

# Consumer Lending

October 2019

**For most borrowers, credit performs an important function, smoothing income and expenditure and, if affordable, can be beneficial. However, unaffordable lending and borrowing can cause real harm to individuals and society.**

Vulnerable customers are disproportionately affected, with recent FCA supervisory work highlighting the fact that some business models in this sector are benefitting from consumers struggling to repay in full and on time.

As a result, the FCA's appetite for change in the consumer credit market, and in particular high-cost credit, shows little sign of abating with a number of key regulatory changes over the last 12 months.

With reports earlier this year that over three million consumers are utilising high cost credit, the FCA acknowledges that the task of regulating consumer credit is one of the largest tasks they have undertaken, with significant change already taking place in areas such as credit cards, overdrafts, payday loans, home-collected credit, catalogue credit and store cards. That is against a backdrop of an ever-increasing focus on specific sectors and products. This document takes a look at some of the regulatory challenges arising in respect of regulated consumer finance activities.

## How we can help

Since the FCA began regulating consumer credit in April 2014, our regulatory specialists have provided advisory services to many firms in the sector.

At DWF, our team understands in detail how FCA regulations impact consumer credit firms. So we can help you factor compliance into your operating model whilst navigating the ever changing and complex regulatory landscape. We're experienced at helping consumer credit firms prepare and apply for authorisation, as well as providing practical support and guidance on developing robust regulatory compliance infrastructures across sales, administration, debt solutions, and arrears management.



### We provide consumer credit regulatory support to businesses of all types and sizes, including:

- Insurance premium finance
- Consumer finance for items such as motor vehicles and white goods
- Leasing, hire, personal and business contracts.

As well as working with firms who partake in the above, we also provide support to firms who undertake a wide range of related regulated activities, including:

- Credit broking
- Credit lending
- Consumer hire
- Debt adjusting
- Debt administration
- Debt collection.

At DWF, our team of regulatory experts can help you to navigate the complex and evolving regulatory landscape to keep your firm fully abreast of new developments.

Please contact our experts to discuss in more detail how we can help.

## High-cost credit - overview

Over the last 12 months, the FCA have implemented interventions on overdrafts, rent-to-own and other consumer credit markets as set out in their High-Cost Credit Review.

More recently, the FCA are continuing to scrutinise and focus on areas where they believe there may be continuing harm; this includes the volume of relending, firms' approach to the assessment of affordability and business models that drive unaffordable lending. The FCA are particularly concerned that the business models of some retail lending products, including some subprime credit and second charge mortgage products, are designed to benefit from consumers not repaying their debts. This is alongside a focus on poor value products, services or treatment of those in financial difficulty.

**When considering this, ask yourself the following questions:**

- If you offer 'buy now pay later' (BNPL) do you charge backdated interest on sums that customers repay during any offer period?
- Do you remind customers when the offer period is about to end, to prompt customers to repay?
- Do you increase the customer's credit limit where the customer has not expressly indicated their consent to credit limit increases?

To ensure compliance, we recommend that High-cost credit providers undertake assurance to assess the extent to which the customer is at the centre of the firm's business model, approach to lending, and the treatment of those in financial difficulty. Firms should also consider the complexity of high-cost credit products and how well they are understood by their customers and target market. Further specific sub-sector considerations are set out below.

**Credit cards**

Following the FCA review of credit card fees and charges, firms must take steps to improve customer outcomes in relation to the application of fees and mitigating against harm, particularly for those in financial difficulty. This comes against a backdrop of increased activity from the FCA in the wider consumer credit sector, following announcements on motor finance, a "Dear CEO" letter in relation to the provision of high cost lending products and the introduction of new rules in the rent to own sector.

Firms should be aware of their obligations under the Conduct of Business Sourcebook and should assess whether their policies and procedures in relation to fees and charges are consistent in the delivery of good consumer outcomes. Furthermore, firms will need to regularly assess ongoing compliance by reviewing the systems and controls adopted in relation to arrears, defaults and recovery.

**When considering this, ask yourself the following questions:**

- What does your firm regard as signs of actual or possible financial difficulties? Are (multiple) fees and charges considered as one of those signs?
- Does your firm flag on its systems those customers who are repeatedly incurring fees on their account?
- What are the range of actions your firm takes when identifying a sign of actual or potential financial difficulty and are you satisfied they meet the requirements under CONC?

Firms should also consider FCA rules around "appropriate action", which acts as a reminder that firms must monitor credit card customers' repayment records and take steps where there are signs of actual or possible financial difficulties. In order to continue to provide credit in accordance with the rules prescribed by the FCA, firms must remain alive to continued changes in this area, with their policies and procedures having the protection of consumers at its core.

**Rent-to-own**

On 5 March 2019 the FCA published its Policy Statement and finalised rules on Rent to Own ('RTO') products and alternatives to high cost credit, taking account of the feedback received on its earlier consultation paper on this subject.

The final rules are designed to protect vulnerable users of RTO products by controlling prices. In outline, the finalised rules are:

- A requirement for firms to benchmark base prices against retail prices;
- To set a total cost of credit cap of 100% of the credit amount; and
- To prevent firms increasing their prices for insurance premiums or arrears charges to recoup lost revenue from the price cap.

The rules came into force on 1 April 2019 and apply from that date to any new products RTO firms introduce to the market for the first time. For products that RTO firms are already offering, the rules will apply either at the point the RTO firm raises the price of a product or from 1 July 2019 (whichever is sooner). Micro-enterprises will have until 1 October 2019 to comply.

The FCA are proposing to conduct a further review in April 2020.

**When considering this, ask yourself the following questions:**

- Do you have controls in place to ensure that the cost of credit can never exceed the cost of the product?
- Do you benchmark the cost of products against the prices charged by three mainstream lenders? Do you have the evidence to support this benchmarking?
- Have you adapted your business model to prevent recouping lost revenue from customers by other means?
- Are your financial promotions and disclosure documentation fully transparent when showing the cash value of goods, the amount of interest to be paid, and the total cost to customers?
- Have you stopped selling extended warranties alongside an RTO agreement at point of sale?



Firms should also consider the complexity of these credit agreements and whether they are truly understood by their customers and target market, particularly those customers who may be deemed vulnerable.

## Motor Finance

The motor finance sector has grown rapidly over the last 10 years, largely due to the popularity of Personal Contract Purchase (PCP), which accounts for up to two-thirds of all new and used car finance lending. From a consumer perspective, PCPs provide flexibility and lower monthly repayments. In response, the FCA have carried out a series of reviews to assess the risks to consumers, identifying the following key themes:

### Commission arrangements

The way commission arrangements are operating in motor finance may be leading to consumer harm on a potentially significant scale. For example:

- Some customers are paying significantly more for their motor finance because of the way lenders choose to remunerate their brokers.
- In particular, there appears to be widespread use of commission models that link the broker commission to the customer interest rate and allow brokers wide discretion to set the interest rate. This gives rise to conflicts of interest and creates strong incentives for the broker to charge a higher interest rate. According to FCA analysis, this is a feature of around 60% of the firms in the market.

The FCA estimate that commission models which allow broker discretion over the interest rate could be costing customers £300m more annually when compared against a baseline of Flat Fee models.

The FCA consider that change is needed across the market, to address the potential harm they have identified. They have started work with a view to assessing the options for policy intervention.

### Pre-sale disclosure

The FCA's mystery shopping results also raised a number of concerns in relation to pre-contractual disclosure and explanations. We consider these findings to have a cross-sector implication. Please refer to our cross sector pages for more information.



### Affordability assessments

The FCA remain concerned that not all lenders are complying with FCA rules on assessing creditworthiness, including affordability. In particular, some seem to focus unduly on credit risk (to the lender) rather than affordability (for the borrower). Again, we consider these findings to have a cross sector implication. Please refer to our cross sector pages for more information.

Firms in this sector have some work to do to demonstrate compliance with CONC. In particular, firms should review their remuneration and commission models to ensure there is no link between the interest rate set and the level of broker incentive. Firms should also consider their approach to assessing and demonstrating affordability as well as reviewing their pre-sale disclosure to ensure compliance with CONC.

### Overdrafts

In December 2018, the FCA published proposals to fundamentally reform the overdraft market to address the harm they found from high prices, repeat use, complex charging structures and low customer awareness and engagement. They also made rules to improve competition by requiring firms to provide better overdraft information, including text message or push notification alerts, online cost calculators and tools to reduce barriers to switching. They made it clear that firms should position overdrafts more clearly as a form of debt. The FCA published their Policy Statement on the proposed pricing remedies in June 2019 and the new rules come into effect on 6 April 2020.

#### When considering this, ask yourself the following questions:

- Do you charge higher fees when customers use an unarranged overdraft rather than an arranged one?
- Do you impose fixed fees for borrowing through an overdraft?
- Are your fees for each overdraft a single annual interest rate with no fixed daily or monthly charges?
- Do you advertise arranged overdraft fees in a standard way, including an APR?
- What internal controls and processes do you have to identify and proactively support customers who are showing signs of financial strain or are in financial difficulty?

Firms should improve the visibility and content of key pricing information about overdrafts, particularly when opening a new current account or requesting a new overdraft. This includes automatically enrolling customers into a set of overdraft alerts to address any unexpected overdraft use as well as removing any available overdraft from the amount of a customer's available funds.

**In addition to the sub sector specific regulatory issues, there are a number of cross sector regulatory initiatives that all consumer credit firms need to consider.**

## Pre-sale disclosure

The FCA's mystery shopping results also raised a number of concerns in relation to pre-contractual disclosure and explanations. In particular:

- While it is possible that disclosures may have been made later in the process (not covered the FCA's mystery shopping exercise), it is unclear whether this would be in good time before entry into an agreement, to enable the customer to make an informed decision.
- The FCA have particular concerns in relation to disclosure of commission, especially in respect of DiC and similar commission models where the broker has discretion to adjust the interest rate. There are existing requirements in the Consumer Credit sourcebook (CONC) on disclosure of brokers' status and remuneration, but the FCA did not see clear evidence of compliance with these.
- Lenders also have obligations in this area. In particular, CONC requires lenders to take reasonable steps to ensure that persons acting on their behalf comply with CONC. This includes compliance with rules relating to disclosure of commission. They were particularly concerned that some lenders appear to take the view that it is sufficient that a broker is FCA-authorized, as it can be assumed that they will be compliant with FCA rules (as the FCA will monitor compliance).

### Our view

Firms should review their policies, procedures and controls to ensure they are complying with all relevant regulatory requirements and are treating customers fairly.

## Affordability assessments

The FCA remain concerned that not all lenders are complying with FCA rules on assessing creditworthiness, including affordability. In particular, some seem to focus unduly on credit risk (to the lender) rather than affordability (for the borrower).

The FCA introduced new rules and guidance in July 2018, which came into force on 1 November 2018. In summary:

- Firms must make a reasonable assessment of creditworthiness, based on sufficient information.
- The extent and scope of an assessment should depend upon, and be proportionate to, the individual circumstances.

- The higher the affordability risk in the particular case, the more rigorous the assessment is likely to need to be. For example, the firm may need to obtain additional information, or subject it to additional scrutiny.
- Where income is not taken into account in the assessment, the firm must be able to demonstrate that affordability is "obvious". If not, FCA rules require the firm to take reasonable steps to establish or estimate current income and likely future changes. It is not generally sufficient to rely solely on self-declaration by the customer.
- Where income is taken into account, the firm should also take account of non-discretionary expenditure unless it can demonstrate that it is obvious in the particular case that the customer's non-discretionary expenditure is unlikely to significantly affect affordability risk.
- Any estimates of income or expenditure should be reasonable in the circumstances and firms must be able to evidence this challenge.

### Our view

Firms' policies and procedures should set out clearly the principal factors to be taken into account in assessing creditworthiness, including affordability, in individual cases. We recommend that firms undertake a thorough review of their policies and procedures, in light of these considerations, and make changes where necessary. Firms should then periodically review the effectiveness of its policies and procedures, and its compliance with CONC, and take steps to address any deficiencies identified.

## Other fair outcome themes

Our own research has identified further potential consumer risks in the following areas:

- **Consumers experiencing barriers when attempting to exercise voluntary termination rights in accordance with the Consumer Credit Act.** In one case, a lender would not accept notification from the customer over the phone or in writing but insisted on completion of a standard form, issued by them, which took several weeks to progress. In the meantime, the borrower continued to be liable for monthly payments and interest charges.
- **Unfair use and application of 'fair wear and tear' policies resulting in significant and unfair charges.** We found several examples of lenders fair wear and tear policies that, in our opinion, were unfair and penalised customers for 'damage' that

we would expect to be classed as normal wear and tear. In one case, the lender made charges for 'damage' for which the customer had no means to challenge the application of the policy, nor the charges levied by the lender. Moreover, the customer was given 14 calendar days to make payment in full before the 'debt' was passed to a debt collection agency.

- **Dealers not settling outstanding finance on part exchange vehicles in a timely fashion resulting in further charges to consumers.** We have found numerous examples of dealers accepting vehicles in part exchange on the provision that the dealer settles the outstanding finance as part of the deal. However, in a number of cases we found evidence of dealers not settling the outstanding finance in a timely fashion, leaving the customer still legally responsible for maintaining payments on the loan agreement, even though they no longer owned the vehicle. In one case, we found evidence of customer detriment with the customer incurring late payment charges for non-payment alongside having to make payments for the new finance agreement on their new vehicle.

#### **Our view**

We expect these issues to be a focus for the FCA over the coming months and recommend that brokers and lenders review their policies and procedures to ensure they are treating customers fairly.

### **Governance, systems and controls**

The FCA have also noted that better controls need to be put in place by lenders to monitor broker compliance with CONC rules. Governance processes and the Management Information (MI) provided to Boards and senior managers are important to evidence how firms are responding to the FCA's scrutiny of consumer credit and PCP.

#### **Our view**

We recommend that both brokers and lenders conduct a full review of their internal governance arrangements (including compliance monitoring), systems and controls to ensure they are providing effective oversight and assurance to the board and senior management over the key risks the business is exposed to, including the actions being taken to bring or maintain risks within appetite. MI should be risk based and trended to enable senior management to see how key risks are changing over time.

### **Conduct and Culture**

The FCA sets clear standards that firms and individuals are required to follow. However, they recognise that firms and individuals must make situational, time-critical business decisions, that market practice can evolve more quickly than regulatory requirements, and that the poor judgement of just one individual can cause serious harm to consumers and markets. Good governance, which enables effective oversight of decision-making, is critical for reducing potential harm to consumers or markets.

Culture also plays a critical role. A healthy culture, focused on delivering consumer outcomes, helps individuals in firms to make the right judgements that do not result in consumer or market harm. Conversely, weak governance or poor culture increase the likelihood that harm will occur.

#### **Our view**

We consider that the FCA will pay particular attention on firms' culture and what they see as the four drivers of behaviour: purpose, leadership, reward and managing people and governance. We therefore recommend that firms' are clear on their purpose and undertake regular reviews of leadership behaviours and values, the firm's governance arrangements and that their approach to managing and rewarding people places good customer outcomes at its core.



## How we can help

### Typically, we can assist with:

- New authorisations and applications
- Variations of permission
- Individual applications
- Health Checks
- Change projects
- Governance reviews
- Board Effectiveness Reviews
- Three Lines of Defence reviews
- Due Diligence reviews
- Past Business reviews
- Redress projects
- Internal Audits
- Shadow Skilled Persons reviews
- Target operating models
- Conduct and Culture Evaluations
- Senior Managers & Certification Regime (SMCR) implementation
- Senior Managers & Certification Regime (SMCR) Health Checks



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## Beyond borders, sectors and expectations

DWF is a global legal business, connecting expert services with innovative thinkers across diverse sectors. Like us, our clients recognise that the world is changing fast and the old rules no longer apply.

That's why we're always finding agile ways to tackle new challenges together. But we don't simply claim to be different. We prove it through every detail of our work, across every level. We go beyond conventions and expectations.

Join us on the journey.