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Consumer credit – walking the regulatory tightrope

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Subprime and near prime lending have been subject to intense regulatory scrutiny during the aftermath of the financial crisis. The global economic crisis that took hold in 2007 has largely been attributed to the widespread practice of irresponsible lending to consumers, often with no means of repayment. In 2013, StepChange Debt Charity reported that the average payday loan debt of its clients was £1,657, whereas the same clients' average net monthly income was a much lower £1,379.

When the UK Financial Conduct Authority ("**FCA**") took over responsibility for regulating consumer credit from the Office of Fair Trading ("**OFT**") in April 2014, it promised to crack down on substandard lending practices in a bid to protect consumers and restore public confidence in the sector. This was no mean feat. The OFT's historically light-touch regulation and licensing regime, coupled with minimal supervision, meant that the FCA had the challenge of deciding to what extent – and how quickly – it needed to diverge from the OFT's hands-off approach to consumer credit regulation.

In November 2014, the FCA appeared to have reached a decision. It announced a price cap rule for payday lenders whereby consumers using payday lenders and other providers of high-cost short-term credit would see borrowing costs fall and would never have to pay back more than double what they originally borrowed. This was an important signal to the market that, not only was the FCA adopting a more interventionist approach than its predecessor, it was also seeking for the first time to regulate tariffs as well as conduct. The FCA recently reviewed its approach[1] and concluded that the price cap had improved customer outcomes and should therefore be maintained at the current level. The FCA argued that since setting the cap, consumers pay less, repay on time more often and are less likely to need help from debt charities. Is it therefore safe to assume that the FCA will widen the scope of its intervention in high-cost short-term credit price models in future? This note will examine the UK regulatory approach towards monitoring persistent debt and the effects that this has had – and may have – on the consumer credit industry.

The UK regulatory framework

The UK consumer credit industry is highly regulated by a number of different governmental bodies and firms operating within it are now subject to high standards of monitoring and compliance. The principal piece of legislation that governs consumer credit is the Consumer Credit Act (the "**CCA**"). The CCA imposes various obligations on lenders (and any person who exercises the rights and duties of lenders) to give borrowers rights to withdraw; correctly document credit agreements, guarantees and indemnities; provide post contract information such as statements of account, notices of sums in arrears and default notices; protect consumers who purchase a good or service from a linked supplier and not to take certain recovery or enforcement action until prescribed forms of post contractual notices have been served and prescribed time periods have elapsed. Consumer credit firms are also subject to laws regarding data protection, money laundering and

[1] "High-cost Credit" Feedback Statement FS17/2 July 2017 https://www.fca.org.uk/publication/feedback/fs17-02.pdf

counter-terrorism financing, such as the Data Protection Act 1998[2], the UK Proceeds of Crime Act 2002 and the UK Bribery Act 2010.

Prior to the transition in regulatory regimes from the OFT to the FCA, consumer credit firms were effectively only required to comply with the specific legal requirements imposed under the applicable legislation. Firms were not expressly obliged to focus on, or even consider, customer outcomes. Consumer credit firms' business models were largely centred on maximising profit within the constraints of the law. Since 2014, this is no longer the case.

The rise of persistent debt regulation

Following the transition in regulatory regimes from the OFT to the FCA, a series of tougher measures have been introduced to move staunchly away from the lending practices which allowed firms such as payday lender Wonga to maintain a representative APR of 5,853% in 2013. The FCA has made it clear that it regards non-standard finance as a "high risk" activity and as such dedicates special resources to intensively monitoring businesses in this sector. Its Handbook contains a designated chapter on consumer credit (the 'CONC' sourcebook), which includes rules and guidance in relation to, *inter alia*, financial promotions; pre contract responsibilities and disclosure; affordability and creditworthiness assessments; the handling of vulnerable customers; communications with customers; arrears, default and recovery of debt; debt advice and statute barred debt.

Such rules and guidance speak to the FCA's overarching concern in its approach to regulation of the consumer credit sector: consumer protection. This is consistent with one of the FCA's overall strategic objectives: "to secure an appropriate degree of protection for consumers". The UK regulatory regime relating to the protection of consumers from unfair terms and practices changed at the end of September 2015 as part of the largest consolidation and overhaul of UK consumer protection law[3]. Significant changes brought in included a wide definition of "consumer" to include individuals acting for purposes which are, wholly or mainly, outside of that individual's trade, business, craft or profession. Amongst other provisions, the rules now provide that an unfair term of a consumer contract (a contract between a trader and a consumer) is not binding on a consumer. The Competition and Market Authority introduced further requirements on "high-cost short-term credit" lenders in 2015, obliging them to list on at least one price comparison website and to provide borrowers with a summary of the final costs of their loans.

End of the payday heyday

The FCA's strategic objective of consumer protection has proven to be particularly important in light of highly publicised accounts of payday lenders rolling over customer debt dozens of times so that the final repayment amount ended up significantly more than the original loan amount. In response to this, the FCA introduced the aforementioned caps on lender costs and fees as well as the strict rule that ensures customers will never pay back more than double their original loan amount. Consumer credit firms have had to adjust to a much more complex set of rules and regulations than was previously the case under the OFT's supervision. A firm seeking authorisation to conduct consumer credit activities must now get to grips with a long list of applicable provisions in the FCA Handbook, the Financial Services and Markets Act 2000 ("**FSMA**") and the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001. Additionally, as of 2018, the FCA has confirmed that the UK Senior Managers Regime will be extended to all sectors of the financial services industry (including consumer credit firms). The objective of the legislation is to raise standards of conduct for everyone in financial services. Many of the current requirements for senior managers are increased and supported by additional documentation requirements, which require clarity on spheres of responsibility. The Senior Managers Regime represents a material uptick in ensuring individual responsibility for compliance with the extensive regulatory framework.

Such compliance is expensive and labour-intensive and requires significant investment in resources. Any failure to comply with the applicable laws, regulations, rules or contractual compliance obligation could result in investigations, information gathering, appointment of a skilled person, public censures, financial penalties,

[2] In September 2017, the UK government published the Data Protection Bill 2017 which is anticipated to become law in 2018. This will substantially replace the Data Protection Act although as currently drafted does not increase the regulatory penalties regime which is due to become effective in May 2018 under the EU Data Protection Regulation.

[3] Such overhaul was largely driven by Directive 2011/83/EU of the European Parliament and of the Council of 25 October 2011 on consumer rights.

disciplinary measures and/or enforcement actions. It could also impact the enforceability of the credit agreements underlying a company's debt portfolios, as well as a risk that the FCA may revoke or suspend its authorisation. Indeed, the FCA has publicly taken action against, and imposed requirements on, a number of well-known financial institutions, other financial institutions and debt management companies. In 2014, the FCA required payday lender Wonga to pay compensation to its customers for unfair and misleading debt collection practices, setting a precedent in doing so for firms to provide financial redress to wronged customers. The active role of the Financial Ombudsman Service in investigating and resolving customer complaints against regulated firms further demonstrates a move towards regulatory intervention, and to some extent control, over the economic terms of a consumer credit agreement.

The impact that the stricter rules and regulations have had on the subprime and payday loan markets in particular – both in terms of lender profitability as well as the attractiveness of entering the market itself – cannot be underestimated. The conventional business model of a payday lender is to offer consumers with lower credit scores short-term, high interest loans, with high fees attached. Subprime lenders also specialise in offering finance to consumers with low credit ratings but the loans they offer tend to be longer-term and lower interest loans, often repayable in instalments and without the high fees that are traditionally associated with the payday loan market.

The FCA predicted in 2014 that the enhanced regulation of the consumer credit sector would significantly harm payday lenders' business models and, as a result, 99 per cent. of payday lenders would go out of business. It subsequently reported in November 2016 that, since it took over regulation of the sector, 800,000 fewer people had taken out a payday loan. Some of the larger sub-prime lenders have and may continue to benefit from the gap in the market left by the decline in payday lenders. However, more recently, subprime lenders such as Provident Financial have themselves reported financial difficulties as a result of (to a large extent) an increasingly challenging regulatory environment.

Whilst consumer advocacy groups may herald the perceived end of the payday heyday, such lenders, together with subprime lenders, are nonetheless the primary sources of legitimate, regulated credit for consumers with lower credit scores. This begs the question: if persistent debt regulation were to eventually kill off the payday and subprime markets altogether, where would these customers turn for credit?

Consumer protection – a balancing act

Chief Executive of the FCA, Andrew Bailey, recently expressed concern at the sheer number of people in the UK who rely on loans to make ends meet and acknowledged that access to credit is a necessity in a world where earnings can be erratic. An emphasis on consumer protection must therefore be balanced with the need for non-standard lenders to establish appropriate collection processes for consumers with poor credit ratings and/or previous histories of missed repayments. The profitability and viability of lenders depends to a large extent on their loan recovery rates. If the regulatory balance tips too far in favour of short term consumer protection and as a result recovery procedure options diminish, it may prove increasingly impossible for consumer credit firms to resolve bad consumer loans. It is no surprise that the FCA noted in its July 2017 Feedback Statement that many of its Call for Input respondents had called for a period of regulatory stability.

However, given that the FCA has expressed satisfaction at the way its interventionist approach has worked so far, it does not seem likely that it will change direction any time soon. Indeed its Feedback Statement indicated that it has now set its sights firmly on other high risk areas in the consumer credit space; rent-to-own; home collected credit; catalogue credit and overdrafts. A growing volume of rules and regulation in future may materially limit non-standard lending activity as it will put added pressure on lenders' financial position, and may cause them to re-evaluate their business models or exit the subprime sector altogether.

An increased regulatory focus on high-cost short-term credit coupled with the economic backdrop in the UK (i.e. wage stagnation and impending interest rate rises) may negatively impact loan recovery rates and the challenges facing the subprime market may intensify in the near future. It seems likely, therefore, that we will start to see more subprime lenders experiencing financial distress, as with Vanquis Bank.

The FCA may have found no robust evidence so far of a correlation between regulatory intervention and use of illegal money lenders. Nonetheless, if the larger players in the subprime lending market fail to reconcile their economic needs with the increasing regulatory demands going forward, the regulatory framework aimed at protecting consumers may ironically end up exacerbating consumer credit worries. Those consumers with the lower credit scores – that may already be in financial hardship – may be faced with fewer options for credit and, in the longer term, may be tempted by unauthorised lenders.

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