FINANCIAL CONDUCT AUTHORITY

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The Rt Hon Nicky Morgan MP
Chair of the Treasury Committee
Treasury Committee
House of Commons
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Dear Nicky

RE: Financial Services Compensation Scheme (FSCS) coverage of high-cost short-term lenders

Thank you for your letter of 29 January 2019 concerning Wonga. I have set out answers to your questions below.

Why did the FCA take the decision in 2016 to not include high-cost short-term lenders in the Financial Services Compensation Scheme?

The overall purpose of the FSCS is to provide a scheme of last resort which is funded by live firms. The consumer protection FSCS provides is targeted at those activities that we think are most likely to give rise to financial loss for consumers, for example savings and investments. Only firms carrying on those activities contribute to the cost of funding FSCS compensation through levies.

The FSCS focuses on providing guarantees for deposits, savings and insurance products – lending activities (and compensation from banks) are generally not covered. In the event of the failure of a lender (i.e. when FSCS compensation becomes relevant), customers generally do not suffer losses resulting from the failure of the lender; loan customers are more likely to owe money to the lender (rather than the other way around). For example, mortgage lending is also excluded from FSCS cover.

There was no access to the FSCS when responsibility for consumer credit regulation sat with the Office of Fair Trading. Consideration was given to this issue when consumer credit activities were brought within Financial Conduct Authority (FCA) regulation in April 2014, but the decision was taken at that time not to extend FSCS cover to any of the new consumer credit activities, which included high-cost short-term credit activity. In part, this reflected the general approach highlighted above whereby lending activities are not generally included within the FSCS scheme. The decision also took into account the principle that firms that were already FCA authorised should not have to pay for problematic business practices of firms that predated FCA regulation. We committed to reviewing the position in 2016 when we had further information about the market and the impact of FCA regulation.

We published Consultation Paper 16/42 in December 2016, which formed part of the FSCS funding review. In this consultation, we set out our proposals for extending FSCS protection for some consumer credit activities. Before we consulted, we carried out a detailed review of redress paid to date resulting from FCA regulatory activity in the various consumer sectors. A number of the redress schemes did not represent business-as-usual, but rather resulted from the increased supervision by the FCA to address conduct risks, and a number of skilled persons reviews.

We concluded that most consumer credit activities (including high-cost short-term credit activity) should remain outside FSCS protection because inclusion would not be proportionate.

This was because:

- Most of these firms do not hold client money or assets[1]. It is our view that consumer credit activities such as lending, credit reference and credit information services are unlikely to give rise to financial losses to consumers either (i) often or (ii) of significant amounts. However, we acknowledge that the consumers in this sector may be vulnerable consumers for whom even a small loss is significant.
- Losses to consumers have reduced since we took over the regulation of consumer credit. We know that consumers still suffer harm from consumer credit firms, but the position has improved significantly as a result of our approaches to supervision and authorisation, and other requirements imposed on these firms via our rules, for example the price cap.
- If FSCS cover were to be introduced for high-cost short-term credit lending activities, a stand-alone funding class would be unlikely to be sustainable to cover compensation payments and the cost of assessing claims so cross subsidy from other firms is likely to be unavoidable.

In addition to this, it is worth noting that the FSCS currently provides the widest and deepest cover in Europe. For example, under the Investor Compensation Scheme Directive (ICSD), investor compensation awards from other EU schemes are usually capped at a minimum of €20,000. However, the FSCS limit for investment claims is currently £50,000 and will increase to £85,000 for defaults on or after 1 April 2019. Most EU compensation schemes only cover loss of client money and assets. As we see compensation as an important part of ensuring investor confidence in UK-authorised firms, the FSCS widens the cover under the ICSD to include breaches of business conduct standards, including poor quality or unsuitable advice (mis-selling).

Is the FCA now planning to re-open the consultation on whether to include high-cost short-term lenders in the FSCS scheme?

Our view continues to be that it is not proportionate to extend FSCS cover to high-cost short term credit activities.

While there is growing evidence to indicate that our interventions in the sector have had an impact on mitigating risks of harm to consumers, including vulnerable consumers, we are aware that in some cases conduct breaches have led to losses to consumers. However, where conduct issues have been identified, we have taken a robust supervisory approach with these firms and have ensured that redress schemes are implemented where appropriate.

To date we have carried out the following activity across all consumer credit sectors to address harm and to reduce risks to consumers:

- secured a total of £900 million redress (write downs and payments) for over 1.47 million consumers where firms have fallen short of our expectations
- initiated 29 s.166 Skilled Persons reviews
- imposed more than 70 Voluntary Requirements and Own Initiative Requirements
- reviewed more than 20,000 risk events
- published five thematic reviews

[1] We decided to provide FSCS cover for debt management firms because they hold client money.

We continue to supervise the other major providers of high-cost short term credit and we use intelligence from a number of sources e.g. firm visits and the Financial Ombudsman Service to ensure that, where possible, consumers who have suffered losses as a result of conduct breaches are appropriately compensated.

If the FCA is not considering inclusion of high-cost short-term lenders into the FSCS how does the FCA intend to ensure that consumers are not financially disadvantaged if their high-cost short-term lender goes into administration?

As set out above, through our supervisory tools we seek to prevent and minimise financial disadvantage to consumers while firms are solvent.

In October 2018, we sent a *CEO* letter to high-cost short term credit lenders informing these firms that they should take prompt action to:

- Assess their lending activity to determine whether creditworthiness assessments are compliant
- If deficiencies are found, firms should take remedial action to ensure continuing lending activity is compliant and consider whether proactive redress may be required; and
- Inform the FCA if they are unable (now or in the future) to meet their financial commitments because of any remediation costs.

The administration process itself can help to address the risk of consumers being financially disadvantaged. As part of this process, the insolvency practitioner will call for all creditors to come forward. In the high-cost short-term credit sector this will be likely to include consumers who believe they may be owed redress by the failed firm. It is likely any successful redress claims would be set off against the amounts those consumers owe to the firm.

I hope that this is helpful.

Yours Sincerely

Andrew

Andrew Bailey
Chief Executive