Consultation response

CP17/27: Assessing creditworthiness in consumer credit

Response from the Money Advice Service

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Joseph Surtees, Policy Manager
joseph.surtees@moneyadviceservice.org.uk
Tel: 0207 943 0018

1. About us

1.1. The Money Advice Service (MAS) is a UK-wide, independent service set up by Government to improve people's ability to manage their financial affairs. Our free and impartial money advice is available online and by phone or webchat.

1.2. As the statutory body for financial capability, MAS has led work with financial services firms, the third sector, government and regulators to develop the Financial Capability Strategy for the UK.[1] This 10-year strategy aims to give people the ability, motivation and opportunity to make the most of their money.

1.3. We are funded by a statutory levy on the financial services industry, raised by the Financial Conduct Authority.

1.4. The *Financial Guidance and Claims Bill 2017*, which makes provisions establishing a new financial guidance body was introduced in the House of Lords on 22 June 2017.

1.5. We have a statutory function to assist members of the public with the management of debt. Our latest data shows 8.3 million adults in the UK are living with over-indebtedness.[2]

2. Executive summary

2.1. We very much welcome this consultation, the outcome of which presents an opportunity to develop a strategy to improve public understanding of credit scoring and, by extension, the decision-making journey for people struggling to understand lending processes.

2.2. We agree that firms should consider affordability based on the risk customers are unable to make payments and should take into account the impact of borrowing on other financial commitments. We would like further detail on how the FCA intends firms to differentiate between the types of financial commitments individuals may have.

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[1] Money Advice Service, *Financial Capability Strategy for the UK*, (October 2015)

[2] Money Advice Service, *Press release: 'One in six people in the UK burdened with financial difficulties'*, (19 September 2017)

2.3 We believe the FCA could go further in recommending how firms communicate in the event of an individual being declined for credit.

2.4. Income and expenditure information is key if firms want to have an adequate understanding of a potential customer's financial position. Therefore, we wonder if it is in the best interest of consumers for firms to rely on estimates of income where they have concerns about affordability. Firms must show suitable rigour in understanding an individual's entire financial position, so they can ensure credit is provided, or not provided, appropriately.

2.5. If there is concern about the cost to lenders of appropriate income and expenditure assessments, or a diversity of approaches, the FCA may want to consider mandating the use of the MAS-developed Single Financial Statement (SFS).

2.6. Assessment of the creditworthiness of consumers should respond to their characteristics and circumstances and not only the nature of the credit. Our segmentation model, which groups UK consumers into easily understood, addressable and discrete segments, could help firms in this regard.

2.7. The FCA will have to do more to help firms resolve the inherent tension between concerns about long-term minimum payments on credit cards and the proposals in this consultation on open-end credit.

3. Consumer credit, financial capability and financial wellbeing

3.1. MAS has a statutory objective to enhance the understanding and knowledge of members of the public on financial matters (including the UK financial system). Our research shows a lack of financial confidence and knowledge creates real problems for people seeking to engage with consumer credit products. Currently:[3]

- Many UK adults (42%) do not describe themselves as being confident managing their money (giving themselves a score of seven or less out of ten).
- Even more (53%) do not describe themselves as being confident choosing financial products.

[3] Money Advice Service, *Financial Capability Strategy for the UK*, (October 2015)

- Around half agree their financial situation makes them anxious or don't see that they themselves can make a difference to their situation.

3.2. New analysis of our Financial Capability survey for this consultation shows that people who are less confident making decisions about financial products and services[4] are far more likely to be suffering over-indebtedness. While 53% of the UK adult population do not feel confident making decisions about financial products and services, this rises to 65% of those who are in financial difficulty.[5]

3.3. We are responding to this consultation, as it is our view poor creditworthiness assessments can contribute to low levels of financial capability by resulting in both immediate detriment but also longer-term disengagement:

1. They can result in individuals being provided with credit they cannot manage, in the near term pushing them into persistent debt and in the longer-term leading to distrust of credit markets; and
2. They can result in people being denied credit they could manage, causing them to turn to higher-cost forms of borrowing, exacerbating immediate problems (1 in 6 people with consumer credit debt suffer moderate to severe 'financial distress').[6] Again, over an extended time-frame this can lead to disengagement from the credit market.

3.4. Both problems can be exacerbated by poor communication about lending decisions.

3.5. Improved creditworthiness assessments, and better communication, will help counter these issues. Positive customer interaction with credit markets also represents an opportunity for firms to identify those at risk, and provide or signpost to appropriate help. Effective early intervention measures will be crucial in this area and we support the FCA taking forward the research findings from OP28 with consumer credit firms.

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[4] Those who score less than 8 on a scale indicating financial confidence.

[5] Who have, in the last six months, either fallen behind or missed a credit payment, or fallen behind or missed a payment on domestic bills for any 3 or more months

[6] Financial Conduct Authority, *Occasional Paper No. 28: Preventing financial distress by predicting unaffordable consumer credit agreements: An applied framework.* (July 2017)

4. Response

Q1: Do you agree with our proposed changes to the scope of the creditworthiness rules and proposed transitional arrangements?

Q2: Do you agree with our approach to the meaning of affordability and the factors that should be taken into account by firms?

4.1. We agree that firms should consider affordability based on the risk customers are unable to make payments over different time-frames. Families often have uncertain incomes, which can mean credit that seems immediately affordable is unaffordable in the long term. ONS data shows there are currently 1.4 million employment contracts that do not guarantee a minimum number of hours.[7] In addition, many people have low awareness of their ongoing commitments. Our 2015 UK Financial Capability Survey found 22% of UK adults do not regularly keep track of their income and expenditure.[8]

4.2. We further agree affordability assessments should consider the impact of borrowing on other financial commitments. Unaffordable borrowing can lead to missed payments, in particular on priority bills, which can lead to a loss of goods and services. In our response to the FCA consultation on credit card remedies we provided data that showed:[9]

- Three-quarters (75%) of those behind on credit card bills are behind on 2 or more bills, compared to only 44% of those who are not behind on credit card bills.
- Nearly two-thirds (66%) of those behind on credit card bills are unable to afford basic expenses (food etc).

4.3. With consumer credit lending increasing it is crucial firms show suitable rigour in creditworthiness assessments. As the Bank of England Executive Director for Financial Stability said in a recent speech:

"The spiral continues and borrowers rack up more and more debt. Lending standards can go quickly from responsible to reckless.

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[7] Office of National Statistics, *Contracts with No Guaranteed Hours, Employee contracts that do not guarantee a minimum number of hours: 2017 update,* (May 2017)

[8] Money Advice Service, *Financial Capability Strategy for the UK*, (October 2015)

[9] Money Advice Service, *Response to: CP17/10 Credit Card Market Study: consultation on persistent debt and earlier intervention remedies,* (July 2017)

The sorry fact is that as lenders think the risks they face are falling, the risks they – and the wider economy – face are actually growing." [10]

4.4. It is important firms have adequate information about their potential customers and take this into account when making a lending decision. As the FCA's *Financial Lives* research demonstrated potential borrowers face a diversity of circumstances. For example, those living in rented accommodation are likely to be in a more precarious position than homeowners. Almost half (47%) of those who rent say they would struggle to pay their rent if payments went up by less than £100 per month.[11] We believe the FCA should provide adequate guidance for firms to help them differentiate between the types and changing impact of other financial commitments individuals may have.

4.5. The data required for such assessment may not be collected at the moment. FCA research has found only 40% of firms currently verify expenditure information.[12] There are two concerns related to this, attached to two potential customer types. First, if firms are overly cautious in lending decision based on a lack of adequate information there is a danger that lower-income consumers are completely excluded from affordable credit. Second, if firms lend when they probably should not, based on a similar lack of adequate information, this will equally have a detrimental impact on households.

4.6. We believe the FCA could go further in recommending how firms communicate in the event of an individual being rejected for credit, especially as 96% of firms have 'hard stop' policies in place, which identify factors that will always mean applications are rejected.[13] Individuals in this position will both want to understand why they have been rejected, and why it may be in their best interest to seek financial advice.

4.7. The FCA has accepted the value of adequate firm communication on financial resilience by mandating high-cost short-term lenders include a risk warning, signposting potential borrowers to MAS, in financial promotions.[14] Because of this, MAS developed a toolkit to help consumers signposted to our online guidance. The toolkit uses this friction in their

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[10] Bank of England, *"Debt strikes back" or "The Return of the Regulator"?* - speech by Alex Brazier, Executive Director, Financial Stability Strategy and Risk, (July 2017)

[11] Financial Conduct Authority, *Financial Lives,* (October 2017)

[12] Financial Conduct Authority, *Assessing creditworthiness in consumer credit: Summary of research findings,* (July 2017)

[13] Ibid

[14] CONC 3.4.1R

decision-making process to help applicants think through options for cheaper and lower risk alternatives.[15]

4.8. There are numerous other Money Advice Service tools that might be of use to firms in this area. For example, we have launched a new 'how-to' operational toolkit to help creditors support consumers who fall behind on payments. 'Working Collaboratively with Debt Advice Agencies' encourages creditors to examine their debt collection strategies and collaborate with the debt advice sector to better support consumers in financial difficulty.

4.9. We believe the FCA should direct other lenders to refer potential customers to these tools to ensure they have a rounded view of their financial situation and can act appropriately. We are happy to discuss this further with the FCA.

Q3: Do you agree with our proposals on the use of income and expenditure information?

4.10. It is important that firms have an adequate understanding of potential customers' financial position before making a lending decision. Income and expenditure information is a key aspect of this, which is why it is worrying 28% of firms see information on potential customer disposable income as either 'not very' useful, or not useful 'at all'.[16] Many households are in a precarious financial position, and decisions about their creditworthiness necessarily exist on fine margins. Our research shows that nearly three-quarters of households receive an unexpected bill every year, with a typical cost of £200–400. However, 26% of working-age adults have no savings to fall back on and a further 29% have less than £1,000 saved.[17]

4.11. More rigour on tests of income and expenditure could ensure people aren't offered unaffordable credit and could have positive effects on mitigating demand.

4.12. If there is concern about the cost to lenders of appropriate income and expenditure assessments, or a diversity of approaches, the FCA may want to consider mandating the use of the MAS-developed Single Financial Statement (SFS). MAS launched the SFS on 1 March 2017. It is the result of a broad collaborative project with the debt advice and creditor sectors to reach consensus on a standardised approach to affordability across the

[15] https://www.moneyadviceservice.org.uk/en/payday-loans/self_service

[16] Financial Conduct Authority, *Assessing creditworthiness in consumer credit: Summary of research findings,* (July 2017)

[17] Money Advice Service, *Savings Evidence Review*, (July 2017)

UK. Use of such standardised information can help banks adequately understand and report on customers' financial situation.

Q4: Do you agree with the factors which we propose that firms should have regard to when considering proportionality of processes for assessing creditworthiness including affordability?

4.13. There should be consistency on the factors firms consider when making lending decisions, but assessment of creditworthiness should respond to their characteristics and circumstances and not only the nature of the credit being offered. For example, a lack of financial capability can lead to poor borrowing decisions and, in the long-run, over-indebtedness. Four out of ten adults are not in control of their finances – ie, they do not know their current account balance to within £50, do not feel their approach to budgeting works well or cannot keep up with their bills and commitments without difficulty.[18]

4.14. The FCA may therefore wish to go further than it does in this consultation and help firms better understand personal factors to take account when making a creditworthiness assessment. For example, it could recommend firms consult our segmentation model, which groups UK consumers into easily understood, addressable and discrete segments. Firms can use this segmentation model, alongside internal data, to understand what types of customers are most likely to be struggling and which may benefit from more attention. There is further potential for our segmentation model to work in partnership with data the FCA has collected for its *Financial Lives* work, which would better help firms understand the needs of potential customers.

4.15. This is an approach that supports the findings of the OP 28, which argued:

[There is] *'a role for an assessment that measures factors beyond credit risk in order to assess whether granting credit would result in a predictably unaffordable credit agreement.'*[19]

4.16. Our segmentation model might work well in conjunction with interactive guidelines on DTIs, created for specific lender types.

[18] Money Advice Service, *Financial Capability Strategy for the UK*, (October 2015)

[19] Financial Conduct Authority, *Occasional Paper No. 28: Preventing financial distress by predicting unaffordable consumer credit agreements: An applied framework*, (July 2017)

4.17. One concern we would flag to the FCA here is the potential for the proposed rules on proportionality to represent a loophole for firms seeking to bypass income and expenditure checks.

Q5: Do you agree with our proposals for open-end and running-account credit, guarantor loans and peer-to-peer loans?

4.18. We support the FCA's decision to make a rule of current guidance that with an open-end agreement, firms should make a reasonable assumption about how long the credit is likely to be for. However, we would appreciate greater clarity from the FCA on what factors it expects firms to use to make such an assumption.

4.19. We are concerned that there may be an inherent tension between the FCA worries about long-term minimum payments on credit cards[20] and the proposals in this consultation on open-end credit. The current consultation seeks to clarify that the volume and content of information that must be considered when assessing creditworthiness will be lower the lower the level of affordability risk. However, as CP17/10 pointed out, although minimum payments do not necessarily represent an affordability risk they are an expensive way of borrowing large amounts over an extended period. There is a possibility that the conflict between these two stances could cause confusion for lenders and potentially long-term detriment for consumers as firms cannot develop adequate policies on affordability checks for credit cards. More prescriptive requirements will safeguard reliability of decisions across all firms.

Guarantor loans and peer-to-peer loans

4.20. New forms of lending can cause consumer detriment, especially if it is not adequately regulated. For example, data from a leading debt advice charity shows the number of people they advise with debts to guarantor lenders increased from 635 in 2012 to 10,663 in 2016.[21] Therefore, we agree with the FCA's proposals to tighten regulation on guarantor loans and peer-to-peer loans.

4.21. New analysis of our Financial Capability survey shows that people who are not confident they understand financial products are disproportionately likely to turn to guarantor lending

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[20] As expressed in *CP17/10: Consultation on persistent debt and earlier intervention remedies,* (August 2017)

[21] StepChange, *Statistical Yearbook 2016,* (May 2017)

and P2P. Those who lack confidence represent 53% of the UK adult population but 61% of those taking out a guarantor loan and 69% of those taking out a P2P loan.

4.22. With P2P we support extending the creditworthiness requirements to include a significant increase in the amount of credit or the credit limit. However, we wonder whether further thought might be given to the scope of regulation on the lending side, given this is a form of investment not covered by the Financial Services Compensation scheme.

4.23. As changing regulatory protections can spur greater use of products, we believe that the FCA will need to monitor how its proposals on guarantor loans and P2P loans affect the way in which individuals approach borrowing.

Q6: Do you have any views on our proposals in relation to firms' policies and procedures for creditworthiness assessment?

4.24. We agree that firms' policies and procedures should be in writing, and set out the principal factors to be considered in assessing creditworthiness.

4.25. We further agree that firms should periodically review the effectiveness of their policies and procedures for creditworthiness assessments.

Q7: Do you have any views on the use of CRA data and products, or other data sources, as part of an assessment?

4.26. One big issue consumers have is understanding the use of credit scoring in lending decisions. Research from the consumer group, Which? has shown several common misconceptions in this area:[22]

- Three quarters (77%) of people incorrectly think there is a credit blacklist
- 60% of people incorrectly think credit reference agencies make lending decisions
- 54% of people wrongly believe all credit reference agencies hold the same information about them

4.27. One optimum outcome of this consultation may therefore be a strategy to improve public understanding of credit scoring and, by extension, the decision-making journey for people struggling to understand lending processes.

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[22] Which?, *Press release: What's the score with credit reports?*, (21 May 2016)

4.28. We may be able to assist the FCA in this aim. Through the Financial Capability Lab, we are currently working in partnership with the Behavioural Insights Team and Ipsos MORI, to conduct testing on the topic of 'helping people to take control of their spending and credit use'. This testing looks to build on work already being done by others, including relevant work by the FCA, and we would welcome the opportunity to share and gather information from the FCA, particularly any relevant results from the behavioural trials.

4.29. One further aspect of CRA data the FCA may wish to further consider is its potential use as a pre-arrears tool, routing people to debt advice. A Money Advice Trust / Personal Finance Research Centre report[23] from 2011 illustrated the positive impact such a pre-arrears approach can have, and we urge the FCA and authorised firms to do more in this area, taking on the learnings from OP28.

Q8: Do you have any other comments on our proposed changes to CONC in relation to creditworthiness including affordability?

Q9: Do you agree with our assessment of the costs and benefits of the proposed changes?

Q10: Do you have any comments on the equality and diversity implications or other aspects of our proposals?

[23] Money Advice Trust/Personal Finance Research Centre, *Understanding financial difficulty: Exploring the opportunities for early intervention*, (October 2011)