Responsible Finance Response

Financial Ombudsman Service: Our 2022/23 Plans and Budget Consultation

31st January 2022

Summary of our Submission

Our submission to this consultation relates only to the proposed reduction in free cases to pre-PPI levels from 25 to 3. This is a threat to community finance providers, and therefore to consumer credit provision as a whole in the UK for people excluded from mainstream bank finance.

Responsible Finance is the only trade body in the UK 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 to smooth fluctuating incomes and expenditures. Throughout our response we refer to either “our members” – meaning CDFIs and other asset-locked mission driven lenders – or we refer to the wider sector as “community finance”, which we define as our members and as credit unions.

- **Current landscape:** Access to unsecured credit is widely acknowledged as an essential tool for households. Both the Financial Conduct Authority (FCA) and HM Treasury (HMT) have publicly expressed their support for the growth of the community finance sector in providing access to credit for households excluded from mainstream finance, and their interest in helping the sector to scale. The Financial Ombudsman Service (FOS) can play a role in furthering the aims of the Government and the financial regulator – thereby improving the financial resilience of UK consumers – by creating a fee carve out for the community finance sector.
- **Proportionality:** 88% of our members’ loans have a value less than £1,000. The average loan size for CDFIs is £655. This means that the £750 FOS case fee is multiples more than the income that is received by our members on each loan and many multiples more than any of that income which is surplus. We believe this is disproportionate for community finance providers which are not pricing their loans to make a profit. If individuals within the sector are targeted by CMCs, the costs could quickly devastate the affordable lending sector, reversing significant commitment and investment made by government and regulators.
- **Customers and Complaints:** Our member organisations report very low levels of complaints, especially those which go on to be referred to the FOS. However some worrying trends have been developing in this area including opportunistic compensation requests based on an increasing public knowledge of FOS case fees. The FOS’s Annual Complaints Data showed new complaints about unaffordable lending in banking and credit rising from 26,000 to over 57,000 from 2019/20 to 2020/21. These complaints were typically linked to historic lending and often submitted by CMCs.
- **Proposal:** The proposed reduction in free cases from 25 to 3 puts the community finance sector at risk, particularly if it becomes a target for complaints. We recommend that the FOS makes a specific exemption of waiving the case fee for community finance providers where a case is not upheld.

The Current Landscape

Access to unsecured credit is widely acknowledged as an essential tool for households. For most people borrowing is relatively straightforward through mainstream products like bank overdrafts and credit cards. However, credit is not available equally across the UK. People on low or unstable incomes, with poor or 'thin' credit histories, or receiving benefits income can struggle to access finance. Even before Covid-19, one fifth of UK adults had low financial resilience. This meant, for example, they could not withstand a £50 reduction in their monthly income. And those who have no, or limited, savings – currently one in four UK adults – are extremely vulnerable to financial shocks.

These excluded customers must rely on non-mainstream sources of credit such as doorstep loans, rent-to-own stores and payday loans. As more and more of commercial lenders exit the market, consumers have few options of where to turn to for their credit needs. Concerningly, the use of illegal moneylenders is not widely understood or reported on. And informal borrowing from friends and family increased to one in ten adults in 2020[1]. This is not an optimal or sustainable long-term solution.

Community finance organisations, including CDFIs and other responsible lenders, provide a cheaper, fairer alternative for low-income and financially vulnerable households who would otherwise only be able to access high-cost credit. They are focused on getting good customer outcomes throughout the loan journey. Access to affordable credit improves the wellbeing and resilience of individuals by offering them a tool to smooth fluctuating incomes, cover unexpected calls on their finances, and spread the cost of expected larger expenses. This could be to spread the cost of buying a washing machine, or to cover higher expenditure during the school holidays.

CDFIs' customers are in the bottom two income deciles, 70% are on benefits and 60% live in social housing. Currently they lend to 25,000 – 30,000 customers per year. This is compared to the 5 million consumers who take out high-cost credit[2], 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[3].

Our members save their customers £260 - £400 on average per loan compared to a high-cost lender (depending on loan size). That's more than 2 months' worth of gas and electricity bills at a time when families are feeling the pinch more than ever. Community lenders are a critical part of the financial ecosystem, and there is support from government and calls from stakeholders for the sector to scale up to fill the vacuum in fair credit.

In its recent report on the credit safety net and problem debt, StepChange debt charity said:

"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."[4]

[1] Financial Conduct Authority (2021) Financial Lives 2020 survey: the impact of coronavirus
[2] Ibid
[3] Helen Thomas (2021) Crackdown on high-cost credit leaves gap that must be filled. Financial Times.
[4] StepChange (2022) Falling Behind to Keep Up.

A major constraint to the growth of the responsible finance sector is its undercapitalisation. Not only in capital to on-lend, but investment to upgrade the sector's systems and infrastructure. Because of this any additional costs levied on the sector damages margins which are already tight, further hampering the sector's ambitions to scale and provide an optimal option for short-term credit.

Both the Financial Conduct Authority and HM Treasury recognise the importance of the community finance sector in the UK and have expressed support for scaling it:

"The Government are desperately keen, and have taken steps, to ensure that low income consumers can access safe, affordable and sustainable credit." John Glen MP, Economic Secretary to the Treasury.[5]

"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 Woolard Review.

[5] Hansard

Precedent of Support for the Community Finance Sector: 2019 FCA Fee Exemption

Throughout 2018 Responsible Finance worked with the FCA 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. We estimate that since 2019 the exemption has saved CDFIs (not including credit unions) £30,000. That means £30,000 reinvested back into their organisations to improve products and operational efficiencies.

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.*

As well as lending affordably, giving customers advice and support, being flexible and offering payment holidays, the community finance sector also needs to pivot and innovate to keep pace of technological advancements. It needs to outcompete peers in the high-cost lending sector and become the favoured option.

So far, the sector has been keeping pace by bootstrapping investments in systems, IT and marketing but its growth is very sensitive to external costs. The benefits of making the policy and regulatory environment favourable to the community finance sector will be reflected in helping to unlock its pathway to scale and increase investment in its systems and processes. Our vision is for the sector to become the default lender for customers excluded from mainstream finance.

Taking money from the already thin margins that the community finance sector is operating under is ultimately bad for the sector's customers. And the knock-on impact of that could likely be more people having to go to illegal lenders who evade the scrutiny of the FCA and FOS.

Proportionality

88% of our members' loans have a value less than £1,000. The average loan size for CDFIs is £655.

Loan amount and duration	**Cost of interest paid by customer to the lender**
£500 over 3 months	£98
£500 over 6 months	£163
£500 over 9 months	£234
£750 over 3 months	£147
£750 over 6 months	£242
£750 over 9 months	£349

These costs of lending are largely fixed and do not vary proportionately to the size or term of the loan. This means that to be sustainable the £98 - £350 income on each loan has to cover all of a lenders' costs including:

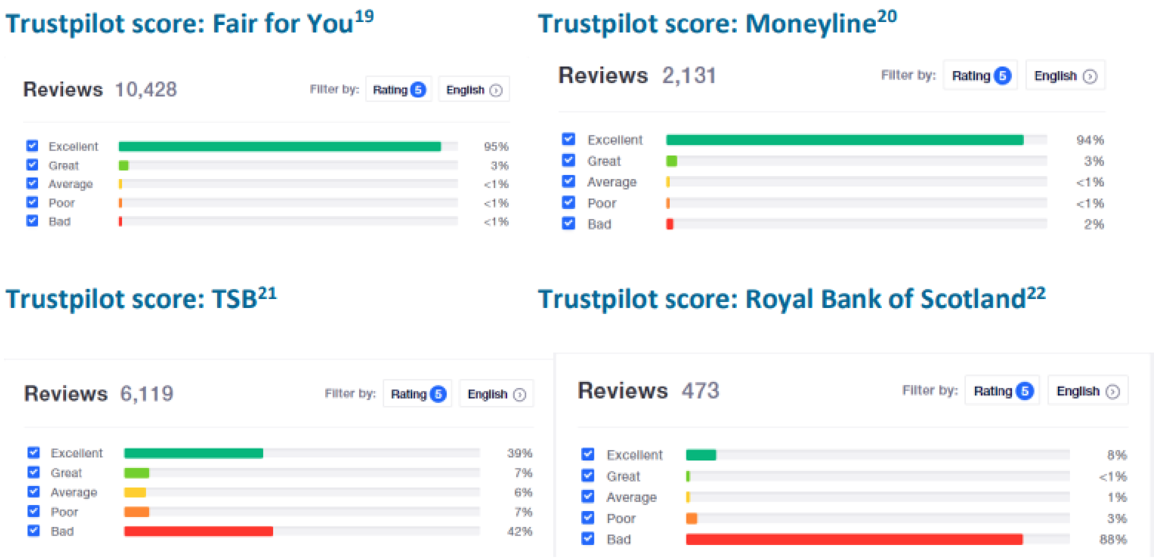
- Cost of capital raised from social investor or bank to on-lend
- Marketing costs
- Loan set up and administration
- Back office systems and technology
- Office and branch costs
- Credit referencing and Open Banking charges
- In house collections when a loan goes into default
- Loan defaults
- Complaints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

The £750 FOS case fee is multiples more than the income that is received by lenders on each loan and many multiples more than any of that income which is surplus. We believe this makes the £750 case fee disproportionate for community finance providers, which are not pricing their loans to make a profit. **If individuals within the sector are targeted by CMCs, the costs could quickly devastate the affordable lending sector, reversing significant commitment and investment made by government and regulators.**

Customers and Complaints

Community finance providers' goals are totally aligned with their customers. Both want the loan to put the customer in a more financially resilient position. Our members provide an incredibly high-quality of service to their customers and because of this complaints levels have been low throughout the history of the sector.

The image below shows a comparison of the Trustpilot scores of two of our member organisations, Fair For You and Moneyline, with two mainstream banks:



[6]

Despite their high-quality customer service and social mission, community finance providers still receive complaints from time to time as with any other consumer-facing organisation. When we surveyed members as part of our response to this consultation their feedback was that complaint levels are low, and complaints that are referred to the FOS are even lower and rarely exceed 3 per year. However, as the sector scales and becomes more publicly visible we are concerned this could increase.

The FOS's Annual Complaints Data showed new complaints about unaffordable lending in banking and credit rising from 26,000 to over 57,000 from 2019/20 to 2020/21. These complaints were typically linked to historic lending and often submitted by CMCs. Complaints data on specific high-cost lenders highlights how CMCs are working their way through the market lender-by-lender, often leading to firm collapse. In recent years there have been a number of high-profile exits from the subprime lending market. The number of lenders has fallen by nearly two thirds since 2016[7]. A market failure is being created at a time when rising vulnerability means alternative finance is most needed. It is irresponsible that there is no clear plan from the Government or the regulator for maintaining the provision of credit for vulnerable, low-income households. This is why support for community lenders is more important than ever.

[6] Carnegie UK (2021) Advancing affordable credit. Figure 1.
[7] Helen Thomas (2021) Crackdown on high-cost credit leaves gap that must be filled. Financial Times.

It is right that customers who have been impacted by unaffordable lending are seeking redress. However, the surge in complaints is in danger of further contracting the consumer credit market resulting in even more limited credit options for customers excluded from mainstream finance.

We would like to highlight the following specific impacts, developments and concerns:

Claims Management Companies and Opportunistic Claims

- The risk of blanket claims from Claims Management Companies (CMCs) is ever present. This is even more acute as we raise awareness of the sector (as per Responsible Finance's strategy) and the sector scales.
- Increased levels of opportunistic complaints are being seen from people using the freely available online templates.
- Individuals and Claims Management Companies are aware of the cost to lenders if the case 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. Given the sector's average loan size of £655, the cost of settling (even if the lender is not at fault) before the claim is progressed to the FOS can present a cheaper alternative if the number of free cases has been exceeded.
- Our members have received '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. But the risk remains, and it could quickly become a situation which threatens the sustainability of the sector.
- If chargeable claims increase, lenders may be forced to consider raising their interest rates in response to the additional risk. This would have a negative impact on the sector's customers.
- 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 members and it does not help them to counter claims from individuals who are aware of the cost to firms if cases are referred to the FOS.

Innovation and Growth in Community Finance

- The increased risk presented by the reduction in free cases could disincentivise growth in the community finance sector and act as a barrier to new, innovative players entering the space.
- According to FOS data affordability complaints have been increasing. The reduction in free cases now would penalise the consumer credit market when larger companies benefitted from the increased number of free cases through the PPI scandal.

Clarity on Affordability and Firm Expectations

- It would help reassure the community finance sector if the FCA and the FOS could work together on continuing to explore and develop a universal standard as to how we think about affordability to drive consistency. This should explore the opportunities that exist in relation to Open Banking.
- The FOS should also work with the FCA closely on the new Consumer Duty so it is clear what expectations the new rules will place on firms and how the FOS will decide if there have been breaches.

Proposal

We understand that like our members' cost of lending the FOS's costs for investigating cases are likely not to significantly vary proportionately depending on the size or type of product being investigated. We acutely understand the need to be sustainable and cover costs. Because of this, we believe there is a strong case – similar to the FCA's fee carve out for Community Finance Organisations – to waive fees for community lenders and spread the very small costs of investigating the low levels of complaints from this sector over the wider commercial financial market.

It is in the interests of the wider market that this cohort of customers is served well, as their financial stability has knock-on impacts across the economy. If a banks' customer is persistently in debt to high-cost lenders they are likely to never – or take a very long time – to move from a position of financial exclusion to inclusion, where they can eventually take out bank lending products including mortgages. Community lenders foster these customers' financial resilience, help them to build their credit scores, and save money. The aim is to get the customer to a position where they can take on finance from a mainstream provider in the future if they choose.

We believe that the FOS is well placed to make this argument to the financial services industry with the support of the FCA and HM Treasury. And given the extremely low levels of complaints which are referred to the Ombudsman from the community finance sector, this should provide reassurance that the spread of the fee amongst commercial financial institutions will not be excessive.

The proposed reduction in free cases from 25 to 3 puts the community finance sector at risk, particularly if it becomes a target for complaints. We suggest the FOS considers the following options with regards to case fees for the community finance sector.

We recommend that the FOS makes a specific exemption of waiving the case fee for community finance providers where a case is not upheld.

If this is not deemed to be feasible, we suggest the FOS explores the following two alternatives:

1. Create a carve out for community finance providers which retains the 25 free case allocation.
2. Reduce the case fee for community finance providers so it is more proportionate in relation to their lending activity.

We believe these should apply to all community finance providers including credit unions and other asset-locked lenders.

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.

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Case Study

At the time Megan felt her chances of being approved were unlikely "I did go in with the attitude that I wasn't going to be accepted, I thought my income would be too low and I wasn't going to get the help but I definitely gained more than just a loan. It changed my outlook on things. You were there when I needed it." "It turned me completely around and I managed to save after I used Moneyline. I haven't stopped saving since." Megan finished repaying her loan and continued saving, firstly just with Moneyline but she now saves independently and has four types of savings accounts.

Prior to taking out her loan, Megan had been homeless for around a year after her supported housing for young people tenancy was terminated after getting into rent arrears. She had lived on the streets and various women's refuges, but after falling pregnant was able to find some more permanent accommodation from the Council which she has maintained for almost 4 years now. "Before having my son I was homeless…Money wasn't really something that was around, I just went from one day to the next, it was all very chaotic and when my son came into my life things needed to change you gave me that motivation and help I'd never received before with money."

Megan has only ever used Moneyline once because her ability to save since using Moneyline has meant she has been able to save for the things she wanted/needed rather than take out a loan. Even when she was experiencing some issues with housing disrepair in her council house linked with leaks and damp issues, because of her good savings habits, instead of needing another loan she managed to save and make the repairs one at a time rather than get everything done all at once.

Even during lockdown, Megan's focussed approach to savings remained strong: "I took the opportunity during lockdown to save really hard and put as much away as I can each month." Megan mentioned she's not really saving for anything in particular, "I look at it like a security blanket". Megan is hoping to get a job next year when her son is at school full time, something she hasn't been able to do so far due to not having have any support with childcare.
*name changed

Alphabetical List of Responsible Finance Members Providing Personal Credit

- Adage Credit
- Auden
- Conduit
- CWRT
- Creditspring
- Fair Finance
- Fair For You
- Lancashire Community Finance
- Lendology
- Lendwise
- Moneyline
- Robert Owen Community Banking
- Salad Money
- Scotcash
- Street UK