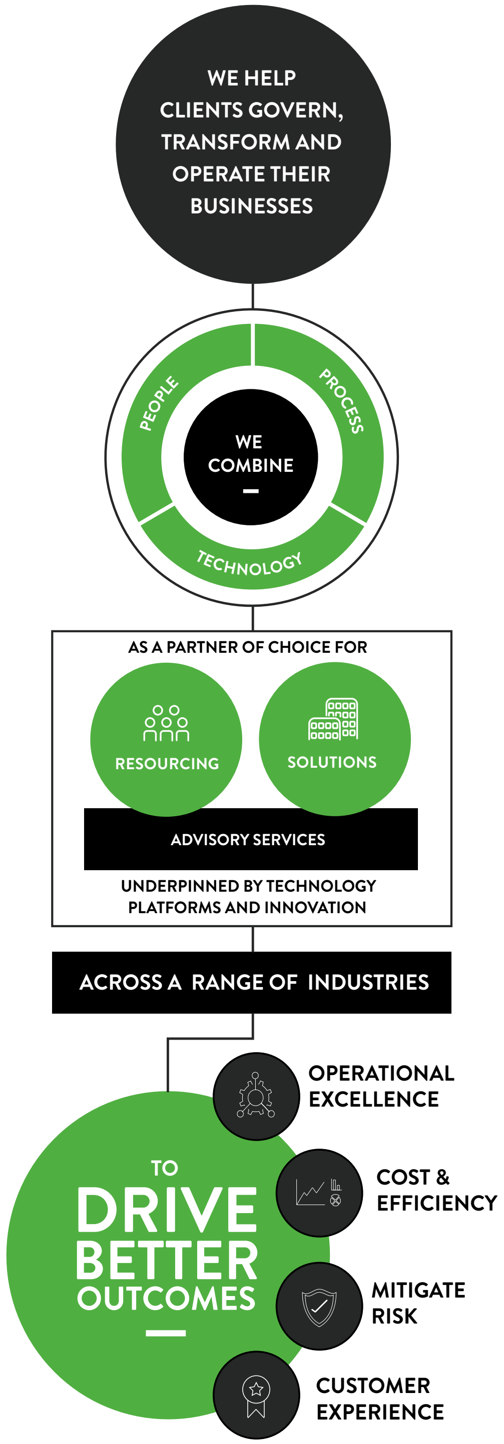
WE HELP FIRMS GOVERN, TRANSFORM AND OPERATE THEIR BUSINESSES TO DRIVE BETTER OUTCOMES.

When our clients need support, it almost always involves customer considerations, it is often multi-channel and always requires an approach that is compliant with regulation.

In our engagement with clients we are, above all else, collaborative and always at the forefront in the development of innovative, tailored and transformative solutions. These typically combine people, processes and technology to drive better customer, commercial, and regulatory outcomes.

Our services include resourcing and outsourcing solutions, backed up by an expert advisory capability.

We have a solid reputation for being easy to work with, which has been earned through continuous improvement and consistency in exceeding our clients' expectations throughout all stages of delivery.



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