StepChange Debt Charity response to FCA credit information market study terms of reference MS19/1.1

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StepChange Debt Charity is the largest specialist debt advice charity helping people across the UK. We provide free debt advice to people over the telephone and online. In 2018, over 650,000 people contacted us for help and support with their problem debt and we provided full debt advice to 357,000 people.

Preamble

We welcome the FCA's decision to undertake a credit information market study. Through our experience as a debt advice provider, we are aware of a number of issues linked to credit information that affect the extent of problem debt and access to affordable credit. We broadly welcome the four themes the FCA proposes to use to explore questions linked to credit information. It is particularly important that the study includes a sharp focus on issues that are likely to have the greatest impact on people with vulnerable characteristics and welcome the FCA's commitment to look specifically at this issue (4.13).

In taking forward the study, the FCA should look widely at credit information. This means identifying the positive outcomes for consumers credit information supports and asking basic questions about the extent to which the existing credit information system supports these outcomes, and whether there are alternative, more effective approaches that could be supported by the regulator or others.

In this response, we have outlined the issues we believe it is crucial the FCA addresses through the market study to ensure credit information works well for consumers.

The relationship between credit information and problem debt

StepChange data strongly suggests those who experience problem debt have often accumulated one or more debts when they were already in financial difficulty. Signs of difficulty that credit information might be expected to address include being over-extended, having fallen behind on debt repayments, or having fallen behind on utility and rent payments. For example, in our recent report, *Red card: subprime credit cards and problem debt*, we found that 25% of those in the general population with a subprime card reported being behind on at least one were behind on at least essential bill, including rent, utilities and debt repayments, when they took out the card (this rose to 47% among StepChange debt advice clients).[1]

Problem debt is also usually linked to multiple debts. StepChange clients have on average six unsecured debts when they seek debt advice: clients are most likely to have multiple credit card and payday loan debts, with an average of 2.7 debts for each client with these types of debt.[2] Most clients also have debts across multiple <u>types</u> of product, most often including an overdraft and one or more credit cards and/or personal loans. Packages of debt tend to vary across income groups, with high cost credit products such as catalogue credit common among those with low to middle incomes, and those with middle incomes more likely to have debts such as car hire purchase agreements.

The extent of problem debt across multiple debts and products reflects a lack of prescription and clarity in creditworthiness rules, compliance issues and a failure by firms to adequately monitor and

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[1] StepChange (2019) *Red card: subprime credit cards and problem debt*.
[2] Data based on StepChange Debt Charity client data Jan-June 2019, based on 213,843 clients advised.

respond to a customer's circumstances. Credit products may also interact in ways that cause or exacerbate financial problems. Limitations in data sharing and credit information contribute to these problems: firms may not be aware a customer has experienced repayment difficulties with products not held by the firm, or the nature of these difficulties. This might be because firms typically update credit information on a monthly basis for products like revolving credit, which leads to a lag in reporting difficulties, or because data does not include information such as whether or not a customer is making a minimum payment, which might help a firm understand if a pattern of repayment behaviour across a range of products suggests difficulty. While there is now a clear expectation that high cost short-term credit firms will update credit information in real-time, we continue to see clients who have accumulated loans through high frequency borrowing and we are unclear as to the extent of participation in real-time data sharing and the effectiveness of this system in preventing inappropriate lending.

We are also unclear as to the extent that firms use credit information to effectively to prevent financial difficulty. There is a gap between feedback from firms about how thoroughly and robustly they undertake creditworthiness and affordability checks and feedback from our clients about the extent to which they were already in financial difficulty when they took out a credit product. A central theme that may emerge through the market study is the potential to add additional sources of data to credit records to more easily identify financial problems like arrears in creditworthiness assessments. It is important that a proportionate emphasis is also put on firm practice and conduct in using credit information effectively.

The limitations of credit information make it more likely that firm will lend or increase limits after a customer has shown signs of repayment difficulty, and less likely firms will intervene before financial difficulties escalate. To understand the extent to which limitations in credit information contribute to avoidable problem debt, the FCA should:

- identify gaps in credit information that undermine effective creditworthiness and affordability assessments and early intervention;
- assess the extent to which credit information is shared by firms on a comprehensive and timely basis, i.e., regardless of the scope of credit records, whether data sharing is sufficiently effective to ensure the system fulfils its potential; and
- assess how effectively firms use credit information in supporting creditworthiness and affordability assessments.

By undertaking this analysis, the FCA can identify how the credit information system can be developed, and what actions can be taken by firms, to better support good lending decisions and reduce problem debt.

The role of credit information in shaping access to affordable credit

We welcomed the FCA's recent update on its work in this area (*Alternatives to high cost credit*) but are concerned that the focus of the FCA's work on this issue in relation to credit information falls primarily on narrow issues affecting affordable credit providers (like access among credit unions and CDFIs to appropriate data).

Credit information has a central role in dictating access to mainstream credit: firms operating at scale rely on this data, in tandem with their own automated systems, to make lending decisions. Credit information also affects risk-based pricing; the reliability of this data in predicting risk is therefore central to the extent to which the market works fairly for consumers.

To consider this issue, the FCA should examine the relationship between credit information, access to different forms of credit and pricing. We would particularly like to see the FCA conduct analysis to compare consumers' underlying circumstances, credit information (for example, using credit scores) and patterns of credit use and pricing. This analysis would help identify where limitations in credit information are a significant factor in lack of access to appropriate credit products or inappropriately priced products. This type of analysis would give help policy makers interested in financial inclusion and affordable credit a much clearer understanding of the nature of the challenges they are seeking to address, including to what extent issues in access or high costs relate to limitations in credit information or other factors like the inability to lend to consumers at a responsible interest rate taking into account credit risk. In turn, it would be clearer where options like improving the quality, sharing or use of credit information would make a difference, or where providing alternatives to commercial credit through capital investment or subsidy must be considered.

At present, there is a vigorous and well-intentioned public discussion among a range of consumer, policy and regulatory stakeholders about reducing use of high cost credit and increasing access to affordable credit. However, the reality is that many of the factors that affect access to credit are not visible to policy makers due to the absence of this type of segmentation analysis.

We recognise this analysis would not be straightforward, but believe it would have important value for the FCA, its stakeholders and policy makers in understanding what steps can be taken to address inappropriate credit use and support access to affordable credit. The exercise would also help understand to what extent the present system of credit information is supporting good consumer outcomes.

Credit information and recovery from problem debt

At present, credit reporting for those who experience problem debt and/or enter a debt solution appears to be inconsistent. There is, rightly, a range of flexible options available to firms to support customers who experience financial difficulty; for example, in negotiation with a client or debt advice agency, firms may agree to a payment holiday, a temporary token payment, a reduced payment or a suspension of interest charges and fees. In exceptional circumstances, firms may write-off debt.

Depending on the situation, firms then use a range of credit information markers, including default, 'reduced payment' or 'arrangement to pay' flags. Firms that agree to some degree of forbearance may not use any negative marker. It is not clear how these choices are made, and it is likely to be a matter of individual lender preference and policy.

Taken together, the inconsistency in credit reporting may undermine the effectiveness of credit information as a tool in making creditworthiness assessments because the information recorded does not reflect underlying payment behaviour; and there is little scope to differentiate between a spectrum of behaviours relevant to understanding credit risk.

We are particularly concerned that credit information does not work well for those who experience problem debt and put in place a debt solution that involves rescheduled payment. In this scenario, the most likely reporting outcome is that a negative arrangement to pay flag is placed on a credit file, with a detrimental impact on a credit score. Subsequent successful repayment, however, seems to offer no positive benefit. The negative flag remains for six years or longer, after which it is no longer included in the credit report and the credit score may improve. We would urge the FCA to look at the lack of transparency for consumers about how different approaches to dealing with payment difficulties will affect access to credit and the price of credit in the future when those financial difficulties are resolved.

Credit risk is shared between lender and borrowers; when borrowers cannot repay outstanding debts, this often reflects inappropriate lending or an unpredictable change of circumstances. Repayment in agreement with a creditor represents a positive payment behaviour that it often does not make sense to overlook and consider in narrow terms as bad debt. If the credit information system had the capacity to better reflect a spectrum of repayment outcomes, it would also offer a more in-depth picture of payment behaviour and may reduce unnecessary financial exclusion (and the displacement of creditworthy borrowers to more risky high cost products).

The effect of credit information on consumer behaviour

In the ToR, the FCA notes that poor consumer awareness and understanding of credit information could affect creditworthiness, access to credit or the price of credit (4.22). We agree but believe the FCA should use the market study to consider a wider range of negative consequences linked to consumers' awareness and understanding of credit information. This includes:

- Credit information is an implicit, and sometimes explicit, 'stick' that we see often lead to negative behaviours like continuing to make debt repayments despite hardship, taking out credit to repay debt (and compounding financial problems), and delaying engaging with creditors or seeking debt advice. We are concerned that the ToR (2.3) reflect the extent to which the 'incentive' role of credit information has been accepted uncritically; we say more below about how the way that credit information affects consumers' understanding of credit demands more scrutiny, but it is also important the market study identifies the extent to which the incentive role of credit information directly leads to negative rather than positive effects.
- People who have an impaired credit record or are new to credit may choose to use credit products (marketed as 'credit builder' products or otherwise) explicitly to build their credit rating, often encouraged to do so by marketing that may exaggerate the positive benefits of a credit score, because they believe that their credit record affects access to credit or other financial services; by using these products, people take on risk that may lead to adverse outcomes.
- Firms that offer consumers a means of checking their credit record increasingly act as credit intermediaries: this closely links the act of checking a credit record with the decision to take out credit; this may lead people to take out credit they would not otherwise have used or lead people to use inappropriate (or sub-optimum) products because they are sign-posted to a more narrow range of options than might be available to them.

Problems linked to ‘credit builder’ products emerged strongly in our recent work on subprime credit cards. Of clients who reported that the main reason they took out a subprime credit card (defined as a card with an APR of 30% or more) was to build their credit rating (18%), half went on to use the card in practice for this purpose; the most common reasons people actually used the products were to meet day to day living expenses or unexpected costs and repay debt. This suggests a pattern in which many of those who take out credit builder products because they are concerned about their credit rating encounter financial and ultimately repayment difficulty, and raises questions about how credit builder products that carry significant risks and costs are marketed to financially vulnerable people.

More generally, credit builder products are problematic given that a credit score is only one factor affecting creditworthiness assessments. Although in principle it is possible to ‘build’ a credit score without borrowing (by spending on a card and repaying the balance in full each month), our experience is that advice from firms fails to emphasise this and implies instead that the ‘right’ way to use a credit builder card is to stay within the limit and always make at least minimum payments. (This issue appears to stem in part from confusion between ‘credit builder’ and ‘low and grow’ product structures.) Many people using these products, which tend to carry high interests rates compared to average market rates, are therefore likely to pay significant amounts in interest charges unnecessarily.

Commentary by respondents to our survey of clients with a subprime card also suggested some serious misunderstandings of credit information are common; for example, one client reported taking out a credit builder card when they were already struggling with debt, hoping to use the card to improve their credit rating, access lower cost credit and reduce the cost of repayments. This type of example touches on a broader question about the extent to which the cultural import of credit information, which is created and sustained by an ‘ecosystem’ of credit record agencies, credit information intermediaries, firms and other organisations in the consumer credit sector, serves the public interest. It is beneficial for credit information providers and credit firms for people to place an outsized significance on their credit rating, even if this leads to poor decision-making and negative outcomes for some individuals.

To ensure these issues are considered fully, the FCA should look not only at how consumers understand and use credit information, but how firms (including CRAs, credit information intermediaries, comparison websites and creditors) present and use credit information, how credit information influences credit market structures and, in light of consumer experiences, whether this leads to harm and detriment. The FCA should particularly examine the consumer harm linked to credit builder products and explore options to better equip consumers to avoid difficulties, such as disclosure requirements and ‘myth-busting’ work with the Money Advice and Pensions Service and/or other stakeholders.

The governance of credit information

Finally, the ToR describe arrangements for collecting and sharing credit information but do not link the governance of credit information to the themes of the market study. This subject is particularly relevant to the future evolution of credit information.

In general, we are concerned that the way that the collection and sharing of credit data that affects a range of goods like financial services, utilities and housing is subject to limited independent checks and scrutiny. This issue has become particularly acute as the role of credit information in people's lives has grown. We note, for example, that credit checks are now routinely conducted by tenant checking services on behalf of landlords, translating a credit record into risk assessment advice, and Experian's Rental Exchange tool now allows people to submit rental data to their credit record directly or through third party tools (and that this rental payment data may be viewed by some landlords as well as creditors).

We are concerned that, while there is understandable enthusiasm among consumers for an additional means of improving their credit record, insufficient attention has been paid to the policy issues raised by these developments: many people will see their credit record negatively affected if they miss rental payments and in a recent survey of our debt advice clients, one third reported that they believed credit information had negatively affected their access to housing.[3] There have been additional discussions between government, credit reference agencies and stakeholders about the potential to incorporate other sources of private or public data into credit information, such as council tax payment records, which might create similar issues.

The Steering Committee on Reciprocity shapes how information is collected and shared and consists of creditors and financial organisations (and those collecting and sharing information must also comply with relevant data protection requirements). These arrangements are not sufficient to protect the public interest as credit information evolves in a way that can have far-reaching impacts on social outcomes. At present, there is no mechanism (beyond data privacy regulation) for challenge on behalf of consumers about how credit information is collected, shared and used, nor an independent actor within governance arrangements with the capacity and incentive to identify public policy issues and liaise with elected policy makers and other stakeholders. Ultimately, the weakness of credit information governance arrangements may constrain rather than promote innovative uses of data because the arrangements are insufficiently transparent, inclusive and robust to provide a trusted platform for data sharing.

Next steps

We hope this summary of concerns is helpful in taking forward the market study. As noted, we broadly welcome the themes the FCA has identified to guide the study. However, we have noted a number of issues the FCA should consider to address the impact of credit information on consumers that are not yet touched on fully in the ToR. StepChange is glad to provide any information or insight as a debt advice provider that is helpful, and we are happy to work further with the FCA to support the market study.

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[3] StepChange Debt Charity (2018) *Locked Out: Examining the impact of problem debt on people's housing situations*