Review into change and innovation in the unsecured credit market ("the Woolard Review")

Joint response from the Financial Inclusion Commission and Fair By Design

1 December 2020

About the Financial Inclusion Commission

Financial inclusion remains a significant challenge for 21st century Britain, a nation which prides itself on being a global leader in financial services. Just under 1 million people do not have a bank account, 16 million adults lack home insurance cover and 10.5 million UK adults would be unable to cover one month of living expenses if they lost their source of income.

Financial exclusion is a major contributing fact to vulnerability for millions of people, and vulnerability whether permanent or temporary leads to financial exclusion for millions of others.

The Financial Inclusion Commission (FIC) is an independent body of experts drawn from UK politics, financial services, businesses, the charity sector and academia. https://www.financialinclusioncommission.org.uk/

Our mission is to champion financial inclusion as a public policy priority. We work with policy makers and a wide range of stakeholders, to come up with practical policy proposals for government, business and civil society.

About Fair By Design

Fair By Design (FBD) is dedicated to reshaping essential services such as energy, credit and insurance, so they don't cost more if you're poor. People in poverty pay more for a range of products including energy, through standard variable tariffs; credit, through high interest loans and credit cards; insurance, through post codes considered higher risk; and payments, through not being able to benefit from direct debits as they are presently structured. This is known as the poverty premium.

We collaborate with regulators, government, and industry to design out the poverty premium.

Disclosure: Fair By Design has a Venture Fund that provides capital/funding to grow new and scalable ventures to innovate the market and design out the poverty premium. This investment fund is an early-stage investor in Wagestream, an Employment Salary Advance Schemes.

The Barrow Cadbury Trust manages our advocacy work, and Ascension Ventures manages the Venture Fund.

Response to call for evidence

The FIC and FBD welcomes the opportunity to contribute to the Financial Conduct Authority's review into change and innovation in the unsecured credit market (the Woolard Review).

For more information about this response please contact Carl Packman at Fair By Design (c.packman@barrowcadbury.org.uk) or Chris Pond, FIC Chair via Commission@ukfinclusion.org.uk

Summary of recommendations

We make the following recommendations to the FCA in this response:

- We recommend that the FCA carries out work to identify where consumers are using unsecured consumer credit in ways that could be avoided if problems in other areas of the market were fixed, or areas of other markets were fixed (e.g. in utilities markets like energy or water).
- Additionally, the FCA should use its powers to ensure solutions helping consumers avoid expensive credit are brought to market and made widely available. For example, Request to Pay[1].
- We want to see essential services designed so they are as inclusive as possible.
- The FCA must maintain its behaviouralist regulatory approach in order to identify the processes new and innovative firms are using, and the unique harms that could potentially arise if otherwise unchecked.
- The FCA should carry out a wide-ranging study of the role data plays in delivering good outcomes for consumers today, in which they would examine how firms may abuse data (knowingly or unknowingly) in ways that are potentially detrimental to consumers.
- The FCA should also publically set out its own approach to issues like data ethics and algorithmic accountability, in relation to unsecured consumer credit but also more broadly. This is to ensure all regulatory gaps regarding the uses and abuses of data, that could potentially be detrimental to consumers, are closed.
- We recommend that the FCA makes the changes necessary to bring Buy Now Pay Later firms under its regulatory remit.
- We recommend that Employment Salary Advance Schemes (ESAS) providers, that lend consumers money through an employer, should be brought under the FCA's regulatory remit.
- We recommend that ESAS providers that do not lend money out to consumer/employees, who instead allow employees to access already earned income, should not be brought under the FCA's regulatory remit. We recommend investigating whether it would be more appropriate for the Payment Systems Regulator (PSR) to bring them under its regulatory remit.

[1] https://www.requesttopay.co.uk/

- We recommend that for ESAS providers whose business model allows employees to access already-earned income *and* access loans against future earnings, that the latter part of the business be regulated by the FCA as unsecured consumer credit.
- We recommend where possible ESAS firms oblige their organisational clients to pay all costs to serve, including any fees that might currently be incurred by employees for accessing their already-earned income.
- We recommend that the FCA commissions research to understand more about consumer/employee financial outcomes when using ESAS providers.
- We recommend that ESAS providers establish a code of conduct where they commit to making sure fees are paid by employers for reasons given above.
- We recommend that the FCA sets rules explicitly obliging providers to use customer data in a way that helps identify harm, with a view of providing appropriate and timely support.

Our response

Drivers and use of credit

Many consumers in the UK will use unsecured consumer credit in a productive way that befits their financial circumstances. For this group of consumers, outcomes tend to be very good.

Some, for instance, will benefit from the additional protection and accumulation of rewards from using a credit card to purchase goods, and paying it off in full each month. Strictly speaking this group may be using a credit card but not accessing credit in the process.

However, there are other consumers who use unsecured consumer credit in a way that becomes detrimental to their financial circumstances. It's this group who we will focus on in this response. Increased appropriate protections for this group of consumers is absolutely vital today.

We are particularly concerned about situations where people are using expensive, interest-bearing credit to pay for essentials. Particularly those people who are trapped in a cycle of using credit for this reason. It's an egregious part of the poverty premium jigsaw.

Previous research demonstrates that often people use unsecured as a means of obtaining something they need (e.g. to cover "unexpected expenses including important bills"[2]). Credit is seldom the 'thing' that is needed, but the *mediating product* between an individual and the thing they need.

Too often the only credit available is expensive. Using that credit can too often lead to negative outcomes for consumers.

[2] https://www.fca.org.uk/publication/consultation/cp18-13.pdf

On the most expensive end of unsecured credit is payday loans. When the Competition and Markets Authority (CMA) carried out its investigation of the payday loans market, it found that 53% of customers had used the money for living expenses (such as groceries and utility bills)[3].

Other research has found similar uses of unsecured consumer credit. Further details reveal more information on what kind of consumer is more likely to use credit in this way.

Researchers from the Personal Finance Research Centre at the University of Bristol carried out an analysis of the Financial Capability Survey of 2018. Adults who said they or their household often used credit for everyday household bills were typically living in younger households with dependent children. They were likely to be in full-time work themselves, but were polarised by household income (being drawn disproportionately from both the lowest and highest income groups). Around one in three had a disability and a similar proportion reported recent mental health problems in the last year[4].

In the literature review for this report, the researchers also found that:

- Using credit (specifically a credit card) for food or other living costs is more than twice as likely among those with low incomes as the average[5].
- Rising living costs have disproportionately affected low-income families because they spend proportionately more of their incomes on essentials, including food, bills and housing (which have also risen more than headline inflation)[6].
- High-cost credit is often taken out to pay for living expenses and bills. Some rely on it to manage their finances longer term (survival borrowing)[7].
- Avoiding default charges on bills is an important reason for borrowing[8].

Reliance on credit use is also a likely outcome for consumers unable to access insurance protection. As WPI Economics has previously demonstrated:

> "If something goes wrong but the household does not have insurance [such as contents insurance, or item insurance], there are a number of options [available, including either] to use savings, or to use credit. [However] low-income households

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3 https://assets.publishing.service.gov.uk/media/54ebb03bed915d0cf7000014/Payday_investigation_Final_report.pdf
4 http://www.bristol.ac.uk/media-library/sites/geography/pfrc/Why%20adults%20regularly%20use%20credit%20for%20food%20and%20bills.pdf
5 https://responsible-credit.org.uk/the-fca-is-%2022%20guilty-of-regulatory-failure-politicians-must-act-to-protect-low-income-credit-cardborrowers/
6 https://www.jrf.org.uk/blog/why-more-parents-feel-intensely-worried-about-money-anddebt
7 https://www.fca.org.uk/publication/research/alternatives-high-cost-credit-report.pdf
8 https://www.fincap.org.uk/en/insights/the-cost-of-financial-insecurity

are less likely to have built up savings to cover an emergency, and may lack access to (affordable) credit"[9].

Our view is it's very likely that were there more flexibility in the payment scheduling of utility bills such as energy and water, or a breathing space period in place, then use of expensive credit could be avoided. Request to Pay[10] offers a solution on this.

If unsecured credit is being used by particular consumers to obtain basic essentials, then this demonstrates a major problem. Particularly for consumers on low incomes/in vulnerable circumstances.

However, this is potentially a grey area between social policy and regulatory policy (and also across different regulators as well).

Other research has reinforced this point:

- An analysis of County Court Judgments (CCJ) shows that problem debt is concentrated in cities with low average pay and high welfare receipt[11].
- Between 2006-08 and 2016-19, the rise in the proportion of households using consumer credit overall, and some of the more expensive forms of consumer credit in particular, was greater for those in the bottom income quintile than it has for middle and higher-income households. Low borrowing costs have disproportionately benefitted higher-income households (in the form of reduced mortgage costs)[12]

We feel that work is needed to ensure more people are able to access the things they need, rather than having to use credit as a means of obtaining that thing.

The first step of this work is to identify the reasons why consumers are using different types of consumer credit. This would determine whether credit is being used where there should instead be improvements made to the system elsewhere (e.g. flexibility on paying utility bills, access to affordable insurance, income maximisation).

We recommend that the FCA carries out work to identify where consumers are using unsecured consumer credit in ways that could be avoided if other areas of the market were fixed, or areas of other markets were fixed (e.g. in utilities markets like energy or water).

Additionally, the FCA should use its powers to ensure solutions helping consumers avoid expensive credit are brought to market and made widely available. For example, Request to Pay.

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[9] https://barrowcadbury.org.uk/wp-content/uploads/2019/04/Insurance-and-the-poverty-premium-WPI-Economics-final.pdf
[10] https://www.requesttopay.co.uk/
[11] https://www.centreforcities.org/wp-content/uploads/2020/04/Household-debt-and-problem-debt-in-British-cities-1.pdf
[12] https://www.resolutionfoundation.org/app/uploads/2020/01/An-outstanding-balance.pdf

We acknowledge that part of this work is outside of the remit of the FCA. In which case the solution will require a much more collaborative approach between government departments and regulators. **We advocate such collaboration in this review.**

This review asks us to consider access to credit in a healthy credit market. We agree that in a healthy credit market there will be people not able to access credit.

Credit will not be the appropriate product for everyone. But there must be something in place for people where credit is not the answer, to avoid people becoming stranded. Examples include: payment flexibility, such as Request to Pay, breathing spaces, grants, a revamped Social Fund, or a No Interest Loan Scheme (NILS) product.

The FCA must maintain guidance to financial services firms to signpost, where necessary and possible, to other services where obtaining credit from that provider is not possible.

Change and innovation in the supply of credit

The pace of change in the unsecured market is unprecedented. It is a much more difficult task for the regulator today to properly understand all the technical aspects of new and innovative firms entering the market today.

The world of consumer credit that is primarily sold online brings further challenges, especially those covered by a range of different regulatory rules including Payment Services Regulations and Electronic Money Regulations. The processes that these firms use to communicate with and target customers, including using personalised advertising, can be very complex. It's hugely different from the ways "bricks and mortar" lenders have traditionally done it.

There is an additional problem: we know that appropriate regulation takes time, but the more time taken the greater the risk of stifling innovation in the licensing period.

Never-the-less, it is appropriate that this process is done properly to ensure regulation is proportionate, fair, and has due regard for consumers (including those at greater risk of being in vulnerable circumstances).

There is a strong need for an inclusive design[13] approach to drive regulatory intervention today. Many essential services, like financial services, are almost all still designed for the 'perfect consumer' – who never becomes ill, always has a steady income, is able to understand complex terms and conditions and always has the time and technology to easily find the best deal for them.

By way of a remedy **we want to see essential services designed so they are as inclusive as possible**.

- All regulators of essential services should adopt inclusive design strategies to:
    - help set their priorities:

[13] https://fairbydesign.com/news/inclusive-design-in-essential-services/

   - develop and implement interventions;
   - assess their effectiveness; and
   - guide their expectations of business.
- Where inclusive design cannot solve issues the government and regulators should work together to bridge the policy divide – so markets work for everyone.

There are greater risks to consumers when so many more firms are digital by default today. These firms are far more sophisticated in using behavioural biases to their advantage.

We feel that **the FCA must maintain its behaviouralist regulatory approach in order to identify the processes new and innovative firms are using, and the unique harms that could potentially arise if otherwise unchecked.**

Furthermore, there remains a lack of evidence as to whether lenders using greater amounts of personal data to make credit decisions is good for consumer outcomes, particularly in the personal lending space. Yet this is still considered received wisdom by many providers, small and large, operating today.

We think **the FCA should carry out a wide-ranging study of the role data plays in delivering good outcomes for consumers today, with the view of setting definitive standards on what data is most useful and productive for providers** (since not all data is credit data).

The FCA should also publically set out its own approach to issues like data ethics and algorithmic accountability, in relation to unsecured consumer credit but also more broadly. This is to ensure that all regulatory gaps regarding the uses and abuses of data, that could potentially be detrimental to consumers, are closed.

The questions that regulators, including the FCA, should consider in relation to data regulation gaps have been raised by Hetan Shah, the Executive Director of the Royal Statistical Society[14]. These include questions like “What is an appropriate level of human oversight in their areas?” and “Who will be ultimately responsible for any decisions taken on the basis of algorithmic processes?” We feel that these questions are very appropriate for data-led consumer credit firms to answer, and for their regulator to be asking.

The role of regulation in unsecured credit markets

Currently there are new firms entering the market that sit outside of the FCA’s regulatory perimeter, that potentially should be brought within it. This includes firms that are considered ‘Buy Now Pay Later’ (BNPL) and Employment Salary Advance Schemes (ESAS) firms.

These firms are different from other consumer credit firms for a number of different reasons. BNPL firms are very different from ESAS as well.

[14] https://royalsocietypublishing.org/doi/10.1098/rsta.2017.0362

Buy Now Pay Later (BNPL)

Some BNPL firms oppose sitting within the FCA's regulatory perimeter on the grounds that they are not interest-bearing forms of credit, and therefore unsuited to the regime.

We disagree. Where consumers enter into a contract that provides them with something which legally belongs to another entity for the duration of the contract period (whether that is a cash loan from a creditor, an item of clothing from a retailer, or a promise of repayment from a payment merchant), there must be suitable protections for that consumer.

This is because the outcomes for the consumer are very similar as with other forms of consumer credit.

There must also be standards set on how these businesses operate, and how they treat customers. We are concerned that the way these firms are presented online when processing payments makes it appear that they are the default way to buy online.

There must also be a uniformity of rules applied to these firms on assessing consumer affordability to ensure people aren't entering into credit contracts where they are unable to meet payment commitments. We feel this is proportionate.

As a result, **we recommend that the FCA makes the changes necessary to bring BNPL firms under its regulatory remit**.

It is worth reflecting on information about consumer outcomes from BNPL contracts that we already have access to.

Research by Money and Mental Health Policy Institute found that:

- People with mental health problems are twice as likely to have fallen behind on payments for products bought with credit from a retailer (16% compared to 7% for people without mental health problems).
- A quarter of people with mental health problems report that they have bought something on impulse that they didn't really need because they could pay later[15].

We have seen research carried out by management and technology company Capco that says more than half of 18-34 year olds using Buy Now Pay Later (BNPL) have missed a payment and nearly two thirds (62%) say BNPL is making them spend more, potentially increasing their chances of getting into debt.

In their research, 44% of respondents are unsure whether BNPL means 'taking on debt' or 'deferring a payment' – rising to 57% among 18-34 year olds. A slight majority (54%) of consumers want more regulation and education around BNPL personal finance products.

15 https://www.moneyandmentalhealth.org/point-of-sale-credit/

Employer Salary Advance Schemes (ESAS)

On ESAS, we have seen a number of new market entrants enter this space in recent years. Many firms involved have an explicit remit of helping employees avoid using high cost credit. We note that the FCA has previously mentioned that when "used in the right way, ESAS can help employees. They can be a convenient way for employees to deal with unforeseen expenses and occasional short-term cash flow"[16].

On the specific question of whether ESAS firms should be brought under the FCA's regulatory remit, we note that some providers are neither providing credit nor something which legally belongs to another entity (e.g. a business).

Where an ESAS is the mechanism through which an employer is providing an employee a defined portion of that employee's already-earned income, this should be treated differently from a credit product.

Some ESAS providers, on the other hand, lend employees new money that an employee hasn't earned or accrued. Therefore, they are an employer's lender of first resort. Strictly speaking this is a credit contract where a consumer is entered into a contract via their employer.

As a result, this consumer/employee should enjoy consumer protections. It would also make sense to apply affordability tests to someone who is borrowing money from an institution that they haven't earned.

We agree with the conclusion of the Money and Pensions Service that "reviewing the range of products/services offered across the market, the distinction between advances of accrued salary and loans facilitated via the employer repayable from salary should be borne in mind."

The FCA should bear the difference between ESAS providers in mind. We recommend that where a consumer/employee is borrowing money they haven't earned, from their employer's lender of first resort, that this should be brought under its regulatory remit.

For ESAS providers that make available already-earned income but do not lend money out to consumer/employees, we recommend that this be treated differently, and not brought under the FCA's regulatory remit. We feel that this would be akin to regulating and applying consumer protections to a broader set of ways a person spends their money in a way that isn't appropriate for the regulator.

However, we do believe that this activity, and the firms providing it, should be governed by a regulatory framework. We feel it would perhaps be more appropriate for the Payment Systems Regulator (PSR) to have oversight over this type of ESAS.

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[16] https://www.fca.org.uk/news/statements/fca-sets-out-views-employer-salary-advance-schemes#:~:text=They%20are%20often%20promoted%20as,they%20can%20raise%20similar%20issues.

For both types of ESAS, we do feel it is good practice for employers to provide useful financial information to employees using such schemes. For example, from the Money Advice and Pensions Service.

For ESAS providers whose business model allows employees to access already-earned income *and* access loans against future earnings, the latter part of the business should be regulated by the FCA as unsecured consumer credit.

Some ESAS providers make loans against future earnings. Currently these providers are authorised by the FCA, with the front-end (which the consumer sees) authorised or registered as Payments Services Directive (PSD) agent or an E-Money Directive (EMD) agent. Our view is that if these providers are making loans to employees, then this is the important detail for whether they are appropriate for consumer credit regulation.

Other ESAS providers act as brokers for loans from separate entities. Our view is that the FCA should uphold its existing regulatory approach to credit brokerage in the Consumer Credit Sourcebook (CONC).

With this being such a new approach, there is plenty that various stakeholders (including third sector organisations) can learn about the use of ESAS. **We therefore recommend that the FCA commissions research to understand more about consumer/employee financial outcomes when using ESAS providers.** This would determine how useful they are for good consumer outcomes, for assisting different groups of consumers, and how it affects the use of other forms of financial services.

While this would not be in scope for the FCA, **we recommend where possible ESAS firms oblige their organisational clients to pay all costs to serve, including any fees that might currently be incurred by employees for accessing their already-earned income**. We feel this would be justified on the grounds of the considerable evidence available on the benefits of employee financial wellbeing[17].

Lastly on this, **we recommend that ESAS providers establish a code of conduct where they commit to making sure fees are paid by employers for reasons given above**.

While we acknowledge here that some ESAS providers are not providers of credit (and therefore unsuited to consumer credit regulation), we do feel it is appropriate for the outcomes of the employees to be considered by all ESAS providers and the employer as well. After all, struggling to meet financial commitments might be one of the reasons some people use these providers. A commitment to ensuring employees using ESAS are able to access other forms of support where necessary, such as debt advice, should feature in any code of conduct.

[17] See for example: https://www.smf.co.uk/wp-content/uploads/2016/01/Working-Well-How-employers-can-improve-the-wellbeing-and-productivity-of-their-workforce.pdf

Cross-subsidisation in the unsecured credit market

We are aware of significant anecdotal evidence suggesting high degrees of cross-subsidisation for those with 'Free-If-In-Credit Personal Current Accounts, by those with heavy use of arranged or unarranged overdrafts (which includes a proportionately high number of consumers the FCA identifies as vulnerable)[18].

Whatever the truth behind this evidence, we feel that in the interests of ensuring good consumer outcomes that firms should engage in more cross-subsidisation to facilitate lower cost credit for those who struggle to access mainstream credit currently.

This is on the grounds that there is evidence of considerable harm in a market where many consumers are unable to access affordable credit within the financial mainstream, and are instead left to take on high cost credit to the detriment of their finances in general.

The impact of covid-19 and the FCA's response

We feel that Covid-19 has emphasised and entrenched existing issues that many consumers face. Particularly for consumers who relied on unsecured consumer credit as a means of supplementing low incomes.

Evidence from other organisations (including StepChange) suggests that the demand for different types of unsecured credit has risen[19].

Temporary emergency measures set by the FCA, such as payment holidays, do have a broader relevance to customers in financial difficulty more generally today. We feel that providers should be much more proactive (using customer data insights where appropriate) in identifying signs of harm and introducing necessary forbearance measures. **We recommend that the FCA set rules explicitly obliging providers to use customer data in a way that helps identify, prevent and/or mitigates the risk of harm.**

This will help to avoid customers seeking help too late (which reduces stress on the debt advice sector), or not seeking help from their providers at all which carries its own significant risks.

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[18] See for example: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/370876/Financial_Services_Consumer_Panel_discussion_paper.pdf (p.2); https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/financial-services/deloitte-uk-emea-centre-for-regulatory-strategy-cross-subsidies-in-the-cross-hairs-digital.pdf (p.4); https://www.friendsprovidentfoundation.org/wp-content/uploads/2017/11/How-much-does-free-banking-cost-Bangor-University.pdf (p.7); http://www.smf.co.uk/wp-content/uploads/2017/09/Switching-the-measure-final-version.pdf (p.20).

[19] https://www.express.co.uk/finance/personalfinance/1359423/universal-credit-debt-stepchange-rishi-sunak