Building a non-prime lending market that delivers for **UK consumers**

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Foreword

Andy Sleigh
Chief Operating Officer,
ClearScore

Since ClearScore's launch in 2015, we have grown to support over 14 million UK customers with their financial well-being, giving us a comprehensive perspective on the evolution of the credit market over the last nine years. We have seen a significant reduction in the options for non-prime borrowers during this time.

The deterioration of the non-prime credit market over this period is not the result of a single factor. Instead, a confluence of diverse elements has led to the withdrawal of investment capital and reduced innovation — leading to sub-optimal outcomes for UK consumers. The non-prime market has contracted by more than 30% since 2019 — and this contraction has, in turn, pushed more people towards unregulated and illegal lending.

In response to these multi-faceted issues, ClearScore has used its convening power to bring together our lending partners to develop a series of actionable recommendations to build a more robust and equitable non-prime lending market.

This report, co-authored with Ernst & Young LLP (EY UK), proposes practical and comprehensive solutions to address the array of factors affecting the market. By doing so, we aim to work with government and regulators to support the creation of fair, accessible and sustainable non-prime lending. This is especially critical in the short term, given the current economic climate and the ongoing cost of living pressures, but also in the long term, given the knock-on economic impact that a well-functioning credit market can have on broader economic activity.

In closing, I express my gratitude to EY UK for co-developing this report and to our lending partners for their significant contributions, advice and support. I hope the ideas and recommendations contained herein will ultimately improve the financial well-being of the broader UK public by advocating for a reformed non-prime credit market.

Christopher Woolard CBE
Partner,
Ernst & Young LLP

Three years ago, I had the privilege to undertake a review into the unsecured credit market on behalf of the FCA Board. Since then there have been several developments. The Financial Conduct Authority (FCA) has completed an investigation into the credit information market and set out targeted interventions to improve the information used by lenders to make lending decisions. The government committed to introducing new rules for providers of buy-now-pay-later (BNPL) products, although as of today, BNPL remains unregulated despite the market doubling in size. Developments in technology have opened the prospect of a more sophisticated understanding of affordability and better customer support.

At the same time, the economic environment has become increasingly challenging for households and businesses with cost-of-living pressures and interest rates higher than we have been accustomed to in the last decade. This situation has further emphasised the importance of access to affordable, regulated credit. Credit isn't the right answer for everyone, but it does play a vital role in enabling people to participate in the modern economy — particularly in challenging economic times.

Unfortunately, the lenders we spoke to when researching this report say that the UK consumer credit market is becoming increasingly difficult to operate in, reducing choices for consumers, especially those considered to be higher risk. The reasons are set out in this report — many of which will be familiar to those who have operated in the market for a long time and are consistent with the themes in my 2021 review.

The objective of this report is to offer a view of how the market could evolve, building on the work that government and regulators are already doing to remedy some of these issues, like rebalancing incentives for claims management companies (CMCs) taking cases to the Financial Ombudsman Service. However, a more strategic reset is required if we want to build a market that delivers for UK consumers by attracting investors and incentivising lenders to compete. A vibrant market with a variety of firms will lead to more choice and fairer prices for consumers. Much of this can be achieved through existing tools without needing to pass new primary legislation.

I'd like to thank ClearScore and its partners for commissioning Ernst & Young LLP to undertake this report. I hope this research supports policymakers and the market in their efforts to create a better-functioning market that serves customers well.

[1] Financial Conduct Authority, 'The Woolard Review — a review of change and innovation in the unsecured credit market' (February 2021).

Executive summary

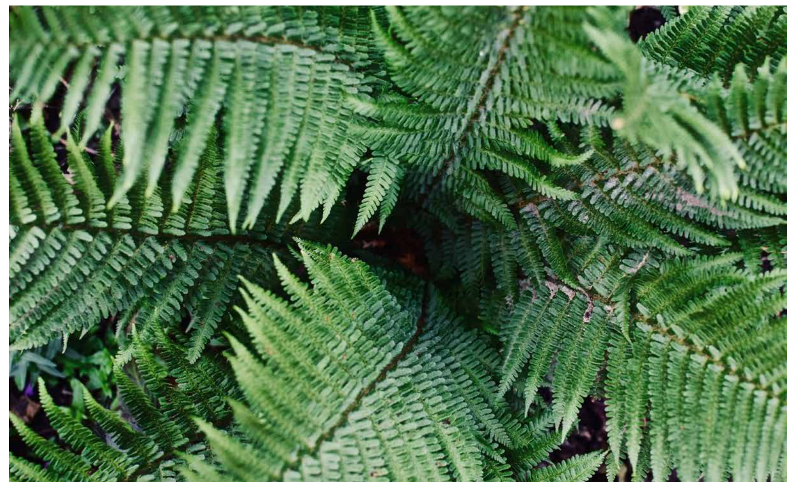
The UK needs a long-term strategy for the non-prime lending market to rebuild confidence and broaden access to regulated credit for a wider group of customers. The government has already recognised the need to make changes — including by paving the way to change the Financial Ombudsman Service's (the Ombudsman's) case fees, committing to introducing new rules to regulate buy-now-pay-later (BNPL) and announcing a review of the Consumer Credit Act 1974. We encourage policymakers to build on this foundation — providing a stable and supportive regulatory environment for private-sector firms offering affordable credit.

Policymakers should support industry efforts to improve how the cost of credit is communicated plainly and clearly, including by exploring new ways of illustrating the cost to consumers for loans with terms of less than a year. This will go some way to address the negative and binary perceptions of lenders offering loans with higher annual percentage rates (APRs), which currently undermines the attractiveness of lending to higher-risk consumers where the likelihood of default is higher due to greater uncertainty of income and a lower saving buffer.

Innovations like open banking and, more broadly, open finance have the potential to revolutionise how firms make decisions about who to lend to. It is a particularly promising innovation for firms lending to non-prime customers with thin credit files or irregular incomes. Some firms are experiencing significant improvements in the accuracy of their lending decisions. In contrast, others need more certainty about how the regulator and the Ombudsman will treat them if something goes wrong. The regulator's efforts to improve the quality of credit rating agency (CRA) data will further improve lending decisions — but a joined-up approach to open finance between the FCA and the Ombudsman would support quicker and more widespread adoption.

The lender perspectives and analysis of ClearScore data presented in this report point to a withdrawal of firms and product types from the market — leading to reduced access and higher lending rates for non-prime customers with low or average credit scores. Exclusion is leading more customers to seek alternative solutions including unregulated BNPL products, relying on family and friends, and simply going without essentials. There has also been a concerning growth in illegal moneylending reported by organisations such as the Illegal Money Lending Team, Fair4All Finance, and the Centre for Social Justice. Local Trading Standards have been releasing warnings about loan sharks in their area.[2] This is happening at the same time as many people are struggling with higher day-to-day costs and declining real incomes in a much more challenging economic climate.

The reasons for a decline in access are varied and complex. This report attempts to unpack them and offer practical solutions. The industry is committed to working collaboratively with the government and regulators to build a well-functioning non-prime market that delivers better outcomes for all consumers.



[2] Illegal Money Lending Team, 'Report reveals more than one million in debt to loan sharks in England' (2022); Fair4All Finance, 'As one door closes' (June 2023); Centre for Social Justice, 'Swimming with sharks' (March 2022); Devon County Council, 'Trading Standards warn of loan sharks as households borrow to meet rising costs' (November 2022).

The role of non-prime lending in a well-functioning economy

Used responsibly, access to affordable, unsecured credit provides the flexibility people often require to meet their everyday needs. Regulation plays an important role in the consumer credit market — ensuring that lending is done responsibly and providing valuable protection for those who may seek to utilise credit.

A well-functioning economy is one that offers a range of credit options — serving prime and non-prime customers. Yet the number of underserved customers in the UK is growing. In 2018, it was estimated that around 12 to 13 million customers had non-standard credit histories meaning their needs were going unaddressed. Today, this figure has risen to 16 to 17 million people — with an estimated shortage of credit supply of around £2 billion.[3]

Many of these customers are referred to as 'non-prime' and are, on average, seen as higher risk — with thin or poor credit files resulting in lower credit scores. This may be because a customer has not used much credit before or struggled to repay debt in the past. Their credit score alone may not reflect their ability or willingness to repay, leaving millions of people with a real need for credit struggling to access the flexibility they need.

[3] L.E.K. 'Improving Access to Lending for the Financially Vulnerable' (November 2023).

CREDIT SCORES

'Non-prime' describes individuals considered higher risk, denoted by their average-to-low credit scores. These customers may have more limited access to credit and be charged higher interest rates to cover the cost to the firm of the customer failing to repay. This category is sometimes split into 'sub-prime' (those with the lowest credit scores) and 'near-prime' (those with near-average credit scores).

The term 'prime' refers to customers with higher credit scores who are seen to be more likely to repay a loan. These customers often benefit from favourable terms, including lower interest rates and access to larger loan amounts.

This problem is becoming increasingly acute as people find it harder to cover their usual living expenses because of the effects of the COVID-19 pandemic and the current cost-of-living pressures. In July 2023, Citizens Advice reported that over 50% of their clients are in a budget deficit.[4] The FCA's Financial Lives Survey estimated that in the six months to January 2023, 77% of UK adults felt the burden of keeping up with their bills and credit commitments had increased.[5] 17.5 million people are estimated to be financially vulnerable.[6] For many consumers categorised as non-prime, the burden is far higher. Flat or declining wages, combined with high inflation, have squeezed room for unexpected costs – with core living expenses making up an ever-increasing proportion of their income.

Community development finance institutions (CDFIs) and credit unions play an important role in offering affordable credit to non-prime customers. However, it is unlikely these business models will, on their own, be able to address the growing level of unmet customer needs.

Non-prime customers borrowing through CDFIs are more likely to borrow smaller sums for shorter periods to meet unexpected one-off costs in their lives. Each loan will require closer oversight, sometimes with increased manual intervention or flexibility increasing the cost of lending. The average loan size (less than £1,000), the term (less than 52 weeks) and a lack of economies of scale make it difficult for these organisations to drive down their fixed costs.[7] Together with the cost of wholesale borrowing and the risk base of their customers, this means CDFIs have historically charged APRs of above 100%, and sometimes over 200%, even though charging these rates by the for-profit sector has been stigmatised.[8]

Credit unions also serve non-prime customers and those seeking small sum and short-term credit, but they face limitations that, if left unaddressed, mean they will only be part of the solution to support the needs of the non-prime market. Credit union loan capital is derived from the deposits and shares held by members – with very little funding from other investors. Operating costs, including the cost of acquisition, remain problematic for credit unions – and the interest rate they are allowed to charge is capped at 42.6% APR. However, as not-for-profit co-operatives, they do not have the same shareholder pressure to make profits. Technology could increase the potential size and reach of credit union lending but requires significant investment.

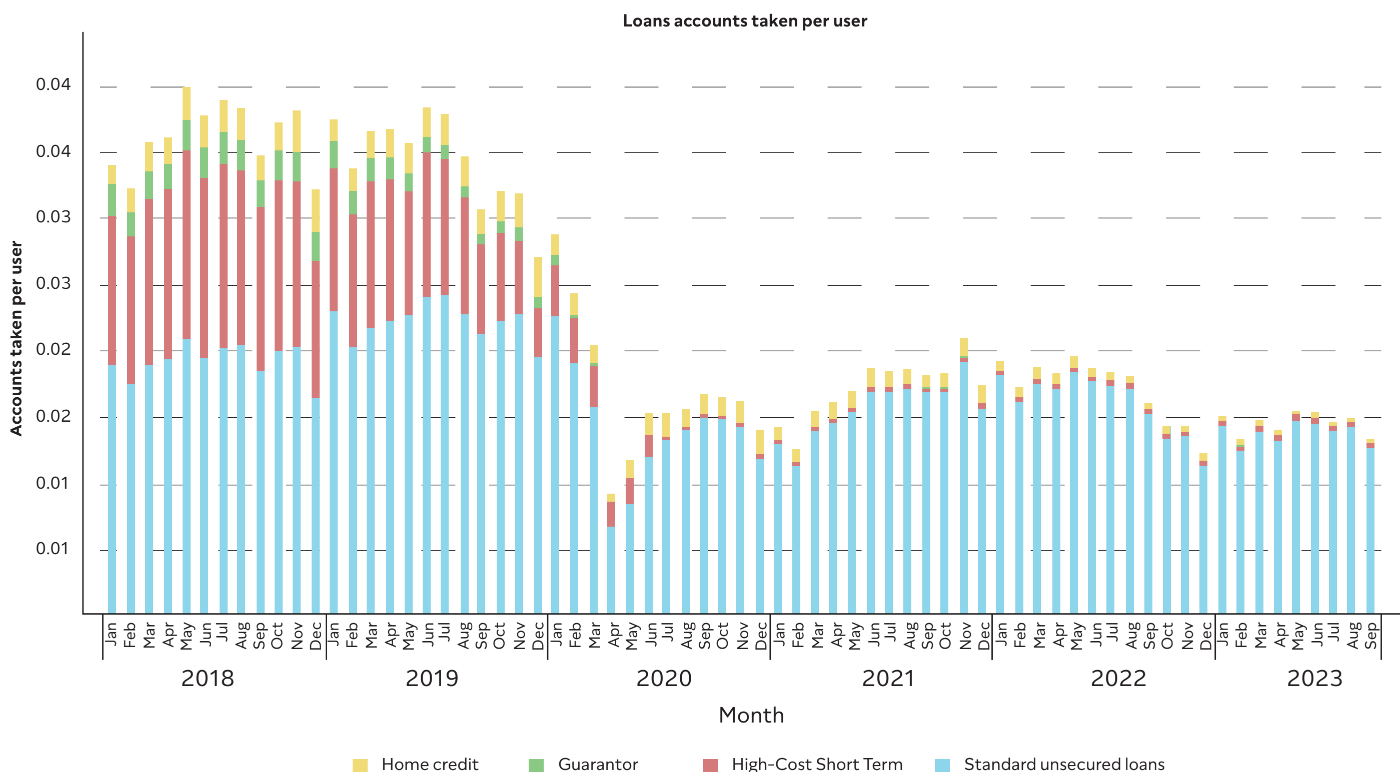
[4] Money and Pensions Service, 'Debt advice clients with deficit budgets': findings and opportunities from call for evidence' (August 2023).
[5] FCA, 'Financial Lives: Consumer experience of the rising cost of living' (January 2023).
[6] Fair4All Finance, 'Fair4All Finance Segmentation Model' (October 2022).
[7] Fair4All Finance, 'Community Finance Sector Reporting Q4 2022' (February 2022).
[8] Financial Conduct Authority, 'Alternatives to high-cost credit report' (July 2019).

SECTION TWO

Evidence of market failure

The credit market is failing non-prime borrowers. Since 2019, there has been a huge decline in the holding of debt products (see Chart 1 below) over the same period as cost-of-living pressures have risen. This can be directly attributed to the withdrawal from the market of home credit, guarantor loans and high-cost short term credit (HCSTC). The number of HCSTC loans issued between Q1 2018 and Q1 2022 fell by 86%.[9] At the same time, the growth in unregulated products like BNPL has risen.

Chart 1: Decline in the availability of credit (per ClearScore user)



Note: Uses all available bureau data of users signed up to ClearScore UK at the time (does not require them to have visited the ClearScore marketplace). Accounts taken per user = the number of accounts taken divided by the number of users ClearScore pulled a credit score for in a month.

[9] FCA PSD006 cited by Fair4All Finance, 'Blog: Illegal money lending and the changing credit market' (October 2022).

For non-prime customers, the removal of access has been particularly acute given the credit sources withdrawn from the market were predominantly held by non-prime borrowers (see Charts 2 to 4 below).

Chart 2: Holding home credit

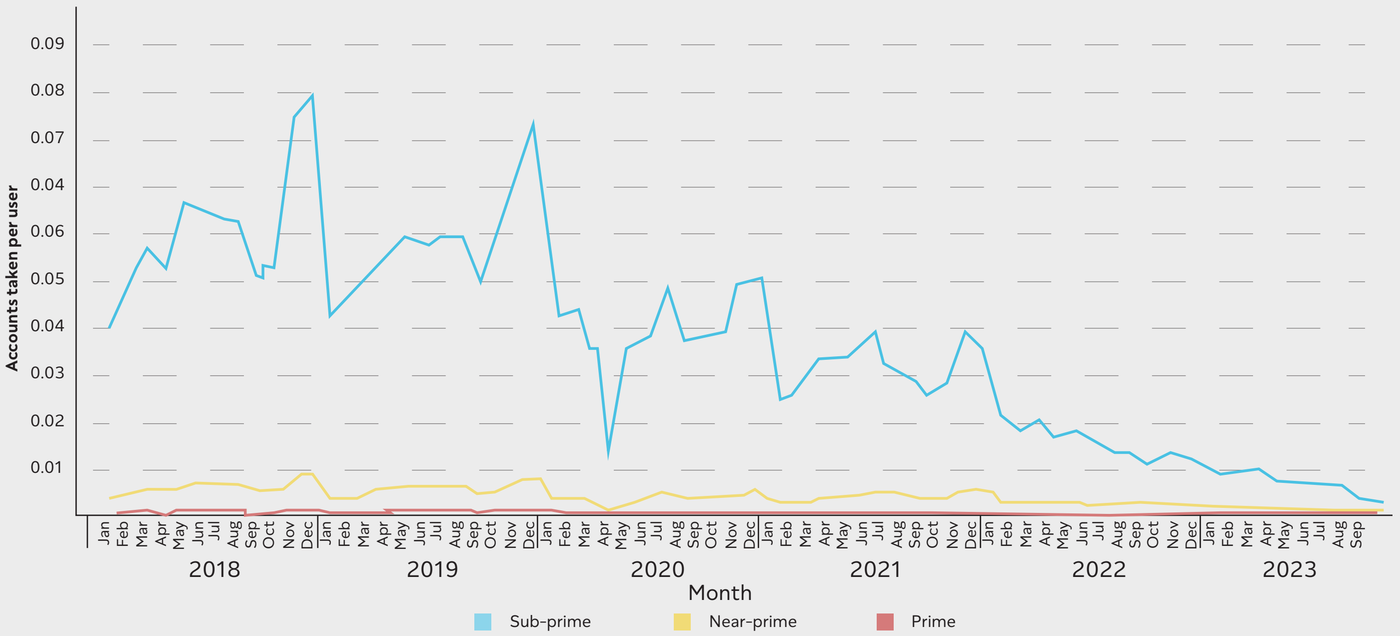


Chart 3: Holding guarantor loans

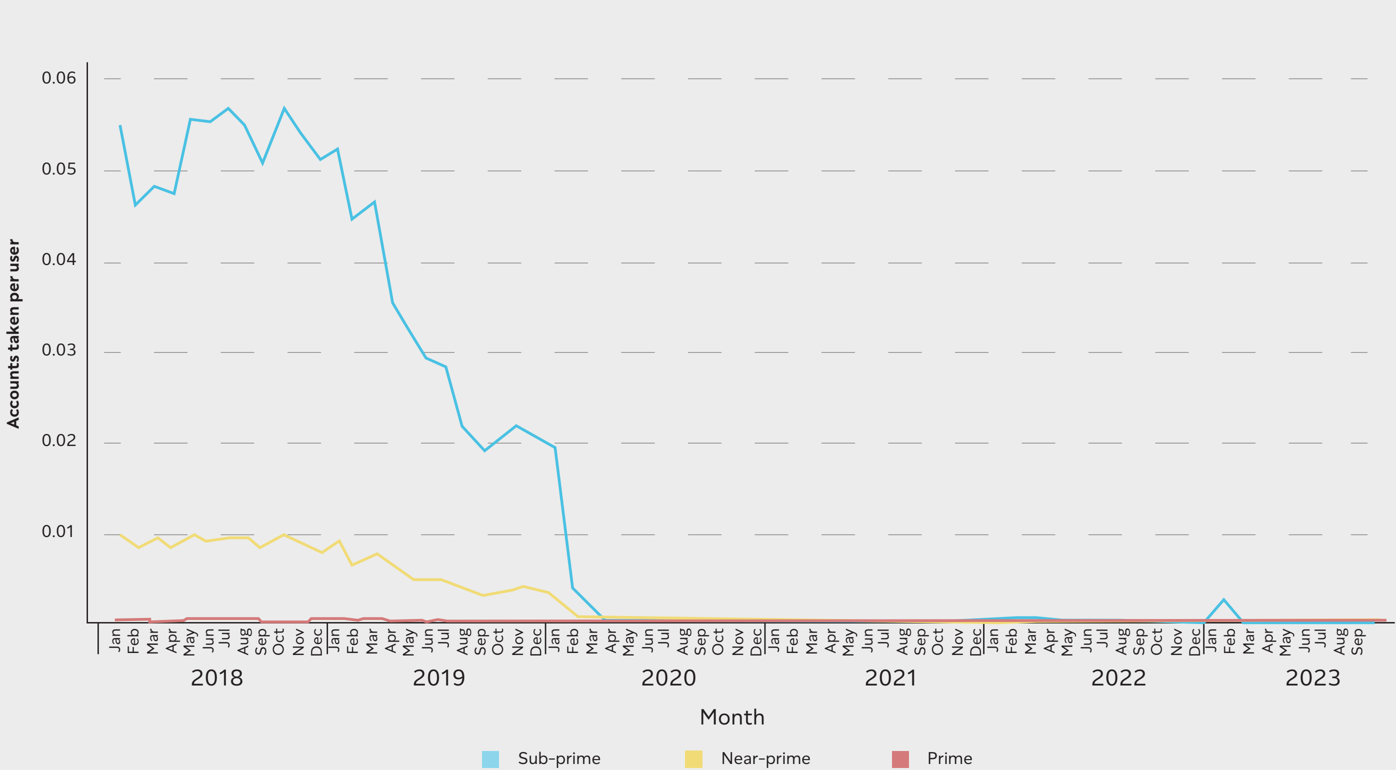
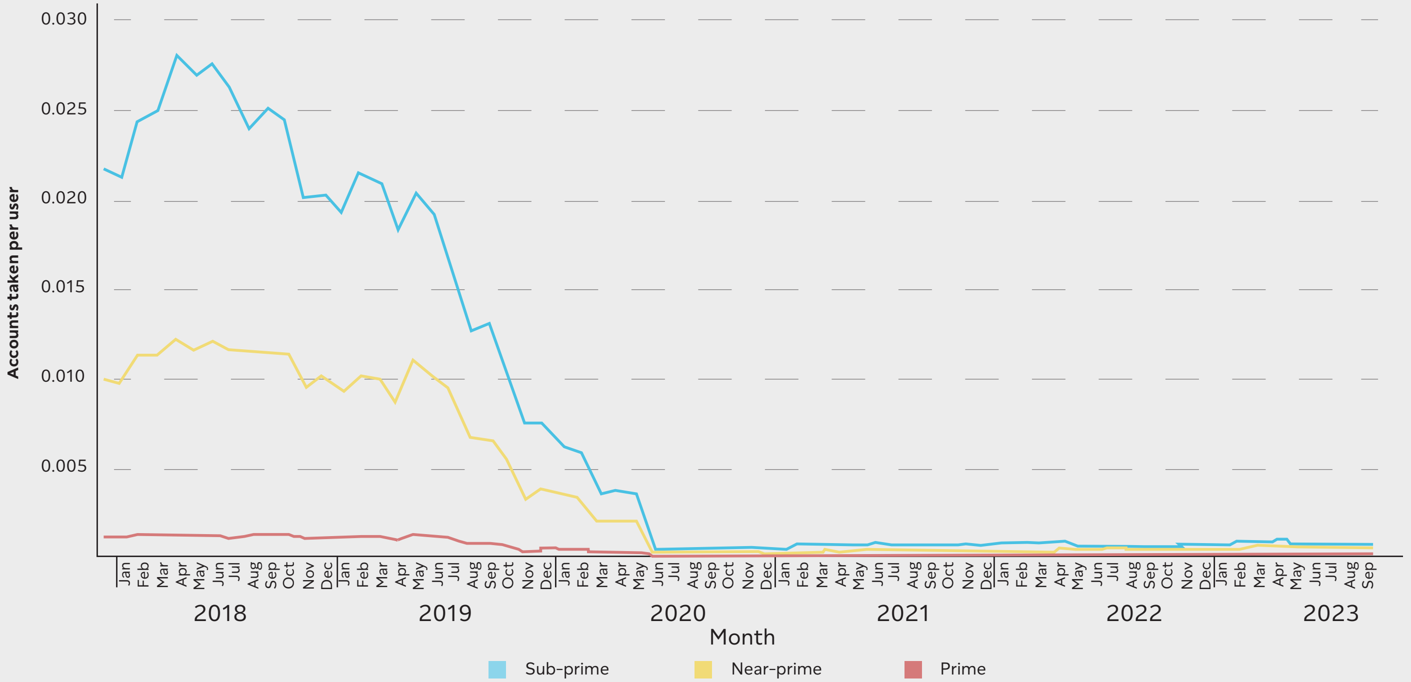
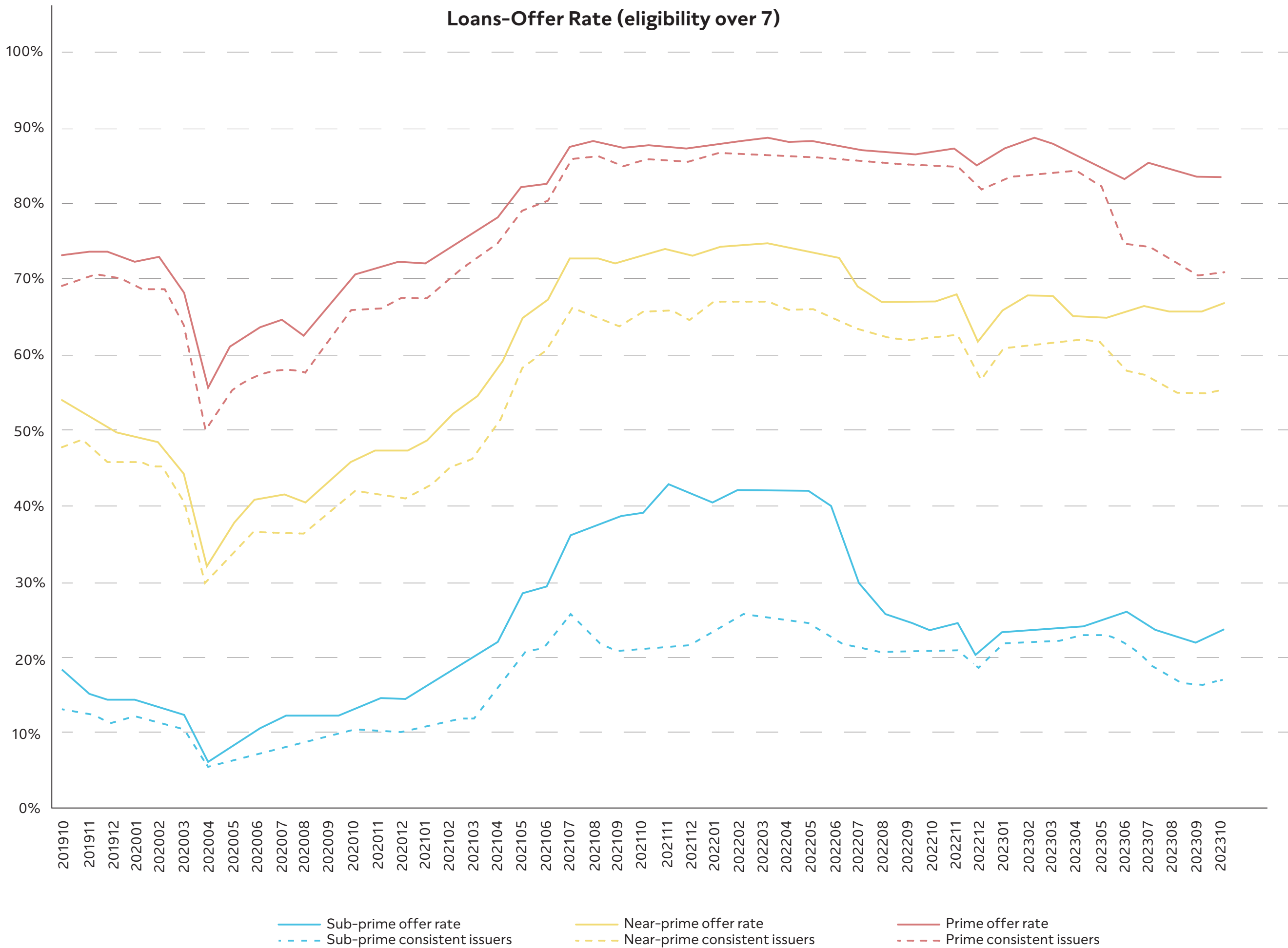


Chart 4: Holding HCST



While we have seen a decline in these sources of credit for non-prime borrowers – the remaining credit market has not expanded to meet the needs of those in the non-prime population who have lost access.

Chart 5: Offer rate for loans by credit rating (eligibility over 7)



Source: ClearScore.

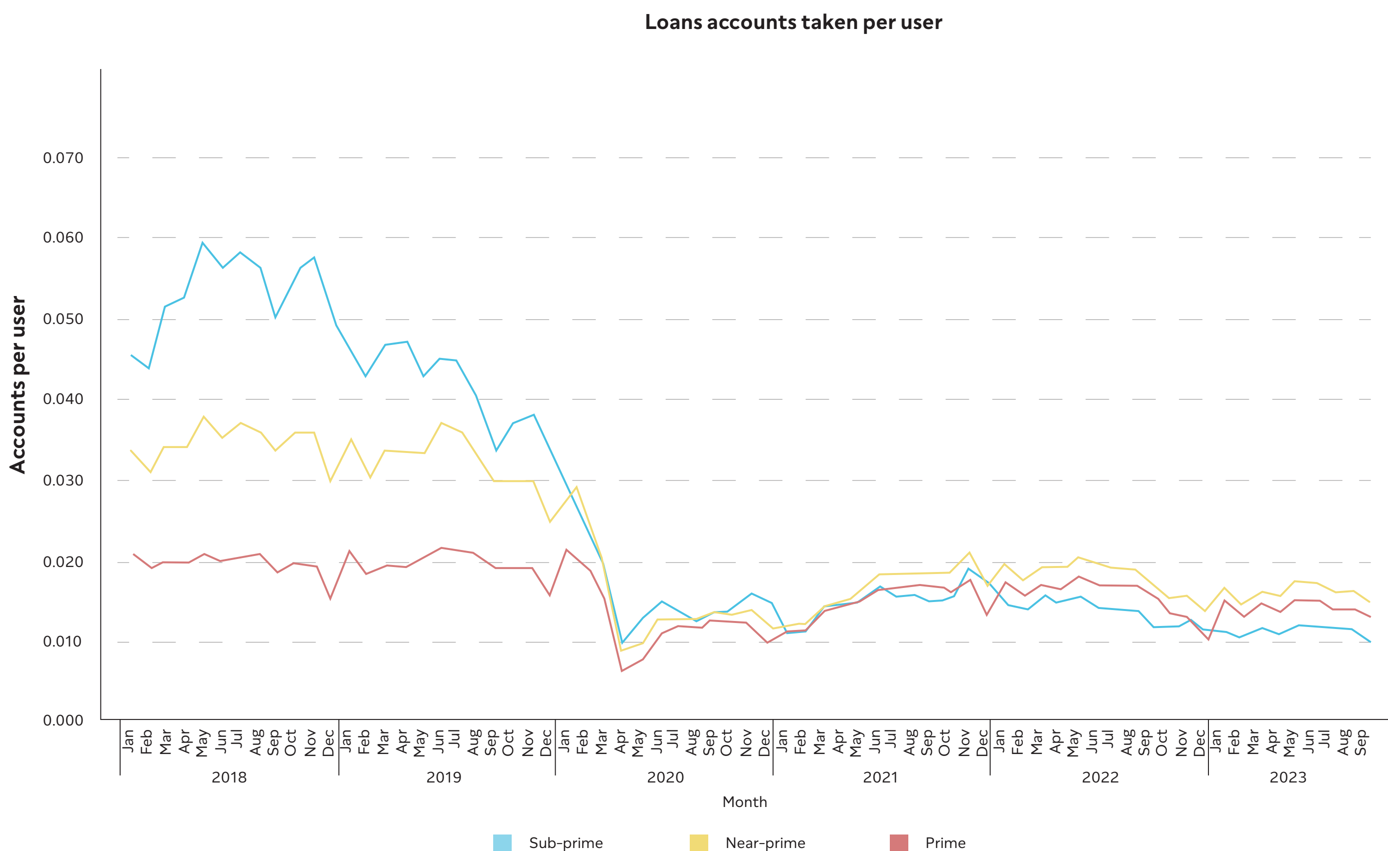
Note: The graph above depicts Loan offers with an eligibility rating over 7 or where downstream open banking was required for eligibility. An eligibility rating of over 7 indicates that the chance of a customer being approved for a loan is over 70%.

In 2021, over 40% of sub-prime customers were receiving loan offers. Since then, there has been a steep decline and the proportion of sub-prime borrowers receiving an offer is now broadly equivalent to the end of 2019. This decline can be attributed to some lenders exiting the market and a reduction in the variety of credit products on offer. Since then, unsecured lending has failed to grow significantly. This suggests that other providers have not filled the gaps left by those who exited the market, and access to credit for non-prime borrowers remains restricted.

Only 28% of individuals looking for a loan on ClearScore could be described as being 'served' by a competitive market for credit (that is, they are offered more than two loans when shopping around).

This view of a market where competition is not working is reinforced in the loans' APR. ClearScore data shows that the average APR for the highest-ranking loan offered on their site over the past year had increased by 2.4 percentage points for underserved users but only 1.5 percentage points for served users. The impact on access to credit for non-prime (near and sub-prime) and sub-prime in particular is clear in Chart 6 on the next page.

Chart 6: Loan accounts taken per ClearScore user



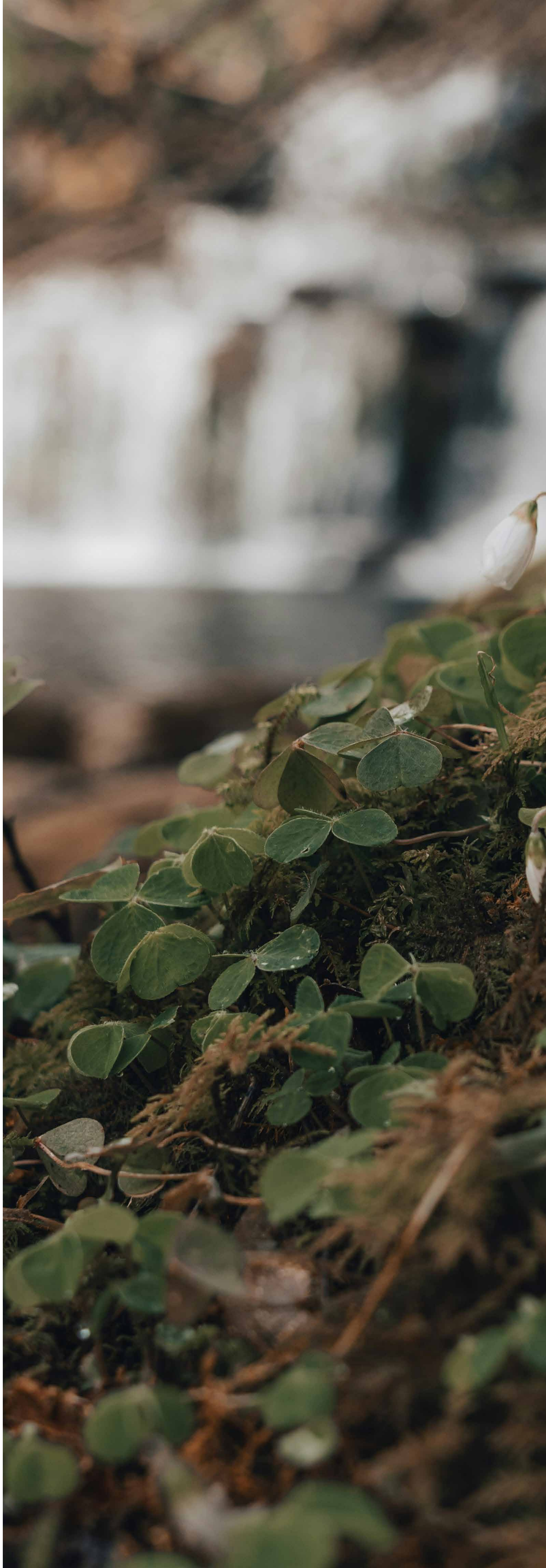
Note: Uses all available bureau data of users signed up to ClearScore UK at the time; accounts taken per user = the number of accounts taken divided by the number of users requesting ClearScore pull a credit score in a month.

The lack of access to affordable lines of credit leads to more people turning to sub-optimal alternatives or going without essentials. Looking at FCA data, 12.8 million adults (24% of adults) applied for one or more credit products in the two years to May 2022, of which 2.9 million were refused (24% of all adults who applied). Some 50% of over-indebted applicants were declined, as were 69% of adults in financial difficulty and 72% who had used a debt advice or debt management service in the previous 12 months. The FCA found that, of those who were declined, 19% said they were forced to borrow from friends and family, 9% said being declined resulted in their default on a loan, bill or payment and 2% said they turned to an illegal or unregulated moneylender.[10]

Recent research by IPSOS for Fair4All Finance found that over three million people in Great Britain may have borrowed from an illegal moneylender in the last three years. When asked, 7% of people said they or someone in their household had used an unlicensed or unauthorised lender that charged them interest (sometimes known as a loan shark or illegal moneylender). [11]

Many unserved in the traditional credit market increasingly turn to innovative, but currently unregulated BNPL providers. BNPL provides a flexible, seamless experience that can deliver benefit to consumers. However, BNPL firms are not subject to the same rules as consumer credit firms, meaning customers are not protected as much as when they use regulated consumer credit.

ClearScore data shows that while one in three people in the served market used BNPL – this rose to one in two people in the unserved population (those getting no credit offers when shopping around). Underlying these figures has been a rise in the use of BNPL by the served population of 44% since January 2021. Over the same period, growth in the use of BNPL by the larger unserved population has been even greater at 53%. Most concerning, though, is that almost one in five (20%) unserved consumers using BNPL in October 2023 were already in arrears in one or more of the credit cards or loans they held at the time of taking out the BNPL product.



[10] FCA, 'Affordable Credit – use of different credit products and consumer vulnerability' (October 2023).
[11] Fair4All Finance, 'Millions turning to unauthorised lenders as new report shines a light on illegal moneylending in Great Britain' (June 2023).

SECTION THREE

Reasons for market failure

We spoke to several lenders as part of our research for this report — this section is based on their perspectives. We do not believe that a single issue on its own has, or could have, resulted in the problems we see with the market today. Combined, the issues have contributed to a withdrawal of investment capital and reduced innovation in the non-prime market.

> *Our experience is that securing institutional capital for non-prime lenders has significantly increased in difficulty over the past decade. Institutional capital providers have been pushed away from the non-prime space by the regulatory uncertainty and levels of complaints fuelled by CMCs.*
>
> **EY Partner, Corporate Finance**

Challenge 1: Perception and unwritten rules driving a contraction in supply

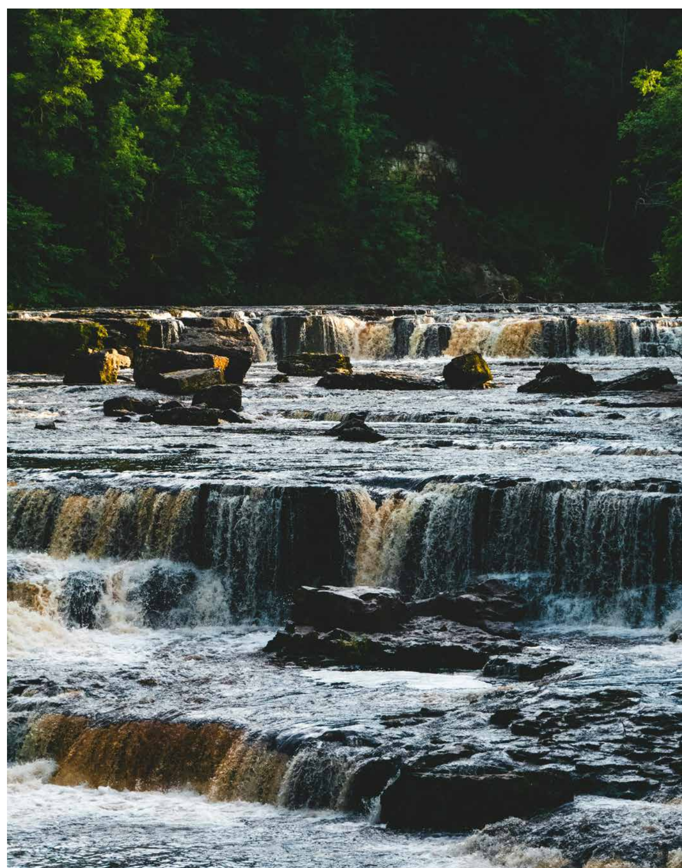
Firms have reported that societal perceptions of an acceptable cost of credit, reinforced by regulatory activity on price, are reducing the viability of operating in the market for some customer segments and risks. These perceptions have been shaped by past poor firm behaviour — leading to firms and their investors withdrawing from lending to non-prime customers. In this environment, unclear expectations from the regulator about what good practice looks like act to constrain the type of propositions lenders are prepared to offer in the market.

When the FCA took on responsibility for regulating consumer credit, it committed to tackling poor market conduct, including where firms failed to consider affordability and pushed customers further into debt.

The FCA enforced against firms operating in certain segments, which led to high-profile failures. To prevent harm, the FCA imposed price caps, including in payday lending and rent-to-own. New rules defined HCST credit as loans with terms of less than 12 months with 100% APR or more. At the same time, the FCA also explored access to credit issues, including 'mid-cost' credit.

However, since then, the regulator has continued to focus on price. Firms offering products with APRs of 50% or more report finding themselves under closer and more regular scrutiny from FCA supervisors in recent months. The fair value rules introduced by the Consumer Duty are still untested and seen by many to potentially signal a further focus on price over access.

Although price caps apply only to certain types of lending products, in practice firms report caps have influenced pricing across the unsecured consumer lending industry and lave led to mainstream banks' withdrawal from providing unsecured loans to non-prime customers. Few lenders we spoke to are willing to charge above 49.9% APR because the wider society considers this price socially unacceptable and would attract additional attention from the regulator through enhanced supervision. Even if a firm wanted to charge above this rate, they said they could not because their investors would not provide equity or debt funding for products or require a risk premium above these thresholds. This is even though some social enterprises (for example CDFIs) charge APRs of close to 100% to reach some sub-prime customers.



Although high interest rates on some borrowing can be an indicator that either the market isn't working or that the individual should not be borrowing the money — research by the Carnegie Trust suggests APR is not a primary decision factor for borrowers who value timeliness, flexibility, trust in the lender and affordable repayments over the cost of the loan, when making borrowing decisions.[12] While considered more appropriate for longer-term loans such as mortgages, focusing on APR for short-term, small-sum loans may be unhelpful compared with the actual need and affordability for the individual.

Past enforcement action has also led to a perception in the market that certain business models are considered unacceptable by the regulator. For many non-prime lenders, even today, there is a perception that any enforcement action from the FCA will eventually be terminal for their business. As shown in charts 1 to 4, entire market segments have evaporated following regulatory intervention — with other forms of regulated credit not absorbing the residual demand.

Lower interest rates for customers are desirable from most public policy perspectives — but the trade-off is a contraction in supply. The cost of wholesale funding has risen significantly due to increased interest rates — and the uncertain economic environment is causing firms to be more conservative in their risk-taking. The British Business Bank reported that in 2022 alone, wholesale funding costs for marketplace lenders and CDFIs increased by 'around 50%'.[13] This leaves firms with less room to generate profits, particularly where there is a perception of a price ceiling — further reducing the ability to make a fair return for lending to this market.

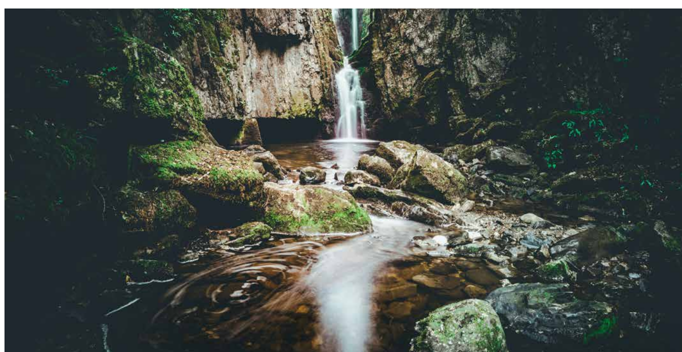
[12] CarnegieUK Trust, 'Meeting the need for affordable credit' (2015).
[13] British Business Bank, 'Small Business Finance Markets 2022/23' (2023).

Challenge 2: Barriers to innovation

In recent years, we have seen an unprecedented change in financial services driven by a series of technological changes, big data, open banking, blockchain and most recently, the emergence of AI. Each has the potential to reshape consumer credit – driving efficiencies and broadening access while helping better understand the affordability of a loan for any individual.

The use of open banking and open finance to support more accurate lending decisions is growing – and some firms are seeing powerful results. For example, for the same risk appetite, one firm we interviewed was able to lend to six times more customers than they would have been able to without open banking data. Around 85% of their customers are happy to consent to share their data once they understand the benefits.

However, other firms are finding their experiments with open banking and open finance are **held back by internal uncertainty about how the regulator and the Ombudsman might perceive these innovative approaches should something go wrong.** Developing and testing analytical models that can generate insights from customer data can take several years for firms to implement as they adjust their lending model to the new data. During this time, firms may hold customer data but not yet use it to inform live lending decisions. Firms reported a concern that if a customer complained about a lending decision made during this period (where the firm possessed detailed insights into the customer's transaction history through open banking but was not yet using it to inform live lending decisions) the Ombudsman would uphold the complaint on the basis that the firm should have used all data in its possession.



USING OPEN BANKING TO BROADEN ACCESS TO CREDIT FOR NON-PRIME CUSTOMERS

Open banking allows a customer's financial data to be shared between banks and other financial services providers. This can be especially useful where customers have thin credit files, lower credit scores or irregular income.

Credit scores can be an inaccurate reflection of a customer's financial situation and may over- or under-state a customer's creditworthiness. This issue was recognised explicitly by the FCA in their Credit Information Market Study – and the regulator is now taking steps to remedy it.[14]

According to one firm we spoke to, one in four of the customers they decline are gambling excessively, despite having good credit scores. They also experience 70% fewer defaults than would have been expected "based on the credit score alone, due to the ability to make better decisions using open banking data.

The data is not yet perfect, and firms are having to invest significant resources into ensuring their models categorise transactions correctly. An example is rental payments, which can be difficult to spot where customers live in shared accommodation and divide costs between several occupants or if the landlord is a private individual.

Similar concerns apply to other forms of innovation. Firms believe that entering the market with a non-standard approach could, later, be judged to have been misaligned with acceptable practice at a future date. Lenders we spoke to pointed to the prolonged period of regulatory change and action in the market, which has led firms with particular business models to exit the market (for example, guarantor loans and doorstep lending). Others worry about being identified as an outlier through new product sales data reporting – further reducing lender appetite to bring innovation to the market. The fear is that one upheld finding could snowball into a liability threatening the firm's viability. The result is a market that holds back from experimentation – restricting the benefits that could increase access and lower the cost of credit.

[14] FCA, 'MS19/1.3 Credit Information Market Study Final Report' (December 2023).

Challenge 3: The disproportionate impact of CMCs

Although CMCs can play an important role in helping customers who have suffered harm access the compensation they are owed, some firms reported that **current incentives are leading to high, unpredictable costs and large numbers of baseless complaints against them and reducing the attractiveness of the market to investors.** According to the Ombudsman, 'at present, over half of [the] complaints referred by professional representatives are not upheld where [their] approach to issues is already well established', for example, affordability assessments and mis-selling.[15]

WHAT ARE CMCs?

CMCs manage complaints and claims against regulated financial services firms on behalf of customers in return for a fee. They can play an important role by helping those who have suffered harm to access the compensation they are owed. The FCA regulates some types of CMCs, including those that provide services for claims concerning financial services products and services.

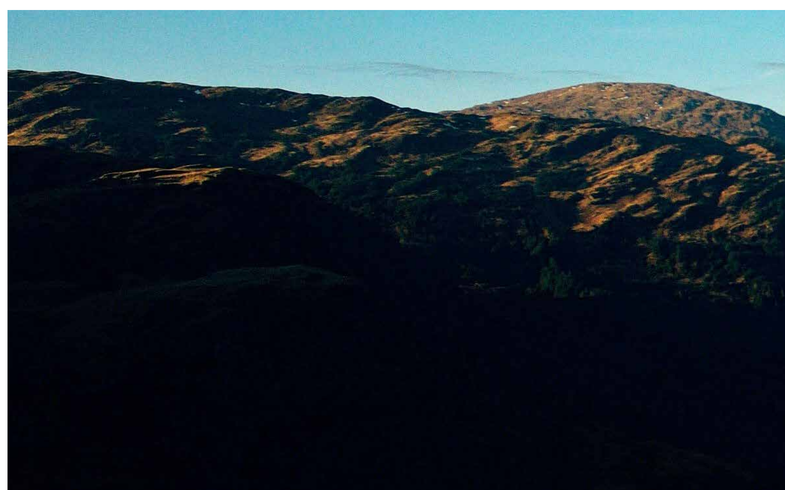
The costs associated with dealing with CMC-generated claims can be significant for lenders and are a key factor in driving market exits. For every claim, a firm must carry out an internal investigation. From the fourth complaint onwards, firms must pay a £750 case fee to the Ombudsman for every complaint investigated – regardless of the outcome.[16] On the other hand, there is little cost currently on CMCs involved in immediately passing the complaint to the Ombudsman, and the problem is likely to get worse with the advent of AI, which will help CMCs automate their activity and exploit channels such as social media to scale lead generation rapidly. Mass claims, whether valid or not, can be enough to force a firm into settling to avoid costs escalating.

The balance of incentives throughout the process may also be leading to perverse outcomes. Firms are reluctant to challenge the initial findings of case handlers because the perceived cost of escalating the case to an ombudsperson brings the prospect of additional publicity once the case is published. This can, in turn, drive more CMC-originated claims.

Firms report that these costs ultimately increase the cost of business which is passed onto consumers through higher APRs and causes lenders to be more cautious in calculating affordability. In cases where claims are about genuine wrongdoing, these costs may be warranted. However, lenders we spoke to identified examples of CMCs using past Ombudsman decisions to make generic, mass submissions – often without even contacting the individuals concerned. They were regularly seen to be using subject access requests to pressure firms into settling a case.[17] The comments from the Ombudsman support these assertions noted above.

It is possible that the FCA's interventions in the credit information market and greater use of open finance will make it easier for firms to defend responsible lending decisions because the information they use to make those decisions will be more accurate. This is the experience of one lender we spoke to. However, this alone does not remove the cost associated with investigating and preparing to defend claims, as well as Ombudsman case fees, which are currently payable by the firm that is the subject of the complaint – regardless of the outcome.

The government has recognised this problem. It introduced a clause to the Financial Services and Markets Bill 2023 designed to enable the Ombudsman to make rules requiring other parties, which could include CMCs, to pay fees in connection with the investigation of complaints. In December 2023, the Treasury published draft legislation that would enact the power if adopted – and the Ombudsman is now consulting on the proposal.[18] As of today, however, the issue remains unaddressed.[19]



[15] Financial Ombudsman Service, 'Our 2024/25 Plans and Budget Consultation Paper' (December 2023).
[16] Financial Ombudsman Service website, 'case fees'.
[17] Subject access requests are a right under data protection legislation allowing individuals to ask an organisation whether they are using or storing their personal information, and to request copies of that information verbally or in writing.

Challenge 4: Retrospective impact of regulatory change

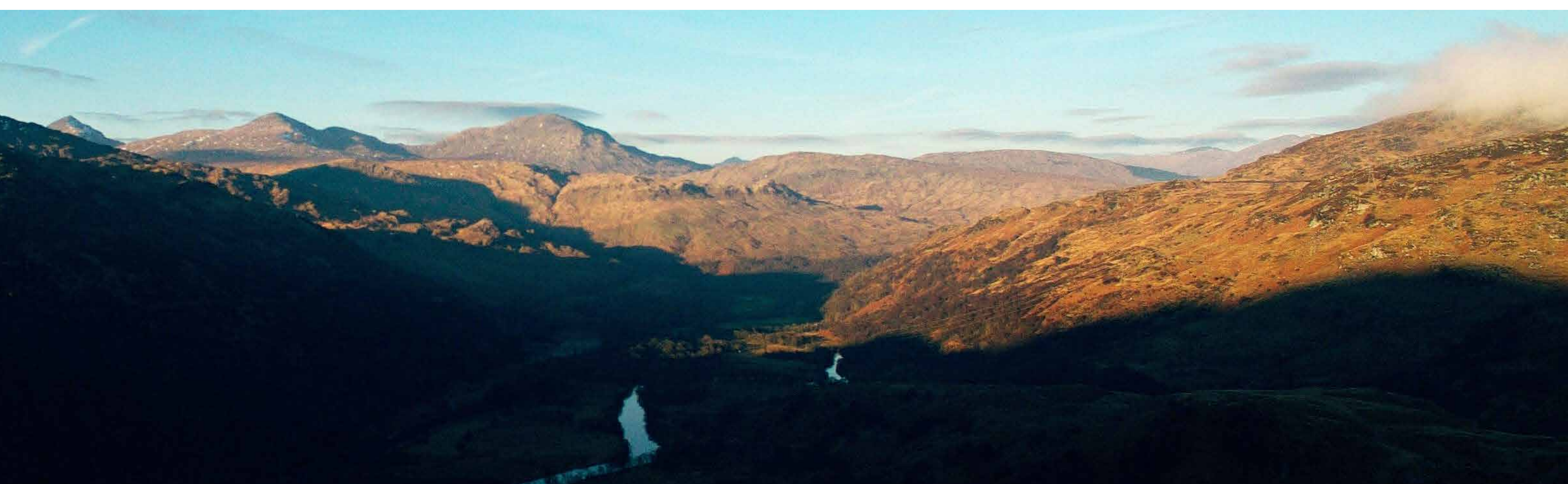
An ongoing challenge for firms operating in the market is their need for wholesale sources of capital to finance non-prime lending. **The continual and rapidly changing regulatory environment increases the risk premium required by funders of non-prime credit.** This, combined with the belief noted earlier in this report that there is a regulatory price ceiling, leads to firms withdrawing access from the market.

Over the past 10 years, the consumer credit market has experienced a sustained period of regulatory and public scrutiny driven by serious misconduct from a small group of firms. The diagram below charts some of these interventions. Firms recognise that much of the action taken by the FCA was necessary to protect consumers from future harm and boost consumer confidence in the market. However, the continually changing regulatory landscape is unattractive to investors who seek to invest over multi-year time horizons. This makes it harder for firms to secure the funding needed to operate in the market.

Firms we interviewed do not see an end to this pattern of regulatory intervention in the future and fear continually increasing funding costs as more institutional investors exit the market and competition is reduced. The type of investor is another important factor which drives the cost of capital. One firm reported being unable to source funding from Tier 1 banks for loans of over 50% APR, leaving them to choose between funding from hedge funds and private credit funds, which seek higher returns on investment, thereby increasing the cost of capital.

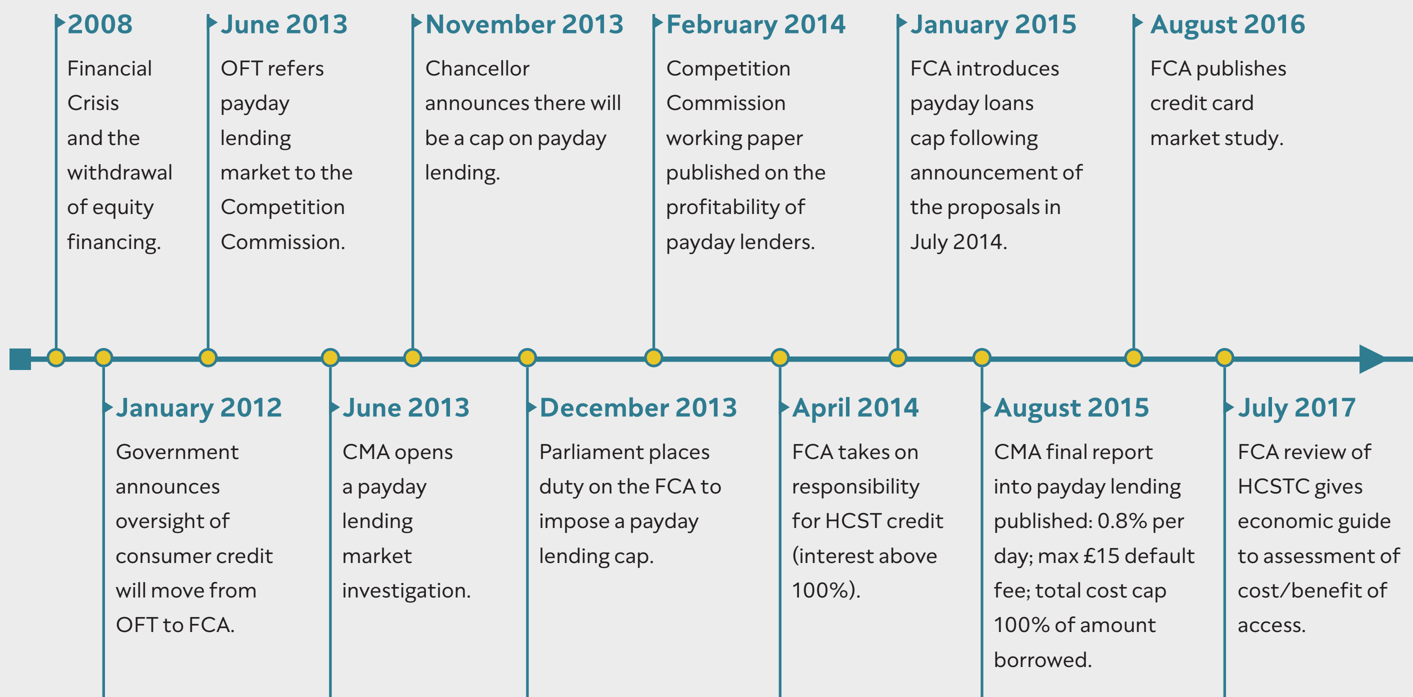
Changing regulatory and societal expectations on credit providers also challenges the Ombudsman. Lenders we spoke to are concerned that the Ombudsman's case handlers applied today's best practice retrospectively, and that decisions can appear inconsistent. The industry has consistently raised this issue over several years. Given the length of time between an original lending decision and a case being considered by the Ombudsman, the risk of retrospection without careful documentation of best practice at certain times remains an issue, however careful the Ombudsman is. One lender reported experiencing cases where the Ombudsman has set thresholds for affordability assessments beyond the principles laid out in the FCA's Consumer Credit Sourcebook — therefore removing the subjectivity the lender has relied upon in its assessment. For example, the lender pointed to an implication that the Ombudsman considers a debt-to-income ratio of above 25% as a signal that it is not appropriate to lend.[20]

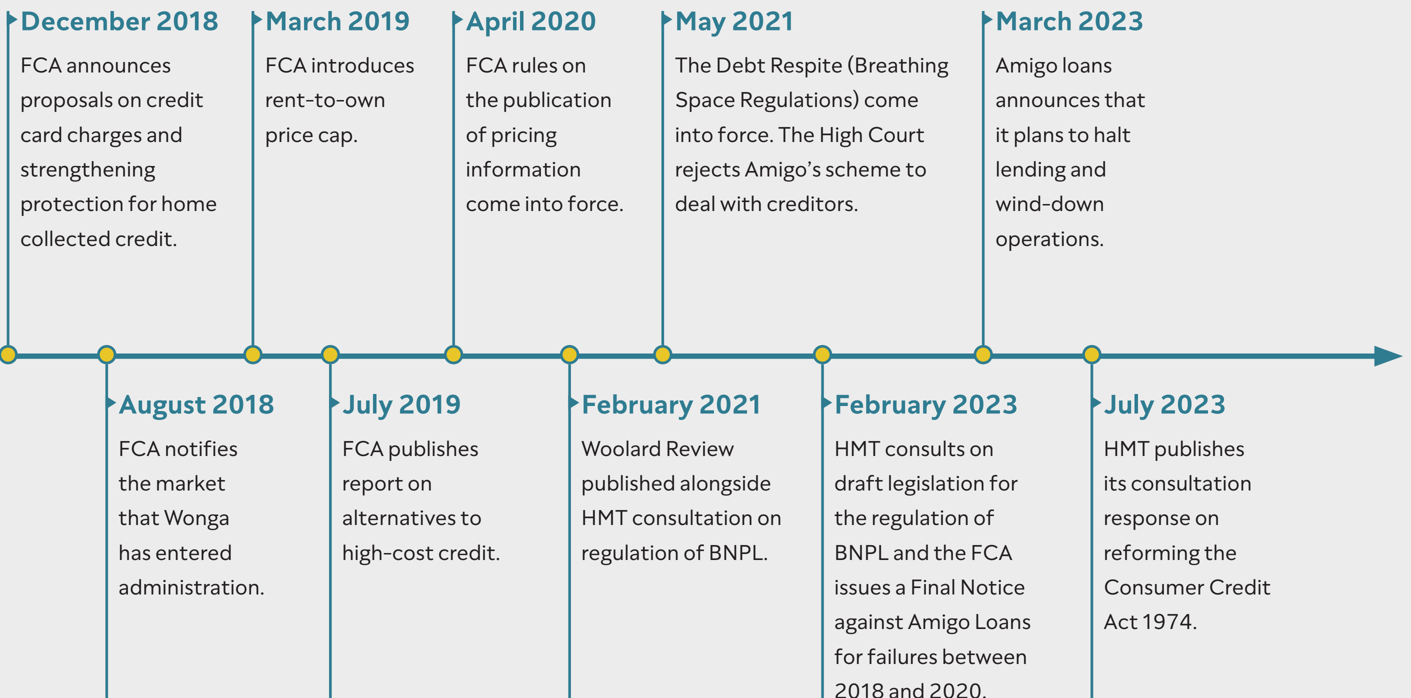
While the evidence for this occurring in practice is anecdotal, with no evidence of systematic retrospective decision-making, the firms we interviewed said it had discouraged them from entering or expanding further into the market.



[18] The Financial Services and Markets Act 2000 (Ombudsman Scheme) (Fees) Regulations 2024; Financial Ombudsman Service, 'Our 2023/24 plans and budget' (December 2023).
[19] See Section 63 of the Financial Services and Markets Act (FSMA) 2023, which amends paragraph 15 of Schedule 17 of the FSMA 2000.
[20] See CONC 5.2A.18G(2), which contains guidance about the option of conducting an analysis of the customer's debt compared to the customer's income, depending on what is proportionate to the customer's individual circumstances.

Timeline of regulatory activity in the UK consumer credit market



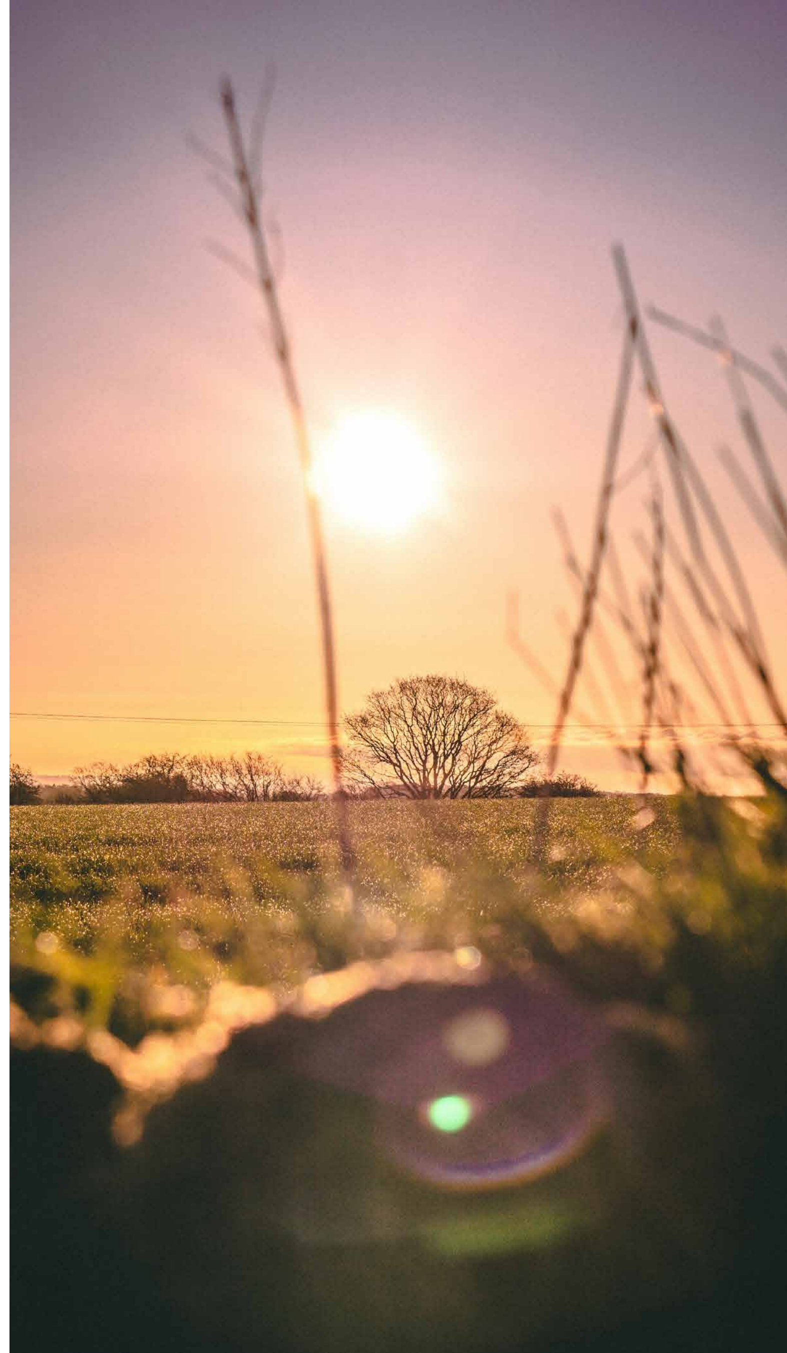

August 2018
FCA notifies the market that Wonga has entered administration.
December 2018
FCA announces proposals on credit card charges and strengthening protection for home collected credit.
March 2019
FCA introduces rent-to-own price cap.
July 2019
FCA publishes report on alternatives to high-cost credit.
April 2020
FCA rules on the publication of pricing information come into force.
February 2021
Woolard Review published alongside HMT consultation on regulation of BNPL.
May 2021
The Debt Respite (Breathing Space Regulations) come into force. The High Court rejects Amigo's scheme to deal with creditors.
February 2023
HMT consults on draft legislation for the regulation of BNPL and the FCA issues a Final Notice against Amigo Loans for failures between 2018 and 2020.
March 2023
Amigo loans announces that it plans to halt lending and wind-down operations.
July 2023
HMT publishes its consultation response on reforming the Consumer Credit Act 1974.

Challenge 5: An un-level playing field

The emergence and rapid growth of BNPL have demonstrated a clear demand from consumers for easy access to affordable credit for, usually, low-value products. Used well, BNPL products offer customers a relatively frictionless, flexible and low-cost way to manage their money. However, the market has grown outside of the regulatory protections enjoyed by customers elsewhere in the unsecured lending market. Having a significant credit segment outside of regulation distorts the market, making investment relatively more attractive into a service characterised by lower regulatory protections and costs. A level playing field where the same risk enjoys the same regulation can help support lending capital reaching those areas of the market best able to deploy it effectively.

The growth in popularity of BNPL among consumers and investors has been significant. In 2021, the Woolard Review ('the Review') estimated that five million customers had used BNPL at least once since the start of the Covid pandemic. Furthermore, the Review found that around 1 in 10 of all first users of BNPL[21] who also banked with one major high street bank were in arrears when they first used BNPL. Subsequent research conducted by the FCA predicted that 27% of UK adults (approximately 14 million) had used BNPL at least once in the six months before January 2023.[22] Investors, particularly private equity funds, have funnelled huge sums of money into BNPL — recognising the potential customer benefits and relatively light touch regulatory controls and risk — particularly when compared with other consumer credit products. Since 2020, $7.37bn (approximately £5.79bn) of debt and equity has been invested in the UK's BNPL sector across 11 companies.[23]

The Woolard Review recommended the regulation of BNPL to ensure effective consumer protection in the market. The Review garnered widespread support and was accepted by the government with a commitment to legislate made on the same day the Review was published in February 2021. The government consulted on policy proposals in October of the same year — followed by a consultation response in February 2022. A consultation on draft legislation was published in February 2023 — and feedback on the consultation is expected.[24]



The challenge remains that BNPL is at risk of being used by those who cannot afford to make the repayments and would have been denied credit by a regulated provider. The fact that affordability checks are not required in all segments of the consumer credit market is a clear distortion which, in turn, makes it more attractive for investors to provide capital to firms offering unregulated products.

[21] The Woolard Review
[22] FCA, 'Financial Lives: Consumer experience of the rising cost of living' (January 2023)
[23] Pitchbook data (November 2023).
[24] HM Treasury, 'Regulation of Buy-Now-Pay-Later: consultation on draft legislation' (February 2023).

Challenge 6: Accurately assessing affordability

Assessing the affordability of a loan is an essential part of deciding whether to offer a loan. Firms face several challenges in being confident that their assessment will be judged at a future date as fair. As a result, the firms we interviewed told us that **unnecessary caution can be built into affordability assessments.** This restricts the availability of credit.

The affordability rule was introduced following the transfer of responsibility for consumer credit regulation from the Office of Fair Trading (OFT) to the FCA in 2014 and rising concerns over the affordability of payday lending.

It requires regulated lenders to consider if a customer can afford the cost of a loan, rather than simply considering if the customer is likely to repay. The FCA expects firms to consider a customer's history of repaying and the likelihood that they will be able to afford to do so in the future.

The affordability rules are principles-based which means they are flexible but place responsibility on lenders to judge what is considered affordable. As noted by the FCA – 'creditworthiness assessment is not an exact science – and some credit will turn out to be unaffordable due to unforeseen events and circumstances even if the initial assessment was appropriate and rigorous'.[25]

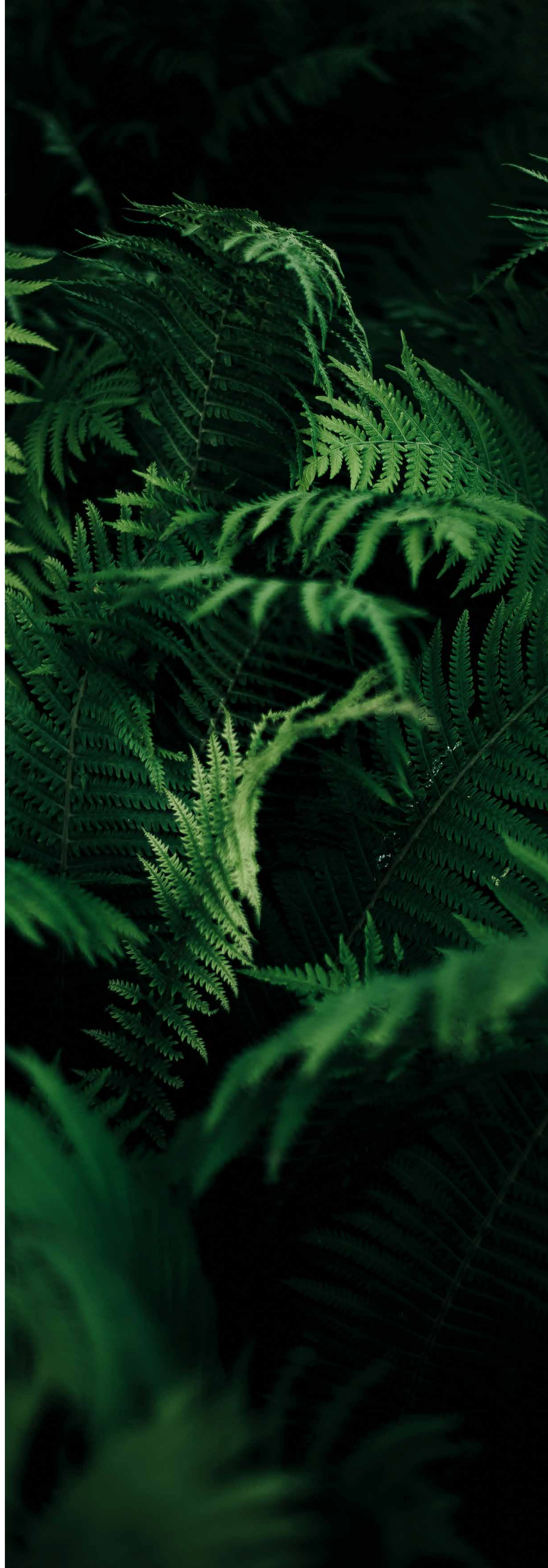
Firms face several challenges in making the assessment:

- The accuracy, availability and accessibility of data inputs. Self-reporting and using ONS averages can result in inaccurate customer income and expenditure assessments. Open banking can be a simple way of processing applications for credit – but its use is not yet widespread. It cannot be the only solution because it relies on customers being willing to share their data. Current account turnover (CATO) data, used by lenders to verify income, is currently shared in different formats and different levels of granularity – negatively impacting the effectiveness of affordability assessments. This problem is particularly acute for the non-prime lending market: Lenders offering personal current accounts (in other words, banks) can access more granular information on income – but few lenders serving the non-prime market are banks. The FCA has acknowledged the negative impact this has on competition between lenders and has proposed solutions to level the playing field.[26]
- Judging which items from a potential customer's expenditure are essential. To manage the risk of an inaccurate affordability assessment – some firms take a more cautious approach to assessing what is essential expenditure. This approach could reduce the affordability of the loan and decrease access. For example, some lenders calculate affordability based on a customer's ability to maintain their current standard of living – including regular recurring payments such as media content subscriptions. Others, especially those serving the sub-prime market who rely on face-to-face interactions – spend significant resources on engaging with customers to understand their capacity to cut back on discretionary spend to ensure they can make their loan repayments. One firm reported including a buffer to mitigate the risk that their assessment was too narrow.

[25] FCA, 'Assessing creditworthiness in consumer credit – Feedback on CP17/27 and final rules and guidance' (July 2018).
[26] FCA, 'Credit Information Market Study Final Report' (December 2023).

- Building in future changes in expenditure into the affordability assessment. Over time, inflation, interest rates and customer circumstances can change. An affordable loan can retrospectively look unaffordable. There is a requirement in the affordability test to account for future increases in expenditure, but in the higher inflation environment that we now find ourselves, this is a more challenging task than in the low inflation environment when the rules were written.
- Accurately judging customer behaviours and attitudes. While the credit assessment tries to capture the likelihood of repaying, firms will never fully be able to predict future customer behaviour towards repaying their loan.

These challenges and the risk of action by CMCs encourages firms to second-guess what enforcers may think in the future and make increasingly cautious decisions. Firms are used to interpreting principles and use other signals to help them understand the regulator's expectations — such as decisions made by the Ombudsman about complaints. However, firms find it difficult to search previous rulings to learn and improve. In addition, given the level of flexibility in the affordability rules and the fact that Ombudsman decisions are taken on a case-by-case basis, there is a high risk of inconsistency in Ombudsman findings. Given the inherent challenges in judging affordability, the facts of a case considered by one case handler may lead to a different outcome from the same facts considered by another. Inconsistency, whether real or perceived, hurts investor and firm confidence — reducing the appetite to participate in the market. It also makes it more difficult for firms to interpret what is expected of them.



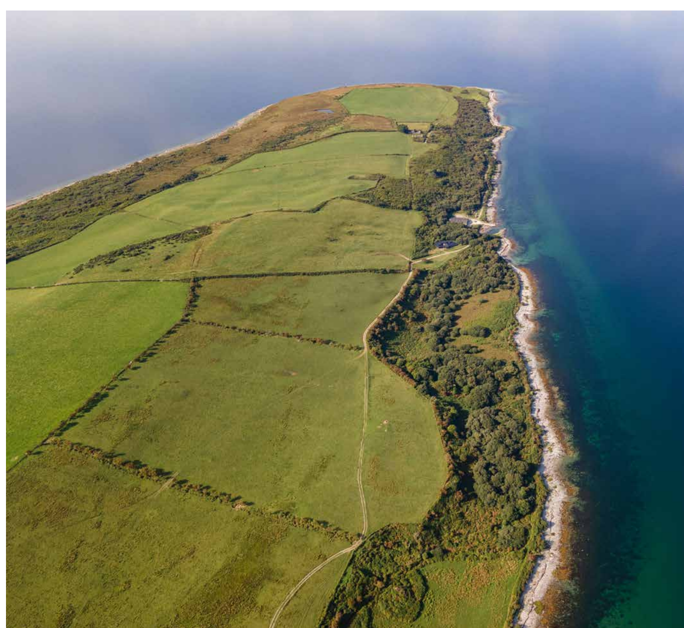
SECTION FOUR

Building a non-prime lending market that delivers for consumers

Many lenders and their investors have lost confidence in operating in the non-prime market because of how the market has developed and the factors set out in this report. Steps need to be taken to raise confidence and make it attractive again — allowing customers to get credit they can afford and lenders to make a fair return for the risk they take.

Recommendation 1: Set a clear strategy and vision for a well-functioning non-prime lending market

Firms and investors have set beliefs about how regulators perceive the non-prime lending market and point to a pattern of regulatory change over the past 10 years — damaging investor confidence in the market. Many believe in informal interest rate caps and that the regulator does not want certain business models to succeed or expand. Regulators and the government should support the need for a thriving competitive market for credit and the role that private-sector firms play in offering affordable credit to non-prime customers. A new long-term strategy is needed to demonstrate their commitment to fostering a more stable environment where competition can thrive.



To address this issue, the FCA, in partnership with the PRA (due to their role in overseeing banks and credit unions) and HMT (due to their overall responsibility for the UK financial services sector), should:

- Articulate how it wants the consumer credit market to operate for non-prime customers and set a long-term strategy for how the sector will be regulated. This should cover:
    a. The importance of non-prime lending and the role of for-profit firms in providing access to credit, including to people who may be less well-off.
    b. If there are APRs and default rates per segment that cause greater concern or are unacceptable.
    c. If there are product features or business models that are unacceptable.
- Agree on a consistent and transparent way to refer to the cost of credit and publish the meaning of key terms in its strategy. Although the term 'high-cost credit' has a meaning in regulation — in practice, its scope has expanded to any loan with an APR of over 50% due to the reasons we've set out in this report. It is vital that firms and investors understand the language regulators use.
- Commit to reviewing how the cost of credit is communicated to customers (see Recommendation 4 below).
- Confirm if the government will pursue reforms to the Consumer Credit Act, and if so over what timeframe.
- Introduce new rules to allow the FCA to regulate BNPL and create a level playing field.
- Commit to setting measures to track how government and regulatory interventions are contributing towards the development of a competitive market.

Recommendation 2: Setting expectations for the role of open finance in assessing affordability

Although it's not a silver bullet, many lenders are looking to open finance to significantly improve their understanding of a customer's financial circumstances, support better lending decisions and offer better rates to consumers. However, firms we interviewed said they would welcome a clearer articulation from the FCA about their expectations for the role of open finance in calculating affordability to facilitate adoption.

If the FCA wants to encourage the use of open finance, it needs to work collaboratively with the Ombudsman to reassure firms of their approach. This could be achieved by publishing examples of acceptable and unacceptable practice. The FCA should also make clear to firms if it expects them to use open finance to support lending decisions and, if so, in what circumstances.

Recommendation 3: Address the unnecessary burdens posed by CMCs

Addressing the imbalance of power between CMCs and regulated lenders would reduce the cost associated with operating in the market where firms are treating customers fairly and complying with the FCA's rules.

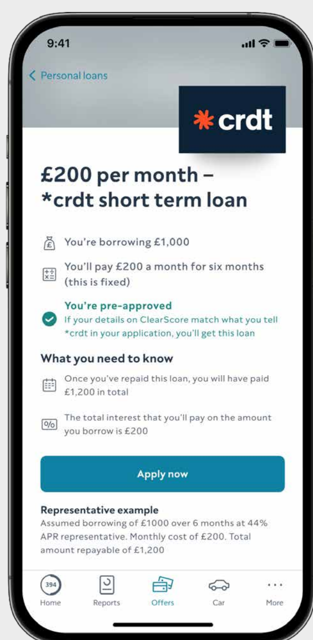
The government has already recognised the need to tighten controls on CMCs by including a provision in the FSMA 2023 that would allow for the Ombudsman to charge case fees to third parties. The Ombudsman is now consulting on these changes. Once introduced, the Ombudsman should make the necessary changes to its rules and seek approval from the FCA on those rules – allowing the case fee to be charged to CMCs. This will rebalance incentives and encourage CMCs to only take on cases with a real prospect of succeeding.

Recommendation 4: Develop alternative methods of communicating the cost of short-term loans to consumers

The system of APRs stems from European legislation.[27] Given that the UK can depart from this – the FCA should work with the industry to test and develop new ways of communicating the cost of loans to consumers, as part of the planned reform of the Consumer Credit Act. This could involve defining and publicising a category for customers who do not normally receive low-cost offers and using cash sums rather than APRs to express clear information about the cost of borrowing.

Perceptions of 'high' APRs are overwhelmingly negative, and this reduces lender and investor appetite to offer short-term loans to non-prime customers. APR is an effective tool for customers to understand and compare the cost of loans with terms of 12 months or more. However, it is not necessarily the best way for customers to understand how affordable the loan is, particularly for loans with terms of less than 12 months. Communicating the true cost of a loan in pounds and pence would provide a more transparent view of the true cost of short-term loans to the customer.

ClearScore example of how the cost of short-term credit products could be communicated to potential customers in an easy to understand way



[27] Consumer Credit Directive 2008/48/EC

The FCA has run field trials through its Behavioural Economics function about how credit card charges are disclosed to customers. Running similar trials on how best to communicate and compare the cost of shorter-term loans, including through simple disclosure of the amount paid in interest for a loan, could be an effective way to trial future policy changes or interventions. Any subsequent changes to rules could be delivered through the government's planned Consumer Credit Act reform.

Recommendation 5: Clarify expectations on affordability and fair value

The lack of clarity around the FCA's expectations for how lenders should calculate affordability and the perceived high risk of a complaint about affordability being upheld by the Ombudsman are reducing the confidence of lenders to operate in the non-prime market. The Consumer Duty adds an extra layer of complexity in this space – particularly given the new rules requiring firms to ensure the products and services they supply to retail customers are 'fair value'.

The FCA is a principles-based regulator – and the industry should not expect it to set out detailed rules. However, many of the concepts used in regulation are subjective. Regulatory guidance could help clarify the FCA's expectations and help firms understand how to approach certain scenarios – particularly where judgements are finely balanced. Specifically, the FCA should be more explicit about the types of expenditure that are considered essential. This would give firms and customers greater flexibility to borrow where needed and sacrifice future spending to pay for this borrowing. Guidance would also be useful on the data sources the regulator would expect firms to use instead of open banking data – including if customers' self-declared expenditure can be relied upon.

Additionally, the FCA should clarify how it wants firms to approach pricing for risk in the context of the new Consumer Duty rules on fair value. In FG/22, the FCA stated that firms may price for risk, provided they could demonstrate fair value. However, in their February 2023 letter to CEOs and Directors of Mainstream Consumer Credit Lenders, the FCA suggested that even where a consumer poses a higher risk, charging an unreasonably high rate could be considered unfair. Firms would benefit from greater clarity around what could be considered unreasonable by the FCA.

Another area where greater clarity would be beneficial is expectations over how firms should account for changes in expenditure over time. At present, many firms feel the need to build in buffers to account for a range of inflation scenarios. The FCA should be clearer with firms about

their expectations over how future price rises should be incorporated, which takes account of the increased uncertainty over future price rises since the COVID pandemic.

Recommendation 6: Produce supervisory guidance to ensure consistency

Publishing a vision for the non-prime consumer credit market and additional guidance to help firms comply will help restore confidence in the market. However, FCA supervisors must ensure their approach to supervision is consistent with this approach. Any contradiction will undermine the FCA's efforts to convince lenders and their investors that it is open to firms offering affordable lending products to non-prime customers.

For example, we heard during interviews with lenders that FCA supervisors use APRs as a way of assessing the degree of scrutiny required. While it is necessary for the FCA to take a risk-based approach to supervision given the huge number of firms it supervises, this focus on APRs created a perception among lenders and their investors that the FCA does not approve of loans with APRs of over 49.9% and would be more likely to act against firms.

Creating and publishing supervisory guidance is a tool that will ensure greater consistency between FCA strategy and practice.

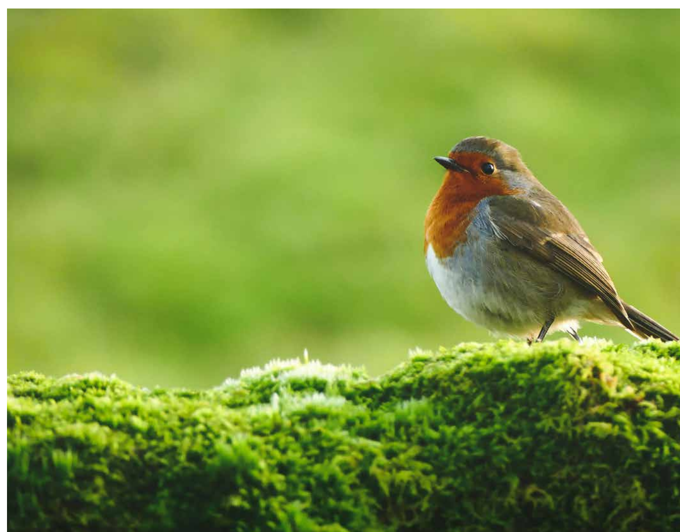
Recommendation 7: Promoting better communication between the industry and the Ombudsman

Firms report finding it difficult to learn from decisions that the Ombudsman makes. Although decisions and case studies are published on the Ombudsman's website — these are case-by-case rather than thematic. Some firms reported employing staff to go through these decisions and highlight areas where their firm may need to change their approach. Additionally, firms find that individual case decisions do not support firms' understanding of the Ombudsman's views of best practices or how regulatory interpretations may shift over time.

Proactively identifying best or acceptable practices by the Ombudsman may help firms update their processes to align with what is expected of them. The Ombudsman, with the FCA, could better communicate themes and trends that emerge from complaints.

This may also ease concerns about inconsistency in the Ombudsman's decision-making. However, firms will need to continue to recognise that all decisions depend on the facts of the case. If lenders have examples of cases they think are inconsistent, industry bodies could also play a useful role in collating these and leading conversations with the Ombudsman to better understand the reasons for their decisions in each case. Engaging with one body, rather than multiple firms, is likely less resource-intensive for the Ombudsman.

In addition, industry bodies could lead in developing and agreeing best practice approaches that set out how the industry applies FCA rules at a time. This could support the Ombudsman when making decisions about complaints concerning events that happened in the past — when regulatory expectations may differ from how they are today.



CALL TO ACTION

Access to credit allows customers to participate in modern UK society. Whether paying for a new washing machine or replacing their children's school uniform — millions of customers rely on credit to manage their finances effectively. ClearScore and its partners call on the government, the FCA and industry to work together to restore confidence and deliver a non-prime credit market that works for a wider range of customers. The recommendations above set out actionable steps that can be taken to achieve this goal.

Authors

Andy Sleigh
Chief Operating Officer, ClearScore

Sara Sheridan
Director of Data & Insights, ClearScore

Tom Markham
UK General Manager, ClearScore

Rebecca Ingledew
Senior Data Analytics Manager, ClearScore

Christopher Woolard CBE
Partner, Ernst & Young LLP

Alex Roy
Director, Financial Services Consulting – Regulatory Insights, Ernst & Young LLP

Fran Clausen
Manager, Financial Services Consulting – Regulatory Insights, Ernst & Young LLP

About The ClearScore Group

The ClearScore Group began with the launch of the ClearScore app in the UK in July 2015 to help everyone, no matter their circumstances, achieve greater financial wellbeing. Since then, it has expanded to include a second online marketplace (DriveScore) and an open banking services business optimised for use in credit marketplaces (D·One). The Group combines beautifully designed apps, with powerful, consumer-controlled data, and a cutting-edge technology stack to deliver high-growth marketplaces that retail financial products. The Group has grown rapidly to serve over 20 million users across the UK, South Africa, Australia, Canada and New Zealand. The Group now partners with over 150 financial institutions around the world to ensure that the right product gets to the right user at the right time.

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The views reflected in this article are the views of lenders interviewed as part of this project and do not necessarily reflect the views of the global EY organization or its member firms.

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