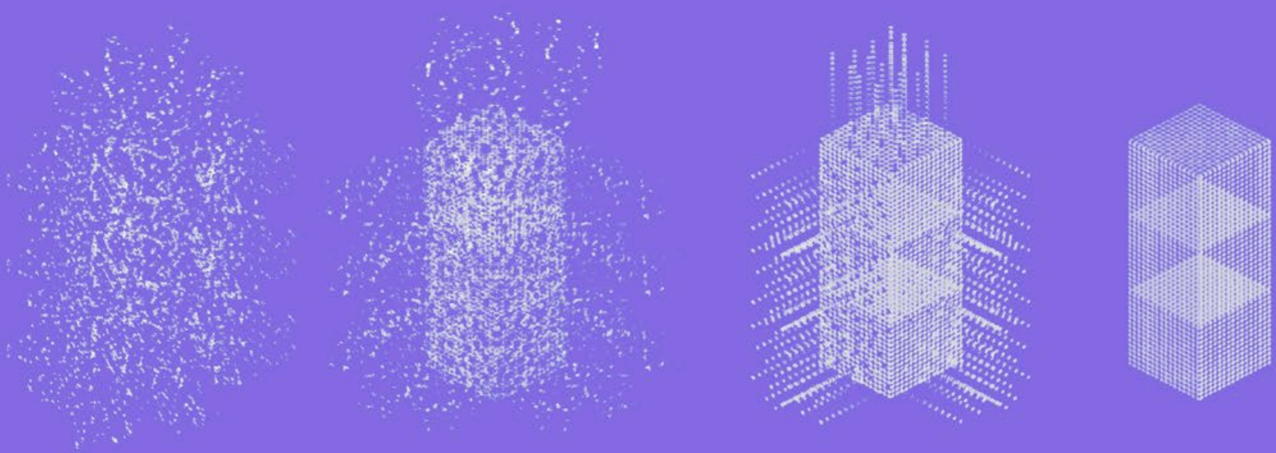
It's time to redesign our financial system

FUSE

Introduction: It's time to redesign our financial system

By Sho Sugihara, Co-Founder and CEO, Fuse



The cost of living crisis continues to impact the finances of households across the UK.

Rising interest rates are piling on the pressure as the Bank of England seeks to reduce inflation to its target of 2%, with its top economist, Huw Pill, saying people need to 'accept they are poorer'.

Against this bleak backdrop, it's little surprise that people are turning to lenders for support, with figures from the Office for National Statistics (ONS) showing that, as of May 2023, almost a quarter of adults were borrowing more money than a year ago.

As reliance on credit continues to build, so too do the number of those considered financially vulnerable. With this increase in the number of financially vulnerable borrowers comes corresponding pressure on lenders and financial institutions to protect consumers. To do this effectively, they need accurate and real-time insights into not just borrower affordability, but - more importantly - vulnerability.

However, the current financial system hasn't been built to accommodate or support vulnerable consumers effectively, and this needs to change fast if we are to create a fairer, more equitable system.

Paving the way for a more outcomes-based approach

Having previously worked in the healthcare sector before moving into fintech, certain elements of the UK financial system remind me of the US healthcare system a decade ago.

This started to change when insurance firms and regulators pressured healthcare providers to deliver more affordable and effective treatments to consumers.

What emerged was the idea of Value-Based Care; a delivery model where providers are rewarded based on patient health outcomes – so only when the patient's health improves. This is a model that finance can learn a lot from.

To help reverse the long-term impact of the cost of living crisis for consumers, it's crucial financial institutions start thinking in a more outcomes-based way. A focus on prevention rather than cure when it comes to consumer financial struggles would allow banks and other lenders to offer more proactive support solutions, and remove barriers for those seeking financial aid. In short, there is a need for Value-Based Finance.

So why isn't this idea of Value-Based Finance more widely adopted already? Banks are generally in better health compared to earlier in the millennium, and alternative approaches like Open Banking are being adopted to support lenders to be more inclusive.

But to really enable systemic change, stronger incentives are still required. This will take regulatory pressure – just like in healthcare – to ensure it happens at pace. This is the reason we believe the Consumer Duty, which takes effect from 31 July 2023, will be a powerful catalyst for change. A first step on the road to a more outcomes-focused financial model.

At Fuse, we are committed to supporting this much-needed transformation across financial services through improving consumer financial health and education. To gain further insight into the current financial landscape, we commissioned Opinium Research to survey 100 UK lenders and 2,000 UK adults exploring the current state of play for consumers, how lenders are responding, and - more broadly - perspectives on the future of consumer borrowing.

By partnering with lenders and industry stakeholders to push for meaningful, long-term regulatory and behavioural change across the financial system, we believe we can help to secure a brighter future for consumer finance.

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The state of play for Britain's struggling consumers

The cost of living crisis has had a profound impact, tipping many people over the edge when it comes to their finances.

Rising prices and spiralling inflation have combined to significantly increase the number of financially vulnerable people in the UK.

More than a third (35%) of UK adults are now scared for their financial future, and nearly half (49%) are more concerned about their financial position now than at any point in the previous three years.

The continuation of a damaging trend

While the cost of living crisis has certainly piled additional pressure on households, it should be noted that this isn't really a new phenomenon. It goes back further than the past few years, and can be traced all the way back to the 1979 oil crisis.

Since then, growth in wealth (GDP) has outpaced the growth in distribution of this wealth (median real income), and consumer finances have stagnated. Real income remains below 2008 levels, with real wages falling again by 2% in May's ONS census, continuing this trend and exposing the need for systemic change.

More than a third of lenders (35%) say they have seen an uptick in the proportion of financially vulnerable consumers over the past year. And as they struggle to cope, one in three (31%) people believe that their bank or lender could be doing much more to support them in making more informed decisions - this could include promoting financial education tools to ensure they're aware of all the appropriate products available to them and proactively offering support on existing products.

49%

of people are now more concerned about their financial position now than at any point in the previous three years

58%

of UK adults – over 30 million people – used a credit product in the last year

Lavinia, 26, from Wales, joined Pave* in June 2022. Her credit score has increased by 106 points since becoming a member.

"When I came to the UK from Romania six years ago, I didn't know what a credit score was or why it was important. I moved into rented accommodation, and a miscommunication with the landlord meant that I accumulated debt due to missing bill payments, and this severely impacted my credit score.

"I have no savings and have been rejected for credit so often in the past that I stopped believing I would ever be accepted. Pave has provided a lifeline for me and my family, giving me the information and support I need to start improving my credit score. My credit score has gone up by more than 100 points already, and I am now able to access forms of credit that weren't available to me before.

"For people like me who have a low credit score but want to avoid paying off debt by getting into more debt, Pave is invaluable. It has given me a chance to do the right thing, and opened doors for me that had previously been closed - I'm very thankful for that."

*Pave, the consumer-facing credit builder app with over 100,000 all-time subscribers, is the sister company that has powered Fuse's algorithms

A growing reliance on credit

This year's research has identified a rise in consumer borrowing that is indicative of the increasing cost of living, with nearly three-fifths (58%) of UK adults - over 30 million people - using a credit product in the last year. A fifth (21%) of consumers are now relying on credit and loans to pay for essential expenses, such as utility bills and food shopping, with 30% dipping into their savings to cover these everyday costs.

One in five (20%) - almost 11 million people - also say they will be forced to borrow to get by in the next six months. Almost a quarter (23%) of people used a high-cost lender, of which one in ten (11%) having to do so as they had no other viable choice.

David* joined Pave in August 2022. Their credit score has increased by 24 points since becoming a member.

"I have always had good financial habits, but the rising cost of living meant that I had to start relying on credit - mainly my overdraft - to get by. I had been putting in applications to see my credit options without knowing that this would impact my credit score - since then credit has become much harder for me to obtain, and I am reliant on savings to pay for essentials like my rent and groceries.

"While I've not missed a repayment, being so reliant on credit and savings just to get by has increased my feelings of anxiety about my finances. Joining Pave has made me feel supported and reassured - the tips and detailed updates help me to feel less worried and more in control of my finances, and the boost in my credit score means I am now able to access credit from most lenders. A little support can go a long way."

*Not their real name.

The situation is particularly tough for younger people, many of whom are just setting out on their financial path. Half (49%) of 18-34 year-olds are already relying on savings to pay everyday expenses, with 43% saying they use credit and loans to pay for essential items - often as they have accumulated fewer savings or this pot has been used up by other expenses such as high rental costs.

20%

say they will be forced to borrow to get by in the next six months – this equates to 11 million people

Worryingly, **37% of 18-34 year-olds believe that their bank has taken advantage of their vulnerable situation and increased charges**, compared with the average of 18%, whilst 60% no longer know what their finances will look like in six months and two-fifths (42%) expect to borrow.

The majority of borrowers aged 18-34 also want improved support tools to help them to make better financial decisions. **More than half (55%) say they need better guidance and support from financial services companies about the credit options available to them whilst 54% want improved financial education to empower them in their financial decision-making.**

A similar number (55%) say their bank or lender could be doing more to support them to make smarter financial decisions. The findings highlight a generation that feels unsupported by the very financial institutions that should be supporting them.

With more and more people turning to credit, it's crucial that lenders make sure that they are extending services responsibly and doing what they can to protect vulnerable consumers.

This is where the Consumer Duty can help to drive real change. The new regulation sets higher and clearer standards of consumer protection across financial services, and requires banks and lenders to put their customers' needs first.

It means that providers will need to proactively monitor customer vulnerability, and ensure that consumers can achieve good financial outcomes.

But this is just the start. Amidst the current cost of living crisis, we are still talking much more about how to prevent lenders from failing than about how to make people more financially resilient. As we emerge from 2023, we must focus more on improving consumer finances, and investing in the necessary steps to make this happen.

55%

say they need better guidance and support from financial services companies about the credit options available to them

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How lenders are responding to the cost of living crisis

Understandably, given the volatile economic context, the UK's lenders have witnessed a significant increase in demand.

The research shows that **a third (32%) of lenders have seen an increase in consumers asking to borrow more that they can safely afford.** The same number (32%) have also seen consumers increasingly requesting to raise their credit limit on existing products in the last 12 months.

Further upticks noticed by UK lenders include consumers applying for products that aren't right for their financial situation (31%), consumers not passing credit checks (29%), and consumers applying for credit more regularly (23%).

Identifying a need for more responsible lending

Focusing specifically on the cost of living, around a third of lenders (32%) have seen an increase in customers defaulting on their payments in the last 12 months. During this period, **29% have seen an increase in borrowers asking for support,** and 28% have seen an increase in borrowers with multiple credit products. Both increases offer a stark indication that as consumer reliance on credit is growing, so must responsible lending practices - clearly, without this shift, borrower outcomes risk remaining below the required standard.

Meanwhile, 28% of consumers say they need better guidance and support from financial services companies about the credit options available to them, with the figure rising to 55% of 18-34 year-olds.

32%

of lenders have seen an increase in consumers asking to borrow more that they can safely afford

As the younger generation has less experience with managing finances and may be more reliant on credit, there is clearly a gap that lenders have to fill to ensure that all borrowers have access to the support and information they need.

On average, lenders have turned down 31% of prospective customers in the last 12 months due to failing affordability checks. Interestingly, this number is slightly higher for lenders who are yet to introduce Open Banking technology (33%) - those lenders not leveraging Open Banking technology risk turning down applicants who may fail traditional affordability checks but would be accepted by lenders using a more holistic and accurate approach such as Open Banking. Two-thirds (65%) of lenders say this rate is higher than the year before.

29%

of lenders have seen an increase in consumers failing credit checks

55%

are either not ready - or unsure if they will be ready in time - for the new Consumer Duty deadline

The need to step up to support customers isn't lost on lenders. Eight in ten (80%) believe they will need to provide more tailored support to borrowers struggling with the cost of living crisis.

And a need to prepare

However, many lenders simply aren't ready for the next stage in the evolution of the industry.

More than half (55%), for example, are either not ready - or unsure if they will be ready in time - for the new Consumer Duty deadline. This is perhaps understandable, given there is a large amount to do to cover the four outcome areas, involving products and services, price and value, consumer understanding, and consumer support. However, the FCA has recently warned financial institutions of their upcoming responsibilities - and the sanctions which they could face, if they don't meet the new requirements.

Small and medium sized businesses admit to being less prepared for the incoming rules, while larger companies appear to be generally better prepared. This is driven by a range of factors, including time, financial challenges, and expertise - issues which impact firms of all sizes, but often particularly hit SMEs hardest.

Three-fifths (60%) of lenders believe they are too busy to investigate the new Consumer Duty requirements in detail. Meanwhile, more than half of lenders (51%) do not have the expertise in-house to meet the incoming requirements. Once again, small and medium sized businesses are more likely to suffer from a lack of expertise in-house (58% and 67% respectively admitted this was an issue), compared to large businesses (35%).

More strikingly, **two-thirds of lenders (67%) claim there hasn't been enough support from the FCA regarding the implementation of their new rules.**

The research also suggests that lenders are concerned about the timing of the new Consumer Duty rules, with substantial resources required to meet the regulations at a time when lenders' margins may already be under pressure due to rising costs. According to two-thirds (67%), it has taken focus away from business development, and nearly three-quarters (72%) say the regulatory change has come amidst a financially challenging time for their business.

In order to become compliant, **61% of lenders say they will need to bring in a third party to provide support and guidance,** while 68% are looking to introduce new technology. Sourcing external expertise will be vital for those lenders with substantial work to do to meet the new regulations. There is really no time to waste if lenders are to ensure their business model is fit for purpose moving forward.

In order to become compliant

61%

of lenders say they will need to bring in a third party to provide support and guidance

"The Fuse service - enriched Open Banking data - provides Knoma with comprehensive and accurate affordability metrics, providing Knoma the confidence to decision loan applications. The high quality data provided by Fuse has allowed Knoma to increase auto-decisioning for student finance to >70%, allowing us to reach more people. Especially at times like these, when personal finances are so squeezed, it is critically important that we are lending safely and only to people who can safely afford to repay."

Brett Shanley, CEO and Founder, Knoma

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The journey to a fairer future for all

Despite the anticipated challenges of getting ready for it, almost three-quarters of Britain's lenders (72%) believe that the Consumer Duty regulation will transform consumer lending for the better.

And 77% say that the new rules are the first step in a long journey to improving borrower outcomes.

Enhancing the financial wellbeing of borrowers (30%) and allowing lenders to serve consumers who may previously have been excluded from credit (24%) were also cited by banks and other lenders as likely positive outcomes of the Consumer Duty.

A tech-led revolution

Two-fifths of lenders (40%) also believe that the introduction of the Consumer Duty will result in more financial institutions harnessing technology to help measure affordability more accurately, and 29% think technology will become more important to provide bespoke tools and products to borrowers.

30%

of lenders believe the Consumer Duty will enhance the financial wellbeing of borrowers

24%

say it will allow them to serve consumers who may previously have been excluded from credit

29%

think technology will become more important to provide bespoke tools and products to borrowers

40%

of lenders using Open Banking technology claim that it enables quicker decision-making

38%

say it increases the accuracy of affordability assessments

Four in five (80%) say that automated lending decisions based on data insights are the future of consumer borrowing. Acting upon this belief, almost all (95%) lenders are planning to, or already do, use Open Banking technology to help with lending decisions. Among larger institutions, nearly three-fifths (58%) already use it, with the proportion slightly lower for medium (44%).

Four in ten (40%) lenders that already use Open Banking technology claim that it enables quicker decision-making and increases the accuracy of affordability assessments (38%). An additional third (34%) also point out that Open Banking helps them to protect vulnerable consumers, and 30% claim it enables them to treat consumers more like individuals.

Transforming to a more outcomes-driven model

As noted by lenders themselves, the Consumer Duty is just the first step towards a more outcomes-driven industry, but it's a strong start. Around two-fifths (39%) of the lenders surveyed said that they believe it will encourage greater vigilance when it comes to dealing with financially vulnerable customers.

But there is still a long way to go. **Two thirds (67%) of lenders acknowledge that the lending sector will need total reform if it is to truly prioritise borrowers' financial health ahead of profit.**

The regulatory elements of the Consumer Duty, including requiring lenders to take all reasonable steps to avoid causing foreseeable harm to customers and act in good faith, provide solid foundations

One of the next critical steps to support the transformation to a wider model of Value-Based Finance focused on borrower outcomes is to further expand the range of datasets and insights available to lenders through Open Banking and other transaction analytics services, such as Fuse.

This will provide lenders with richer data-driven insights about a prospective borrower's financial health, improving lender decision-making, reducing defaults, and boosting profitability – all while enhancing borrower protections and support.

These improved tech solutions are vital to provide insight into borrowers but, just as importantly, monitor outcomes, ensuring that lenders, and the financial system more generally, becomes more focused on delivering value to consumers.

67%

of lenders acknowledge that the lending sector will need total reform if it is to truly prioritise borrowers' financial health ahead of profit

Conclusion: Reimagining consumer finance with a focus on genuine, long-term value

Our research has highlighted that it's a challenging time for the UK's consumers. Over a third are worried about their financial future, and a fifth are reliant on credit and loans to cover essential expenses.

More than a third of lenders have seen an increase in the proportion of financially vulnerable consumers over the past year, and this figure will likely rise as the cost of living crisis continues to tighten its grip.

But there is hope on the horizon. Two-thirds of lenders realise the need for total reform in the lending sector in order to shift people's financial wellbeing ahead of profit.

It's therefore also a very exciting time for the industry. The new Consumer Duty has parallels to a product design approach that changed healthcare forever, and if we now seize the opportunity, it can do the same for finance too, ushering in an age of Value-Based Finance with consumer outcomes at its heart.

The latest developments in artificial intelligence, meanwhile, are enabling more holistic and robust credit risk and financial health assessments, which can help lenders to increase acceptances, reduce losses, and monitor vulnerability to ensure better outcomes for customers. This is a tectonic shift with the power to reinvent finance as we know it, and it's a change that's long overdue.

However, there is work to be done to get there and collaboration is vital. In order to meet the requirements of the new rules, six in ten lenders will be bringing in a third party to provide support, and 68% are looking to introduce new technology.

A lot of hope is being pinned on Open Banking technology, with almost all lenders surveyed either already using it, or planning to. Emerging datasets provide solid foundations for a more outcomes-driven model, opening up a wealth of in sights that can be used to better support Britain's borrowers by monitoring their ongoing financial health, while also assessing the impact of the financial products that they use.

For banks especially, there is an opportunity to leverage a huge wealth of untapped data, utilising current account transaction data to gain improved insights into customers and potential borrowers.

Greater insight into both affordability and vulnerability as well as the roll-out of bespoke tools can offer a solution for the one in three UK adults who believe that their bank could be doing more to support them in making more informed decisions. Furthermore, the inclusion of consumers previously denied credit will be encouraging news for the quarter of consumers who used a higher cost lender – with 11% doing so as they had no other option.

Crucially, transaction data analytics using AI will unlock the data strategies that banks and other lenders will need to be able to identify, monitor, evidence, and stand behind the outcomes their customers experience, both to meet the requirements for the Consumer Duty and to ensure that their model is fit for future purpose. We believe that through continued cross-sector collaboration - with policymakers, technology providers, and lenders – the industry can help people to not just survive these difficult times, but to thrive.

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