Regulatory Briefing

The FCA's regulation of consumer credit: the practical impact of the new rules

June 2014

As of 1 April 2014 the Financial Conduct Authority (the FCA) assumed responsibility for the regulation of consumer credit in the UK. Firms (including individuals) carrying on regulated financial services activities in the UK must be authorised by the FCA unless they qualify for an exemption or an exclusion. This almost doubles the number of firms that the FCA regulates, adding in the region of 50,000 consumer credit firms to the regulatory regime. The new rules mean that consumer credit firms must comply with the FCA’s high-level standards and the FCA’s Principles for Businesses and rules prescribing systems and controls.

This Briefing considers the practical application of the new rules focusing on the scope of the consumer credit regime and the key exemptions.

A. An overview of the new regime

The changes to the regulation of the consumer credit market are a result of the present Government’s regulatory reform programme announced in January 2012. In the Government’s view, the legislation then in place was: (1) insufficiently flexible to keep pace with a rapidly evolving market; (2) lacked coherence to the detriment of consumer protection; and (3) obscured adequate market oversight.

The FCA’s consumer credit regime applies to agreements between a ‘lender’ and a ‘borrower’ where they are entered into with individuals, sole traders, partnerships of two or three partners (unless all of the partners are bodies corporate), and other unincorporated bodies (again, unless they consist entirely of bodies corporate). Credit agreements entered into with companies or bodies corporate are not regulated by the FCA under the consumer credit regime.

Most businesses that offer goods or services on credit, who lend money to consumers or provide debt solutions and advice to consumers will be carrying out consumer credit activities and regulated by reference to the new FCA regime. Both the format and the content of these agreements is prescribed in detail by the new rules. Mistakes in drafting the agreements can render them unenforceable.

The introduction of the FCA’s rules-based approach aims to deliver a better outcome for consumers by facilitating rapid intervention where the regulator finds problem practices, products, firms and individuals. In contrast to the Office of Fair Trading (the OFT) which it succeeds as regulator, the FCA is able to make and apply binding rules on firms and their activities, introduce stronger controls on market entrants and secure redress for consumers.

With the implementation of the new rules, all consumer credit firms must comply with the requirements for handling, reporting and publishing complaints. The new conduct rules are contained in the FCA’s specialist Consumer Credit Sourcebook (CONC). CONC sets out the detailed obligations that are specific to consumer credit-related regulated activities. They build on and add to the obligations in the FCA’s Principles for Businesses, the General Provisions (GEN) and the Senior Management Arrangements, the Systems and Controls Sourcebook (SYSC) and the requirements of the Consumer Credit Act 1974 (the CCA).

In general terms the OFT rules and guidance have been carried across to the FCA regime. Where the Government considers that a particular area is cause for concern, CONC includes additional conduct standards for those activities. These generally relate to firms in the high-cost short-term credit sector (including pay day loans) and peer-to-peer lending platforms.

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1 A ‘credit agreement’ is defined by article 608(3) of the Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No.2) Order 2013 which provides that "credit agreement" means an agreement between an individual or relevant recipient of credit ("A") and any other person ("B") under which B provides A with credit ("A") and any other person ("B") under which B provides A with credit of any amount."
Except in the case of debt management firms, the new rules do not require consumer credit firms to hold minimum levels of capital. That said, all FCA-authorised firms are required to hold appropriate financial resources as a result of Principle 4 and the FCA threshold conditions in Schedule 6 to the Financial Services and Markets Act 2000 (FSMA).

The new regime applies a two-tier approach that differentiates between higher risk and lower risk activities. Firms carrying on a lower risk activity are able to apply for a limited permission and are subject to a lower fee.

B. New regulated activities

At the same time as transferring the regulation of consumer credit from the OFT to the FCA, the Government has taken the opportunity to include twelve new areas within the scope of regulation. Key among them are:

- operating an electronic peer-to-peer lending platform
- credit intermediation (broking)
- debt adjusting, counselling, collecting and administration;
- entering into a regulated consumer hire agreement as owner or lender
- providing credit information and credit referencing

For an activity to be a regulated activity it must be carried on ‘by way of business’. The ‘by way of business’ test will apply in assessing whether something falls within the scope of regulation. The FCA rules provide that the business element differs depending on the activity in question. In the case of a not-for-profit body providing debt counselling advice for example, the rules provide that it is regarded as doing so by way of business.

PERG 2.3.3G provides that whether or not an activity is carried on by way of business is ultimately a question of judgment that takes account of several factors (none of which is likely to be conclusive). Relevant considerations include the degree of continuity, the existence of a commercial element, the scale of the activity and the proportion which the activity bears to other activities carried on by the same person but which are not regulated.

C. The interim permission regime

In order to provide firms with sufficient time to address the additional compliance burden that the new rules impose, an ‘interim permission’ regime will remain in place until 31 March 2016. From 1 April 2016, all licence holders will need to be fully authorised. During the period from 1 April 2014 until the FCA authorise a firm, its supervision work will be a combination of reactive work and targeted work in areas of greatest risk.

Firms holding consumer credit licences from the OFT were obliged to register with the FCA for ‘interim permission’ in order to be entitled to carry on consumer credit activities from 1 April 2014. An interim permission will have been granted provided that:

1. by 31 March 2014 the individual or firm had notified the FCA of their wish to obtain an interim permission and had supplied the FCA with the relevant information in the prescribed form;
2. they paid the fee required by the FCA; and
3. they held a valid CCA licence from the OFT that was not revoked or suspended immediately before 1 April 2014.

If a firm had an OFT licence and registered for interim permission, it is entitled to continue to carry on consumer credit activities until the FCA requires it to be fully authorised. A firm or individual undertaking consumer credit business without interim permission must cease that activity until they have applied for and received authorisation. Firms that want to take on new activities, outside the scope of their interim permission, should also now apply to the FCA for authorisation. They cannot undertake the new activity until permission is granted.

2 See CONC 10 and CASS 11.
4 PERG 2.3.2 provides that the business element differs depending on the activity in question.
5 The Financial Services and Markets Act 2000 (Consumer Credit) (Transitional Provisions) (No.3) Order 2014 extends to 30 September 2014 the deadline for local authorities to notify the FCA and pay the relevant fee to obtain interim permission under the Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No.2) Order (SI 2013/1881). Previously the deadline was 31 March 2014.
D. An application for full permission

Firms must be fully authorised by the FCA where they want to carry out consumer credit activities beyond the interim permission period. By 15 May 2014, the FCA will have written to every firm holding an interim permission informing them of when they must apply for full authorisation. Each firm will be given a specific three-month window of time in which to submit their application between 1 October 2014 and 31 March 2016. Firms that fail to apply for a full permission within their allotted time-frame must cease to carry on any activity within the scope of the new consumer credit regime. Applications from new entrants to the consumer credit market can apply for a full permission at any time.8

Firms must pay a fee when they apply for authorisation, and then an annual fee for every year they are authorised. The application fee is a one-off payment and will be scaled by reference to the firm’s consumer credit income. Once a firm is fully authorised it will be categorised by the FCA for conduct and prudential purposes. The categories will reflect the level of risk which they pose to the FCA’s objectives. The key drivers for the FCA’s categorisation will be the size of the firm, the number of customers and the potential risk posed to retail customers.

E. Appointed representatives

The FCA will allow certain regulated activities to be carried on by appointed representatives (who are not themselves authorised) where an authorised firm (the principal) appoints the representative on the terms prescribed by the FCA rules. The authorised firm remains fully responsible for any misconduct by their appointed representative during the course of carrying on the authorised firm's business. The rules require the principal to establish, implement and maintain adequate policies and procedures to ensure that the agent complies fully with the principal's regulatory obligations (CONC 14.1.4.R(1)).3

F. Categories of authorisation

The FCA has two broad categories of authorisation for consumer credit firms: (1) limited permission; and (2) full permission. The FCA's approach to authorisation is different for each category. Firms that require full permission will be subject to more checks and have more conditions to meet when applying for authorisation and beyond. Firms carrying on activities that the FCA has designated 'lower risk' may apply for 'limited permission'.

(1) limited permission activities are:

- consumer credit lending (where the main business is selling goods and non-financial services and there is no interest or charges) – this excludes hire-purchase and conditional sale;
- consumer hire;
- credit broking (where the main business is selling goods or non-financial services and broking is a secondary activity)10;
- credit broking in relation to the ‘Green Deal’;
- not-for-profit debt counselling and debt adjusting;
- not-for-profit credit information services;
- local authorities (lending within the scope of the Consumer Credit Directive).

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8 See the FCA webpage at http://www.fca.org.uk/firms/firm-types/consumer-credit/consumer-credit_interim.
9 PERG 2.10.9G provides that ‘in certain circumstances, an appointed representative may not be an exempt person, but may have a limited permission to carry on certain credit-related regulated activities’. See also http://www.fca.org.uk/firms/about-authorisation/getting-authorised/Becoming-an-appointed-representative.
10 The Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No.2) Order 2014 amends the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544) to remove certain credit broking activities from the scope of regulation. In particular, it extends the regulatory exemptions for broking credit agreements so that broking certain types of credit agreements, including government-sponsored housing, schemes is not a regulated activity.
(2) full permission (higher-risk) activities are:

- consumer credit lending (including personal loans, credit card lending, overdrafts, pawnbroking, hire-purchase, conditional sales);
- credit broking (including introducing consumer to lenders as a main business activity);
- debt adjusting;
- debt counselling;
- debt collection;
- debt administration;
- providing credit information services;
- providing credit reference agency services;
- peer-to-peer lending.

G. Threshold conditions and conduct standards

All firms are required to demonstrate that they meet the FCA’s minimum standards (threshold conditions) to become authorised. Firms must identify the key individuals who will be performing controlled functions and those persons must be approved by the FCA. The FCA’s rules for the systems and controls that firms must apply are intended to be proportionate by reference to the nature, scale and complexity of a firm’s business and the degree of risk that they pose to consumers. The FCA’s training and competence requirements do not apply to consumer credit activities. Instead the FCA relies on the Principles11 and SYSC rules12 to establish the standards that firms must meet.

In order to improve the outcome for consumers, the FCA has imposed new standards for firms carrying out specific activities. These apply to firms in the high-cost short-term credit sector (including payday loans); firms providing debt advice (including not-for-profit advice firms); firms that hold client assets (for example pawnbrokers or log book lenders); peer-to-peer lending platforms; and firms that outsource the tracing of debtors to third party tracing agents.13

The FCA places each firm that it regulates into one of four broad ‘conduct categories’: C1, C2, C3 or C4. The categories broadly reflect a firm’s size and customer numbers and the corresponding level of risk. Firms in category C1 receive the most intensive regulatory supervision.

H. Exemptions

Even if an agreement is one that falls within the scope of the FCA’s consumer credit regime, it may fall within one of the categories of exemptions that are available. Broadly, the exemptions relate to the nature of the agreement; the nature of the lender/borrower; the number of repayments to be made; and/or the total charge for credit.

In general terms the previous CCA exemptions including those relating to high-net-worth individuals, business purposes and investment properties remain. Only the exemptions most likely to be relevant to private banks and investment managers are considered below.

(1) The nature of the agreement14

A credit agreement is an exempt agreement if:

(1) it is a regulated mortgage contract or a home purchase plan; or
(2) the lender provides the borrower with credit exceeding £25,000; and the agreement is entered into by the borrower wholly or predominantly for the purposes of a business carried on, or intended to be carried on, by the borrower.15

There is a presumption that a credit agreement is entered into wholly or predominantly for business purposes where the borrower provides a declaration to that effect in the form set out in Appendix 1 to CONC App1.16

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11 In particular principle 3 (management and control) and principle 9 (relationships of trust).
12 SYSC 5.1.1R requires firms to employ personnel with the skills, knowledge and expertise necessary to discharge their responsibilities.
13 The detail of these requirements is not considered in this Briefing. If you require any further information, please let us know.
14 Credit to corporate bodies and partnerships of more than three partners is exempt (60L of the Regulated Activities Order). See also Articles 60C(3) and (5) of the Regulated Activities Order and CONC App 1.
15 PERG 2.7.19C G.
(2) **Agreements connected to a country outside the UK**

A credit agreement will be exempt from regulation under FSMA where:

(a) the agreement is made in connection with trade in goods and services between the UK and a country outside the UK, or within or between countries outside the UK and

(b) the credit provided to the borrower is in the course of business.\(^\text{17}\)

(3) **Exemptions relating to the nature of the borrower or hirer**

Agreements which would otherwise be regulated by the FCA's consumer credit regime can step outside of its requirements (and the protection and remedies that it affords) where the borrower or hirer is a "high-net-worth individual".\(^\text{18}\)

The exemption is available where:

(a) the borrower or hirer is an individual;

(b) the agreement is either secured on land or for credit which exceeds £60,260 and either

(c) the agreement includes a declaration (in the prescribed form) confirming that the borrower or hirer received a net income totalling at least £150,000 during the previous financial year; OR

(d) includes a declaration that the borrower has total net assets with a value of at least £500,000.\(^\text{19}\)

If the answer to (a) and either (b) or (c) is YES, the credit will be eligible for an exemption.

In order to apply the exemption, the borrower must be willing to sign a statement of declaration of high net worth (in the form set out in CONC App 1)\(^\text{20}\) and agree to forgo the protection and remedies that would be available if the agreement were a regulated credit agreement or a regulated consumer hire agreement.

An individual's 'net assets' for the purposes of the calculation must exclude: (1) the value of the borrower's primary residence, or any credit secured on that residence; (2) any rights of the borrower under an insurance contract that is long-term and is neither a reinsurance contract or an insurance policy for life insurance or income protection insurance where a surrender value is less than the premium paid; or where (3) any benefits (such as a pension) that the borrower is entitled to on retirement, death or termination of service.

(4) **Investment transaction exemption**\(^\text{21}\)

The credit agreement will be exempt from regulation under FSMA where:

(a) the lender is an investment firm or credit institution; and

(b) the agreement is entered into to enable the borrower to carry out a transaction relating to any of the instruments listed in section C of Annex 1 to the Markets in Financial Instruments Directive (2004/39/EC) (MiFID); and

(c) the lender is involved in the investment transaction, the credit will be exempt from regulation under FSMA.

(5) **Exemptions relating to the number of repayments**\(^\text{22}\)

There are a number of exemptions relating to the number of repayments; for example, in the case of fixed sum credit repayable in four instalments over a period of less than 12 months, without interest or other charges and not secured.

(6) **Overdrafts**

These are within the scope of the FCA consumer credit regime but can benefit from a light touch regime in relation to the drafting of formal credit agreements.

(7) **Buy-to-let agreements**

These are generally exempt from the FCA’s consumer credit regime.\(^\text{23}\)
(8) **Secured loans typically subject to the FCA’s consumer credit regime**

In substance, regulated mortgage contracts are excluded from the FCA’s consumer credit regime. These loans are subject instead to the FCA’s regime in its Mortgages and Home Finance Conduct of Business Sourcebook (MCOB).24

One important category of secured loans to which the FCA’s consumer credit regime does apply are loans secured by a second charge on property. The FCA has adopted guidance previously issued by the OFT for lenders and brokers on second charge lending. Specific conduct requirements apply in relation to regulated credit agreements (lending) secured on land. The rules and guidance are set out in CONC 15.

It is worth noting that the Mortgage Credit Directive (MCD) which was approved by the European Parliament on 4 February 201425 must be transposed into UK law by March 2016. It will introduce new conduct requirements for both first and second charge mortgages.

Pending the implementation of the new rules that will apply as a result of the MCD, firms which take second charges as security should have registered for interim permission under the consumer credit regime, and new entrants to the second charge market (who do not hold a CCA licence and cannot get an interim permission) must apply for a full consumer credit permission.

(9) **Exempt professional firms**

Members of designated professional bodies (described in Part 20 of FSMA) may carry on certain specified regulated activities while being supervised and regulated by their professional body rather than the FCA. There are ten professional bodies currently designated as falling within this exemption (including seven law and accountancy professional bodies).

I. **Financial Promotions**

The FCA's financial promotions regime largely replicates the form and content of the Consumer Credit Act requirements.26 New financial promotion rules have however been implemented in those areas where the FCA considers that there is most risk of detriment to consumers. These rules apply for example in the case of short-term credit, cold calling and in the case of activities undertaken by debt management companies.

J. **Concluding remarks**

As of 1 April 2014 the FCA assumed responsibility for the regulation of consumer credit. When considering this regime two questions are key: (1) is the consumer credit-related activity within the scope of the FCA’s regime; and (2) is the agreement a regulated agreement or does one of the exemptions apply?

Most FCA rules in CONC became enforceable on 1 April 2014. Most, but not all, of the rules in CONC are also subject to a six-month transitional provision ending 30 September 2014. During the transitional period firms must comply with the FCA rules in CONC unless they can demonstrate compliance with a ‘corresponding rule’ (a provision in specified OFT guidance, specified provisions of the CCA or certain CCA regulations; that is substantially similar in purpose and effect to the FCA rule in CONC to which it relates).27 Once a firm is fully authorised it will be obliged to report information to the FCA online on a regular basis – either six-monthly or annually depending on the nature and size of the business. The reporting regime takes effect from 1 October 2014 and applies to firms from this date or the date of authorisation, if later. It does not apply to firms with interim permission.28

Agreements that are covered by the FCA’s consumer credit regime are subject to detailed prescriptive regulation. Rules apply to the drafting of the agreements and to the substance of the pre- and post-contract information. Firms authorised to provide consumer credit must take care to ensure that they comply with these rules as well as ensuring that the activities they undertake fall squarely within their FCA permission. The consequences of failing to comply are

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23 Article 60D of the Regulated Activities Order.
24 A regulated mortgage contract is a loan to an individual borrower (or trustee) secured by a first charge over land/property in the UK, at least 40% of which is used as or in connection with a dwelling by the borrower or the borrower’s family.
25 Mortgage Credit Directive 2014/17/EU
26 The detail of those rules is not considered in this Briefing. If you require guidance, we are happy to provide it.
28 Please refer to the FCA webpage for details of the reporting regime at http://www.fca.org.uk/for/firms/firm-types/consumer-credit/regulation/reporting-requirements.
onerous. A Court may apply its powers to re-open a credit agreement where it considers that the terms create an unfair relationship between the lender and the borrower and may change the terms (including the amounts payable).  

Where the FCA finds firms failing to comply with the new rules, it has warned that it will apply its enforcement tools to impose fines and require firms to offer redress to their customers where necessary. In appropriate cases criminal sanctions may also be imposed.