The Financial Inclusion Centre

Financial markets that work for society

HIGH-COST CREDIT REVIEW: CONSULTATION ON RENT-TO-OWN, HOME-COLLECTED CREDIT, CATALOGUE CREDIT AND STORE CARDS, AND ALTERNATIVES TO HIGH-COST CREDIT

DISCUSSION ON RENT-TO-OWN PRICING

FCA CONSULTATION PAPER CP18/12

SUBMISSION BY THE FINANCIAL INCLUSION CENTRE

INTRODUCTION

The Financial Inclusion Centre is pleased to submit a response to this important consultation/ discussion paper. Before responding to the specific questions, we would like to make some general introductory observations.

As with the work on overdrafts, we appreciate the level of additional research and analysis the FCA has undertaken to help us understand the scale and nature of the detriment experienced by vulnerable people who are targeted by suppliers of various forms of high-cost/ sub-prime credit.

SUMMARY OF OUR POSITION

We very much support many of the proposals in CP18/12 aimed at improving the information provided to consumers in these markets. No doubt, *some* consumers will benefit from these measures and act more effectively in the market.

Moreover, the supply side measures proposed to influence the behaviour of high-cost/sub-prime credit suppliers could have *some* effect on making them behave more responsibly.

But, considering the overall package we are not convinced that these measures go far enough. The FCA seems to see its role in being a referee, or creating a level playing field, between consumers and suppliers in the market rather than *making* the market work. Regulators are best placed to make this market work – not consumers.

The nature and extent of financial harm in this market

The analysis in the Equality and Diversity Assessment shows how much detriment groups with protected characteristics experience given their reliance on high cost, high risk, poor value products such as RTO, door step lending, and catalogue lending. We make a similar point in our response to CP18/13. The poorest, disabled, and BAME households are more likely to be paying unjustifiably high prices for consumer credit due to circumstances beyond their control.

The margins on extended warranties sold with RTO products are extremely high. The FCA's own analysis found that providers are making profits of £25m-£40m a year on £40m-£45m of sales. Claims ratios are low. Only £4 is paid out for every £10 in premiums paid – this is a very poor value product and looks like it is being sold to many consumers who do not need it.

As FCA analysis shows, the median level of debt held by rent to own and home credit borrowers more than doubled in two years; the median level of debt held by catalogue borrowers has not risen so much but it still grew by 30% over two years[1]. This could be exacerbated by a range of external factors. The continued squeeze on wages and the roll out of universal credit (UC) are major concerns. We have already seen evidence that households with UC are much more likely to be in rent arrears than households generally. Nearly three-quarters of households on Universal Credit are in rent arrears compared to 26% of all households[2]. Similarly, households on UC are more likely to have debt problems than households on legacy benefits[3].

However, many of the more complex UC cases have yet to be rolled out – households on existing benefits or tax credits will be transferred from July 2019. The FCA's interventions in the payday lending market has resulted in a much better functioning market and has helped promote more sustainable borrowing. But, we are concerned that these improvements may not be sustained. We fear that the UC roll out – along with the continued squeeze on wages – will leave growing numbers of households vulnerable to being targeted by the high-cost/ sub-prime consumer credit industry (regardless of which form it takes).

Institutionalised detriment

In effect, consumers targeted by high-cost/ sub-prime lenders are a captive market and open to exploitation by detrimental charging and selling practices. We are always wary of using phrases such as 'institutionalised detriment' as this level of criticism should be reserved for the most egregious practices.

But, it is hard to escape the conclusion that this is indeed what is happening to many of the most vulnerable households in this sector of financial services. To be clear, we do not have the evidence to prove that high-cost/ sub-prime lenders are deliberately targeting households with protected characteristics. However, deliberate targeting isn't a necessary condition for institutionalised detriment. The conditions for institutionalised detriment are:

i. The use of exploitative market practices that could cause significant harm to groups with certain vulnerabilities – in this case, charging levels and structures, and selling practices
ii. Existence of vulnerable groups who are at greater risk of being harmed by these practices
iii. Evidence of vulnerable groups actually being harmed by those practices

[1] https://www.fca.org.uk/news/speeches/high-cost-credit-what-next
[2] https://www.localgov.co.uk/Housing-bodies-warn-of-increase-in-Universal-Credit-rent-arrears/45655
[3] https://www.citizensadvice.org.uk/about-us/policy/policy-research-topics/debt-and-money-policy-research/universal-credit-and-debt/

iv. Failure to act to stop those market practices known to cause harm (or at least limit their impact)
v. Failure to ensure groups affected by harmful practices obtain redress

The harm caused to many consumers with protected characteristics meets those conditions.

What can be done to protect vulnerable consumers?

The question is: what should be done to protect these vulnerable consumers? We have become concerned that recently the FCA increasingly sees its primary objective as raising consumer awareness or increasing consumer engagement to stimulate competition. The Annex - *Competition in the high-cost/ sub-prime consumer credit market* explains how relying on information remedies and competition to protect consumers and improve markets is not an effective use of resources.

Stopping detriment should be the primary objective for regulators – using the most effective means possible. This is particularly important in markets such as high-cost/ sub-prime consumer credit markets where by definition consumers are vulnerable and have limited options).

If in doing so, regulators manage to also increase engagement or raise awareness, then so much the better. But, raising awareness/ improving engagement should be the secondary objective.

The level of detriment evident in this market warrants a much tougher approach from the FCA. With this in mind, we make a number of calls on the FCA to protect very vulnerable consumers who use these markets. We must keep in mind here that a very high proportion of consumers who have no choice but to use the high-cost/ sub-prime consumer credit markets are groups with protected characteristics.

We have seen how effective the interventions in the payday lending market have been – particularly the price cap. These interventions have been a very effective, direct form of consumer protection by constraining business models, made borrowing more sustainable, and clearing space for alternative, non-profit lenders.

We argue that the overall primary objectives for this review should be to:

- Reduce the cost of credit paid by consumers
- Reduce the amount of high-cost/sub-prime credit used by consumers, and ensure that credit is used sustainably
- Force lenders to treat consumers fairly
- Ensure consumers get redress and are protected from the consequences of tougher regulation

In order to achieve a well-functioning consumer credit market, we need to change the default setting from the current setting in which credit is aggressively *sold* by suppliers to one in which consumer credit is actively and knowingly *bought* by consumers.

To achieve this, we call for:

- **Consistent regulation:** we need a consistent approach to regulating high-cost/ sub-prime consumer credit. Therefore, we call on the FCA to cap costs in these sectors and bring in a general rule that no borrower should repay more than twice the original amount borrowed – regardless of the form of consumer credit.

- **Limits on loan refinancing:** we support the proposals in this condoc to improve the way information is provided to borrowers. But, this will not be enough to constrain supplier/ intermediary behaviours or promote sustainable borrowing. Therefore, there is a need to limit the number of times loans are refinanced.
- **Change the default setting**: as a general principle, we should move towards a system where consumers have to proactively ask for credit limit increases, refinancing, or to be contacted by credit suppliers or intermediaries. We must change the default setting in the consumer credit market away from one where consumer credit is sold to one where consumers actively buy consumer credit.
- **Product governance:** the FCA needs to make greater use of its product governance powers – particular the temporary product intervention powers to constrain the market and protect vulnerable consumers until a wider, more permanent set of reforms are introduced.
- **Greater transparency:** the FCA has been producing some excellent analysis recently - for example, the analysis to support the payday lending review and now this analysis to support the high-cost/sub-prime credit review. Furthermore, the Financial Lives initiative has added significantly to the corpus of research on financial behaviours and vulnerability. We would urge the FCA now to use the schedule for the roll-out of UC to monitor and supervise the behaviours of high-cost/ sub-prime credit providers located in those areas which have already seen a roll out of UC and which are about to see a roll out over the rest of 2018 and during 2019.
- **Reviewing the FSCS:** although not covered in this consultation process, we also urge the FCA to urgently review the remit of the Financial Services Compensation Scheme to ensure that consumer credit firms are covered. As the recent experience with Wonga shows, consumers who are entitled to redress may not get that redress once secured and preferential creditors are paid. There is a risk that this will be repeated with other firms in the high-cost/ sub-prime sector as regulation takes effect.
- **Debt buying/ debt collection:** as the example of payday lending shows, regulation has consequences. Analysis revealed that much of the revenues were dependent on inherently detrimental business models. As a result, many firms have exited the market and/ or debt books have been sold on or collections outsourced. The activity of buying loan books and debt collection has not received enough scrutiny. Payday lenders, RTO, and doorstep lenders have been guilty of some egregious practices. But, at least they are relatively well known and in the public eye. This is not the case with firms which buy debts or collect debts on behalf of another firm. We call on the FCA to review these activities to establish whether firms are appropriately regulated and are treating borrowers fairly.

We make separate recommendations on the regulation of overdrafts in our response to CP18/13.

RESPONSE TO SPECIFIC QUESTIONS IN THE PAPER

RENT TO OWN

Questions for Discussion

Q1: [For Discussion] What alternative solutions could there be to address harm from high prices?

We are very pleased that the FCA is doing further work on a price cap for RTO. We remain convinced that a price cap is the most effective way to protect consumers, constrain supplier/ intermediary behaviours, make borrowing more sustainable, and clear space for alternative, non-profit lenders.

We see no evidence that providing consumers with more information (or in different formats) would have a meaningful impact on supplier/ intermediary behaviours (although we argue that more should be done to require suppliers and intermediaries to inform consumers of alternatives).

But, we would have preferred if the FCA had stated now that it was minded to introduce a price cap and was undertaking further analysis only to determine the level and structure. The process outlined by the FCA – '*undertake the significant additional analysis needed to reach a conclusion on whether to consult*' – suggests that this could take some time and leave vulnerable consumers unprotected.

In the meantime, there are other measures the FCA could adopt to protect consumers. The two most important are:

- Using the FCA's product governance powers to greater effect - specifically the temporary product intervention rules to ban practices which are clearly harming vulnerable consumers. We would urge the FCA to move to an approach based on the 'precautionary principle'. The level of harm already evident (and the protected characteristics of consumers being targeted by RTO providers) warrants this approach. For example, the FCA could limit the gross inflation of the RTO base prices. Similarly, the FCA could ban the use of contingent charges for missed payments and cap the price of extended warranties.
- Tougher supervision of product governance standards particularly how product design and sales practices are stress tested by firms.

Q2: [For Discussion] What issues should we should take into account in carrying out further work on a price-cap?

We think the approach adopted by the FCA for the payday lending price cap review was robust and should form the same basis for the RTO price cap analysis. But, this is a small market and we would urge the FCA to speed up this analysis.

Questions for Consultation RTO

Q3: Do you agree with our proposals for a point of sale ban on extended warranties?

Yes, we very much support the proposal for a point of sale ban. We think this is necessary and appropriate. But, there are some additional measures needed to deal with the harm caused by extended warranties. With only £4 paid out in claims for every £10 paid in premiums this is very poor value compared to other forms of insurance, and compounds the financial harm experienced by vulnerable consumers. The FCA's own analysis shows that providers are making profits of £25m-£35m a year on £40m-£45m of sales.

The FCA is also proposing that consumers be given more information when they are offered the extended warranty. But, this should be toughened up to require RTO suppliers to explain verbally the existence of alternative options and provide details of the extended warranties comparison website[4]. The low level of claims and very high profits also justify a cap on the price of extended warranties.

Q4: Is the two day deferral period the right length of time?

We think two days is the right amount of time. But, we have concerns about what happens after the deferral process has begun.

What the FCA proposes would still allow RTO suppliers to aggressively target consumers to sell extended warranties. It would be preferable if RTO suppliers were allowed only to provide information on extended warranties including details of alternatives but not allowed to follow up. That is, the decision to purchase should be left entirely to the consumer without being influenced by the RTO supplier.

Q5: Do you have any comments on the proposal to provide adequate explanations to enable the consumer to make an informed decision?

We agree with the information that should be included. As well as providing written information, the key information should be provided verbally to the consumer. Moreover, as mentioned, information about the extended warranties website should be provided.

Q6: Do you have any comments on our proposed definition of rent-to-own?

It is not clear why motor finance is excluded. Moreover, excluding *all* lending to business consumers must create regulatory risks. As we have seen from previous examples of misselling of unregulated

[4] Although this website is not very comprehensive.

products and activities to SMEs, these consumers can be just as vulnerable as retail consumers and need protecting.

Q7: Do you have any comments on the proposed period for firms to implement the new rules?

No comment.

HOME COLLECTED CREDIT

Q8: Do you have any comments on our draft guidance on interpretation of s.49 CCA?

No. We agree with the FCA's interpretation.

Q9: Do you agree with our proposed new rules on explaining the costs of refinancing compared with a concurrent loan?

Yes. We agree with the new rules on explaining the costs of refinancing. But, it is important the FCA specifies how this is done not leave it to the discretion of firms.

We are at a loss to explain why the FCA has decided not to pursue a price cap on home credit. This is an expensive form of credit which can cause much detriment. A price cap would be the most effective way to protect consumers, constrain lenders' behaviours, and promote sustainable borrowing behaviours.

Moreover, the FCA has also ruled out other more direct interventionist measures such as limits on refinancing. Nor does the FCA seem to be addressing the risks created by the use of commission payments to incentivise doorstep lending agents to sell more loans.

There is little evidence to suggest that the information remedy proposed (explaining the costs of refinancing) on their own will be effective at constraining home credit firms' behaviour and/ or promoting more sustainable borrowing.

The decision not to consider a price cap is all the more inexplicable given that the FCA recognises that home credit products are not *as* complex as some other high-cost/sub-prime credit products. Therefore, there would actually be less work involved in setting an effective price cap on home credit.

Overall, we think the proposals on home credit are very weak and will leave consumers vulnerable to hard selling.

Q10: Do you have any comments on the proposed period for firms to implement the new rules?

No comments.

CATALOGUE CREDIT AND STORE CARDS

Q11: Do you agree with our proposals for new rules clarifying that firms must explain clearly upfront how interest will be charged if the customer does not repay within the BNPL offer period?

Yes. But it is important that, where possible, credit providers should verbally warn borrowers about the impact of not repaying within the BNPL offer period. The FCA should mandate how and when these warnings are provided, not leave it the discretion of credit providers.

Moreover, we share the concerns of the FCA expressed in para 4.13 about the practice of charging on the whole balance from the date of purchase in the event that the consumer fails to repay the entire amount for BNPL and similar offers. The best way to stop this is to ban it rather than rely on information remedies to constrain this practice.

Q12: Do you agree with our proposals to require firms to prompt customers to repay before the expiry of a BNPL or similar offer period?

Yes.

Q13: Do you agree the rules should not include a specific time or period to issue the prompt? If not, what should it be?

We disagree that the rules should not include a specific time or period to issue the prompt. This would lead to inconsistencies and provide opportunities for credit providers to choose the least effective options. The FCA is best placed to determine the time or period given the insights it has from its behavioural economics work.

Q14: Do you have any comments on the guidance on how firms may comply with this rule?

No, apart from to say that the FCA should mandate how firms should comply with rules not leave it to firms' discretion.

Q15: Do you have any comments on our proposals for a three month implementation period?

We support this.

Q15: Do you have any comments on our proposals to extend the existing rules for credit cards and store cards regarding credit limit increases to catalogue credit?

We support the idea of a consistent approach. But we make two points. The system for increasing credit limits should be 'opt-in'. That is, the consumer should proactively have to seek an increase. We were disappointed that the FCA adopted a muddled approach for the credit card market. There is no reason that this should be repeated in this market.

Secondly, this new arrangement should not be voluntary as is the case with credit cards. These issues are too important to be left to self-regulation.

Q17: Do you have any comments on our proposals for a three month implementation period?

We support this.

Q18: Do you have any comments on our proposals to extend the existing rules for credit cards and store cards to not increase credit limits or interest rates for customers at risk of financial difficulties to catalogue credit?

We very much support this.

Q19: In particular, do you have any comments on our proposal to use the same definition of 'at risk of financial difficulties' for catalogue credit?

We also support these proposals. As with consumer credit generally, more needs to be done to ensure that lenders refer borrowers in financial difficulty to debt advice charities.

Q20: Do you agree with our proposals that firms should have to take steps to be compliant as soon as the rules come into force?

Yes. We very much support this.

Q21: Do you have any comments on our proposals to extend the existing rules for credit cards on earlier intervention to catalogue credit and store cards?

We support the principle of extending the rules on early intervention to catalogue credit and store cards. But, as we argued with credit cards, we believe the FCA should specify the rules and guidance. This is too important to be left to lenders.

Q22: Do you consider that there are any particular aspects of data that is particular to catalogue credit and store cards which firms in these markets should also monitor?

No. However, it is important to emphasise that catalogue credit and store card providers should understand a borrower's holistic financial position not just his/ her repayment record on catalogue or store card debt.

We would also suggest that the act of taking out a BNPL deal *per se* indicates that a consumer could be already financially stretched or might have limited understanding of the structure and costs of these deals.

Q23: Do you have any comments on a six month transition period for implementation?

We support this.

Q24: Do you agree with our proposals to extend the existing rules for credit cards on persistent debt to catalogue credit and store cards?

We support this.

Q25: Do you agree with our proposals on the implementation period?

Yes.

Q26: Do you agree that we should adapt the guidance to remove the reference to a reasonable repayment period of 3 to 4 years?

Yes.

Q27: Do you have any comments on our definition of 'retail revolving credit'?

No comments.

Q28: Do you have any comments on what types of product may be caught over and above catalogue credit and store cards?

No except to reiterate that all forms of consumer credit should be treated consistently – particularly the need for a general principle to ensure that borrowers never repay more than twice the amount borrowed.

ALTERNATIVES TO HIGH-COST CREDIT

Q29: Do you have any comments on our draft guidance for registered social landlords?

We are very encouraged that the FCA is considering the barriers to providing low cost alternative credit and taking action where possible. We appreciate that there are limits to what the FCA can do given that some of the problems facing vulnerable borrowers are social policy issues and are more within the remit of Government.

At the Financial Inclusion Centre we are focusing on a number of issues that would address these barriers:

- **Social Lending Bonds:** we argue there is a need for a dedicated recognised Social Lending Bond asset class to encourage long term patient capital investment from institutional investors into community lenders (although credit unions face restrictions on how much external capital they can receive so legislation may have to be amended if they are to be able to utilise external capital).
- **Capacity building:** we are engaged in a major capacity building programme for credit unions.
- **Infrastructure and cost issues:** a key barrier we have identified is the lack of a comprehensive support and distribution infrastructure to improve the efficiency of distribution, make it easier for borrowers to engage with alternative lenders, and process relevant data to assess risk. Distribution and economies of scale are critical to reduce unit costs of borrowing.
- **Trusted intermediaries:** we very much support the view that 'trusted intermediaries' such as RSLs, local authorities, and employers could play a bigger role in providing access to affordable, sustainable credit given the established relationships they have with vulnerable communities. They are key to establishing efficient distribution channels and producing economies of scale.

We are convinced that the FCA could make a very important contribution to addressing these barriers and would welcome the opportunity to work with the FCA on this.

We have no specific comments on the draft guidance for RSLs.

Equality and Diversity Assessment

Q30: Do you agree with our initial assessments of the impacts of our proposals on the protected groups? Are there any others we should consider?

The data contained in the Equality and Diversity Assessment is very helpful for understanding the level of detriment faced by groups with protected characteristics. The proportion of customers of high-cost/ sub-prime consumer credit that are made of people with protected characteristics is very worrying – this also applies to unarranged overdrafts (which we deal with in our response to CP18/13).

The level of detriment faced by these consumers has led us to conclude that much tougher, more direct interventions are needed. While we support many of the proposals in this CP, they do not go far enough to protect these vulnerable consumers.

This marks the end of the submission by the Financial Inclusion Centre

If you have any questions, please contact:

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ANNEX – COMPETITION IN THE HIGH-COST/ SUB-PRIME CONSUMER CREDIT MARKET

It is important to understand the real effects of competition in the high-cost/ sub-prime markets rather than the theoretical effects.

How well served a consumer is by any market (but particularly financial services) depends on four sets of factors:

- **Consumer profile**: generally speaking people with higher incomes and/ or perceived to be lower risk will be offered more and better choices (of course, consumers with low incomes and/ or perceived to be a high risk will also be attractive to certain types of supplier/ distributor precisely because they have few realistic options and may be desperate or form a captive market).
- **Consumer capability and vulnerability:** this relates to the skills consumers have to operate in the market. In theory, capable and confident consumers will force suppliers/ distributors to improve their offerings so promoting effective competition. The more capable a consumer is, the better the deal s/he can seek out in the market. Or, to be more precise, given the poor quality of products in financial services, the more able s/he is to avoid being missold/ sold a poor value product. Capable consumers will consume products in an optimal way.
- **Product design:** generally speaking, the more complex a product (or contract) is, the greater the risk of misselling and/ or consumers buying inappropriate or unsuitable products.
- **Industry structure, efficiency and culture:** inefficient industries are limited in the number of consumers they can seek out, reach and serve viably. Industries with a poor culture tend to use product development and innovation, marketing techniques to exploit rather than help consumers. Industries with poor culture will take advantage of a captive market to exploit desperate consumers with few realistic choices – unless constrained by law and regulations.

We know from evidence that in many markets, those conditions set out above are reasonably well met and competition works for consumers. It has the effect of bringing down end-user costs as suppliers and intermediaries become more efficient. There is a competitive advantage in good conduct and being trusted by consumers which means suppliers and intermediaries see the point in treating customers fairly.

But, those conditions are met only in a few retail financial services markets – and certainly not in the high-cost/sub-prime credit market.

Consumers in the high-cost/sub-prime credit market have access to few good value choices. This is regardless of which particular form of high-cost/sub-prime credit as all are poor value compared to mainstream credit provided to more fortunate consumers.

We also know from experience that the demand side (consumers) generally exerts very limited influence on complex financial markets. Retail financial services are primarily supply side driven and competition is for distribution rather than the end-consumer. Despite years of regulators trying to address the information asymmetry[5] problem (which seems to form the core of the FCA's 'theory of change'), there is no compelling reason to believe that information solutions will have a significant effect in protecting consumers or improve supplier/ intermediary behaviour.

This is an even greater issue in markets such as high-cost/sub-prime credit. Many households on low incomes are very good at managing money – they have no choice but to make ends meet. But, the evidence suggests that overall households on lower incomes have lower levels of financial capability than higher income households (as measured by planning ahead, staying informed, and choosing products)[6]. Lower income households are more likely to use high-cost/sub-prime credit so it must be reasonable to assume that they will be at higher risk of detriment. This will be compounded by the fact that these products and contracts are very complex compared to mainstream loans.

It should also be noted that lenders are not just responding to a genuine consumer need or an expressed preference. The aggressive promotion and selling of credit (this applies to most forms of consumer credit not just high-cost/sub-prime credit) actually *creates* demand for and promotes use of credit. This contributes to overindebtedness and undermines financial resilience.

Furthermore, as we know from the now well-studied payday loan market, this creating of demand involves the use of expensive marketing, promotion, and distribution activities (eg. commission payments) to:

- reach potential borrowers to persuade them to take out new credit and existing borrowers to repeat borrowing; and
- compete with rivals to gain and maintain market share.

In other words, the very act of competition pushes up, rather than reduces, end-user charges. The fiercer the competition, the greater the upward pressure on end-user prices.

[5] 'Information asymmetry' really is of little value in tackling the root causes of market failure in financial services. For any theory to have real value, it has to be helpful in *explaining* market failure and, most importantly, it should be possible to *act effectively* on the insights provided by the theory. Information asymmetry theory may have some academic value for economists. In the ideal world of competition theory, we would have a group of informed consumers dealing with suppliers/ intermediaries on a level playing field. But, in the real world, regulatory interventions designed to address information asymmetries have not been, and are unlikely to ever be, effective at protecting consumers, constraining supplier/ intermediary behaviours, and improving efficiency. The focus of regulatory interventions needs to be on where these have been shown to be effective – that is, constraining supply side behaviours.

[6] See for example, https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/incomeandwealth/articles/financialcapabilityingreatbritain/2015-06-24#levels-of-financial-capability-by-socio-economic-characteristics