Transfer to the new consumer credit regime

policis

The impact for firms, consumers and the credit market

Executive summary

Study focus

The Government intends to reform the regulation of consumer credit, which is to be transferred to a new regulator, the Financial Conduct Authority (FCA), one of the successor bodies to the Financial Services Authority. This independent study was commissioned by the FSA and was undertaken by Policis in collaboration with Europe Economics. The aim of the study is to understand how firm behaviour and the compliance costs of the new regime will impact on the potential outcomes of the new regulatory regime for consumers and the credit market. This Policis study focuses on market psychology and how this will impact on firm behaviour. A companion volume by Europe Economics focuses on the impact of the compliance costs of the new regime.

The regime

The new FCA regime will differ from the current OFT regime, which rests on the Consumer Credit Act (CCA), in that it will be based on the Financial Services and Markets Act (FSMA), with requirements having the effect of secondary legislation. The FCA will be a better resourced, more intrusive and more pro-active regulator and will have product intervention and price-capping powers. Senior executives within firms will be personally accountable for conduct missteps.

In line with Government commitments to proportionality and continuity, the policy framework is intended to be low cost, and therefore supports a relatively limited supervisory structure. It contains elements of the current OFT regime, based on the CCA and OFT guidance, alongside the FCA rules and principles for business, albeit that the legal underpinning of the new regime will differ from that of the more clearly rules-based CCA. The regime includes elements of the FSMA regime that apply in other markets, such as the Approved Persons and Appointed Representative regime. Some elements of the OFT regime will still be in effect when regulation is transferred to the FCA in April 2014.

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Evidence base

This study rests on comprehensive original quantitative research with 105 firms, which, although they represent fewer than 1% of the 50,000 active consumer credit licence holders, collectively control the overwhelming majority of credit supply.

All but one of the major banks participated in the study. The banks alone provide 100% of overdraft finance, 80% of personal loans and 90% of lending on credit cards.[1] Credit card lending represents £58bn of the total £169bn[2] of unsecured consumer credit lending in 2012. Firms participating in the study also control the majority of sub prime lending, including more than 80% of home credit lending[3] and more than 60% of payday lending.[4] The study also rests on 63 qualitative interviews with trade associations and a wide range of firms.

The research was undertaken in a live policy environment. The detail of specific requirements contained within the regime were still being developed and were not shared with firms. Views on the new regime expressed in the qualitative and quantitative research are therefore based on firms' experience and observation of the outcomes of the FSMA regime in other contexts and FSA prior actions and communications.

The study also draws on secondary analysis of quantitative consumer surveys covering access to credit and patterns and outcomes of credit use. These include the YouGov Debt Tracker 2012, based on 1,994 nationally representative consumers, and surveys by Policis for HM Treasury and Friends Provident Foundation based on nationally representative samples of 1,511 consumers aged 18–65 in the lowest 50% of household incomes and 1,002 high-cost credit users. Analysis also rests on macro statistics and industry data from the Bank of England, The British Bankers' Association, UK Cards and the Finance and Leasing Association.

1. Source: Bank of England.
2. Source: Bank of England.
3. Source: OFT High Cost Credit Review, firms lending and market share data supplied to the study.
4. Source: OFT Payday Lending Compliance Review.

Key findings

- The majority (60%) of firms in the study were supportive of a tighter and more robust regulatory regime and a more pro-active regulator, seen as better able to protect consumers and eliminate rogue firms. Fewer firms (40%) support the transfer to the FSMA regime.
- A large majority of firms saw the new regime as open to subjective interpretation by a regulator with few perceived constraints on power and insufficient mechanism for challenge.
  - 70% of lenders believe the regime will be subject to a degree of interpretation by the regulator and will lack clarity as a result.
  - 70% of lenders and more than 80% of large mainstream firms feel that there is potential for the regulator to act without due process.
  - The single most important concern is the fear of retrospective action, a concern for 73% of lenders.
- The qualitative research with firms suggests that the key driver of firms' behaviour will be their perceptions of the nature and consequences of conduct risk. Firms report that a defensive stance on regulatory risk is already shaping strategy and behaviour across a wide range of activities.
- Bank of England and industry data and the research with lenders and credit reference agency data suggest that access to credit for low income[5] and non-standard consumers is fragile, and will become more so under the new regime.
  - 86% of large lenders believe lending conditions will be permanently tighter across the risk spectrum even when the economy recovers.
  - 65% of mainstream lenders felt that the new regime would result in reduced credit supply.
  - 82% of large lenders feel that a move to a FSMA regime will reduce credit supply for high risk borrowers.

"You're looking at a much smaller pool of quality customers that we are all going to be fighting harder for and a larger group on the outside looking in whose options are going to be more limited." (Bank)

- The consumer research data suggests that demand for credit is now tempered with caution but remains strong. It also suggests those on modest incomes struggle to access credit.
  - 18% of the UK adult population claim to have applied for some form of credit in the last six months.
  - 35% of those aged 18–65 living in low-income households have now been refused credit, primarily by mainstream lenders.

"The traditional finance sector has stopped functioning properly, and it's the lower, you know, 15, 20% of the population. So where these people…used to get overdrafts from banks, they could get, they could go to the bank and get a car loan, they could meet a lot of their requirements through traditional sources. That's all been stripped away so…it's creating a vacuum." (Credit reference agency)

- Firms see the credit market of the future as being as dominated by big brands (believed by 57%) and as increasingly delivered online (believed by 66%)
- Firms feel the new regime will reinforce concentration among large firms while also being less conducive to innovation.
  - 60% of lenders believe the new regime will result in a less diverse supplier mix and 84% that it will result in a greater concentration of business in fewer larger players.
  - 75% of mainstream lenders believe the new regime will be less conducive to innovation.
- The consumer research indicates that there is potential for consumer detriment in both the mainstream and sub prime sectors; the issues are complex and the balance of risks not clear cut.
  - The lender data shows that some business models in both the sub prime and mainstream sectors rest heavily on behaviour-driven costs, particularly for those on low incomes.
  - Analysis of patterns of consumer account management and data on debt by product types from consumer survey data indicates that short term products can lead to high and rapidly escalating costs for some consumers but mainstream products carry greater risk of long-term unmanageable debt and financial breakdown and can also be high cost.[6]

5. Low income throughout refers to the lowest 50% of household incomes.
6. From the consumer survey data on the debt and cost of debt service associated with different products, the worked examples of the impact of consumer's behaviour on the real cost of credit to the consumer and the data submitted by firms on the components of revenues derived from behaviour-driven costs in this study. See pages 58-61 of the main report for detail, which also references other studies.

Outcomes

On the basis of the evidence from the macro data, the qualitative and quantitative research with firms and the consumer data, it is Policis' judgment that:

- The new regime would seem likely to deliver to the Government goals of improved oversight, effective redress and enhanced consumer protection.
- There is potential, however, for a range of outcomes to emerge from the transfer to the new regulatory regime, which may rest in large part on market psychology.
- Against the background of fragile access to credit there are significant risks around credit supply. The new regime may act to exacerbate the difficulties already faced by those on modest incomes in accessing the credit that they need. There are risks also for innovation.
- Defensive strategies in which firms seek to minimise conduct risk in all aspects of their activities will reduce consumer detriment.
- However, these strategies will also result in a narrower range of products sold through fewer channels, and to a more homogenous and lower risk customer set.
- Much will depend on the execution of the new regime and both the tone and content of regulator communications around it.
- Different approaches could result in either a smaller, cleaner and more narrowly focused market or a more widely drawn market with greater diversity and fewer access issues.
- How far the downside risks crystallise is likely to rest on firms' perceptions of the clarity of regulatory requirements, the gravity of conduct risk and the checks and balances on regulator power.

The future

It will be important to consider access in the balance of other consumer protection issues if the new regime is to deliver a market that works well for all consumers, including those on low incomes.

It will be critical that intervention to address detriment – wherever it arises in the market – is rooted in an in depth understanding of market and consumer dynamics and moves away from a product silo perspective on the issues. There is otherwise potential for unintended effects.

The downside risks for credit supply, access to credit and innovation will be most effectively moderated by encouraging market diversity, new entrants and competition.

To the extent that access to credit rests on market psychology, the risks to supply might be moderated by seeking to inject into the new regime greater certainty on the regulator's expectations and some comfort for firms on the new regulator's accountability.

Ultimately what we want as a society in terms of the nature and scale of the credit market is a political issue and should be the focus of widespread public debate.

"Now, under the current OFT regime, you've got Parliament makes the law and the OFT regulates it and has to comply with it. The FSA style regime's different because effectively the FSA is lawmaker, judge, jury and executioner as well. So I can see that, from a regulator's perspective, it's great because they can do what they want. From a business perspective, it introduces a lot of uncertainty."
(Non-bank lender)

Market dynamics

- Firms report that the excesses of the "bubble" era have given way to greater realism and transparency in credit pricing, and more sustainable lending:
  - The fall-out from the pre-crisis years is still working through in terms of costs and other consequences for firms.
  - Firms are running off unprofitable business and have rationalised credit lines and revised lending criteria.
  - Mainstream lenders are clear that they will focus on quality customers and seek to grow their share of a shrinking pool of such business.
  - Some large firms are locked in to some legacy customer groups they no longer wish to serve and will seek to exit these segments.
- Firms anticipate only modest credit growth and declining profitability, even over a 3–5 year timescale:
  - 70% of large lenders see reduced opportunity to enhance profitability, regardless of any regulatory change.
  - 51% anticipate modest growth, 19% see lending staying flat, and 10% anticipate further decline.
  - Only a minority (26%) of sub prime lenders anticipate continued rapid growth.

- The evidence from both supply side research and consumer data is that access to credit for a significant minority of low-income, non-standard and high-risk borrowers may become increasingly fragile:
  - The research with firms indicates that banks and other mainstream lenders are moving definitively away from higher risk borrowers; 88% of lenders believe lending conditions will be permanently tighter across the risk spectrum even when the economy recovers.
  - Firms report that lending criteria are being set higher than commercial considerations or compliance dictates to protect against regulatory risk.
  - In difficult funding conditions the research suggests that other lenders are not necessarily willing or able to meet this demand; 74% of lenders believe that funding challenges will continue to be a feature of the market.
  - Firms report that borrowers who do not fit electronic automated decisions or those with non-standard circumstances may struggle to access credit.
  - Non-standard lenders will not necessarily meet demand. Sub prime lenders have the highest decline rates in the market; and just 1 in 8 payday loan applications is accepted.[7]
  - Firms see the future of the credit market as digital and increasingly mobile and data-driven, and dominated by big brands. An increasingly sophisticated online credit infrastructure is developing. Aggregators, and in some high-risk sectors the lead generators also, are increasingly the interface with consumers, and are taking a growing share of market value. The supplier mix increasingly includes global and offshore firms.
  - There is some evidence that innovation in the alternative lending space may go some way to stimulate competition, create consumer choice and counter credit disenfranchisement. All of the resulting options are likely to be high cost to the customer, however.

Consumer dynamics

- The demand analysis reinforces the view from the supply side that low-income and high-risk borrowers face increasing barriers to access to credit.
- The consumer data suggests that the macro picture of consumer deleveraging obscures several key features of the demand environment, including a mismatch between supply and demand:
  - Demand is tempered with caution but remains strong – some 18% of the UK population claim to have applied for some form of credit in the last six months.
  - It would appear that a significant tranche of low-income and high-risk borrowers can no longer borrow in the credit mainstream – more than a third (35%) of those aged 18–65 living in low-income households have been refused credit.
  - Alternative supply appears to fill only some of the gap – primarily for emergency cash – and for only some of the people who need credit.
- A proportion of those not able to access credit should not be borrowing, but this is difficult to scale.
- A significant minority of those on low incomes will have characteristics that may influence responsible lending decisions and work to limit their access to credit:
  - 1 in 5 (19%) of low-paid workers have unpredictable incomes.
  - A fifth of those in the lowest income quintile aged 18–65 admit to "bad credit".
  - A quarter (24%) of low-income households aged 18–65 have some history of uneven payment on commitments.
- There appear to be potential consumer detriment issues in both the non-standard and mainstream sectors:
  - Sub prime products can be very high cost and debt can escalate rapidly in the short term, but debts are nonetheless paid back relatively quickly.
  - Mainstream products carry greater risk of long-term unmanageable debt and financial breakdown, particularly for those on low incomes.
- The consumer data suggests that despite the low incidence of bad debt, more than 5m consumers are cycling debt they cannot pay down:
  - 9% of the population are cycling overdraft and credit card debt, together owing some £84bn.
  - 10% of credit card holders, and more than quarter of those on low incomes, make minimum payments on credit cards, at an estimated cost of £6bn p.a.
- We conclude that given unmet demand and the scale of unmanageable debt there is potential for unintended effects from either firm behaviour or regulatory intervention. The evidence[8] is that the balance of costs and risks, and the potential for unintended effects consequent on a restriction of mainstream or sub prime credit, are not clear cut.
- Based on the consumer data, it is clear that firm behaviour or regulatory intervention that acts to restrict or expand mainstream or sub prime lending will create a displacement effect between the two sectors that could work in either direction:
  - There is potential for access to credit to be further restricted, for increases in financial distress and for stimulus to illegal lending in either case.
  - It is not clear that costs to consumers will be higher in the sub prime sector while both mainstream and sub prime sectors have their own risks.
- Illegal lending thrives in a credit vacuum and tends to be concentrated in those who have lost access to credit. In a digital age, the risk is of the emergence of unregulated online lenders and introducers – which might in large part be offshore.

7. Source: Teletrak.
8. From the consumer survey data on the debt and cost of debt service associated with different products, the worked examples of the impact of consumer's behaviour on the real cost of credit to the consumer and the data submitted by firms on the components of revenues derived from behaviour-driven costs in this study. See pages 58-61 of the main report for detail, which also references other studies.

Firms' attitudes and responses to the new regulatory regime

- Regulators have reportedly achieved some important advances in enhancing consumer protection and tackling consumer detriment, albeit that there remain problematic sectors.
- Firms report a definitive shift in thinking and behaviour and claim significant improvements in conduct standards and responsible lending:
  - These reported changes have arisen in part as a result of the Consumer Credit Directive, Irresponsible Lending Guidance, various reviews and a tougher regulatory stance.
  - More fundamentally, however, firms' attitudes to conduct risk and the increased emphasis on compliance are shaped by the cost and consequences of the PPI, LIBOR and other scandals.
- Firms see the benefits of a tighter and more robust regulatory regime:
  - These are seen primarily as elimination of rogue firms and enhanced consumer protection.
  - Firms also see enhanced powers and the ability to intervene on products and prices as supporting early intervention on detriment and damaging firm behaviour.
- The proposed costs of the new regime and the regime's supervisory requirements are much lower and less onerous than firms anticipate.
- Firms nonetheless see compliance costs as less likely to influence firm behaviour and market outcomes than perceptions of regulatory risk.
- Firms are less supportive of the transfer to a FSMA style regime than of robust regulation more broadly:
  - Six out of ten firms (60%) are supportive of a tighter and more robust regulatory regime.
  - 40% of firms are supportive of a change from a CCA to a FSMA regime, with 20% of firms, but just 12% of lenders are very supportive.
  - Lenders are least supportive of the change to a FSMA regime, with 30% of lenders "not at all" supportive.
- Firms see the new regime as carrying significantly increased regulatory risk in comparison to the more clearly rules-based CCA regime.
- There is a perceived lack of checks and balances on regulator power. Fears of a potential lack of due process and difficulties in challenging the regulator are deeply and widely felt:
  - 67% of firms and 70% of lenders are concerned that the regime will be subject to a degree of interpretation by the regulator and will lack clarity as a result.
  - 64% of firms, 70% of lenders and more than 80% of large mainstream firms feel that there is potential for the regulator to act without due process.
- Firms feel exposed to regulatory risk not only on new activities but also on existing business models.
- There is a pervasive fear of retrospective reinterpretation of principles and of retrospective action:
  - The single most important concern is the fear of retrospective action, a concern for 67% of firms and 73% of lenders.
- Firms claim that the perceived potential for subjective interpretation of principles in the new regime is felt likely to reinforce a defensive stance on the management of conduct risk.
- Firms anticipate responding to the new regime by minimising risk across all activities:
  - selling a narrower range of products through fewer channels to enable greater control and support evidencing of compliance;
  - focusing on a more homogenous and lower risk customer base to minimise conduct risk.
- Firms anticipate the outcomes of the new regime to be a less vibrant market with business increasingly concentrated in fewer, larger firms:
  - A half of firms (50%) saw the FSMA regime resulting in reduced opportunity for consumer credit.
  - Some 78% felt it would result in a greater concentration of business in large firms.
  - Eight in ten firms (80%) felt a FSMA regime would be a less conducive environment for small business.
- Firms also believed that the new regime would result in greater caution on innovation and product development:
  - Six in ten (62%) believed innovation would be held back.
- Lenders claim also that they will not take on responsibility for intermediaries within the AR regime, again on grounds of regulatory risk.
- The outcomes of the new regime are seen to be a more compliant and orderly market (67%) but views are more mixed on public trust and consumer detriment:
  - A third (34%) of firms believed the FSMA regime would create greater public trust. However, 61% took the view that there would be no difference between the CCA and FSMA regime in this respect.
  - Four in ten (39%) believed the FSMA regime would reduce consumer detriment while one in ten (11%) felt that consumer detriment would be enhanced. A half felt the change from the CCA to the FSMA regime would make no difference to the regulators' ability to address consumer detriment.
- There was consensus that the move to the FSMA regime would impact credit supply for higher risk borrowers, deepening and hardening existing risk aversion:
  - More than half of firms (54%) felt that the new regime would result in reduced credit supply.
  - Two-thirds of firms and eight in ten large lenders felt that a move to an FSMA regime will reduce credit supply for high-risk borrowers.

The full report can be found on: http://www.policis.com/publications/regulation/new-credit-regime.pdf