fair4all finance

FOS future funding model Fair4All Finance response

August 2022

Introduction

We welcome the opportunity to respond to the Financial Ombudsman Service's discussion paper on its future funding model.

Given Fair4All Finance's remit we have focused our response on issues that will impact the supply of fair and affordable credit to customers in vulnerable circumstances.

We want to see funding model that supports a sustainable consumer credit market for financially excluded customers.

Our response calls for

- An exemption from FOS case fees for community finance organisations, in line with concessions for credit unions and consistent with the FCA's regulatory approach. This would remove a barrier to these organisations scaling to meet the need for affordable credit among financially excluded customers
- Varying case fees by product type to reflect the generally lower cost of dealing with consumer credit complaints. In the longer term we also support case fees being proportionate to loan size
- Introducing a modest case fee for CMCs to rebalance incentives between CMCs and firms and improve standards among CMCs

About Fair4All Finance

Fair4All Finance is a not for profit organisation founded in early 2019 to improve the financial wellbeing of people in vulnerable circumstances by increasing access to fair, affordable and appropriate financial products and services. We have three main priority areas:

- Expanding provision of affordable credit through a scaled community finance sector

- Partnering with banks and financial services providers to support the delivery of products and services for customers in vulnerable circumstances
- New product and market development – developing and scaling products and services to address market gaps

You can find our full strategy here.

Our response

Building a sustainable consumer credit market

Q6: Do you agree that we should vary case fees according to the type of product the complaint relates to? If you agree, do you think we should also introduce fees that are chargeable according to case stage?

In recent years there has been a huge contraction in the provision of credit to customers excluded from mainstream lending options. From 2019 to 2021 the home credit and high-cost short-term credit markets shrank by £1bn, issuing 3.25m fewer loans a year[1].

A key factor in the decline of 'sub prime' lending has been the sustained high volume of affordability complaints, facilitated partly by claims management companies (CMCs), which has led to the collapse or withdrawal of many high-cost lenders.

In 2021/22 there were over 57,000 new FOS complaints about unaffordable lending, typically linked to historic lending and often submitted by CMCs. The latest data suggests this remains a significant issue across the consumer credit industry[2].

It's right that customers who have suffered as a result of unaffordable lending are claiming redress. But this surge of complaints has also had the unintended consequence of contracting the consumer credit market for people with limited borrowing options.

Although the supply of credit has contracted, demand is still high

- The number of people borrowing from family and friends increased from 3.6 million in 2017 to 5.9 million in 2020[3]
- More than 17 million people have used unregulated buy now pay later products[4]
- Recent estimates place the number who may be using loan sharks at over 1 million[5]

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[1] Fair4All Finance analysis of FCA and firm data
[2] Financial Ombudsman Service, Annual complaints data and insight 2020/21 and 2021/22
[3] FCA, Financial Lives Survey (2017-2020)
[4] BBC, 'More than 17 million have used buy now, pay later services'
[5] Centre for Social Justice, Swimming with Sharks (2022)

At Fair4All Finance we estimate there are 11 million people who may need access affordable credit. We are working to address this gap and help build a market for sustainable alternatives to high-cost credit.

Small, short-term loans delivered in a fair and affordable way are a vital tool for people with low financial resilience, allowing them to smooth incomes, weather financial shocks or access essential items.

Our Affordable Credit Scale Up Programme has focused on giving tailored support, investment and grant funding to drive the growth of community finance providers, such as credit unions and community development finance institutions (CDFIs). However, the sector doesn't have the scale needed to address the gap alone.

In line with recommendations from the Woolard Review, we want to see more mainstream and commercial financial services providers entering this market and serving customers in vulnerable circumstances. Currently, mainstream financial services don't offer the affordable short-term credit needed by customers with low financial resilience, excluding millions of people with irregular incomes or thin or damaged credit files. But despite calls in the Woolard Review last year for banks to offer or fund more alternatives to high-cost credit, there has been little progress from industry.

Serving customers in vulnerable circumstances is challenging and the margins on the small, short-term loans that so many people need are relatively small. Lenders and investors tell us that the risk of being targeted by CMCs disincentivises them from entering this market, particularly when case fees are proportionally high compared to the size of the loans involved.

We would like to see a funding model that supports the development of a sustainable consumer credit market for customers with low financial resilience.

To help achieve this, **we support varying case fees by product type, so that fees for consumer credit cases better reflect the lower cost of handling.**

In the longer term, **we also support varying case fees in consumer credit proportionately to the size of the loan.**

These measures would reduce the disincentives for investors and providers to enter this challenging but vitally important market.

We suggest the FOS should be cautious of introducing fees that are chargeable according to case stage. Given the behaviour of CMCs and current incentives in the model (see section below), there is a concern that CMCs could use this to pressure lenders to unfairly resolve cases early to avoid higher fees. If implemented, the process should be designed to reduce these incentives.

Supporting community finance organisations

These issues are even more acute for community finance providers such as CDFIs. CDFIs (most of which are set up as not-for-profit community finance organisations, as defined in the FCA handbook) work with customers in some of the most financially vulnerable circumstances and have expertise in conducting fair and thorough affordability checks in difficult cases. This is reflected in the fact that currently community finance providers receive very few complaints.

CDFIs demonstrate the powerful positive impact that small, short-term loans, delivered in a fair and responsible way, can have on people's wellbeing. An independent impact report into the CDFI Fair For You found that they had generated over £50 million of social value, helping to move 71% of their customers away from high-cost credit and improving customer mental health[6].

But this is necessarily a challenging market to serve, with fine margins of sustainability. Unlike other lenders, community finance providers don't price their loans to make a profit. And because they serve customers in more financially vulnerable circumstances, they need to offer flexible forbearance policies, provide additional support services and be prepared to write off significant amounts of debt from customers who can no longer pay – an issue which has increased significantly due to the financial impact of the pandemic and increases to the cost of living.

The illustrative example below indicates the small amount a CDFI has left over from a loan to cover fixed costs and reinvest into their business:

	Loan amount	Loan term	Interest paid by customer	Bad debt write off of capital + interest[7]	Cost to serve per loan[8]	Net amount
CDFI (169% APR)	£500	8 months	£187	-£124	-£50	£13

Given the trends we are seeing in affordability complaints, we are concerned that CMCs may speculatively turn their attention to other parts of the consumer credit market, including the community finance sector.

We have heard reports from community finance providers that some individuals and CMCs have tried to 'weaponise' the disproportionate cost of fees for community finance providers in order to secure early settlements for spurious claims.

And because after a certain threshold firms must pay case fees even for non-upheld complaints,

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[6] Centre for Responsible Credit (2020), The Social Impact of Fair For You
[7] Fair4All Finance internal assessment of average CDFI in 2021 c18% bad debt write off
[8] Fair4All Finance NILS procurement ITT (2021) range of cost of loans for bidders £30 to £70

community finance providers are at risk even when they do the right thing. This is more pressing now that the number of free cases for firms have fallen from 25 to 3.

In the example above, a single case fee of £750 for an affordability complaint which is not upheld could wipe out the returns on around 60 affordable loans. We are therefore concerned that the current fee structure is a disincentive for lenders that provide fair and affordable credit to scale and raise their profile.

CDFIs are asset and mission locked organisations that generate huge social value, working with small teams and often at the margins of sustainability. Applying the same fees across all financial services places a disproportionate burden of cost on community finance providers.

For these reasons we believe there should be an exemption for community finance organisations from case fees, in line with concessions for credit unions.

There is precedent for exemptions like these that reflect the unique status and social value of community finance.

Credit unions already have an exemption from FOS case fees for their core business of personal lending, which is set out in FEES 5.5B.5.

The FCA treats credit unions and community finance organisations in the same way, granting both an exemption from consumer credit fees. In 2019 the FCA set out the reasoning for the concession:

> 'CFOs and CUs are identified through robust definitions based on compliance with statutory requirements outside FSMA. This gives us (and other fee-payers) comfort that the concessions we have given them are targeted on firms which genuinely have a social purpose… We are therefore of the view that restricting the concessions to CFOs and CUs meets our requirement for the criteria to be objective, consistent, transparent and simple, whilst also allowing us to continue to support the government's policy of improving the range of socially responsible choices available to vulnerable consumers.[9]'

Credit unions and CDFIs are both asset locked organisations with a mission to improve people's financial wellbeing. They are both seen as having a vital and complementary role in providing affordable credit to excluded customers, including by the government and the FCA.

Granting an exemption for community finance organisations, as defined in the FCA handbook, would align the FOS's approach to CDFIs with its approach to credit unions. It would also align the FOS's approach to that of the FCA.

Given the currently very low number of complaints received about community finance organisations, an exemption around non upheld fees would not materially impact the FOS's budget.

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[9] FCA (2019), Handbook Notice No 63

However, it would remove a barrier to the growth of fair and affordable credit provision, which remains an important strategic aim for the government and for the FCA.

Claims management companies

Q11: Do you have evidence to demonstrate problematic behaviours from CMCs and do you think a charge from the Financial Ombudsman Service would prevent them?

The FCA has previously identified a range of problematic behaviours among claims management companies (CMCs). These included

- Misleading, unclear and unfair advertising to consumers
- Not providing customers with the information they need to make a well-informed choice about using a CMC – as well as a lack of clarity on fees
- Poor service standards, including poor-quality advice, inadequate processes and procedures, and sub-standard representation
- Failing to undertake sufficient checks and collect relevant information before presenting claims to third parties, resulting in submission of spurious claims, slower processing and poor outcomes
- Some firms recycling and remarketing claims, giving rise to nuisance calls

The FCA has also had to introduce a price cap on CMCs to prevent excessive charges to consumers, which were sometimes higher than 40% of redress received.

Lenders report that some CMCs

- Submit complaints on behalf of individuals who have not been a customer of a firm or have already had their compliant resolved through another CMC
- Submit questionable letters of authority, misuse customer data and submit complaints on behalf of customers without their instruction
- Use the threat of the case fee to encourage firms to settle early on cases

The current funding model incentivises this problematic behaviour by CMCs. As they pay no fee, CMCs have no stake and little to lose in making speculative complaints about firms. **We therefore believe there should be a modest fee for CMCs to bring a case to the FOS**.

This would encourage CMCs to take more care to validate the legitimacy of a complaint before taking it to the FOS. It would also reduce their ability to 'weaponise' the case fee.

We recognise how important it is that the FOS remains free to consumers. However, we don't believe that the cost of a case fee for CMCs will be passed on to the consumer or will be a barrier to legitimate complaints.

CMCs already charge customers fees, and have consistently operated on a "no-win, no-fee" basis so consumers don't face upfront costs to access their services. Coming under FCA regulation and the introduction of the price cap has removed the risk that CMCs will pass excessive costs on to the consumer.

Prevention

As we said in our response to the FOS's plans and budget 2022/23 consultation, we strongly support the FOS's strategic focus on preventing complaints.

In the interest of consumers, we want to avoid a repeat of what has happened in the high-cost credit market, where people suffered detriment from poor lending practices, and now in many cases are not getting the redress they are entitled to because the high-cost lenders are collapsing – sometimes with the weight of retrospective complaints as a contributing factor.

Working closely with the 'regulatory family' will be vital for making sure that new regulatory developments don't lead to more complaints down the line. Feedback from financial services on the FCA's Consumer Duty indicates that firms are uncertain over what the new standards of the duty mean for them. At the end of implementation of the Duty, it should be clear what expectations the new rules place on firms and how the FOS will decide if there have been breaches. It's important that there is unanimity between approaches to supervision and redress.

We support the FOS's aims to improve its engagement and sharing of insight to prevent complaints and unfairness arising, and so that firms have a better understanding of what constitutes good and bad practice. Potential measures could include

- Improving navigation and search function of the case decision database, including more granular filtering, to help firms better identify relevant cases among the thousands available
- Further promotion of decisions and case studies with wider implications for firms' conduct, particularly concerning new trends. This could include a tag in the database for decisions with novel implications
- More outreach with firms on decisions around new trends, so that firms have a better understanding of what an appropriate resolution is for a given complaint, and fewer customers or CMCs need to escalate to the FOS
- In collaboration with the regulatory family, data and insight on complaints trends shared by the FOS should lead to clarifying guidance on rules