FCA publishes outcome of high-cost credit review

On 30 July, the FCA published a Policy Statement clarifying its expectations in terms of the approach firms take to assessing credit risk and affordability. These rules are due to be implemented by 1 November 2018 and firms will need to ensure that they holistically consider the impact of these changes.

The FCA's aim is to ensure customers are protected from poor culture and practices which lead to inappropriate lending decisions and poor customer outcomes. The FCA Policy Statement introduces changes to the Consumer Credit Sourcebook (CONC) which aim to enhance protection for consumers whilst balancing the need for proportionality. These proposals are outlined in their feedback, policy decisions and final rules and guidance following the consultation paper issued in July 2017.

The FCA's changes to CONC require firms to make a reasonable assessment of a customer's ability to afford the credit repayments without significantly affecting their wider financial situation as well as their willingness to repay.

This alert summarises the background to this review, the FCA's findings, response and expected next steps.

Who does this impact?

The FCA's clarifications and revised guidance will be relevant **to all consumer credit firms**, but may be of particular interest to those firms lending to customers which a higher indebtedness ratio and lower levels of disposable income. These may include:

— High cost short term lenders;

— Sub or near prime motor finance providers;

— Home collected credit; and

— Catalogue credit firms

How can KPMG help?

KPMG has extensive experience of reviewing of affordability assessment frameworks and working collaboratively with firms to enhance the robustness of these. These engagements have been delivered across the consumer credit sector and at a number of firms under direct FCA scrutiny.

Our Regulatory, Credit Modelling, Data Analysis and Operational Transformational specialists have the expertise, insights and tried and tested tools/ templates to help you critique your current approach and (where appropriate) understand the improvements required to satisfy the FCA and deliver fairer lending decisions for your customers whilst remaining proportionate and appropriate in light of your business model.

What do firms need to do?

Now

Review the finalised rules and guidance and complete a gap analysis exercise to identify any actions required to ensure compliance by the specified deadlines.

Aug-Sept 18

Review and make changes to necessary systems and processes to ensure they are aligned to the FCA's requirements (and expectations) and are delivering fair customer outcomes, or to provide assurance that existing policies and procedures meet requirements.

1 Nov 2018

New rules and guidance come into effect.

2018/2019

Look out for the FCA's market study on credit information which may impact the amount and types of information available from Credit Reference Agencies (CRAs) and other sources, as well as how this is accessed. Firms operating legacy or older systems may need to make changes in order to facilitate access to data which may enable more robust affordability assessments.

These timescales are likely to prove challenging to firms that operate legacy systems and who conduct the affordability assessment/maintain records of that assessment via those systems.

Background

Since taking responsibility for the regulation of consumer credit in 2014, the FCA has been addressing issues in the consumer credit market. In July 2017, the FCA released its consultation paper Assessing creditworthiness in consumer credit. This proposed changes to rules and guidance surrounding the assessment of creditworthiness in order to clarify regulatory expectations.

This consultation paper advocated that firms implemented a reasonable approach to creditworthiness, which makes a judgement on the individual circumstances of the borrower and is proportionate to the costs and risks of the credit. The FCA has now published its finalised rules and guidance. When carrying out assessments, firms are required to consider;

— The potential for commitments under the agreement to negatively affect the customer's financial position; and

— The customer's ability to make repayments as they fall due, or in the case of an open end agreement, within a reasonable period.

The clarifications in this paper also made clear:

— Distinction between affordability and credit risk;

— That firms need to consider and assess not only whether the customer will repay their loan, but also whether repayments will be affordable;

— Factors that should be used when designing affordability checks that are appropriate and proportionate;

— Appropriate role of income and expenditure information in lending decisions, including not relying on customer self-certification and clarifying the income which can be considered as part of the affordability assessment.

  Notably the FCA has decided to allow household income to be considered providing that there is a reasonable expectation that this could be used to repay credit; and

— Expectations around policies and procedures which should focus on customer outcomes having regard to the risks of the credit and customer characteristics.

Findings

The FCA expressed a reluctance to be prescriptive due to the diverse nature of the firms impacted by these changes and the different business models they operate. There is also a risk that overly prescriptive requirements would stifle the innovation of automated assessments and the development of models to better understand customer behaviours. The FCA did however focus on the outcomes these changes are intended to deliver. Below we consider each of these outcomes in turn, as well as some of the practices we have encountered as part of our work.

Meaning of affordability

The FCA identified a requirement to introduce an **explicit definition of 'affordability risk'** and formalise the concepts of the two components of a lending decision – credit risk and affordability risk. The FCA has also introduced a requirement to consider affordability in terms of the risk of the customer not being able to make payments as they fall due, without having to borrow or being unable to meet other financial commitments and without having a significant negative impact on their wider financial situation.

The policy statement outlines the **expectation that firms base their assessment on information available to them at the time, and not to ignore information which may suggest a material change in the customer's circumstances** during the period of the credit. This means that greater consideration needs to be given to potential changes over the lifetime of an agreement and particularly those that are reasonably foreseeable (e.g. a change in mortgage payments). This is especially important for customers who are likely to have inconsistent expenditure each month.

The FCA has also clarified its proposals around the use of household income. **Firms will be able to take account of other income, including from other household members, where they reasonably expect this to be available throughout the lifetime of the agreement**. Where another person's income is taken into account, so should the other person's non-discretionary expenditure with sufficient evidence of this being retained.

Income and Expenditure

The FCA clarified the situations in which a firm does and does not need to estimate or establish a customer's income. **Income will not be limited to salary and wages, but can also include income from savings or income from another person (such as when household finances are pooled)**. It will not be generally sufficient to rely on self-certification without independent evidence.

The FCA has not prescribed what would be sufficient 'independent evidence' to verify income and expenditure.

We have seen firms successfully;

— Use automated tools to undertake bank statement or wage slip analysis (including through online platforms facilitated by open banking);

— Use CRA data to build a picture of the consumer's financial health; and

— Use ONS data to supplement or challenge information available from CRAs and provided by the customer.

A hybrid approach is often used, in which income and expenditure can be verified to a certain confidence level using automated solutions, with buffers or adjustments made dependent on the risk profile. Additional manual checks of bank statement and wage slips are then only completed where necessary.

The Policy Statement also sets out the **requirement for firms to consider how income and expenditure may change over the lifetime of an agreement**, rather than taking a snapshot view at point of application. This may prove more difficult for customers who have unstable income and fluctuating expenditure. The FCA has recognised it may be not reasonable to independently evidence customer declared expected changes, but it may be possible to foresee or model some changes, such as changes in mortgage repayments, or changes to existing credit repayments. This may drive an increased focus on behavioural economics and the identification of different socio-economic factors which increase the likelihood of an individual suffering financial distress over the duration of their loan as these could be used to enhance how future changes in circumstance are considered.

Proportionality

The FCA identified a **need to clarify the factors that should be taken into consideration when deciding on a proportionate approach to assessing creditworthiness**. This includes the type of credit, amount and duration, total payable, charge for credit and APR, and the potential consequences of non-payment.

Affordability assessments should still be proportional, but need to consider more than just the amount of credit. (e.g. £100 might be material for some customers). **Firms need to assess the risk of the amount of credit based on individual customer circumstances**. Modelling affordability assessments and using indicators like DTI (Debt to Income) (although not prescribed) can allow firms to demonstrate they have assessed proportionality on an individual basis and allow them to tailor their products appropriately

The FCA has also recognised the significant role played by credit information in lenders' assessments of affordability. In its Business Plan for 2018/19 the FCA outlined its intention to undertake a market study in this area, and will use the responses to this Policy Statement to inform the scope of any future work into the use of CRA data and products (and other data sources), which it anticipates will commence in early 2019.

Controls

The FCA found that more clarification was needed around the **requirement for policies to be in writing**, and set out the principle factors taken into account by firms when assessing creditworthiness. The review also identified that **firms must assess, and periodically review, the effectiveness of policies and procedures for creditworthiness assessments, and the firm's compliance with these and CONC**.

Where technology or automation has been used as part of a creditworthiness assessment, firms will need to consider their arrangements for reviewing these policies and procedures and ensure that compliance and internal audit colleagues have the knowledge and skills required in order to sufficiently test automated solutions.

The FCA considers its proposals will build on existing SYSC (Senior Manager, Arrangements, Systems and Controls) requirements, and expect firms to maintain a record of each transaction where a regulated credit agreement is entered into, or where there is a significant increase in the amount of credit or credit limit.

The FCA will not require firms to keep a record where an application is declined, but firms may wish to do this to evaluate the effectiveness of their policies and procedures.

With the emphasis on tailoring affordability assessments and decision making to individual customer circumstances and making informed assumptions, there comes increased dependence on record keeping and firms need to be able to evidence the rationale behind the decisions made.

Open-ended agreements/ running account credit

The FCA has introduced a requirement for firms to make reasonable assumptions on how long credit is likely to be held for, and factor this into their affordability assessment.

Affordability assessments should be made on the basis that the customer draws down the ensure credit limit at the earliest opportunity and repays by equal installments over a reasonable period and firms need to be satisfied that if the customer does this, they can afford to repay comfortably and without undue difficulty.

There will be a requirement on firms to establish what will be a 'reasonable period' for repayment and this should be done by taking regard for the typical repayment of a fixed sum loan for an equivalent credit amount. The FCA is leaving it open to firms to make their assumptions regarding the length of the period of repayment. Assumptions will also have to be made around likely further drawdowns and repayments. Whilst firms may make their own assumptions, they must be able to evidence what these assumptions are, and the rationales as to why they are reasonable. Firms may wish to consider modelling potential assumptions based on existing customer data, customer profiling and risk assessments.

What this means for me/ What we can do for you

Failing to design and implement appropriate creditworthiness assessments by the implementation deadline of 1 November 2018 will significantly impact customers where inappropriate lending decisions are taken as well as negatively impacting firms resulting in:

— Impact to business volumes as assessments which are too strict / rigid result in applications being inappropriately rejected;

— Increased default rates where assessments are insufficiently robust; and

— Increased complaint volumes, particularly as a number of CMCs (Claims Management Companies) are becoming increasingly aggressive in pursuing affordability complaints.

We are have worked with a diverse range of firms within this sector with different models and challenges and are happy to discuss the impact these changes may have on your business.

For more information, please contact:

Simon Walker
Partner
Risk Consulting
E: simon.walker@kpmg.co.uk

Marc Ireland
Director
Risk Consulting
E: marc.ireland@kpmg.co.uk

Key links

CP18/12 and CP18/13: Consultations on High-cost Credit and on Overdrafts

Assessing creditworthiness in consumer credit

KPMG Consumer Credit

kpmg.com/uk

Designed by CREATE | CRT100335A