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Regulating by Values: Is a sustainable responsible lending policy required?

Report of the Social Market Foundation seminar 2006
Edited by Barney Gough

The Social Market Foundation

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Preface

Stephen Knight, Executive Chairman, GMAC-RFC

We are proud to be the only lender in the world to have formed a single-purpose charity targeted at preventing borrower repossession wherever it occurs, and whoever the lender is. It is in furtherance of that cause that we were pleased to sponsor this debate on responsible lending covering a wide range of topics, some of which are mentioned below.

Of course, responsibility in lending should be shared between borrowers and lenders. As lenders we must ensure that our products are fair, competitive, suitable and presented transparently. But there are also key roles for consumers in responsible borrowing, and for regulators, public policymakers and consumer groups in commenting responsibly.

Some predictions over the last few years about collapsing property prices and a crisis in arrears and repossessions, based on outdated thinking, have not come true and have worried borrowers unnecessarily. We were pleased to share at the conference newer statistics and measures for assessing the likelihood of these outcomes.

Consumer borrowing is high but indicators published by the Council of Mortgage Lenders, for example, suggest affordability is still manageable by historic standards. This is not to say borrowers and lenders aren't facing challenges, which will be intensified if interest rates keep rising. But there is no reason to believe that many thousands of borrowers will be turned into forced sellers any time soon, which, in turn, is a prerequisite of a significant property price reversal.

Much progress has been made by lenders in terms of underwriting mortgage applicants. The old-fashioned system

of checking applicants' income, applying an arbitrary multiple and then concluding that the mortgage can be afforded served borrowers badly, particularly in the aftermath of the last recession. Today's more sophisticated credit scoring and profiling, crucially assessing attitude to credit and ability to manage debt, is allowing more realistic decisions to be made.

The greatest benefit to arise from conferences such as these derives from listening to others. Lenders in particular will always benefit from listening to the impact their products, policies and actions have on consumers' lives via MPs and consumer groups. And, hopefully, what we had to share at the debate will assist others in their representation of consumers and ability to help them. We commend the Social Market Foundation for the work they do in this regard.

Considered, civilised and lively debate, where each individual spends most of the time listening, is the way to solve most problems.

Overview from the SMF

Ann Rossiter, Director, SMF

A rapidly increasing number of households in the UK are struggling with personal debt, which has more than doubled in this country since the turn of the century.[1] Personal insolvencies have reached record levels and, with interest rates steadily climbing, are likely to rise further.[2]

The problems associated with increased over-indebtedness have received much media attention, with countless stories of the misery caused to individuals and households. In a number of cases, these stories have been accompanied by instances of seemingly irresponsible lending. A range of industry practices, from the marketing of loans, through to the assessment of applications and after-sales services, have come in for criticism from consumer bodies and the media. Much of this criticism has been directed at credit card companies and other sources of unsecured debt, though mortgage lenders have not escaped unscathed.

In this climate, personal debt has become an issue of rising concern for policymakers. There have been calls for policy to promote more 'responsible lending'. However, agreement on the definition of this concept, and the implications for both government policy and for the industry, has been difficult. In particular, its relation to individuals' responsibility for their own financial decisions has proved a contentious issue. In terms of government action, the concentration has been on strengthening regulation of both marketing and lending policies, but policymakers are now looking for a more comprehensive approach.

This seminar brought together some of the most important minds from within the sector to discuss whether a sustainable

1 Office for National Statistics, *Monthly Financial Statistics December 2006* (http://www.statistics.gov.uk/downloads/theme_economy/FinStats_Jan07.pdf, 12/2006).

2 The Insolvency Service, *Insolvency Quarterly Statistics Q3 2006* (http://www.insolvency.gov.uk/otherinformation/statistics/200611/index.htm01/2007).

responsible lending policy is required in response to the difficulties over personal debt. It also asked what form such a policy might take and how government can best work with the lending industry to find a way forward.

Attendance list

Speakers

John McFall MP, Chair, Treasury Select Committee
Stephen Knight, Executive Chairman, GMAC-RFC
Fiona Price, Director, Cross Market Interventions, DTI
Peter Tutton, Social Policy Officer, Citizens Advice

Attendees

Names	Organisation
Joanne Aitkin	Mortgage Finance Gazette
Iain Anderson	Cicero Consulting
Rebecca Atkinson	Mortgage Strategy
Tina Barnes	Citizens Advice
Jackie Bennett	Council of Mortgage Lenders
Clive Betts MP	Labour Party
Camilla Codrington	Media Strategy
Kirstina Combe	MBNA
Keith Davis	HM Treasury
Becca Downing	Cabinet Office
Ben Forsyth	Prudential/Egg
Damon Gibbons	Debt on our Doorstep
Jessica Gilbert	Lexington Communications
Helen Goodman MP	Labour Party
Natalie Helm	Fishburn Hedges
Jo Hillier	Opinion Leader
Matt Holmes	Lexington Communications
Marilyn Holness	FSA
Jonathan Horsman	Project Associates
Pula Houghton	Which?
Jahanara Hussain	Toynbee Hall
Ilan Jacobs	GE Money

Carole King	Provident Financial
Jeff Knight	GMAC-RFC
Kirsty Marshall	Lansons
Eileen McMillan	GMAC-RFC
Vicky Mitchell	Capital One Bank Europe
John Murray	Lending Strategy
Robin Newham	HM Treasury
Mark Persad	Financial Services Authority
Chili Reid	adviceUK
Paul Ross	British Bankers' Association
John Rowland	Cicero Consulting
Edward Simpson	Finance and Leasing Association
Andrew Vereker	HM Treasury
Claudia Wood	Resolution Foundation
Melanie Worthy	Politics International

Speaker 1: John McFall MP, Chair, Treasury Select Committee

John McFall has been Chair of the Treasury Select Committee since July 2001. The Committee's responsibilities include scrutiny of the policy, expenditure and administration of HM Treasury, the Bank of England and the Financial Services Authority (FSA), which regulate the financial services industry.

John is MP for West Dunbartonshire, where he has been particularly active in promoting regeneration. Since Labour came to power in 1997, he has also served as a government whip and parliamentary undersecretary in the Northern Ireland Office.

The Treasury Committee has been looking at the issue of transparency of credit card charges, and restoring confidence in long-term savings, for quite a number of years. It is also an area that is very much on the agenda in terms of our future work.

The lenders and the consumer groups' regulators that we examined during our inquiries all recognised the importance of responsible lending, but had difficulty setting an agreed definition. For example, Barclays told us that unlike many cases of clearly irresponsible lending characterised by misleading or exploitative practices, such as knowingly lending to customers who are overcommitted, responsible lending is not easy to define.

Lenders tended to believe that responsible lending included aspects such as clear marketing and promoting awareness of free financial advice organisations. But, in comparison, consumer groups emphasised the importance of lenders assessing

a borrower's income and expenditure before lending, and also encouraging consumers to consider for themselves the affordability of loans.

In its report into credit card charges, the Treasury Committee concluded that responsible lending means more than simply meeting the minimum legal requirements for lending companies.[3] It also includes driving forward best practice, and 'treating customers fairly'. In terms of this latter aspect, it has been the Financial Services Authority, the regulator of banks and lenders, that has dragged industry along over the years. To correct this, there needs to be more initiative from the industry itself. Having carried out its investigations, the committee made a number of recommendations aimed at encouraging responsible lending, including putting in place rules to restrict unsolicited increases in credit and the issuing of credit card charges, which in our eyes appeared to be entirely iniquitous.

As the Treasury Committee noted in our report, the lending market has changed significantly from the time when people would have a current account, mortgage, personal loan and credit card with the same bank. Financial liberalisation has brought many benefits to consumers, including greater competition and product innovation. However, it has also resulted in people having relationships with many different lenders. Indeed, EPax has indicated that 21% of people now hold four or more credit cards. In these circumstances, it is important that there is comprehensive data sharing within the industry so that firms can accurately assess a consumer's ability to repay debt.

We have seen some welcome initiatives from individual firms in this respect, but much more needs to be done to ensure that this best practice spreads across the industry. It can be difficult when people have multiple credit cards but make the minimum repayments necessary. This means they are not flagged up by systems that are designed to keep only information on those who have been in arrears. But the potential risks of not ensuring proper data sharing have been seen in the tragic and highly politicised cases reported in the media over the last few years.

Overall, there has not been enough impetus put into data sharing, particularly from those in the industry. While there have been a number of initiatives, there are still information 'black holes' that need to be filled so that lenders can undertake

3 Treasury Select Committee, *Credit Card Charges and Marketing* (London: The Stationery Office Ltd, 2005).

proper risk assessment. I do also recognise that the government has a role to play in this area, especially concerning the issue of the so-called historic accounts, where consent to share the data was not obtained when the account was opened. And I hope the DTI consultation on this issue will result in major improvements.

In the Banking Code, banks state that before they lend a person any money or increase their overdraft, credit card limit or other borrowing, 'we will assess whether we feel you will be able to repay it'.[4] I hope the current review of the Banking Code will expand on this and identify best practice for banks to follow. There is scope for improvement, particularly in the credit card market, where a long period could elapse between the initial credit check conducted by the bank, and the time at which the consumer draws down the credit.

Responsible lending also requires responsible marketing and selling practices, and for this it is important that a bank's corporate commitment to responsible lending is not subverted at branch level by inappropriate sales incentives or commission. I fully understand the pressures that individual employees are under to achieve their targets at branch level, but this is an issue that corporate management should both be aware of and take into account when setting policy.

However, even with entirely responsible lending practices in place, there will always be cases of people getting into financial difficulties. In these circumstances, it is important that people have access to free and impartial advice to help them resolve

Responsible lending also requires responsible marketing and selling practices, and for this it is important that a bank's corporate commitment to responsible lending is not subverted at branch level by inappropriate sales incentives or commission.

4 British Bankers' Association, *The Banking Code* (London: BBA Enterprises Ltd, 2005).

their problems. The support from the financial services industry has been vital in this respect, with advice organisations such as Money Advice Trust and Citizens Advice providing help in often difficult circumstances.

In addition, the government has provided £45 million to increase the provision of debt advice through the financial inclusion fund. This initiative has resulted in the recruitment of over 450 debt advisers, and should help over 100,000 people obtain access to free and impartial debt advice. But funding has so far only been allocated for the years 2006-07 and 2007-08. In our latest report on financial inclusion, we of the Treasury Select Committee noted that there is little point in the government setting up this fund and putting in place debt advisers, if the structure then collapses in eighteen months time.[5] This is an issue that the government urgently needs to take action on, so there can be a long-term strategy for financial inclusion.

Banks are now finding that their more lenient lending practices in previous years are resulting in increased bad debts in the unsecured credit market. This rise is occurring despite a relatively benign economic environment with historically low interest rates and unemployment. If a bank has lent irresponsibly to a consumer, then it can have no complaint when the consumer enters into an individual voluntary agreement (IVA) or files for bankruptcy.

The former of these has risen in popularity over the last few years in particular. But there are still some significant issues surrounding IVAs. As with all financial transactions, it is important that the consequences of taking out an IVA are fully explained to the consumer. There is also the worry that the advice consumers are receiving is unduly influenced by the commission available to the adviser. Certainly in some cases of IVAs that I have encountered, it seems to be the consumer who pays at the end of the day: the IVA does well, the bank eventually gets its money back, but the consumer is left paying thousands of pounds in extra repayments. This is a situation that needs to be addressed.

5 Treasury Select Committee, *Financial Inclusion: Credit, savings, advice and insurance* (London: The Stationery Office Ltd, 2006).

During the committee's investigations, I have therefore identified several elements within responsible lending, including:

- comprehensive data sharing
- the thorough assessment of consumers' ability to repay the debt before lending
- responsible selling practices
- help for people if they fall into difficulties and cannot afford to repay the debt.

As I mentioned at the beginning, we are continually monitoring whether the recommendations from our Treasury Committee report have been implemented. Issues such as data sharing and the correct use of annual percentage rate (APR) statistics in selling practices are still very much on the agenda.

Progress has been made on the APR issue – there is now a single definition. But there are still some ten or eleven different methods that companies use to calculate interest. The companies claim that this is a result of product innovation. But the Committee has made it clear that if there's an asymmetry of information, in which the customer has not been made aware of all the details of the loan deal, then this represents an unfair playing field and something has to be changed.

While we have made progress in the past few years, there are clearly still some big issues that need to be resolved. Just tackling problems with APR would result in a full agenda for the Committee and myself over the next few years. There may be some comfort for the lobbyists here today that I've got other things to do – my total attention will not be simply on APR issues. But I can guarantee that our wary eye will be there.

Speaker 2: Stephen Knight, Executive Chairman, GMAC-RFC

Stephen Knight is the current Executive Chairman of GMAC-RFC, the tenth largest lender in the UK mortgage market. GMAC is the leading lender within the non-conforming sector, which provides mortgages for those borrowers who are unable to obtain a loan in the mainstream market, either because of their credit history or other specific mortgage requirements. Both this sector and GMAC itself have shown strong growth over the last decade.

In total Stephen has over 30 years of experience in mortgages, having worked at Halifax and Citibank early in his career before becoming founder and chairman of Private Label, the UK's first mortgage packager. He has also held non-executive directorships of a number of companies, including John Charcol, which have resulted in several industry awards, and has written two books on the industry.

I intend to cover just three topics during my speech today: increased sophistication in underwriting; the use of industry statistics to inform the responsible lending debate; and the role of responsible commentating.

First, underwriting techniques. In the past, lenders would leave mortgage applicants waiting around for weeks while they were applying for employment records. Having then secured a piece of paper stating a particular income, they applied a simple multiple to that figure, and then made a giant leap of faith that because the applicant has got the income, they have got the financial ability to afford the mortgage. And in a large number of cases this was incorrect, as was made evident in the recession

of the early 1990s.

This approach to mortgage underwriting, in which simple income multiples were used to assess ability to pay, is still promoted by some commentators even today, despite the fact that it often lets customers down very badly and particularly the most vulnerable customers.

Lenders learned from the experience of the last recession that some people can afford a high income multiple, while others can afford no more than two times their income. And because of this disparity, simply checking someone's income is actually much less important than determining their attitude to credit, and their ability to understand and manage debt. A number of lenders have, therefore, adopted a much more sophisticated approach to mortgage underwriting.

Today there are three different credit bureaux, and increasingly they are able to share data on borrowers' current loan, credit card and mortgage accounts. This data has allowed those lenders willing and able to invest in technology to profile accurately customers as to their ability and propensity to pay, and to manage debt. Credit scorecards have evolved, initially managed alongside manual underwriting and eventually taking over entirely. These scorecards allow lenders to identify the characteristics of a mortgage application most closely associated with historically good or bad arrears performance, and use this to forecast the risk associated with any particular new applicant.

Prudent lenders have been able to introduce various different automated affordability tests, so as to predict likely income range. In addition, electronic identification has greatly reduced the ability to instigate paper identity fraud and quality assurance checks – for example, telephone calls to employers, prudent post-offer sampling etc. – have further added to the accuracy of affordability checks.

The final piece of the jigsaw in improving the underwriting procedure has been to remove much of the human element. There are many instances where the so-called underwriting instincts of a branch manager have led to the right decision in a particular application, but there are twice as many examples where human error, and the vulnerability of humans to influence and leverage, has produced a wrong decision. And I will now share with you some never-before published statistics that

prove these points overwhelmingly.

The Council of Mortgage Lenders (CML) publishes arrears statistics for the entire industry, with prime mainstream lending as its main source. Despite the fact that our lending includes a higher proportion of niche buy-to-let and self-certified mortgages (that are normally associated with greater risk) than the overall CML sample, our serious arrears still outperform the industry benchmark. This is a direct result of the automated underwriting procedures that we have put in place over the last three years. Similarly our sub-prime lending (which is lending with the aim of rehabilitating borrowers with previous credit difficulties so they can go back to the mainstream market) shows levels of arrears that are significantly lower than the industry benchmarks applied by Fitch, the independent credit rating agency. Lastly, we have also found that the rate of complaints using our system is far lower than lenders using the old income-multiple based approach.

This is all evidence that trying to establish a borrower's income down to the last penny, applying simple multiples to that figure and assuming that they have the ability to repay, actually has little to do with consumers' protection or consumer advantage. The lending industry, save for a few stragglers, has moved on in this debate, and we need public policymakers to move on with us.

I now turn to the more general issue of house prices and affordability. Over the last two decades house prices have risen far faster than incomes. Average house prices, which in 1985 stood at 3.4 times the average wage, are now over six times the average wage in this country. These numbers often cause great

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concern among industry commentators and public policymakers, leading to regular predictions of a house price collapse. But the formula of comparing average house prices to an average single person's income is so outdated as to be of little value – as witnessed by the fact that there has been no collapse, despite all the predictions.

To give but one example of the irrelevance of these figures, the national average income is used, which includes the income of those who are not currently and never want to be homeowners, which clearly distorts the calculation. Moreover, for some years now the majority of mortgages have been funded by two incomes, not one.

It is, therefore, much more instructive when judging issues of affordability to look at figures on the initial mortgage interest a person pays as a percentage of gross and net income at the time of application. According to the CML, borrowers were typically paying 26% of their net income on a mortgage some 26 years ago, which went up to 37% in 1990 (the time of the last property market crash).[6] The latest figures show it to be at just 21% – a historically low figure.

That is not to say, of course, that the general level of house prices and consumer indebtedness is not a concern, or does not need to be a concern for lenders and public policymakers. It is a concern. But these figures demonstrate that we are not on the edge of a crisis, which some would have us believe.

The same conclusion can be reached by looking at the current level of arrears. It is certainly a worrying trend that arrears, having bottomed out in 2004, have started to rise again. But current arrears levels are not at crisis or even historically high numbers. Serious arrears are equivalent in value to less than 0.5% of total mortgages outstanding, with arrears in general only around the same levels seen in 2002 and over a third less than they were in 1998.[7] And I do not remember a great worry over affordability back then. The same can be said for figures on repossession.

The main reasons for house price acceleration can be found in significant social trends. Until these social trends change, it is difficult to see a house price collapse occurring. The first of these trends is an inexorable rise in the number of household formations from 19 million in 1991 to 21 million in the cur-

6 Council of Mortgage Lenders, *Loans for Home Purchase: Lending and affordability* (http://www.cml.org.uk/cml/filegrab/2ML4.xls?ref=4626,12/2006).

7 Council of Mortgage Lenders, *Mortgages Arrears Semi-Annual Statistics* (http://www.cml.org.uk/cml/filegrab/AP1.xls?ref=2750,12/2006).

rent year and 26 million forecast for 2026. Associated with this, there has been a steady reduction in the number of people within each household from 2.45 in 1991 to 2.31 today and 2.1 forecasted for 2026. Marital break-up and more people living alone are important drivers of this trend.

Inward migration in excess of outward migration is a second population-related trend that is creating additional pressure on increased house prices. In addition to these pressures from the demand side, new house building is at its lowest for nearly 40 years, impeded in part by planning bureaucracy – an area that I know the government intends to address.

If interest rates keep rising throughout 2007-08, alongside an increase in inflation and an increase in unemployment, then of course borrowers in general and the lending industry in particular face some serious problems. But those are the only conditions that might contribute to a house price collapse. Average house prices may be high in relation to average incomes (although not nearly as high as the six times ratio reflected in the updated formula). But affordability remains reasonably comfortable for most and there's no reason to believe that there will be significant numbers of forced sellers, as there were in the last recession.

Responsible lending together with responsible borrowing, which perhaps we discuss too little, is our highest priority within the mortgage industry. But I also believe that responsible commenting and public policymaking is important. The more temperate, considered and grounded in fact the comments are, the less harm will be caused to mortgage borrowers, particularly those who are vulnerable. As lenders, we are only too well aware of the panic selling that sometimes follows intemperate predictions of a house price collapse. Anyone who followed that advice in the last few years has been caused significant personal financial damage. Comments made about income multiples and income checking, without any detailed understanding of the profiled and predictive underwriting that lenders now use, can divert resource away from serving customers and into defending the new underwriting methods.

We at GMAC-RFC operate in a dozen or so countries around the world, and in many of them, particularly in continental Europe, consumers are being significantly disadvantaged

by over-regulation, in part because of attempts at protection. In France, for example, it is determined to be irresponsible lending if more than a predetermined percentage of income is advanced by way of mortgage – that percentage is predetermined by policymakers. As a result, there is less home ownership in that country, less product choice, there's no freedom to release equity or consumer empowerment that derives from that, and there is more fragility in their economy.

In Germany, by way of another example, it is simply impossible to complete a mortgage quickly. There are black and white rules about cooling off, aimed at protection, that actually prevent anyone from completing a fast transaction. As a result, there is inflexibility, less home ownership, less consumer choice, less consumer empowerment and market inefficiency. Opinion formers and policymakers should never allow our public debate to encourage a move down that regulatory path. Therein lies significant consumer disadvantage.

So I conclude by saying this: life is not perfect in the mortgage lending world, any more than it is in public service or indeed the media. But the evidence shows that maybe it is not as bad as many like to make out.

Speaker 3: Fiona Price, Director, Cross Market Interventions, DTI

As Director of Cross Market Interventions, Fiona Price is responsible for the legislative framework for consumer credit, over-indebtedness, sale of goods and supply of services, weights and measures, and consumer safety. She chaired the DTI's Over-indebtedness Task Force and coordinated the government's over-indebtedness strategy. She is also responsible for the department's funding of face-to-face debt advice and for implementation of the Consumer Credit Act 2006.

She joined the department in 1978 and has worked in a wide range of posts, including trade promotion, sponsorship of the Post Office, privatisation and contracting out, and sponsorship of the research councils.

I would like to start by tackling the issue of exactly how we define 'responsible lending', since there is no commonly understood and agreed definition. Is it just about assessing an application for a loan to decide whether or not a potential borrower is likely to be able to repay, or is there something more to responsible lending? In my view, responsible lending must take into account both the whole lending process and every aspect of the relationship with the borrower. This is something that lenders are increasingly recognising.

Responsible lending needs to start right back at the beginning of the process – the marketing of products. There are two advertising slogans I have seen recently that highlight this point: 'Things get better when you say yes' and 'Seen it? Want it? Get it.'

These slogans are no doubt clear, fair, reasonable, not

misleading, as the Banking Code requires; but are they really responsible? And it is not just a question of slogans; the way the lender manages the account can contribute, or not, to responsible lending. For example, unsolicited increases in overdraft and credit card limits have attracted a lot of concern and criticism. From personal experience, I've never asked for an increase in a credit card limit, but they do keep on going up. I've never asked for an overdraft, but one day my bank wrote to me and said: 'We've given you one'.

We, at the DTI, do welcome the additional requirements in this area that were included in the last edition of the Banking Code. These required lenders to undertake appropriate checks to assess a customer's ability to repay before they increased limits; not to offer increased limits on accounts that are in arrears or fall below credit scoring thresholds; and to allow consumers, importantly, to opt out of receiving credit increases and to reduce their credit limits.

There are also issues of responsible lending when it comes to dealing with those who are in debt. Lenders have a responsibility to contribute to ensuring that effective help is available for those who get into difficulty, that they are treated sympathetically, and that debt collection is carried out sensitively and appropriately.

The government has increased its contribution to funding telephone debt advice services through a national helpline, and we are pleased that the industry has done similarly. We are also investing £45 million over the next two years to achieve a step change in the availability of face-to-face advice for those in areas or social groups that suffer from high financial exclusion. But more is required if the demand for debt advice is to be met.

Irresponsible lending matters because it fuels over-indebtedness, which, as we know, can be hugely damaging to a person's quality of life. And there are also costs to society more generally and to the credit industry that need to be considered.

So how do you promote responsible lending? Regulation certainly has a part to play and we are currently in the process of strengthening credit legislation. The Consumer Credit Act 2006 is designed to bring the regulatory framework up to date, and to improve those areas in which the 1974 act is not working effectively.

This process has three main aims:

- to improve consumer rights of redress
- to improve the regulation of consumer credit businesses
- to establish a fair and competitive framework for consumer credit agreements.

Some of the new provisions will help to promote responsible lending. For example, the new act introduces a strengthened test of fitness to hold a consumer credit licence and includes explicit recognition that the Office of Fair Trading (OFT) will take irresponsible lending into account in making licensing decisions.

In future, the OFT will now take into consideration the skills, knowledge and experience of applicants, and the practices and procedures they propose to apply in their business, in addition to whether they have past convictions. They will also consider whether the applicant has engaged in deceitful, oppressive, unfair or improper business practices. The act explicitly spells out that that includes irresponsible lending.

Where the OFT has concerns about the way a business is, or is likely to be, run it will be able to impose requirements on the licence and will have sanctions available if the business fails to observe those requirements. This all means that in the future the OFT will be able to focus, in line with better regulation principles, on targeting those businesses that risk assessment shows are more likely to cause harm to consumers.

The new act will also remove the extortionate credit test

Where the OFT has concerns about the way a business is, or is likely to be, run it will be able to impose requirements on the licence and will have sanctions available if the business fails to observe those requirements.

in the current legislation, and replace it with a test of whether there is an unfair relationship between the lender and the borrower. This will enable courts to consider all aspects of the relationship between the lender and borrower when arriving at decisions about abuse of position. In addition, they will be able to examine the terms of the agreement, the way the lender has exercised or enforced any of their rights under the agreement, and anything else that is done by, for or on behalf of the lender, whether that is before or after making the agreement. This clearly links in with the issue of responsibility.

Lastly, a mandatory alternative dispute resolution scheme is included within the act, which will make it easier for consumers to challenge any unfair practices.

On another front, the Financial Services Authority (which is in charge of financial regulation) has put in place a 'Treating Customers Fairly' initiative, which is also relevant to responsible lending. For example, this requires that products are designed to meet consumer needs and that they are targeted accordingly; that customers are provided with clear information, kept appropriately informed before, during and after point of sale; that advice given to consumers is suitable and takes account of their circumstances; and that they do not face unreasonable barriers for switching products or providers, submitting claims or making complaints. If lenders are following these guidelines, they are a long way towards lending responsibly.

However, regulation can only go part of the way to ensuring responsible lending. We want to see lenders continue to develop good practice themselves; not just looking at the letter of the law, but considering the issues from the consumer's point of view. Many in the industry have recognised the need to do more to ensure they are lending responsibly, which is in their own self-interest. After all, it is not good for their business to lend to people who are not going to be able to repay.

We very much welcome the steps that lenders collectively have been taking to strengthen self-regulation. These include strengthening the Finance and Leasing Association (FLA) Code, and the continuing development of the Banking Code. We will be looking to the review that has just started to strengthen that further.

The DTI is also looking for self-regulation to deal with

concerns about the unsolicited provision of credit card cheques, the sending of pre-completed credit card cheques, and lack of transparency around the terms and conditions attached to those cheques. These have been a major source of concern and led to a number of amendments being proposed during the passage of the Consumer Credit Act. These amendments were not accepted, but we agreed to consult on the need for legislation to deal with concern, which we completed in 2006. As a result of industry's agreement to further self-regulate, ministers recently announced that they would not be introducing new regulation in this area.

As has already been stated, data sharing is key to the process. Lenders do need good information to make good decisions. We welcome the commitment that credit card lenders have made to share all the data that they can. But we also recognise there is a gap in the information because lenders cannot share data on accounts that were opened before they routinely asked for consumer consent to share data.

We published a consultation on 11 October 2006 on the possibility of lifting the legal barriers to sharing this data on historical accounts, where it is proportionate and subject to appropriate safeguards. However, we can only do this if we can show that it is within the constraints imposed on us by European data protection legislation. Therefore, evidence is needed both to demonstrate that there is a real benefit to customers and that there are not alternative ways of delivering the same sort of benefits without overriding people's rights associated with personal information. In addition, we need to show that appropriate safeguards can be put in place.

Lending responsibly is a particular concern where vulnerable groups are involved. In this context, we particularly welcome the initiative that the FLA has taken in partnership with the money advice sector to identify and disseminate good practice in dealing with people who have mental health problems, and the commitment that it has signed up to in its code, to take good care of customers who suffer from health problems, including mental health difficulties. There are opportunities for taking equally constructive action with regard to other vulnerable groups.

In total, there is a lot going on in terms of regulation, but

that is not the end of it. We are likely to see over-indebtedness increasing as energy bills, interest rates and total borrowing rise. I do not expect to see any let up in pressure, and the industry does need to respond. There is a clear risk to firms' reputations if their names are associated with multiple cases that, at least on the face of it, appear to involve irresponsible lending.

There is also a clear risk that if industry does not take action, ministers will feel they have to step in with further regulation. As in the example of credit card cheques, ministers are willing to give self-regulation a chance, even under strong pressure to regulate. But codes of practice need to deliver. Ministers will be watching carefully to see how well the initial self-regulation works and how it then evolves to keep up with developments.

There have been some welcome initiatives to find more effective ways of identifying those who are, or are about to become, over-indebted. But they need to be adopted more widely. Lenders need to make sure that staff on the front line understand how to lend responsibly and that their incentives are in line with good practice; that they are not being incentivised, for example, to sell more insurance policies regardless of whether they are right for the customer.

In conclusion, there are many positive steps that are being taken. We have come a long way in developing a more responsible and supportive framework, but there are still very significant challenges and more to do. I hope that we can continue to respond to those in partnership.

Speaker 4: Peter Tutton, Social Policy Officer, Citizens Advice

Peter Tutton is a Social Policy Officer at Citizens Advice, a position he has held since autumn 2004. In this role he deals mainly with credit and debt issues, receiving evidence reports from Citizens Advice Bureaux throughout the country that highlight the most serious problems that their clients are facing in this area. He is in charge of analysing problems in the credit market based on this evidence, together with the statistical database on debt enquiries that come into Citizens Advice.

Previous to taking on this role he worked in a Citizens Advice Bureau for eight years, specialising in financial advice.

It is the consequences of irresponsible lending for consumers, rather the lending itself, that has led to this discussion receiving such a high profile. This is an area of severe and mounting difficulties. As an illustration, it has traditionally been benefit issues that have produced the largest number of enquiries to the Citizens Advice Bureau (CAB). But debt is now catching up extremely quickly, with some 1.4 million new debt problems registered last year alone.

Of this 1.4 million, about 800,000 were specifically concerned with consumer credit debt, a figure that has almost doubled over the last ten years. Overall, we estimate that around 450,000 people sought advice on debt from CAB in 2006. Hopefully, this should give an idea of the scale of the problem we are facing.

Problems in other areas can cause people to topple over

into financial difficulties more generally. We have, for instance, seen a large increase in housing payment enquiries, which cover both rent and mortgage payments. There has been a rise in mortgage debt enquiries among lower income homeowners, and those with secondary and sub-prime mortgages in particular. In addition, there have been increasing difficulties over utility debts, following on from the recent rise in fuel prices, and in council tax debts, which is probably connected with the real-terms increase in council tax.

When CAB clients are asked for the reasons behind their debt problems, the responses are not particularly surprising. Job loss, illness and relationship breakdown all register as important factors. These are catastrophic life events that can suddenly change an individual's ability to meet repayment commitments. But many respondents simply state 'low income' as the main reason. These are often people struggling over a long period of time, trying to budget on a low income, perhaps needing to use credit for essential items. Once they take out this credit, they then find themselves locked into a cycle of increasing their credit to pay off interest from previous debt.

Another significant reason is overcommitment – which was mentioned by 30% of clients in a 2001 CAB survey. When you investigate further, people often say, 'I have overcommitted myself in credit', suggesting that the situation has sneaked up on them. Again, this is particularly prevalent among those with low incomes. As debt has risen as a proportion of income, they are more vulnerable to small shocks in income or expenditure, such as a particularly large fuel bill. This then pitches them into greater debt and, again, a negative spiral is created.

There are, therefore, a number of elements that can cause overcommitment. But often poor management skills lie at the root of the problem. By not accounting for small changes in circumstances, people leave themselves vulnerable to debt problems.

Having surveyed over-indebtedness from a customer point of view, we also have to recognise the issues concerning the supply of credit. There are a number of cases in which people have easy access to too much credit. Aggressive marketing of credit now takes place, and, in some cases, we have seen evidence of irresponsible lending.

I will give you three examples that illustrate some of the elements that we believe are included within irresponsible lending.

- A CAB in Cornwall saw a couple in their late 60s living on a small pension, who had managed to build up £127,000-worth of debt on two loans and fifteen credit cards. Two cards from one bank alone allowed £20,000 of that credit.
- A CAB in Berkshire saw a 25-year-old woman with a disability who had built up £72,000-worth of debt spread over thirteen major creditors. She had seven accounts with one lender, two loans, four credit cards and an overdraft totalling £39,000. Four accounts with another lender totalled £27,000.
- A case involving secured lending came up at a CAB in Kent. In this case, a couple with three children, who received means-tested benefits, had fallen into financial difficulties following the birth of the children. They then borrowed to cover the difference in income, but steadily this debt grew. Having fallen into arrears with this unsecured debt, they were advised by the mortgage lender to borrow against their house. As time passed, they ended up with five secured loans from that lender, and one secured loan from another lender, and with six other unsecured creditors on top. As a consequence, they are now faced with the repossession of their property.

These are cases of simply 'bad' lending: cases where people's indebtedness has spiralled to such an extent that you wonder how banks can continue to supply them with further credit. But what do these cases mean in terms of responsible lending?

The CAB would contrast irresponsible and responsible lending as coming from two different concepts. The cases above mainly refer to irresponsible lending, which can be roughly defined as instances in which the lender has not properly ensured that the credit products are affordable and suitable for the needs of the borrower.

These cases also highlight that lenders are often not making best use of the information that is already available to them. Many of the households involved had multiple loans from the same institution, often using the same product, but somehow the information was either missed or ignored by that institution. The CAB does support greater data sharing, but this is not

the whole story. The industry also needs to improve the way in which it uses this information.

There also needs to be progress on both the manner and the control of sales. For example, another worrying tendency that we have observed is for prime mortgage lenders who first reject an applicant because of their troubled credit history to then refer them on to another, often subsidiary, sub prime lender. We question whether this will prevent over-indebtedness or, alternatively, will it actually lead to many people simply being shunted to a higher cost of credit?

There are steps being taken to reduce irresponsible lending. There are new licensing provisions that the OFT will supervise in 2008 and an improved unfair credit relationships test that comes into force in April 2007. In addition, the Unfair Commercial Practice Directive forms another safeguard. We hope these initiatives will make a large difference to the problem of irresponsible lending. But it is now a question of how the new guidelines and powers are used by regulators and lenders.

Responsible lending, on the other hand, is a different and wider concept. It is on a higher level – about how, given that we have a liberal credit market, we not only minimise the risks of default or repossession, but also minimise the costs of the debt when people do fall into difficulties.

There are a number of illustrative issues in this regard. For example, there has been much debate around the role of payment protection insurance (PPI). The OFT stated that PPI is enormously expensive and often sold as single premiums with a loan attached, which is then charged at a high level of interest. It also reported that the commissions associated with PPI were sometimes up to 55%-70% of the value of the PPI. Therefore, this is a product that can cause over-indebtedness rather than protect people from it. There is a suspicion that the profit from the PPI is artificially bringing down or subsidising the rate of interest on the actual loan. But is it responsible lending to treat something that is meant to be a form of protection as simply another opportunity to make as much profit as possible? As part of examining responsible lending we need to improve the protection available against the risks of lending.

Another area of concern has been the design of mortgage

products. Mortgages that have an initial discount rate have become popular among borrowers. But after the initial period of low rates lasting six to eighteen months, the borrowers then find themselves in difficulty when they are forced to move to a higher rate. This is an area where lenders need to be careful to ensure that borrowers can afford the loan across its foreseeable future.

Debt enforcement and collection should also be considered as part of responsible lending. Bad practices in terms of collection or enforcement in one area can exacerbate debt problems by driving borrowers further into over-indebtedness.

Again, an example of unjustified charges on a secured loan might help to illustrate this point. A CAB in Greater Manchester recently received an enquiry from a man who had fallen into financial difficulties following a relationship breakdown. He had built up mortgage arrears and told his lender that he was seeking advice from the CAB. However, the lender then wrote to him saying that it was sending out its own debt counsellor and this would cost him £90. If he cancelled, it would cost him £60, and a further £50 charge would be made for every month he stayed in arrears. This is clearly an example of irresponsible lending – simply making the situation for the borrower even worse, to the detriment of both the borrower's ability to repay the loan and the lender's prospect of receiving payments.

The 'Treating Customers Fairly' initiative from the FSA is something that we, as a consumer group, are greatly encouraged by. However, to ensure that the consumer feels the benefits, we need to make sure this is a transparent process. At present there is no real attempt to inform borrowers of the improved treatment that they can expect to receive. Often when we have asked lenders to send a copy of their business policies

Debt enforcement and collection should also be considered as part of responsible lending.

to demonstrate their responsible nature, we receive glossy packs containing only superficial information. This points to a problem with transparency as to how the wider concepts of responsibility that lenders are supposedly embracing are feeding back to what consumers are actually experiencing. Hence lenders' lending and selling policies become hard to challenge, and redress becomes difficult.

In conclusion, a number of issues come down to the good faith that is necessary for voluntary regulation to work properly. There are undoubtedly positive steps being taken, and there are lenders and trade associations that have responded to the problems of debt. The work of the FLA on mental health is a great example. It has helped to start a process in which the whole industry is looking at problems of a social group that is particularly vulnerable to debt problems. But practices to do with charges, particularly arrears charges, demonstrate the bad faith that still exists.

Responsible lending ultimately comes down to the industry taking a serious and concerted look at how the costs and risks of debt can be minimised in an open way that treats customers fairly. Can this process happen just from the industry itself? We at the CAB believe it could, but we are less convinced that it will actually materialise. We are still seeing too many cases of bad practice, often concentrated in certain sectors. Our experience of voluntary regulation codes suggests they work best if there is a strong external regulation available in the background, which can be called upon when voluntary regulation proves deficient. The regulatory change we are seeing will hopefully feed into the practices of firms, but as yet it remains to be seen.

Discussion

The discussion began with the issue of responsible marketing. A delegate asked how there could be progress on this when regulatory guidelines seemed loose enough to allow marketing that heavily enticed consumers into taking out debt, without prominently displaying the possible risks. In addition, one delegate felt that there were too many bodies that had some responsibility for financial marketing regulation, making coordination difficult, and that the APR quoted on advertisements often varied when it actually came to buying a product.

Fiona Price accepted that the regulatory line was difficult to draw on this issue and that the current environment did seem to encourage people into taking on debt, while Peter Tutton suggested that perhaps the FSA could include principles on fair marketing within its regulation. However, they also pointed out that it was the responsibility of the individual to research properly the financial products that they took out and that, as long as the correct information was being provided, it was difficult to regulate against 'enticing' advertising. Stephen Knight also stated that the rate quoted in the marketing of products was, by regulation, one that a representative borrower could expect.

Leading on from this, there were several comments concerning financial inclusion. John McFall stated that this was a key area of the Treasury Select Committee's current work, as it had found in a recent report that poor people generally paid high rates for access to credit.[8] A delegate agreed, but was concerned that advice was being made available only after individuals had fallen into difficulties rather than beforehand, possibly even during the initial product selling stage, as a means of preventing these difficulties. Fiona Price stated that earlier advice was an issue that the government was looking at, while

8 Treasury Select Committee (2006) op.cit.

Peter Tutton pointed out that the Citizens Advice Bureau was currently running pilot courses for consumers that were aimed at beginning to tackle the alarming level of financial illiteracy among the population.

The discussion then turned to the issue of affordability. A delegate pointed out that the Bank of England had recently predicted that if interest rates remained on their current upwards course then debt servicing interest payments would rise to the level seen in 1992 in real terms. Another delegate felt that the buy-to-let sector was probably the most vulnerable, as borrowers here would have a lower propensity to pay, since it was not their family home that was in danger of being repossessed. In this case it might be the tenants of these landlords, and particularly the poor, who were most disadvantaged. However, Stephen Knight pointed out that, while there might be some concern if interest rates kept on rising, the affordability statistics he had produced earlier were strong evidence that we were not near a tipping point, and that buy-to-let was actually the best performing of all sectors in terms of arrears. In addition, research that his company had undertaken showed that the majority of tenants chose to rent for personal or employment reasons, rather than being forced into it by affordability constraints.

Another delegate then asked about issues surrounding regulation, and in particular the reasons behind the DTI seemingly fighting against an addition to the European Consumer Credit Directive that would make irresponsible lending illegal. Fiona Price responded that it was not a question of the DTI blocking the aims of responsible lending, but rather the form that the proposed addition had taken was unhelpful and obstructive. She stated that regulation surrounding licensing was central to tackling this issue, and was the area they were working hardest on in terms of the European Directive.

A delegate then asked why the relationship between a lender and borrower could not be considered unfair simply on the basis of the product having an excessively high interest rate. Fiona Price responded that regulation was not intended to stop 'bad' decisions by consumers in which they accepted an excessively high interest rate, as this would impinge on an individual's responsibility for their own financial affairs, but rather

it was directed towards creating transparency, understanding and competition in the market so that individuals were best placed to make their own decisions. This argument was supported by several other seminar participants, including Stephen Knight who pointed out that mortgage lenders and brokers are now required by regulation to give every borrower a key facts illustration (KFI) – a document that lays out all the details of a product in a standard form to make comparison with other products easier – whenever they give advice about a particular product. It was felt that this type of regulation best promoted individual responsibility on financial issues, although Peter Tutton felt that consumers, particularly those on low incomes, needed to be encouraged to shop around, as they were presently not doing so thoroughly.

One delegate questioned exactly how transparent the underwriting procedure on loans was to borrowers. He stated that borrowers were simply rejected or quoted a rate, often higher than they expected, without being told exactly why they were considered to be of higher risk or how this rate had been worked out. Stephen Knight explained that there was a limit to how open lenders could be, due to the legally confidential nature of the information that the decision was based on, but that borrowers were directed towards the FSA website for comparative information and could simply look at their own credit record if they wanted to understand the reasoning behind their higher rate. He felt that, together with the need for KFIs, there was a reasonable level of customer empowerment.

Stephen Knight added that there was a serious danger in making regulation overly burdensome or inflexible, and that this would harm consumers. He quoted the example of regulation effectively blocking progress in the equity release market because the product was not envisaged in the 'rule book', and praised the FSA for its current emphasis on principle-based regulation that allowed for greater flexibility. He also stated that additional charges for those borrowers who fell into arrears merely reflected the extra cost incurred in dealing with them. If these charges were not made, those borrowers who kept up to date with repayments would effectively be penalised by having to cover these costs. Peter Tutton did support the move to principle-based regulation, as it looked more at the outcomes

of company practices not solely whether they were following 'the rules', but thought that it would require the regulator to be more proactive to show that offenders would be dealt with.

The discussion moved on to the topic of individual voluntary agreements. One delegate felt that IVA marketing made it seem as if defaulting on debts and going into insolvency was no longer a major issue. He suggested that this would have a negative impact on the culture of responsible borrowing, and so they should be further regulated. Fiona Price went through the existing regulation for IVA providers, mainly concerning their licensing and misleading advertisements. However, Peter Tutton said that the CAB had seen a number of cases of malpractice in the IVA market. He believed that both stronger regulation and better co-ordination were required, though he accepted that it was early days in this respect, so better regulation and selling practices might evolve in the near future. Lastly on this issue, a delegate brought up the idea of culpability within insolvency, stating that bankruptcy terms should, by law, be longer for those who took out loans that they knew they would not be able to repay. However, he accepted that it was difficult to prove this type of culpability in practice.

The discussion concluded with a delegate asking about the provision available for people who were rejected by the mainstream mortgage market. She questioned whether enough was being done to provide them with other options, particularly through credit unions or the social fund, so that they did not seek loans from a 'cowboy' or doorstep lender with an excessive interest rate. Stephen Knight supported this sentiment, saying that further innovative ideas were needed. Fiona Price stated that there was already a £36 million growth fund administered by the Department of Work and Pensions that supported growth in this area.

Conclusion

The SMF seminar *Regulating by Values: Is a sustainable responsible lending policy required?* consisted of four presentations followed by a thorough and thought-provoking discussion. The seminar covered topics ranging from the correct division of responsibility between the individual consumer, lenders and government within lending relationships to the exact nature and cost of particular irresponsible lending practices. In addition, it considered the measurement and degree of affordability of current mortgages levels, the causes and possible solutions to over-indebtedness and the future for both regulation and underwriting processes within the industry.

The seminar began by considering the challenge of defining the concept of responsible lending. While irresponsible lending can be associated with particular lending practices, in particular misleading borrowers or selling a product that is unaffordable or unsuitable to the borrower, responsible lending was felt to be a more comprehensive term that includes elements from every stage of the lending process.

Responsible lending firstly includes a thorough assessment of an applicant's ability to repay the loan. This, importantly, means promoting effective data sharing, so that lenders can have available all the relevant information on an applicant associated with their previous and current borrowing record and financial situation. There are issues associated with data privacy in this respect, but a number of speakers felt that, despite recent improvements, the industry and government should do more to promote data sharing. Companies also need to keep up to date with best practice in the industry, particularly in underwriting, in order to make best use of the data available. This includes harnessing the potential of complex credit scoring techniques

and automated processes where appropriate.

Sustainable responsible lending then goes beyond this assessment of applications to include practices that are in line with 'treating customers fairly'. Some of the elements within this term mentioned during the seminar were:

- Responsible marketing. Advertising must be clear and informative. Ensuring that APR statistics are representative and the risks associated with lending are quoted is a legally required minimum. There was then some debate as to whether highly enticing advertisements that encouraged a 'buy now, pay later' culture represented irresponsible marketing or simply normal advertising practices.
- Responsible selling practices. In particular, there was emphasis on ensuring that incentives given to staff did not encourage them to sell products to borrowers without clear evidence that they could afford the repayments. The importance of good quality advice that took account of borrowing options and an individual's circumstances was emphasised.
- A fair relationship between the lender and borrower. This means that the lender provides all the relevant information to the borrower and does not abuse their powerful position by, for instance, placing unreasonable charges on those who fall into arrears.
- Good quality independent and impartial advice for those who do fall into repayment difficulties. Recent initiatives to provide free debt management advice in this area have received financial support from both the government and industry players, but they are still in their early stages of development. Once again, advice must take account of all the options available, emphasising the risks and costs involved in every possible solution.

The seminar went on to discuss the extent to which regulation could or should be used to promote these aims. A number of recent changes have strengthened the regulatory environment, for instance, by placing restrictions on unsolicited increases in overdraft or credit card limits and putting in place a tougher licensing process. However, it was agreed that the aims of regulation should be concentrated on promoting transparency, understanding and competition in the market. Importantly, regulation should not be so tight as to impinge on an individu-

al's own responsibility for their financial decisions. For example, the onus is on the individual to shop around to find low priced products and understand the risks involved with different types of lending once they have been given the information. 'Bad' borrowing decisions are not the regulator's responsibility.

As was mentioned by one of the speakers, overly tight or burdensome regulation has the potential to do serious harm to consumers, particularly by restricting choice and innovation in the market. It was agreed that the move by the FSA towards risk and principle-based regulation had the potential to allow for greater flexibility, although we are yet to see the full consequences in practice. Self-regulation, which has itself been reformed over the last two years, has a role to play, but it was felt that this is most effective when set against a strong external regulatory environment, which can step in when self-regulation proves deficient.

There was much discussion of the need to promote financial literacy so that individuals can best take on responsibility for their financial decisions. It was pointed out that financial illiteracy is most common among the poor, and it is also this group who are most likely to fall into financial difficulties. Actions have, therefore, been taken to promote financial inclusion, including the piloting of free financial literacy courses and its inclusion in school curricula. However, this is clearly a deep-rooted problem and efforts to deal with it are still in their initial stages. Effective action to create a responsible borrowing culture is even more difficult, particularly given the enticing marketing by lending companies. Improving financial literacy and publicising the dangers of over-indebtedness are, perhaps, two of the main policies that can be followed in this area.

It was also felt that there was an important division between secured and unsecured lending. Data on affordability of mortgages, which examined the proportion of the borrower's monthly income that goes towards mortgage repayments, showed that the situation in the secured lending market was not as worrying as many commentators have suggested using simple income multiples data. Although it was emphasised that there was no room for complacency and that there would be reason for concern if interest rates continued their upwards trend, the current level of arrears and repossession are not high

when set in historical context, and it was generally felt that we were not near a tipping point. There is, perhaps, more of a concern about the situation in unsecured lending, which is an important contributor to the current upward trend in personal insolvencies. Much of the concern about irresponsible marketing, as well as the ease of access to credit, was centred in this sector.

It is clear that in the current climate of increasing personal borrowing, individual insolvencies and interest rates, there is a need for government policy to promote sustainable responsible lending. Many necessary reforms and mechanisms have already been put in place from a regulatory point of view. The manner in which government agencies use these new guidelines and powers, together with the response from industry players, will be crucial over the next two years. The initial signs are encouraging, but if the industry does not continue to take a more responsible and sustainable lending approach, particularly through self-regulation, then tighter government regulation may prove necessary. The government's aim of promoting financial inclusion to allow for the improved exercise of individual responsibility in financial decisions has a major role to play. However, this change in culture as well as individual skills will only be possible over a considerable period, and the policies in place are still in their infancy.