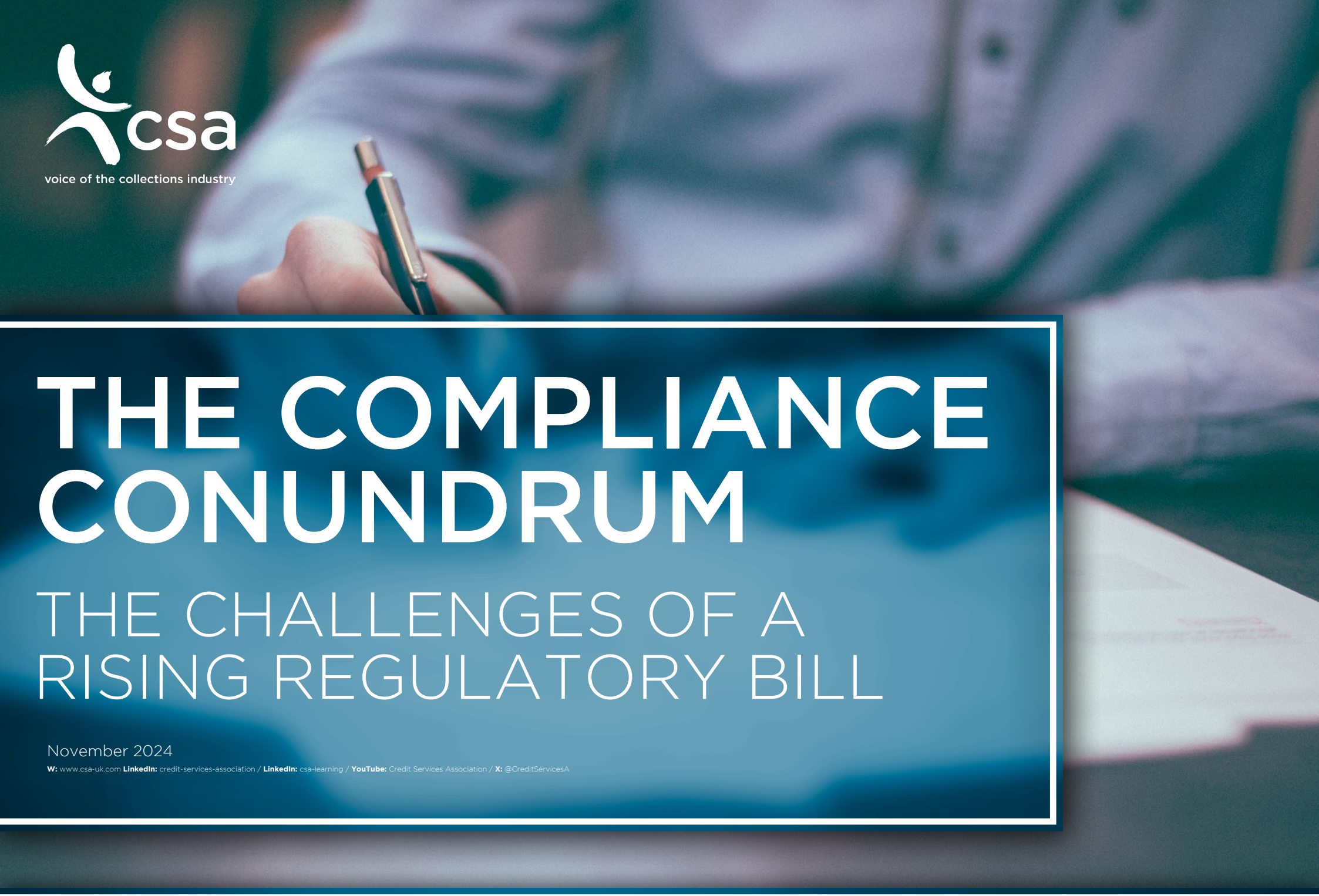

csa

voice of the collections industry

# THE COMPLIANCE CONUNDRUM

## THE CHALLENGES OF A RISING REGULATORY BILL

November 2024

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# EXECUTIVE SUMMARY

The important role that the debt collection and debt purchase sector plays in the credit cycle is often overlooked – but it is critical in ensuring that creditors have viable and cost-effective options for tackling non-performing loans. Without a functioning purchase and collections sector, lending criteria would inevitably be tightened, the cost of credit would likely increase and access to credit would suffer as a result.

Debt sale can deliver enormous benefit to lenders by removing costly non-performing loans (NPLs) from their balance sheet. Capital adequacy requirements mean that the there is a significant cost to retaining NPLs, so the secondary market offers a valuable route to minimising a bank's exposure and freeing up capital for new lending. Based on recent reporting on NPL sales[1] , the UK secondary market potentially frees up billions in capital that can be used to offer new lending, thereby supporting the cycle of credit. In some cases, sellers could see as much as £2 capital benefit for every £1 of debt sold.

Debt collection offers similar benefit, affording creditors a regulated and cost-effective route to reducing their level of NPL exposure and, consequently, their capital requirements. It also ensures access to invaluable expertise and experience not just in recoveries, but in the identification and treatment of vulnerable customers. The ability to demonstrate a commitment to delivering good outcomes without facing the costly overheads of in-house collections is critical under the Consumer Duty regime.

But the sector faces significant financial pressure as the cost of regulation continues to increase year-on-year. The Financial Conduct Authority (FCA) is ten years into its regulation of consumer credit and, in 2024, an average debt purchaser will pay almost seven times what they would have paid in regulatory costs in 2015. For an average debt collection agency, they will pay more than double their 2015 regulatory invoice. Firms in the sector have limited scope to create new sources of revenue-generation, so each increase in the regulatory bill risks pricing viable and well-run firms out of the market, jeopardising the sector's important role in the credit cycle.

An in-depth review of the rise in financial services regulatory costs and any consequential impact on innovation, growth and competition is long overdue. Recent events, such as the poorly thought through proposals to publicise enforcement investigations, raise doubts about the value that the regulatory system delivers to firms. We would like to see the House of Lords Financial Services Regulation Committee take a closer look at regulatory costs – not just the fees that firms pay, but the costs that come with keeping up with constant regulatory change. With the Financial Ombudsman Service (FOS) taking an increasingly active role as a quasi-regulator, any examination of regulatory costs should also consider the financial impact to firms of operating in an environment of inconsistent regulatory regimes.

While changes in regulation may be an acknowledged part of working in a regulated sector, the pace of that change in financial services is relentless. In recent years, firms have routinely faced periods of overlapping regulatory changes, each change a major project in itself. When carrying out an analysis of the costs and benefits of a proposed change, the regulator rarely considers the cost to firms of implementing the proposal alongside other changes already underway. While the FCA is improving its approach to cost-benefit analyses, as per enhancements set out in its recent statement of policy[2] , we would like to see greater consideration of the cumulative impact of change.

Regulatory change also creates new opportunities for complaint-related costs, especially where there is ambiguity or uncertainty. The Consumer Duty, in particular, creates a lot of uncertainty for firms – and where there is uncertainty, professional representatives for complainants will look to take advantage. The FOS urgently needs to introduce its case fee for professional representatives to ensure that the right behaviours are being incentivised – there is currently little reason for claims to be scrutinised prior to being raised because escalation is free. Not only do we need a case fee for professional representatives, we need one that mirrors the case fee that respondent firms pay, to avoid further weaponisation of the case fee.

Ultimately, we recognise that regulatory cost is a part of doing business, and we have no objection to the regulator deriving its costs from the regulated population. But as the regulator's remit continues to grow, as its expectations become more and more difficult to discern, and as questions emerge about the regulatory regime itself, it is essential that there is sufficient scrutiny to ensure that firms and markets, and consequently, consumers, are not inadvertently being damaged by the growing regulatory bill.

[1] PwC: European loan portfolio sales: Market update (Q4 2023)
[2] FCA: Statement of policy on Cost Benefit Analyses (July 2024)

CHAPTER ONE

# INTRODUCTION

As the cost of doing business in the collections and purchase sector continues on its ever-upward trajectory, it is an opportune moment to reflect on how the first decade of FCA-led consumer credit regulation has contributed to that rise and to contemplate the damage that further squeezing firms' finances could have on consumers, the market, and the availability of credit.

The FCA took over consumer credit regulation from the Office of Fair Trading (OFT) in 2014. Ten years later, the cost of carrying out a regulated activity has reached unprecedented levels – we are a long way from a £500 consumer credit licence, with even the smallest of consumer credit firms expected to pay over £1,000 for their regulatory permissions, never mind any additional levy costs.

Under the FCA's tenure as consumer credit regulator, firms have had to implement wide-ranging change every year. With new consultations and policy statements released on a monthly basis, the sector has had to adapt to an environment of ceaseless regulatory change, all of which comes with significant cost.

With a new government on a mission to drive economic growth in the country, attention turns to how the financial services sector can contribute. The sector has a prominent role to play given its ability to distribute capital across the economy through lending, not to mention the sector itself representing over eight percent of UK economic output. But for lenders to be suitably equipped to deliver the requisite levels of affordable lending, they need to have strong capital positions, which is where the collections and purchase sector can play a critical role.

The UK's secondary market for non-performing loans is an essential tool for lenders to improve their immediate liquidity and reduce their credit risk exposure. In doing so, credit risk becomes better distributed across the financial services industry and, with a stronger capital position, lenders can more ably support consumers with new lending.

In a similar vein, the collections sector enables lenders to access expert resource in a cost-effective way that minimises their own compliance overheads and ensures customers receive the necessary support when repaying their arrears, which is crucial at a time when the FCA's Consumer Duty has brought a stronger focus on delivering and evidencing good outcomes. Using that collections expertise to secure repayment not only improves the lender's capital position, but also allows borrowers to return to the economy as they remedy their own financial position. This is a mutually beneficial symbiotic relationship: collections and debt purchase aids the good health of the wider creditor community and therefore the economy at large.

In order for collections and purchase firms to continue in this role, measures must be taken to loosen the ever-tightening squeeze of regulatory and compliance costs. But the prospect of any let-up in regulatory and compliance costs looks less and less likely in light of various factors, including:

### Regulatory uncertainty arising from the Consumer Duty

Firms are unclear not just on regulatory expectations, but how the FCA plans to enforce the Duty. Regulatory uncertainty, especially the type of uncertainty that makes it difficult to predict the potential risk of redress and penalties, is unsurprisingly not appealing to investors.

### Client / vendor assurance requirements

With increased expectations on firms to evidence good outcomes, the sector is unlikely to see any reduction or consolidation in creditor audit requirements, which is a significant expense, not to mention resource demand, for firms.

### Disproportionate fees and levies

Fee levels are not proportionate to the size of the sector or the risk it poses. For example, even though the sector generates fewer than 1% of complaints to the Financial Ombudsman Service (FOS) per year and has maintained a healthy uphold rate of, on average, 30% per year across the last five years, it is still expected to contribute significantly via the FOS levy.

### Rising regulatory data requirements

Increasing numbers of ad-hoc information requests from the regulator detract from firms' ability to operate business-as-usual, with staff having to meet unexpected (and relatively short) regulatory deadlines at the expense of their essential day-to-day work. These requests are difficult for firms to plan for, given their ad-hoc nature, and it would be inefficient and costly for firms to simply keep staff on-hand just in case a request comes in.

### Limitations on generating new income

The nature of the industry's work makes it difficult to generate new revenue streams, especially collections agencies operating on a contingent basis, who are increasingly expected to do more and more specialist work focused on ensuring good outcomes all while their compensation remains linked predominantly to the amount recovered – even where recovery might not be the eventual outcome. Not to mention growing requirements to generate and provide data, as creditors themselves face increasing data demands or look to exploit new data-driven technology.

### Cumulative effect of intervention:

The regulator often fails to assess the cumulative impact of its interventions, an often-overlooked challenge for firms, especially when carrying out cost-benefit analyses.

A well-functioning credit cycle where consumers can access affordable lending, where lenders are adequately positioned to meet those lending needs, and where existing customers can access essential forbearance, is reliant on an effective collections and purchase sector to support in the management and reduction of NPL stocks, thereby freeing up capital for new lending.

It is to be welcomed that both Government and the FCA have begun a dialogue about the potential duplication of regulations in the rulebook and whether streamlining can occur, but this only touches lightly on the scale of the compliance cost question. **In the interest of preserving the sector's important role, we are making a number of recommendations. In particular, we are calling for:**

- **The House of Lords Financial Services Regulation Committee to carry out an inquiry into rising regulatory costs in the financial services sector.** Particularly exploring the degree to which regulatory intervention and year-on-year cost increases has impeded growth, competition and innovation.

- **Government, regulators and other relevant stakeholders to consider how they can enhance their cost-benefit analyses prior to implementing change.** In particular, consideration must be given to the cumulative impact of multiple and simultaneous changes.

- **Both regulated and non-regulated creditor clients to re-think how they compensate debt collection agencies to ensure that firms are being rewarded for the work they undertake and the outcomes they deliver**, not simply the recovery of the arrears. Debt resolution comes in many forms these days and delivering debt resolution – and thus good outcomes – does not come without cost.

CHAPTER TWO

# RISING COSTS

In the 10 years since consumer credit regulation became the responsibility of the FCA, and the 25 years since the creation of the Financial Ombudsman Service, firms have seen tremendous increases in the cost of regulation and compliance. Assessing the overall cost of regulation and compliance is complicated because there are so many facets to it, but there are some fairly broad-brush areas we can consider – funding the regulatory infrastructure; responding to regulatory change; maintaining day-to-day compliance; growth or contraction in the market and competition.

Contributions to the regulatory coffers are an acknowledged part of doing business, but the scale of those contributions has grown substantially in the last decade, no matter the size of the firm.

Similarly, regulatory intervention in this period has been significant, and each new initiative, piece of guidance, or rule change carries a range of cost and resource demands for firms, including conducting gap analyses, seeking legal or consultancy support, implementing change, and the ongoing costs of maintaining compliance. Just the prospect of intervention can even come at a cost to firms, if the idea sufficiently spooks firms or investors – for example, reference in the FCA's 2023 portfolio letter[3] to collection of statute barred agreements prompted some disruption in the market, with some specialist firms having work unexpectedly withdrawn while creditors contemplated their options.

Alongside the funding of regulation and responding to regulatory change are the day-to-day costs of compliance - governance, monitoring, quality assurance, regulatory reporting, etc. And in recent years, particularly during and beyond the pandemic, firms have also had to contend with an increase in ad-hoc regulatory information requests, which not only eat up day-to-day resource, but also come without the benefit of preparatory lead-in time that firms have with regulatory change.

In a sector that has limited flexibility to alter fees to reflect increased overheads, and which cannot just launch a new product or service to generate new revenue streams, these rising costs will inevitably affect profitability and potentially make it unsustainable to operate. In fact, we have seen significant contraction in the market throughout the era of FCA regulation, and we continue to see market exits, mergers, and acquisitions as firms adjust to meet the demands of the regulatory environment. This kind of activity may be healthy where it is driving non-compliant firms out of the market; but in many cases, the cost of regulation has simply become prohibitive and continuing down this path risks making regulated work viable for only the largest of firms, with the knock-on effect of reducing competition in the market.

[3] FCA: Implementing the Consumer Duty for Debt Purchasing, Debt Collecting and Debt Administration Services ("DPCA") portfolio (February 2023)

## Funding regulation

If we take a closer look at the rise in regulatory fees and levies first of all, we can see that the cost of simply doing business (i.e. being an authorised firm), has seen massive increases since the FCA began regulating consumer credit.

We can see in Fig. 1 the various fees and levies that have been, or are, applicable to debt purchase and debt collection firms during the last decade. While minimum fees generally remain viable for the firms they are targeted at, the variable rates have risen considerably.

The changes to the funding of debt advice that came in 2018/19, driven by the creation of the Money and Pensions Service (MaPS), saw particularly substantial increases for debt purchase firms. The decision by the FCA to conflate purchasers with lenders and calculate contributions to this levy on the measure of 'value of lending' led to disproportionate distribution of funding for debt advice. Given that debt purchasers do not lend and the theoretical value of the debt they own is not an actual reflection of the realisable value of that debt, it is not an appropriate measure by which to levy debt purchasers. Much to our disappointment, there has not, to date, been any review of the CC03 funding category.

Fig. 1. FCA consumer credit regulatory fees and levies 2015/16 and 2024/25

| | 2015/16 | 2024/25 |
|---|---|---|
| **Minimum periodic fee(s)** | £300 / £500 / £1,000 | £1,250 / £1,500 / £1,750 |
| **Variable periodic fee** | £0.78 per £1,000 of turnover over £250,000 | £1.7640 per £1,000 of turnover over £250,000 |
| **Financial Ombudsman Service levy (minimum)** | £35 | £35 |
| **Financial Ombudsman Service levy (variable)** | £0.02 per £1,000 of turnover over £250,000 | £0.952 per £1,000 of turnover over £250,000 |
| **Consumer Financial Education Body (CFEB) levy (minimum)** | £10 | n/a |
| **CFEB levy (variable)** | £0.37 per £1,000 of turnover over £250,000 | n/a |
| **Single Financial Guidance Body debt advice levy (variable)*** | n/a | £168.32 per £m or part £m of the value of lending |
| **Devolved authority debt advice levy (variable)*** | n/a | £22.747 per £m or part £m of the value of lending |
| **Single Financial Guidance Body money advice levy (minimum)** | n/a | £10 |
| **Single Financial Guidance Body money advice levy (variable)** | [1]n/a | £0.883 per £1,000 of turnover over £250,000 |
| **Illegal Money Lending levy (minimum)** | n/a | £10 |
| **Illegal Money Lending levy (variable)** | n/a | £0.266 per £1,000 of turnover over £250,000 |

* applicable to CC03 firms, including those with regulatory permission for exercising, or having the right to exercise, the rights and duties of the lender; not applicable to CC02 firms

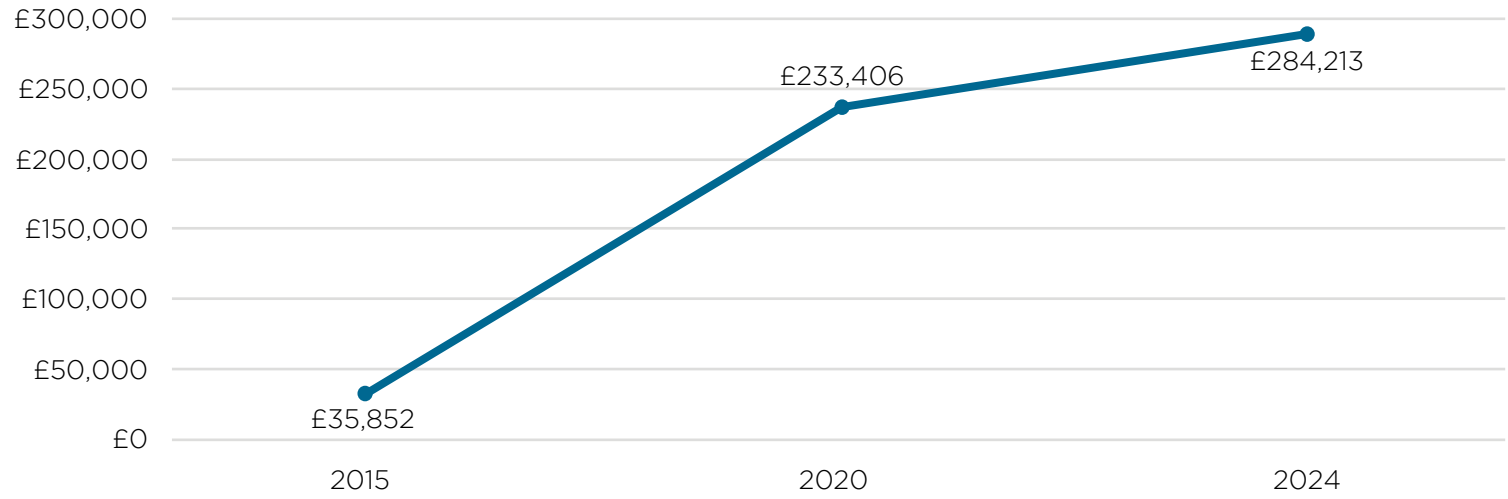
If we take a couple of relatively conservative examples of an average debt purchase firm and a debt collection firm[3] , we can see that regulatory fees have risen enormously. Our illustrative example purchaser has seen an increase in its annual regulatory fees and levies of almost 700% between 2015 and 2024, while the example collection agency's costs have risen by 132% (for context, UK Consumer Price Index (CPI) inflation since 2015 has been only 34%).

If the 2015/16 fee and levy costs had moved with inflation over the period to date, the purchaser would have paid around an additional £12,000 on their 2015/16 fee, while the collection firm would pay around an additional £1,000. Instead, the collection firm's costs more than double and the purchaser sees an unbelievable rise of more than 7 times the original FCA invoice.

And this is just what it costs a firm to get its foot in the door. Then come the costs of actually complying with the rules, regulations and legislation – all of which can change with increasing regularity.

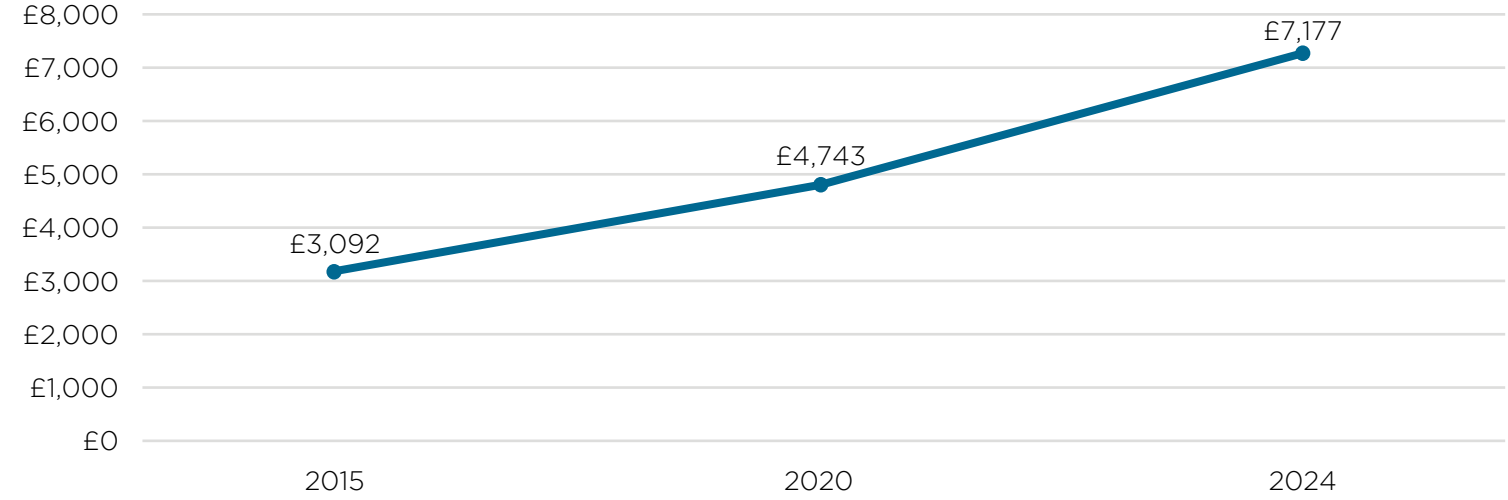
## Regulatory Fees and Levies - average debt purchaser

Fig. 2. Illustration of cost increases for average debt purchase firm
*Example debt purchaser owning £1bn in lending (face-value) and with annual turnover of £30m.*




## Regulatory Fees and Levies - average debt collection agency

Fig. 3. Illustration of cost increases for average debt collection firm
*Example debt collection agency with annual turnover of £2m.*



## Moving the goalposts – regulatory change

It is to be expected that the regulator intervenes where rules are not working as intended, or where there is misconduct as a result of gaps in regulation, or where advancements mean that rules are no longer fit-for-purpose. But regulatory intervention, for many firms, feels like it has moved at a relentless pace in recent years with little pause, as firms are now expected to implement major change on an almost routine basis.

In just the last five years, firms have had to overhaul their governance and accountability frameworks to meet the expectations of the **Senior Managers & Certification Regime**; they have had to scrutinise their key business services to ensure they have adequate levels of **operational resilience**; and they have been faced with the introduction of the **Consumer Duty**, which comes with so much uncertainty that even after the implementation deadline, firms are awaiting clarity on how the FCA expects certain concepts to be applied and understood. And just as the Consumer Duty deadline passes, firms will be getting underway on their next major project – pulling apart their regulatory reporting infrastructure and redesigning it to ensure they can meet the extensive requirements of the incoming **Product Sales Data** reporting regime.

### 2020

- **Embedding SM&CR** (came into force Dec 2019)
- Temporary Covid guidance
- Bounce Back Loan guidance
- Rule changes related to Debt Respite Scheme Regulations

### 2021

- Consumer Duty: consultation
- **Operational resilience: policy statement**
- Tailored Support Guidance
- Changes to annual financial crime reporting requirements

### 2022

- **Consumer Duty: policy statement**
- Baseline financial resilience regulatory return: consultation
- Improvements to the Appointed Representatives regime policy statement
- New cancellation and variation enforcement powers
- Credit Information Market Study: interim report

### 2023

- **Consumer Duty first deadline**
- Product Sales Data: consultation
- Strengthening Protections for Borrower: consultation
- Operational resilience and critical third parties: consultation
- Baseline financial resilience regulatory return: policy statement
- Credit Information Market Study: final report

### 2024

- **Consumer Duty final deadline**
- **Product Sales Data: policy statement**
- Strengthening Protections for Borrowers: policy statement
- Motor finance complaints pause / market review
- Publicising enforcement investigations: consultation

Fig. 4. Regulatory change / proposals 2020-2024

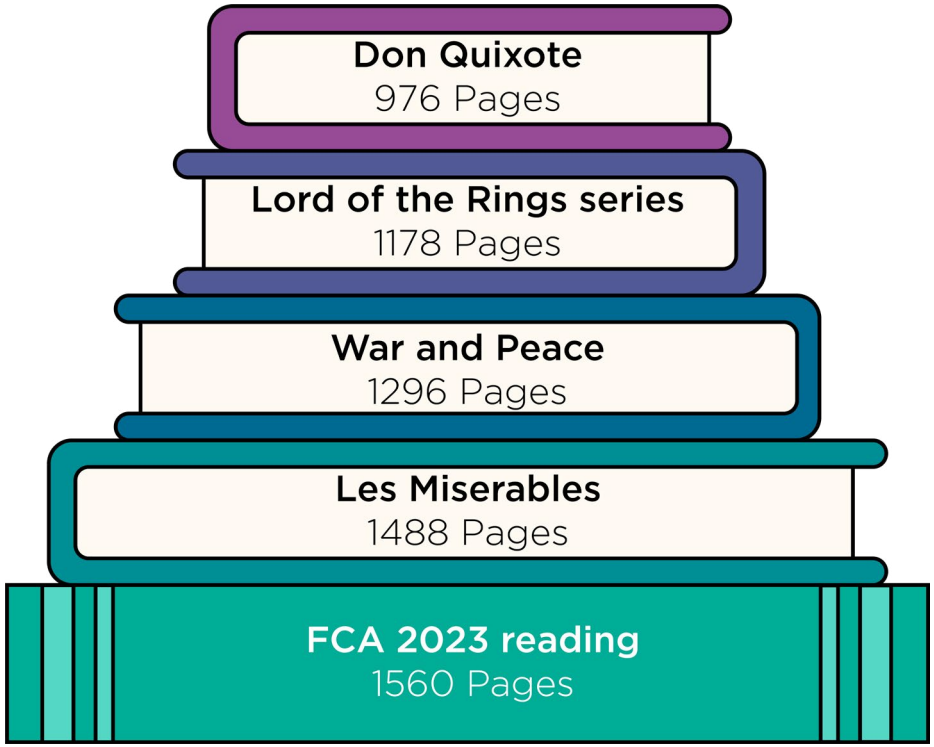
"In 2023, there were 19 FCA publications of possible relevance to the collections and purchase sector [...] Across those 19 publications were 1560 pages of material for firms to digest..."

Each of these exercises comes at considerable expense to firms, and that is without the day-to-day changes to rules and guidance that the FCA makes each year. Those more mundane changes may not need firms to fundamentally alter their business, but they will require firms to assess the new rules / guidance, carry out gap analyses, undertake any necessary change and implement that change in a way that ensures it becomes business-as-usual, not to mention reviewing and responding to the initial proposals to make sure that the changes don't bring unforeseen consequences.

The sheer volume of FCA consultations and policy statements alone demands hours of reading, simply to determine whether a firm or sector is inadvertently in scope of a new rule or have been overlooked as part of a regulatory change. In 2023, there were 19 FCA publications of possible relevance to the collections and purchase sector – excluding fee and levy consultations and policy statements, quarterly consultations and handbook notices. Across those 19 publications were 1560 pages of material for firms to digest and determine their relevance (or irrelevance) to the firm. War and Peace comes in a few hundred pages slimmer and there is no statutory obligation to have read that.

Regulatory change does lead to enhancements in a number of firms, but many other well-run businesses will often feel under pressure to make change, even where change might not be necessary.

Fig.5 FCA required reading in 2023 compared to other famous literature



## The burden of regulatory information requests

Reports from CSA members indicate that 2024 has been one of the busiest years for ad-hoc information requests from the regulator. Some of those requests are driven by the FCA's need to understand more broadly how the Consumer Duty is being implemented; some are driven by the FCA's efforts to better understand the particular challenges and risks of the collections and purchase sector. And some have been driven by specific topics, such as the approach to statute barred debt and the FCA's review of its vulnerability guidance.

But a legitimate basis for seeking information from firms does not eliminate the cost that each request incurs for firms. Firms need to assign individuals, or teams of individuals, to review the request, to locate and validate the information, and to collate and then submit it in a suitably digestible format. In many cases, the ad-hoc nature of the request means that the individual (or individuals) tasked with responding to the request will do so at the expense of their day-to-day activities, especially in smaller firms, which creates further costs for the firm.

The FCA does make some effort to understand the impact of its requests on firms, inviting firms to quantify the cost of responding to the information request. Many firms, to our knowledge, rarely provide this information, or at least not the most accurate picture of it, because they are under pressure to simply dispense with the regulator's request and return to their day-to-day responsibilities. In the interest of transparency, it would be helpful if the FCA published some of this data, to better illustrate the cost of requests to firms.

In light of increasing requests, the FCA has stated that it will take a proportionate and pragmatic approach where firms need extensions to timeframes for data requests. And, speaking to CSA members, this does appear to be the case. But the FCA also needs to be aware that it has cultivated an impression among many firms that non-compliance with an information request, mandatory or voluntary, is unlikely to be tolerated and carries a risk of repercussions for failing to provide what the FCA asks for, or of being perceived by the regulator as being inadequately resourced.

On the one hand, the regulator needs information to be a truly effective oversight body; on the other, it must be more cognisant of the impact of its requests on firms. In the United States, legislation[4] requires public bodies to estimate the time burden on a consumer of an administrative regulatory requirement; a similar initiative for FCA information requests could aid the regulator in determining the time necessary for response and the recipient firm in quickly determining the rough resource demand of a request, as well as simplifying the quantification of request-handling costs.

The simplest solution, however, would be better internal exchanges of information within the FCA so that firms, especially SMEs, receiving multiple simultaneous requests are not overwhelmed and can be confident that a conversation with the regulator about the challenge of providing information will not be met with a perception that the firm is poorly resourced or is uncooperative.

[4] US Environmental Protection Agency: Summary of the Paperwork Reduction Act (accessed October 2024)

## Market impact

The costs of being authorised, running a compliant business, and meeting the demands of regulatory change has meant that, for some, the business was no longer sustainable. As a result, the FCA era has seen plenty of contraction in the market, with a series of mergers, acquisitions and market exits.

In 2014/15, when the FCA first took on consumer credit regulation, the CSA had 346 members engaged in debt collection and debt purchase activity; the market has contracted significantly in the intervening period and there has been a drop of over 100, with 2024 figures showing there are now just 219 CSA members engaged in this type of work. In the first year of FCA consumer credit regulation (from 2014/15 to 2015/16), both the full and foundation categories of CSA membership saw a reduction. Much of the market contraction can be attributed to a series of mergers and acquisitions over the decade, but some is also the result of market exits, as it no longer became sustainable to do business.

Notably, there has been a significant drop over the years in the 'foundation' member category, a category of membership available only to firms in their first 2 years of trading. In 2013/14, there were 31 'foundation' members; in 2023/24, there were just 6. Naturally, by virtue of its eligibility criteria, the numbers in this category will fluctuate as firms move into their third year of trading and become full members. But such a substantial drop suggests new entrants to the market are now exceedingly rare, as it has become prohibitively expensive to operate and the contraction in the market has made it much harder to compete with many of the larger firms.

CSA Members engaged in debt collection and/or debt purchase activity.

**2015/16: 346 CSA members**

**2023/24: 219 CSA members**

Fig. 6 Number of CSA members engaged in debt collection and/or debt purchase activity in 2015/16 compared to 2023/24.

CHAPTER THREE

# COST BENEFIT ANALYSES

Regulators and legislators will occasionally conduct cost-benefit analyses when presenting their regulatory or statutory changes, in order to demonstrate that they have considered the financial implications of the changes they are presenting. The depth of those analyses can vary, particularly if there is no obligation to present any such analysis. In our experience, several aspects often go unconsidered in CBAs including:

- Consideration of other regulatory / statutory changes
- Consideration of downstream impact / ripple effect of change
- Consideration of redress / claims management activity / complaint increases

"...it will have a knock-on effect on firms further down the supply chain, as they have **new requirements and expectations imposed on them.**"

### The impact of concurrent change:

One factor that the FCA's cost-benefit analyses have often failed to account for is the impact of simultaneous changes. The pace of regulatory change can be rapid and relentless, and the reality for firms is that they are now expected to frequently implement multiple changes.

Analysing how a particular proposal might affect firms at that specific moment in time would be fine if that were the only change the firm were being asked to make; but regulatory change never happens in isolation – it comes alongside other changes, short-, medium-, and long-term, and alongside other regulatory demands, like regular and ad-hoc information requests. Firms' resources are inevitably stretched by simultaneous regulatory projects, and then further stretched by information requests.

While that may not negate the need for a particular regulatory change, it should at least be a consideration. The cycle of regulatory change and the accompanying strain on resources makes it more difficult for firms to dedicate resource to innovation.

### Ripple effect:

Firms carrying out outsourced work can often be forgotten when it comes to cost-benefit analyses. Where a change is made that impacts the outsourcer, it will have a knock-on effect on firms further down the supply chain, as they have new requirements and expectations imposed on them. The outsourcing firm is also likely to apply additional scrutiny to the supplier to ensure that they are meeting the new requirements. These 'ripple effects' are often overlooked when costs are being assessed. This is particularly problematic because many of the affected firms will be SMEs with limited leverage to push back against the outsourcer or to demand increased compensation to account for the change.

There is also a 'ripple effect' in terms of how change affects the complexity of a particular job role, potentially making roles far more complex than they once were, necessitating increased remuneration, training costs, and possibly recruitment costs.

### Complaints and redress:

Cost-benefit analyses rarely consider the impact of change on complaint handling, claims management activity and redress. Where a change opens the door for complaints, either because a practice is being prohibited or because there is ambiguity in the change, it is inevitable that complaint volumes will spike. This carries a cost not only for dealing with the influx of complaint activity, but also the subsequent case fee costs incurred as a result of FOS referral, which can come regardless of merit.

This year has seen the motor finance sector under regulatory investigation in relation to historic commission practices – a practice that was already subject to FCA intervention several years ago[5]. At the time, complaint and redress costs did not form part of any cost-benefit analysis in making the change. The presumption would be that, with the practice now prohibited, firms could take the necessary action to prevent future occurrences and a line would be drawn under it. Instead, some years later, there is a large-scale investigation, along with the prospect of a sector-wide redress scheme, driven by complaints to the FOS. This is being carried out under the guise of breaching Principles, rather than rules, which illustrates the need for impact analysis and specificity around complaint implications. If regulatory Principles have been breached, it is unclear why the FCA didn't take such steps at the time of its original intervention. It also begs the question why even change the rules in 2019 if, in 2024, the regulator determines that the rules were sufficiently clear prior to the intervention to prevent firms engaging in the practice.

Failing to give due consideration to complaint implications when it intervened in 2019 now risks firms facing a large-scale, potentially costly redress scheme, or an influx of complaints from claims management firms and other professional representatives, bringing with it the associated financial pressure in terms of resources and potential FOS case fees. It has created widespread uncertainty not just for firms but for investors. The prospect of the regulator revisiting historic interventions for possible redress schemes will massively hamper the investability of the financial services sector.

Earlier this year, the FCA published a statement of policy[6] detailing its approach to cost-benefit analyses, a useful overview of the process and the extent of analysis undertaken. It has also established a cost-benefit analysis panel which is intended to provide expertise and insight in future analyses. We would encourage the FCA to work with its newly-established panel and further review potential gaps in its cost-benefit analysis framework and how it can best address those gaps.

[5] FCA: Motor finance discretionary commission models and consumer credit commission disclosure: consultation paper (October 2019)
[6] FCA: Statement of policy on Cost Benefit Analyses (July 2024)

CHAPTER FOUR

# WHY DOES THIS MATTER?

There are many benefits to a well-functioning debt collection and debt purchase sector, which can often be forgotten when the sector is discussed. But to get a clearer idea of the value of the sector, we need our own ***It's A Wonderful Life*** moment, where we consider what things might look like if there wasn't a viable debt collection or debt purchase sector.

**Without outsourcing options, lenders would need to carry out more in-house recovery activity.** This would come with considerable overheads, including recruiting, employing and training staff, putting infrastructure in place, maintaining compliance with all relevant rules and regulations, ensuring it had all necessary governance and oversight in place, and establishing relevant processes and policies.

A debt collection firm will have spent many years building up not just the infrastructure, but the experience, knowledge and skills for this type of work. And by acting for multiple clients, it can achieve economies of scale in key parts of the recovery process in a way that a single lender may not be able to.

**As overheads increase, then lenders will inevitably need to fund that increase, which may mean the cost of lending goes up.** The simplest route for a lender to make up the costs of bringing its collections activity in-house is passing that cost onto the consumer. Borrowing may become more expensive as a result.

**Sub-prime products may become less viable without a back-end debt collection option.** It may be popular in some circles to criticise sub-prime products but many of these fill a gap in the market that prime lenders are less willing to cater to. Sub-prime lenders recognise that the consumers that use their products are at a higher risk of default, which is why the cost of borrowing is often higher. But those lenders rely on access to a debt collection market to ensure that cost-effective recovery efforts can be made. Lenders in this market tend to have far less resource than many prime lenders, so their ability to absorb the costs of bringing collections activity in-house is even more limited.

Lenders that cannot afford to bring collections in-house and that no longer have the option to outsource to a third-party that will deliver FCA-compliant collections activity will be left with few options.

One may be to **exit the market entirely and cease offering the lending product.** Another may to be **tighten lending criteria** to ensure that they do not lend to those customers that are higher-risk and, thus, more likely to be costly in the long run. Both options would see many consumers unable to access credit, which would not be consistent with the regulator's major focus on enhancing financial inclusion.

A third option may be to **make increased use of law firms and enforcement agencies**, although regulated lenders may struggle to square this with their regulatory obligations.

For larger lenders, if they have no secondary market for non-performing loans to turn to, they are likely to come under increased pressure to comply with growing capital adequacy requirements. Non-performing loans carry a higher risk-weighting in capital adequacy calculations (see chapter 5) and without the option to offload some of their credit risk to debt purchasers, **lenders will need to retain more capital to ensure they stay compliant**. And if lenders are holding on to more capital to account for their non-performing loans (while also facing increased recovery costs because they have no viable outsourcing route), they are going to be more limited in what new lending they can offer.

Where there is a reduction in credit availability, not only would we see increased financial exclusion, we would also potentially see **consumers turning to riskier sources of lending, most concerningly illegal sources**. The scale of illegal lending may be difficult to truly ascertain, but the damage that it causes is well-documented.

This is clearly an absolute worst-case scenario, but some of those risks could materialise even without us reaching the extreme outcome of a non-existent collections and purchase sector.

Lenders, consumers and the economy benefit when there is a well-functioning debt collection and debt purchase sector.

- The credit cycle is maintained because lenders are able to reduce their capital requirements by offloading non-performing exposures, which frees up capital for new lending.
- This, along with the work of debt collection agencies to recover outstanding balances, also enables the cost of credit to remain affordable as lenders can recoup more of what is due to them without the considerable expense of doing this in-house.
- With the economies of scale that come with collecting on behalf of multiple creditors, collection agencies can deliver good outcomes and appropriate customer journeys in a way that an individual creditor may struggle to do. This can range from having dedicated vulnerability teams to support customers with different needs through to enabling customers to agree sustainable repayment arrangements online.
- Where debts are sold, this can often mean that consumers no longer face increasing fees, charges and interest, as these are routinely stopped.

CHAPTER FIVE

# DEBT SALE AND CREDIT AVAILABILITY

One of the less-explored benefits of a healthy debt sale and debt collection market is how they can enable lenders to reinvest elsewhere, particularly in terms of available new credit.

In 2017, the chair of the European Central Bank's (ECB) Supervisory Board, Daniele Nouy, highlighted the risk posed by banks holding high levels of non-performing exposures (NPEs), stating that *"NPEs keep banks from providing loans to the economy"*[7] . Some years later, in its briefing paper, *'Minimum loss coverage for non-performing loans'*[8] , the European Parliament elaborated on the risk posed, noting that *"high NPL [non-performing loans] levels require banks to hold higher amounts of regulatory capital and pay a risk premium on liquidity markets, reducing their profitability and growth prospects."*

In 2019, recognising the importance of a secondary market and the risks of banks building up excessive levels of NPLs, the EU introduced its 'backstop' regulation[9], which requires banks to hold 100% core equity against unsecured NPLs after 3 years. In a 2021 blog post[10], Elizabeth McCaul, a member of the Supervisory Board of the ECB, wrote that the backstop "*is an effective tool to prevent the excessive build-up of new NPLs on bank balance sheets by creating buffers which allow banks to promptly tackle NPLs through sales or write-offs*".

The UK's capital requirements may have their own nuances, but the implications of holding high levels of NPLs remain the same as in the EU. Which means, in short, lenders subject to capital requirements need to be able to reduce their NPL exposures, whether through recovery of the amounts due or through offloading the exposure itself via sale or securitisation, in order to enhance their prospects for profitability and growth.

As a result, debt collection and debt purchase firms have an important role to play in maintaining the health of the credit cycle and facilitating the availability of affordable credit.

[7] ECB: Regulatory and supervisory responses in Europe to the current financial environment (Danielle Nouy) (accessed August 2024)
[8] European Parliament: Briefing: Minimum loss coverage for non-performing loans (May 2019)
[9] Official Journal of the European Union: Regulation (EU) 2019/630 (April 2019)
[10] ECB: Provisioning for a clean balance sheet (Elizabeth McCaul) (accessed August 2024)

# Debt sale

Debt sale, alongside securitisation, is crucial in ensuring lenders have mechanisms to remove non-performing exposures on their balance sheets. After the 2008 banking crisis, banks were required to hold certain levels of capital relating to their lending, in an effort to prevent the crisis from happening again.

The scale and specifics of these requirements can vary depending on the type of loan product. The requirements become much more onerous in circumstances where unsecured loans become non-performing, as banks are required to hold more money for those accounts. When calculating the level of capital they must hold, banks must assign a risk-weighting to their assets as part of that calculation – NPLs, unsurprisingly, carry a more significant risk-weighting when it comes to these calculations, with some risk-weighted at up to 150% of the loan value. In short, this means that a bank must hold more capital for those particular assets. It is therefore in their interest to either recover the amounts due or reduce their risk by taking the exposure off their balance sheet.

While there is a corresponding loss when selling NPLs at below the face-value of the loan, because the seller loses value on the asset there are ways in which any potential loss is mitigated. The NPL sale itself delivers capital and liquidity benefit to the seller. Under its capital adequacy requirements, the bank will have provisioned a particular amount against the loan, further protecting it from loss. And prior to any lending, the bank will have priced in to its product offering the anticipated default rates. When they come to the secondary market, lenders will know what value they need to attain from a portfolio to avoid loss, and that will generally be their 'line in the sand'. The secondary market plays an essential role in better distributing the credit risk across the industry and facilitating new lending.

### Calculating capital requirements: high-level examples

**Performing loan**

Let's take the illustrative example of a £1,000 unsecured loan, Firstly, we need to look at the lender's capital requirements upon origination of the loan. An unsecured retail loan comes with a risk-weighting of 75%. That risk-weighting tells us how much of the loan value we need to consider as the starting point for our calculation. For the purposes of the calculation, this means that the starting point is 75% of the loan value, so the figure we're concerned about becomes £750 (calculations below).

Capital adequacy is set at 8% (under Basle II), so this means the lender needs to hold at least 8% of £750.

*Loan risk-weighting (75%): £1,000 x 0.75 = £750*
*Capital adequacy requirement: £750 x 0.08 = £60*

**Non-performing loan**

If that £1,000 unsecured loan becomes a non-performing loan, the risk-weighting increases considerably. The risk-weighting for a NPL has a floor of 100%, rising to as much as 150% depending on how much the bank has provisioned for the loan (the risk-weighting is higher if a bank has provisioned less). Provisioning is where the bank absorbs a particular loss amount on the loan value in advance.

So, a non-performing loan of £1,000 for which the bank has provisioned less than 20% (let's say 10%) will carry a risk-weighting of 150%. Allowing for provisioning, which doesn't have capital requirements, this means that the **capital requirements for a non-performing loan can reach almost double that of a performing loan.**

*Provisioning for loan (10%): £1,000 x 0.9 = £900*
*Loan risk-weighting (150%): £900 x 1.5 = £1,350*
*Capital adequacy requirement: £1,350 x 0.08 = £108*

Of course, if a bank has provisioned more against the loan up-front, its capital requirements may be far more manageable.

Fig. 7 High-level examples of capital requirements for a performing and non-performing loan

So, what actual capital benefit can debt sale bring to sellers? Specific figures will vary depending on the notional value of the book sold, the price paid and the seller's provisioning – but we can take a fairly high-level look at this.

In Fig. 7 (see previous page), we can see the difference it makes to the bank's capital adequacy requirements if an asset is non-performing. In some cases, the capital requirement can be almost double that of a performing asset, depending on how the bank has provisioned against the loan. It follows, then, that removing a non-performing asset from the calculation will bring some benefit to the bank in the form of reduced capital requirements. On the other side of that calculation, however, is the credit loss that comes from selling an NPL below face value.

These are complicated calculations and sellers will look to secure some degree of net benefit when offloading the exposure. Achieving net benefit from a sale will potentially be made easier depending on how much the seller has provisioned against the loan. Whether there is a high level of provisioning is likely to depend on the availability of excess capital beyond the requirements, as well as the bank's approach to risk

When weighing up the combined sale amount and level of provisioning against the capital requirements applicable to NPLs, it is reasonable to surmise that sellers will see capital benefit anywhere up to £2 per £1 of debt sold. The scale of that benefit will vary from seller-to-seller, depending on a number of factors. Nevertheless, according to 2023 data, a return of this level of capital benefit could theoretically unlock up to £1.4bn in new consumer lending availability[11].

What this can then mean in terms of consumer benefit can vary and could include banks making new credit available, making existing credit opportunities more affordable, or offering more rewarding investment opportunities to savers. The critical point is that the sale of debt ensures banks are positioned to deliver these consumer benefits.

## Debt collection

The outsourcing of debt collection has a less immediate, but nevertheless beneficial, impact on capital adequacy calculations. While the overall risk of non-performing loans cannot be transferred, it can be reduced. The service that collections agencies provide affords creditors a more cost-effective route to recovery of NPLs without the credit loss that comes from selling debts below face value. This might be especially appealing for sub-prime lenders where increasing due diligence requirements can make debt sale a more costly endeavour.

Outsourcing cuts overheads for lenders, enabling them to access third-party facilities and expertise without having to conduct the activity in-house – and without having to foot the accompanying bill needed to put in place the infrastructure, resource and oversight. As discussed in chapter 4, the absence of a functioning debt collection sector would have wide-ranging ramifications for consumers and lenders. Having to bring collections activity in-house would come at considerable expense, while also bringing the operational and reputational risk that comes with carrying out this specialist activity. By reducing lender overheads and returning outstanding amounts to lenders, capital positions are enhanced and lenders are equipped to make further credit available.

[11] PwC: European loan portfolio sales: Market update (Q4 2023)

CHAPTER SIX

# ARE THE COSTS PROPORTIONATE TO THE BENEFIT?

It is fairly clear that costs for the sector have risen significantly in the last decade, with little consideration for the impact on the market. At the same time, the sector has seen contraction as a result of mergers, acquisitions and market exits, which means that regulatory costs are coming from a smaller pool.

The cost of regulation is a part of doing business, but it is reasonable to ask whether a decade of substantial cost increases is in fact proportionate.

**Financial Conduct Authority periodic fees:** Are firms getting value from their periodic fees? Where they once paid a £500 fee for a consumer credit licence regardless of size, the absolute minimum annual costs now start at £1,000 and increase from there as levies and variable fees are added into the mix, with only the smallest of firms qualifying for those minimum periodic fees.

On the one hand, the regulator needs to recover its funding needs from the regulated population and, even though the amounts are now significant, it has for the most part been fair in its distribution of regulatory costs. On the other hand, the ever-increasing cost of changing compliance requirements, the uncertainty and ambiguity stemming from those changes, and the data requests that result in little return output to firms do raise some question marks around whether the FCA's fees are delivering value-for-money for the firms they regulate.

At a minimum, we would expect to see better quality output from the FCA where firms are required to set aside their business-as-usual activities in order to satisfy an FCA information request. The FCA also needs to do more to provide certainty around rule changes, especially where uncertainty risks an increase in speculative claims management activity and FOS referrals.

**Debt advice funding:** The funding of debt advice is a topic that many have sought to resolve but one which few have succeeded in tackling. There remain numerous holes in the data – the myriad sources of funding; the amounts being contributed; where the funding is going and how effective it is in delivering good customer outcomes. In our response to MaPS' debt advice strategy consultation in early 2024, we called on them to take up a more central role in collating this kind of data – it is our view that the data is essential for making decisions around the future funding of debt advice.

But are FCA debt advice funding arrangements proportionate? When we look at the massive rise in CSA member levy contributions when changes were made in 2019, it is difficult to argue that they are proportionate. At a minimum, the measure for calculating contributions for debt purchasers disproportionately inflates the value of accounts on their books, treating them as if they have the same value post-sale as they do to the originating lender. The advice levy also means that debt advice funding places a disproportionate burden on the financial services sector, even though there are other sectors that benefit significantly, including utilities and public sector.

In our 2022 report, *'Wide of the Mark? Assessing the delivery and value of free-to-client debt advice'*[12], we made several recommendations, including the need to broaden contributions to debt advice and to open up advice funding to regular consultation. Those recommendations still stand and would go some way to creating a more proportionate funding framework.

[12] CSA: Wide of the mark? Assessing the delivery and value of free-to-client debt advice (April 2022)

**Financial Ombudsman Service costs:** Financial services firms face two types of cost when it comes to the FOS – the case fee charged for each case they investigate, and the FOS levy which is collected by the FCA. Neither is particularly proportionate for the collections and purchase sector.

On the case fee, there have been promising steps toward passing over some of these costs to claims management companies (CMCs) that raise unsuccessful complaints – although this is still just a theoretical change at this point. The proposals, while welcome, also do not go far enough, with CMCs only expected to pay a portion of the case fee in the event of an unsuccessful case fee, as opposed to the full case fee. Which means firms will still face significant costs even when complaints are found in their favour, an aspect that is open to exploitation by some complainants.

The levy, which is intended to cover the FOS' day-to-day costs and provide the organisation with a stable source of income, has fluctuated considerably over the last decade. As with many levies, consumer credit firms are bundled together in a single category and a proportion of the funding is distributed across firms within that category. However, in the case of collections and purchase firms, this is clearly unfair, given the major disparity between complaint volumes generated by these firms and complaint volumes generated by the lenders that make up the vast majority of that consumer credit category.

For example, according to the FOS' 2023/24 annual complaint data[13], debt collection accounted for 844 of the 51,296 new consumer credit cases, less than 2% of all new consumer credit cases. And yet, collections and purchase firms will be expected to contribute to the FOS funding at the same level as firms generating far higher volumes of work for the FOS. The FOS' recent H2 2023 business-specific data[14] illustrates this further – several CSA members are named in the data, but collectively they account for 0.7% of banking and credit complaints. Those CSA members also have an average uphold rate (24.4%) far below the banking and credit average (35%).

The levy costs to CSA members are disproportionate when considered against the member firms' actual cost to the FOS and it warrants further consideration by FOS. However, it is the case fee that demands the most immediate review, given its susceptibility to exploitation on a large scale.

Fig. 8 Consumer credit complaints and debt collection complaints, FOS annual complaints data 2023/24


[13] FOS: Annual complaints data and insight 2024/24 (accessed September 2024)
[14] FOS: Half-yearly complaints data: H2 2023 (accessed September 2024)

CHAPTER SEVEN

# CONCLUSION AND RECOMMENDATIONS

The rising and cumulative costs discussed in chapters 2 and 3 mean that the sector is beginning to see a tighter squeeze on profit margins. The market has contracted significantly in the last decade and it risks contracting further if cost pressures do not ease. It is getting harder and harder for collection agencies to deliver on regulator and client demands without clients paying more for their services. Increasing uncertainty around regulatory intervention, especially in the wake of the Consumer Duty, the FCA's motor finance investigation, and the FCA's proposals regarding 'naming and shaming' firms subject to investigation[15], has likely impacted investment appetite.

With a new government focused on delivering growth, the regulator must ensure that it is striking an appropriate balance between consumer protection and creating an environment in which firms can operate and innovate with proportionate regulatory and compliance costs. Proportionality is critical in creating that environment and, right now, it does not exist.

In this closing chapter, we set out several measures for industry stakeholders, including the CSA, that we believe could go some way to reducing the challenges facing the sector.

[15] FCA: Our Enforcement Guide and publicising enforcement investigations - a new approach: consultation paper (February 2024)

## House of Lords Financial Services Regulation Committee

We recognise that regulation is essential for consumer confidence and driving out bad actors and poor practices, and that regulation requires funding. But we are concerned that the regulator's objectives to protect the integrity of the UK financial system and to promote competition in consumers' interests are being undermined, with ever-rising costs leading to market contraction and market exits. T**he House of Lords Financial Services Regulation Committee should investigate this matter further, looking specifically at the proportionality of rising regulatory costs in financial services and their impact on innovation, growth and competition.**

## Financial Conduct Authority

While the FCA has taken positive steps with its policy statement on cost-benefit analyses and establishment of a cost-benefit analysis panel, there remain aspects that merit consideration in the analyses, particularly the impact of simultaneous regulatory change. The relentless pace of regulatory change means that firms are often in the midst of multiple regulatory changes, whether that is analysis, preparation, or implementation, and those costs should be considered when assessing the impact of a proposed change. **We would like to see the regulator give some thought to how they can incorporate this into their cost-benefit analysis processes, as well as analysis of the downstream impact and the potential for complaint and redress activity.**

It is reasonable that the FCA seeks information from its regulated population. But these requests can quickly become burdensome and costly for firms. **There must be better internal exchanges of information within the FCA so that firms,** especially SMEs, receiving multiple simultaneous requests are not overwhelmed and can be confident that a conversation with the regulator about the challenge of providing information will not be met with a perception that the firm is poorly resourced or is uncooperative.

## Money and Pensions Service

The scale of the increase in costs to firms of funding the debt advice sector is substantial. As we discussed in our 2022 paper, *'Wide of the Mark? Assessing the delivery and value of free-to-client debt advice'*[16] , the picture of debt advice funding is incredibly muddy. There are a number of question marks such as where funding is coming from, other than the levy, how that funding is being used, and whether contributions from other sectors are necessary to achieve a more fairly-funded advice sector. Earlier this year, **we called on MaPS to take on a more central role in collating and communicating data about the funding of the advice sector, and we would reiterate that recommendation here**, particularly as a clearer picture about advice funding would identify inconsistencies and imbalances in existing funding arrangements, which could be re-balanced to cut costs for those unfairly burdened with the lion's share of funding.

[16] CSA: Wide of the mark? Assessing the delivery and value of free-to-client debt advice (April 2022)

### Financial Ombudsman Service

FOS funding is another area ripe for review. The funding model has faced scrutiny in recent years, but there remain problems – as long as firms must pay a full case fee for cases found in their favour, it will be open to exploitation. And the levy unfairly places a disproportionate funding burden on collections and purchase firms that account for a fraction of its work. **We look forward to seeing the outcome of the FOS' consultation on charging claims management companies, even if we believe the proposals should remove the imbalance in CMC and respondent case fees.**

We would recommend the FOS review the proportionality of levy costs for the collections and purchase sector, given their minimal complaint volumes.

### Government and industry

Debt sale can play a key role in enhancing lenders' capital positions, thereby facilitating credit availability. **We recommend the government and regulator ensure that the secondary market for NPLs remains functional and healthy, and that innovation and investment are not stifled by regulatory uncertainty or disproportionate compliance costs.**

### Credit Services Association

The CSA can do more for its members in terms of reducing the impact of the regulatory burden. At present, CSA members receive weekly and ad-hoc alerts about regulatory developments, but the detail in these alerts will vary from communication to communication. There is scope for the CSA to better support its members in managing the resource challenge that comes from the need to digest each and every relevant regulatory publication by improving the information it shares with members. With this in mind, **we recommend that the CSA explores how its current approach to disseminating critical updates can be enhanced – not just in terms of detail, but also accessibility and scale – with a view to reducing the regulatory burden on members.**

# Recommendations

1. We recommend the House of Lords Financial Services Regulation Committee carries out an inquiry into rising regulatory costs and the impact of regulatory costs and intervention on growth, innovation and competition.

2. We recommend that the FCA reconsiders its use of the 'value of lending' measure in relation to debt purchase firms' contributions to the funding of debt advice and adopt a more appropriate and proportionate measure.

3. We recommend that regulatory cost benefit analyses give greater consideration to the cumulative costs of interventions; the downstream impact, especially on supply chain firms; and the potential for complaint, redress and claims management activity.

4. We recommend that the FCA improve its internal and external communication in relation to regulatory data requests to minimise the burden of multiple requests, particularly on SMEs, and to encourage engagement from over-burdened firms.

5. We recommend that MaPS takes up the responsibility for collating overarching data about the funding of the advice sector.

6. We recommend that debt advice contributions are drawn from a wider cross section of organisations whose customers and service users require advice, to ensure that it is genuinely equitable. Doing so should widen and deepen the pool of contributions while simultaneously redressing current disproportionality.

7. We recommend the FOS consider aligning the proposed CMC case fee with the standard respondent case fee.

8. We recommend the FOS reviews the allocation of its levy to collections and purchase firms and whether it is disproportionate to the volume of work generated by those firms.

9. We recommend the government and FCA ensure that the viability of the secondary market is not unduly jeopardised by regulatory uncertainty or disproportionate compliance costs.

10. We recommend that the CSA builds on its membership communication, committing to minimising the regulatory burden for CSA members by disseminating critical updates and information.


csa
voice of the collections industry