GOUGH SQUARE CHAMBERS' CONSUMER CREDIT COLUMN: NOVEMBER 2017

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In the November column, Lee Finch provides an overview of the current FCA rules on creditworthiness assessments and considers future changes to the rules.

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Background

Since the dawn of the credit industry, lenders have, in their own self-interest, been considering whether prospective borrowers are likely to repay their debts: creditors have always been deciding whether prospective borrowers are worthy of credit. Historically, this creditworthiness assessment was unstructured, informal and focused on the creditor's interests. However, as the credit industry developed, the creditworthiness assessment has become the subject of ever increasing regulation, with consumer protection given an ever increasing focus.

In 2010, the OFT introduced guidance on irresponsible lending. On 1 February 2011, the assessment of creditworthiness was given a statutory footing when section 55B of the Consumer Credit Act 1974 (CCA) was introduced as part of the UK's implementation of the Consumer Credit Directive (*2008/48/EC*). Most recently, in April 2014, when the regulation of consumer credit was transferred from the OFT to the FCA, section 55B was repealed and the creditworthiness rules were moved to the FCA's Consumer Credit sourcebook (CONC).

Current rules on creditworthiness

With a number of exceptions (for example, agreements secured on land which are subject to their own rules), creditors are required to "undertake an assessment of the creditworthiness of the customer" before entering into a regulated credit agreement (CONC 5.2.1R). The rules do not specify how this assessment should be carried out, but instead set down a number of high level principles that must be met:

- The prospective creditor must consider the potential for repayments to adversely impact the customer's financial situation (CONC 5.2.1R(2)(a)).
- The prospective creditor must consider the ability of the customer to make repayments as they fall due over the life of the agreement, or in the case of open-end agreements to repay the credit within a reasonable time (CONC 5.2.1R(2)(b)).
- The creditworthiness assessment must be based on sufficient information obtained from the customer where appropriate and a credit reference agency where necessary (CONC 5.2.1R(3)).

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- The extent and scope of the creditworthiness assessment should be dependent upon and proportionate to factors including:
  - the type of credit;
  - the amount of credit;
  - the cost of credit;
  - the financial position of the customer;
  - the customer's credit history;
  - the customer's existing financial commitments;
  - any future financial commitments of the customer;
  - any future changes to the customer's circumstances that could be reasonably expected to have a significant adverse impact on the customer's financial position; and
  - the vulnerability of the customer (CONC 5.2.3G).

However, it is likely to be disproportionate to consider all of the above factors in all cases (CONC 5.2.4G(1)).

Prospective creditors are also required to consider the adverse impact that an agreement may have on a prospective guarantor's financial position (CONC 5.2.5R(2)). Moreover, the obligations do not cease once an agreement has been entered into - creditors are required to undertake a further assessment of creditworthiness before significantly increasing the amount of credit provided, or the credit limit allocated under a regulated credit agreement (CONC 6.2.1R).

Compliance with the rules

While the high level nature of the rules allows flexibility, it also creates uncertainty and the lack of prescriptive requirements can leave prospective creditors unsure of what they have to do to comply. For example, while it is obviously right that the assessment should be proportionate to the individual situation, what does this mean?

In trying to answer this fundamental question, creditors across the industry have taken a wide variety of approaches with some adopting a highly intensive assessment and others a more light touch process. While the nature of any given lending business will affect the extent of the creditworthiness assessment that should be carried out, there is no common consensus among firms offering the same form of credit as to the level of scrutiny that the FCA expects. Nevertheless, it is important that firms ensure they take sufficient and appropriate steps while also striking a sensible commercial balance:

- Failing to carry out a sufficient creditworthiness assessment can lead to regulatory intervention from the FCA, or legal action from the debtor (whether under section 138D of the Financial Services and Markets Act 2000 (FSMA) for breach of the FCA rules, or section 140A of the CCA for the existence of an unfair relationship). The financial and reputational consequences of regulatory intervention, litigation or even voluntary action to remedy non-compliance can be significant.

  By way of example, the rent to own provider Bright House has recently committed to proactively provide redress of approximately £10.1 million to 81,000 customers whose circumstances had not been properly assessed before the commencement of the loan.

- On the other hand, adopting a procedure that is unduly onerous unnecessarily increases the costs of the assessment for the creditor and results in consumers being unnecessarily denied credit. Restricting credit

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without good cause is bad for consumers and the economy, and particularly bad for creditors who are needlessly turning away business.

These are not simply theoretical problems. In its 2015/2016 business plan, the FCA identified the risk of potential harm to consumers from poor culture and practices in assessing creditworthiness. Consequently, the FCA carried out detailed research into firms' current practices and found evidence of both under compliance and overly restrictive processes.

FCA's proposal

To address these issues and reduce the risk of potential harm to consumers while also freeing firms from unnecessarily restrictive practises, the FCA proposes to make changes to CONC. These proposed changes include:

- More clearly distinguishing between affordability and credit risk; that is to say, distinguishing between determining whether a proposed credit agreement is affordable for the customer (a customer focused approach) and determining the risk of default (the more traditional creditor focused approach).

- Specifically defining "affordability risk" as the risk that the borrower would not be able to make repayments as they fall due over the life of the agreement, out of the borrower's own income, without the borrower having to borrow to meet the repayments, without the borrower failing to make any other payment due under a statutory or contractual obligation, and without the proposed repayments having a significant adverse impact on the borrower's financial situation.

- Specifying further factors that should be used when designing affordability checks that are appropriate and proportionate in relation to individual lending decisions.

- Clarifying the appropriate role of income and expenditure information in lending decisions.

- Detailing the FCA's expectations around firms' policies and procedures, which should focus on outcomes, having regard to the risks of the credit and customer characteristics.

The FCA published a *consultation paper* (CP17/27) setting out these proposed changes and invited feedback by 31 October 2017.

The FCA's intention is not to reinvent the wheel, but to make their expectations clearer without falling in to the trap of being overly prescriptive. To that end, the proposals should be welcomed but it must be noted that the correct balance of flexibility and certainty may prove elusive. The FCA's proposal will, no doubt, have produced a variety of responses and we will not know the FCA's final approach until the second quarter of 2018 when a policy statement is expected.

In the meantime, the current rules remain unchanged. However, CP17/27 provides a valuable insight into what the regulator expects when firms carry out creditworthiness assessments. It should also be borne in mind that this work is being carried out against a background of warnings about a new "credit bubble" and is part of the FCA's wider work programme: the FCA's work on creditworthiness is intended to compliment developments in the areas of persistent debt and problem debt.

Future of creditworthiness assessments

Irrespective of the FCA's actions, there are changes afoot for creditworthiness assessments. Currently, creditors largely rely on transactional information (if any) that they hold on a consumer together with the information that can be obtained from credit reference agencies. Inevitably, this gives creditors an ability to more easily and accurately assess the creditworthiness of their existing customers than the customers of other institutions. Open banking has the potential to change that.

Open banking is bringing a number of significant changes to the UK financial sector (beyond the scope of this column, but for more information, see *Practice note: overview, Hot topics: UK implementation of PSD2: Open*

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banking standard). For present purposes, the significant change is the ability for consumers to more easily share their transactional data with third parties, including third party creditors undertaking creditworthiness assessments. The FCA acknowledges that this change could provide firms with a greater amount of information to draw on when making the creditworthiness assessment (see paragraph 5.81 of CP17/27). Moreover, open banking has, for better or worse, the potential to significantly disrupt the UK consumer finance industry, encouraging new entrants, new business models, new products and further developments in financial technology all of which could drive the continued evolution of creditworthiness assessments.

Gough Square Chambers' consumer credit columns

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