What does 'good' relending look like?

The FCA is in the final stages of consulting on its proposals for a new Consumer Duty[1], which focuses on ensuring improved outcomes for users of financial services and products. In this briefing, CfRC's Executive Director, Damon Gibbons, considers how the proposed duty could help to address long-standing problems associated with 'relending' in the UK's consumer credit markets.

What is 'relending'?

'Relending' takes three main forms. Firstly, 'refinancing', which includes:

- 'Topping up' existing credit facilities,
- Extending the term of the credit agreement, and
- Debt consolidation.

Secondly, advancing new credit using 'parallel agreements' to increase the overall amount borrowed.

Finally, repeat lending, which can either be immediately consecutive to the repayment of outstanding balances, or following a break in time.

Regardless of the specific form that the relending takes, there are potential benefits for both the borrower and the lender:

[1] The consultation is open until 15th February 2022. See CP21/36 Financial Conduct Authority (2021). 'A new Consumer Duty: Feedback to CP 21/13 and further consultation'. Available at https://www.fca.org.uk/publication/consultation/cp21-36.pdf

- For borrowers, the use of an existing lender reduces search and application times, and potentially increases the likelihood of acceptance.
- For creditors, there are lower customer acquisition costs (potentially impacting profitability) as well as opportunities to increase customer satisfaction and maintain the lending relationship over time.

However, the different *forms of relending* also come with their own potential benefits and problems.

The refinancing of existing agreements can be helpful to borrowers facing increased financial pressures over the course of an existing agreement, or for those who can afford to take on more borrowing and who have identified a new need for this.

However, it can also lead to increased debt levels and higher overall interest and fees. This is particularly the case where agreements provide for the 'rolling over' of all or most of the capital liability on payment of periodic interest and fees (e.g., payday loans, credit cards), or which provide for repayment of the outstanding balance of an initial loan by an increased new one (debt consolidation), in which case, the interest levied on the first is effectively compounded, notwithstanding the Early Settlement Regulations.

Providing easy access to 'topping up', such as through unsolicited credit card limit increases, may reduce search and application costs for borrowers but it also runs the risk of negatively impacting affordability and/or encouraging unsustainable borrowing behaviours.

Extending repayment durations to manage affordability, whilst attractive in the short-term, may also increase default risk. This is particularly likely if there is a high propensity for the borrower to experience income and/or expenditure shocks. From the borrower's perspective, extended payment durations increase overall interest costs and may also reduce their resilience to cope with shocks.

Providing additional credit through concurrent or parallel agreements may provide an alternative, providing for lower total costs when compared to the refinancing of existing agreements. However, entering into additional agreements has the disadvantage of creating a higher repayment burden, and managing numerous agreements poses its own challenges for some borrowers due to 'mental-accounting costs' (Ong et al, 2019[2]).

Finally, **repeated credit use**, whilst not necessarily associated with increased debt levels, risks becoming persistent, with borrowers caught in a relationship of 'credit dependency' (McCartney & Gibbons, 2008[3]). This applies regardless of whether there is a break between the initial drawing down of credit and the taking of another. For example, with respect to overdraft and credit card borrowing, it is possible for outstanding balances to be completely cleared when a borrower's income is received only for a new, often increased, outstanding balance to be run up before the next payday. Over time, the durations between borrowing shorten and the level of indebtedness grows.

The FCA's research and proposed 'Consumer Duty'

The above issues were all well documented within the FCA's report into the relending practices of high-cost credit lenders, published in 2020[4], with the FCA recording "significant concerns that repeat borrowing could be a strong indicator of a pattern of dependency". In that report, the FCA set out its expectation that

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[2] Ong, Q., Theseira, W., & Ng, I. (2019) 'Reducing debt improves psychological functioning and changes decision-making in the poor' available at https://www.researchgate.net/publication/332472709_Reducing_debt_improves_psychological_functioning_and_changes_decision-making_in_the_poor

[3] McCartney, I., & Gibbons, D. (2008). 'Protecting low-income borrowers in the credit crisis'. Available at https://www.responsible-credit.org.uk/reports/protecting-low-income-borrowers-in-the-credit-crisis

[4] Financial Conduct Authority (2020). 'Relending by high-cost lenders'. Available at https://www.fca.org.uk/publications/multi-firm-reviews/relending-high-cost-lenders

firms should “only agree to refinance if they reasonably believe it is in the customers best interests”.

The report also identified that “rigorous affordability assessments” were the key to “avoiding harm in this area” and that “firms should ensure that they are making proportionate and responsible assessments of the sustainability of borrowing”. The FCA also flagged up the need for firms to consider appropriate alternatives to relending, including forbearance, and referrals to debt advice.

Consumer Duty

The proposed Consumer Duty, which the FCA is seeking to finalise by August 2022, is intended to reinforce the focus of firms on delivering “good outcomes” for borrowers and will introduce three cross cutting rules: firms must: (i) act in good faith, (ii) avoid foreseeable harm, and (iii) enable and support customers to pursue their financial objectives.

The Consumer Duty is also expected to drive improvements with respect to the design and delivery of products and services; deliver fairer prices and better value; aid consumer understanding and improve customer support.

Of particular interest with respect to relending, are:

- The proposed requirement to ensure that customers can make informed decisions, with the information they need provided to them at the right time, and in a way they can understand.
- The proposed requirement for customer support processes to be designed around customer needs, for example by introducing elements of ‘positive friction’, and
- The proposed “minimum set of factors” to be considered in the assessment of Fair Value. These include the total price being paid, and whether this is reasonable in relation to the benefits offered by the product or service.

What could good look like?

In our view, the Consumer Duty could prove to be a useful regulatory intervention because it requires relending practices to be considered within a broader customer journey and lender/ borrower relationship, with greater focus on borrower outcomes.

Lenders must, of course, be economically viable, but the Consumer Duty could provide a check and balance to the incentive to relend based on increased, short-term, profitability alone.

As we now discuss, the Consumer Duty could also usefully drive improvements in the communication of affordability *and sustainability* assessments to consumers; incentivise more robust consideration of alternatives to relending, and result in a fairer distribution of the reduced costs associated with relending, where this takes place.

However, much still depends on how lenders respond to the new requirements. Given that the affordability assessment rules were repeatedly flouted, leading to a considerable increase in complaints to the Financial Ombudsman Service, the supervision and enforcement arrangements for the new Duty may yet prove paramount[5].

Understanding customer need and improving communications

Many previous relending problems have arisen due to the aggressive marketing of increased credit facilities, top up loans etc. This has, for example, included unsolicited increases in credit card limits or the direct marketing of additional

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[5] In this respect we welcome the FCA's statements that "The Consumer Duty would become a central part of our supervisory approach. We would embed it into our assessment criteria, including our firm and portfolio assessment models" and that it will "challenge firms and intervene robustly to prevent harm, expecting them to be able to demonstrate how they achieve good consumer outcomes. Firms can expect to be asked to demonstrate how their business model, their actions and their culture are delivering good consumer outcomes."

loans. Such marketing is often timed when existing balances are about to be, or have recently been, cleared. The marketing of relending opportunities therefore appears to have been primarily driven by lender desire to minimise acquisition costs rather than because of any real, ongoing, understanding of the customer's needs.

Building in an ongoing communication with the borrower and promoting flexibility in lending practice – including the potential for relending as just one of several possible options – from the outset of agreements would, in our view, be a better approach. There is no doubt that under some circumstances relending can be mutually beneficial.

However, any available relending options should ideally be presented alongside other possible options and information, for example offers of temporary payment breaks and details of who to contact if the borrower needs forbearance or other forms of help (see below).

The relending options being presented also need to be informed by an ongoing assessment of the customer's needs, with their potential pros and cons clearly explained.

With many lenders now incorporating Open Banking into their onboarding processes, and with increased FinTech activity taking place to provide 'financial health dashboards' it should be possible for lenders to more easily communicate their current assessment of a borrowers affordability position, and overall 'debt burden'.

These dashboards should provide a clear picture for customers of their 'headroom' for further borrowing which, in our view, is best expressed by two indicators:

- **The lender's calculation of their disposable income**, conducted in accordance with the FCA's affordability assessment requirements. These require an estimate of non-discretionary expenditure to be made, taking account of "payments needed to meet priority debts, and other essential

living expenses and other expenditure which it is hard to reduce to give a basic quality of life". The assessment also needs to include other payments that the customer has a contractual or statutory obligation to make, including with respect to other outstanding credit agreements. Communicating this assessment effectively requires lenders to make explicit their assessment of what constitutes an acceptable level of the customer's "essential living expenses", and lenders should provide opportunities for customers to discuss this calculation to improve the information available to them regarding needs.

- **The lender's assessment of the customer's debt servicing burden**, calculated as a ratio of debt repayments relative to their disposable income. This provides an indication not only of the immediate repayment pressures facing the customer but also their potential exposure to income and/or expenditure shocks.

Making the lenders view of the borrower transparent by relaying these measures back through 'financial health dashboards' would, in our opinion, encourage greater dialogue with customers concerning their actual financial position and needs. For example, making the affordability assessment transparent would encourage customers to disclose additional household sources of income which may not have been picked up in the Open Banking data.

Ultimately any decisions regarding relending (and the most appropriate form it should take) need to be informed by the above indicators both *at the time of an inquiry or application*, and by the lender's assessment of their direction of travel *over time*.

If the direction of travel is clearly negative, with 'headroom' reducing significantly over time, then it may be more appropriate to offer alternatives to relending (as below), even if that relending would be permissible by the firm's affordability assessment and other underwriting policies. Alternatively, agreement to relending could take place with additional signposting to other forms of support.

In our view, there are clear benefits for lenders as well as borrowers in keeping track of these indicators, as a concentration of customers with low levels of 'headroom'

poses a considerable credit risk for lender, as would an overly restrictive interpretation as to what constitutes "essential living expenses", especially in the current climate where living costs are rising relative to incomes. We therefore recommend that lenders incorporate these indicators into the, at least, annual Consumer Duty reports to their Boards, which are being recommended by the FCA[6].

Alternatives to re-lending

Every form of relending has an alternative. Low-income borrowers seeking a top up loan may be eligible for a grant or for help with heating and other costs. Those repeatedly using credit to make ends meet may be missing out on benefits. Many seeking to temporarily reduce their repayments may prefer forbearance and repayment flexibilities to the extension of loan durations, and people with multiple debts may be better served by seeking a formal debt solution rather than a debt consolidation.

The question arises as to how far lenders will be prepared to go to assess whether relending offers "good outcomes" for the customer *relative* to these alternative possibilities. At minimum, we believe that a firm's relending policies should inform customers with little or declining 'headroom' of the existence of these alternatives prior to making a relending decision and should provide time for the customer to reflect on their options.

Some lenders will go much further. For example, Scotcash is already embedding a benefit calculator into its customer journeys, and Nationwide has put in place direct referral arrangements to Income Max. Many lenders also have direct referral arrangements in place with debt advice agencies.

Fundamentally, lenders need to review their processes to determine what level of information they hold on borrowers which could aid in the identification of

[6] Para 14.14, footnote 1.

alternatives to relending, and how they may supplement this to aid effective signposting or referrals when borrowers approach them for refinancing or repeat loans, if there are indications that relending could result in a negative outcome.

For short-term credit lenders this can pose a problem. These lenders will not hold continuous information about repeat customers when these return after a break since the end of the previous agreement. However, this problem could be overcome if lenders were to provide a free financial health dashboard for their customers on an ongoing basis. Building a customer journey focused on the ongoing provision of financial health assessment (and additional tools to improve this) in which the credit offer is just one part, would encourage longer-term relationships; yielding better information to inform future relending decisions.

Incentives and profitability

Relending to existing customers is frequently more profitable than seeking new customers. Acquisition costs are lower, and as loan values are also prone to increase over time, the associated operational costs per £ lent can fall considerably. This creates a clear profit maximising incentive for firms to push at the boundaries of acceptable practice. In our view, the FCA is right to seek to address this by requiring lenders to consider whether prices are fair and offer value to their customers. We therefore welcome the proposed requirement[7] that firms consider "the expected total price customers will pay, including all applicable fees and charges over the lifetime of the relationship between customer and firm."

Where relending takes place, there is a certainly a need to ensure that the cost savings being made by lenders are distributed more fairly, by differentiating prices for new and repeat customers. Failure to do so is an indicator of a lack of price

[7] Para 6.11 in footnote 1, above.

competition, as was found by the Competition Commission inquiry into the Home Credit (door to door lending) market undertaken in 2005/06[8].

It may be that advertising differentiated prices would facilitate greater competition for customers with repeat credit needs. But, more importantly, in our view, there also needs to be a 'hard cut-off' regarding total cost price, which should be communicated to customers. For example, with respect to its persistent credit card debt rules, the FCA requires actions to be taken by lenders once the amount of interest, fees, and charges reaches 100% of the amount borrowed, and this '100% limit' forms the basis of a hard cap on prices for payday lenders.

We would therefore encourage lenders to set out their own policies with relation to hard caps - at levels which are lower than these - and to use a customer's position relative to their cap, to both inform customers of this and help inform when the firm to take additional steps to encourage alternatives to relending. For example, a firm promising never to charge more than 75% in interest, fees, and charges, could design a communications plan regarding alternatives to relending which would kick in when the customer reaches 50% on the measure.

Conclusion

The new Consumer Duty proposed by the FCA is an important regulatory intervention and offers significant potential to improve relending practice in the UK's consumer credit markets.

Whilst both lenders and borrowers can benefit from relending, the incentives of each party are not perfectly aligned and there are clear dangers relating to both

[8] Competition Commission (2006). 'Home credit market investigation: Final Report and Appendices and Glossary'. Available at: https://webarchive.nationalarchives.gov.uk/ukgwa/20140402195157/http://www.competition-commission.org.uk/our-work/directory-of-all-inquiries/home-credit/final-report-and-appendices-glossary

affordability and sustainability. In our view, there is a need for lenders to better track and communicate their assessment of the financial health of their customers and consider at what points they will encourage alternatives to relending, as well as how they will operationalise referrals to other agencies which could help address any underlying financial problems.

To reduce the incentive to relend inappropriately, and potentially foster more effective price competition for repeat borrowers, firms need to more fairly share the cost savings associated with relending activities and could also advertise their differentiated rates.

To ensure that borrowers do not become ‘credit dependent’, lenders should also commit to, and publish, a hard stop policy concerning the total costs that they expect to charge over the lifetime of their relationships with borrowers. They should use that measure to inform their communications strategies for repeat customers - encouraging them to take action to address their financial difficulties as soon as these begin to emerge.