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# Changes to the protection of guarantors under regulated agreements: opportunities missed and problems created

**KEY POINTS**

- As part of recent FCA reforms, creditors are now required to undertake affordability assessments in respect of guarantors under regulated credit and hire agreements.
- Guarantors are now afforded the same protection as debtors in terms of being treated fairly under Principle 6.
- Such changes raise difficult issues of implementation and conceptual questions concerning the nature of secondary obligations.

The FCA has recently tightened up the protection afforded to guarantors under regulated credit and hire agreements. This article considers those changes and their broad consequences for the UK lending markets. It focuses on the conceptual and practical difficulties posed by two new requirements that a creditor should assess whether a guarantor can afford to offer his guarantee and that a creditor should treat him fairly.

## INTRODUCTION

'A guarantor is a schmuck with a pen' – at least, that is, according to the old joke amongst Wall Street lawyers. It may therefore be thought odd that whilst debtors under regulated credit and hire agreements have for decades been afforded an increasing degree of statutory protection, their guarantors have (until recently) largely been left to fend for themselves.

And so it was that in November the Financial Conduct Authority (FCA) sought to address the perceived lack of safeguards afforded to guarantors. Fresh from its decisive action reigning in the payday lending industry, the FCA amended the rules set out in the Consumer Credit Sourcebook (CONC).

Such reforms, however, raise difficult questions not only as to their effectiveness, scope and implementation but also concerning the fundamental nature of secondary obligations.

Six months into the new rules, this article reviews and critiques the FCA's recent changes and looks at their possible broader implications for the credit industry in the UK.

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## THE HISTORICAL CONTEXT

With certain notable exceptions, it is fair to say that parliament has for centuries largely ignored the plight of guarantors, preferring instead to delegate their cause to the common law. The evolution of the statutory protection of guarantors has been a slow one, punctuated only rarely by stuttering advances.

The starting point in any discussion is of course s IV of the Statute of Frauds 1677, which created the requirement that a guarantee should be in writing and be signed by the guarantor or his agent. In the context of consumer credit, it took nearly 300 years for parliament to expand upon these relatively nominal requirements. Sections 22 and 23 of the (now repealed) Hire Purchase Act 1965 added two key developments providing (in embryonic form at least) that key information had to be provided to the guarantor. A guarantor under a hire-purchase, credit sale or conditional sale agreement had to be provided with copies of the credit agreement and the guarantee within seven days following their execution. Such copies were subject to requirements including legibility. Absent such copies the guarantee would be unenforceable without the leave of the court. A guarantor was entitled – upon payment of 2s 6d – to a copy of the credit agreement, guarantee and statement of account.

It was not until the Consumer Credit Act 1974 (CCA) that the protection of guarantors received significant attention in parliament. Whilst it replicated some of the information requirements of the Hire Purchase Act 1965, Pt VIII of the CCA went further in three key respects. First, the form and content of regulated guarantees became heavily prescribed (s 105(4) of the Consumer Credit (Guarantees and Indemnities) Regulations 1983). Second, it was no longer sufficient for a copy of the credit agreement to be provided *post hoc* and a guarantor became entitled to a copy of any existing credit agreement at the point he signed his guarantee (s 105(5)). Third, any default notice served on a debtor had to be copied to a guarantor, presumably to allow the guarantor an opportunity to chivvy the debtor along, provide the funds necessary to avoid a default or at the very least to have some warning of his impending liability.

### THE IMPETUS FOR CHANGE

And that has been the position for some 40 years. So why change now?

As noted at the start of this article, the FCA's overhaul of the protection of regulated guarantors comes immediately after its clamping down on the high-cost short-term credit (HCSTC) industry. This is no coincidence. One of the foreseeable consequences of squeezing payday lending was to drive debtors into the arms of the guaranteed loans sector. This was inevitable. By capping the overall charges which payday lenders could levy, the FCA made it uneconomical for lenders to do business with those customers deemed too risky. After all, interest rates are intrinsically linked to perceived risk and so by capping rates, the FCA also capped the level of risk which lenders would be prepared to take. Higher risk customers therefore had to shop elsewhere.

And so the guaranteed loans sector expanded to fill the void. Whilst loans backed by guarantees are nothing new, they began to be touted more aggressively to the subprime market. Those debtors who were too risky to be given HCST credit at a mere 1,509% APR could obtain credit at a more modest mean APR of 46.3% so long as a guarantee was offered.

Thus by plugging one leak in the dyke, a new leak was sprung and the FCA has moved quickly to fill it. Whilst it is a relatively small market (worth £154m in 2013) it is growing one and this too may explain the FCA's decision to act.

### THE PERCEIVED PROBLEMS

But what were the specific issues causing concern to the FCA? In its three consultation papers on the subject,[1] the FCA does not state the specific problems which it sought to remedy. It does not appear that any thematic review had been conducted which had highlighted the need for reform.

However, in its response to the first consultation paper, Citizens Advice[2] noted a near-five-fold increase in the number of requests for help from guarantors in 2015 when compared with the previous three years. If this metric can be taken as a barometer of the health of the sector then perhaps it indicates underlying systemic problems.

Citizens Advice noted four key problem areas as highlighted by its casework, and these might be taken as a useful checklist:

- Guarantors not understanding (or being misled as to) the nature of their liabilities, with one guarantor having been told that his guarantee was equivalent to providing a character reference;
- Misconduct at the point of sale, with some creditors failing to provide legible copies of contractual documents, some guarantors being subject to undue influence and others having their signatures forged;
- Affordability and creditworthiness, with some guarantors being unable to satisfy their secondary obligations; and
- Enforcement and forbearance, with some guarantors being subject to aggressive collection practices.

### THE NEW REGIME

In order to effect its changes, the FCA has amended CONC in five key respects (amongst others). Following the first round of consultation it was conceded by the FCA that these changes should apply only to guarantors who are themselves individuals and not to corporate guarantors. (It must be remembered that the term "individual" here includes sole traders. And this creates the first anomaly: a sole trader who eg, guarantees a subcontractor's loan will be covered by the new provisions whereas a company guaranteeing an employee's loan will not.)

Secondly and of most significance, guarantors are now deemed to be "customers" for the purposes of Principle 6 ('A firm must pay due regard to the interests of its customers and treat them fairly.') and Principle 7 ('A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.') This small amendment (for which see CONC 3.4.3A R) is of vast importance and is discussed below.

**Of most significance, guarantors are now deemed to be customers for the purposes of Principle 6 ... and Principle 7.**

Thirdly, adequate pre-contractual information must be given in order that the guarantor understands the nature of his liabilities.

Fourthly, a creditor must assess whether the guarantee will adversely affect the guarantor's financial situation, and to this end the creditor must undertake a financial assessment.

Finally, a guarantor is entitled to the same degree of forbearance and other indulgences when in financial difficulties.

### THE PATH NOT TRODDEN

Some suggestions put to the FCA during its consultation were not adopted. For instance, it was suggested that a *proforma* pre-contract information sheet should be prescribed, with set wording and set warnings. The FCA decided against producing such a document, preferring instead a generalised obligation. This may have been a missed opportunity as a simple fact-sheet (such as those which routinely accompany default notices) could have ensured clarity, content and continuity.

Similarly, the FCA declined to prescribe a cooling-off period for all guarantors (although a guarantor may already withdraw before the credit agreement is executed). This presumably would have prevented the efficient and effective working of the sector. As with HCST credit, one of the factors which creditors boast is their ability to advance loan monies within short time scales, often hours. A cooling off period of even seven days would have dampened this business model. However, this may have been a missed opportunity as pre-contractual information alone may often be inadequate if there is no time to digest it away from the gaze of the hopeful debtor.

Finally, and perhaps most interestingly, the FCA declined to require that a guarantor should be given copies of arrears notices. Albeit that he receives copies of default notices, he will not receive copies of other statements which would provide an early warning of trouble ahead.

## ANALYSIS

### A piecemeal approach

There is an obvious preliminary point here, albeit not a critical one. Owing to the scope of the FCA's remit, these changes will affect only guarantors where the principal debtor falls within the consumer credit framework. Thus, where a husband takes out a regulated loan for, say, a new car, and his wife guarantees the loan, the wife will have the protection of the new rules (because of her husband's status). However, suppose that the wife takes out a loan for her trade such that she falls within the business purposes exemption. The credit will not be regulated and so if her husband guarantees the loan he will not benefit from the new rules (because of his wife's status).

This highlights the problem of the fragmented approach. In the scenarios above, both guarantors are equally deserving (or undeserving) of the new safeguards. The fact that one receives greater protection than the other is an accident borne not out of the identity and characteristics of the guarantor but out of the scope of the consumer credit regime.

It is beyond the FCA's remit to roll out its new rules in favour of all consumer guarantors. If there is merit in such a proposal it will have to come from parliament.

### Incrementalism

In one sense, many of the new rules are simply the next incremental step along the road to greater consumer protection. What began in 1677 with a requirement for writing and a signature – and progressed in 1965 to copies of key documents – has now reached a new peak in that a pre-contract explanation is required to ensure a guarantor understands what he is signing up to. This surely is a laudable and simple requirement.

> ... it is difficult to see that a guarantor will now have any greater protection because of the non-actionable duty that he be treated fairly.

### Solving the problem?

One question which must surely be addressed is whether the medicine matches the malady. Unfortunately, there is some difficulty here in that the FCA did not state at the start of their consultation which specific ills they were seeking to cure. As such, it is almost impossible to quantify its success.

However, it was noted above that Citizens Advice highlighted a checklist of four key problem areas. Will the changes address these problems?

Yes and no.

To the extent that some guarantors fundamentally misunderstand the nature of their liability, a pre-contract explanation may well assist. However, in the absence of a prescribed text and without a cooling off period, it remains to be seen just how much impact this will have. Consumers are famous for their unwillingness to read warning notices. And if a creditor is intent on misleading a guarantor then he will still be able to do so. Similarly, if a guarantor does not read or understand the guarantee when presented to him (and which already contains the following warning: 'YOU MAY HAVE TO PAY INSTEAD…') then will it make a difference if the same information is provided to him twice?

The picture is also mixed in terms of misconduct at the point of sale. The examples given by Citizens Advice are all ones which already find a remedy. Where illegible copies of documents are provided, the guarantee will be unenforceable without an order of the court. If a purported guarantor's signature is forged then there will be no contract. And if a guarantor is subject to undue influence or misrepresentation then equity will intervene. As such, it is difficult to see that a guarantor will now have any greater protection because of the non-actionable duty that he be treated fairly.

A more favourable analysis can perhaps be applied to enforcement. Prior to these changes, a guarantor being chased for payment could issue proceedings for injunctive relief and claim damages if the creditor's conduct constituted harassment. There are recent well-publicised cases of debtors successfully proving harassment (for example *Roberts v Bank of Scotland PLC* [2013] EWCA Civ 882) and no reason why a guarantor could not do so either. However, the threshold for harassment is a very high one. Now, however, a creditor must act with forbearance and must treat the guarantor fairly. As such, the guarantor is placed in the same position as the debtor.

### The conceptual difficulties of affordability assessments

CONC 5.2.5 R now requires affordability assessments:

> '(2)Before entering into the regulated credit agreement, the lender must undertake an assessment of the potential for the guarantor's commitments in respect of the regulated credit agreement to adversely impact the guarantor's financial situation.
> (3)A firm must consider sufficient information to enable it to make a reasonable assessment under this rule…'

This is highly problematic. First of all it is not clear what is meant by 'adversely impact the guarantor's financial situation'. It is explicitly envisaged in all guarantees that the guarantor may have to make payment and to that extent his "financial situation" will of course be "adversely impacted". There is no guidance as to the cut-off point between an acceptable and unacceptable adverse impact.

There is a further and more serious problem. It is relatively simple (in theory) to estimate whether a debtor will be able to make the required repayments and the arithmetic is as simple as deducting expenses from income. The same exercise can be carried out for the guarantor. However, by the time a demand is made under a guarantee, the situation may well have progressed far beyond a missed monthly repayment. At the very least there may be several months' arrears. At worst, the credit agreement may have been terminated with all sums due immediately. In such a case it is meaningless to ask whether a guarantor can afford the monthly repayments if he will be asked for the immediate lump sum payment of termination damages which may be in a different order of magnitude.

A similar problem concerns likelihood. Whereas it is certain that a debtor will have to make the required periodic repayments, in the absence of default a guarantor will never have to do so. To what extent should this be reflected in the "potential" for the guarantor's financial situation to be adversely impacted? Indeed, if a proper affordability assessment of the debtor has been conducted then it presumably follows that the creditor has no reason to believe that a particular guarantor will even be called upon (beyond the usual inherent risk of default).

Further still, the assessment of a guarantor's ability to make payment must surely proceed on an entirely different footing to the assessment of a debtor. Generally, a creditor is concerned with whether a debtor can afford repayments out of his regulator income. But this is not always the case with guarantors. A guarantor may not be able to afford to pay damages out of his disposable income and may have to resort to drastic measures such as raising finance elsewhere or selling assets up to and including the family home. That is the risk run by the guarantor who may be prepared to take the risk on the basis of altruism or commercial need and because he believes that the eventuality is an unlikely one. So long as he is fully aware of the risk being run and offers his guarantee freely then there is no reason in principle why he should be prevented from standing as a guarantor – he is entitled to be a *schmuck with a pen* if he so chooses.

Finally, the requirement to assess affordability coupled with the requirement to treat a guarantor fairly rather implies that the FCA's unstated aim is that a guarantor should be entitled to step into the shoes of the defaulting debtor and so take over the debtor's periodic loan repayments. This would make sense of the affordability assessment: can the guarantor afford the monthly repayments? It would also make sense of the requirement to treat a guarantor fairly. Surely it is fairer to allow the guarantor to make periodic repayments over a number of months or years as the debtor would have done than to demand immediate repayment of the full balance. Alternatively, the new requirement to forbear will in many cases result in the same outcome. If a guarantor can only pay the termination damages by recourse to selling his home, but could pay the periodic repayments from his disposable income, then the latter would surely be required.

Although this hypothesis is as yet untested, it is likely that this is where the requirement to treat guarantors fairly will end up. If so, this beguilingly simple nuance will create a fundamental conceptual change in the practical role of the guarantor.

Traditionally, a guarantor's obligation is to pay damages in the event of the principal debtor's default once the relationship between creditor and debtor has broken down (though of course everything depends upon the wording of the agreement). His obligation is in essence a secondary one. Whether or not the guarantor has any day-to-day involvement with the repayment of the loan behind the scenes is of no concern to the creditor. However, the requirement to treat a guarantor fairly – if interpreted as outlined above – will in practical terms pull the guarantor out of the shadows and place him in the shoes of the debtor. As well as conceptual implications, this will have practical implications. Is a creditor to serve a fresh demand each month on a guarantor when a repayment is missed by the principal debtor? Or will a guarantor be asked simply to set up a standing order in anticipation of future breaches by the debtor? Or is it expected that a creditor will terminate the credit agreement before demanding the full sum from the guarantor only to allow the guarantor the same repayment terms as offered in the now-terminated credit agreement? These questions as yet are unanswered.

## A fundamental disconnection

As noted above, interest rates reflect risk (at least in an efficient market). And so it is that some subprime debtors are being charged rates of up to 50% for loans backed by guarantees. This is an odd phenomenon which demonstrates the inefficiency in the market. An interest rate of 50% (as opposed to 5%) may be explicable where the perceived risk of default is extremely high. But it is less explicable where the creditor has the benefit of a guarantee and has also conducted an affordability assessment in respect of the guarantor.

Surely the presence of the guarantor (who will usually have a much better credit score than the debtor) should drive down the risk and also the rate. Put differently, suppose the guarantor would himself be able to obtain a loan at (say) 5%. If he stands as guarantor for a loan, surely the debtor can benefit from the guarantor's good standing and so too obtain a rate of 5% (or something similar to it, making allowances for additional costs).

For so long as the interest rates levied fail to reflect the creditworthiness of the guarantor, this fundamental disconnection will persist. This may be something for the market itself to correct through competition, or for the FCA or CMA to look into.

## The scope for greater impact

In the example above of the husband and wife, it was noted that there is no reason in principle that one guarantor should

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*Biog box*

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receive greater protection than another simply because of the status of the debtor. Whilst the FCA itself cannot remedy this disparity, Parliament can do so. It is therefore conceivable that in the not-too-distant future the growing trend of consumer protection will continue apace so that all guarantees given by consumers will be regulated to some extent.

Whether or not such further regulation is either warranted or desirable remains to be seen. A small extension of the requirements laid down in 1677 (eg, by adding a requirement for a prescribed statutory warning) may not be problematic. However, the greater the regulatory burden then the greater the cost of credit as passed on to debtors. Further, overregulation in the form of affordability assessments and limits on enforcement may similarly push up the cost of credit for some and drive others from the market. The effect on small and medium enterprises – which routinely obtain overdrafts and other forms of credit on the back of directors' guarantees – could be difficult to quantify. Whilst such regulatory problems are not strictly matters of law but of economics, they are factors which any regulator or legislature would need to consider carefully before progressing with caution.

## CONCLUSIONS

The protection now afforded to guarantors broadly represents an incremental development of the law and is largely to be welcomed. However, the new obligation to undertake affordability assessments of guarantors is a difficult one to understand at a conceptual level and raises difficult questions. Further, the right of a guarantor to be treated fairly will likely lead to a situation in which a guarantor is no longer strictly a secondary obligor but is entitled or required to step into the shoes of the defaulting debtor. In addition, there is the possibility that the new layer of protection afforded to some guarantors under regulated credit agreements will be extended more generally to all guarantors resulting in unforeseeable but likely difficult consequences for the lending markets. ■

1 CP15/6 Consumer Credit – proposed changes to our rules and guidance (February 2015); CP 15/23 Consumer Credit – feedback on CP15/6 and final rules and guidance (September 2015); GC 16/2 Proposal to issue guidance on the FCA's view of enforcing security under the Consumer Credit Act 1974 (February 2016).

2 A Problem Shared? Exploring the market for guarantor loans.

*Further Reading:*

- Guarantees and performance bonds: problems of drafting and interpretation [2013] 10 JIBFL 614.
- Consumer credit: A new era approaches [2013] 6 JIBFL 358.
- LexisNexis Financial Services blog: Consumer protection – statutory wording and contractual effect.