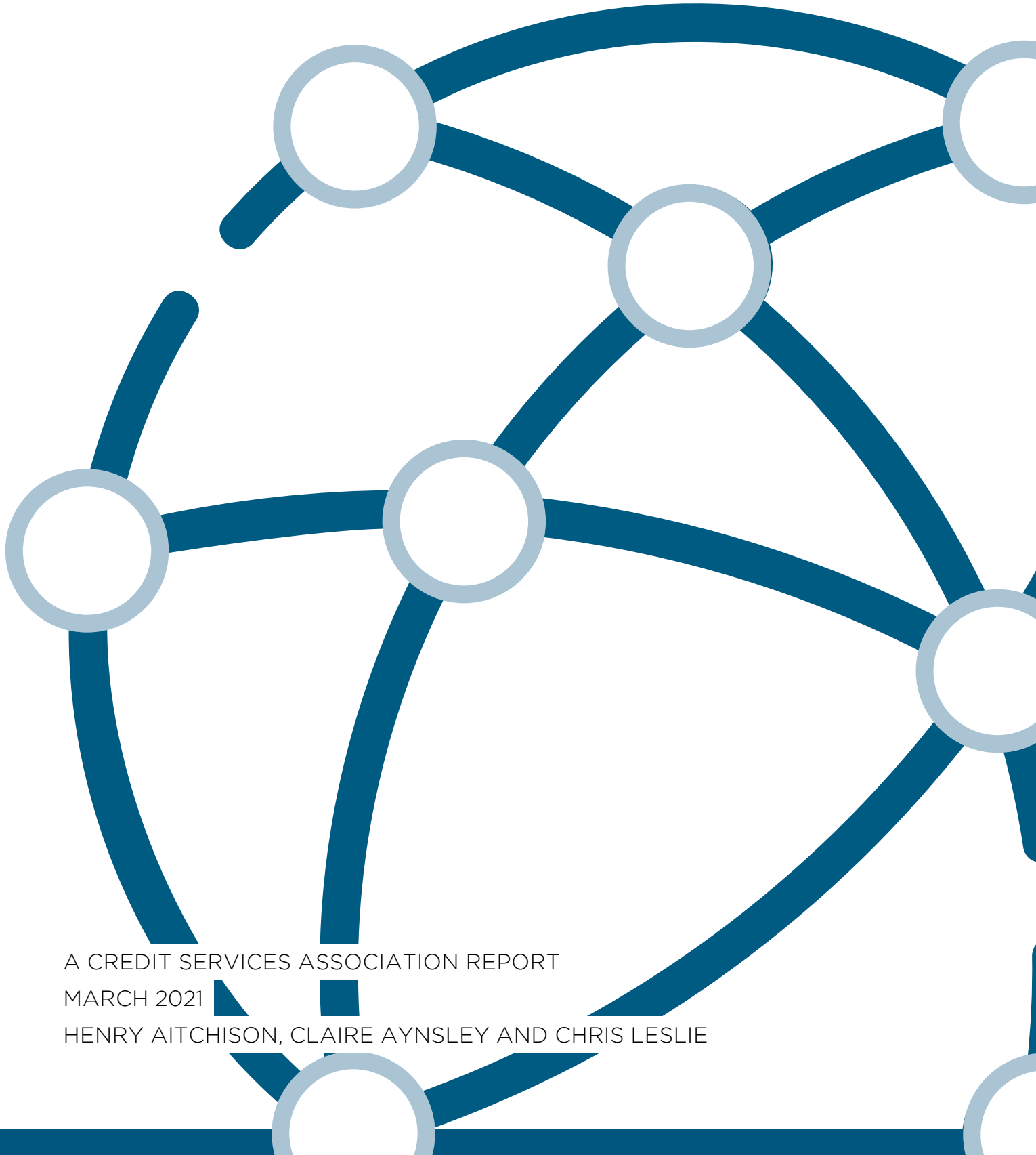
COST OF COMPLIANCE

PRELIMINARY REVIEW 2021



A CREDIT SERVICES ASSOCIATION REPORT

MARCH 2021

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ACKNOWLEDGEMENTS

We are grateful to the individual members and members of the Board of the Credit Services Association who have assisted us in undertaking this preliminary research. The challenges of the current economic climate and the pace of regulatory change have a significant claim on members' time and resources and we are indebted to those who have taken the time to provide us with data and particularly to those who have participated in the qualitative discussions. Both have been crucial in helping us to better understand the dynamics of regulatory and compliance cost, and the challenges that these pose.

A. SUMMARY

Every type of firm, irrespective of product, service or market, bears costs associated with doing business; regulatory costs to meet legal obligations, adapting business practices to comply with sector-wide rules, meeting reporting requirements for regulators and clients and more besides.

Society has been wrestling with how to regulate financial products and the behaviours of those involved in some way for more than three and a half millennia. In the UK today – especially after the past twenty years of experience and through the global financial crisis – our regulatory system intends being principles-led, focused on risk and taking a 'prudential' rather than 'tick-box' approach.

This report aims to help quantify the impact of regulation and compliance on our sector, not to argue against the value of regulation nor the principles driving them. The CSA is supportive of the UK's regulatory framework and our Code of Practice sits comfortably alongside the approach taken by statutory regulators. Nevertheless, as the association representing the overwhelming majority of member firms operating in this range of financial services, we believe it is our responsibility to provide data and feedback to the regulatory community so that a strategic assessment can be made of the overall impact of regulation and compliance on the market. New regulatory and compliance changes are made every month, yet their accumulated cost and impact is rarely looked at as a totality. We believe that for regulation to be effective, it must be proportionate and appropriate. And the key to assessing proportionality is a true understanding of the cost of compliance and that it is a blend of direct regulatory costs, fees and levies, and the more substantial costs of ensuring that regulatory and commercial requirements are met.

Good regulation ensures that a balance is struck between the interests of the consumer, the interests of the market and the interests of the market participant. However, well-intentioned but misguided interventions can sometimes hurt precisely those they were intended to help.

The post pandemic world may see more complexity, and new initiatives (such as the debt respite scheme and statutory debt repayment plans) all add to industry compliance requirements.

This report concludes that – on a very conservative estimate – the debt purchase and collections sector currently pays at least £5million annually in regulatory fees and levies (see para 3.19); that a further £25million is paid in compliance obligation towards debt advice charities; and that the overall operational costs of compliance (not including direct levy requirements) are at least £25million annually.

In other words, the formal and statutory fees and levies, which are increasingly significant, represent just the tip of an iceberg (around 10%) of regulatory obligations contributed by this sector.

While the costs of regulation are significant, the far larger costs is that of the broader cost of compliance. The advent of more formalised regulatory requirements, the expectations on clients passed through to the secondary market, the standards expected by institutional investors – all have raised compliance requirements in recent times. From our initial survey of sector firms, it appears that in staffing terms, the proportion of resource involved seems to trend generally to between 15% and 25% of all staff in some cases.

There are important points of context that we urge regulators to consider for the future, including the time required to redesign business practices to meet new regulatory requirements, the limited benefit that new technology can ever bring to reducing compliance costs, and a desire across our sector to engage more actively with customers at an earlier phase, to prevent consumer detriment worsening in the first place.

Our primary findings, though, are focused on the anxieties expressed by firms across the sector about the potential consequences of compliance cost increases, especially if these become excessive. These potential consequences can be avoided if regulators support a proportionate approach in future but risks include:

- A squeeze on other operating costs and in turn pressure on resources available for additional forbearance which regulators might desire
- Pressure on available resources for investment in innovative processes or customer-facing services
- Increasing difficulty maintaining levels of elective contributions to debt advice
- A reduction in competition across the market if costs make participation uneconomic
- Pressure on firms to pursue collections at a faster pace
- Reduced resources available to dedicate to important new initiatives such as achieving net zero, ESG ambitions or discretionary support for financial literacy

Reasonable regulatory costs and compliance costs are widely recognised as being simply the cost of doing business, and we would not attempt to argue that this should be otherwise. However, unreasonable and/or disproportionate costs of any description can have profound negative effects whether in terms of competition or in generosity of concession. Regulation that is unnecessarily costly or disproportionate and inequitably applied simply harms firms, customer interests and the wider economy. Ultimately, is the consumer and the economy that pays the price of mistakes.

We intend at a later date to undertake a more extensive investigation into cost dynamics which will not only consider in greater depth many of the issues that we have noted in this review, but also seek to better understand the dynamics of the wider sector which in turn should contribute to more effective lobbying on behalf of members.

B. RECOMMENDATIONS

i. **Improve impact assessments of regulatory and policy proposals -** Government and FCA institute a more transparent approach to testing the proportionality of regulatory interventions and more routine impact assessments, so that the indirect consequences of compliance costs on the financial services sector can be assessed more effectively before policies are executed. The CSA will continue to explore what options for such a proportionality metric in the round may be appropriate for regulators to deploy.

ii. **Regulators to better understand compliance across markets -** While primary creditors face regulators directly, the 'secondary market' is in some respects regulated twice – first, facing regulators themselves, and then again indirectly through the compliance expectations on creditor clients. Such additional checks and balances are inherent in the secondary debt market and regulators should take into account the additional safeguards this creates.

iii. **Acknowledge and address potential for regulatory systems to be abused -** Ombudsman and case investigation processes should guard against the creation of unintended behaviours capable of being exploited unfairly. Lenders and collection agencies require financial stability which can be challenged if compliance processes are badly designed and drain excessive costs which might otherwise benefit customers more broadly.

iv. **Benefit of early engagement -** The CSA should consider further work to better understand the scale and benefit of encouraging early engagement by exploring member experience.

v. **Benchmark the value in debt advice -** The CSA should undertake further work with members to explore customer journeys and outcomes to benchmark value in debt advice.

vi. **Wider contributions to and greater accountability for debt advice -** The CSA should engage with external bodies to press for greater accountability in the levels and nature of debt advice support, and that the cost of subsidising free-to-client debt advice is shared more fairly across a much wider cross section of creditor types.

vii. **Regulators to communicate issues more effectively -** While regular and early communication of issues is vital, regulators should also take care to ensure that they are clear as to the issue, the evidence and the part of the market that the issue arises in.

1. INTRODUCTION

1.1 In this preliminary review, we hope to explore the nature, scale and diversity of costs that firms face in complying with the requirements of operating in the collection and purchase markets.

1.2 Every type of firm, irrespective of product, service or market, bears costs associated with doing business but what drives these costs can be highly variable. In parts of the economy where there is an official body with a 'gatekeeper' function – where permission is required before a firm is allowed to engage in the activity – there are quite specific costs associated with getting, and also often maintaining, that permission. In others, it might be the more contingent costs associated with undertaking a particular activity or dealing in a particular market.

1.3 Some, like financial services, will have wider regulatory frameworks that impose duties or restrictions on the conduct of business and which normally will give rise to additional costs necessary to meet legal obligations and/or the standards expected of firms wishing to remain in the market. These and the costs of entering and remaining in the regulated space can be termed 'regulatory costs' but what that means in practice can be complex and contingent. The cost of a licence or of authorisation is relatively straightforward to determine at an individual level. The cost of developing and producing, for example, documentation that meets specific form and content standards for use in particular instances and is delivered in specific circumstances will be harder to quantify at anything but a firm level.

1.4 Inextricably linked to regulatory cost is what might be termed the 'cost of compliance'. That involves firms subject to regulatory requirements taking those and translating them into business practices and processes to deliver the desired outcome. A regulation might mandate a communication in a specific form and at a specific time, but a compliance function translates this into reality. Compliance takes the raw regulatory requirements and designs systems for ensuring that communications are sent when they should be, meets the requirements laid out for content (potentially modulating these to reflect particular needs amongst its own customers), checks that this happens in practice, makes adjustments if necessary and tracks performance over time, reporting within the organisation whether or not what should happen, has happened. There may also be external reporting requirements to either regulator or clients.

1.5 Compliance can also encompass the less obvious consequential costs of regulation such as HR, training, infrastructure, external support and oversight, senior managers, internal and external reporting and so on. Since firms vary hugely, as do the markets they operate in, it follows that there is no easy way to map the costs of compliance in a consistent and easily comparable way.

1.6 However, compliance (and therefore compliance cost) is far broader than simply undertaking activities linked to a mandatory regulatory structure. Another key driver for cost can be the behavioural expectations of those you do business with. A client might mandate behaviours and standards that exceed those of the regulator, a frequent observation in the collections and purchase markets. While political and media angst is often concerned with a possible 'race to the bottom' on standards, such commercially driven compliance requirements are often calibrated in the opposite direction. On top of this, internal firm values can drive other compliance dynamics such as the increasing focus on environmental and sustainability considerations.

1.7 Good regulation and compliance costs money and, if it improves the outcomes for consumers, there can be no argument that it is money well spent for the business or for society. Bad or disproportionate regulation and compliance cost merely harms those that they are intended to help whether through a lessening of competition in a market and/or related markets, loss of facility or access, or – predictably – greater cost to the end user. If policymakers should have taken away only one lesson from the 2008 Financial Crisis, it should be that an event or disruption in one market or location can rapidly ripple out to create undesirable disturbances in others.

1.8 The intention of this preliminary research is not to identify or monetise every conceivable cost across the debt collection and purchase sector. Nor is it to argue with the burden of direct regulatory costs; after all good regulation and good compliance practice may cost money but it has wider benefits to society, economy, firms and customers. It is rather to begin to better understand not only the broad direct regulatory costs faced by firms in the debt collection and purchase markets, but also the 'hidden', indirect, costs they face. From there it is hoped that it will be possible to understand their evolution and growth, and what the potential consequences are of the accumulating costs for all participants.

2. PURPOSE, BENEFITS AND RISKS OF REGULATION

The history of current regulation

2.1 The regulation of financial services is not a facet of the modern age. Society has been wrestling with how to regulate financial products and the behaviours of those involved in some way for more than three and a half millennia. From the Code of Hammurabi, through the laws of Rome, of medieval Europe and so on, law makers have variously tried to control who can do business, the detail of how that business is conducted, what price is socially acceptable, and what happens when relationships fail.

2.2 Unsurprisingly, history has shaped or influenced many of our current approaches. The concept of properly executing a credit agreement would be as conceptually familiar to a Roman heading out to fight Hannibal and his elephants in the late third century BCE as it is today under the Consumer Credit Act 1974. Oddly enough, so would the somewhat Draconian consequences to the lender for failing to do so.

2.3 Regulating and/or capping prices as a tool is even older, with many civilisations attempting to set a limit on costs according to the morality of the day. Unfortunately, regulatory price manipulation has a long history of falling short as an effective mechanism for social policy and morality. Short term 'success' usually gives way in time to negative effects such as restrictions in supply, exclusion of consumers from markets, disruption in markets, erosion of competition and the requirement (and cost) for a bureaucracy to oversee the controls. As one writer put it: *'The case against price controls is not merely an academic exercise, restricted to economics textbooks. There is a four-thousand-year historical record of economic catastrophe after catastrophe caused by price controls.'*[1]

2.4 Laws are inevitably a product of their time and the outlook of the society in question and price controls can – if risks are understood and managed – have a limited value. There is, however, a broad constant: some measure of control is normally required to ensure fairness in the round but beyond a certain point regulation can become a problem in itself, not part of the solution. The more intrusive and more costly relative to the benefit achieved, the less effective a regulatory regime can become and the wider the unintended and undesirable effects. In extreme cases, regulation can begin to be viewed as the answer to any issue not merely a potential tool once the issue has been considered properly - 'how do we regulate?' rather than 'do we need to regulate and, if so, how?'.

[1] DiLorenzo, Thomas J: Four Thousand Years of Price Control, Mises Institute [accessed 5 March 2021].

The Current Regime

2.5 In the UK, regulation of financial services is grounded in the principles of the Financial Services and Markets Act 2000 (FSMA)[2]. FSMA was an exceptionally powerful and, on paper at least, a well-designed tool. However, the single regulatory authority created by that Act – the Financial Services Authority – was replaced by a tripartite approach in the Financial Services Act of 2012 in the wake of the global financial crisis (GFC) and perceived failures of that initial FSMA framework. In simplistic terms, HM Treasury has a legislative and high level policy making role, and the Prudential Regulation Authority (PRA) (embedded since 2013 in the Bank of England) is responsible for the prudential supervision of approximately 1,500 systemically important firms such as banks, building societies and insurers. The third limb of the system is the Financial Conduct Authority (FCA) which is primarily a conduct regulator (with prudential responsibilities for those not subject to the PRA) for some 58,000 firms covering a broad swath of financial services products and activities.

2.6 This structure is largely a reflection of those profound regulatory failures that contributed to the GFC of 2008. The principal regulator of the time, the Financial Services Authority, had both prudential and conduct supervisory responsibilities but was widely criticised for failing to fully understand the markets, products and firms that it was responsible for. As a result, it failed to identify and mitigate clear signs of risk before they crystallised or to supervise in a way that recognised differing levels of risk and applied resources accordingly. A regulatory mentality often described as 'box-ticking' rather than identifying and proportionately managing risk not only contributed to the GFC, but to other large-scale failures, such as failing to recognise the obvious and inherent risks in the selling of Payment Protection Insurance before large scale mis-selling occurred.

[2] There are other regulatory tools available to the FCA – concurrent competition regulation, market studies and so on, but the core of the regulatory system is based on the powers in FSMA.

Purpose, Benefits and Risks of Regulation

2.7 Regulation can achieve a variety of benefits. It can standardise approaches in a way that reduces information asymmetry between firm and consumer for complex products while facilitating more streamlined and cost-effective products. It can facilitate competition by levelling playing fields between firms, making it easy to enter the market and fostering competition on quality and cost. At its simplest it can decide who should be allowed to participate in a market and what they should do (or not do) when they are there.

2.8 Good regulation ensures that a balance is struck between the interests of the consumer, the interests of the market and the interests of the market participant. It is transparent and accountable in its conduct, as well as coherent, objective and rational in its approach and application. A consumer is informed or provided with the means to be informed, protected from behaviours they should not reasonably have to experience or risks they cannot foresee, but nevertheless are expected to bear responsibility for their own actions.

2.9 'Better regulation' has been high on the agenda of successive Government and Parliaments for over 25 years. In 2004, the House of Lords Select Committee on the Constitution published its Sixth Report[3] which considered many of the same issues as are still being discussed today. It suggested[4] a useful viewpoint that 'Good regulation depends on:

- Good regulatory design
- Control through the process of accountability; and
- Accountability for outcomes: regulatory performance.

2.10 Much has been, and continues to be, written on the concept of better regulation whether in the form of the principles set out by the Organisation for Economic Co-operation and Development[5], or in the form of the Better Regulation Framework produced by the Better Regulation Executive[6]. The fact that such a diverse range of organisations continue to largely retread the same ground, speaks volumes to the extent to which better regulation is genuinely entrenched in regulatory behaviour.

[3] House of Lords, Select Committee on the Constitution: Sixth Report [March 2004].
[4] Ibid: Table 2 following paragraph 60.
[5] OECD (2014), The Governance of Regulators, OECD Best Practice Principles for Regulatory Policy, OECD Publishing, Paris, https://doi.org/10.1787/9789264209015-en.
[6] Better Regulation Executive: Better Regulation Framework – Interim Guidance [March 2020].

2.11 The risks of misguided or poorly calibrated regulation are plain to see. While credit remains easily, and currently relatively cheaply, available to those that can comfortably afford it, for those with an impaired history or few options beyond the more expensive forms, the choices are becoming increasingly limited in part as a consequence of regulatory intervention. Any dealings with customers that are either vulnerable or in financial difficulty carries with it increased regulatory requirements, which in turn generate increased cost. That is not to argue for or against the appropriateness of such products or to comment on their morality. It is merely to reflect that, in the real world, different dynamics between customer, product, risk, firm and regulation can drive costs in different ways. What might be true for customers who can access prime- and cheap – products, may not be the same as for those in other demographics and with other needs. A well-intentioned but misguided intervention can hurt precisely those that it was intended to help.

2.12 An increasingly common feature of the regulatory space is that, having created a problem in the first place there is an ex post facto review of how the markets should respond to resolve it. The Woolard Review[7] of the unsecured credit market, is an excellent example. The answer to having reduced access and availability (and increased costs) of credit to 'riskier' borrowers as a consequence of regulation, is seemingly to call for alternative and cheaper providers to fill the gap so that consumers are not excluded. However, such businesses have always been able to enter the market, yet policymakers do not seem able to explain why they do not enter, or if they do they lack the ability to grow in scale. But perhaps the more pertinent question to ask is why were the downsides of intervention not articulated and considered **before** the intervention took place?

The point of exploring this is not to debate or draw conclusions on the merits of the FCA's interventions in the high cost credit space. Rather it is to illustrate that regulatory intervention can, and does, have profound implications beyond the obvious to firms and consumers alike. Arriving at an approach that is balanced and proportionate in the round is as crucial in achieving the right outcome as is understanding and mitigating the consequences of whatever approach is decided upon.

[7] The Woolard Review: Change and Innovation in the unsecured credit market [February 2021].

The Present and the Future

2.13 The response to the COVID pandemic brought significant shifts in commercial activity and was almost universally disruptive across the economy. Businesses had responded well in giving additional forbearance even before official calls for it to happen. However, the pause in activities and the ongoing economic uncertainty means that regulators will need to reflect carefully how these disruptions – including those mandated such as the payment deferrals – have affected resources and reserves. The impact on consumers will have an effect on repayment likelihood and returns for large proportions of the population for some time. Government will need to be alert to potential for those pressures to manifest in unexpected ways amongst consumer behaviour.

2.14 To add to the complexity of the future, Government is continuing to press ahead with its plans in relation to debt relief. The first element, the Breathing Space moratorium ('debt respite scheme') with its debt relief component, will present challenges even to those firms more familiar with the concept of more targeted and considered forbearance when it comes into force in May 2021. The increased resources required for administering complex arrangements required for the creditor will present operational and cost implications even for firms already offering structured forbearance. The Government's claim of a significant financial benefit to business in the first year as a result of this is viewed with some bemusement[8].

2.15 The structure of the second element, the statutory debt repayment plan (SDRP), is expected in 2021 with a view to introduction in 2022. Details of the Government's current thinking are scarce which, from a planning and implementation perspective, is a matter of concern. Initiatives that require last minute implementation have an effect on the cost and practicability of doing so, in addition to the cost implications of the policy proposals.

2.16 It is not merely in the debt space itself that firms are facing increased costs. Moves to augment charging in relation to court processes or apply stricter regulation to specific issues such as parking fines, for example, also contribute to the tapestry of rising costs, and it is important that these are considered in the round. Whatever the size of a market, increasing cost (or a decreasing ability to recover those costs) will not solely be borne by business.

[8] Debt Respite Scheme (Breathing Space Moratorium and Mental Health Crisis Moratorium) (England and Wales) Regulations 2020: Press Release and Impact Assessment.

3. THE DYNAMICS OF COST

General

3.1 The cost of a regulator to an individual firm is not the same as the cost of regulation. The cost of regulation is not, in turn, the same as cost of compliance. For example, a regulator might cost an industry £X million, the cost of regulation might be £Y million and the cost of compliance might be £Z million. As we have discovered in our initial work, isolating these additional costs is far from easy but understanding the conceptual differences between cost types and recognising how they can be influenced by regulatory or legislative activities is crucial to evaluating the benefits and risks of regulation.

3.2 Conversely, failing to recognise these differences or the wider dynamics of cost means that the true value and cost of interventions, and therefore the consequential effects on markets and customers, cannot be properly mapped. This preliminary review seeks to shed new light on these cost dynamics for the debt collection and debt purchase sector – and our conclusions follow.

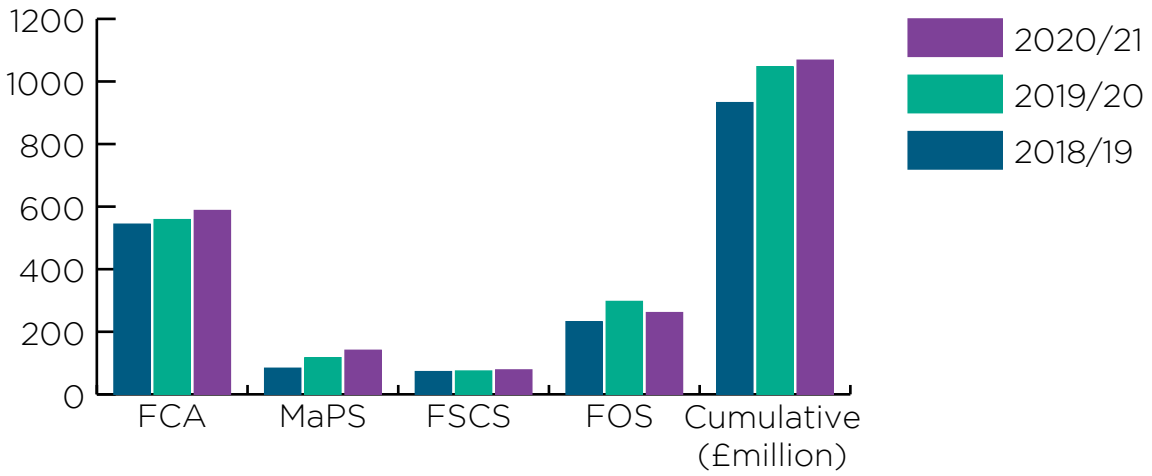
Cost of Regulators

3.3 As already alluded to, how firms are affected by regulatory costs depends on a variety of factors. Size, turnover, the number and nature of activities can all play a part. Increases in costs are often felt unevenly across a market, particularly where inappropriate metrics for calculation are used. The cost of the regulators themselves is more straightforward to map.

3.4 Policymakers tend to view costs of the regulators themselves through the lens of the theoretical value of the market that it expects to pay for it. In 2014, the National Audit Office[9] (NAO) noted that the cost of splitting the Financial Services Authority into the PRA and FCA had resulted in a 24% increase in cost, or £127 million between the 2012/13 and 2013/14 financial years. A total of £664 million in direct regulatory cost for a market valued at an estimated £234.2 billion. Viewed in such a crude way, the cost of regulators appears almost insignificantly reasonable. However, there are three fundamental flaws in that approach: 'value' in a market is not synonymous with disposable capital; the ratio of regulatory cost to market value is immaterial in terms of assessing quality, effectiveness and value of regulation; and higher cost does not equal quality. A more rational starting point would be realisable value for all of the participants versus the cost of compliance.

[9] National Audit Office: Regulating Financial Services [21 March 2014].

3.5 The cost of the regulatory system generally has been rising year on year. Excluding the cost of the PRA, the cumulative operating costs of the FCA, Money and Pensions Service (MaPS), Financial Services Compensation Scheme (management expenses) (FSCS) and the Financial Ombudsman Service (FOS) all follow a broadly upward trajectory.



I Fig 1: Relative costs of different elements of regulatory structure.

3.6 This representation is crude and merely illustrative. FOS costs, for example, are a combination of levy and case fees and therefore how much, cumulatively, financial services must actually pay depends on the level of complaint FOS deals with (but not necessarily the level of merited complaints). The FSCS compensation levy is also not included because that fluctuates according to the extent to which the FSCS believes that compensation claims will draw upon the existing levy funded pool and will require topping up, and the extent to which risk will increase meaning a larger pool is required. Similarly, other elements such as the Illegal Money Lending Levy (IML) are relatively small and not included.

3.7 However, as already indicated, the trend in direct regulatory costs for financial services as a whole is upward. But part of the challenge is that the different aspects of regulator costs fall unevenly across the regulated population and have increased unevenly over time. The graph below gives an illustration of this for firms in six different hypothetical scenarios:

- A small firm with income of £60,000, and subject either to the limited (Scenario A) or full (Scenario B) permission regimes
- A medium firm with full permission, £2 million in income (Scenario C), and the same scenario but with £1 million of 'lending' activity (Scenario D)
- A large firm with full permission, £20 million in income (Scenario E), and the same scenario but with £10 million of 'lending' activity (Scenario F)

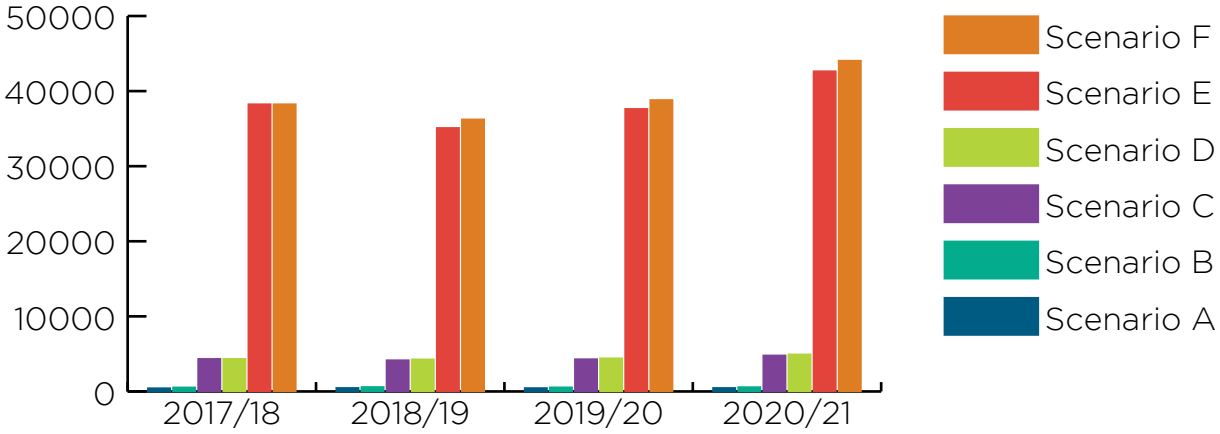


Fig 2: Distribution of the cost of 'regulators' across different firm size scenarios and activities.

3.8 Members of the Credit Services Association do not 'lend', as such. However, some members will be treated by legislation as 'creditors' where they purchase the rights and obligations to some types of debt, notably consumer credit debts. This is relevant to the position in relation to fees in that 'creditors' are treated as if they were lending for the purposes of some elements of the fee calculation in relation to debt advice[10].

[10] Notably the liability for fee elements where the CC03 fee block is relevant to the calculation.

3.9 Fig 3 below gives a slightly different perspective on the distribution of costs across different parts of the regulatory structure showing fluctuations of the individual costs in themselves and as a component of the overall cost to the hypothetical Scenario 3 firm of the regulatory structure. The cost of the FCA itself, while proportionally the largest by amount has increased at a relatively shallow rate reflecting the FCA's attempts to keep increases to already substantial costs relatively flat. The Illegal Money Lending Levy, controlled by HM Treasury has been similarly stable.

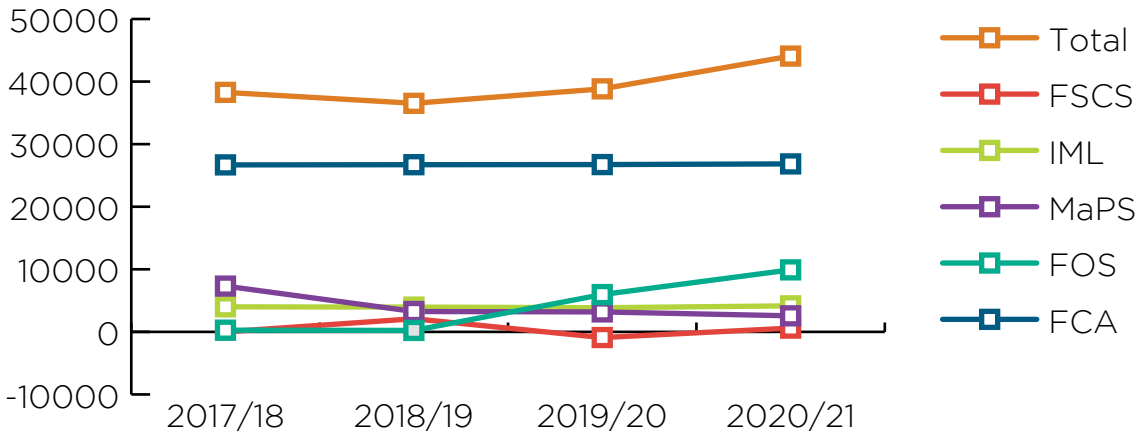


Fig 3: Movement in individual regulatory cost elements over the last four annual cycles – Scenario F.

3.10 By contrast, the elements relating to MaPS, FSCS and the FOS have shown far greater volatility. As already noted, the FSCS levy is somewhat contingent on circumstances. Its management expenses have slowly increased over time, but the 'pools' from which compensation are drawn have changed over time. In 2018, there was a need to top up the pool to reflect that parts of consumer credit were being included in the scheme. Firms received a slight rebate in 2019, with the pool requiring 'topping up' again in 2020.

3.11 It is also worth noting that the FSCS pool includes provision for compensating for the failure of debt management firms. However, the most structurally significant debt management firms, whose failure could potentially result in the highest loss to consumers, are excluded from the requirement to contribute. Instead, and somewhat peculiarly, the shortfall in contribution is made up by consumer credit firms. In other words, creditors are being required to underwrite insuring the risk of loss of funds which would go to settling debts to themselves which, mildly put, seems somewhat counter-intuitive and difficult for the levy system to justify[11].

[11] It should be noted that provision of free to client debt advice is largely underwritten by many of the same firms, whether voluntarily or as part of the levy system. Moreover, free to client providers are not required to contribute to the regulatory system in the same way. They are, for example, not charged case fees for complaints against them.

3.12 Looking at the other end of the spectrum, a very small firm (Scenario B) predictably faces very different levels of direct cost for the regulatory structure. The distribution of costs is largely the same and the only fluctuations are to be found in the FCA and FSCS levies.

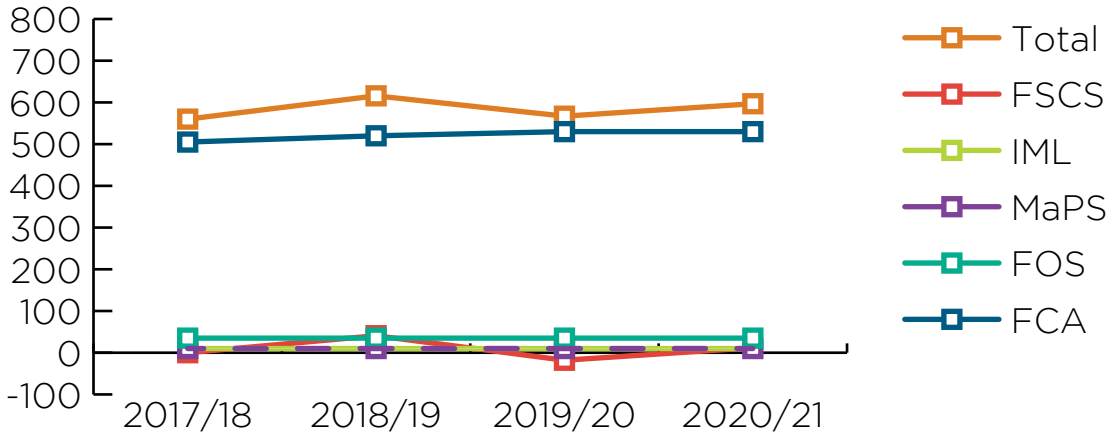


Fig 4: Movement in individual regulatory cost elements over the last four annual cycles – Scenario B.

3.13 Although many of the requirements of the consumer credit regime overseen by the Office of Fair Trading remain unchanged, it is nevertheless difficult to do a like for like comparison between regulatory structures. That said, it is worth observing that the annual maintenance cost for an indefinite consumer credit licence was £208 for a sole trader and £505 for a partnership and limited company in the year before OFT regulation was handed over. Depending on how the smallest of firms are constituted this represents an uplift of between 18% and 287% in cost of the regulator.[12]

[12] It should be noted that the FCA's demands can flex with need whereas the Office of Fair Trading's costs required Parliamentary approval for change and were therefore less flexible.

3.14 In the course of producing this preliminary review, CSA members were surveyed to better understand the cost of the regulatory structure to firms in real terms, and to see how this compared to the more 'theoretical' costs of the scenarios chosen. Approximately 50% of members subject to the FSMA–based regulatory structure contributed information representing a broad cross-section from the relatively small to the very large. Fig 5 below shows the proportion of responses by CSA fee band.

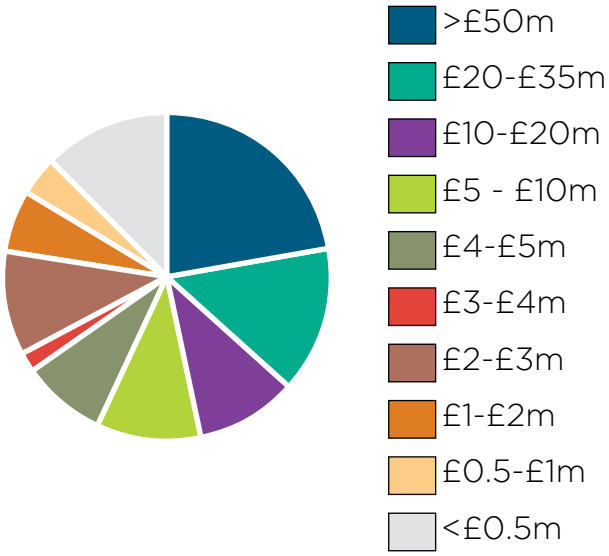
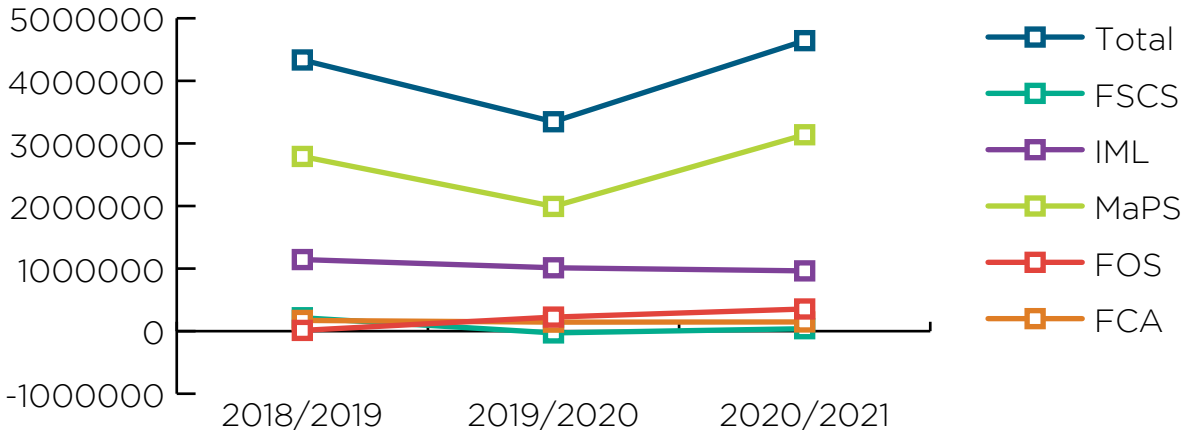


Fig 5: Proportion of respondents by CSA fee band.

3.15 We asked these members to provide us with details of the levy-related costs that they had contributed in the three latest financial years[13]. While this information was provided at an individual level in response to the survey, in common with all information provided by members through the DGI portal, only the aggregated and anonymised costs are available to us in preparing this review.

[13] 2018/2019, 2019/2020 and 2020/2021

3.16 However, this aggregated information nevertheless provides a valuable insight into the cumulative costs that members have faced in terms of the regulatory structure over a three year period.



I Fig 6: Cumulative levy related costs across contributing members between 2018/19 and 2020/21.

3.17 As can be seen, the overall picture shows a somewhat different pattern than for the individual scenarios used at Figs 3 and 4. While IML, FSCS and FOS generally show a slightly rising pattern of costs and the FCA shows a shallow decline, the MaPS contribution is disproportionately high. It is likely that this a reflection of the fact that the scenarios did not include very large members where 'lending' in a levy sense[14] makes up a disproportionately large contribution to the overall fees total.

3.18 The graph shows a pronounced dip in the MaPS contribution in year 2019/2020. This does not represent a drop in the level of the MaPS budgetary demand, which has increased year on year, but rather a correction in as much as many of the firms making the largest contributions, amongst members, to the MaPS budget had over-reported 'lending' levels in 2018/2019 because the reporting methodology saw firms misinterpret the requirements to report as more extensive than strictly necessary. Once this is adjusted for, even roughly, it illustrates that the demand on firms in relation to MaPS, has increased by at least 100% over 3 years[15]. It should also be borne in mind that these firms are also significant voluntary contributors to free-to-client debt advice. In 2018, conservative estimates from member data show that CSA members contributed at least £25 million of the then £60 million total national contribution to free-to-client debt advice funded under the so-called fairshare model.[16]

[14] The CC03 fee block.
[15] The debt advice levy has grown from about £55 million to over £100 million.
[16] The fairshare model is primarily utilised by Stepchange and Payplan, though it is also used to a lesser degree by other debt advice firms. Creditors make payments to the debt advice firm equivalent to a proportion (often between 11 and 13%) of each repayment that they receive.

3.19 Figure 6 above shows that total fees and levies for those responding to our survey were around £4.6million in 2020/21. Based on the size distribution of those that did not participate, we estimate that the overall fees and levies contribution in 2020/2021 to be at least £5 million[17]. We believe the actual figure to be higher, potentially substantially so, but in the absence of reliable data or sufficiently robust assumptions that can be used to project costs for some key levies and fee components in a realistic way, these have been excluded.

3.20 While the precise cost of the regulatory structure for members of the CSA is not yet fully known, what is clear is that that regulatory cost is dwarfed by the sums committed to wider compliance or elective costs, such as contributions to debt advice.

Fig 7: Illustration of formal and wider regulatory compliance costs.

Anomalies

3.21 However, it should be noted that regulatory structure cost is not wholly transparent even though it is relatively straightforward to map.

3.22 The MaPS cost, for example, is overseen and agreed by the Department for Work and Pensions. However, there is no transparency around how costs are arrived at or utilised in respect of those expected to pay for it. Given that MaPS is the third iteration of a consumer advice and information body and both predecessors were criticised on effectiveness and value for money grounds, this state of affairs is a concern.

3.23 This is especially so as part of the funding that is passed to the MaPS relates to the funding of free-to-client debt advice which, as a market, lacks strategic oversight or external validation of quality, consistency and value for money. The lack of transparency and accountability on levy methodology is therefore a profound concern. In mid 2020, the Government announced that it would be adding a further £14.2 million in debt advice levy to financial services industry costs, with firms in the CC03 fee block expected to contribute to the further £7million or so of that.

[17] We have used conservative estimates and assumed that the income level for each firm is at the mid-point of the relevant 4 smallest CSA membership fee brackets. This approach is intended to deliberately under-estimate regulatory and fee contribution. However, a very small number of non-respondents were involved in purchase and for these we have taken an average of the contributions made by members in the same CSA membership bracket than did participate.

3.24 The FOS cost is also not entirely transparent. FOS funding is a mix of levy based funding (which is predictable) and funding derived from 'case fees' for considering individual complaints and therefore contingent. In other words, the smaller proportion provides a measure of financial stability, the larger share derives from charging for work actually undertaken. It has recently, with the agreement of the FCA, begun a process of adjusting the relative ratio of levy to case fee costs, moving from the levy being 15% of income to a target of about 50% income from levy. At the same time, individual case fees will increase.

3.25 This approach is justified partly on stability grounds and partly on the basis that FOS case fees have not properly reflected actual cost particularly as, it is argued, complexity is becoming more of a consideration. While the former is understandable, the latter is more difficult to credit. Given FOS' familiarity with most of the markets and products and the fact that grounds for complaint vary little in general terms, it seems that 'complexity' is a subjective opinion without clear evidence.

3.26 There are also significant anomalies in respect of the class of businesses asked to pay fees and levies, versus those who one might expect to contribute to the costs of regulation. The natural principle – that the originator of debt should pay for its regulation – is not pursued consistently. Although they may contribute to debt advice in their own ways, public sector bodies and utilities are not required to contribute to the statutory regulators in the same way as others in the private sector, despite in many cases forming a very significant portion of what can be termed 'problem debt' in the UK. This anomaly ought to be addressed in a fairer and more transparent way.

3.27 Regulators should, as a matter of minimum standards, be transparent and accountable not only to Departmental and Parliamentary oversight, but to those which are expected to cover their costs. Cost increases should be clearly justified and evidenced and capable of withstanding scrutiny by unrelated and uninterested third parties other than Parliament and Ministerial Departments. Consultation should happen in all cases, concerns should be anticipated and addressed with a robust evidence base that can be tested.

The cost of regulation

3.28 Distinct from the cost of the regulatory structure itself is the cost of meeting regulatory requirements both in implementing change and routine costs. Unlike the cost of the regulators, these are highly variable between markets, products and firms. Better regulation principles expect that Government and Government departments will make some reasonable and realistic attempt to quantify the benefits and costs of proposals. Change to requirements can have a profound effect on costs both positive and negative.

3.29 The FCA is required, in most cases, to set out the projected costs and benefits of a proposed course of action. From that, it is, in principle, possible to cast the proposals in a balanced way with positives, negatives and evidential limits clearly set out. Doing so enables retrospective review of the extent to which assumptions where realisable. An example of a somewhat exhaustive Cost Benefit Analysis (CBA) can be found in relation to the introduction of the Senior Managers and Certification Regime (SMCR).[18]

3.30 However, CBAs are not always thorough and in some cases do not take place at all. In consulting on proposed changes to its rules and guidance on creditworthiness and affordability[19], the FCA chose to rely on a legislative provision that waived the obligation to consider cost implications in detail. It took the position that since it was merely refining how it was articulating its views this should generate no, or only minimal, additional cost. Unfortunately, as is clear from the consultation paper, what the FCA failed to recognise was that even a change in articulation of view is capable of driving significant costs. Firms necessarily wished to ensure that their understanding of requirements in practice was still right after the change so cost was incurred. This particular outcome is neither novel nor surprising and regulators should always expect this behaviour, and reflect this accordingly in analyses.

3.31 Equally, while the paper considered the potential benefits of its action, the consideration largely focused through the lens of unaffordable lending – for which the FCA has found remarkably little evidence since 2014 - rather than acknowledging the risk in the opposite direction existed as well. Specifically, that its own intervention could also inadvertently result in increased costs for consumers and decreased access to credit, and that firms might well incur costs unnecessarily as a result of checking systems and processes or changing lending criteria to guard against a risk of regulatory action or concern that may well not have been there.

[18] Individual Accountability: Extending the Senior Managers and Certification Regime, Cost Benefit Analysis: FCA [July 2017].
[19] Assessing creditworthiness in consumer credit, Annex 2: FCA [July 2017].

3.32 While regulation is a necessary component of commercial activity, a failure to understand a proposed course of action in its widest sense and a failure to understand the cost dynamics, means that regulators cannot determine what the impact of proposals actually might be to markets. Unsurprisingly, the words of regulators can have an effect that they did not mean or intend.

3.33 Another facet of the cost of regulation is the timing, volume and frequency of change. Again, change can be needed, it can be urgent and ultimately it is not necessarily a bad thing. However, ill-timed or uncoordinated change can also carry a cost particularly where it impacts on fixed systems and processes such as IT and infrastructure. The ongoing uncertainty regarding the Government's Breathing Space scheme has been compounded by the lack of legislative and operational clarity from policy makers and the short time to implement.

3.34 IT and infrastructure cost can be particularly pernicious because they often require long lead times to plan, test, implement and validate , and also to align with any other planned or necessary changes already in train. Unrealistic timeframes for implementation often give rise to increased costs as either resources need to be redeployed or brought in. As an example of how the speed or scale of change can lead to oversights and costs, consideration could be given to the post Consumer Credit Directive implementation period where a number of lenders reported significant losses, in some cases as a consequence of not having included a handful of words relating to partial early settlement in statutory forms.

3.35 Implementation of regulatory interventions will inevitably generate cost, including unintended cost. However, it is important to recognise that routine regulatory activities such as regulatory reporting and responding to information requests also carry a cost. While regulatory reporting is relatively straightforward, ad hoc requests for information as part of a project that the FCA has decided to undertake can be profoundly disruptive whether because of their frequency or their breadth, or more often a combination of these and a short time frame for response. A request for a large volume of non-standard information with a three week deadline for response potentially at the same time as the same resources are being used to implement other regulatory changes can be decidedly unhelpful.

3.36 Clearly, it is right that the regulatory structure is amended to reflect changing issues where there is a compelling case to do so. It is also perfectly reasonable to expect firms to bear the legitimate cost of making adjustment or checking systems where this is the case. Similarly, it is right that the regulatory system seeks information to establish and maintain an extensive understanding of the markets that are regulated.

3.37 However, the preliminary indications would suggest that a lack of co-ordination regarding proposals for change and/or requests for information can unreasonably add to the burden that firms must carry. Similarly, the understanding of the cost dynamics that firms face coupled with an incomplete understanding of benefits, costs and risks may have led to proposals being made which were not, in the round, beneficial to the consumer.

3.38 Regulatory costs then can be difficult to predict and variable in their application whether at the implementation stage or as part of business as usual. Even changes that, on the face of it, are likely to have minimal practical consequences in cost terms if existing rules are being followed, can nevertheless generate changes in commercial attitudes and increased cost as a consequence of added commercial caution. It is important to understand that notion of upheaval because regulatory costs feed directly into wider compliance costs. A failure to take a holistic view of individual costs and a global view of the cumulative effect of costs on the part of the regulatory structure inherently means that it cannot determine the relative benefit of its interventions or whether those interventions are having an additional adverse effect on factors such as competition.

'Weaponised' regulatory costs

3.39 In giving evidence to the Treasury Select Committee[20], the Chief Ombudsman and Chief Executive of the FOS, Caroline Wayman, was asked directly whether she had seen evidence of regulatory costs being used as a threat by complainants. To quote the example used by Chairman, Mel Stride: *"Look, you might as well pay me my £300, £400 or £500 because, in the event this goes to the financial ombudsman, it is going to cost you more than that anyway. Pay up"?* - Ms Wayman suggested that while she had seen little evidence of consumers doing so, she implied that it was a behaviour she would expect from a claims management company.

[21] Oral Evidence, Question 8: Treasury Select Committee [9 November 2020].

3.40 Anecdotal evidence from members paints a somewhat different picture of both consumers and others (such as claims management companies) taking this approach. So, even if there is no merit to their complaint, should the FOS consider it, a fee of currently £650 could be applied.[21] In other words, even if a firm *'stands behind'*, to quote Ms Wayman's evidence, their conduct and refuses to compensate a customer with a meritless complaint, they can still potentially be financially penalised and to a significant degree. Making the complaint incurs no cost to the complainant and, should case fees be payable, firms will incur a cost. To paraphrase one respondent, why would you risk incurring a £650 case fee and the time and resource cost of dealing with FOS on a baseless complaint in relation to a £400 debt? The current system favours the interests of those who abuse it, and the regulatory structure that allows it.

3.41 While the scale of this is as yet unclear, it nevertheless shows that the regulatory system as it currently stands is perfectly capable of being routinely abused to the detriment of credit markets, and by extension their wider customers. That members have raised this as a consistent and growing issue, would indicate that it merits further exploration in future work by the CSA. **Recommendation: Ombudsman and case investigation processes should guard against the creation of unintended behaviours capable of being exploited unfairly. Lenders and collection agencies require financial stability which can be challenged if compliance processes are badly designed and drain excessive costs which might otherwise benefit customers more broadly.**

Anomalous costs

3.42 It is also worth noting that regulators and the regulatory system can, on occasion, give rise to unexpected or disproportionate costs. For example, it is a well trodden path that some provisions of the Consumer Credit Act 1974 are somewhat draconian in the way that they apply sanctions. Even the slightest failure to precisely include prescribed wording or fail to provide a notice at the correct time can result in an automatic 'administrative' penalty such as losing the right to interest[22]. The example of Northern Rock Asset Management is by no means isolated demonstrating that even where there is no measurable detriment to the consumer, the prescriptive nature of regulation can still inflict considerable cost for even the most minor error.

[21] A firm currently receives a number of 'free' cases, though arguably, and particularly in light of the increased levy demand, these are in effect 'pre-paid' by financial services firms as a whole. After these are used, a case fee per complaint considered is applied irrespective of outcome.
[22] For example: Asset Resolution (Consumer Credit Act) - Thursday 11 December 2014 - Hansard - UK Parliament.

3.43 The conduct of regulators themselves is equally capable of imposing unnecessary costs out of proportion to the issue at hand. The FOS in upholding complaints against firms can, and does, apply interest[23] for the period it feels that the customer was out of pocket. However, there are often delays in the time taken to reach decisions to uphold complaints, which means that firms are effectively penalised for inefficiency of the regulator. According to the FOS' own annual report and accounts for 2019/2020, only 56% of complaints were dealt with in 3 months and 10% of complaints remained outstanding after 12 months. A delay in resolving a complaint can therefore add an additional financial penalty as a consequence not of the firm's conduct, but that of the regulator.

3.44 It is entirely proper that firms should be accountable for what they themselves have done, but it is less easy to see that they should be responsible for underwriting the failings of others. This is particularly the case for purchasers where rigorous due diligence on purchasing accounts might not always identify four – quite literally in some cases - missing prescribed words or necessarily have been aware of failures in relation to customer accounts before they purchased them.

Compliance Costs

3.45 So far this review has considered the costs of the regulatory structure and then the separate costs of complying with the regulatory regime in so far as the latter is possible. In essence, how much does it cost to join the club and stay in the club, and then the costs of participating in different activities and how these, and the requirements for participating, can change over time. It is perfectly reasonable that such costs should exist, but they must be genuinely controlled, proportionate and appropriate in the round. If there must be cost bearing changes, these and the benefits should always be considered both individually and collectively.

3.46 As part of this preliminary review and alongside our survey work with CSA member firms, a series of qualitative interviews were conducted to fully understand the dynamics of responding to regulatory and compliance costs. From that exercise we conclude that, although the cost of the regulatory structure and the cost of regulation are significant, the far larger cost is that of the broader cost of compliance - and there appear to be a number of reasons for this.

[23] Potentially 8% per annum simple interest.

3.47 In 2003, the then regulator of consumer credit activities, the Office of Fair Trading (OFT), published what it termed 'fitness guidance' – a document which set out behaviours that firms engaged in debt collection activities either should or should not do. This was not a speculative document projecting the potential for harm but rather one that largely detailed practices that the OFT had seen and which it considered unacceptable and likely to take enforcement against. In October 2011, the OFT issued revised debt collection guidance[24] providing far more detail on behaviours it expected to see as a minimum and those it would consider unacceptable or conditionally unacceptable.

3.48 The OFT debt collection guidance set out four broad principles for the conduct of debt collection business which were aligned to the central themes of the underlying legislation:

- Treat debtors fairly
- Be proportionate
- Be transparent and
- Exercise forbearance and due consideration.

Alongside this was an extensive list of minimum standards of conduct and unfair business practices and some elements drawn from the CSA's own Code of Practice. Much of the OFT's guidance continues to be reflected in the FCA's current requirements set out in the Consumer Credit handbook (CONC).

3.49 The reason this is relevant to the matter of the cost of compliance is that some respondents emphasised the point that, while compliance had always been a facet of normal business operations, the guidance crystallised the importance of putting it on a more robust footing. One respondent described the significance of compliance in general terms as being *'the cost of the right to do business'*. The more general point is that these sentiments are emblematic of an industry that was already focused on effective compliance before the transfer of responsibility to the FCA.

[24] Debt Collection: OFT Guidance for businesses engaged in the recovery of consumer credit debts (OFT664Rev): Office of Fair Trading [October 2011]. Note this document was further revised in November 2012.

Internal drivers for compliance above the minimum

3.50 As suggested elsewhere, firms frequently tend toward the cautious. Where the regulator makes negative observations or expresses an expectation, it rarely matters whether these are meant as passing observation, possible concerns with little evidence or tightly focused reflections of a specific but different corner of the financial services world. Firms will often take a risk averse approach. This can from time to time result in unnecessary cost being incurred, and on occasion have a directly negative effect for consumers, as firms undertake unnecessary compliance evaluations.
Recommendation: While regular and early communication of issues is vital, regulators should also take care to ensure that they are clear as to the issue, the evidence and the part of the market that the issue arises in.

3.51 Inherent caution is not solely the preserve of firms. The Senior Managers and Certification Regime is a measured and important part of the regulatory approach which we would support. Although the CBA accompanying the extension of the regime was exhaustive, one consequence can be that individuals in such functions can tend to the cautious given the potential personal exposure. As such, matters such as internal reporting, risk and root cause analysis can become considerable.

3.52 The greater emphasis on compliance coupled with the desire for ever higher standards, skills and experience also presents a less obvious cost dynamic on an HR side. Although bringing in the right level of skill, experience, ability and fresh perspectives has obvious benefits for contributing to strengthening compliance, the downside is that greater demand drives up cost in terms of recruitment and retention that perhaps has not received the consideration that it should.

External drivers for compliance amplify costs

3.53 There are several other considerations that were also highlighted as driving firms to have compliance standards above the regulatory minimum. Institutional investment also contributes to driving firms to adopt a robust approach to compliance. It was noted that investors were not inclined to accept unnecessary risk in investment or reputation. A more robust approach to compliance is therefore a necessity.

3.54 Although this particular driver tends to only directly affect debt purchase firms, the indirect effect spreads further. Purchase firms do not always collect debts themselves and may outsource to other collection firms. As a result, that stronger drive toward compliance and protecting reputation tends to inform the expectations that purchasers have of those they appoint.

3.55 Client expectation too, although perhaps fractionally less forceful than that of investors, is nevertheless a potent driver for better performance in a compliance sense and for many of the same reasons. A collector that cannot meet client expectations or requirements or that puts a reputation at risk is unlikely to secure or retain work. The challenge, however, is that client expectations or requirements can often be in excess of those of the regulator.

3.56 Multiple clients will likely mean multiple audits, multiple standards, a wide range of reporting requirements and, potentially detailed and prescriptive requirements on handling issues such as forbearance, engagement, communication and so on. Meeting these requirements can be a major cost factor for firms and meeting them individually is impractical from a systems and controls perspective. As a result, the indications are that there is a de facto 'race to the top' in practice. Firms indicated that there is a tendency to default to the most extensive client requirements.

3.57 Recommendation: While primary creditors face regulators directly, the 'secondary market' is in some respects regulated twice – first, facing regulators themselves, and then again indirectly through the compliance expectations on creditor clients. Such additional checks and balances are inherent in the secondary debt market and regulators should take into account the additional safeguards this creates.

Scale of the cost of compliance

3.58 As already indicated, compliance tends to be much wider than simply complying with the requirements of the regulator, but seems to be driven by a wider range of factors and carrying a much wider cost base. However, on the present data it is not possible to reduce compliance costs to 'pounds and pence'. Firms all have a discrete compliance function and, depending on the size of the firm, this may be a single individual that wears multiple hats or it may be a small team of people. But members were keen to emphasise that actually compliance activities were spread far more widely.

3.59 The following list is not exhaustive, but examples of sources of compliance activity outside a compliance function included:

- IT expertise
- Internal lawyers
- External lawyers and/or external compliance support
- Specialist auditors
- Training resources
- Human resources
- Data analysis
- Data protection
- Monitoring and reporting functions
- Quality assurance
- External standards and codes
- Specialist customer handlers (ie vulnerability or mental health)
- Senior managers

3.60 Interestingly, the expectation might be that as some of these functions overlap or duplicate each other there might be cost reduction. However, it was suggested that to some degree the separation of activities or the use of external resources to perform partly the same task was actually a reflection of desire to have mechanisms for evaluating and validating other parts of the process by providing a different perspective on performance measures.

3.61 To try to develop a mechanism for quantifying what this meant for firm cost, respondents were asked to give a rough indication of the proportion of staff that were actually engaged in compliance activities throughout the business. This is a crude measure as 'staff' numbers and firm models were highly variable. A smaller firm with fewer staff might have individuals wearing multiple hats. Larger firms or differently structured firms might make greater use of external resources, for example, increasing the proportion of individuals involved in compliance relative to overall staff numbers.

3.62 While the evidence is not sufficiently extensive to necessarily be representative of the membership as a whole, and the respondents on this particular point were primarily FCA regulated firms, there were nevertheless some interesting trends:

- Compliance 'teams' tended to be relatively compact and influenced both by the size of the business and the business model used. In smaller firms, compliance might be the responsibility of a single senior individual with multiple functions. In larger firms, compliance and regulation functions tended to have several dedicated staff.
- Where we have data, there appeared to be at least twice as many individuals involved in compliance related activity supporting compliance teams as there were dedicated compliance resources.
- Again where we have data and significant outliers are excluded[25], the proportion of all resource involved seemed to trend generally to between 15% and 25% of all staff in some cases and 15% to 25% of non-consumer facing staff in others. This will require further investigation to explore in greater depth.

3.63 The staff population across the membership as a whole fluctuates from quarter to quarter. However, if we assume a current staff population of 10,000[26], and we assume that proportions of staff dedicated to compliance and broader compliance follows this trend

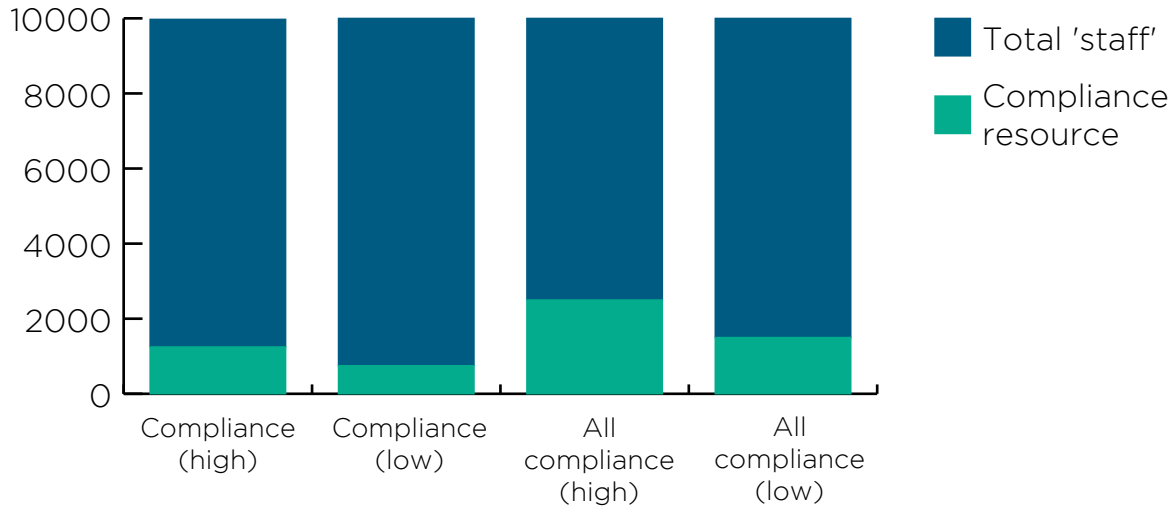


Fig 8: Projected estimates (high and low) of specifically compliance staff as a proportion of total staff and then a similar comparison for wider staff engaged in compliance activities as a proportion of total staff.

[25] We did not encounter examples where resource for compliance was significantly below the range, but there were some instances where the proportion of compliance resource relative to the overall proportion of staff were much higher than the range, presumably reflecting the particular business model.
[26] Our most recent information suggests the figure is very slightly below this.

3.64 There is no guide as to what level of 'compliance' resource as a whole should be used, nor what is reasonable or what is excessive. Firms are clearly calibrating resource to respond to perceived needs and risks. What is clear, is that the cost of compliance is a significant one across the industry. It may be worth exploring these costs with members in greater detail, with a particular emphasis in expanding understanding in relation to non-FCA regulated firms to provide a measure of contrast.

3.65 The website Glassdoor suggests that the national average for a generic compliance officer role is circa £31,311. If we take the lowest estimate for only specific compliance functions (7.5% of total employees), that would translate to an annual industry cost for compliance staff of some £23 million. Put another way, the conservative estimate of compliance staff cost alone would be roughly at least five times the fees and levies paid by 50% of CSA members toward the cost of the FCA and so on. Salaries are, of course, variable so the actual total will be considerably higher for different or specialist or more senior compliance functions. Similarly, the cost of contributions to debt advice alone is also at least five times the cost of the regulatory system to industry. In other words, debt advice and compliance staff alone constitute at least ten times the cost of the regulatory structure. Significantly, this is before costs that sit on the periphery of the compliance landscape (IT, HR, Legal, external support etc) are factored into the equation.

3.66 This suggests two things. First, that the CSA should work closely with a broader cross-section of members to understand compliance and other costs in far more detail across industry, not only in an FCA-centric way. Doing so should help to develop a granular understanding of costs and what drives them. Second, that policymakers and regulators should, when developing proposals keep firmly in mind that it is not only the costs relating to the specific proposal that should be considered but that there should always be a realistic appraisal of the wider cost implications.

4. CONTEXT AND CHANGE ACROSS THE SECTOR

Insufficient time to design and implement compliance effectively

4.1 While not directly related to the question of cost, one feature of discussions was a concern that the pace of change, both at a regulatory level and at a higher Governmental policy level, was such that it did not allow for proper planning and execution. On the one hand, the pace of change meant that firms were under constant pressure (from cumulative consultations, information requests, Dear CEO letters and so on) to make changes or to consider issues without necessarily having sufficient time to view them in an holistic sense or for them to bed in.

4.2 On the other hand, there was a sense that regulators and policymakers were also not leaving themselves enough time to properly consider emerging or perceived issues, and that as a result some proposals were poorly designed or considered and presented additional unnecessary challenges. The design and implementation of the Breathing Space moratorium, for example, left much to be desired and it was unclear whether proper thought had been given to its wider implications.

Technology is not a simple antidote to compliance costs

4.3 It is often argued that technology can help reduce regulatory and compliance burden through, for example, deploying AI and machine learning where feasible to undertake tasks. While there is a sense that new technologies may lead to some efficiencies, there is caution that at least in the collections and purchase spaces, such efficiencies may be less than anticipated.

4.4 A broadly consistent perspective was that the net benefits of new technologies and techniques can take some time to become apparent. Speech analytics can be helpful, but it still requires oversight, monitoring and crucially data analysis. The output of such analysis can be useful in identifying verbal cues or wider trends, but there is still a need for a person or persons to determine what verbal cue to look for in the first place and make sure systems change over time to keep pace with customers

4.5 Similar reservations apply to concepts such as machine learning and AI in as much as there will still be a need to 'teach the system' in the first place, making sure that the system is performing as expected and identifying when change is needed. Technology is certainly capable of contributing to greater efficiencies and smoother customer journeys, but those benefits would to a degree be offset by a continuing need for human involvement. As technology solutions become more complex, so must the compliance framework that surrounds them.

Preventative measures

4.6 Prevention was also a consistent theme. A consumer's position can begin to improve once they begin to get help, whether as formal debt advice or simple interaction with a creditor or collector. However, the timing of engagement was felt to be far more critical than perhaps policymakers recognised.

4.7 As a basic principle, the earlier engagement takes place, the less the opportunity for financial difficulty to deteriorate and spiral out of control. Early engagement can help forbearance measures be put in place sooner so that a single missed payment on a single account does not become six months of arrears on multiple accounts. It would also mean that even where the financial difficulty was profound, the potential difficulty could be arrested while a longer term solution was found. While the legislative framework recognised this by getting information to the debtor early, recent initiatives seemingly did not recognise this point.

4.8 There was a persistent theme in responses from member firms that Government would be better served focusing on articulating the genuine benefits of early engagement to restoring financial well-being with firms than offering debt relief at the expense of those owed the debt. Formal debt advice as the sole answer to problem debt is a policy that risks losing sight of the large pool of consumers that, when they did finally engage with creditors and collectors, appear to have found that a solution could be reached without the need to seek advice. Driving higher levels of self help and earlier engagement should benefit customers, firms and help free advice providers to deal with the more challenging circumstances, arguably far more so than subsidising a sector that requires considerable improvement.
Recommendation: The CSA should consider further work to better understand the scale and benefit of encouraging early engagement by exploring member experience.

5. POTENTIAL CONSEQUENCES OF EXCESSIVE COST BURDEN

5.1 Thus far we have attempted to understand and to a limited degree quantify the costs of compliance to firms in the wider sense. While some of the regulatory costs do appear to have grown somewhat disproportionately, and there are things that the regulatory system could do significantly better, it must be recognised that compliance and regulation are necessary. But they must also be justifiable, proportionate and comprehensible. Critically, both policymakers and the regulatory structure should have regard to the unintended consequences of the unmanaged escalation of costs.

5.2 During our review, many of our member firms expressed a number of views as to potential consequences and costs of the current pace of regulatory change. We feel it is important for the regulatory and policy-making community to understand that there are a number of significant anxieties that arise, should regulation result in disproportionate cost in the future. We should stress that the following consequences are all *possibilities*, rather than definitive predictions of what could occur if the cost of compliance grows excessively:

Absorbing compliance costs squeezes other operations

5.3 Popular myth tends to focus on the face value of the market and presume that financial services firms are all profit and risk free, which is clearly not the case. This in turn leads to a mistaken belief in some quarters that rising compliance costs can be simply absorbed by shareholders, or reduced profitability.

5.4 The reality is that DCAs and DP firms have limited options when it comes to absorbing increased costs. Unlike banks, which have the option to price for risk with greater flexibility, collectors and purchasers are subject to greater market forces when it comes to pricing. A creditor that does not like the price of a collector can simply move their business to a cheaper competitor. A purchaser can only purchase at a price that a creditor is prepared to sell for. What might ultimately be recovered is an unknown for both but it is difficult for costs to be passed up the chain.

5.5 At the same time, the regulator requires firms to ensure adequate financial resources and resilience. Many firms experienced a period of inactivity and/or reduced income as forbearance was increased during the COVID pandemic thus there is a period of significantly reduced income that is slowly working its way through parts of the system. Given the importance of ensuring adequate financial resources and resilience from a regulatory standpoint, such voids in income coupled with increases in regulatory and compliance cost, present potential challenges.

5.6 As there is limited scope to move cost in the way that many other financial services firms do, increased cost results appear to be squeezing other operational budgets and constraining other important activities.

5.7 Much of the forbearance granted by firms in the secondary market is considerably more generous than a regulator might reasonably expect. Yet there is a discernible risk that a requirement to absorb significant compliance costs may drive firms to lessen that level of forbearance available to customers. While such an impact would still be above minimum expectations and maintaining acceptable practice in a regulatory sense, the customer would be the one that loses out. Approaches to collection including speed and nature of action to recover may also change. There may also be less scope to write off or part settle than is currently the case, should firms be forced to absorb excessive costs of compliance. It is therefore vital for regulators to understand that compliance cost escalation can have unwelcome indirect consequences for customers.

5.8 Additionally, it seems likely that wider initiatives such as the Breathing Space Moratorium and the planned Statutory Debt Repayment Plan, both of which would grant debt relief for customers, risk imposing further and arbitrary[27] costs on business. In light of the apparent lack of proportionality in the design of those schemes and proposals, the likelihood of unforeseen consequences occurring would seem greater.

5.9 A squeeze on operating costs can put pressure on a whole array of other important functions and services. It should also be remembered that compliance departments themselves are not immune to budgetary pressures. Firms that champion strong regulatory outcomes may still feel the need to manage compliance costs internally, especially if new requirements increase obligations but it is possible for these to be undertaken by the same number of staff – or delegated within an organisation. We have no evidence to suggest that compliance resources are losing priority compared with other functional budgets – but it is nevertheless a risk whose consequences should be considered.

[27] Arbitrary in the sense that the Government has yet to provide a credible explanation of how it has balanced the competing rights and interests of both parties to a transaction as HM Treasury publicly stated would be the case in late 2015 (Paragraph 2.10, Government Response to the Independent Review of the Money Advice Service [March 2015].

Innovation Investment constraints

5.10 More constrained financial positions are also likely to interfere or restrict investment in innovation. Businesses that are, in effect, regulated by the regulator and by clients as already described, are driven to seek greater efficiencies and more effective ways of operating. With budgets fixed and little room to generate new resources, there is a risk that long term upgrades of processes or technology are deferred in order to cover short term compliance costs. Indirectly, customer services may not be improved at the pace that would otherwise be expected.

5.11 This being said, firms are very much committed to achieving better outcomes for debtors because, as experience clearly shows, doing so increases the likelihood of at least some repayment where this is possible whereas aggressive collections activity has the opposite effect, a fact often forgotten in public and regulatory attitudes to collections. Investment in new processes and engagement must be encouraged by regulators, not deterred.

Discretionary Debt Advice resources under pressure

5.12 There are three particular concerns in relation to free to client debt advice.

- There appears to be little effective oversight of debt advice provision, meaning that longstanding questions in relation to quality, consistency and efficiency remain unanswered. This may in part be a consequence of the lighter touch approach to regulation of such bodies, compared to commercial competitors.
- The level of funding, both compulsory and voluntary, drawn from the financial services sector is extremely large, particularly so when considered against output. While demands for funding have risen year on year, actual advice delivered appears to have increased at a far slower pace. Preliminary figures for 2020 would seem to indicate a reduction in debt advice provision despite two increases in levy.
- The calculation method for the compulsory component is inherently unfair, particularly to those subject to the CC03 fee bracket.

5.13 The funding of debt advice is a mix of the compulsory levy driven costs and the voluntary costs. In 2018, the total funding for debt advice sat at approximately £172million[28], relatively evenly split between levy, voluntary and 'other' sources of funding. Compulsory funding is in 2021 currently about £100 million though elective costs have fallen slightly as a result of the pandemic affecting repayments using the Fairshare scheme.

5.14 The manner in which demands are determined and then applied can be somewhat contentious. Of the £14.2 million supplementary increase in 2020/2021, we understand that £7.5 million was allocated to three organisations to insure against loss of earnings. As they get paid as a result of consumers making repayments to creditors under Fairshare, consumers ceasing payments as a consequence of the COVID pandemic meant a reduction in income. The MaPS solution was to force creditors to, in effect, pay for the privilege of not receiving payments themselves and at a time when their own income was pressured.

5.15 As statutory compliance and regulatory costs rise, elective costs such as voluntary contributions to free-to-client debt advice may be put at risk. Firms will find it increasingly difficult to justify, or in some cases afford, the cost of underwriting free-to-client advice, especially without stronger external assurance on the value or quality of those services.

5.16 Recommendation: The CSA should undertake further work with members to explore customer journeys and outcomes to benchmark value in debt advice. Early indications suggest, and this would benefit from greater study, that many customers find that early engagement with creditors and collectors is the most effective route to debt resolution.

5.17 Recommendation: The CSA should engage with external bodies to press for greater accountability in the levels and nature of debt advice support, and that the cost of subsidising free-to-client debt advice is shared more fairly across a much wider cross section of creditor types.

[28] 'The money merry-go-round' and accompanying infographic: CSA [27 March 2019].

Reduced competition

5.18 The debt collection industry is a diverse one with a wide range of different sized firms that have specialisms in many different sectors of the economy and which contribute to vibrant competition. Competition benefits creditors, which in turn ultimately benefits debtors. One obvious, but frequently overlooked, consequence of an excessive compliance cost burden may be a reduction in competition. Smaller firms specialising in particular products or services will be slowly forced from the market or absorbed into larger competitors. The Financial Conduct Authority is obliged by law to ensure relevant markets function well and have an operational objective to promote effective competition in the interests of consumers. Compliance measures which put pressure on the ability to sustain effective operations and thereby narrow the number of participants in the secondary market risk having a detrimental impact.

5.19 **Recommendation: We recommend that the Government and FCA institute a more transparent approach to testing the proportionality of regulatory interventions, so that the indirect consequences of compliance costs on the financial services sector can be assessed more effectively before policies are executed. The CSA will continue to explore what options for such a proportionality metric may be appropriate for regulators to deploy.**

Less generous collections

5.20 As we have alluded to throughout, the collections and purchase processes are often more generous than they are required to be and have less scope to absorb or offset excessive cost. The reality is that forbearance and time to seek advice is relatively easy to obtain for longer periods than those required by the regulatory system or the incoming Breathing Space scheme. Similarly, a debtor is unlikely to face any additional cost or interest on a debt acquired by a purchaser even if the purchaser has the contractual right to apply them.

5.21 If, however, accelerating compliance costs continue to push financial positions, there is a question as to whether firms will have scope to adopt as generous approaches as at present. Firms may feel operational cost pressures to pursue their legitimate interests and rights but at a faster pace. Those externally responsible for driving compliance costs should therefore carefully consider the extent to which generous concessions may be adversely impacted.

ESG, financial capability and financial literacy

5.22 It is not only activities linked to the collection of debts or the management of accounts that collection and purchase firms are engaged in. Environmental and Social Responsibility has grown in importance and our members are no different in having a keen focus on ESG related issues. Similarly, members are increasingly active in attempting to aid in improving financial capability and financial literacy with an increasing availability of tools, guides, resources, partnering with external providers and self help and so on.

5.23 These are not mandated by the regulatory system but are a reflection of firm values and a keen understanding of what their own compliance functions are telling them about the people and the challenges that they face in the real world. Member firms recognise the inherent value in applying resource to such tools and activities in the unique position that they are in, to actually reach people in difficulty and either support, or help them find support from specialist providers. Collectively, CSA members have far more contact with consumers in financial difficulty than the entire debt advice sector – and that contact is an opportunity to both resolve consumer difficulties and improve ESG standards more broadly. It would be a great pity if escalating costs puts these programmes, projects and opportunities at risk. Chances to add value to both consumers and wider society may not be statutory obligations in the same was as is the case for regulatory compliance, but these new initiatives, particularly the journey to net zero and inclusivity at the workforce, should not be adversely affected if compliance cost pressures grow disproportionately.

Conclusion

5.24 Reasonable regulatory costs and compliance costs are widely recognised as being simply the cost of doing business, and we would not attempt to argue that this should be otherwise.

5.25 However, unreasonable and/or disproportionate costs of any description can have profound negative effects whether in terms of competition or in generosity of concession. It risks stifling innovation yet fosters and rewards inefficiency in those external elements that those costs cover. It would be deeply unfortunate if the regulatory community viewed firms less as stakeholders, whose interests should be fairly regarded, and more as simply a source of funding. Regulation that drives out firms that behave properly because it costs too much is of questionable value to society and excess cost can erode customer benefit.

5.26 Our preliminary review necessarily focused on compliance in an FCA regulated world, largely because data is considerably more accessible. However, it is important not to lose sight of the wider dimension. Initial proposals to strengthen oversight in the collection of parking charges which were wholly disproportionate, would have had a profound effect not only on the cost in collection, but almost certainly in the cost of the parking charges themselves. The recent proposals to increase court based costs could also have a significant effect on wider cost dynamics.

5.27 Regulation is, in principle, a good thing and it is perfectly reasonable to expect those that are regulated to contribute to those costs. Regulation that is unnecessarily costly or disproportionate and inequitably applied simply harms firms, customer interests and the wider economy. Ultimately, it is the consumer and the economy that pays the price of mistakes.

5.28 As such, we intend at a later date to undertake a more extensive investigation into cost dynamics which will not only consider in greater depth many of the issues that we have noted in this review, but also seek to better understand the dynamics of the wider sector which in turn should contribute to more effective lobbying on behalf of members.

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ABOUT THE CSA

The Credit Services Association (CSA) is the only National Trade Association in the UK for organisations active in the debt collection and debt purchase industry. The Association, which has a history dating back to 1906, has over 300 member companies which represent 90% of the industry, and employ approximately 11,000 people. At any one time its members hold up to £67 billion for collection, returning nearly £4 billion in collections to the UK economy per annum. As the voice of the collections industry, our vision is to build confidence in debt collection by making the entire process clear, easy to understand and less stressful for all those involved.

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Good regulation ensures that a balance is struck between the interests of the consumer, a well-functioning market and the interests of market participants. This report aims to quantify the impact of regulation and compliance on our sector, helping policy-makers achieve proportionality in their approach.

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