

Irresponsible lending

- a scoping paper

August 2008

OFT1012

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1 FOREWORD

- 1.1 The Office of Fair Trading (OFT) is conducting a consultation on the scope for a project covering the irresponsible lending element of the fitness test set out in section 25 of the Consumer Credit Act 1974.

Responding to this scoping paper

- 1.2 Consultees responding to this paper are asked to supply a brief summary of the interests or organisations they represent, where appropriate. We ask that any suggested changes or comments on the documents be submitted in writing (by email, or alternatively by letter or fax, as indicated below).

The consultation period

- 1.3 The consultation period began on 1 August 2008 and will run until 24 October 2008. This period of 12 weeks is in accordance with the criteria set out in the Cabinet Office's Code of Practice.

Next steps

- 1.4 We will collate responses to the paper and publish a summary of these. We will set out the final scope for the project taking into account all comments received and will move to a consultation on the substantive aspects of irresponsible lending later in 2008.

All responses and comments should be sent to:

Mark Hopkins
Room 2C/O19
Office of Fair Trading
Fleetbank House
2-6 Salisbury Square
London
EC4Y 8JX
Fax: 020 7211 8123
Email: mark.hopkins@oft.gsi.gov.uk

Data use statement for responses

Please note that we may choose to refer to comments received in response to this consultation in future publications. In deciding whether to do so, we will have regard to the need for excluding from publication, as far as that is practicable, any information relating to the private affairs of an individual or any commercial information relating to a business which, if published, would or might, in our opinion, significantly harm the individual's interests, or, as the case may be, the legitimate business interests of that business ('confidential information'). If you consider that your response contains such information, that information should be marked 'confidential information' and an explanation given as to why you consider it is confidential. All information received is subject to Part 9 of the Enterprise Act 2002.

If you are replying by email, these provisions override any standard confidentiality disclaimer that is generated by your organisation's IT system.

2 ABOUT THE OFT

- 2.1 The OFT is a non-ministerial Government Department. Our mission is to make markets work well for consumers. The tools to achieve this goal are found within the competition and consumer law regimes which lie at the heart of UK economic policy. The competition and consumer regimes are complementary to each other. Empowered and well-informed consumers act as a positive stimulus to competition between businesses. Where consumers are able to make informed decisions, businesses are more likely to innovate, reduce inefficiencies in production and supply and compete in ways which make markets work well for consumers and the wider economy.
- 2.2 A primary part of our role to make markets work well for consumers is the operation of the consumer credit licensing regime provided for by the Consumer Credit Act 1974 (CCA). As part of this, the OFT is responsible for licensing all those engaged in regulated consumer credit activities. We are supported in this by our enforcement partners in Local Authority Trading Standards Services (LATSS).
- 2.3 In carrying out our functions under the CCA we seek to maintain vibrant and competitive markets for all forms of consumer credit whilst ensuring that appropriate standards of consumer protection are adhered to by industry. We aim to focus our resources on those areas where there is the highest risk of consumer harm, using both the gateway role and the ongoing monitoring of the licensing regime to set regulatory standards where appropriate and to prevent consumer harm before it occurs.

3 IRRESPONSIBLE LENDING PROJECT: SUMMARY

Objective/outcomes

- 3.1 The objective of the irresponsible lending project (the project) is to provide a clear OFT position on the test for irresponsible lending under section 25 of the CCA.
- 3.2 It is expected that the outcomes of the project will include the publication of guidance setting out the basic standards expected of licensees in relation to irresponsible lending practises.

Project scope

- 3.3 The project will consider behaviour and practices around the decision to lend, or to extend an existing line of credit, and the nature and extent of any assessments of a borrower's ability to repay.
- 3.4 The project could be limited to the matters in paragraph 3.3 above or could also cover other aspects of consumer credit lending which impact upon lending and borrowing decisions to a significant extent or which may potentially cause consumer harm. These may include, but are not limited to, matters such as:
 - advertising and marketing
 - selling techniques
 - product design
 - use of credit scoring techniques
 - appropriateness of product to borrower
 - sale of associated products and,
 - account management (including handling of default/arrears).

Our initial view is that the wider scope would ensure that the outcomes of the project would be more useful for both businesses and consumers, as it would make clear our position across the range of matters listed as opposed to simply on the narrower issue of the lending decision itself.

- 3.5 The project will cover all main types of consumer credit lending. This will include, but is not limited to, unsecured personal loans, secured loans

(second charge mortgages), credit cards, hire-purchase, payday loans and home credit.

- 3.6 The project will also cover all parties to the loan, including credit brokers and intermediaries.
- 3.7 This initial phase of consultation is intended to establish the overall scope of the project in the context of the OFT's licensing and regulatory remit, through discussion with stakeholders and interested parties. Any responses to the proposed project scope should be received by **24 October 2008**.
- 3.8 Once the scope of the project has been settled we intend to adopt a fully consultative approach with all interested parties which will include bilateral meetings and roundtable discussions. It is also likely that we will produce an issues paper for discussion later in the project, and a report summarising the main findings. There will be a formal consultation on any guidance that is produced as a result of the project's findings.
- 3.9 The intention is to complete the project and publish initial guidance for consultation within a 12 month period. However, subject to the outcome of the project, we may undertake further sector-specific or product-specific work.

4 IRRESPONSIBLE LENDING PROJECT: DETAILS

Background

4.1 The Consumer Credit Act 2006, which amended the CCA, introduced two concepts which have a particular bearing on the issue of responsibility in lending. These are the consideration of credit competence in the assessment of fitness, and the explicit identification of evidence of irresponsible lending as a matter to which the OFT must have regard in assessing fitness to hold a consumer credit licence.

4.2 The OFT has provided some clarification on what constitutes irresponsible lending in its general fitness guidance (OFT 969, published January 2008) which states:

'Lenders may take different approaches to responsible lending in line with variations between the needs of different sectors of the market. However, lenders should always take reasonable care in making loans or advancing lines of credit and should take full account of the interests of consumers in doing so. They should undertake proper and appropriate checks on the potential borrower's creditworthiness and ability to repay the loan and to meet the terms of the agreement. The checks should be proportionate, taking account of the type of agreement, the amounts involved, the nature of the lender's relationship with the consumer, and the degree of risk to the consumer.'

4.3 There is also pre-existing guidance, particularly that available in the OFT's Non-Status Lending Guidelines (OFT 192, revised in 1997). In terms of irresponsible lending, this focused primarily on issues related to the consumer's ability to repay any loan and to meet the terms of the agreement including:

'Lenders should comply at all times with the principle of responsible lending. All underwriting decisions should be subject to a proper assessment of the borrower's ability to repay, taking full account of all relevant circumstances including the purpose of the loan, the borrower's income, outgoings, employment, age, state of health and previous credit history, and details of any other mortgages or loans or any life assurance

cover or payment protection insurance. The aim should be to ensure that the borrower does not take on a commitment which they are unlikely to be able to fulfil. If brokerage or other fees, or an insurance premium, are to be added to the loan, the lender should assess the borrower's ability to repay on the basis of the total amount of the loan including any such charges.

Lenders should take account of any seasonal variations in the borrower's income, and any likely future changes in income or employment or other relevant circumstances, together with the nature and extent of any existing financial difficulties. They should concentrate on the borrower's ability to repay the loan, rather than on the value of equity in the property on which the loan is to be secured.

Lenders should take all reasonable steps to verify the accuracy of information provided on or in support of the loan application. They should check any apparent omissions or discrepancies, and query any unusual features. They should ensure that all underwriting staff are properly trained and supervised.

In assessing ability to repay, lenders should ensure that they have sufficient evidence regarding the borrower's income and other financial details. What will be sufficient in any given case will depend upon the circumstances of that case, and is a question of fact and degree. The need for supporting evidence will be greater, the higher the self-declared income or the larger the loan relative to the borrower's income or other financial circumstances. If adequate documentary evidence is not available, and there is doubt over whether the borrower will be able to afford the repayments, the loan should not be made. If a lender fails to check the borrower's ability to repay a loan secured on the borrower's property, this will be irresponsible lending. It might also be regarded as lending on equity alone. Both of these the Office has long regarded as unacceptable.'

- 4.4 The general fitness guidance makes it clear that the Non-Status Lending Guidelines continue to apply pending the development of specific guidance on irresponsible lending, and should still be followed where relevant.

- 4.5 The OFT has made a commitment to revisit the issue of lending practices to identify those inconsistent with responsible lending and, where appropriate, to produce guidance setting out the OFT's views. The initial phase of the project is centred on consultation with a wide range of stakeholders on the scope of this work, bearing in mind the OFT's fundamental licensing objective of assessing fitness. This initial phase of the project will define the range and nature of the project work to be undertaken.
- 4.6 Regard will also be had to wider regulatory issues including the new Consumer Credit Directive (which is due to be implemented in national law by June 2010), the FSMA regulatory regime including the FSA's Treating Customers Fairly (TCF) initiative and relevant self regulation regimes.
- 4.7 The Directive will require Member States to ensure that 'before the conclusion of the credit agreement, the creditor assesses the consumer's credit-worthiness on the basis of sufficient information, where appropriate obtained from the consumer and, where necessary, on the basis of a consultation of the relevant database'. An assessment will also be required before any significant increase in the amount of credit. BERR are leading on transposition of the Directive, and have convened a number of working groups to consider specific elements. We will have regard to emerging conclusions on proposed legislation as the project progresses.

Project scope detail

- 4.8 The concept of 'irresponsible lending' is now an explicit part of the fitness test, and the scope of the project is therefore limited to considerations of fitness, rather than to wider related concepts such as levels of over-indebtedness, or factors relating to social policies.
- 4.9 The text of the CCA covering the fitness test and the specific mention of 'irresponsible lending' is set out in Annexe A.
- 4.10 In most consumer credit lending transactions, the focus for any consideration of irresponsible lending will be the decision making process itself and the use of any information available which underpin the decision of whether or not to lend, and on what terms.

- 4.11 Considerations about the affordability of a product or amount (the consumer's ability to repay), and the likelihood of repayment (the consumer's expected level of risk) are a key and central part of most mainstream lending decisions.
- 4.12 The exact nature of these considerations, or the information needed to make responsible lending decisions will depend on the types of products involved and the individual consumer involved. For example, issues relating to decisions around medium or large loans secured on residential property will be different to those relating to small-amounts of credit in the home, payday lending or credit linked to the purchase of goods or services.
- 4.13 In considering the general scope of the project, the OFT needs to ensure that different products and different consumer groups are dealt with in a manner which is appropriate to the specific circumstances, and that there are no unintended regulatory consequences of the OFT's views – that is, the need to set standards for different markets and products according to the likelihood and significance of consumer harm, and therefore to ensure that burdens on business and consumers are not restrictive or that responsible avenues for consumer credit are not closed off.
- 4.14 Although decisions about affordability and the likelihood of repayment are the central concerns of business in making lending decisions, when viewed from the consumer side it may be helpful to look at the whole of a transaction as a series of interlinked stages which make up the lending package, including:
- advertising and marketing
 - selling techniques
 - product design
 - use of credit scoring techniques
 - appropriateness of product to borrower
 - sale of associated products and,
 - account management (including handling of default/arrears).

It may be that consideration of each of these factors on its own is not enough to further understand or define 'irresponsible lending', and that

consideration needs to be given to a combination of these stages alongside the central considerations of affordability and likelihood of repayment. Each of these stages in the lending transaction is briefly expanded below:

Advertising and marketing

- 4.15 Advertising and marketing tend to be the most common gateway to credit. Businesses are increasingly using behavioural marketing techniques and disaggregated marketing data to target their products at those groups of consumers who are most likely to take up demand.
- 4.16 Business to consumer advertising and marketing issues are covered by a variety of consumer protection laws, both within the CCA and sub-ordinate regulations and by wider laws such as the Consumer Protection from Unfair Trading Regulations 2008 (CPRs).
- 4.17 Despite the application of specific laws relating to advertising and marketing, it can be argued that the manner in which products are advertised is relevant to the project as it has a large bearing on the consumer's decision to borrow.
- 4.18 Issues of relevance to the project could include, but not be limited to: misleading advertising, transparency, comparative advertising, use of incentives, behavioural marketing techniques, and targeting of products at particular consumer groups.

Selling techniques

- 4.19 Closely related to the initial advertising or marketing of a product are the techniques used by businesses and business sales-teams in making an actual sale.
- 4.20 Issues of relevance to the project could include, but not be limited to: relationship selling, the use of testimonials, persuasion techniques, hard-selling, cold-calling and other unsolicited approaches, the interactions between lenders and market intermediaries, and the disclosure of fees and commissions.

Product design

- 4.21 Following on from the initial sale of product, there may be aspects of a product or the terms and conditions relating to that product, which may have deliberate or unforeseen negative effects on a consumer's ability to repay or likelihood of default.
- 4.22 Issues relevant to the project could include, but not be limited to: the transparency of a product's features, the way a product's features are communicated, any additional explanatory material, the flexibility of a product to change following changes in consumer circumstances or market conditions, and the communication of any changes.

Use of credit scoring techniques

- 4.23 Credit scoring and behavioural scoring techniques are a central part of the operation of modern consumer credit markets. Information is available through Credit Reference Agencies which can enable lenders to make better informed decisions on a consumer's ability to repay and likelihood of default.
- 4.24 It can be argued though that it is not just the level and type of information available which is important, but the way which the information is used.
- 4.25 Issues of relevance to the project could include, but not be limited to: decisions made without the use of credit scoring, the use of consumer information in targeting predatory lending, manual review of credit scoring decisions, communication of refusal, and reverse lending decisions – that is, basing a lending decision on the maximum amount a consumer can repay, regardless of need or suitability.

Appropriateness of product to borrower

- 4.26 Consumer credit is a core part of the modern economy and there are likely to be many times when making a decision to borrow using a particular product will be beneficial for a consumer. Consumer credit enables people to smooth their consumption levels and their living standards through different economic circumstances, borrowing in times of need and repaying through small, affordable repayments or deferring repayment to times of better financial circumstance.
- 4.27 The beneficial uses of credit can be both for the long-term, as in loans for education or mortgages etc or the short term, as in payday lending. The appropriateness of a product to a particular borrower will depend very much on the individual circumstances of the borrower and their needs and financial situation. For example, securing credit against residential property can ensure lower rates of repayment, but could cost more in the long-term and have very severe consequences should default occur, likewise short-term credit such as payday lending can be costly yet necessary in emergencies, but it may also be inappropriate if circumstances lead to roll-over lending.
- 4.28 Issues of relevance to the project could include, but not be limited to: securing unsecured credit, borrowing to pay off debts, use of running account credit, roll-over lending for home credit or payday loans, unsolicited increases in credit limits, and the use of credit card cheques.

Account management (including handling of default/arrears)

- 4.29 Most lending takes place over the medium to long-term. The decision to lend will have been made in one set of circumstances but the lifetime of the loan and its repayments usually goes on for months or years. Consumer or business circumstances may change. The manner in which an individual loan account is managed, both in terms of standard repayments and action on arrears or default, can have a large effect on the consumer involved.

4.30 Issues of relevance to the project could include, but not be limited to: communications of outstanding balance, early repayment options, basic administration of a loan book, including the effects of securitised loan-books, sale and purchase of debts, arrears handling, use of repayment holidays, variation of terms, default charges, action on default, including possession actions and charging orders.

OFT initial view on the project scope

4.31 Our initial view is that the project should cover the wider scope and include all of the stages of the lending process. This will help to ensure that the outcomes of the project are more useful for both businesses and consumers, as it would make clear our position across the range of matters listed, as opposed to simply on the narrower issue of the lending decision itself.

4.32 Widening the scope will also ensure that the OFT takes into account all of the relevant factors with regard to each lending product, enabling us to set minimum standards which are appropriate to high levels of consumer protection whilst also ensuring that burdens on business are minimised. For example, responsible approaches to product design and account management could provide the necessary levels of consumer protection so that the lending decision itself can still be flexible enough to allow for inevitable failure in some cases.

Question 1: Do you agree with the OFT initial view that the scope should cover all stages of a lending transaction?

Question 2: Are there any other factors which you think should be included within the scope of the project?

Question 3: Are there any factors which you think should not be included within the scope of the project?

Question 4: Do you have any other comments or suggestions on the scope of the project?

PROJECT APPROACH

Methodology

- 4.33 The project will involve information and evidence gathering through consultation with businesses, trade associations, consumer groups and other regulators. This consultation will cover the whole of the consumer credit market and involve lenders, intermediaries and advisers.
- 4.34 Information and evidence gathered will be analysed and assessed against the OFT's previous guidance on irresponsible lending and fitness generally. Regard will also be had to other OFT guidance including that on unfair relationships, unfair contract terms and the CPRs.
- 4.35 Different lending markets, products and practices will be looked at both individually, in order to assess any specific issues, and collectively to assess common themes and standards.
- 4.36 In the project, as well as listening to the views of all stakeholders, we will look at related legal and regulatory precedents both in the UK and internationally. This may include looking at any aspects of 'irresponsibility' which may occur in non-credit regulatory regimes.
- 4.37 From this analysis, the OFT will develop a set of minimum standards below which businesses may be considered to be acting irresponsibly upon which it will consult with business and consumer interests.
- 4.38 The final outcomes of the project will be put in draft to the consultees and published once comments have been given full consideration.

Question 5: Do you agree with or have any comments or suggestions relating to the proposed methodology?

5 FURTHER INFORMATION

- 5.1 More information about the Office of Fair Trading and our work can be found on the website at www.oft.gov.uk
- 5.2 Please send your comments by no later than 24 October 2008 via email to mark.hopkins@oft.gsi.gov.uk or by post to:

Mark Hopkins
Room 2C/O19
Office of Fair Trading
Fleetbank House
2-6 Salisbury Square
London
EC4Y 8JX
Fax: 020 7211 8123
Tel: 020 7211 8238

- 5.3 Responses will be made public at the end of this consultation unless you tell us that you do not agree to this.

ANNEXE A – TEXT OF CCA

A.1 The concept of 'irresponsible lending' is now written into statute in section 25 of the Consumer Credit Act 1974. The relevant paragraphs of the section are as follows, with those relating to irresponsible lending highlighted in bold:

- (2) In determining whether an applicant for a licence is a fit person for the purposes of this section the OFT shall have regard to any matters appearing to it to be relevant including (amongst other things –
 - (a) the applicant's skills, knowledge and experience in relation to consumer credit businesses, consumer hire businesses or ancillary credit businesses,
 - (b) such skills, knowledge and experience of other persons who the applicant proposes will participate in any business that would be carried on by him under the licence,
 - (c) practices and procedures that the applicant proposes to implement in connection with any such business,
 - (d) evidence of the kind mentioned in subsection (2A).

- (2A) That evidence is evidence tending to show that the applicant, or any of the applicant's employees, agents or associates (whether past or present) or, where the applicant is a body corporate, any person appearing to the OFT to be a controller of the body corporate or an associate of any such person, has—
 - (a) committed any offence involving fraud or other dishonesty or violence,
 - (b) contravened any provision made by or under—
 - (i) this Act,
 - (ii) Part 16 of the Financial Services and Markets Act 2000 so far as it relates to the consumer credit jurisdiction under that Part,
 - (iii) any other enactment regulating the provision of credit to individuals or other transactions with individuals,
 - (c) contravened any provision in force in an EEA State which corresponds to a provision of the kind mentioned in paragraph (b),
 - (d) practised discrimination on grounds of sex, colour, race or ethnic or national origins in, or in connection with, the carrying on of any business, or

- (e) engaged in business practices appearing to the OFT to be deceitful or oppressive or otherwise unfair or improper (whether unlawful or not).**

- (2B) For the purposes of subsection (2A)(e), the business practices which the OFT may consider to be deceitful or oppressive or otherwise unfair or improper include practices in the carrying on of a consumer credit business that appear to the OFT to involve irresponsible lending.'**

ANNEXE B

B COMMENTS OR COMPLAINTS ABOUT THE CONSULTATION PROCESS

- B.1 If you wish to comment on the conduct of this consultation or make a complaint about the way this consultation has been conducted, please write to:

Jessica Precious
OFT Consultation Co-ordinator
Room 5C/O39
Office of Fair Trading
Fleetbank House
2-6 Salisbury Square
London
EC4Y 8JX

ANNEXE C

List of Consultees

Advertising Standards Authority (ASA)
Advice Services Alliance
Advice UK
Association of British Insurers (ABI)
Association of British Credit Unions Ltd
Association of Finance Brokers (AFB)
Association of Mortgage Intermediaries (AMI)
Association of Payment Clearing Services (APACS)
Banking Code Standards Board (BCSB)
Bar Council and Bar Standards Board
Better Regulation Commission (BRC)
British Bankers Association (BBA)
British Chamber of Commerce (BCC)
British Cheque Cashers Association
British Retail Consortium (BRC)
Building Societies Association (BSA)
Callcredit
Christians Against Poverty
Church Action on Poverty
Citizens Advice
Citizens Advice Scotland
Confederation of British Industry (CBI)
Consumer Credit Association UK (CCAUK)
Consumer Credit Counselling Service (CCCS)
Consumer Credit Trade Association (CCTA)
Council of Mortgage Lenders (CML)
Credit Services Association (CSA)
Debt Managers Standards Association (DEMSA)
Debt on our Doorstep
Department for Business, Enterprise and Regulatory Reform (BERR)
Department of Enterprise, Trade and Investment in Northern Ireland (DETI NI)
Direct Marketing Association (DMA)

Enforcement Services Association
Equifax plc
Experian Group Limited
Federation of Small Businesses
Federation of Small Businesses (Scotland)
Finance & Leasing Association (FLA)
Finance Industry Standards Association (FISA)
Financial Ombudsman Service (FOS)
Financial Services Authority (FSA)
Financial Services Consumer Panel
Foundation for Credit Counselling
General Consumer Council for Northern Ireland (GCC NI)
H M Treasury (HMT)
Information Commissioners Office (ICO)
Insolvency Service
Institute of Money Advisers (formerly MAA)
LACORS
Law Society of England and Wales
Law Society of Northern Ireland
Law Society of Scotland
Mail Order Traders Association (MOTA)
Ministry of Justice (MoJ)
Money Advice Liaison Group (MALG)
Money Advice Scotland (MAS)
Money Advice Trust (MAT)
National Consumer Council (NCC)
National Consumer Federation
National Debtline
National Pawnbrokers Association (NPA)
Northern Ireland Association of Citizens Advice Bureaux
Payplan Limited
Personal Finance Research Centre
PhonepayPlus
Radio Advertising Clearance Centre
Research Institute for Consumer Affairs (RICA)
Retail Motor Industry Federation (RMIF)
SCOTSS

Scottish Chamber of Commerce (SCC)
Scottish Consumer Council (SCC)
Scottish Executive
Trading Standards Institute
Welsh Consumer Council
Which?