Responsible Finance

Responsible Finance Response

Creating a Funding Model for the Future: A Discussion Paper

August 2022

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About Responsible Finance

We want the UK to have a diverse financial system where investment flows into communities to create positive social, environmental and economic impact. To enable this, we lead a strong responsible finance sector, giving communities access to finance and the opportunity to transform lives.

Responsible Finance is the UK trade body for Community Development Finance Institutions (CDFIs). Our members are non-profit or asset-locked social lenders who make small value loans to individuals excluded from mainstream finance. This enables them to smooth fluctuating incomes and expenditures.

Our response to this consultation has been written in consultation with our member CDFIs.

Summary of our response

The current £750 Financial Ombudsman Service case fee with only 3 free cases is disproportionately high for the small lenders serving the vital sub-prime lending space given the relative size and simplicity of the financial products they provide.

Our response therefore recommends that the Financial Ombudsman Service:

1. Varies case fees according to the type of product the complaint relates to.
2. Varies case fees according to the size of product the complaint relates to.
3. Grants a full case fee exemption for lenders which are captured under the FCA's definition of a Community Finance Organisation.

Without these actions the fees threaten the sustainability of CDFIs and disincentivise new investment, and new providers, entering this crucial market which is trying to divert vulnerable consumers away from high-cost and illegal moneylenders.

We appreciate your consideration of our recommendations and look forward to working with you on this important issue.

What is the current landscape for "subprime" consumers?

- Access to unsecured credit is an essential tool for most households.
- However people on low or unstable incomes with poor or 'thin' credit histories, or receiving benefits income, can struggle to access finance.
- Over 1/4 UK adults have low financial resilience, meaning they may have low or erratic incomes or low savings[1].
- Nearly 1 in 4 UK adults has less than £100 in savings[2]. Those who have no, or limited, savings are extremely vulnerable to shocks, such as if their boiler breaks down or they receive an unexpected bill.
- 11 million people in the UK struggle to access affordable credit[3]. Having to choose between going without essentials or using high-cost or illegal moneylenders has a significant impact on physical and mental health.
- The situation is now more acute due to the cost of living pressures facing households.
- These excluded customers must rely on non-mainstream sources of credit such as home collected credit, rent-to-own and payday loans. But as more and more of commercial lenders exit the market, consumers have fewer options of where to turn to for their credit needs.
- Over 1 million adults in England are currently estimated to be borrowing from an illegal moneylender[4].
- Informal borrowing from friends and family is on the rise[5]. This is not an optimal or sustainable long-term solution.
- In recent years there have been a number of high-profile exits in the consumer credit market which serves this customer segment. The number of lenders has fallen by nearly 2/3 since 2016. A market failure is being created at a time when rising vulnerability means alternative finance is most needed.
- The use of Buy Now Pay Later is also on the rise, including amongst CDFI customers. Many CDFIs report a high proportion of applicants now showing multiple BNPL payment transactions (seen through Open Banking), which has doubled since October 2021 when the Universal Credit uplift was removed. Without regulation and proper affordability checks, the use of BNPL can trap people in an ever-worsening cycle of debt and fees.

What are CDFIs and how do they improve access to finance?

- **Small, short-term loans delivered fair and affordably can be a lifeline for households with low financial resilience** to smooth fluctuating incomes, cover unexpected calls on finances, and spread the cost of expected larger expenses. This could be replacing a broken washing machine or purchasing new school uniforms.

[1] Financial Conduct Authority (2021) Financial Lives 2020 survey: the impact of coronavirus
[2] Money and Pensions Service Financial Capability Strategy for the UK (2021) Financial capability of UK adults How well do UK adults manage money?
[3] Fair4All Finance: Tackling financial exclusion through Dormant Assets
[4] Centre for Social Justice (2022) Swimming with Sharks: Tackling Illegal Moneylending In England
[5] Financial Conduct Authority (2021) Financial Lives 2020 survey: the impact of coronavirus

- Having a reliable and trustworthy credit provider has a positive long-term impact on health and wellbeing[6].
- According to an impact report from CDFI Fair For You, access to affordable credit saves the NHS millions of pounds due to the positive health benefits of essential appliances, improved sleep, leading to improved mood and reduced anxiety and depression[7].

- **Community Development Finance Institutions (CDFIs) provide a cheaper, fairer alternative for low-income and financially vulnerable households who would otherwise only be able to access high-cost credit, or be unable to access credit at all:**
  - There are approximately 10 CDFIs which lend to individual consumers across the UK.
  - CDFIs conduct thorough affordability checks to ensure a customer can afford to borrow.
  - CDFIs are structured as community benefit societies, registered charities or community interest companies limited by guarantee. Because of this they are captured under the FCA's definition of a Community Finance Organisation (CFO). Through this they are exempt from all payment of FCA consumer credit fees[8].
  - Alternatively some CDFIs have an asset lock in place to ensure that a portion of returns are reinvested into their social mission of improving access to fair, affordable finance for individuals who face a poor choice when they want to access finance.
  - According to one CDFI's social impact report, 90% of its customers indicated they would have turned to door-to-door lenders, rent-to-own stores, and payday lenders if they hadn't been able to borrow from a CDFI, and 5% would have turned to an illegal moneylender[9].
- **CDFIs' objectives are completely aligned with those of their customers to improve their financial wellbeing and resilience.** This means that all CDFIs reinvest all, or a portion, of surpluses into helping customers and keeping interest costs down. Any reduction in surpluses caused by increased costs, such as through case fees, reduces the amount that can be reinvested.
- **CDFIs currently lend to around 70,000 customers per year.** This is compared to the 5 million consumers who take out high-cost credit[10], and the 11 million people in vulnerable financial circumstances that exclude them from mainstream credit; a number which is 3 million higher than before the pandemic[11].
- **£374 is the average loan size on a CDFI loan, and CDFIs save their customers on average £190 per loan compared to a high-cost alternative:**
  - The market they serve is challenging with fine margins of sustainability.
  - The median APR on a CDFI loan is 169%. Many loans from high-cost credit providers have APRs exceeding 1000%[12].
- **CDFIs are focused on getting good customer outcomes throughout the loan journey, including through the provision of wrap around support:**
  - Between autumn 2021 and May 2022 two CDFIs identified £7.5 million in unclaimed benefits for 18,200 people through an integrated benefits checkers in their online loan

[6] Moneyline (2021) Impact Report.
[7] Gibbons, D. (2020) The Social Impact of Fair For You.
[8] FCA (2019), Handbook Notice No 63
[9] Centre for Responsible Credit (2020) The Social Impact of Fair For You
[10] Ibid
[11] Helen Thomas (2021) Crackdown on high-cost credit leaves gap that must be filled. Financial Times.
[12] For example Quid Market. Website last accessed 02/08/2022. Representative APR on a £300 loan over 3 months: 1296.5% APR, Maximum APR 1625.5%.

applications. This works out at £414 per person each month they can go on to claim; decreasing the likelihood that these customers will need to seek credit in the future and significantly impacting their financial resilience.

- **CDFIs provide a high-quality of service to their customers and because of this complaints levels have been low throughout the history of the sector.**

CDFI Customer Demographics are very similar to illegal moneylender customer demographics:

CDFI Customer Demographics in 2021	**Victims of Illegal Moneylenders according to the Centre for Social Justice[13]**
52% social housing tenants	48% social housing tenants
65% with an income below £21,300	62% with an income below £20,000
41% unemployed	49% unemployed
67% benefits recipients	75% benefits recipients
77% women	
41% lone parent with a child/children under the age of 18	
31% private rental tenants	
24% from an ethnic minority	
51% located in the North and the Midlands	

What are the similarities and differences between CDFIs and credit unions?

"CFOs and CUs are identified through robust definitions based on compliance with statutory requirements outside FSMA. This gives us (and other fee-payers) comfort that the concessions we have given them are targeted on firms which genuinely have a social purpose… We are therefore of the view that restricting the concessions to CFOs and CUs meets our requirement for the criteria to be objective, consistent, transparent and simple, whilst also allowing us to continue to support the government's policy of improving the range of socially responsible choices available to vulnerable consumers.[14]"

– Financial Conduct Authority

- CDFIs and credit unions are complementary lenders. They form distinct and important elements of the affordable credit landscape.
- Both provide access to finance for customers unable to access it fairly elsewhere, and are set up to get the best outcomes for their customers rather than maximise shareholder returns.
- Working in tandem, credit unions and CDFIs provide widespread and seamless access to affordable finance and thus a comprehensive and robust alternative to high-cost lending.

Below is a side-by-side comparison of CDFIs and credit unions:

	Credit Union	**CDFI**
FCA Authorised	Yes	Yes
PRA Authorised	Yes	No. CDFIs do not take customer deposits in savings accounts.

[13] Centre for Social Justice (2022) Swimming with Sharks: Tackling Illegal Moneylending in England
[14] FCA (2019), Handbook Notice No 63

	Credit Union	CDFI
Interest Rate Cap	42.6% APR	No legal interest rate cap. As non-profit and asset locked organisations CDFIs price the loan at what it costs to deliver. This means they can price for the increased incidence of loan default for the client base they serve, meaning they can lend to those who are most excluded from all other forms of credit, including credit union loans.
Who do they lend to?	It is required by law that credit union members have something in common with one another, known as the "Common Bond" that all credit unions will stipulate. This can be where the borrower must live to qualify as a member of the credit union or it could be a common employer.	CDFIs can lend to individuals anywhere who pass their affordability and creditworthiness checks. The majority of CDFIs cover the whole of the UK through online and telephone lending, providing a direct alternative to online high-cost lenders.
Do they lend online and over the telephone?	A number of credit unions carry out online lending, but this must still be to individuals within their common bond.	The majority of CDFIs carry out nationwide online and telephone lending.
Does a customer have to save with the lender before getting a loan?	A customer must become a member of a credit union before applying for a loan, and some will require them to build up some savings first.	CDFIs are primarily loan providers. Their customers do not need to become members or build up savings before applying for a loan.

"Our Affordable Credit Scale-Up Programme has focused on giving tailored support, investment and grant funding to drive the growth of community finance providers, such as credit unions and community development finance institutions (CDFIs). Community finance providers are asset locked organisations with a mission to improve people's financial wellbeing, and so their objectives and interests are completely aligned with those of their customers.[15]*"*

– Fair4All Finance, founded in 2019 with Dormant Assets money for financial inclusion.

What do Debt Advice sector, the Government and the FCA say about CDFIs?

Debt charities, the Government and the Financial Conduct Authority all recognise the importance of CDFIs and support the sector's scale-up:

[15] Fair4All Finance response: FOS plans and budget 2022/23

"Safe credit alternatives to unsuitable products are central to giving those who are struggling better tools to navigate difficult periods. Fair4All's work to scale up alternative credit and the government's commitment to support the pilot of a no-interest loan scheme are welcome. However, the ambition of this work does not match the scale of the gap in supply of safe alternatives. The recent FCA Woolard Review noted particularly that mainstream firms could be asked to do more to meet the needs of customers currently excluded from the market or served by subprime products.[16]"

– StepChange Debt Charity

"The Government are desperately keen, and have taken steps, to ensure that low income consumers can access safe, affordable and sustainable credit.[17]"

– John Glen MP, Former (2018 – 2022) Economic Secretary to the Treasury.

"Community lenders offer a valuable alternative to high-cost credit. They should be encouraged to grow or subject to regulatory change, combine with credit unions."

– The FCA's Woolard Review.

Consultation questions

Q1: Do you agree with how we suggest building on our current principles and are there any other factors we should take into account?

Given the acknowledgement that the FOS plays a key role in the UK's financial services ecosystem, the funding principles should also be outward looking take into account the economic reality of consumers and promoting the best outcomes for them. They should at a minimum have regard to financial inclusion.

Q2: Do you agree with our option of changing the CJ levy to recover fixed overheads?

Yes, provided the levy is based on a firm's ability to pay and should therefore be linked to profitability.

Q3: Do you agree with our proposal for simplifying the VJ levy?

We do not hold a view.

Q4: Should we retain our single, flat case fee or do you support a differentiated case fee model?

We support a differentiated approach.

Q5: Do you agree that we should charge different case fees according to the stage the case has reached before it is resolved? Do you consider this would create any unhelpful incentives?

We do not agree with this approach. This will not give lenders certainty of fees and may incentivise cases to be solved prematurely.

[16] StepChange (2022) Falling Behind to Keep Up.
[17] Hansard

Q6: Do you agree that we should vary case fees according to the type of product the complaint relates to? If you agree, do you think we should also introduce fees that are chargeable according to case stage?

It is essential that consumers can approach the FOS with complaints. At the same time, the FOS's approach to firms should be reconfigured to ensure it is proportionate and does not penalise small firms lending in the vital, yet sub-scale consumer credit sector which is actively diverting customers away from high-cost and illegal lenders and offering them fair products that build financial resilience.

By working with Responsible Finance to implement the following recommendations the FOS can support the long-term sustainability and scale up of the CDFI sector. This will result in more people having access to fair credit, fewer people getting trapped in a cycle of unsustainable debt, and better wellbeing and health amongst the most financially vulnerable consumers.

Recommendation	Rationale	Impact if change not made
Grant a **full case fee exemption for lenders which are captured under the FCA's definition of a Community Finance Organisation**[18].	• The FOS should align its approach to CDFIs with that of the FCA by exempting Community Finance Organisations from all payment of case fees[19] (see Text Box 1 below). • This would also align the FOS's approach to CDFIs with its approach to Credit Unions, given that the two are complementary in the affordable credit landscape (see Text Box 2 below). At the moment CDFIs generally receive an extremely low number of complaints that are referred to the FOS therefore the impact on the FOS's income would likely be small.	Potential to lead to closures of CDFIs and eliminate access to fair and affordable credit for tens of thousands of people each year. Stifle innovation and growth in Community Finance. The increased risk presented by the £750 FOS case fee will disincentivise growth in the community finance sector by diverting limited resources away from product innovation and investment in technology to contingency for complaints. Deter new funders coming into the sector (helping CDFIs to scale up and reach economies of scale, thereby reducing costs for consumers) who are worried about the risk of complaints.
Vary case fees according to the **type of product** the complaint relates to.	As credit providers CDFI cases fall into the category of consumer credit. These cases are generally noted by the FOS to be simpler and therefore less costly to resolve. At the same time, in the case of firms which specialise in other products, such as investments and mortgages, the financial firm likely receives a much larger fee/interest from the client, enabling it to better resource the costs of FOS case fees.	
Vary case fees according to the **size**	• 98% of CDFI loans have a value less than £1,000, 96% have a term under 12 months.	

[18] FCA Handbook: Community Finance Organisation.

[19] From the Responsible Finance membership base the following lenders are classed as Community Finance Organisations: Scotcash CIC, Moneyline IPS, Fair For You CIC, Fair Finance, Lancashire Community Finance, Lendology, Street UK. These lenders receive an extremely low number of complaints that are referred to the FOS.

<table>
<tr>
<td>of product the complaint relates to.</td>
<td>

The average loan size is £374.
Therefore the £750 FOS case fee is more than double the average product size for CDFI loans.
On a £500 loan over 6 months, the average cost of interest and fees paid by a customer to a CDFI is £148.
<table>
<tr><th>Loan amount and duration</th><th>Cost of fees and interest paid by customer to the lender</th></tr>
<tr><td>£500 over 3 months</td><td>£80</td></tr>
<tr><td>£500 over 6 months</td><td>£148</td></tr>
<tr><td>£500 over 9 months</td><td>£212</td></tr>
</table>

The costs of lending for CDFIs are largely fixed and do not vary proportionately to the size or term of the loan. This means that to be at least sustainable the interest and fees on a loan has to cover all of a lenders’ costs including:

Cost of capital raised from social investor or bank to on-lend
Marketing costs
Loan set up and administration
Back office systems and technology
Office and branch costs
Credit referencing and Open Banking charges per loan
In house collections when a loan goes into default
Loan write-offs
Complaints handling
The additional costs of advice and support including: access to debt advice, budgeting help, benefits income maximisation.

After accounting for these fixed costs, the surplus profit on each loan is so small that one single FOS case fee wipes out the surplus from potentially dozens of affordable loans.
This inevitably will restrict a lender’s ability to lend to more customers and scale-up to serve demand.
We would welcome working with the FOS to come to a proportionate fee level based on the size of the product.

</td>
<td>Act as a barrier to new, innovative firms entering the lending space at a time when a diversity of new providers is needed for consumers.

Act as a barrier for existing firms looking to expand into making low-value, short-term loans to “sub-prime” customers.
Increase interest and fees for customers as lenders seek to cover disproportionate case fee costs and risk.

CDFIs will settle customer claims, even if they would not be upheld by the FOS, before a customer can bring the case to the FOS as the cost to the CDFI in settling is much lower than the £750 case fee.

According to FOS data affordability complaints have been increasing. The reduction in free cases now is penalising the consumer credit market when larger companies benefitted from the increased number of free cases through the PPI scandal.

Reduce access to credit for vulnerable and financially excluded households at a time when it is more important than ever, through hampering the scale-up of the CDFI sector.</td>
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Text Box 1: Precedent of Support for the Community Finance Sector: 2019 FCA Fee Exemption

Throughout 2018 Responsible Finance worked with the Financial Conduct Authority to extend its fee exemption for the community finance sector. Prior to this change, Community Finance Organisations with a consumer credit income greater than £250,000 were subject to FCA fees.

The consultation contained the following wording:

'**Community finance organisations and credit unions**

5.9 We are proposing to extend our concessions for CFOs and CUs by exempting them from all payment of consumer credit fees. This proposal affects FCA fees only but, in the light of the consultation responses, we would welcome views on whether similar concessions should be considered for the other levies we collect.

5.10 CFOs provide alternative finance. They are defined as community benefit societies, registered charities or community interest companies limited by guarantee. The term includes some community development finance institutions (CDFIs), though not all CDFIs are also CFOs. When we began regulating consumer credit in 2014, we exempted CFOs and CUs from payment of minimum fees up to £250,000 of credit-related income. Above that threshold, they pay on the same basis as all other consumer credit firms - £1,095 minimum fee in 2018/19 plus the variable rate. **We explained in our first CP on consumer credit fees that we were introducing this concession to support the government's policy of improving the range of socially responsible choices available to vulnerable consumers.'***

**CP18/34: Regulatory fees and levies: policy proposals*

The Handbook notice alerting firms of the change said:

'Exempting CFOs and CUs from fees

3.32 CFOs and CUs are identified through robust definitions based on compliance with statutory requirements outside FSMA. This gives us (and other fee-payers) comfort that the concessions we have given them are targeted on firms which genuinely have a social purpose. Nonstatutory arrangements do not provide sufficiently robust guarantees against firms reinterpreting their mission statements to downgrade the importance of their social purpose.

3.33 We are therefore of the view that restricting the concessions to CFOs and CUs meets our requirement for the criteria to be objective, consistent, transparent and simple, **whilst also allowing us to continue to support the government's policy of improving the range of socially responsible choices available to vulnerable consumers.**

3.34 CFOs and CUs with annual income under £250,000 are currently exempt from consumer credit fees. The process of exempting them in this way is an inefficient additional administrative procedure and we believe that exempting them fully from consumer credit fees is justified in terms of the streamlining of processes and removing a relatively inefficient cost. **All fee-payers would benefit from us streamlining our administrative process.'***

**Handbook notice No 63. February 2019.*

Text Box 2: Financial Ombudsman Service Credit Union Case Fee Exemption

‘Credit unions are only required to pay a fee on cases which relate to an activity for which they pay more than a minimum fee towards the FOS General Levy. For core business, credit unions are only required to pay the minimum fee. However, credit unions with full consumer credit permission are also required to pay levy fees for the credit-related activities industry block. These credit unions would still only pay a minimum fee for this industry block, unless their annual income from consumer credit lending is over £250,000, the threshold at which they would also start paying a tariff-rate levy fee for consumer credit activities.

In terms of how this works with the free case allowance, the allowance only applies to cases that the firm is liable to pay for, meaning that non-consumer credit related cases would not count towards a credit union’s free case allowance. As a result, a credit union would need to have over £250,000 annual income from consumer credit lending *and* have at least four FOS cases directly related to consumer credit lending in order to pay the £750 case fee.’*

*Correspondence from the Association of British Credit Unions

Q7: Do you agree with reducing the margin of 15% to 5% and removing the free case allowance in group fee account arrangements?

We do not hold a view.

Q8: Do you agree that an initial fee at conversion will protect us and levy payers from the risk of not recovering costs for completed work?

Yes we agree provided the fee is proportionate as per question 6.

Q9: Do you agree that a time limit of 12 months to claim for overpayment of fees provides firms with a sufficient opportunity to make any claim for repayment?

We do not hold a view.

Q10: Do you agree that we should include the data that results from any new fee structure as part of the quarterly report we publish on our website?

Yes

Q11: Do you have evidence to demonstrate problematic behaviours from CMCs and do you think a charge from the Financial Ombudsman Service would prevent them?

We agree with the proposal to charge professional representatives a fee to bring a case to the FOS. This will ensure both the lender and the CMC has some skin in the game. Given that CMCs charge customers fees anyway, and that many companies operate on a no-win no-fee basis, charging CMCs an upfront fee should not be a barrier for legitimate customer complaints. This is particularly the case now that the FCA has implemented a fee cap for CMCs to limit the percentage of redress they are able to take.

- The risk of blanket claims from Claims Management Companies (CMCs) is ever present to the CDFI sector. This is even more acute as we raise awareness of the sector and it scales up through investment from Fair4All Finance and other investors.
- CDFIs sometimes receive ‘fishing expeditions’ from CMCs where they send a group of cases and make a request for information prior to sending the cases to the FOS, hoping the lender will either settle or show them something that indicates a weakness in underwriting. So far members have been able to write a blanket response back and the claims have been withdrawn. Despite this the risk still remains and has the impacts described above in question 6.
- Individuals and Claims Management Companies are increasingly aware of the cost to lenders if a complaint is referred to the FOS and have began approaching lenders asking for compensation pay-outs in the knowledge that it will cost the lender more if they progress the complaint to the FOS.
- We understand that published decisions from the FOS can act as a deterrent to CMCs targeting social lenders. Whilst this is helpful, it does not provide a high-level of reassurance to CDFIs or to potential funders in the sector.

Q12: Would you like us to consider introducing differentiated fees based on case complexity in future? How should complexity be defined and how could fees based on complexity be applied most effectively?

We suggest this should be kept under review in light of the potential changes made in relation to question 6.

Q13: Would you like us to consider offering discounts for cases resolved in batches in future, or do you think that fees based on the stage a complaint reaches would have the same impact? What would be an appropriate minimum and maximum number of complaints to form a batch?

We do not hold a view.

Q14: Would you like us to introduce supplementary fees for firms which are uncooperative and how do you define ‘uncooperative’?

We do not hold a view.

Q15: Do you agree that these options should not be taken forward or should we reconsider any of them – and if so, why?

We agree these options should not be taken forward.