Responsible Finance Response: The FCA's Credit Information Market Study

Interim Report and Discussion Paper

21st February 2023

About Responsible Finance

Responsible Finance is the UK trade association for Community Development Finance Institutions (CDFIs). We believe in a fair financial system where investment flows into communities to create positive economic, social and environmental impact. To enable this we lead a strong responsible finance sector so communities have access to finance to transform lives. Our members make loans in disadvantaged communities that are not adequately served by mainstream financial service providers.

Responsible finance providers are mission driven not-for-profit and asset-locked organisations. They offer affordable credit and support to people who are under-served by mainstream finance providers who may otherwise borrow from high-cost lenders or illegal loan sharks.

About Our Response

We welcome the opportunity to respond to the [Credit Information Market Study Interim Report and Discussion Paper](). We consulted with members to inform this paper, and met with the Credit Information Market Study team alongside member CDFIs in 2022. Given our role, Responsible Finance's response primarily focuses on the impact of the credit information market on the CDFI sector, rather than on consumers more generally.

Responsible Finance believes that the Credit Information Market in its current form harms access to affordable credit, contributes to the poverty premium and results in poor consumer outcomes. We believe the proposals outlined by the FCA will begin to set a positive pathway to improve access to affordable credit, but the opportunity to transform the credit information sector to a more inclusive system which better reflects the realities of people's lives should not be missed.

Our response provides an overview of the credit information market in relation to CDFIs and access to affordable credit and makes recommendations in relation to the FCA's proposed remedies, rather than responding to each individual consultation question. It recommends:

1. Reform the governance of the credit information industry to create an inclusive, transparent and accountable body with a clear obligation for financial inclusion. The body should have greater FCA oversight going over and above what is currently proposed due to the need for extensive, urgent reform. The new body should incorporate the consumer voice as well as the views of small lenders (Remedy 1)
2. Create one single third party entity to act as a central repository and distributor of information, where lenders are mandated to simply and for free report their customer's repayment data. The onus should be on each CRA to then draw on and process this consistent information. It should not be on lenders, and the process should be streamlined. (Remedy 2A)
3. Enable CIUs to easily and cheaply draw on this information to inform their credit assessment processes.

4. In line with recommendation 2, we agree that as part of this change a common data reporting format for lenders and CRAs should be created, to improve consistency of credit information and allow credit information users, such as lenders, to switch more easily between CRAs. Increased nuance should be built in in consultation with lenders and regularly reviewed in areas such as marking customer defaults and payment holidays. We also agree with the proposal to establish a new regulatory reporting framework for designated CRAs (Remedy 2B & 2C)
5. CRAs and CISPs should be required to prominently signpost to statutory credit file information to ensure fewer customers pay for what should be a free service. (Remedy 3A)
6. Responsible Finance supports the proposal of creating a single central customer portal which:
    a. Streamlines access to credit information
    b. Streamlines data dispute process
    c. Enables consumers to record Notices of Correction and vulnerability markers on their files
    d. Responsible Finance strongly agrees with this portal being made available through a formal regulatory solution.
    (Remedy 3B & 3C)
7. The FCA should recommend that CRAs align with the FCA in formally recognising community lenders and therefore provide a significant discount for these types of lenders in order to reduce costs for financially vulnerable and excluded consumers and promote the sustainability and scale up of the affordable credit sector. This would help to address the issues outlined in the market study where smaller lenders do not have the bargaining power of larger lenders, and disproportionate credit information costs are passed to vulnerable consumers.
8. The FCA should mandate that CRAs actively focus on supporting financially excluded and vulnerable customers and getting good outcomes for them. Particularly for current 'credit invisibles' and those which do not live predictable financial lives. This could be through incorporating Open Banking data responsibly, so as not to further exacerbate financial exclusion.
9. The FCA must ensure CRAs/the proposed single third-party entity holds up to date data which is refreshed frequently, so lenders make decisions on 'real time' data which is ultimately more accurate and better for the consumer. The monthly reporting cycle can often mean credit information is out of date. This more frequent reporting will only be possible if the process is streamlined for lenders, in line with the recommendations above. (Remedy 4A)

Our Response

1. <u>Background</u>

Between 2019 to 2021 the high-cost short-term credit and home credit markets shrank by £1 billion, issuing 3.25 million fewer loans a year[1]. Over 1 million people are now borrowing from illegal loan sharks; 700,000 more than the most recent official estimate[2]. And victims face a range of interwoven disadvantages; with many of the same disadvantages that CDFIs' customers face:

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[1] Fair4All Finance Analysis of FCA and firm data
[2] Centre for Social Justice (2022) Swimming With Sharks

CDFI Customer Demographics in 2021[3]	Victims of Illegal Moneylenders according to the Centre for Social Justice
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

One in four UK households do not have any savings at all, leaving them highly vulnerable to a financial shock[4]. Access to affordable credit can improve the wellbeing and resilience of individuals by offering them a tool to smooth fluctuating incomes, cover unexpected calls on their finances, or pay for expected larger expenses such as a new washing machine or the school summer holidays. CDFIs are vital in providing this service and rerouting people away from high-cost and illegal lenders.

In 2022 CDFIs lent £34 million to 67,000 customers with an average loan size of around £500. This is compared to the 5 million consumers who take out high-cost credit[5], and the 11 million people in vulnerable financial circumstances that prevents them from accessing mainstream credit; a number which is 3 million higher than before the pandemic[6]. CDFIs save their customers on average £190 per loan compared to a high-cost alternative. The median APR on a CDFI loan is 169%. Many loans from high-cost credit providers have APRs exceeding 1000%[7]. It is vital the sector is scaled up to fill the vacuum in access to affordable credit.

'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.[8]' – StepChange Debt Charity

A key barrier to the financial inclusion of consumers and their ability to access credit is the credit information supplied by Credit Reference Agencies (CRAs). CRAs play a critical role in the lending decisions of financial organisations, and therefore in including and excluding consumers from access to vital credit. It is well known that existing models create credit 'invisibles' or a 'thin file' if a consumer does not have a traditional financial background; for example if someone is new to the UK or young. There are currently 5 million 'credit invisible' adults in the UK[9]. This limits the credit options available to them, hampering their ability to access lower cost credit.

At the same time, the credit information market is set up in a way that advantages people with traditional, predictable financial lives. Yet this is not the reality for many consumers in the UK. People who may have experienced a period of short-term difficulty and go on to recover may have their ability to access affordable credit negatively impacted for a disproportionately long period of time, despite being on a stable financial footing again and able to afford to borrow.

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[3] Responsible Finance (2022) Loans That Change Lives
[4] Direct Line Group Research (2023) Less than a month to hardship for over six million households.
[5] Ibid
[6] Helen Thomas (2021) Crackdown on high-cost credit leaves gap that must be filled. Financial Times.
[7] 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%.
[8] StepChange (2022) Falling Behind to Keep Up.
[9] Experian

Despite this, the 'locking out' by credit information data is increasingly shown to only be loosely related to the ability to afford to borrow. Conversely, Open Banking data allows lenders to see real-time, accurate and detailed bank account data of applicants, and use this to make a thorough and informed decision on whether a loan is appropriate for that customer. Open Banking technology has been embraced by the affordable lending sector and has been found to be a more fit-for-purpose method than traditional credit scoring of assessing whether low income and vulnerable customers can afford to borrow (see p.6 'Spotlight on Open Banking').

2. 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:
  - There are strong links between physical, mental and financial health.
  - Having a reliable and trustworthy credit provider has a positive long-term impact on health and wellbeing[10]. 92% of customers state that with the cost-of -living crisis, knowing they could turn to CDFI Fair For You gave them peace of mind[11].
  - According to research, 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[12].
- **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, illegal lenders, or be unable to access credit at all:**
  - There are approximately 10 CDFIs which lend to individual consumers across the UK.
  - 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).
  - 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 research conducted by a CDFI, 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[13].
- **CDFIs' objectives are completely aligned with those of their customers to improve financial wellbeing and resilience.** This means that 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 credit reference agency fees, reduces the amount that can be reinvested and therefore increases the amount the end consumer pays. High costs also harm the long-term sustainability of CDFIs.

[10] Moneyline (2021) Impact Report
[11] Fair For You (2023) Measuring the impact of Fair for You on customer health and wellbeing
[12] Gibbons, D. (2020) The Social Impact of Fair For You
[13] Centre for Responsible Credit (2020) The Social Impact of Fair For You

'As with credit unions, community lenders offer a valuable alternative to high-cost credit. They should be encouraged to grow…The FCA, the Treasury and Responsible Finance should report on ways to increase the lending capacity of Community Development Finance Institutions (CDFIs)...' –The FCA's Woolard Review (2021)

3. How do CDFIs use credit reference agencies?

- CDFIs are typically credit information users (CIUs).
- The majority of CDFIs use a combination of credit Information from a Credit Reference Agency (CRA) and Open Banking data to produce a full picture of their customer's circumstances. However some CDFIs use only Open Banking.
- CDFIs will typically only gather information from, and report information back, to one CRA due to the associated high costs and resource involved in doing so.

4. What are the key issues for CDFIs in relation to the credit information market?

High cost of accessing credit information from CRAs:

- CDFIs report that the cost of accessing credit information from CRAs is prohibitively high, and one of the highest costs their organisations face. This cost is passed on to consumers in the interest rates that CDFIs must charge to remain sustainable.
- CRAs do not recognise the social benefit of CDFIs or align their approach to Community Finance Organisations with that of the FCA. Pricing structures disadvantage small organisations which do not have the buying power of larger CIUs and cannot take advantage of economies of scale.
- CDFIs' contracts with CRAs are generally on a 'cost per search' basis. This means that despite a low conversion rate from applicants to loan approvals and disbursals (currently around 4%) all loan applications incur this cost. Given that the typical CDFI loan size is very small at around £400, CRA costs form a high proportion of the overall costs of making a loan.
- Data from a sample of CDFIs shows that over 6% of the sector's lending costs comprise of CRA costs (for those who use data from CRAs), and for some make up as much as 10%, despite only gathering information from one CRA.
- At the same time CDFIs report being compelled to sign long-term contracts with minimum volume levels. This meant that during the pandemic when CDFIs had lower levels of lending due to reduced affordability, they continued to pay CRA costs. This harmed the sector's sustainability at a time when the operating environment was already extremely difficult.
- As mentioned in the market study:

  'While the marginal cost to the CRA of a search for an existing CIU is likely to be very small and no different for a large or small lender, there are certain fixed costs of sales and onboarding new CIUs that are spread over higher volumes for larger CIUs. As a result, CRAs tell us they often give 'volume discounts' of up to 20-30% to clients that commit to larger contracts. Accordingly, some smaller, social purpose lenders have told us that smaller lenders pay many multiples more per search than large lenders. As a result, the cost of credit information is likely to be a greater proportion of such CIUs' total operating costs relative to their revenue, especially considering that they typically lend smaller amounts.'

- The FCA's interim report states that the three large CRAs tend to compete in similar client tender processes and that head on competition helps buyers achieve price reductions, and that 80% of customers had been able to negotiate price discounts or freezes. This is not reflected in the experience of CDFIs who have very limited time and resource, particularly as switching to a different CRA when a CRA is integrated into their systems would be extremely burdensome. Due to the fact that CDFIs generally only partner with one CRA which is integrated into their operations, their bargaining power is further diminished; particularly as it was noted that CRAs tend to use different data formats.
- It therefore appears that CDFIs are likely to be paying vastly higher rates for credit searches with CRAs than larger financial institutions which do not serve the excluded, vulnerable customers that CDFIs do.
- The combination of these factors means that the disadvantage faced by CDFIs in accessing credit information is being passed on to CDFI customers, which are some of the most vulnerable in the UK. This has a direct impact on the poverty premium paid to access credit.

Inconsistent and unreliable information from CRAs:

- The Credit Information Market Study interim report stated that only in 30% of cases do all 3 CRAs hold consistent information. This is extremely troublesome given the fact that the cost of gathering credit information from more than one CRA is too prohibitive to be a solution for CDFIs and other small lenders.
- The report's finding that the choice of CRA and its impact on the outcome of an application for credit impacts middle and lower scoring individuals disproportionately is clear evidence that the credit information market isn't working well for consumers. Particularly, as noted:

  'for some smaller lenders the additional costs of seeking additional data can be too great, given the margins on which they operate. Around 91% of credit applications in our sample of credit files involved a search at a single CRA. Additional CRA searches are generally only undertaken where no or little information was available from the first CRA. This makes the impact of differences more important than if data from more than one CRA was used for each credit application.'

- At the same time CDFIs report that the information provided by CRAs is slow to update and isn't effective in less stable economic environments. They also note that the affordability tools offered by CRAs to lenders are inaccurate for lending to the financially excluded and vulnerable customer bases they serve.
- Given the CDFI sector's extensive use and experience in Open Banking, they report seeing information from CRAs that makes a customer appear creditworthy, but when supplemented with the CDFI's Open Banking analysis the customer is in fact showing strong signs of financial distress.
- This is a particular issue for consumers who borrow from lenders which don't use Open Banking, and so may receive a loan which isn't suitable and they cannot afford.
- CDFIs report that in this way Open Banking technology is an important tool for tackling financial exclusion. Given this and the Salad Money research outlined below, it is vital that CRAs are compelled to focus on supporting financially vulnerable and excluded customers. Open Banking will be a key tool in this.

Spotlight On: Open Banking Technology

Whilst most CDFIs use a combination of CRA data and Open Banking, one CDFI Salad Money uses only Open Banking data to assess the creditworthiness of its customers and does not use data from any CRAs.

The level of detail provided through Open Banking data enables lenders like Salad Money to see:

- Employment income and benefit payments
- Current credit repayment liabilities
- Essential regular expenses, such as housing and food
- Current and historic credit difficulties such as CCJs
- Markers of vulnerability, such as gambling
- Markers of financial distress, such as returned direct debit payments

To assess the value of CRA data and Cifas fraud data over and above that of Open Banking, Salad Money conducted an extensive retrospective analytical review of the customers it has lent to using both CRA and fraud data[1]. The review found that:

- **10% of Salad Money's customers would otherwise have been excluded by lenders that rely on CRA data:** these customers do not have a credit score, yet payment data shows loans made to these customers perform no worse than a typical customer, suggesting they are being unnecessarily excluded by other lenders.
- **Open Banking is a superior way of underwriting its customers:** it provides a highly granular, holistic, and real-time window into an applicant's financial circumstances in a way that traditional credit scoring cannot.
- **Credit reporting can lock customers out of accessing affordable credit:** 88% of Salad Money's customers have some form of impaired credit histories.
- **CRA data is a weak indicator of vulnerability indicators such as gambling.**

Information and data taken from: Salad Money (2023) Review of Credit Reference Agency and Cifas Data

Reporting information back into CRAs is resource intensive:

- As mentioned earlier in this response, there are development costs associated with reporting information back to more than one CRA, therefore CDFIs generally only report information back to one CRA.
- Whilst most CDFIs only report back to one CRA, one has experience of reporting back to all three CRAs through its involvement in the No Interest Loan Scheme pilot. They note that this is an extremely time-consuming exercise to perform and takes c. 1 day per month. CRAs say they are not currently able to share information between each other, citing competition restrictions.
- At the same time, CDFIs noted that an expansion of and regular reviews of the categories for reporting back into CRAs would support consumers, particularly at the more vulnerable end of the consumer market. At the moment the categories – such as 'paid' and 'not paid' – are very simplistic. Some CDFIs have around 14 different payment statuses for their customers given their complex financial lives and CDFIs' flexibility as lenders.

- The onus, and therefore time and cost, should not be placed on lenders to share data with all CRAs individually. Instead a single third party entity should act as a central repository and distributor of information, where lenders can easily and for free report their customer's repayment data.

Transparency, detail and impact on the end consumer:

- The lack of transparency into what goes into making a credit score is extremely complex and problematic for vulnerable customers. Research has found that only 40% of adults know their credit score, and 60% don't understand how credit scores are calculated[14].
- At the same time credit scores appear to disadvantage lower income consumers, such as those who do not have predictable financial lives, and renters. It does not respond or take into account the insecure nature of tenancies, which often mean moving often is necessary but not an indicator that individuals are bad tenants. This also leads to people not being on the electoral roll.
- It would be beneficial to consumers if rental payment data (with sufficient granularity) could be reported to CRAs and used in credit scores.
- It is vital to ensure that consumers are aware of how to access their credit score for free, and are given clear and transparent information on how their credit score is calculated.

5. Summary: How does the credit information market negatively impact access to affordable credit for lower income consumers?

Access to affordable credit vital for many consumers' financial resilience and stability, but the Interim Report and our research with member CDFIs has shown that the Credit Information Market is not currently working for consumers. In summary, the market negatively impacts access to affordable credit through:

- **High costs for accessing credit information passed on to consumers, exacerbating the poverty premium:**
    - Smaller lenders are at a disadvantage compared to large financial institutions in negotiations with CRAs. This leads to them paying more to access credit information and being trapped in high 'cost per search' contracts. The cost of this is magnified due to the small amounts they lend, meaning CRA fees make up a higher proportion of the costs of making each loan (around 6%) compared to higher value loans made by larger financial organisations.
    - Because of their non-profit and asset locked organisational structures, CDFIs charge their customers the cost of delivering the loan. This means that they do not have large surpluses and costs must be passed on to the consumer to enable them to remain sustainable. The estimated margin a CDFI receives to reinvest on a £500 customer loan is at £13.
    - Given low conversion rates for lenders, 'cost per search' models result in the customers who are approved paying for the vast number of credit searches on those who must be declined due to affordability.

[14] Plend (2022) Financial Inclusion Report

  - The cost to CDFI customers – some of the most financially vulnerable consumers in the UK – of disproportionately high Credit Reference Agency Costs is significant and adds to the poverty premium.
  - High costs harm the sustainability of the CDFI sector itself and its ability to scale up in line with the recommendations in the FCA's Woolard Review.
- **Unreliable and inconsistent credit information leading to declines and poor consumer outcomes:**
  - Current CRA models lack detail and nuance, meaning many people are excluded from access to credit through being 'credit invisible' or by having historical impairments on their credit files, despite being in a stable financial position and able to borrow.
  - Factors such as changing address which can negatively impact a person's credit score do not take into account the realities of life for people on lower incomes who are in less secure tenancies.
  - CRA data is not regularly updated meaning it is often inaccurate and out of date.
  - CRA data does not have sufficient nuance for lenders reporting missed payments.
  - Most lenders do not report back to all CRAs meaning there are inconsistencies in the data held by different CRAs leading to different customer outcomes depending on which CRA the lender is using.

6. <u>Recommendations:</u>

The following recommendations would support the FCA's objectives of protecting consumers, enhancing market integrity through ensuring the credit information market is transparent and consumers can trust it, and promoting effective competition in the interests of consumers. All recommendations should be enacted through formal regulatory solution, rather than relying on industry-led change. Without a formal mandate for the proposed recommendations it risks nothing changing for financially vulnerable borrowers.

1. Reform the governance of the credit information industry to create an inclusive, transparent and accountable body with a clear obligation for financial inclusion. The body should have greater FCA oversight going over and above what is currently proposed due to the need for extensive, urgent reform. The new body should incorporate the consumer voice and the views of small lenders (Remedy 1)
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