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MANAGING CUSTOMER DEBT VULNERABILITY IN UK

A FRAMEWORK FOR DEBT RESPITE SCHEME PREPARATIONS

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Written by EXL BFSI Analytics Team

Jyoti Sinha
Project Manager

Rashmirekha Basu
Senior Consultant

Manish Dureja
Senior Engagement Manager

Contributors

Priya Pahuja
Consultant

Exl.Insurance@exlservice.com

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A Framework for Debt Respite Scheme Preparations

Customer vulnerability to debt in the UK has come increasingly come under more scrutiny. Research suggests that more than 24 million[1] people in UK display one or more potential characteristics of vulnerability to debt, such as mental health issues. Financial Conduct Authority (FCA) research estimates that about one in six people with outstanding consumer credit debt, or about 2.2 million[2] individuals, are suffering financial distress.

The FCA has implemented regulatory initiatives to make lenders recognize customer vulnerabilities in a focused, precise way. This includes introducing the Debt Respite Scheme, which comes into force on 4th May 2021 to grants moratoria to over-indebted individuals.

This complex regulation requires lenders to begin implementing a comprehensive framework to best help their vulnerable customers. By understanding the regulation's specifications, key participants, and areas of impact, organizations can be prepared for its impacts. This includes transforming specific operations, data, risk, and reporting management practices to comply with the Debt Respite Scheme.

The Debt Respite Scheme consists of the Breathing Space Moratorium, and the Mental Health Crisis Moratorium. Under both of these moratoria, creditors are not allowed to retroactively charge interest, default fees, or other charges if the debtor leaves without entering a debt solution.

The Breathing Space Moratorium Mandate

The Debt Respite Scheme puts in place processes and measures aligned with Consumer Credit Sourcebook (CONC) requirement that firms involved in credit-related regulated activities keep in mind consumer interests and treat customers fairly[3]. To achieve this end, the regulation provides eligible individuals with access to free professional debt advice services from an authorised person[4]. It also assists debtors with seeking sustainable solutions by temporarily pausing creditor enforcement action, freezing interest payments, fees, penalties, and other charges.

This scheme can be availed by individuals living in England and Wales. Its provisions also applies to business debt owed by individuals who are not VAT (value added tax) registered and not in partnership with anyone else. Important also to note that individuals will have access to the Breathing Space Moratorium once every 12 months, and there is no limit to the amount of individual or total debt that can be protected during the 60-days moratorium.

[1]https://international-adviser.com/more-than-24-million-vulnerable-clients-in-uk-says-watchdog/

[2]https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/714860/Breathing_space_call_for_evidence_response_for_publication_TB.pdf

[3]https://www.handbook.fca.org.uk/handbook/CONC/2.pdf

[4]This must be an FCA regulated debt advisor, or an organisation which qualifies for exemption such as a local authority

Special Features of the Mental Health Crisis Moratorium

The Debt Respite Scheme also attempts to address the unique and vulnerable circumstances of people dealing with severe mental health crises. In order to access this special moratorium

In order to access this moratorium, a debtor, or a person acting on their behalf, must provide a debt advisor evidence of undergoing mental health crisis treatment, including a signed declaration from an approved mental health professional. This treatment includes an individual being detained in a hospital or removed to a place deemed safe by police under certain sections of Mental Health Act 1983, as well as individuals receiving crisis treatment from a specialist mental health service provider in a hospitals or community

This moratorium lasts for the duration of debtor's treatment for mental health crisis along with an additional 30 days. An individual can still considered eligible for Breathing Space moratorium, meaning the moratorium can last the length of their mental health crisis treatment plus an additional 90 days.

Although debt advisor will need to assess the financial ability of the applicant to service outstanding debt there is also no capping of the number of times an individual receiving mental health crisis treatment can enter moratorium via this mechanism.

Included and Excluded Qualifying Debts

The following criteria applies to both the Breathing Space and Mental Health Crisis moratoria.

Personal Debt: Qualifying debts under the scheme include almost all financial services debt, court judgements (excluding fines), and any arrears owed to a local or central government. Although secured debts, such as hire purchases and conditional sale agreements, are ineligible, non-capitalised arrears are within scope.

Business Debt: For eligible sole traders with a turnover below the VAT threshold, qualifying debt includes business credit, business utility bills, supply chain debts, all national and local taxes including employer and employee NICs (National Insurance Contribution), PAYE (Pay As You Earn), business rates, and VAT.

Certain types of debt are out of scope for this type of relief:

- Debts incurred as a result of fraudulent behavior
- Fines imposed by a court, including criminal fines
- Confiscation orders
- Child maintenance
- Payments and debts arising after an order made in family proceedings
- Social fund loans
- Student loans and personal injury liabilities
- Existing charge order or an attachment of earnings

Key Participants and Interactions

Several key participants have specific interactions and responsibilities within the scope of the Debt Respite Scheme.

1. **Debtors:** Over-indebted individuals and those suffering from mental health crisis, as attested by Approved Mental Health professionals, can access the relevant moratoria via an authorised debt advisor.

   If the Breathing Space Moratorium is triggered, the debtors will be obliged to:

- Fulfil their ongoing liabilities, including mortgage payments, rent, insurance premiums, taxes, water & sewerage charges, utility supplies, and other similar bills
- Not access further credit in excess of £500 either alone or jointly without approval from a debt advisor

- Engage with a debt advisor as considered appropriate
- Inform debt advisor of material changes in financial position

  If the Mental Health Moratorium is triggered, these obligations do not apply.

2. **Debt Advisor:** Debt advisors have the authority to judge the merit of a debtor's application for accessing either the Breathing Space or Mental Health Crisis moratoria. Additionally, they can cancel the moratoria based on their assessment of a creditor's request for review or as mandated by the regulation.

a. Breathing Space Moratorium:

- Assessing Debtor Eligibility: Advisors initially check if a debtor owes qualifying debts to a creditor, and verify the debtor lacks sufficient funds to discharge debts as they fall due. Secondly, advisors then determine if there is a realistic chance and need of entering into a formal debt solution. The advisor then verify debtor has not accessed Breathing Space within last 12 months of application and is not subject to Mental Health Crisis Moratorium. Finally, verify debtor is not an undischarged bankrupt or subject to an interim order or individual involuntary arrangement.
- Conducting Midway Review: The advisor conducts a review between the 25th and 35th day of the moratorium to ensure continued compliance with all eligibility requirements. This includes ascertaining if a debtor is continuing to engage with the advisor on searching for a solution. Unless creditors notify the advisor of a debtor's failure to pay for ongoing liabilities or an unapproved access of credit for £500 or above, it is assumed that all eligibility conditions are satisfied. At this stage, the advisor can exercise discretionary power to cancel the moratorium if a debtor fails to comply with eligibility requirements, but only if a debtor's personal circumstances do not make such an action unfair or reasonable.

b. Mental Health Crisis Moratorium:

- Assessing Debtor Eligibility: In addition to verifying the eligibility of debts and that a debtor is not an undischarged bankrupt, subject to an interim, order or under an individual involuntary arrangement, debt advisors are also required to receive evidence from an approved mental health professional showing that an applicant is undergoing treatment for a mental health crisis. The advisor also obtains relevant information on a debtor's finances from at least one credit reference agency.
- Periodic Review: The advisor will request confirmation from a nominated point of contact to verify that a debtor is still receiving treatment every 20 to 30 days.

c. Other Responsibilities Common to Both Moratoria: The advisor must notify the Insolvency Service and debtor of a debtor's entry and early exit or termination from both moratoria. They must also differentiate between personal and business debt in applicable cases. It is also the advisor's responsibility to review a debtor's request for a withholding address, and to decide if creditor requests for reviewing the moratorium have merit.

3. **Insolvency Service:** The main responsibility of the Insolvency Service will be ensuring a smooth, timely flow of information and managing the related administrative burden. This includes operating a digital-first service where the creditors are informed when a debtor enters Breathing Space. It will also maintain a private register of individuals in moratoria, with creditors only having access to the details of their specific debtors.
4. **Creditors:** Upon notification of a debtor entering either moratoria, creditors must confirm the sum of the debt owed to them, with a specific focus on any eligible debt that has been excluded and if there exists any other creditors by assignment.

The onus of updating debt advisors and relevant assigned creditors is on the creditor, who is also liable for any losses related to failure regarding making these updates.

Creditors may request a debt advisor to review a moratorium application in the following circumstances:

a. A creditors' interests are believed to be unfairly prejudiced in favour of debtors application

b. A debtor was ineligible for the moratoria at time of application

c. A debt does not qualify under the moratorium

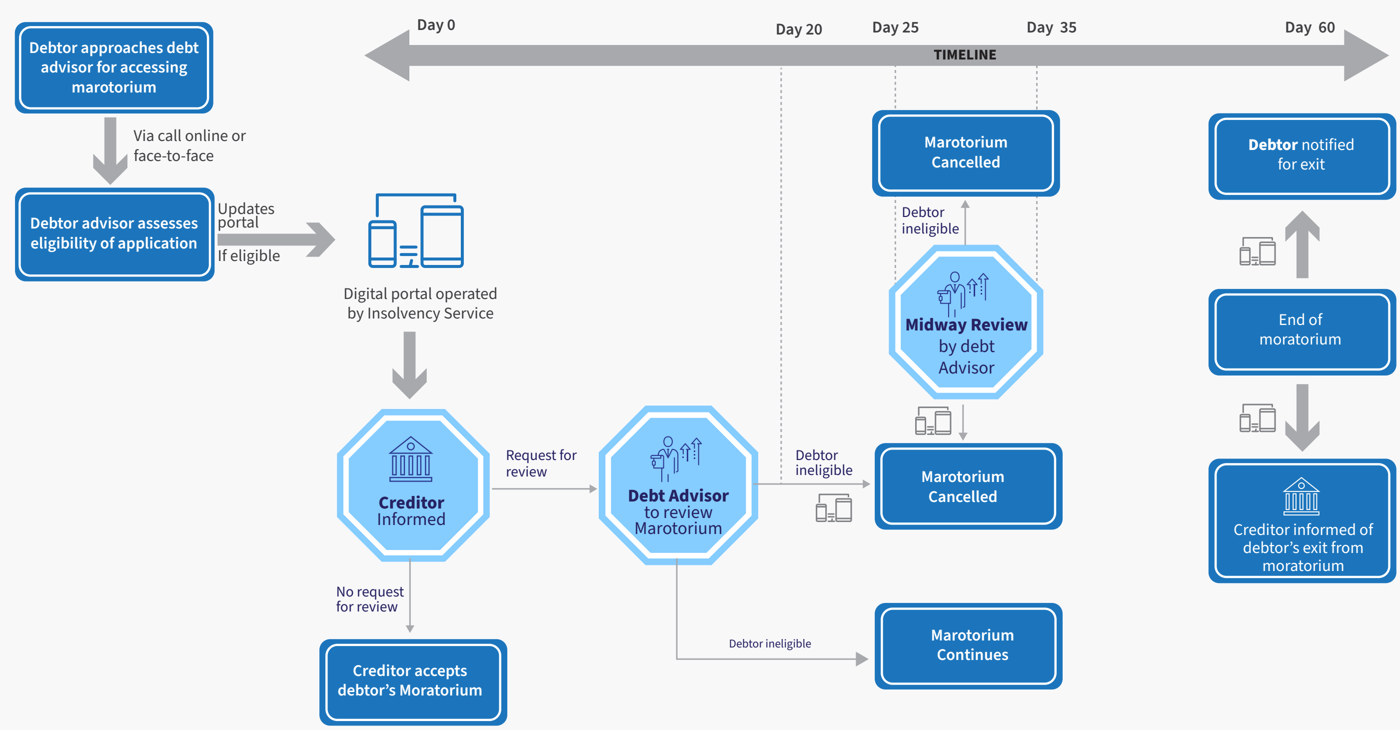
d. An individual has sufficient funds to discharge or liquidate their debt as it falls due

This request must be made within 20 days from beginning of the moratorium. This can be escalated to county court in certain cases.

Potential Challenges

Certain potential challenges may disrupt the functioning of the scheme.

1. **Complications for Mental Health Crisis eligibility:** The Mental Health Act 1983 referenced in the Debt Respite Scheme does not specifically state which exact medical conditions qualify as a mental disorder, instead defining it as, "any disorder or disability of mind". The Mental Health Crisis moratoria requires a diagnosis from an approved mental health professionals. In absence of an individual proactively approaching a professional for a diagnosis, or, even worse, not having access to specialized medical services, it would be hard to objectively measure if deserving cases are being unfairly barred from accessing the moratoria. Additionally, there is also a need to assess the possibility of applicants abusing the respite from debt payments that this regulation provides.



A standard template for assessing mental health crises may help to ensure consistency in capturing information and seamless processing. This is expected to be completed before the regulation comes into force.[5]

2. **Guidelines for due diligence by debt advisors:** Debt advisors might inadvertently provide inaccurate or incomplete details about a debtor to the central portal run by the Insolvency Service. The regulation does not provide any suggested timelines for modifying such mistakes, nor do they provide any guidelines on verifying uploaded details[6].

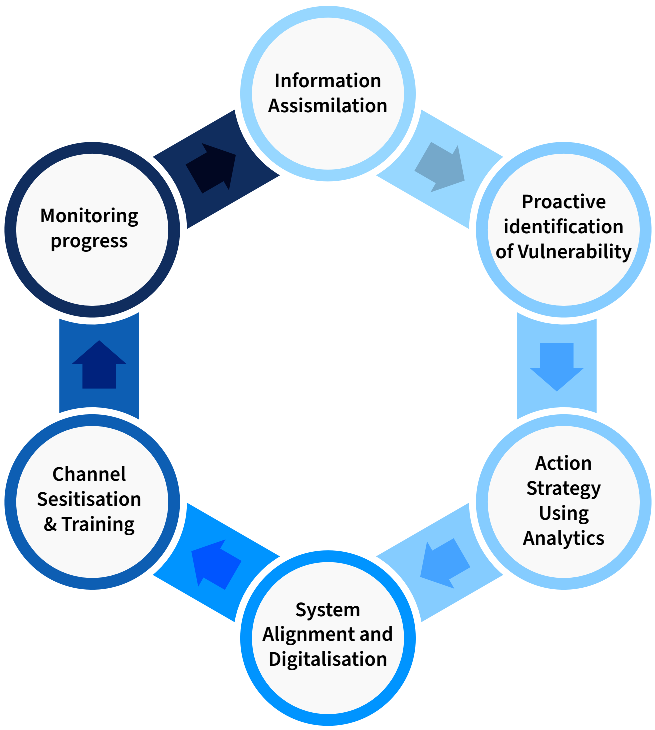
3. **Information flow and technical dependencies:** Since creditors are wholly dependent on the digital portal for information, this creates potential challenges if the portal's speed, accuracy, or other functions perform poorly. There is also the question of what contingency measures are in place if the portal goes down. While the regulation does mention the possibility[7] of portal malfunction, it does not provide a timeline for providing creditors with updated information. This can lead to potential misalignment where creditors continue to pursue enforcement actions against customers who have actually entered a Breathing Space or Mental Health Crisis moratoria. It is important to account for such mishaps in order to prevent creditors from facing losses from legal liabilities or reputational damages.

4. **Process Oversight:** The consultation response of HM Treasury, published in 2019, mentions the possibility of an oversight mechanism similar to similar to what exists for monitoring creditor compliance in situations of insolvency[8]. This would involve flagging debtor non-compliance to an insolvency practitioner or debt advice agency. However, at the time of writing this paper, there exists no further clarity about the exact process by which creditor compliance will be monitored.

Preparing for the Breathing Space and Mental Health Crisis Regulation

UK banks and building societies prepare for this new regulation using a proposed solution framework. This framework enables financial organizations to address current customer needs as well as proactively position themselves to better understand customer vulnerabilities and actions when the regulation goes into effect.

Banks should consider taking six sequential steps to prepare for this regulation based on their current data, technology, operations and organizational capabilities.



[5]Outcome of Breathing Space Consultation as published on 19th June'2019

[6]https://www.legislation.gov.uk/ukdsi/2020/9780348209976 (20)

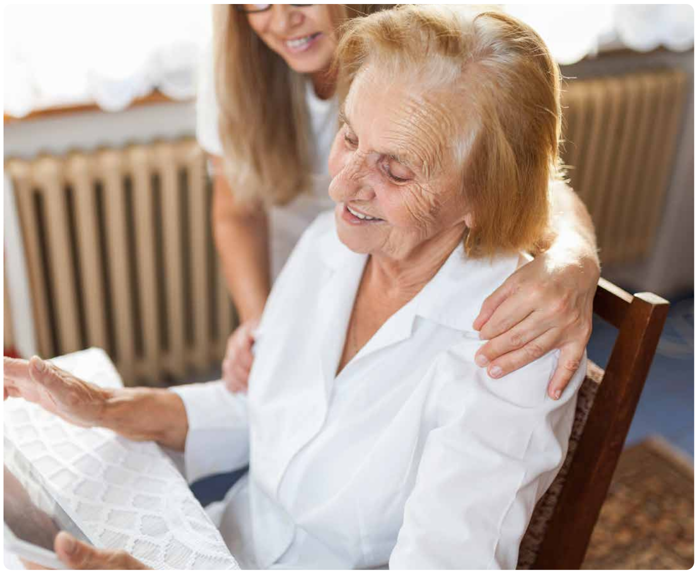
[7]https://www.legislation.gov.uk/ukdsi/2020/9780348209976 (39(1,2))

[8]Outcome of Breathing Space Consultation as published on 19th June'2019

1. **Information Assimilation for Breathing Space eligibility:** Establishing a data model accounting for customer vulnerability and Breathing Space eligibility, and subsequently a data lake or mart with this information, is crucial. This data model should enable a single customer view of new applicants, provide flexibility to update information for the existing Breathing Space enrollees.

Key features of the data model and lake should include:

- Accurately identifying new applicants based on information shared by the Insolvency Service central portal, covering information related to all lending relationships with the customer.
- Differentiate between an individual's personal debts impacted by the moratorium and any likely-excluded business debts
- Embed customisable triggers for those in the Mental Health Moratorium, which does not have a specific fixed end date.
- Ability to provide updates to core banking databases and collection systems to freeze the accrual of interests, penalties, fees, late payment charges for affected accounts during the moratorium, and re-enable them once the moratorium concludes.

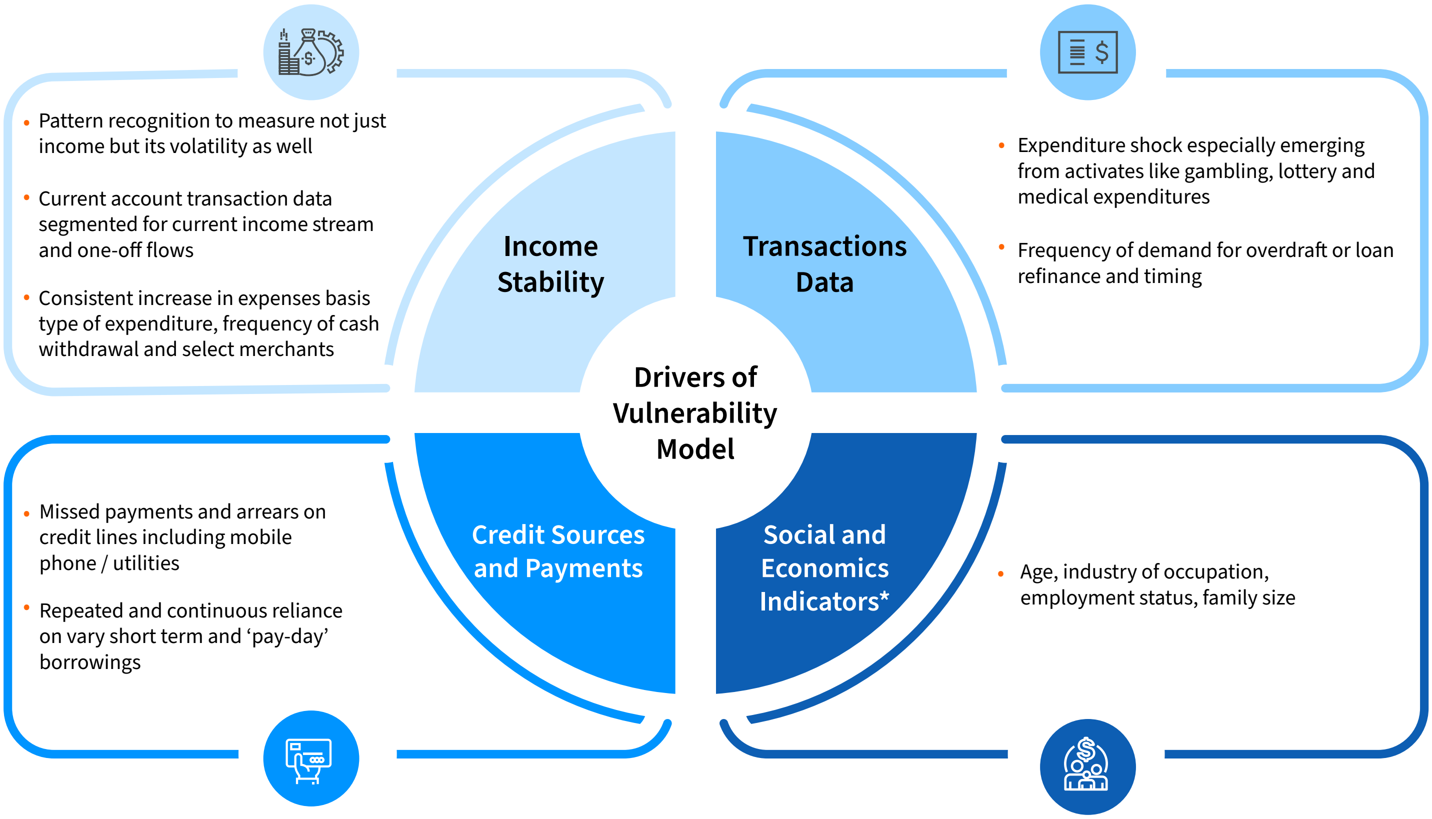


- Account for possibility of retroactively charging interest or other charges if a borrower if found to have incorrectly or fraudulently accessed the Breathing Space moratorium.
- Capture information from a bank's interactions with customers including any feedback during the collections process, as well as indicators, triggers, and predictions that a customer may be entering a vulnerable state.
- Monitor the progress and performance of the program including any impact on profits and losses, breaches, and potential improvement areas.

2. **Proactively Identify Vulnerable Customers:** Banks must consider what parameters or information can help them proactively identify vulnerable customers. This must reflect accommodations around payment or forbearance plans, as well as new credit offerings for these customers.

Proactively identifying vulnerability can be accomplished using predictive analytics modeling. This model's design and implementation should consider the following:

- **Phased model targeting:** Within the first six months of the regulation kicking in, the creditors should build and deploy 'vulnerability prediction model' which should be based in existing vulnerability information in the collection data. Subsequently, creditors should attempt to identify look-alike customer groups that share traits with the existing customers seeking Breathing Space. This model should be calibrated to ensure accuracy over time.
- **Intelligent Driver Selection:** Examine factors beyond existing drivers of estimated probability for defaults to include areas including income stability, credit sources and payments, transactions data, and social and economic indicators



* Social indicators to be used only for positive and supportive actions towards customers and not for denying credit or any adverse actions

3. **Action Strategy Using Analytics:** Before working on operational delivery, banks must develop an action and response strategy around the impact of this regulation on profits and losses, fraudulent or incorrect claims, and other areas.

These response strategies should be implemented with the following considerations:

- **Devising post-Breathing Space payment plans:** At a minimum, a bank's collections function must examine its existing forbearance plans and available options to offer once a customer has exited the Breathing Space moratorium. In some cases, completely new plans may be needed, such as settlement plans for customers facing persistent sources of vulnerability.
- **Overall impact on profits and losses:** While significant bottom-line impacts are not likely during the first year of the regulation, banks must consider their overall customer profile and vulnerability, paying special considerations to aging portfolio profiles and industry uncertainties. For certain segments, loss-given-defaults may need to revised upward as part of IFRS9 accounting.
- **New acquisition and offerings:** In the medium to long term, banks should consider segmenting product options for customers based on any future estimated vulnerability. Such product options would likely have lower interest on borrowings and provide easy-to-understand switching options, fees, and other features.
- **Existing customer management:** Using vulnerability models and existing risk scorecards, banks should consider vulnerable customer segments who need immediate assistance for their debt. This scoring should be taken place at least on a quarterly basis, and ideally every week.

- **Potentially fraudulent claims:** Applications for the Breathing Space moratorium may contain inaccuracies, or in some cases intentional fraud. This could occur across several areas:

a. Misrepresenting individual or business finances when they are actually sufficient to discharge a debt

b. Accessing loans >= £500 on an individual or joint basis from another creditor during the Breathing Space moratorium without debt advisor's permission

c. Debtor failure to notify advisor on improved financial or heath circumstances that should automatically end their Breathing Space moratorium

d. Potential collusion with debt advisor

4. **System alignment and digitalisation:** Creditors need to redesign customer journeys and digitize collections workflows and procedures to minimize the cost burden of the regulation and avoid costly compliance failures. The processes must be robust and auditable.

Some of the key aspects of such an agile and digitized process would include:

- **Real-time information processing:** This would include enabling communication between the Insolvency Services centralized platform and a bank's Breathing Space data lake to create a single source of truth for the collections function. Ensuring a seamless information flow to any third parties involved in collections will be required as well.
- **Flexible and customisable triggers:** From process standpoint, flexibility will be needed to quickly change the status of any lending relationship if the insolvency portal or customer indicates vulnerabilities. Some of banks and building societies may already have necessary provisions for identifying some of these vulnerabilities, but the collections user interfaces and platforms will need to have access to information from the Insolvency Service portal as well. Any suspended or re-instated fees and charges must also be shown.
- **Digitalised information processing and monitoring:** Collections must deploy automate cross-referencing any received debtor information with their internal processes. Automated processes will also be needed to check for any additional debts or customers taking on new liabilities. Finance organizations should also consider converting paper records into electronic files.

5. **Channel Sensitisation and Branch Training:** Customer and debt advisor communications related to the Deb Respite Scheme must be crafted with empathy and sensitivity. Branch and collection trainings must be updated to account for the new regulation.

Changing the channel and training strategy should take into account the following considerations:

- **More touchpoints and better communication:** For both customers choosing the Breathing Space moratorium and those identified as vulnerable by the bank, finance organizations must ensure clear communication. Large banks may need to invest in collection centres providing separate queues to address the payment cases for vulnerable customers.
- **Repayment options and reminders:** Vulnerable customers may need additional guidance on any available repayment options, as well as timely reminders on any fees or other charges. These

communications should be sent out using an omnichannel approach to ensure the customer receives them over their preferred channel.

- **Feedback and surveys:** Banks should initiate their own feedback surveys for any identified vulnerable customers. This questionnaire should cover aspects including if a customer is facing any undue burden in paying their debts, whether they will be able to continue paying for next 6-12 months, and if the amount of monthly debt impacts their ability to pay for basic necessities.

6. **Program dashboard and tracking:** Banks will need a comprehensive dashboard to understand and address issues pertaining to this regulation. This includes commercial, customer, and operational impacts.

The following views should be included as part of a program dashboard:

- **Customer view:** This view would report for the general statistics around customers seeking Breathing Space, as well as those the bank identifies as vulnerable. This will help banks to define prudent response strategies to address these customers' needs.
- **Commercial view:** This would cover explicit and implicit costs. Explicit costs would include technology and enablement costs, while implicit costs would reflect on losses or gains on long term recoveries and incomes.
- **Operations and analytics view:** This would cover details around vulnerable customers proactively approached, collection operations and related KPIs like average handle time, and cases entering or existing the Debt Respite Scheme every month.

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EXLSERVICE.COM

lookdeeper@exlservice.com