Hot topic

New proposed consumer credit lending rules: Customer affordability

The FCA wants to ensure that consumers have access to affordable credit and that when credit is granted the resultant debt is sustainable and able to be repaid. The Consumer Credit Sourcebook (CONC) includes rules to encourage responsible lending by consumer credit firms and to help firms assess a customer’s ability to repay credit. But the FCA’s principles-based approach to date has meant that lenders have applied varying interpretations of the creditworthiness and affordability rules.

New proposals set out in CP17/72 Assessing creditworthiness in consumer credit: Proposed changes to our rules and guidance published on 31 July 2017 aim to clarify rules in respect of:

- the distinction between affordability and credit risk
- the factors that should be used when designing affordability checks that are appropriate and proportionate in relation to individual lending decisions
- the appropriate role of income and expenditure information in lending decisions
- our expectations around firms’ policies and procedures which should focus on outcomes, having regard to the risks of the credit and customer characteristics.

The proposed rules are also set against the backdrop of the Bank of England’s Financial Policy Committee warning that the recent rapid growth in consumer credit could represent a risk to lenders if they fail to tighten up underwriting standards. The PRA also recently published a statement instructing firms to review prudential requirements in relation to consumer credit lending. Furthermore, also published alongside the FCA’s consultation is an Occasional paper considering the economic framework around the causes of unaffordable consumer credit debt. So firms are under pressure to ensure that they give careful thought to their lending processes.

The FCA says that the rules are intended to provide clarity. But as the rules apply to a diverse body of financial services businesses providing consumer credit, lenders should not expect concrete guidance. And the FCA has indeed not provided this. Rather, the regulator states clearly that firms should assess creditworthiness proportionately and in relation to a customer’s individual circumstances.

Highlights

At the heart of the proposed creditworthiness rules is customer affordability.

Lenders must be able to conclude, based on a reasonable assessment, that the customer can afford to repay a debt both now and in the longer term in a way that does not result in the customer experiencing significant financial difficulties.
As well as creating some new affordability rules, the FCA also introduces the concept of ‘affordability risk’. The regulator also seeks to clarify existing rules, guidance and their scope. The proposals apply to all consumer credit agreements but exclude non-commercial loans (where the lender is not acting in the course of a business) and small value, restricted use credit loans. Certain pawn broking agreements are also exempt, as are unarranged overdrafts.

The FCA invites responses to its consultation by 31 October 2017.

**The new rules and their scope**

The proposed rules have a wider reach than the previous rules and the regulator has taken the opportunity to clarify rules subject to oversights in drafting when the rules were first written.

What’s out?

Arrangements that are out of scope are:

- Non-commercial agreements
- Small-low value loans for restricted-use credit.

These agreements were previously excluded from the scope of section 55B Consumer Credit Act (which formed the basis of this section of CONC); and the FCA has noted that including them within the CONC creditworthiness regime was an oversight.

Unarranged overdrafts are also out of scope but are currently separately under review as part of the FCA’s high-cost credit review.

What’s in?

In addition to all regulated credit agreements, the rules now apply without limitation to agreements that relate to a person’s death. For example, agreements that cover inheritance tax, court fees and probate applications. Another oversight had resulted in CONC rules being applied to these type of agreements in limited circumstances only. The FCA proposes to delete CONC 4.2.5R (8) and (9) (Pre-contractual adequate explanations) to reflect this change.

The FCA also proposed to create an exemption for pawn broking agreements provided the amount the customer has to pay is limited to the value of the item to be pawned. Where additional charges are likely to be levied or due, an affordability assessment will need to be undertaken.

**Assessing creditworthiness**

At the heart of the proposed creditworthiness rules is customer affordability. Lenders must be able to conclude, based on a reasonable assessment, that the customer can afford to repay a debt both now and in the longer term in a way that does not result in the customer experiencing significant financial difficulties. This includes increases in the amount of credit, for example in relation to a credit card. Lenders must also be aware of separate increases over a period of time which together may amount to a significant sum. The FCA does not define the term significant in this context so firms must assess this in relation to an individual customer.

The new proposals result in a major overhaul of chapter 5 of CONC. CONC 5.2, 5.3, 5.5 and 6.2 will disappear under the proposals and be replaced by a new 5.2A dealing with initial assessments, pre-contractual credit increases, scope changes, creditworthiness test, guarantor obligations, the meaning of affordability, and expectations in relation to information verification. Affordability assessments in relation to P2P lending are moved from CONC 5.5 to a new 5.5A section that includes rules around post-contract credit increases. CONC 5.4 Conduct of business: credit brokers remains unchanged.

A summary of the changes is set out below:

**Summary of changes:**

<table>
<thead>
<tr>
<th>Existing CONC provision</th>
<th>Proposed changes</th>
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<tbody>
<tr>
<td>CONC 5.2 and 5.3 and CONC 6.2</td>
<td>Combined in a new CONC 5.2A, covering both the initial assessment by lenders and post-contractual credit increases (5.2A.4R)</td>
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<tr>
<td>CONC 5.2.1R</td>
<td>Minor changes to scope of creditworthiness rules (5.2A.2R); clarifying that creditworthiness comprises credit risk and affordability (5.2A.9R); elaborating on the meaning of affordability (5.2A.10R)</td>
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<tr>
<td>CONC 5.2.2R</td>
<td>Single test of creditworthiness (5.2A.4R) applying to all relevant agreements with some limited exceptions (5.2A.2R)</td>
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<tr>
<td>CONC 5.2.2R, 5.2.3G and 5.2.4G</td>
<td>Clarifying the meaning of proportionality and the factors to be taken into account by firms when deciding on the extent and scope of an assessment and the types and sources of information to use or verify (5.2A.19R to 5.2A.23G)</td>
</tr>
</tbody>
</table>
Existing CONC provision | Proposed changes
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CONC 5.2.5R and 5.2.6G | Clarifying the obligation to assess potential impacts on a guarantor (5.2A.31R and 5.2A.32G)

CONC 5.3.1G | Clarifying the meaning of affordability (5.2A.10R) and the role of income and expenditure information (5.2A.13R to 5.2A.18G); clarifying that income for these purposes must be the customer’s own (5.2A.14R); elaborating on the assumptions to be used for open-end agreements and running-account credit (5.2A.24R to 5.2A.28G)

CONC 5.3.2R and 5.3.3G41 | Elaboration of requirements relating to firms’ policies and procedures for creditworthiness assessments (5.2A.33R and 5.2A.34G); clarifying expectations in relation to verification of information (5.2A.21 and 22G)

CONC 5.3.4R | Pawnbroking carve-out becomes an exception where certain conditions apply (5.2A.2R)

CONC 5.5 | Moved to new CONC 5.5A covering assessments by P2P platforms (to parallel requirements on lenders); expanded to include post-contract credit increases under P2P agreements (5.5A.5R)

### Specific lending requirements
The FCA proposes additional requirements relevant to specific types of agreements:

**Credit cards**

- In considering creditworthiness, firms must make an assessment about the length of time that the customer may hold the credit. Firms may wish to consider this requirement in the light of CP17/10: Consultation on persistent debt and earlier intervention remedies that the FCA published on 3 April 2017.
- Affordability assessments should be made assuming that the customer draws down the full credit limit on day one and will repay by equal instalments over a reasonable period.
- Lenders should also make reasonable assumptions about how the customer will continue to use the credit.

**Guarantor loans**
Lenders must consider if the decision to lend will have a negative impact on the guarantor’s financial situation (along with the assessment made about the borrower). The assessment of both does not have to be identical in nature but should allow the lender to understand the scope of the guarantor’s commitments.

**P2P lending**
- New proposals will bring P2P lending in line with the position for other lenders requiring creditworthiness assessments to be made.
- Creditworthiness assessments for P2P lending should now also be undertaken where there is a significant increase in the amount of credit or the credit limit.

It is proposed that CONC 6.2 will be amended to reflect the requirement to undertake a post-contractual creditworthiness assessment.

### Making the decision to lend
Lenders must make their assessment on the basis of sufficient information received from the customer and credit reference agencies. The information must be enough for the lender to understand what is affordable to that customer. But neither what might be considered ‘sufficient’ nor the types of information that might be used are set out in the rules or guidance. So lenders must therefore carefully think about the types of information that will help them build a clear picture of each individual customer’s financial situation.

### How will the customer pay?
Requiring firms to think about risk in relation to lending is not new. But the regulator introduces a new concept of ‘affordability risk’. Affordability risk requires firms to think about risk in terms of the customer not being able to make repayments both now and in the future, and what it will take for the customer to make payments i.e. will the customer have to borrow to pay or use their savings? Ultimately, the lender must be satisfied that the customer can sustain payments under the agreement.

### The role of income
While savings as a means of repayment is not prohibited, under CONC 5.2A.10, the preferred repayment method is income. A customer may use their savings or other assets but they must expressly state their intention to do so and if savings are to be used, lenders must explore the purpose for which those savings and assets were accumulated and the effect on the customer’s circumstances if they are used to repay the debt.
While income is an important factor in the customer’s ability to repay, the regulator takes a more ‘light-touch’ view about its role in the lending decision and encourages a proportionate approach to the relevance of income. In some cases, depending on the amount and cost of the credit, lenders may take a view that it’s not necessary to consider income. They could make this decision based on factors such as market knowledge of the salaries paid particular industries and jobs, and the customer’s credit report. But even where it is necessary to gain more information about the customer’s income to make a lending decision, lenders could make an estimate of income based on the customer’s employment status or current account activity. Proportionality is key in this decision-making process but the lender’s decision must be able to stand up under challenge. Lenders must also think about possible fluctuations in income where this is relevant to the individual.

**The importance of maintaining and updating policies and procedures**

Lenders are already required under CONC to implement clear and effective policies in relation to their creditworthiness assessments but the FCA proposes to build on these requirements with the following proposals:

- the proposed revised rules will specify that lenders must have written policies and procedures that set out the main factors to be taken into account in assessing creditworthiness. The policies and procedures must also be approved by the firm’s senior personnel or governing body.

- lenders will be expected to undertake a regular review of the effectiveness of their policies and procedures and compliance with CONC requirements.

- clear records of transactions to grant or significantly increase credit will be expected to be maintained. Lenders are not required to keep a record of declined credit applications but it may help where a firm must demonstrate the effectiveness of its policies and procedures.

- lenders will be expected to establish, implement and maintain robust governance arrangements and internal control mechanisms to demonstrate that they comply with the creditworthiness rules.
What do firms need to do now?

Firms should:

• review existing affordability procedures in line with the proposed new definitions and CONC rules changes
• review policies and procedures
• review products which may have been affected by the revised scope of the rules.
• engage with the regulator to ensure you achieve the best outcomes for your business

The consultation closes on 31 October 2017.

If you would like to discuss any of the issues outlined in this paper, please speak to your usual PwC representative or one of the contacts below.

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