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Podcast 4: The Woolard Review

Jo: Welcome to the latest episode in the Allen & Overy podcast series "*In Credit*". My name is Joanne Owens and I'm counsel in Allen & Overy's financial services regulatory group. I'm joined by senior associate Victoria Ferres and also associate Sophie Skeet.

In this episode, we are going to focus on the recently published Woolard Review in the unsecured lending space.

In September 2020, the FCA asked Christopher Woolard to conduct a Review into change and innovation in the unsecured credit market and the role of regulation in such a market. In this context, "unsecured credit" is broadly defined as covering credit cards, overdrafts, personal loans and high-cost short-term credit. It also covers currently unregulated products such as some buy-now pay-later arrangements or payroll lending. The report was published on 2 February 2021 and follows on from the Call for Input from industry stakeholders and firms in November 2020.

So let's dive straight in.

Victoria: Sophie, can you give us the headline points from the report?

Sophie: Sure. The report is structured according to key themes including (i) innovations in the unsecured credit market, (ii) access to credit, which is actually pervasive across all themes, (iii) the impact of Covid-19 on the unsecured lending market, and (iv) the role of regulation. Within each theme, there are a number of recommendations put forward to the FCA – a total of 26 recommendations across all themes. We won't have time in this podcast to go into all 26 recommendations, but we will draw out the main recommendations and those flagged by Mr Woolard as being particularly urgent, being the need to:

- bring buy-now pay-later products within scope of the regulatory perimeter;
- ensure there is secure provision of debt advice, especially through the recovery from coronavirus; and
- maintain a sustained regulatory response to the pandemic.

Theme 1: Innovation in the unsecured credit market

Victoria: First off, let's take a look at innovation. Whilst the report acknowledges the significant benefits that innovation can bring, it also found that innovation has resulted in a source of potential consumer harm. The report focuses in particular on innovation with respect to the buy-now pay-later market and employer salary advance schemes, but for the purposes of this podcast we will focus on the findings as they relate to buy-now pay-later.

Jo: Most buy-now pay-later agreements fall outside of the FCA's regulatory remit and take the form of deferred payments or short instalment loans. These are currently unregulated as they rely on the exemption found in Article 60F(2) of the Regulated Activities Order (RAO). However, the report suggests that this exemption (which was carried over from the CCA) was never intended for such products but was to exempt short-term invoice deferral.

It is not surprising that buy-now pay-later is being scrutinised as part of the Review as the FCA has already done a lot of work on regulated buy-now pay-later products as part of its high-cost credit review.

Victoria: The report focuses heavily on the significant growth of the unregulated buy-now pay-later market in recent years and particularly over the course of the pandemic. As a result of this rapid growth, the report indicates that such products pose potential harm to consumers and therefore that regulatory oversight is appropriate to ensure that the product develops in a way which is beneficial to the consumer. It therefore recommends that the FCA should work with Treasury as a matter of urgency to introduce amendments to legislation to bring all buy-now pay-later products within scope of regulation. After that, it will be for the FCA to develop an appropriate regulatory framework. Clearly, any changes to the perimeter in respect of the Article 60F(2) exemption will need to be carefully drafted to avoid the unintended consequence of bringing other exempt products (such as interest free loans to pay gym membership or season ticket loans) within scope. It is therefore expected that a formal consultation process would be appropriate to understand the potential impacts of regulation.

Sophie: Won't this mean that, once exempt buy-now pay-later agreements are brought within the perimeter, retailer partners will potentially be carrying on regulated credit broking activities under Article 36A of the RAO?

Victoria: Correct. That will be an important consideration for Treasury when drafting legislative changes. Buy-now pay-later providers partner with many hundreds of retailers, which vary in size and sophistication. The regime applying to retailers should therefore be proportionate. The report suggests that retailer partners could, for example, become appointed representatives rather than seek FCA authorisation, with the buy-now pay-later providers assuming responsibility as the principal for the appointed representative.

Joanne: It is worth stating that the report does acknowledge the benefits of buy-now pay-later products and the recommendation in no way constitutes a condemnation of the sector. For customers who can afford to repay on time, it is a cost-free way to manage finances and short-term cash-flow issues. For customers who are less able to repay, buy-now pay-later is a cheaper alternative to high-cost short-term loans and provides options where those customers can struggle to secure mainstream financing. However, there is a real tension between: (i) the benefits of digital innovation (ie the speed and ease at which consumers can access products as and when they need to); and (ii) the need to ensure good customer outcomes through balancing information asymmetries and understanding the role of behavioural economics. Given the FCA's historic work on both of those topics, some of the findings in the report are not that surprising.

Sophie: There is also a point to note here about digital transformation and the impact which it can have on access. For most of us, smooth customer journeys, faster credit decisions and reduced costs for lenders represent clear advantages of borrowing in the digital age. Yet the growth of online lending and digital platforms, a trend accelerated by Covid-19, is not beneficial for all borrowers. Not all customers can, or want to, access online platforms. These customers should not be unduly excluded from access to credit. The report recommends that the FCA put in place guidance for digital design in the consumer credit sector that focuses on good consumer outcomes, such as taking specific account of vulnerable customers. Another interesting recommendation is that the FCA update its disclosure requirements for use in the digital age.

Jo: An example of this is the findings of the December 2020 survey undertaken as part of the Review. These findings illustrate that not all consumers understand what buy-now pay-later is or appreciate that it is not already subject to regulation. As a result, consumers might not be as rigorous in their decision-making and might not fully take into account the consequences of missing payments or the absence of the protections afforded by a regulated product, including being able to refer complaints to the Financial Ombudsman Service. Exploratory research conducted by the FCA's Behavioural Economics and Design Unit found that the typical buy-now pay-later customer journey tapped into customer behavioural biases.

Victoria: The report also states that the incentives between buy-now pay-later providers and merchants may constitute a source of harm. Buy-now pay-later providers make money through fees paid by partner retailers, rather than the borrowers. This strong relationship often works well to the benefit of all parties: the customer can afford to buy products that they need but which are otherwise outside their current means; retailers see greater conversion rates on their websites; and buy-now pay-later providers receive partner fees that cover the costs of lending. However, that relationship could in theory work to the customer's detriment. Mr Woolard was concerned that some buy-now pay-later advertising may be designed to drive sales without due consideration for affordability.

Sophie: A related risk is that buy-now pay-later offers are presented as the default payment method or in a long list of payment options. Some respondents to the December 2020 survey reported that they didn't understand which payment methods in that list were debit and which were credit.

Joanne: Finally, affordability. Another key area of focus for the FCA since 2014. Most buy-now pay-later providers carry out a 'soft' credit check, mainly to assess the credit risk to the provider rather than affordability of the product to consumers. Whilst most providers will not allow consumers to continue using a product if missed payments are outstanding, since buy-now pay-later providers do not report to credit reference agencies, providers are less likely to know about missed payments with another provider. The report therefore indicated it is common for a consumer to reach their limit with one provider and switch to using another before clearing the debt. We know that the FCA is looking at the role of credit information in assessing affordability so it is not surprising that they may be concerned about lenders not having a complete picture of the consumer's credit file when undertaking that assessment. Indeed, the review recognises that there are significant opportunities to build a better credit information market for the benefit of consumers and lenders and so also makes recommendations in that regard including the FCA resuming its Credit Information Market Study and in particular looking at how to improve the speed and sharing of information across the credit sector.

Victoria: When customers can't pay, buy-now pay-later providers take a variety of approaches to late payment, defaults and collection practices. Information about these processes are also contained in terms and conditions which may not always be drawn to customers' attention at checkout. Regulation would streamline procedures relating to late payment and arrears, as well as introduce transparency requirements around key terms.

Joanne: The report also touches on two major growth areas: (1) moving outside the traditional realm of financing fashion purchases to large household items such as electrical goods; and (2) expanding to in-store operations. Purely from that perspective and having regard to the FCA's consumer projection objective, it does seem difficult for the FCA to maintain that this product should not be regulated.

Theme 2: FCA response to Covid-19 and future impacts

Sophie: Does that cover it on the report's response to recent innovations?

Victoria: Think so! Time to discuss the inevitable: Covid-19…It almost goes without saying that the pandemic and the FCA's response has affected the unsecured credit market – we've already spoken about this at length in previous podcasts! What's different here is that the FCA is looking forward rather than reacting to an evolving crisis.

Joanne: A big part of that is anticipating consumer expenditure trends. In particular, the report notes that the economic effects of the pandemic will increase the demand for debt advice and estimates that around 1.5 million additional people will require debt solutions in order to recover. This year will see the introduction of the government's Breathing Space scheme and there are plans for the introduction of a Statutory Debt Repayment Plan (SDRP). Such statutory debt solutions provide fertile ground for reviewing how the sector works as a whole.

Victoria: Immediate steps proposed by the report are that the FCA must urgently coordinate with the government and other agencies (including the Money and Pensions Service) to ensure that providers of free debt advice have access to secure, long-term sources of funding so that they can continue to serve those in difficulties and meet the demands of the pandemic. It's also important that debt solutions are suitable, meaning known problems in the personal insolvency sector need to be addressed, such as problems created by the fee structure of Individual Voluntary Arrangement and Protected Trust Deed arrangements on debt advice and lead generators.

Coordination is also required to ensure that customers are not driven to unsuitable solutions by (for example) unscrupulous marketing and that barriers to accessing suitable solutions are removed, such as fees for Debt Relief Orders so that the poorest in society can access the help they need.

Sophie: Interestingly, the FCA's final question in its Call for Input was whether its temporary coronavirus guidance, including that related to credit information and forbearance, could have broader relevance for customers in financial difficulty. The FCA took quick action in the early part of the coronavirus crisis by requiring that Credit Reference Agencies (CRAs) 'mask' the files of customers in financial difficulties due to the pandemic. There was little time to consider the longer-term impact.

Now, the Woolard Review recommends that, working with lenders and CRAs, the FCA should investigate further how forbearance is reflected in credit information and how this affects decisions made by lenders and consumers. This includes considering the effect that 'masking' credit files can have and whether all lenders report forbearance to CRAs in a consistent and adequate manner. It should also consider potential alternatives – for example, whether temporary markers that a customer is in financial difficulties could be a more effective and appropriate response.

Victoria: The pandemic has provided an opportunity for the FCA to reflect on 'lessons learnt'. During the first phase, lenders did not have a way to report temporary credit difficulties to CRAs so that any corresponding negative impact on borrowers would be short-term. A more nuanced and consistent approach to recording forbearance information on credit files may better reflect the borrower's true position. This could lead to fairer outcomes for consumers.

Sophie: In terms of the future impact of the pandemic, the report goes on to emphasise that consumer expenditure trends seen during the outbreak are likely to continue. The report projects that, if the economy does not recover quickly, certain low-income and vulnerable groups will borrow more heavily in the face of unemployment and pressure on household budgets. Overall, however, low consumer confidence will drive down demand for credit products. The result is that firms are less willing to lend to new customers, perceiving the risk of impairment to be higher.

Role of FCA Regulation

Victoria: The final part of the report considers the role of regulation in unsecured credit markets. The key question is whether regulation is in the right place overall and whether core issues in the market are being dealt with effectively. When it works well, regulation not only prevents harm but also maximises the benefits of the market to consumers and firms. However, the report indicates that the current approach with respect to credit needs attention if it is to fulfil this role. One of the key points raised in the report is the suggestion that the FCA should start to move away from a sector- or product-based approach and instead move towards an outcome-based approach.

Jo: The FCA has historically developed rules on a per-product basis, for instance in connection with high-cost short-term credit and credit cards. As a result, a focus on outcomes would mark a significant shift in approach. However, conduct across the lifetime of a product can influence customer outcomes – including lifecycle events such as financial promotions, information disclosures, repeat lending, debt advice, solutions and collection. The report comments that the FCA should use its Business Plan Priority to take an outcomes-based approach to regulating the credit market. This would entail setting out clearly what the market should be achieving at each stage of the consumer journey and lifecycle of a product and how regulation can support that.

Victoria: How could this be achieved in practice?

Sophie: Well the report states that the CCA and the FCA Handbook will need to be changed. The FCA already reported on CCA reform in 2019, but this has now become a priority. Transferring information requirements from the CCA to FCA rules would offer an opportunity to revise these requirements in line with an outcomes-based regulatory system and adapt to a digital lending environment. There is also scope to update the CCA reform work following the UK's exit from the EU, which would provide flexibility to amend APR disclosures and give examples of the cost of credit in pounds and pence.

Victoria: Access to credit, as ever, plays a central role. The FCA concedes that a healthy credit market cannot include everyone, but what are the limits of financial inclusion? The most vulnerable members of society are those that cannot access mainstream credit; yet this does not change their need to borrow if unpredictable variations in income and expenses mean they do not have the cash for essential purchases. Regulators must therefore balance the harms that can arise in sub-prime credit markets against the harm of not accessing credit at all.

Sophie: The preventative aspect of this involves ensuring that customers do not automatically turn to high-cost credit in times of financial distress. Considering the high-cost market as a whole, the Woolard report does not conclude that price caps would be an appropriate solution. Instead, there may be more benefit in encouraging the development of a more dynamic market for alternatives to high-cost credit.

Jo: The report explores various barriers to entry in the sub-prime that decrease competition and reduce the credit options available to consumers. In particular, part of the report focuses on how fear of reputational damage discourages established mainstream lenders from participating in the sub-prime market. However, this nervousness about regulation also seems to extend to new entrants. The report comments that start-ups can struggle to secure funding owing to investor anxiety about the perceived complexity of regulation and penalties for non-compliance, as well as the higher costs of lending to sub-prime consumers. Alternative lenders, such as community credit providers and credit unions, can also face barriers to growth and sustainability.

Victoria: Mr Woolard also takes aim at information asymmetries. County Court Judgments (CCJ) can have a significant impact on a consumer's credit file, but many consumers will not be aware that they have a CCJ against them if, for example, they have changed address. Even if they repay the debt, they have no means of informing the court that the debt has been settled so the CCJ remains on their file. The report suggest that lenders should be responsible for informing the courts where a debt has been satisfied.

Joanne: A couple of additional points to briefly note. Repeat lending is an area the report considers merits regulatory intervention. To be clear, the FCA does already have rules to tackle persistent debt in credit cards and repeat use for overdrafts. However, respondents to the report highlighted that there are significant numbers of customers repeatedly taking out fixed term, high-cost loans in a way that is similar to a revolving product. Borrowers in these circumstances may be stuck in cycles of debt in the same way that credit card and overdraft users can be. I recall this being part of the OFT's concerns when it undertook the payday lending review and found that a number of borrowers were trapped in a cycle of debt by taking a new loan to pay off their existing one.

Sophie: Repeat use of fixed-term loans are common in 'credit builder' or 'low and grow' business models which have also come under scrutiny from the FOS on the grounds that finance providers take insufficient care with repeat users. As a result, the report recommends that the FCA should conduct a review of relending. This should set out clear outcomes covering repeat lending and persistent debt across all regulated products. In addition, the FCA's Regulatory Sandbox should consider whether to include 'credit builder' products as part of a future cohort. The aim is to encourage such practices where they deliver effective results for consumers.

Joanne: I think that covers most of the key points! We should flag that the report acknowledges that delivering the overall package recommended by this report will take time. FCA resources are under pressure because of the pandemic and a programme of reform needs to be set in place. We therefore don't expect even the most urgent change to be immediate, but we should expect significant announcements over the course of 2021.

That brings us to the end of the podcast! As ever, we hope you have enjoyed this episode and please do reach out if you have any questions.

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