

Understanding consumer credit

Creditworthiness and affordability: common misunderstandings

There are some common misconceptions among consumer credit firms as to what our rules on creditworthiness and affordability mean. This document has been designed to explain some of the main points and what firms should do to comply with our rules.

We announced in our Business Plan 2015/16 an intention to undertake wide-ranging research with a view to consulting on possible changes to our rules on creditworthiness to clarify our expectations of firms. Ahead of this, we thought it might be helpful to address some of the common misunderstandings that we are encountering.



**You can find more information about consumer credit at
www.fca.org.uk**

Common misunderstandings

1. I have to assess affordability separately from creditworthiness

The requirement in chapter 5 of our Consumer Credit sourcebook (CONC) is to assess the customer's creditworthiness. A key element of this is the customer's ability to make repayments as they fall due (or within a reasonable period in the case of open-end credit such as a credit card or overdraft) but this is not a separate obligation. It is a part of assessing creditworthiness.

The CONC 5 requirement is to assess creditworthiness before entry into a regulated credit agreement, and there is a parallel requirement in CONC 6.2 where the firm proposes to increase significantly the amount of credit or the credit limit.

2. FCA rules prescribe how I should check creditworthiness

We do not prescribe what checks should be made. On the contrary, we make clear that the extent and scope of a creditworthiness assessment should be dependent upon, and proportionate to, factors which may include one or more of those listed in CONC 5.2.3G – such as the type and amount of credit, its cost and the customer's financial position.

CONC 5.2.3G is guidance not a rule, and as such is not binding on firms – it merely indicates matters which may be relevant in assessing creditworthiness, depending on the individual circumstances.

Our approach is principles-based (and outcomes-focussed) rather than prescriptive – the lender must make a reasonable assessment in the individual case but we do not dictate how this must be done. This is consistent with our regulatory philosophy more generally, of setting out broad principles – including 'treating customers fairly' – and giving firms discretion on how to achieve these.



Common misunderstandings

3. The FCA is more concerned with process than outcomes

The creditworthiness assessment should include the firm taking reasonable steps to assess the customer's ability to make repayments in a sustainable manner, without incurring financial difficulties or experiencing significant adverse consequences. For example, the customer should be able to make repayments on time, while meeting other reasonable commitments and without having to borrow further.

We expect the lender to take reasonable steps to assess the customer's ability to do so, having regard to the relevant circumstances.

We make clear in CONC 5.2.4G that a firm should consider what is appropriate in the particular circumstances, but we do not prescribe what this must involve. The key is whether the lender's policies and procedures are effective in mitigating the risks of unaffordable borrowing, and in ensuring that customers are treated fairly and in line with our rules and principles.

4. CONC is full of rules that I have to comply with, which limits flexibility

There are core requirements in CONC 5.2.1R (to assess creditworthiness on the basis of sufficient information) and 5.3.2R (to establish and implement clear and effective policies and procedures). However, most of the remainder of CONC 5.2 and 5.3 is guidance on this, and on treating customers fairly, rather than rules.

As such, it sets out examples of how firms can comply with the CONC rules and our high-level Principles for Businesses, but these are illustrative and non-prescriptive. Firms can comply in other ways, provided that they can demonstrate compliance if asked.

5. I have to make a credit reference agency (CRA) check as part of a creditworthiness assessment

The CONC requirement is to make a reasonable assessment of creditworthiness on the basis of sufficient information, obtained from the borrower where appropriate and from a credit reference agency where necessary. We do not stipulate when it may be necessary to make a CRA check, or what this should comprise, or how lenders should use the information. This is for firms to decide in each individual case.

We can see the benefits of lenders sharing and using CRA data – particularly on a real-time basis – however, we do not prescribe this.

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Common misunderstandings

6. I have to do an income/expenditure check as part of a creditworthiness assessment

The CONC requirement is to assess creditworthiness on the basis of sufficient information. We do not prescribe what is 'sufficient' in each case – this is for the individual lender to decide in the particular circumstances. We say that a firm may want to take into account (among other things) the borrower's financial position, including their income and expenditure and possible future changes, but we do not prescribe this.

It is open to a lender to assess creditworthiness by other means, provided that they can demonstrate if asked that their policies and procedures are effective in mitigating the risks of unaffordable borrowing and treating customers fairly.

7. I have to verify individual income and expenditure as part of a creditworthiness assessment

CONC requires firms to establish and implement clear and effective policies and procedures to make a reasonable assessment. As part of this, the lender should take adequate steps, to the extent that it is reasonable and practicable to do so, to ensure that the information provided is complete and correct.

What is 'adequate' will depend upon the individual circumstances. In some cases it may be unnecessary or would be disproportionate to verify data, and indeed a lender may be able to assess creditworthiness without relying on income or expenditure data at all. This is likely to depend upon the nature of the credit and the risks to the borrower.

8. I would have to use a crystal ball to predict the future

In assessing creditworthiness, the lender must consider the potential for the commitments under the credit agreement to adversely impact the customer's financial situation. Inevitably this is forward-looking. However, this does not preclude taking account of past behaviour, nor does it require a detailed examination of likely future changes in the customer's financial circumstances.

CONC 5.2.3G refers to lenders having regard to such future changes, insofar as they may be reasonably likely to have a significant adverse impact on the customer, but this is merely as an indication of the factors that a lender may want to take into account in the individual case. There is no requirement to do so, provided that the lender's alternative policies and procedures are sufficient for the firm to make a reasonable creditworthiness assessment.

9. I have to use the same creditworthiness checks across the board

We make clear in CONC 5.2.4G that the lender should consider what is appropriate and proportionate in any particular circumstances depending on, for example, the type and amount of credit and the potential risks to the customer.

We highlighted the importance of proportionality in chapter 4 of our policy statement PS14/3 when we made the CONC rules. In particular, we noted that the risk of credit being unsustainable is likely to be greater, the higher the actual and potential costs of the credit are relative to the borrower's financial circumstances; the risks will be correspondingly lower if the credit is free of interest and charges or there are either no charges payable on default or these are insignificant.

Common misunderstandings

10. I have to do a full creditworthiness check even for the smallest loan

The requirement to assess creditworthiness applies (with some limited exceptions) to all regulated credit agreements. However, as noted above, we do not prescribe exactly how this is to be carried out. The amount of credit and the risks to the borrower are likely to be relevant factors in deciding on the extent and scope of an assessment.

Firms should take a common sense approach and decide what is appropriate and proportionate in the circumstances.

11. I have lent to this individual previously so I don't need to do a full creditworthiness check

As above, the requirement to assess creditworthiness applies (with some limited exceptions) to all regulated credit agreements. This is irrespective of whether the individual has borrowed from the firm previously. However, it may be reasonable to take into account the customer's previous dealings with the firm as part of an assessment of whether the customer can afford to repay the credit in a sustainable manner and without undue difficulty.

Again, firms should decide what is appropriate in the particular circumstances – we do not prescribe what checks should be made.

12. Automated processes are ruled out – I have to make a manual assessment

We expect firms to have clear and effective policies and procedures for making a reasonable assessment of creditworthiness in each case. That does not preclude the use of automated processes, provided that the lender can be reasonably satisfied that these are effective in making a reasonable creditworthiness assessment in individual cases.

13. The FCA expects similar assessments for credit and mortgages

Following the Mortgage Market Review, we have introduced specific requirements under our Mortgage and Home Finance: Conduct of Business sourcebook (MCOB) for first charge mortgages (and these will extend to second charge mortgages from March 2016 when the Mortgage Credit Directive is implemented). However, these are limited to residential mortgages and do not extend to consumer credit.

We do not expect firms to read across from these to the CONC provisions (although we do make clear in CONC that a high level of scrutiny would normally be expected where a regulated credit agreement is secured on the borrower's home).

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Common misunderstandings

14. The action taken against some high-cost short-term credit (payday) lenders shows that FCA has a hidden agenda

Where individual high-cost short-term credit (HCSTC) lenders have given undertakings to the FCA, or have agreed to redress programmes, these have been based on the specific circumstances of those cases and on a case by case basis. Firms should not draw inferences from these cases for their own circumstances.

The key is whether a firm can demonstrate that it has adequate policies and procedures for making reasonable creditworthiness assessments, and is applying these effectively, to mitigate the risks of unaffordable borrowing. We have no presumption as to what such procedures should involve, provided that they are clear and effective. Our approach to assessing creditworthiness is set out in CONC, and we have no 'hidden agenda'.

15. Under the FCA's recent consultation proposals, I will need to make exactly the same checks of a guarantor as a borrower

We consulted in February in CP15/6 on amendments to our rules in relation to guarantor lending, including requiring lenders to assess the potential for the commitments in respect of the agreement to adversely impact the guarantor's financial position.

However, we are not proposing to prescribe what checks should be made (just as we do not prescribe the checks to be made in respect of the borrower), nor are we suggesting that the same checks should be made. This is for the individual lender to determine in its own circumstances. We will elaborate on this in our policy statement containing feedback on the consultation and made rules.

16. Under the FCA proposals, I will no longer be able to lend to joint borrowers

We consulted in CP15/6 on additional guidance in CONC 5.2.4G, to the effect that where there are joint borrowers, the lender should consider whether it may be appropriate to have regard to the financial position of each borrower separately (as well as collectively) and the risk to each borrower from the proposed credit. This is because, under a joint loan, each borrower typically is jointly and severally liable for the debt.

However, this is guidance not a rule, and we are not proposing to prescribe what lenders should do. It is for the individual firm to consider what is appropriate in each case, as part of treating customers fairly. We will elaborate on this in our policy statement containing feedback on the consultation and made rules.

Common misunderstandings

17. I am a pawnbroker so don't need to assess creditworthiness

Pawnbrokers are not excluded from the requirement to assess creditworthiness. However, CONC 5.3.4R makes clear that it is permissible in such cases to base the assessment primarily or solely on the value of the pawned item, provided that the customer's total financial liability is limited under the agreement to the proceeds of sale which would represent the true market value of the item.

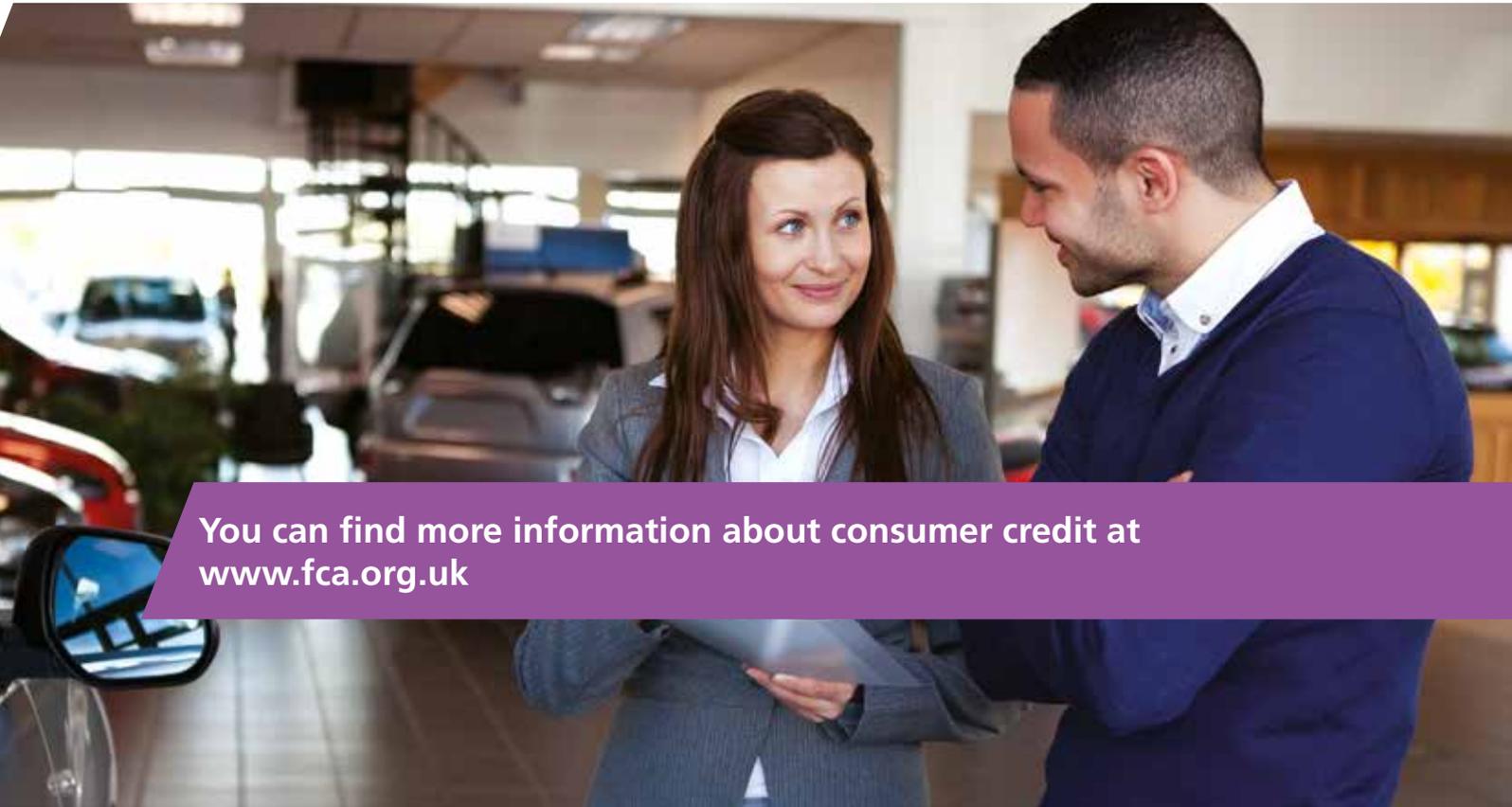
18. Brokers are also required to assess affordability

The obligation in CONC 5.2 to assess creditworthiness (including affordability) falls on the lender. There are separate requirements on credit brokers in CONC 5.4.

Where a credit broker is providing advice or recommendation to a borrower, it should have due regard to whether the product is affordable and whether there are factors suggesting that it may not be suitable for that customer. However, this is not an obligation to proactively assess creditworthiness or affordability. It is about not ignoring evidence suggesting that the credit is unsuitable or unaffordable.

19. Any future changes to CONC will inevitably make it more prescriptive

As announced in the Business Plan, we are undertaking research to understand better how firms assess creditworthiness (including affordability), what tools they use, how effective these are, and what are the outcomes for customers. In the light of this, we intend to consult on changes to our rules, to clarify our expectations of firms.



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