The FCA Practitioner Panel's Response to the FCA's Consultation Paper CP 14/10 - proposals for a price cap on high-cost short-term credit

1 September 2014

Q1 Do you have any comments on our general approach to developing proposals for the price cap?

Overall comments

It is clear that the FCA has made significant efforts to gather and analyse a very large amount of data and evidence in a relatively short timeframe in order to develop its rate cap proposals. Achieving an appropriate balance between protecting borrowers and maintaining credit supply and competition in HCSTC, while discharging its duty to introduce a price cap, was not an easy task for the FCA. The key decisions around scope, form and level of the cap along with how to ensure compliance are complex and interrelated. Design of the new rate cap regime was made especially difficult by the continued extremely high levels of public scrutiny, a newly introduced regulatory regime and the ongoing work of the Competition and Market Authority in the HCSTC sector.

However, in general, the FCA seems to have successfully achieved a balance with its proposals which will have an impact on the sector, its customers and competitors but not one that is likely to be disproportionate. The proposals are generally clear and straightforward for both borrowers and lenders and the proposed compliance and enforcement approach seems likely to be effective. There are only a handful of areas where some further clarification and worked examples would aid lender understanding and preparation for compliance, including in the areas of refinancing and application to multiple instalment loans.

The FCA notes that its survey work may turn out to underestimate the potential increase in illegal lending as a result of the cap. It is therefore important that the FCA continues to work closely with the Illegal Money Lending team to monitor trends in illegal lending before and after the cap comes into effect, and takes targeted action where necessary.

This is the first time a modern regulator has implemented a credit price cap in the UK, in this case in a market with a high degree of ongoing dislocation. The proposal to review the impact of the cap in 2 years time is therefore appropriate and necessary. Giving a 2 year window of greater certainty where changes are less likely will help firms and borrowers make the transition, and encourage investment to be made by new entrants and incumbent innovators.

Areas for further clarification

There are a handful of areas where some further clarification and worked examples would aid lender understanding and preparation for compliance, including in the areas of refinancing and application of the cap to multiple instalment loans.

There is some uncertainty over the treatment of multiple instalment loans with declining balances during early settlement and/or refinancing under the current proposals. In particular, it is not clear how Early Settlement Rebates should be accounted for, nor why refinanced multiple instalment loans are treated so differently to single payment loans being topped up, or repeat lending situations in general.

Refinancing is used very differently in multiple instalment lending than in single payment ‘payday’ loans. In the latter the refinancing is more typically an involuntary ‘roll-over’ of the initial loan to extend the term where the customer is unable to repay as envisaged under the terms and therefore requires more time. Additional costs are typically incurred, often none of the original principal has been repaid and no further credit is advanced. In the former case, the purpose is typically to extend further credit in an affordable way to a borrower most of the way through repaying the principal of an existing loan where further credit is sought. This is often part of a ‘low and grow’ approach to starting customers off with smaller and shorter loans until repayment behaviours can be established, giving the confidence on both sides for additional credit over longer terms, at similar repayments. This approach has proven particularly effective in maintaining sustainable and responsible lending in the non-standard and sub-prime end of the market where external bureau records may be 'thin' or reflect recent problems not representative of the current situation and prospects of the borrower.

Given the complexity of the issues, the Panel recommends that there should be a further, more detailed technical consultation with a selection of firms perceived as 'industry best practitioners' in order to gather their views.

It would be helpful if the FCA could clarify these areas when it publishes its final rules in November, with the addition of more worked examples to aid understanding and compliance. There is a risk that without clarity and consistency, unintended consequences for one format or another might disrupt the overall balance achieved in the proposals. For example, there appear to be instances where proposed approaches to the cap for refinancing would result in far tighter constraints than envisaged in CONC being applied to multiple instalment loans. This could make refinancing of some loans impossible, despite the loans being well within the price cap themselves, and the FCA deciding on a limit of twice when designing the refinancing rules for HCSTC in CONC. These additional much tighter constraints do not seem to apply to topping up single payment loans or repeat borrowing situations. There also appears to be an incentive to offer larger amounts of credit when refinancing multiple instalment loans (as the larger of the initial and new principal is relevant for the total cap), which may conflict with responsible lending requirements in CONC. Overall incentives therefore seem to be weighted in this specific area towards encouraging shorter terms, higher principals, repeat lending and topping up, rather than meeting customer needs responsibly with a 'low and grow' approach. This was presumably not the FCA's intention.

Q2 Form of the cap

The FCA has chosen to propose a cap in three parts: an initial cost cap, a total cost cap and a maximum default charge. This precise approach has not been followed elsewhere, but the cap is designed specifically with the UK market context in mind using what relevant insights can be gleaned from overseas experience. Applying the initial cap to the initial credit issued in single instalment loans and the outstanding balance in multiple instalment and credit line products seems to be a sensible approach. There is clearly also a need for a total cap to limit overall costs, regardless of outcome for the borrower. Historic default fees guidance from the OFT has clearly lost influence as current charges range widely, often exceeding the established £12 level, and often levied multiple times. It is unclear how these relate either to the real cost of default for the lender, and/ or are designed to act as an effective deterrent for the borrower. Therefore a simple single maximum default fee will make the situation clear for all and limit spiralling costs for borrowers in genuine difficulty.

Overall, the price cap structure is very clear and simple for customers, and is likely to be straightforward to communicate and memorable.

Q3 Do you have any comments on the price cap levels?

Level of the cap and likely impact

The combination of a 0.8% per day initial cost cap, along with a total cost cap of 100%, and a maximum total default fee charge of £15, seems to evenly balance incentives to offer shorter and longer term products. The level of the proposed cap is clearly below the current market rates charged and will therefore 'bite', reducing the cost for borrowers in line with the objectives. It does not, however, appear to be uneconomic to provide credit under the cap going forward.

The FCA expects 11% of individuals (c160,000) per year who would otherwise have got HCSTC to no longer be able to do so under the cap. It is clear that some current and past payday borrowers are not well suited to the very short term, inflexible nature of the product. This has resulted in many borrowers having to 'roll-over' loans that they cannot afford to repay on the due date, incurring a range of fees and charges that they did not expect. The degree of contraction anticipated under the new cap, on top of the recent and ongoing reduction in payday lending under the new tighter conduct regime therefore does not seem disproportionate.

The FCA expects at least the 3 largest online payday lenders, and the largest high street payday lender to remain viable under the cap, although competitor reactions and adjustments may allow many more to remain in the market. The payday lending market has already seen a large reduction in supply and some exits under the new tougher conduct regime. The additional impact of the price cap does not seem excessive and will maintain a reasonable level of competition in the HCSTC market allowing for new entrants and innovation to flourish as well.

Overall, the level of the price cap is very clear and simple for customers, and is likely to be straightforward to communicate and memorable. While impacting the pricing and practices of lenders, it should allow healthy competition and innovation to continue. A period of stability in both the level and form of the price cap regime after its introduction in January 2015 will allow lenders to build experience and adapt their offers over time, while giving the certainty required to encourage new entry and investment in innovation.

Q4 Do you agree with our proposals on repeat borrowing?

The FCA's proposals on repeat borrowing seem sensible and pragmatic. Focusing on responsible and sustainable lending decisions at the outset of each new loan is likely to be simpler and more effective than any attempt at cumulative application of the cap, or further caps on borrowing frequency. This preserves the right of borrowers to continue with their chosen lender where they wish to and need to, while placing a strong requirement on lenders to ensure that all borrowing is responsible and borrower circumstances are always rigorously assessed.

Q 5 Scope of the cap

The FCA's conclusion that the widest appropriate scope for the price cap is HCSTC (i.e. explicitly excluding secured loans, pawn broking, community finance organisations, home credit, bill of sale/ logbook loans, and overdrafts) seems appropriate. Payday lending is the clear target of the government's requirement for the FCA to cap prices, but the sector and some of its competitors have evolved from single payment loans to various forms of instalment and revolving credit serving similar needs and customers. Therefore, in order to be effective, the cap must encompass credit offers that are closely related to payday loans, along with their pricing and operational approaches which were the trigger for government action. A wider scope for the cap would not be justified either by existing government direction or borrower protection concerns.

The FCA is also right to ensure that the cap covers all possible costs to the borrower, regardless of their form or where they are levied. The FCA is correct to capture revenues generated by brokering, providing ancillary services, debt administration and collections activities in its cap, as these may all ultimately be incurred by the borrower. This approach also makes avoidance and evasion tactics seen in other jurisdictions more difficult. It will be a challenge for the FCA to monitor and enforce this genuine 'total cost' approach, but it is only through including all revenue sources in the cap that borrowers can be certain of the maximum cost of credit.

Q6 Do you have any comments on our proposed Handbook rules?

No comment.

Q7 Do you agree with our proposals on unenforceability?

Enforcement and compliance

The FCA's proposals to make loans that breach the cap irredeemably unenforceable (including the associated repayment obligations such as CPA and direct debit) should provide the appropriate incentive for firms to ensure that they comply, and have adequate controls in place to ensure that they do not breach the cap.

Other jurisdictions that have implemented rate caps have ended up with complex rules, inclusions and exclusions in an attempt to anticipate avoidance measures. This kind of approach perversely tends to encourage further more creative avoidance tactics not anticipated at the time, resulting in an ongoing 'battle' and regular revisions and additions which create further confusion. The FCA has taken a more simple approach which is likely to prove more effective. The proposed FCA rate cap is based on a simple structure and simple wording to describe the universal nature and intention of the cap. The FCA's clear and firm requirement for HCSTC firms wanting to operate in the UK to demonstrate and evidence compliance in order to maintain FCA authorisation, or be removed from the market is likely to provide a strong and clear basis for enforcement. It will be critical for the FCA to rigorously and actively implement these requirements on all current and prospective HCSTC providers. The appropriate resources, infrastructure and supervisory regime appears to be in place to make this possible.

Q8 Do you agree that we should prevent UK-based debt administrators from enforcing HCSTC agreements on behalf of ECD lenders which include charges in excess of the price cap?

The FCA has identified the issue of the potential for avoidance of the cap (and authorisation in general) by online firms based in other EEA member states using the E-Commerce Directive (ECD). Given this situation, it is imperative that the FCA should prevent UK-based debt administrators from enforcing HCSTC agreements on behalf of ECD lenders which include charges in excess of the cap. The FCA should monitor any UK activities of firms seeking to operate in the UK without FCA authorisation from another EEA member state more generally and seek similar methods to ensure that they either comply with FCA rules or base themselves in the UK and seek FCA authorisation. The FCA should also seek additional powers to act where firms are abusing EU rights to evade FCA rules, in line with current discussions with the Treasury.

Q9 Do you have any comments on the proposed approach to data sharing?

The FCA's proposed approach to data sharing seems appropriate. It should take action if sufficient progress is not made by the time the final rate cap rules are published in November.

There are moves already taking place in the industry to improve data sharing, moving towards more real time reporting and wider coverage. This will help improve lending decisions and encourage credit reference bureaux to compete on quality of service and price, rather than differences in coverage and how comprehensive, accurate and up to date their databases are. This will in turn encourage greater and better use of data in lending decisions and in managing ongoing customer relationships, which will have a positive impact on the market and consumers.

Better external and application data (and better use of it) continues to improve decision making in credit markets, along with greater use of information technology to capture, process and use this data. However, it is worth noting that the data available prior to acceptance can never replace nor beat real recent repayment experience with the customer over time with the specific credit product offered by the firm and chosen by the customer. This type of internal behavioural information is always likely to have a far greater predictive power in making further lending decisions.