Changes to consumer credit regulation: are you ready for 1 April?

During the comprehensive re-examination of financial services regulation that followed the financial crisis, the Government concluded that consumer credit should be moved into the same regulatory ambit as other retail financial services to improve consumer protection and enhance competition within the consumer credit market.

These reforms will have a significant impact, including on groups outside the financial services sector. When the new regime comes into force on 1 April 2014, activities regulated under the Consumer Credit Act 1974 (“CCA”), will become regulated activities under the Financial Services and Markets Act 2000 (“FSMA”) and the Office of Fair Trading (“OFT”) will relinquish supervisory responsibility for consumer credit to the Financial Conduct Authority (“FCA”).

As a result, the large number of retail and industrial groups who have some form of consumer credit licence (e.g. for secondary credit broking where customers are introduced to a lender in connection with sales of goods) will find themselves subject to the supervision of the FCA and the FSMA regime for the first time.

This briefing outlines some of the key elements of this important regime change for companies which are not otherwise FSMA authorised.

TRANSITION TO FCA AUTHORISATION

Existing consumer credit licences will not be grandfathered. Instead, to facilitate the transition, current holders of an OFT-issued consumer credit licence can register for “interim permission” rather than apply for full authorisation from the outset. As long as the existing CCA licence holder has so registered by 31 March 2014, it will be able to continue to carry on all of the regulated activities covered by its CCA licence after 1 April 2014. The online registration process is simple and quick.

Such entities will nevertheless have to apply for authorisation under FSMA in due course, on a timetable to be set by the FCA (with a longstop date of 1 April 2016). The FCA has said that it expects to announce in early 2014, the dates (starting in Autumn 2014) by when specific types of entities with interim permission must apply for full authorisation. The FCA may designate different dates depending on the type of activities and the scale of consumer credit business an entity undertakes.

Companies carrying on regulated consumer credit activities under an interim permission will be subject to fewer reporting obligations and exempt from requirements on certain new aspects of the FCA regime pending full authorisation.

There will also be a six month “safe harbour” period commencing on 1 April 2014, during which the FCA will not take enforcement action against entities who continue to comply with the CCA requirements and OFT guidance that is substantially similar in purpose and effect to the new FCA conduct of business rules for the consumer credit sector.

However, in addition to some specific conduct of business requirements, certain high level standards (such as the Principles for Businesses and high level organisational requirements, discussed further below) will come into force on 1 April 2014. All entities operating in the consumer credit sector, including those relying on interim permission, will be subject to these requirements (without any relaxation or transitional arrangements) from 1 April 2014.
The application for full FCA authorisation will in general be more complex than application for a licence under the CCA regime. Entities applying for full authorisation will be required to satisfy certain minimum organisational requirements (known as “threshold conditions”) including those relating to their financial resources, internal governance and systems and controls arrangements, the suitability of staff and the durability of business models.

**APPROACH TO SUPERVISION**

**Higher-risk and lower-risk activities**

An important difference between the FSMA regime and the CCA regime is the distinction between higher-risk and lower-risk consumer credit activities. Consumer credit entities will be regulated and supervised differently depending on which category they fall into.

Certain activities are considered not to pose any great risk to consumers, although the policy continues to be that they should be subject to a degree of regulation. These are categorised as lower-risk activities.

Lower-risk activities include:

- the grant of credit by non-financial services businesses where no interest or charges are payable (e.g. a sports club which allows membership fees to be paid by instalments);
- consumer hire activities (e.g. of tools or vehicles); and
- credit broking by non-financial services businesses (e.g. the introduction of customers to lenders by a car dealership).

Lower-risk activities will require interim permissions and, in due course, entities performing them will have to apply for authorisation as outlined above. A key difference is that entities carrying on only these lower-risk activities will be able to apply for a limited permission, instead of full authorisation. In addition, these entities will be required to supply less information to the FCA than entities requiring full authorisation, and will also be subject to reduced approved persons requirements.

Higher-risk activities include activities such as consumer lending (e.g. providing personal loans, credit card lending, overdrafts and hire purchase finance) or credit broking (e.g. introducing consumers to lenders as a main business activity).

Those deemed to be carrying on higher-risk activities will be subject to the “core” authorisation regime. Among other things, they will be required to satisfy all the threshold conditions for authorisation and will be subject to greater continuing reporting obligations.

**Scope of permissions**

As licences under the CCA regime were relatively easily obtainable, some companies may have obtained a CCA licence for a particular category or a CCA licence covering a range (or the full range) of available categories on a precautionary basis (for example, certain securitisation vehicles currently hold a CCA licence and certain CCA licence holders’ CCA licence covers all categories of regulated consumer credit activities available regardless of whether they carry on business in all those categories).

Under the FSMA regime, entities will need to consider more carefully the extent to which it is necessary to retain permission to conduct some or all of the consumer credit activities for which they may currently be licensed. It is likely that the FCA will refuse to grant permissions which do not appear to be required for the fulfilment of a business plan. Further, holding certain permissions, or holding a wide range of permissions, may result in (i) more onerous requirements (for example, debt management entities will be subject to minimum capital requirements), and (ii) the entity being given a higher risk rating under the FCA’s supervisory regime and consequently being subject to more intensive regulatory supervision.
SOME FURTHER NOTABLE ASPECTS OF THE NEW REGIME

Principles for Business
The details of the FSMA regime will be set out in the FCA Handbook. Many of the conduct of business requirements will (at least initially) replicate the requirements and guidance under the CCA regime. It has not, however, been a simple copy out exercise and there may be material differences resulting from “translation” of the CCA requirements and OFT guidance into FCA rules and guidance, for example, a change in emphasis as certain provisions move from being guidance to rules.

In addition to the FCA rules and guidance, all FCA regulated entities must also comply with certain high-level requirements, including the so-called “Principles for Business” (the “Principles”).

The Principles are a general statement of the fundamental obligations that entities must comply with under the regulatory system. They are regarded by the FCA as the basis for most of the other more detailed rules and guidance.

In summary, there are 11 Principles which prescribe standards relating to (among other things) the fitness and propriety of the regulated entity, its market conduct, the adequacy of its resources and its governance, the fair treatment of customers and openness with the regulator. They provide the framework for principles-based and outcomes-focused regulation which will impact the relationship between regulated entities and the regulator, and a basis for more regulatory intervention in the consumer credit sector compared to the CCA regime.

According to the FCA, the Principles likely to be of most significance for companies unfamiliar with the FSMA regime include the requirements:

- to have regard to the interests of customers (Principle 6);
- for communications with clients (Principle 7); and
- to deal openly and co-operatively with the regulator (Principle 11).

As noted above, the Principles (together with other high level standards) will apply to all regulated entities, including those operating with interim permissions, from 1 April 2014.

The approved persons regime
The FCA’s approved persons regime is a system for vetting and holding to account individuals who perform what are known as “significant influence functions” (essentially senior managers) or who deal with the entity’s customers (the “customer function”). Together, these functions are known as “controlled functions”.

Individuals appointed to a position in an FCA-authorised entity involving one or more controlled functions must be pre-approved by the FCA. When deciding whether to approve an individual for a controlled function position, the FCA must assess that individual’s:

- honesty, integrity and reputation;
- competence and capability; and
- financial soundness.

Once approved, that individual acquires personal regulatory duties and responsibilities and can be subject to FCA enforcement action for personal failings.

FCA-authorised consumer credit entities will be subject to some but not all aspects of the approved persons regime.

With some limited exceptions, the only individuals requiring approval for lower-risk entities are those who perform “apportionment and oversight functions”.

• for ‘adequate risk management systems’ (Principle 3);
• to maintain ‘adequate financial resources’ (Principle 4);
This includes individuals who have responsibility for ensuring that management responsibilities are appropriately allocated and that systems and controls are in place.

Higher-risk entities (and, in relation to compliance oversight and clients’ money and assets functions, some limited permission entities) will require approval for individuals who perform a broader variety of significant influence functions:

- Governing functions: those who direct the entity’s affairs, such as the CEO and the non-executive directors.

- Significant management functions: in a large or complex entity, individuals comprised in a layer of management with significant devolved responsibilities.

- Compliance oversight functions: individuals responsible for an entity’s regulatory compliance. This will apply to debt management and credit repair business only.

- Money laundering reporting officer: this will apply to any entity covered by the Money Laundering Regulations (except lower-risk lenders).

- Systems and controls functions: those who monitor and report to the governing body on an entity’s compliance with internal systems and controls and its risk exposure. This requirement will apply to all higher-risk entities where individuals perform these functions. The function may be combined with a governing function (other than the function of non-executive director).

- Protecting clients’ money and assets: those with responsibility for an entity’s client money and assets oversight. This requirement will apply to: “large” debt management entities; “large” not-for profit debt advice entities; profit-seeking debt management and debt advice entities. “Large” means holding £1m or more of client money at some point during a calendar year. This controlled function will need to be allocated to a director (or, in some cases, a senior manager) of the entity.

The FCA’s current proposal is not to apply customer functions to the consumer credit activities of any entity.

The introduction of the approved persons regime is an important departure from the CCA regime which included no equivalent requirements.

Impact on M&A processes
Another key change relates to the consequences of a change of control of an authorised entity.

Under the CCA regime, it is necessary to notify the OFT of a change in control of a licensed company after the event. After 1st April (although only from the time that the entity obtains its full authorisation under the FSMA regime), the FSMA change in control regime will apply to authorised entities, with the result that it will be a criminal offence for any person to acquire or increase its control of an authorised entity without obtaining the prior approval of the FCA.

The need to apply for and obtain approval is likely to have a material impact on the timetable and process for any acquisition or disposal where the target or any of its subsidiaries carries on any form of consumer credit business and may therefore be a significant consideration in relation to certain transactions that might not previously have been affected.

NEXT STEPS
Any current CCA licence holder that wishes to continue its consumer credit activities past 1 April 2014 must:

- register for interim permission no later than 31 March 2014; and

- review its readiness to comply with the high level standards (including the Principles for Businesses and high level organisational requirements) from 1 April 2014.
Thereafter, the amount of internal planning required to prepare for the FSMA regime will depend on what sort of authorisation is being sought and the scope of the entity’s current activities (i.e. its familiarity with the FSMA framework, for example, through its involvement with other FSMA authorised entities within or outside its group).

Irrespective of the type of authorisation being sought, all entities holding consumer credit licences should take steps to prepare for the more extensive regulatory requirements of the FSMA regime. Directors and senior management, in particular, should ensure they understand their obligations, and the obligations of the entity’s, under FSMA.

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