Affordable credit

Available in alternative formats

This publication can be provided in alternative formats, such as large print, Braille, audiotape and on disk. Please contact: Communications Department, Joseph Rowntree Foundation, The Homestead, 40 Water End, York YO30 6WP. Tel: 01904 615905. Email: info@jrf.org.uk

Affordable credit

The way forward

Sharon Collard and Elaine Kempson

JOSEPH ROWNTREE
FOUNDATION

First published in Great Britain in February 2005 by

The Policy Press
Fourth Floor, Beacon House
Queen's Road
Bristol BS8 1QU
UK

Tel no +44 (0)117 331 4054
Fax no +44 (0)117 331 4093
E-mail tpp-info@bristol.ac.uk
www.policypress.org.uk

© University of Bristol 2005

Published for the Joseph Rowntree Foundation by The Policy Press

ISBN 1 86134 748 0

British Library Cataloguing in Publication Data
A catalogue record for this book is available from the British Library.

Library of Congress Cataloging-in-Publication Data
A catalog record for this book has been requested.

Sharon Collard is a Research Fellow at the Personal Finance Research Centre (PFRC), University of Bristol.
Elaine Kempson is Professor of Personal Finance and Social Policy Research and Director of the PFRC.

All rights reserved: no part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording or otherwise without the prior written permission of the Publishers.

The **Joseph Rowntree Foundation** has supported this project as part of its programme of research and innovative development projects, which it hopes will be of value to policy makers, practitioners and service users. The facts presented and views expressed in this report are, however, those of the authors and not necessarily those of the Foundation.

The statements and opinions contained within this publication are solely those of the authors and not of The University of Bristol or The Policy Press. The University of Bristol and The Policy Press disclaim responsibility for any injury to persons or property resulting from any material published in this publication.

The Policy Press works to counter discrimination on grounds of gender, race, disability, age and sexuality.

Cover design by Qube Design Associates, Bristol
Printed in Great Britain by Hobbs the Printers Ltd, Southampton

Contents

Acknowledgements iv

1 Introduction **1**
Overview of credit sources available to low-income households 2
Policy background 5
Aims and objectives of the research 8
Research methods 8
About this report 9

2 Borrowing on a low income **10**
Profile of credit use by people on low incomes 10
Advantages and disadvantages of different types of credit 12
What do people on low incomes want from a credit source? 14

3 Lending to people on low incomes **19**
Small loans for short periods 19
Weekly cash payments 19
Managing the risk of default 20
Changes in the commercial sub-prime credit market 23

4 Widening access to affordable credit **25**
The extent of need for affordable credit 25
The type of credit needed 27
Will competition deliver more affordable credit? 28
The potential impact of existing policy initiatives 30
Other options for widening access to affordable credit 32
Conclusion 36

References **38**
Appendix A: Focus groups with low-income borrowers **40**
Appendix B: Round-table participants **42**

Acknowledgements

We are grateful to the Joseph Rowntree Foundation for providing financial support for the project, and to our advisory group who provided valuable advice throughout.

We would like to thank Karen Rowlingson at the University of Bath, who contributed to the secondary analysis of depth interviews and the literature review. We are also very grateful to Anna Ellison and her colleagues at Policis for the data analysis they carried out for the study. Sally Taylor helped facilitate the focus groups with low-income borrowers. Geoffrey Cooke kindly commented on the draft report.

We would also like to sincerely thank the focus group participants, credit providers and round-table participants who made the study possible.

1

Introduction

The poor pay more for many things – but, arguably, it is the extent to which they pay more for credit that puts the greatest strain on their budgets. In fact, levels of credit use vary little with household income. But, in contrast to people who are better off, people on low incomes borrow more often for necessities and use sources of credit that have higher charges (Berthoud and Kempson, 1992; Kempson et al, 1994).

Despite a considerable widening in the availability of credit, access to high-street credit is still severely constrained for people on low and insecure incomes. As a consequence, many of them borrow from lenders operating at the lower end of the sub-prime credit market, where annual percentage rates (APRs) typically range from 100 to 400% (Rowlingson, 1994; Kempson, 1996; Kempson and Whyley, 1999b; Speak and Graham, 2000; Whyley et al, 2000; Whyley and Brooker, 2004).

People living in deprived areas suffer a double disadvantage, especially if they live in a high-rise block of flats or an area of high crime, as licensed lenders may be unwilling to do business in their neighbourhood (Rowlingson, 1994; Kempson, 1996). Unless they have family or friends they can turn to, this leaves them with two options: the Social Fund, which is severely cash-limited and only available to those on qualifying benefits; or unlicensed lenders, where charges can be astronomical and consumer protection is non-existent (Herbert and Kempson, 1996; Speak and Graham, 2000; Whyley et al, 2000).

The sub-prime credit market

There are two groups of lender in the sub-prime commercial credit market. The first tends to offer credit products that cater specifically for the needs of low-income borrowers. It includes some long-standing credit providers, such as home credit companies and pawnbrokers, and some newer entrants such as sale and buy back outlets and rental purchase shops. This report focuses predominantly on these types of lenders.

The second group comprises companies that offer similar credit products to mainstream (or prime) lenders such as banks. The difference is that they are targeted at people who have difficulty gaining access to the mainstream credit market because they have a poor credit record or a history of bad debt.

There have been a number of attempts to develop low-cost credit products for people on low incomes, including credit unions; savings and loans schemes set up by housing associations; and community-based loan schemes. Take-up of these credit services has so far been modest and none of them has made significant inroads into the customer base at the lower end of the sub-prime credit market. Although the reasons for this are not well understood, it is clear that cost is not always the main consideration when people on low incomes decide where to borrow money. The great majority of people who borrow from the home credit companies (moneylenders), pawnbrokers or rental purchase companies are aware of the price they have to pay (Rowlingson, 1994; Collard and Kempson, 2003). Even so, they often

choose to use these lenders as they offer credit products that meet their particular needs.

Overview of credit sources available to low-income households

The types of credit available to people on very low incomes comprise small, short-term cash loans and credit tied to the purchase of goods. While sub-prime credit cards[1] are now available to people with impaired credit records, they have not yet been widely marketed to people on very low incomes. In any case, there is compelling evidence to indicate that many low-income borrowers are wary of using credit cards, as they fear overspending and falling into debt (Kempson et al, 1994; Whyley et al, 2000; Jones, 2002; Collard and Kempson, 2003).

Commercial cash loans

The borrowing requirements of low-income credit users are generally modest – a few hundred pounds at most. **Home credit companies** (also known as licensed moneylenders, doorstep lenders or weekly collected credit companies) are the main commercial providers of small-value personal loans in the UK. The market is dominated by four companies – Provident, Cattles, London and Scottish Bank and S&U. Together, they have 69% of the UK home credit market. Provident is the largest of the four, with 49% of the market. The remainder is spread across a large number of small companies operating at a local or regional level (Datamonitor, 2004).

Compared with the mainstream credit market, the costs of a home-collected loan are high, with APRs ranging from around 100 to 400% or more, depending on the lender and the size and term of the loan. There are, however, no additional charges should the borrower miss a payment and need the loan to be rescheduled (Rowlingson, 1994; Jones, 2002). Loans are typically for £500 or less, repayable over six or 12 months.

[1] Sub-prime credit cards have APRs much higher than the mainstream, typically ranging from 20 to 60% APR, as well as lower credit limits. The APR may come down and the credit limit be increased once a customer has established a history of repayment (Datamonitor, 2004).

The Consumer Credit Association (the trade association for home credit companies) estimates that around 3 million people have loans from one of their members or another licensed home credit company. This may be an overestimate of the size of the market, as surveys consistently put use of home credit companies at around 2% of households (Kempson and Whyley, 1999a) and a recent survey of British consumers indicated that 5% of individuals (around 2.3 million people) had taken out a loan from a home credit company in the past 12 months (Whyley and Brooker, 2004). Survey data complied by Policis corroborates this, indicating that somewhere between 2 and 2.5 million people in the UK use home credit at any one time.

There are several possible explanations for the discrepancies between the survey data and industry figures. First, it is clear that some people are reluctant to admit to using a moneylender. Second, survey questions vary in their wording and often fail to identify people who use home credit companies but make their repayments by direct debit rather than home collection. Third, many people buy vouchers or goods in instalments, rather than taking cash loans, and they may well categorise this as buying on hire purchase when questioned in surveys. Fourth, people who use more than one home credit company at any one time would probably be double-counted in industry figures but appear only once in survey data.

Pawnbrokers offer small cash loans secured on property, usually jewellery. There are two national chains of pawnbroker – Albemarle and Bond, and Harvey and Thompson, with about 50 stores each – but for the most part this industry comprises small companies operating at a local or regional level.

Pawnbrokers typically charge interest per calendar month from the start of a loan, and monthly interest rates across the industry range from around 5 to 12%. Based on a loan of £100 over six months, this equates to an APR of between 70 and 200% (Collard and Kempson, 2003).

All the evidence suggests that fewer people use pawnbrokers than borrow from a home credit company. In a recent survey of British householders for the Department of Trade and Industry (DTI) around 0.1% of people said that

they, or their partner, had a loan from a pawnbroker (Kempson, 2002). Once again, this is likely to be an underestimate as there is much the same reluctance to admit to pawning as there is to using a home credit company. There are no industry estimates of the number of users of registered pawnbrokers, although the National Pawnbrokers Association estimates that there are around 800 shops in Britain. Extrapolating from research conducted in the US (Johnson and Johnson, 1998) one arrives at an average figure of around 1,000 customers and 4,000 pledges per shop per year. If the level of use in Britain were similar, this would give somewhere in the region of three quarters of a million users per year.

A relatively new product in the cash loans market is **sale and buy back**, offered by companies such as Cash Converters and Cash Generator, which operate through franchises with 100 and 70 stores across the UK respectively. Sale and buy back is not strictly a credit product; customers sell their goods to the company and retain the right to buy them back within an agreed period of time – usually a month. These transactions are not currently covered by the Consumer Credit Act and companies do not have to advertise their APRs. They are, however, often criticised for the large difference between the sale and buy back price (Whyley et al, 2000; Jones, 2002). Unlike most pawnbrokers, cash is offered on a wide range of items, including household and electrical goods, although both Cash Converters and Cash Generator also offer pawnbroking services alongside sale and buy back.

A growing number of cheque cashers, pawnbrokers and home credit companies offer **payday loans**, and there are an estimated 1,500 outlets nationwide. Customers write one or more cheques to the company, which, in return for a fee, agrees not to present the cheque for up to 30 days. The customers receive the amount of the cheque, less the fee. To access this form of credit, customers need to have a bank account with a cheque book and also a regular income going into it – normally from paid employment. Although predominantly used by younger working people to fund discretionary spending, payday loans are also used by some low-income families to make ends meet or in an emergency (Dominy and Kempson, 2003).

Finally, there is anecdotal evidence to suggest that **unlicensed moneylenders** are fairly widespread in low-income neighbourhoods (Kempson and Whyley, 1999a; Whyley et al, 2000; Jones, 2002). It is, however, almost impossible to provide a reliable estimate of the extent of unlicensed lending that takes place. According to one study, there could be over 60,000 people in the UK using organised but unlicensed moneylenders at any one time (Kempson and Whyley, 1999b). Many more would borrow from less organised sources – mainly local people offering very small, very short-term loans. Policis estimates that around half a million people on low incomes in the UK have experience of using unlicensed lenders. As part of its plans to tackle illegal moneylending (see later in this chapter), the DTI intends to carry out research to determine the extent of illegal lending in the UK. The costs of borrowing from an unlicensed lender are incredibly high. Examples include borrowing £20 on Friday and paying back £40 the following Monday. It is also common practice for the organised unlicensed lenders to take people's benefit books as security (Whyley et al, 2000).

Non-commercial cash loans

The biggest non-commercial provider of loans to people on low incomes is the government-run **Social Fund Budgeting Loan scheme**. Budgeting Loans are intended to meet the lump-sum needs that people on Income Support, Income-based Jobseeker's Allowance or Pension Credit may be unable to cover out of their income. Loans are interest-free and deducted at source from benefits. People generally apply to the scheme for essential items such as furniture, beds and bedding, and white goods.

In 2003-04, 1,250,000 Budgeting Loans were awarded. Of these, around a half (51%) were made to one-parent families. Gross expenditure on the scheme was around £484 million; the average award was £384. The demand for Budgeting Loans far outstrips the available resources, and the rate of refusal is high. Around a quarter of applications in 2003-04 were turned down. The main reasons for refusal were either because applicants had not been in receipt of a qualifying benefit for 26 weeks (30% of refusals) or because of outstanding Social Fund debt (54%).

Membership of **credit unions** has grown rapidly in Britain over the past 10 years, albeit from a very low base. Their development has been patchy, with lower levels of provision in England and Wales than in Scotland (or Northern Ireland). As a result, many communities do not have access to a credit union. The latest available figures on credit unions indicate that there are around 700 in Britain with half a million members, spread across employee-based and associational credit unions as well as community-based credit unions[2]. This represents about 1% of the adult population, many of whom will not be on low incomes. A proportion of these members will also be savers rather than borrowers. Credit union interest rates are fixed by law at 1% per month on a reducing balance, equivalent to 12.68% APR. The amount members can borrow is determined by the amount they have in savings; typically this will be in the region of two or three times the amount saved. The value of loans made in 2002 totalled around £220 million, giving an average loan size of around £470. A minority of credit unions have experimented with 'instant access' loans for non-savers.

In addition to credit unions, a new form of **savings and loans scheme**, which is targeted at tenants, has evolved through partnerships between housing associations and building societies or banks. The first of these, New Horizons, was set up by Cambridge Housing Society and Cambridge Building Society. Similar schemes are run in the north east of England, by Darlington Building Society and a group of local housing associations; and in Edinburgh, where Prospect Community Housing Association has established a partnership with HBoS plc. Like credit unions, people can borrow a multiple of their savings, although instant access loans are also offered by some schemes. As these schemes are often regarded as an investment in the local community rather than commercial ventures, the cost of loans is heavily subsidised and interest rates tend to be just 1% above the Bank of England base rate. Loan repayment is underwritten by money deposited with the bank or building society by the housing association. Use of these schemes is fairly modest. One savings and loans scheme, for example, had made 20 loans since 2000; another had made 100 loans in the five years since it opened.

Since the late 1990s, several **community-based loan schemes** have been established, which offer lower-cost personal and business loans without the need to save. These are not-for-profit organisations run in partnership with a commercial bank. Again, they tend to be locally based, serving small geographic areas (Community Development Finance Association, 2004), and include the South Coast Money Line (formerly Portsmouth Area Regeneration Trust), East Lancashire Moneyline, Salford Moneyline and Derbyloans, with other schemes in the process of being set up. The Community Development Finance Association was established in 2002 to promote and strengthen this sector. One such scheme, whose manager was interviewed during the course of this study, had made 1,850 loans in the 32 months since it opened, 90% of which were personal loans, the remainder being related to business start-up or home repair and improvement. On average around 60 to 70 new personal loans are completed each month. The APR for personal loans ranges from around 24 to 31%, depending on the term of the loan and whether the borrower is a new or repeat customer. The average size of loan to new customers is around £400; £700 for repeat customers.

Informal borrowing from **family and friends** is relatively common among people living on low incomes, particularly if they have children (Berthoud and Kempson, 1992; Kempson et al, 1994). The amounts people borrow are small – typically a few pounds to tide them over until payday or until they receive their next benefit payment. This type of borrowing is often reciprocal, particularly among mothers and daughters (Kempson et al, 1994).

In addition, **informal savings and loans schemes** are commonplace in many minority ethnic communities (Herbert and Kempson, 1996; Kempson, 1998). Typically they are based on a group of friends, relatives or work associates who save collectively and take it in turn to have access to the money saved. Similar schemes also exist in some white British communities – in Liverpool, for example, they are known as 'Tonnies' or 'Tontines' (Jones, 2002). These are primarily savings clubs with the money being paid out at an agreed date – often at Christmas. Members can, however, apply for a loan and this sometimes carries interest.

[2] www.fsa.gov.uk/credit_union/cred_stats.pdf

Credit tied to the purchase of goods

Like home credit, **agency mail order** is concentrated among a small number of large firms. The largest by far (with a 71% UK market share) is the merged Littlewoods/GUS business that also runs the Kays catalogue. The two other large companies are Otto, which includes the Freemans and Gratton catalogues; and Redcats, which runs the Empire catalogue. In 2002, around 14 million people in the UK used agency mail order, down from just under 21 million in 1996 (Competition Commission, 2004).

Around one in five (20%) of low-income non-pensioner households use agency mail order, and it is a particularly important source of credit among poor families with children and people unable to work because of long-term ill health or disability (Kempson, 2002). Moreover, it is often the only acceptable form of credit for poor people who are otherwise anti-credit.

Goods bought through mail order catalogues and repaid over 20 or 40 weeks are, technically, interest-free. In practice, their price is often significantly higher than identical items for sale in the high street. If repayments are spread over more than 40 weeks, interest is charged at 28.8% or more (Jones, 2002).

Rental purchase outlets, notably Brighthouse (formerly Crazy George's), have sprung up around Britain in recent years, often in less affluent shopping centres. There are now around 100 Brighthouse stores nationwide. Customers can spread the cost of furniture, white goods and other household items by paying regular instalments to the shop. The attraction for low-income consumers is that, unlike other forms of hire purchase, no credit checks are required. Instead, customers have to provide references, in the form of five people who can vouch for them (see Chapter 2).

Like mail order, goods sold on rental purchase are considerably more expensive than those sold in other high street shops. Moreover, although the APR advertised by Brighthouse is 29.9%, there is evidence to suggest that customers are strongly encouraged to take out 'optional' insurances and service cover, which significantly increase the costs of borrowing (Jones, 2002).

Some of the home credit companies also offer credit linked to the purchase of goods and sell vouchers on credit that can be used in selected stores. The interest rates on these tend to be lower than those on cash loans.

Policy background

Until fairly recently, credit was not perceived to be central to debates on access to financial services. This is because borrowing is often seen as something that exacerbates the problems faced by low-income households, as making repayments reduces their already limited disposable income. But while borrowing money to supplement a low income may not be desirable, it can sometimes be unavoidable – either to buy essential household items or to make ends meet (Kempson and Whyley, 1999b).

In the past few years, however, attention has turned to the high costs of borrowing faced by people living on low incomes. As part of its commitment to tackling the twin problems of financial exclusion and over-indebtedness, the government aims to widen access to affordable credit for low-income borrowers. It has also been under intense pressure to meet its manifesto commitment to tackle the issue of extortionate lending through legislative changes to the 1974 Consumer Credit Act.

Provision of affordable credit

Following the Social Exclusion Unit's report on neighbourhood renewal (Social Exclusion Unit, 1998), the government established 18 Policy Action Teams to look at a wide range of issues around social exclusion. One of these, Policy Action Team 14, examined the scope for widening access to financial services.

Among its recommendations, Policy Action Team 14 called for the development of credit unions in Britain, to provide affordable credit and promote small-scale saving among people on low incomes (HM Treasury, 1999). The government and banks subsequently provided financial support to expand and consolidate the existing credit union network. In July 2002, a new regulatory regime for credit unions was introduced, bringing them under the control of the financial services regulator, the Financial Services Authority (FSA).

Under this regime, credit unions became officially recognised deposit-takers, providing greater consumer protection for credit union members.

The White Paper on consumer credit indicates that the government and the credit union movement have continued to work together to discuss how the sector might be developed further (DTI, 2003).

Policy Action Team 14 also recommended that the Department for Work and Pensions (DWP; then the Department of Social Security) should explore the scope for reforming the discretionary Social Fund. Subsequently, in its 2003 budget the government announced an additional £90 million for the scheme over the three years to 2005-06. Some administrative changes have also been implemented to improve monitoring and ensure that existing resources are directed to those most in need (HM Treasury, 2004a). More recently, the Treasury has announced that from April 2006 the standard repayment level for Budgeting Loans will be reduced from 15 to 12% of the borrower's income, and an end to the complex 'double debt' rule[3] which has confused applicants and limited access to repeat Budgeting Loans in the past (HM Treasury, 2004b, p 47; 2004c, p 64; 2004d, p 27). These measures aside, there have been no substantive changes to the scheme since 1999, despite the recommendations made by several research studies and the (then) Social Security Committee (Whyley et al, 2000; Social Security Committee, 2001; Kempson et al, 2002; Kempson et al, 2004).

Apart from the developments that arose from the recommendations of Policy Action Team 14, a range of other locally based initiatives have been established to provide lower-cost credit. As we noted earlier, these include savings and loans schemes and community-based loan schemes.

[3] All Budgeting Loan applicants have a maximum borrowing level. Those with an existing Budgeting Loan are not able to obtain a new loan until they have repaid half the money they owe. Thereafter, the additional amount they can borrow is the difference between their maximum borrowing level and double the amount they still owe. For example, if the maximum level of borrowing is £700 and an applicant still owes £200 on a current Budgeting Loan of £500, they can take out a new loan of £300 (£700 minus £400, that is £200 × 2).

Despite this progress, many low-income borrowers still do not have a viable alternative to high-cost lenders. In acknowledgement of this, the government reasserted its commitment to promoting access to affordable credit in its 2004 Budget report. Working in partnership with the financial services sector, voluntary organisations and community bodies, it intends to achieve "a significant increase in the availability of affordable credit for those on the lowest incomes" (HM Treasury, 2004a, p 115). This commitment was restated in the Treasury's 2004 Spending Review (HM Treasury, 2004c) and its Child Poverty Review (HM Treasury, 2004b).

> The Government wants to explore mechanisms that allow profitable loans to be made to those on a low income at a much lower rate of interest. The Government therefore intends to work in partnership with the private and voluntary sectors to develop models that make more profitable loans available. Any pilots will be evaluated to ensure that the loans enhance people's ability to manage their finances responsibly. (HM Treasury, 2004c, p 64)

More detailed proposals for increasing access to affordable credit were published in December 2004 as part of the Pre-Budget Report. In particular, the government announced plans to establish a growth fund for not-for-profit lenders to increase the coverage, capacity and sustainability of the sector. Other proposals included mapping the location of credit unions and community-based loan schemes to make sure that financial support for these organisations is appropriately targeted; and a consultation on the costs and benefits of raising the cap on interest that credit unions can charge on loans (HM Treasury, 2004d).

Legislative changes

Alongside these government efforts to increase access to more affordable credit through not-for-profit organisations, significant legislative changes are in the pipeline for commercial consumer credit.

In July 2001, the government launched a wide-ranging review of the 1974 Consumer Credit Act. Among other things, the review aimed to tackle the issue of extortionate lending (DTI, 2003).

Following a lengthy period of deliberation and consultation, the government's plans for reform of the existing consumer credit legislation were outlined in its White Paper, *Fair, clear and competitive*, published in December 2003 (DTI, 2003). This includes steps to create "a more transparent regime so consumers can make better-informed decisions and get a fairer deal" (p 5) and measures to strengthen the credit licensing system. It also sets out proposals to stamp out irresponsible and unfair lending practices.

A number of reforms have already been put in train. These include:

- the mandatory disclosure of specific pre-contract information to consumers before a credit agreement is completed;
- the provision of key financial and other information in a standardised format in consumer credit agreements;
- the introduction of an actuarial formula to calculate the amount of early settlement rebate due to consumers. This replaces the 'rule of 78', which was considered to be unfair to consumers; and
- the form and content of advertisements for credit, such as the key financial information that must be provided and the prominence of the APR.

There are also plans for the provision of better post-contractual information to borrowers, including regular statements of the outstanding amounts owed.

The extortionate credit provisions of the 1974 Consumer Credit Act have been strongly criticised for their ineffectiveness. Few extortionate credit cases have been brought before the courts since the implementation of the Act, and even fewer were proven (Kempson and Whyley, 1999a; DTI, 2003). In the light of this, there has been a concerted campaign for an interest rate ceiling in the UK, such as exists in several European countries and some states of the US. This has been led by Church Action on Poverty through their Debt on Our Doorstep campaign.

In August 2004, however, the government announced that an interest rate ceiling would not be introduced as part of the shake-up of consumer credit law (DTI, 2004a). Research commissioned by the DTI on the effect of interest rate controls in Europe and the US highlighted the danger that poor people would lose rather than gain from such an initiative (Policis, 2004). Instead, the government has chosen to tackle the issue of high-cost credit in other ways. These include legislative changes to broaden the existing 'extortionate credit' provisions to encompass unfair terms and practices as well as the cost of credit (DTI/DWP, 2004).

The White Paper also sets out the government's plans for a cross-departmental strategy to tackle the growing problem of over-indebtedness in the UK. This builds on earlier work carried out by the Taskforce on Over-indebtedness, which was set up by the DTI in October 2000 to look at ways of achieving more responsible lending and borrowing. The policy proposals laid out in the White Paper include a pilot enforcement scheme to tackle illegal moneylenders. The pilot projects, which cover the West Midlands and Scotland, were launched in September 2004.

Finally, the Office of Fair Trading (OFT) announced in June 2004 that it was considering a 'super-complaint' on the home credit industry submitted by the National Consumer Council (NCC)[4]. The super-complaint is based on research carried out by the NCC that suggests that certain features of the home credit sector are having an adverse impact on consumers (Whyley and Brooker, 2004). Following a preliminary review, the OFT concluded that the following features of the home credit market may prevent, restrict or distort competition:

- Many home credit customers are in a poor bargaining position and their financial need may mean that they are not price-sensitive.
- Customers may have difficulty comparing loans and do not appear actively to do so.
- 'Step-up' and 'rollover' loans tend to tie customers in to existing lenders.
- Agents' relationships with customers contribute to making them unlikely to switch lenders.

[4] Under the 2002 Enterprise Act, designated consumer bodies can refer fast-track complaints to the OFT. These super-complaints focus on areas where the complainant suspects there are market structures or practices that are working against the interests of consumers.

- Aspects of the structure of the market may deter entry, particularly on a significant scale (OFT, 2004a).

After a period of consultation with home credit providers, the OFT announced in December 2004 that it had referred the supply of home credit to the Competition Commission for further investigation.

The intense debate around credit and debt in the UK has been mirrored in Europe. Most importantly, a European Directive Proposal on consumer credit from the European Commission was published on 11 September 2002. The underlying aim of the directive was to harmonise the laws, regulations and administrative procedures of the European Union Member States, and this might well lead to significant changes to the credit market, especially moneylending. However, the directive has not passed smoothly through the European Parliament and, at the time of writing, the future and content of the revised directive is uncertain.

Aims and objectives of the research

It is against these policy debates that our research was carried out, with the overall aim of examining the scope for widening access to affordable credit, and assessing the most appropriate and viable ways of ensuring sustainable nationwide provision.

Within this, the study set out to provide:

- a detailed understanding of the features of credit products (including both commercial and non-commercial credit sources) that appeal to and meet the needs of poor people; and conversely those that act as barriers to use;
- an analysis of the constraints on lending to people on low incomes and the key features that can make it a viable proposition;
- an investigation of the scope for reducing the costs of lending and widening access to more affordable credit among poor people; and
- provisional estimates of the scale of demand for affordable credit.

The study focused predominantly on people of working age because credit is used most when people are setting up home and when they have young families, and declines considerably after retirement (Kempson, 2002).

It is important to note that the study was not designed to recommend a 'best buy' among the sources of credit available to poor people. Rather, it is an attempt to look beyond the rhetoric that has dominated much of the debate to see how realistic it is to reduce the costs of lending to people on low incomes who have a high likelihood of default. In doing so, we have looked for ways of reducing the charges made by commercial credit providers and of making the not-for-profit sector more sustainable by reducing the level of subsidy it requires.

Research methods

The research comprised five linked stages:

- a literature review and reanalysis of depth interview scripts;
- focus groups with low-income borrowers of working age;
- a round-table meeting with representatives of trade bodies and government departments;
- interviews with commercial and non-commercial credit providers;
- analysis, carried out by Policis, of a consumer survey of access to and use of consumer credit among people on low incomes.

The research began with a short literature review, followed by the reanalysis of depth interview scripts from five earlier qualitative studies that each looked at use of a wide range of credit sources available to people on low incomes (Kempson et al, 1994; Rowlingson, 1994; Whyley et al, 2000; Kempson et al, 2002; Collard and Kempson, 2003). From this, the main attractions and drawbacks of each type of credit were identified, and the essential features of a credit source for low-income borrowers distilled.

A series of five focus groups were then held with low-income credit users of working age, to explore further the perceived positive and negative attributes of the types of credit they used. Participants were also asked to assess the relative importance of the essential features of a credit source that had been identified in previous studies. Two focus groups comprised people in low-waged work who received Tax Credits; the remaining three consisted of people whose main

income was state benefits (see Appendix A for details).

Telephone interviews were held with a range of credit providers during the course of the research. Among those interviewed were representatives of two high-street banks; three non-commercial credit providers; and three commercial lenders that offer credit to low-income borrowers. The interviews covered a range of topics including: the barriers to lending to people on low incomes; the risks and costs of lending in this market; and the possibility of reducing the costs to the borrower, either commercially or in partnership with other organisations. In addition, interviews were held with a range of other organisations with a direct interest in issues raised by the research – including relevant trade associations and the DWP.

These interviews and focus groups informed the discussion at a round-table meeting, held with representatives from key government departments and trade associations representing both commercial and non-commercial credit providers (see Appendix B for details). The purpose of the round-table meeting was to examine the possible scope for reducing the costs of commercial lending to people on low incomes, as well as the potential for public–private partnerships to offer lower-cost products. A further round of interviews was subsequently carried out, to follow up specific issues that had been raised at the round-table meeting. These included discussions with HM Treasury, the Association for Payment Clearing Services (APACS) and a leading credit reference agency.

This qualitative work was supplemented by quantitative analysis, undertaken on our behalf by Policis, of data derived from a sample of 1,070 nationally representative consumers in the lowest quintile of UK household incomes. Respondents were interviewed face to face in their homes during December 2003.

About this report

The remainder of this report largely draws on the information collected from the focus groups, the round-table meeting, the interviews with credit providers and the quantitative analysis carried out by Policis. The literature review and secondary analysis of depth interviews are written up more extensively in a separate working paper[5].

Chapter 2 looks at borrowing on a low income, starting with a profile of credit use among people on low incomes. Drawing on their experiences of using credit, we then explore what low-income borrowers want from a credit source, and the key features that their 'ideal' source of credit would include.

Chapter 3 switches focus to lending to people on low incomes. This looks at things from the perspective of lenders and covers the distinctive features of lending in a high-risk market and the safeguards needed to contain the level of default.

Chapter 4 brings these two perspectives together, describes the size and nature of the potential market for more affordable credit and explores ways of reducing costs. It also looks at whether competition will deliver more affordable credit, the potential impact of existing policy initiatives and other options for widening access to affordable credit, including changes to the discretionary Social Fund.

[5] The working paper can be downloaded from www.ggy.bris.ac.uk/research/pfrc/index.htm

2

Borrowing on a low income

Over the past two decades, the UK has experienced a credit boom, so that today credit use is the norm rather than the exception. Mirroring developments in the US, the range of credit products and credit providers has increased dramatically. Moreover, in an intensely competitive market, the customer base has expanded to include people who would previously have been excluded because of an impaired credit record or a history of bad debt. This has been made possible by increasingly sophisticated credit screening techniques and the pricing of products to reflect better the risk of lending.

Coupled with record levels of employment and rising incomes, the expansion of the prime and sub-prime credit markets means that more people than ever have the capacity and the opportunity to borrow. For those on the lowest incomes, however, little seems to have changed. People who are either out of work or have low and unstable earned incomes still have relatively few choices open to them when it comes to credit. Their borrowing requirements continue to be largely met by specialist commercial lenders operating at the lower – and more costly – end of the sub-prime credit market.

Profile of credit use by people on low incomes

The Policis survey of people living in the poorest fifth of UK households shows that four types of commercial credit predominated among the sources they had used in the last 12 months: home credit, mail order catalogues, credit cards and other personal loans (such as from a bank or finance house). Use of these sources of credit was eclipsed, however, by borrowing from the Social Fund and from family and friends (Table 2.1).

There were some important differences between the sources used, depending on the financial circumstances of their household. Those with a full-time wage in their household had more often used mainstream credit – credit cards, personal loans and store cards. In contrast, use of home credit was low and hardly anyone had used rental purchase. Borrowing from friends and family was particularly common among this group of householders (Table 2.1).

The pattern of use was quite different among people living in households without a full-time wage – that is, households dependent on state benefits or with only part-time or occasional earnings. Among this group, home-collected credit and mail order catalogues were the sources of commercial credit most often used. Use of rental purchase companies was also mainly concentrated in this group. Even so, 6% had credit cards and 4% had personal loans (Table 2.1). Previous research has indicated that these commitments generally remain from a period of full-time employment (see, for example, Kempson and Whyley, 1999b). But by far the most common source of borrowing was the Social Fund, used by a quarter of these householders in the past 12 months. Compared with households that had a full-time wage, borrowing from friends and family was much less prevalent. As we discuss later, this was probably because their friends and family were in a similar financial position to themselves (Table 2.1).

Table 2.1: Sources of commercial credit used in the last 12 months by people living in the poorest fifth of UK households (%)

	All[a]	On benefits or only part-time or occasional earnings	Full-time earnings
Home credit	6	8	1
Mail order	8	9	5
Credit card	7	6	8
Personal loan (eg bank)	5	4	7
Store card	3	2	6
Car loan	1	1	2
Rental purchase	1	2	[b]
Hire purchase	1	1	2
Payday loan	1	1	1
Pawnbroker	1	[b]	1
Credit union loan	4	5	2
Personal loan from family or friend	13	11	20
Social Fund loan or grant	20	25	2

Notes: [a] All people living in the poorest fifth of UK households; [b] less than 1%.
Source: Policis

The Policis survey analysis also shows that three quarters (75%) of people living in the poorest households say that they have a need to borrow money – at least from time to time. This percentage was the same whether they had a full-time wage or not. At the same time, it was clear that the need to borrow small sums of money was greatest among those without a full-time earner in their household. Faced with the prospect of raising £200 to £300 in the event of a crisis, six in ten (61%) people living in households with no full-time earner said this would be very difficult or impossible without borrowing, compared with less than three in ten (28%) who had a full-time wage coming into the home. Likewise, two thirds (65%) of people in households with no full-time wage said that they would find it very difficult or impossible to save £500 for a special purpose – compared with four in ten (39%) of people in households with full-time earnings.

There were also significant differences in the level of credit impairment between people in households with and without a full-time wage. This was captured in a number of ways in the survey, including adverse credit records (county court judgements; bankruptcy; mortgage possession; or adverse records with credit reference agencies); a history of missed credit payments in the past 12 months (three or more repayments missed; charges for late payment; and demands for immediate repayment in full); and refused credit applications (Table 2.2). In each case the incidence was a good deal higher among people who did not have a full-time wage coming into their household.

Taken together, this analysis suggests that the need for more affordable credit is greatest among people who live in households without a full-time wage – those living on social security benefits, or who have only part-time or

Table 2.2: Degree of credit impairment among people living in the poorest fifth of UK households (%)

	All[a]	On benefits or only part-time or occasional earnings	Full-time earnings
Adverse credit records	24	26	16
History of missed payment	24	26	17
Refused credit application	26	27	19

Note: [a] All people living in the poorest fifth of UK households.
Source: Policis

occasional earnings. This was borne out by the focus groups. The main sources of credit used by participants who were not in work were home credit, mail order and the Social Fund Budgeting Loan scheme. In contrast, those who were in low-paid employment clearly had wider access to credit and several talked about having overdrafts, store cards and credit cards (albeit from sub-prime lenders).

Previous research has likewise found that users of high-cost credit tend to be people living on low incomes over the long term; who are likely to rent their home; and who have dependent children living at home. A significant number of them borrow to make ends meet or to pay bills as a result of ongoing income inadequacy. But a high proportion also borrow from high-cost lenders to pay for Christmas and birthdays, and to buy branded clothes and consumer electronics for their children, to prevent them being stigmatised at school (Kempson et al, 1994; Kempson, 1996; Kempson and Whyley, 1999a; Whyley and Brooker, 2004).

Advantages and disadvantages of different types of credit

The secondary analysis of depth interviews and the review of existing literature provide an insight into the main attractions and drawbacks of the different types of credit used by low-income borrowers.

There were a number of aspects of **home credit** that customers appreciated. It was a familiar source of credit that was straightforward to access. It offered small cash loans that could be repaid weekly in cash. Payments were collected from customers' homes, which was not only convenient but also reduced the chances of default. And lenders were willing to reschedule loans should a borrower be unable to meet the repayments.

The downside of using home credit was its high cost, relative to other sources of credit; the encouragement of further borrowing by some agents; the practice of refinancing or 'rollover' loans; the obligation to pay felt by some borrowers because of their friendly relationship with the agent; the perceived stigma of home collection; and the fact that the collection of payments seemed to have become less reliable, as agents sometimes did not turn up when they were supposed to. These factors deterred some people from using home credit at all. But home credit customers commented on these drawbacks as well.

Pawnbroking also offered a quick and easy way of obtaining cash loans, without the need for lengthy application forms or credit checks. It offered some flexibility in relation to repayment, as a loan can be paid back in full at any time within the six-month contract, without any additional charge for early settlement. Alternatively, it can be renewed for a further six months upon payment of the interest accrued to date. The key drawback was that many people living on a low income simply had nothing of value that they could pledge. Among those who did, the high cost of borrowing, the low loan-to-value rate, not being able to repay the loan in instalments, the risk of losing one's valuables, and the problems of losing a pawn receipt were all cited as drawbacks of using a pawnbroker.

Like pawnbroking, the attraction of **sale and buy back** for low-income consumers was that it offered a ready source of cash. In addition, sale and buy back shops generally accepted a wider range of items than a pawnbroker. People who had borrowed money in this way felt that the main drawbacks were the low loan-to-value rate typically offered by shops and the relatively short period of time they had to buy back their goods before they were sold. The cost of buying property back was another disadvantage. Finally, unlike pawnbroking, sale and buy back is not a credit agreement and therefore customers are not covered by the Consumer Credit Act.

Payday loans offered easy access to credit to people with a cheque guarantee card and regular income. Indeed, users often contrasted this with the difficulty they encountered trying to increase the credit limit on their overdraft or credit card. Payday loans were seen as cheaper than exceeding the credit limits on a credit card or overdraft without authorisation, and the charges were known in advance. Some people also felt that they provided more control over spending than these forms of running account credit.

Set against these attractions were the high costs of payday loans. In addition, some people disliked the very thing that had attracted them in

the first place – namely the ease of access. They felt that it was too easy to get into a situation where they regularly borrowed at the end of each month or their cheques were constantly extended or where they kept deferring repayment of the loan through lack of money.

People invariably considered borrowing from an **unlicensed lender** to be the very last resort for someone who desperately needed cash. The fact that a request for a loan was hardly ever turned down was its only attraction. The cost of borrowing in this way was incredibly high and it was common practice for lenders to take people's benefit books as security. In addition, there was evidence of some organised lenders using intimidation and physical violence if debtors were late with their repayments or had difficulty repaying what they owed.

The main advantage of **Social Fund Budgeting Loans** is that they are interest-free. For Muslims, this means that they comply with the teaching of Islam, which forbids the use of interest-bearing financial products. In addition, since changes to the scheme in 1999, the application form is relatively straightforward to complete and decisions are made fairly promptly about whether or not a loan will be awarded. Users liked the fact that loan repayments are deducted directly from benefits as this minimised the risk of falling into arrears.

The scheme has a number of important limitations, however. It is only available to people who have been in receipt of Income Support or Income-based Jobseeker's Allowance for at least 26 weeks. Use of Budgeting Loans is also limited by lack of knowledge among eligible benefit recipients, as well as lack of understanding about the rules governing the scheme and how decisions are reached.

Moreover, because the scheme is cash-limited, applying for a Budgeting Loan is something of a lottery and a significant proportion of applications are turned down. Even if an award is made, applicants often do not receive the full amount of money they requested. Finally, many users of the scheme were critical of the high repayment rates set for Budgeting Loans.

Credit unions provide access to credit for people who would not be able to borrow from a high-street lender; they are low cost; and the unions are willing to reschedule repayments if a borrower encounters financial difficulties. Other attractions include affordable payments, the friendliness of credit unions and the fact that they are local.

At present, however, many people on low incomes do not have a credit union in their vicinity. The link between saving and borrowing was also perceived as a drawback both by non-members and by members who had low incomes. First, it deterred some people from joining a credit union, as they either could not commit to saving regularly, or they believed that they would be unable to save *enough* money to be able to borrow the sort of sums they normally needed. Second, new members generally have to establish a savings record in the credit union before they can apply for a loan. This was a real difficulty for some people and especially those on the lowest incomes. Third, and the most commonly mentioned drawback among credit union members on low incomes, was that the regularity of their saving was taken into account when they applied for a loan. Some credit unions have experimented with instant access loans backed by loan guarantee funds but the availability of these remains limited. Loan guarantee schemes also have to be carefully and rigorously managed if they are to be effective (Jones, 2003). Another drawback to the link between savings and loans is that members generally have limited access to their savings while a loan is being repaid.

Credit unions' reliance on volunteers can also be a disadvantage. Some people were deterred from joining a credit union because of a perceived lack of confidentiality; others by a fear that volunteers would not be capable of running a professional organisation, especially if there were few or no paid staff. And while some members saw the friendliness of their local credit union as an attraction, others felt that their local credit union was run by a clique that only served a selected group of people.

Borrowing from friends and family was generally interest-free and not subject to a rigid repayment schedule. It could, however, put a strain on relationships. More importantly, people on low incomes often did not know anyone who could lend them anything more than a few pounds.

Informal savings and loans schemes also provide loans that are interest-free and have been set up in Muslim communities because they comply with Islamic teaching. But they were not without their drawbacks. First, there was the risk that people who received the collective savings early on ceased to save once they had got the money. Second, the set level of weekly saving was sometimes beyond the means of people on low incomes.

On the whole, **agency mail order** was the most acceptable of the sources of commercial credit available to people on low incomes. Indeed, it was often the only source that people used – especially among pensioners and people from some minority ethnic communities.

The main advantage of mail order catalogues from the user's point of view was the ability to spread the costs of goods they needed to buy but could not otherwise afford. They also offered a convenient way of shopping for people who found it difficult to get to a shopping centre. People valued knowing exactly how much they would pay for the goods they bought and that the money was repaid in set amounts over a fixed period of time. If they could sign up as an agent in their own right people did so, for the commission they could earn. At the same time, mail order catalogues were accessible to people who might otherwise find it difficult to get access to lower-cost credit as they could be used through a third party.

Buying goods through mail order was perceived to have fewer disadvantages than other sources of credit that are available to people on low incomes. People who chose not to use mail order catalogues did so for several reasons, including fear of overcommitment; the extra costs incurred by defaulting on repayments; and the fact that price mark-ups on mail order goods made them more expensive than buying on the high street. A key drawback is the fact that this form of credit is linked to the purchase of goods, yet people on low incomes often need cash loans for things not available in catalogues.

As well as allowing customers to spread the cost of buying 'lumpy' goods, **rental purchase shops** such as Brighthouse do not carry out any credit checks. All customers have to do is provide the name, address and telephone number of five people who can confirm that they know the customer and verify their address.

Despite the appeal of rental purchase, for most people the disadvantages far outweighed the advantages. The fact that goods bought on rental purchase can be repossessed if payments are missed was the chief drawback from the customer's point of view. Some people also commented on the stringent debt recovery policies. Another disadvantage was cost. Goods sold on rental purchase are a good deal more expensive than those sold in other high-street shops. In addition, although attracted by the advertised APR of 29.9%, customers were strongly encouraged to take out the 'optional' insurances and service cover that increased the total cost even more. For example, it has been calculated that a fridge freezer that could be bought in cash for around £350 would cost over £850 from Brighthouse if the customer paid for it in instalments and took out the optional insurance covers (Jones, 2002).

What do people on low incomes want from a credit source?

In many ways, the focus groups confirm what we already know about the features that are important to low-income borrowers when using credit. Over and above this, however, they give an indication of the relative importance of these different elements.

First and foremost, people on low incomes want to be able to access credit quickly and easily, without lengthy or intrusive application procedures. Linked to this, they want to be fairly sure before they apply that they have a good chance of obtaining the money they need.

Affordable repayments are generally more important to low-income borrowers than the total cost of credit. In addition, a suitable repayment method helps minimise the risk of default. Low-income credit users also value lenders that recognise the difficulty of maintaining regular payments on a low income and so make no additional charges for late or missed loan payments.

Charges for the early settlement of loans were not a key consideration for the focus group

participants when they took out credit. Nor, they said, was the company providing the credit.

Access

Without exception, people on low incomes value the ability to access credit quickly and easily. Among focus group participants, this was one of their highest priorities. Ease of access was a particular advantage of commercial credit sources such as home credit, pawnbroking, sale and buy back, and rental purchase. Invariably, the application process for these forms of credit was described as straightforward and fast, with no lengthy forms to complete or extensive credit checks to be carried out.

> "You can ask [the home credit company] for a loan on the Friday and they'll be out here by the Monday … and they'll give it to you that day, it's convenient."

Indeed, one focus group participant, an existing home credit customer, described how she simply phoned up her local agent when she wanted to take out a loan. In contrast, others said they had been deterred from applying to local not-for-profit loan schemes because of the more complex application procedures.

While low-income borrowers do not think that credit is a right or that it should be given without consideration to their ability to repay, they want to know *in advance* whether or not an application is likely to be successful. This means that the access criteria need to be simple and transparent – the Social Fund in particular was criticised for its complex rules regarding the sums of money that can be applied for and how decisions are made. Changes to simplify these rules have recently been announced (HM Treasury, 2004c).

People also dislike intrusive questioning about their need for a loan. They accept that they need to demonstrate their ability to meet the repayments on a loan. What they dislike is having to justify their wish to borrow for a particular purpose (as used to be the case with the Social Fund) or making their case to a committee of local people (as happens for larger loans from many credit unions).

Providing security for loans, such as savings or goods, can help to reduce the costs of borrowing. But, as discussed earlier, it can also constrain access to lower-cost credit.

Transparency of cost

Like low-income borrowers in previous studies, focus group participants were well aware that they paid high charges for borrowing small sums of money or buying goods on credit. Few users of home credit can quote the APR they are being charged, but they generally know the total amount of money that they have to repay on their loans. The same is not necessarily true of all forms of credit.

APRs are a very poor way of comparing the cost of different loan products at this end of the credit market. First, there are some factors that increase the cost of borrowing but are not reflected in the APR, such as price mark-ups on goods offered for sale on credit, and the sale of insurance policies to people who lack home contents insurance to cover the goods sold on rental purchase. As a consequence, obtaining credit through mail order and rental purchase can look a great deal cheaper than it is. Second, although sale and buy back is similar to pawnbroking, it is not covered by the Consumer Credit Act and no APR needs to be quoted. Third, some lenders levy default charges if payments are missed; others, such as home credit companies, reschedule payments at no extra cost, but build this into the total charge for credit, which has to be reflected in the APR.

As a consequence, although people were aware that costs were high, they found it difficult to say which sources of credit were the most expensive and they wanted the total cost to be fixed and transparent. This meant no hidden charges that emerged only after they had signed (or committed themselves to signing) the credit agreement. While this is a distinct selling point of home credit loans, rental purchase has been heavily criticised for the lack of transparency in its charges. As discussed earlier, people are attracted by the advertised low interest rates, but then find that high price mark-ups and optional extras (such as insurance and warranties) raise the price significantly. Default charges, levied soon after the payment date, added even more to the cost.

Level of repayments

On the whole, the level of repayment and whether or not it was affordable were more important considerations than the total cost of credit or the APR. In other words, people were looking for weekly repayments and amounts that they could easily accommodate in their household budget.

Although Social Fund Budgeting Loans are interest-free, the high levels of repayment attract vociferous criticism from users of the scheme (see also Kempson et al, 1994; Whyley et al, 2000; Barton, 2002; Jones, 2002; Kempson et al, 2002). It has recently been announced that the standard level of repayment for Budgeting Loans will be reduced from 15 to 12% of benefit income (HM Treasury, 2004c). Even so, this still leaves the level of repayment a good deal higher than other sources of credit. In the light of this, focus group participants commented favourably on the fact that, if two Budgeting Loans are taken out in succession, the existing loan has to be repaid in full first before any repayments are taken for the second.

Some focus group participants said they would like to be involved in setting the level of repayments they made to credit providers. Credit unions have been particularly praised for the way that borrowers are encouraged to discuss what they can realistically afford to pay with a loan officer before the amount and term of the loan are agreed (Whyley et al, 2000).

The frequency of payment is another important consideration for people living on a low income. Weekly rather than monthly payments fit in with the period over which they tend to budget. The weekly payment period also suits people (typically benefit recipients) whose income is received on a weekly or fortnightly basis. Home credit customers felt they would struggle if they had to make larger monthly repayments.

> "Because I'm paid weekly it would work out difficult for me because I'd have to put my money away each week … it would be hell, you know. It's alright if you're paid monthly isn't it? But if you're not it would be a bit of a bugbear."

Indeed, the quantitative analysis carried out by Policis for this study indicates that seven in ten low-income home credit users would find it harder to manage their repayments if they were unable to pay weekly. In keeping with this, a key drawback identified by pawnbroking customers was the need to settle the loan in full at the end of the term. Many would have preferred to make regular weekly repayments.

Finally, there is the fact that people like set payments that do not vary over the credit term. So, sources of credit that do not levy separate default charges (for example home credit, credit unions and the Social Fund) were much preferred. This is discussed further later in this chapter.

Repayment method

For low-income borrowers, it is imperative that the method of repaying credit fits in with their strategy for money management, so that they can maintain financial control. Indeed, having an appropriate method of payment was one of the top priorities for the focus group participants.

Home collection has traditionally been popular among low-income borrowers, partly because it is convenient, but more importantly because it minimises the risk of falling behind with payments (see Rowlingson, 1994; Jones, 2002; Whyley and Brooker, 2004). Quantitative analysis carried out by Policis showed that around two thirds (66%) of low-income home credit users said they would find it difficult to keep up their payments without home collection.

However, the home credit customers (past and present) who took part in the focus groups were more ambivalent about home collection. Some found it embarrassing, even degrading, to have an agent call at their door. Others had found home collection increasingly unreliable – they disliked having to wait at home for the agent and ran the temptation of spending the money they had put aside.

> "If they don't come when they say they are coming you end up spending the money."

Home collection also deterred some people from using this form of credit because they associated it with being in financial difficulty and having a debt collection agency visit their home every week to collect arrears payments.

Quantitative analysis of the poorest 20% of households carried out by Policis found that around half (49%) would prefer to use direct debits to make repayments on their household and credit commitments. Only 15% said they would prefer to have payments collected from their home. Home collection was, however, much more popular among home credit customers and those who were credit-impaired. Even so, a quarter (25%) of home credit customers favoured paying by direct debit.

Previous research has shown that, like others, people on low incomes appreciate the convenience of direct debit payments. Indeed, if their incomes were higher, this is how many of them would choose to pay their household bills and other commitments. However, in their current circumstances, they feared incurring hefty bank charges if they did not have enough money in their account at the time the direct debit payment was claimed. With little money to spare, this was a risk they were not prepared to take (Kempson and Whyley, 1999b; Collard, 2002).

These views were reflected among the focus group participants. Most of them said they would prefer to have credit repayments deducted directly from their income rather than collected from their home, particularly if it brought down the cost of borrowing. While some did not rule out the use of direct debits to make repayments, it was much less popular than direct deduction from income. This was largely based on their experience of having Budgeting Loan repayments deducted from their benefit income before they received it. Above all, participants valued the fact that they 'knew where they were' with direct deductions and could not fall behind with payments, at least while they remained on benefits. This echoes the findings from earlier research on the Social Fund (Whyley et al, 2000; Jones, 2002).

Handling of financial difficulties

Life on a low income is a financial balancing act, especially for people of working age. As a consequence, people who live on low incomes for long periods of time almost inevitably find it difficult to make ends meet from time to time.

In recognition of this, commercial and non-commercial creditors who lend in this market generally build in a degree of flexibility to the repayment schedule. Home credit companies, for example, typically expect a 26-week loan to be paid over 30 weeks. Credit unions and community-based loan schemes are also willing to reschedule loans if the borrower falls into financial difficulty. These creditors do not generally levy extra charges for this. The cost of providing flexibility is instead reflected in the total cost of credit.

Focus group participants valued this flexible approach. Like other low-income borrowers, they wanted to spread the charges for default over the period of the loan, rather than face additional charges at a time when, by definition, they were least able to pay.

In contrast, rental purchase companies (and most mainstream lenders too) can have high additional charges for missed payments. This tends to exacerbate an already difficult situation for the borrower. And, while Social Fund Budgeting Loans can be rescheduled, this fact is not widely publicised and few people are aware of the possibility (see Whyley et al, 2000; Kempson et al, 2002).

Credit provider

Previous research on overcoming financial exclusion has found that people want to deal with reputable companies that understand the difficulties of managing on a low income (Kempson and Whyley, 1999a; Collard et al, 2001).

As a consequence, low-income borrowers tend to stick with the 'tried and tested'. They rely heavily on personal recommendations from family and friends when it comes to choosing a lender (Rowlingson, 1994; Whyley and Brooker, 2004) and are wary of creditors they have not used before.

In addition, many long-term users of home credit companies and pawnbrokers value the relationships they build up with staff (Kempson et al, 1994; Rowlingson, 1994; Jones, 2002; Collard and Kempson, 2003). Again, this makes them unwilling to switch lender, even if it means saving money (Whyley and Brooker, 2004).

In fact, this reluctance to switch supplier is true of consumers across almost all financial products. Research for the DTI showed that people were much less likely to switch financial service provider than they were to change to another utility company (DTI, 2000). Moreover, resistance to switching is highest among people on low incomes who fear a disruption to their household budget.

In the light of this, it was surprising that the focus group participants generally agreed that they would switch lender to get a better deal on a loan. It is clear, however, that socialisation, personal recommendation and familiarity are significant factors in people's use (and continued use) of sub-prime lenders. In reality, therefore, it seems likely that among the poorest credit users the level of switching would be comparatively low (at least initially) and particularly to new entrants to the credit market.

The image and perception of credit providers among low-income borrowers have particular implications for the penetration of non-commercial lenders into the sub-prime credit market. It has long been recognised, for example, that shop-front premises are vital to raising public awareness, and use, of credit unions and community-based loan schemes.

Public confidence in non-commercial lenders also needs to be fostered. Credit unions in particular have been criticised for not always being run as professionally as they might be (Rowlingson, 1994; Kempson and Jones, 2000; Whyley et al, 2000; Jones, 2002). The credit union movement is working hard to address this, for example, by encouraging the employment of paid staff and the use of standard financial monitoring systems. In addition, the regulation of credit unions by the Financial Services Authority (FSA) means better protection for members nationwide.

3

Lending to people on low incomes

Lending to people on low incomes differs from mainstream (or prime) lending in a number of key respects. First, there is a higher risk of default as their circumstances are much more likely to change. Second, people on low incomes want (and often need) to make weekly repayments in cash. Both these factors increase the costs of lending. Third, the amounts they want to borrow tend to be relatively small and for short periods of time. As the costs of lending are largely fixed, this means that the charges for borrowing are high in relation to the amounts borrowed. This explains why charges among commercial sub-prime lenders are high; why not-for-profit lenders with lower charges require subsidies; and why mainstream lenders are reluctant to enter this particular market.

In this chapter we look in detail at these distinctive aspects of lending to people on low incomes, as well as giving an overview of recent changes in this particular credit market.

Small loans for short periods

The costs of setting up a loan do not vary proportionately to the size of the loan and, as a result, are high relative to the amounts that people on low incomes need to borrow. Lenders (both commercial and not-for-profit) we interviewed indicated that the cost of setting up a loan for a new customer varies from £30 to £75 depending on the extent to which there is a reliance on face-to-face screening and whether this is done in the home or in an office. Yet the typical amount for a first-time loan tends to be between £100 and £200. Consequently, most lenders in this market seek to establish a long-term relationship with customers as set-up costs are not generally recovered on the first loan. Even on repeat loans, the margins tend to be small, as the amounts borrowed average between £200 and £300. In contrast, mainstream lenders aim to recoup set-up costs on each loan and, therefore, have minimum loan sizes of at least £1,000. This is considerably more money than people on low incomes usually want or need to borrow.

The size of the loan is also important in the context of the costs of both the collection of payments and managing default. This is discussed next.

Weekly cash payments

As we have seen, the great majority of people on low incomes budget by the week and most would choose to make credit repayments weekly as well. Most currently repay in cash – often collected at the doorstep. Even so, as we have seen, many say they would be attracted to payments being deducted directly from their income, in the way that Social Fund loans are repaid. Use of monthly direct debits, however, can be problematic for those who have to stretch their incomes to cover their outgoings.

The experience of collecting payments by direct debit has been more favourable for some lenders than for others. One not-for-profit lender collects all repayments by direct debit but offers customers the choice of doing so either weekly or monthly. In practice, most customers choose to pay weekly and many need help with opening a bank account to facilitate the payments.

Some of the commercial lenders accept monthly direct debit payments from customers provided that they do not default. However, they retain the

option of weekly home-collected payments (with a higher APR) for those who struggle to pay monthly. Indeed, one of them commented that, in their opinion, there will always be a market for weekly home-collected payments.

Other commercial lenders have experimented with monthly direct debit payments for home collection customers with higher incomes and good payment histories. These initiatives were short-lived, as default rates increased, and customers were moved back to weekly home collection. It is not clear whether this was because the payments had been switched from weekly to monthly or because they were no longer 'managed' by the lender.

The experience of the not-for-profit lender that collects repayments by weekly direct debit suggests that weekly payments do reduce the likelihood of default. Even so, safeguards have been put in place by this lender in case borrowers do not have sufficient funds in their account to cover the direct debit payment. If a borrower knows they will not have the money in their account to cover the payment, they are told to phone the organisation in advance and the payment is either not claimed that week or a smaller payment is taken. Although this system incurs extra costs for the lender, no extra charge is made to the customer.

In other words, there are two important cost factors here: frequency and method of payment. Clearly, it costs more to collect 52 weekly payments on a 12-month loan than 12 monthly payments. The cost is higher still if payments are collected in cash rather than by direct debit, particularly if this is done in the customer's home. Again, these costs need to be seen in relation to the relatively small sums of money being borrowed. Indeed, one lender indicated that up to half of the cost of an average loan is directly attributable to running a network of agents who collect weekly repayments (that is, the cost of the agents' pay plus the costs of the other management and staff structures involved).

Managing the risk of default

The risk of default on credit commitments increases as income decreases, partly because people on low incomes experience a higher degree of income instability than those who are better off. Reanalysis of data from the DTI survey of over-indebtedness shows that about a quarter (23%) of households with gross annual incomes of under £10,000 who used credit had fallen behind with the repayments. This compares with only one in twenty (5%) of those with incomes of more than £35,000 (Kempson, 2002). As a consequence, all the lenders we interviewed stressed the need to manage the risk of default by people on low incomes. This had implications for the recruitment of customers, the assessment of risk and the management of loan repayments.

Customer recruitment

The lenders we interviewed have found that word-of-mouth recommendation brings the most reliable customers. New lenders in the low-income credit market find it takes time to build a customer base. They have to rely on advertising rather than personal recommendation and therefore need to screen applicants rigorously. Even so, they often have to accept high default rates in the early years. Before it restructured its business, it is reported that one new entrant to the home credit market experienced bad debt charges that at times amounted to more than a third of its loan book (Datamonitor, 2004).

Risk assessment

Mainstream credit providers generally base their lending decisions on automated risk assessment techniques, notably credit scoring. As a result, most people on low incomes find it difficult to borrow from mainstream lenders, even though these lenders seldom base their decisions on an applicant's income. In practice, people are excluded on the basis of a range of other factors, such as housing tenure and employment status, which effectively act as a proxy for income in most credit scorecards.

Commercial companies that lend to low-income consumers make far less use of these automated risk assessments. Instead, they rely heavily on the face-to-face assessment of potential customers and the use of small initial 'trial-run' or 'step-up' loans. Moreover, they lend to people known to have a higher risk of default by seeking to manage, and so control, that risk.

Risk assessment in the mainstream credit market

Most mainstream lenders use automated credit scoring systems to help them decide whether or not to lend to a potential borrower. These assess the risk of an applicant defaulting on their credit commitments by applying mathematical modelling techniques. Application scorecards are based on the past payment records of other borrowers with similar personal and economic circumstances. Subsequent credit applications may be assessed using behavioural scoring systems, which are based on the applicant's own past payment record with the lender. The credit scoring system allocates points for each piece of relevant information and adds these up to produce a score. Depending on the score, the lender may or may not agree an application for credit.

Mainstream lenders often supplement credit scoring with information held by the credit reference agencies. These agencies hold details of financial and publicly available information, including who is on the electoral roll; court judgements and bankruptcies; information on the performance of credit agreements (particularly adverse performance); and the number of credit enquiries made by an individual[6]. Data on the performance of credit agreements is provided on a voluntary basis by lenders, but by lodging this information they can then access details of any similar credit performance information held by the credit reference agency[7]. There are three credit reference agencies that cover the UK – Experian, Equifax and Callcredit – of which Experian is the largest.

Risk assessment in the low-income credit market

In contrast to the automated systems used by mainstream lenders, those who specialise in meeting the needs of people on low incomes rely heavily on face-to-face screening of new customers. Often this is done in the customer's home. This screening is designed to assess both the capacity for and the commitment to repaying a loan. Unlike remote lenders, those that screen customers face to face potentially have access to much more information about the personal and economic circumstances of applicants (and changes in those circumstances) on which they can base their lending decisions. This provides a check on an applicant's ability to repay, as experience has shown that many applicants present their finances in the best possible light in order to maximise their chances of obtaining a loan. It also enables them to identify more easily people who have a low level of commitment to repaying any money they owe. Rejection rates at this stage are fairly high – between 40 and 60% – even among some not-for-profit lenders.

Commercial lenders will usually only make small loans (between £50 and £100) to a new customer in the first instance. In addition, they often monitor a new customer's ability to maintain payments very closely for the first 10-15 weeks, recording not only how many payments are missed but how many times an agent had to call before successfully collecting the repayment. Indeed, lenders find that this is by far the best way of assessing risk. Both face-to-face screening and monitoring loan repayments add to the cost of lending.

Once a new customer has proved their ability to repay a loan, they can borrow increasing sums of money in subsequent step-up loans. The application and monitoring procedures for repeat loans are generally less rigorous as well, because lenders have found that a borrower's past payment record is the best predictor of future default. Borrowers may, for example, be able to apply for a further loan over the telephone without a repeat of the checks that were originally carried out.

On the whole, the lenders that took part in this study felt that in-house automated credit scoring systems would not be economically viable in the low-income credit market, not least because they are expensive to set up and maintain. That said, some lenders (both commercial and not-for-profit) have been exploring this possibility. One of the commercial lenders we interviewed has developed an in-house behavioural scoring system, not to screen potential customers out but rather to assess the profitability of lending to them, given their likelihood of falling into arrears. A not-for-profit microfinance institution in the US has developed a scorecard to facilitate the identification of people to whom they would certainly consider lending and those who they should definitely decline, enabling them to

[6] www.bba.org.uk

[7] If creditors only lodge default information themselves, they cannot access non-default information lodged by others.

concentrate the more intensive face-to-face screening on those in the middle. Finally, a small number of credit unions have started using the ALERT credit scoring system developed by the Association of British Credit Unions Limited (ABCUL), the main trade body of the credit union movement in Britain.

Moreover, there is evidence to suggest that credit reference agency data is not particularly predictive of borrower behaviour in the low-income credit market. At around £1.50 per search, lenders also argue that it is uneconomic to use this data for low-value loans. As a result, some commercial and not-for-profit lenders are highly resistant to its use. Other lenders do, however, use both these methods of screening – but often in conjunction with face-to-face interviews. Mail order catalogue companies use credit reference agency data, as do a number of home credit companies, including more than 50 smaller lenders[8]. In addition, around a dozen credit unions now lodge and access data held by one of the large credit reference agencies at a preferential rate, negotiated by ABCUL.

Much of the information required by lenders about the credit payment histories of potential low-income borrowers is not currently placed with credit reference agencies. Consequently, there is a danger of a vicious circle developing, where the credit reference information is considered inadequate, so it is not used by some of the key lenders at the lower end of the sub-prime market, which therefore have no incentive to lodge information themselves. There are signs that the information held about people on low incomes is improving. One of the large credit reference agencies now holds both default and non-default information for all mail order and mobile phone companies, as well as many television rental, satellite television and cable companies. A major gas supplier also shares information in this way and, as noted earlier in this chapter, some credit unions have started to lodge data about their members.

There is a real risk, however, that the increased use of application credit scoring and credit reference agency data in the low-income credit market will exacerbate credit exclusion among the poorest households. As companies become better able to ascertain relative customer profitability, they will increasingly move away from lending to less profitable customers – the poorest, the highest risk and the most vulnerable. This is discussed further in Chapter 4.

Risk management

Credit providers that specialise in lending to people on low incomes are notable for the way that they manage the risk of default. Unlike mainstream lenders, they draw a distinction between people who are unlikely to repay a loan in full and those who may, for genuine reasons, struggle from time to time to meet a repayment. The latter is a fact of life for people on low incomes and these sub-prime lenders have processes that accommodate this.

First, they aim to set repayments that they know are affordable for their customers. This is assessed at the same time as the decision about whether or not to lend, and most lenders would argue that this can only be done face to face for people on the lowest incomes.

Second, as we noted earlier in this chapter, many lenders closely monitor the repayments of new customers for the first 10-15 weeks. They also tend to offer very small loans initially, increasing the amount once a customer has a track record of reliable repayment. This is very similar to the 'stepped loans' offered by not-for-profit microfinance lenders to more risky microbusinesses. Credit unions and savings and loans schemes achieve the same end by requiring their members to establish a regular pattern of saving before they can take out a loan.

Third, many lenders in this market 'manage' the repayments of their customers, rather than relying solely on the customer to make payments on time. Traditionally, this has meant home collection, with an agent visiting the customer to collect the money owed. The largest home credit company has around 12,000 agents supported by a network of 300 branches. But home service is much more than a means of collecting payments. Rather, it is central to the way these companies operate, providing a method of assessing potential and repeat customers, selling products and chasing arrears. Without doubt, maintaining a network of agents is the largest single cost

[8] These home credit companies generally only lodge information about credit accounts that have been passed for debt recovery.

incurred by home credit companies, as indicated earlier in this chapter.

In contrast, the Social Fund is able to 'manage' payments by deducting them directly from people's benefit income, so that loan repayments are entirely outside the control of the borrower. Also, as discussed earlier in this chapter, one not-for-profit lender has developed procedures for minimising the level of default among borrowers paying by weekly direct debit.

Fourth, many lenders who provide credit to people on low incomes are prepared to reschedule loans for those who face genuine difficulties. The lenders we interviewed indicated that at any one time between 30 and 40% of customers are late with (or have missed) their payments. Unlike mainstream lenders, they do not view this as default and do not usually levy additional charges for late payment. Even so, the cost does have to be covered – either in the form of higher charges or as subsidies in the case of many low-cost not-for-profit lenders. Accommodating these missed payments can greatly extend the term of a loan and the costs of administering it. Figures from three lenders indicate that they extend the average length of a loan by about 20%. Several lenders said that the propensity of customers to take 'payment holidays' has increased over the past 10 years and this has added to their costs. At least one lender had experimented with payment protection insurance as an alternative to rescheduling loans. But this had added to the complexity of their agreements and, in any case, did not cover general fluctuations in ability to pay, only loss of income through ill health or unemployment.

Finally, some lenders minimise risk of default by requiring collateral for loans, in the form of savings (credit unions and other savings and loans schemes) or valuables (pawnbrokers). As we noted in Chapter 2, this limits access for many poor people – although it undoubtedly enables others to benefit from the lower charges usually associated with such secured loans.

Changes in the commercial sub-prime credit market

Recent years have seen a growth in the sub-prime credit market, with loan and credit card companies targeting people on low but steady incomes from employment – including people with impaired credit histories.

Payday loans, for example, are generally only available to full-time workers and require a bank account and usually a cheque guarantee card as well. The quantitative analysis carried out by Policis found that only 14% of people living in the poorest fifth of UK households had a cheque guarantee card, although this was higher among those with a full-time wage than it was among those without one. Overall, only 5% of them were both in full-time employment and had a cheque guarantee card.

Similarly, sub-prime credit cards and personal loans from new entrants to the sub-prime market are also largely aimed at people in steady work who have a poor credit history. Like payday loans, sub-prime credit cards are in their infancy in the UK, but the scope for further market penetration is considerable (Datamonitor, 2004). Most of the new entrants that offer sub-prime personal loans (with the exception of payday lenders) have a minimum loan size that exceeds the amount that people on low incomes generally want to borrow. The sub-prime markets for car loans and secured loans for debt consolidation are the most developed.

There was evidence both from the focus groups and the interviews with lenders that these new players are attracting some of the better-off home credit and mail order customers. Survey data provided by Policis also indicates that around a third of all home credit customers in the UK now have credit cards, some of which will be from sub-prime card issuers. This was supported by the focus groups we held. The loss of more profitable customers to these new entrants has undoubtedly contributed to the decline of the agency mail order and home credit markets in the UK.

In response to these changes, some of the home credit companies have been moving away from their traditional market of small loans collected on the doorstep. One of the companies we

interviewed estimated that, over the past 10 years, home credit has fallen from about 80% to under 20% of its total business. The remainder of its business is derived from larger loans, including car loans, which are repaid by monthly direct debit.

Similarly, another lender has decided to focus on lending to people in employment, as they usually want larger loans and are able to repay them by monthly direct debit. They also offer secured loans for home improvements. They estimate that about half of the money they collect in repayments is paid by direct debit; the rest is collected at the customer's home. Even so, three quarters of their customers still have repayments collected – reflecting the smaller amounts borrowed by home collection customers. Because they tend to be better off, customers paying on direct debit have default rates that are half those found among people paying through home collection. Customers who cannot manage direct debits may move onto home collection.

When companies diversify in this way, they often develop risk- and cost-based pricing structures. So, for example, customers wanting to borrow £1,000 or more, who also make the loan repayments by monthly direct debit, pay the lowest interest rates. APRs on loans to these customers can be as low as 19.9% if the loan has been set up through a call centre. At the other extreme, a customer with a £500 loan who has the payments collected from their home might pay 80-90% APR. Traditionally, home credit companies have had a high degree of cross subsidy between customers, with the poorest borrowers being the beneficiaries. Further moves towards cost-reflective pricing can only increase the charges that poor people have to pay in the commercial market.

Another home credit company has experimented with a sub-prime credit card that is designed to win back customers they may have lost to new entrants to the sub-prime market. Like the loans offered by this company (and unlike other credit cards), there are no additional charges if a customer goes over the credit limit or misses a minimum payment. These are included in the overall charge for credit and are reflected in an APR that is higher than other credit cards, including those in the sub-prime market. The company is also piloting a stored value card for people who are reluctant to use a conventional credit card but prefer structured repayments collected from their home.

A further consequence of the increasingly competitive nature of the sub-prime market has been a reduction in the number of traditional providers, and greater concentration of business in a small number of companies. The recent merger of GUS and Littlewoods under March UK Limited has reduced the number of companies running agency mail order catalogues from four to three, and left the newly merged company with 71% of the total UK agency catalogue market. Although investigated by the Competition Commission, the merger was allowed to go ahead because of the expansion in credit provision generally (Competition Commission, 2004)[9]. The merger has, undoubtedly, restricted choice for the poorest of mail order catalogue users who do not have access to this wider market.

Similar changes have taken place in the home credit market, with evidence of market consolidation towards the four largest companies (Datamonitor, 2004). As mentioned in Chapter 1, in its preliminary review of the home credit market following the National Consumer Council's super-complaint, the OFT found that competition among home credit lenders seemed to be restricted. Consequently, it decided to consult on a market investigation reference to the Competition Commission (OFT, 2004a).

In other words, it is clear that widening access to credit is continuing to benefit the majority, but at the expense of choice among those on the lowest and least stable incomes. It is these people – who either have no earned income at all or at best sporadic or part-time earnings – who constitute the major market for more affordable credit. We explore this further in the following chapter.

[9] In addition, the two parties told the Competition Commission that "had the sale not occurred, GUS would have wound down its home shopping and home delivery businesses" (Competition Commission, 2004, p 34).

4

Widening access to affordable credit

A number of points are clear from the earlier analysis. First, in the credit market high risk means high cost, which translates either into high charges for the customer or high subsidies. Second, the highest costs are incurred in the provision of credit to people on the lowest incomes, partly because these borrowers represent a high risk and partly because the fixed costs of lending are high relative to the typical loan size. Third, the need for affordable credit is greatest among those who are not in steady full-time employment. These are the people who often need to borrow for day-to-day needs and essential household goods. They cannot gain access to the cheaper end of the sub-prime credit market, let alone borrow from mainstream lenders. And they are least able to save regularly in order to borrow from a credit union or other savings and loans schemes.

In this final chapter we look at the numbers of people who might benefit from more affordable credit and the sums of money involved, and summarise the key features of the type of affordable credit that is needed. We then assess whether competition can deliver what is needed and the potential impact of existing policy initiatives. We conclude with some proposals for making affordable credit available to people on low incomes through commercial lenders; through not-for-profit organisations, such as credit unions and community-based loan schemes; and, finally, through changes to the Social Fund.

The extent of need for affordable credit

To explore the extent of potential need for more affordable credit we have looked at the borrowing behaviour of two groups of working-age people[10]. Our more liberal estimate is based on the 6.2 million people aged between 18 and 64 who live in the poorest 20% (quintile) of UK households and could not meet modest additional expenditure without borrowing; our conservative estimate looks at the 3.3 million people living in these households, who lack ready access to the mainstream credit market in the form of an overdraft or credit card.

Looking first at our **liberal estimate**, around 6.7 million adults (aged 18-64) live in households with incomes in the lowest income quintile. The great majority of these (6.2 million) have little leeway in their budget, saying that they need to borrow at least occasionally, would find it difficult or impossible to raise £200-£300 in an emergency without borrowing or would find it difficult or impossible to save £500 for a special purpose. Not all of them had actually needed to use commercial credit – an estimated 1.8 million had done so in the previous year (including mail order) and their commercial borrowing totalled £1.9 billion.

Much of this borrowing was from mainstream lenders, with around 800,000 people borrowing £1.1 billion from mainstream sources in the form

[10] This analysis was undertaken by analysts at Policis. The analysis focused on people of working age, as they tend to make the heaviest use of credit (see Chapter 1). If people aged 65 and over were included in the analysis, the estimates would clearly be higher.

Table 4.1: Overview of liberal and conservative estimates of borrowing among people on low incomes in the UK

	Liberal estimate (6.2m)	Conservative estimate (3.3m)
Borrowed commercially in past year (including mail order):		
Number of people	1.8m	1m
Total amount borrowed	£1.9bn	£0.75bn
Borrowed from mainstream lender in past year:		
Number of people	0.8m	0.25m
Total amount borrowed	£1.1bn	£0.38bn
Borrowed from high-cost lender in past year:		
Number of people	1.1m	0.75m
Total amount borrowed	£0.8bn	£0.37bn
Of which:		
Borrowed from home credit company		
Number of people	0.5m	0.4m
Total amount borrowed	£0.29bn	£0.2bn
Borrowed from mail order catalogue		
Number of people	0.5m	0.25m
Total amount borrowed	£0.42bn	£0.17bn

of personal loans, hire-purchase finance and credit and store cards. The rest was from high-cost lenders[11], with 1.1 million people together borrowing £0.8 billion. The main sources of high-cost credit they had used were:

- home credit companies, from which 500,000 people on low incomes had borrowed £0.29 billion; and
- mail order catalogues, with 500,000 people on low incomes borrowing £0.42 billion.

Some of these people on low incomes (and people in full-time work in particular) had fairly ready access to mainstream credit in the form of an overdraft or credit card; others were opposed to borrowing money except from family and friends. In our more **conservative estimate** of need we make allowance for these two groups, and also tighten our definition to those who would find it *very* difficult or impossible either to raise £200-£300 in an emergency or to save £500 for a special purpose.

Using this conservative definition, 3.3 million people have a need (and are willing) to borrow but do not have ready access to credit from mainstream lenders. The great majority of them (2.8 million) live in households with either no earned income at all or their only earnings are from occasional or part-time employment. In other words they are, as the focus groups confirmed, disproportionately drawn from people in workless households. About a third of them (1.1 million) are also credit-impaired, would almost certainly find it difficult to access credit and arguably ought not to be borrowing commercially at all. They include people with a history of bad debt, who have a county court judgement, have set up an Individual Voluntary Arrangement with their creditors, have been made bankrupt or had a home repossessed or say that they have a serious adverse credit rating with the credit reference agencies. Almost all of the people who are credit impaired (1 million) do not have an income from full-time employment coming into their home.

Among those with no ready access to mainstream credit, the most common source of borrowing in the past year was the Social Fund, used by 1.27 million people. In addition, around 1 million of them had borrowed from commercial lenders (including mail order companies), to the tune of £0.75 billion. Not surprisingly, the majority of these credit transactions involved borrowing from high-cost lenders (750,000 people borrowing a total of £0.37 billion). Again, the

[11] This includes home credit loans, shopping vouchers, goods bought on rental purchase, payday loans, loans from a pawnbroker or goods bought on credit from a mail order company.

main sources of high-cost credit used were home credit (400,000 people borrowing a total of £0.2 billion) and mail order catalogues (250,000 people taking on credit totalling £0.17 billion). And, even though they had no ready access to mainstream credit in the form of an overdraft or credit card, 250,000 people had borrowed £0.38 billion from mainstream providers in the past year.

Returning to our more ***liberal estimate***, people on low incomes borrowed around £0.29 billion from home credit companies in 2003. A broad estimate of the interest and other charges payable on these loans is around £0.15 billion[12]. In addition, they borrowed a further £0.42 billion to buy goods from mail order catalogues. Price mark-ups vary according to the items bought from mail order catalogues, but we estimate that these might amount to between £0.05 and £0.1 billion[13]. In other words, people living in low-income households paid between £0.2 billion and £0.25 billion extra for their credit in 2003. About half of this cost was borne by people with no leeway in their budget and very constrained access to credit.

Pulling this information together, we see that up to 6.2 million people aged 16-64 on low incomes could not meet fairly modest expenditure without having to borrow, and in the course of a year 1.8 million of them had borrowed money commercially. A significant number of these borrowers (1 million) were people with very constrained access to credit, so that 750,000 had needed to use a high-cost lender.

These estimates are, however, likely to understate the potential demand for more affordable credit, for three reasons. First, they do not include people who have a need to borrow but because of changes in the market find it increasingly difficult to access credit, even from high-cost lenders. Second, more people may be attracted to use credit if it became more affordable. This could include, for example, people who currently only borrow from their friends or family. Third, the estimates do not include pensioners, although levels of borrowing among older people tend to be much lower than among the working-age population.

The type of credit needed

The main need we have identified is for small fixed-term cash loans, without the requirement of security in the form of savings or valuables. People on low incomes want affordable weekly payments with no hidden or extra charges. They like automatic payments, but are wary of direct debits as they carry the risk of high bank charges should they fail. The certainty of direct deduction from benefit is much preferred and many users of home credit like having repayments collected from their home for the same reason. They also welcome the facility to reschedule loans should they encounter temporary financial problems. In other words, potential borrowers want to reduce the likelihood of defaulting, but their requirements inevitably add to the costs of borrowing, whether these are passed on to them or met by subsidies.

The key to lending to people on low incomes is managing the risk of default in the most cost-effective way. This means careful recruitment, minimising the risk of non-payment, and repeat loans to defray set-up costs. Most lenders recognise the need to accept weekly payments and either retain an element of control over the repayments or accept security to underwrite them. The most common method of repayment is home collection; while direct debits are cheaper, they can result in higher levels of default among those on low or unstable incomes. There is a general acceptance that the majority of borrowers need to reschedule their loans from time to time and many lenders in this market do not levy additional charges for doing so.

That said, none of the existing sources of credit fully meets the needs identified by people on low incomes themselves. Home credit comes close to doing so, but the charges are high and some people are deterred by home collection. The Social Fund, likewise, meets many of the needs, but repayment levels tend to be high. The possibility of rescheduling Social Fund loans is not well known and, in any case, is not entirely straightforward. Community-based loan schemes have the potential to meet the need, but access is restricted and repayment methods do not always

[12] See information on charges by home credit companies in Jones (2002).

[13] See information on mail order catalogue mark-ups in Kempson and Whyley (1999a).

meet people's desire for ones that reduce the likelihood of default.

Will competition deliver more affordable credit?

As we have seen, competition is delivering cheaper credit to people in steady full-time, low-waged employment. This raises the possibility that, given time, competition will deliver affordable credit for all. There are, however, good reasons to doubt that it will.

Two trends are discernable in the sub-prime commercial market. The first of these is the move towards risk-based pricing, including among some home credit companies. As a consequence, people with steady, if low-waged, employment can now access cheaper credit provided they can manage to make monthly repayments by direct debit. In contrast, all the home credit companies we interviewed indicated that there is a group of people they could only serve through the much more costly means of weekly home collection. Concerns about lack of competition in the home credit market have resulted in the OFT's decision to consult on whether a referral to the Competition Commission is required.

The second trend is for new types of lending, such as rental purchase, to have low APRs but hidden additional costs. Taking these costs into account, it becomes clear that the total charge for credit is no lower than other sources such as home credit – indeed it can actually be more expensive.

Lenders in the not-for-profit sector offer small loans and interest rates that are a good deal lower than those in the commercial market. But they have yet to offer any real competition to the commercial lenders. The credit union movement has grown appreciably in recent years but, like the commercial market, the bulk of that growth has not been among people on the lowest incomes.

Greater transparency

A number of government initiatives have been designed to increase transparency and provide greater information to consumers in order to stimulate competition. These include the OFT's programme of work on consumer education and the FSA's national strategy to raise levels of financial capability. In addition, regulations laid down as part of the review of consumer credit legislation cover the form and content of advertisements for credit (including the prominence of the APR), the mandatory disclosure of specific pre-contract information and the provision of key financial and other information in a standardised format in consumer credit agreements (see Chapter 1).

Welcome though these developments are, they are unlikely to stimulate greater competition in the credit market serving people on low incomes. First, as we noted in Chapter 2, APRs are a very poor way of comparing the cost of credit at this end of the market, largely because lenders differ markedly in the way that they structure their charges. As a consequence, buying goods on rental purchase at 29.9% APR can work out more expensive than taking a loan at 200% APR from a home credit company to buy the goods from a high street retailer. This is analogous to the situation with credit cards, where variations in the structure of charges mean that a card with a low APR may be more expensive than one with a higher APR (Treasury Committee, 2003). The solution adopted in that market has been the use of summary boxes on all pre-contract and promotional literature, which bring together the key terms and conditions of the card so that consumers can compare one with another. A similar approach might also be appropriate for credit providers generally, and particularly those that concentrate at the bottom end of the market. In this case, the summary box might usefully include:

- total cost of credit of typical loans of typical durations;
- APRs of typical loans of typical durations;
- costs not included in the APR, such as insurance policies that may be required to access a loan – again related to typical loans of typical durations;
- warnings of possible price mark-ups;
- default charges and when they are levied;
- restrictions on access, such as full-time employment, possession of a cheque book, and the need for savings or other forms of security.

There would also be value in bringing this information together in comparative tables, in the way that the FSA currently does for other products. While much of this information could be collected at a national level, it would need to be adapted at a local level by adding information about not-for-profit lenders. This might help to highlight the low-cost credit available in the not-for-profit sector but its potential for opening up competition from this sector is debatable. First, there is the patchy geographical coverage of not-for-profit lenders. Second, their growth will be restricted by constraints on access to capital. Third, given current levels of subsidy, any serious attempt at stimulating competition from not-for-profit lenders would almost certainly raise issues of state aid and anti-competitive behaviour. These points are discussed more fully later in this chapter.

Data sharing

Another option for widening access to credit has been proposed by the DTI's Taskforce on Over-indebtedness, among others. This is for the greater sharing of data by creditors through the credit reference agencies, so that it includes people who currently find it hard to demonstrate their ability to pay. Many of the lenders who took part in this research felt that credit reference data is not sufficiently predictive to justify the cost associated with its use. The quality of the data about low-income consumers has, however, improved greatly in recent years. As a consequence, all mail order companies and about a dozen credit unions now lodge and use the full credit reference data (that is, non-default as well as default information) to inform their lending decisions. Some have even negotiated lower fees for small loans, although cost remains an important deterrent for others who specialise in low-value loans. The quality and comprehensiveness of the data would be greatly enhanced if other lenders lodged default and non-default information with the agencies. Most notably, this would apply to the large home credit companies and to the Social Fund, although in both cases the situation is not entirely straightforward.

As well as the obvious benefit to other lenders, the DWP could benefit by having access to details about the totality of a Social Fund applicant's borrowing, to inform both the decision to lend at all and the level of repayments. There are, however, concerns that lodging Social Fund information could breach data protection legislation, but these may be unfounded. Although the credit reference records of individuals include details of each credit commitment they have, the source of these loans is anonymised. Only the data subject can access information about the sources of borrowing; lenders only know which loan they have supplied.

With home credit companies, the problem lies in the definition of default, since most loans are rescheduled a number of times. If each rescheduling were lodged as default, this might have the effect of restricting access to other forms of credit, rather than widening it. To get around this difficulty, the home credit companies that use credit reference agency data only lodge information on accounts that have been passed for debt recovery.

New initiatives have been developed in the US to capture non-traditional measures of willingness to pay. These enable people with minimal or no credit histories to substitute a history of rent, utility, phone, insurance or health care payments for traditional measures of creditworthiness (Belsky and Calder, 2004). At least one of the UK credit reference agencies has investigated this approach and concluded that it is better (and potentially more reliable) to adopt a more direct way of obtaining the same information, allowing people to consent to their 'creditor' passing details of their payment history to the credit reference agencies. It could then be shared in the same way as other data. There are, however, restrictions on water and electricity companies sharing information, except where they supply 'out of area'. Likewise, there are restrictions on credit reference agencies holding data for rent and Council Tax, because their databases can only hold and share credit data. They would need to set up a separate database for this information and have a reciprocity agreement to permit linkage to the credit reference data. There is a precedent for this, which allows business and personal credit data to be used reciprocally.

An alternative approach would be for consumers to be given a 'portable credit history' by their creditors, either on request or on completion of an agreement. This would provide consumers with a full history of the repayments they had

made on that agreement. Making the provision of credit histories mandatory, however, would increase the cost of lending and could exacerbate the problems of financial exclusion for people with poor repayment histories.

Like the issue of transparency, greater data sharing might help but will not solve the problem of access to affordable credit. Indeed, there is a real danger that the increased use of credit reference agency data will exclude more people from the credit market, as credit providers use the information to 'cherry-pick' their customers. Moreover, if it became mandatory for credit providers to lodge credit reference agency data, the charge for credit to the customer would be likely to increase significantly. Such a move would have a particular impact on small lenders who, unlike large mainstream lenders, lack the bargaining power to negotiate price reductions from the credit reference agencies. This in turn could have the effect of distorting competition.

Lending practices in the home credit industry

In addition to the issues of transparency and data sharing, the OFT has highlighted a number of other lending practices in the home credit industry that they consider could "prevent, restrict or distort competition" (OFT, 2004a, p 1). These include the use of step-up loans that, as we have seen, are widely used as a method of assessing and managing risk in the low-income credit market. This practice may impede switching between credit providers as someone switching to a new lender may only be able to borrow small sums of money until they have built up a credit history. It could, however, be resolved through greater data sharing or the use of portable credit histories as discussed in the previous section.

Another concern raised by the OFT relates to refinancing or 'rollover' loans that tie customers to their existing credit provider. This practice has given rise to widespread criticism, not least from customers themselves. As we discussed in Chapter 3, lenders in the low-income credit market are unable to recoup the set-up costs on small loans in the short-term and therefore seek to build up a long-term relationship with customers. But not all of them do so through refinancing and it is difficult to justify the continued use of this practice.

As mentioned earlier (page 7), following a period of consultation, the OFT referred the supply of home credit to the Competition Commission for further investigation in December 2004.

The potential impact of existing policy initiatives

A number of other policy initiatives may have an impact on the availability of more affordable credit, most notably the changes to the extortionate credit legislation outlined in the consumer credit White Paper; the regulation of credit unions by the FSA from 2002; and recent changes to the Social Fund.

Extortionate credit

The people most likely to end up with extortionate credit bargains are those who have the highest risk of default, including people living on very low incomes and people with a history of bad debt or county court judgements (Kempson and Whyley, 1999a).

As discussed in Chapter 1, a ceiling on interest rates has been heavily promoted in the UK as a means of tackling extortionate credit. On the surface, this is a simple and attractive idea that ought to benefit people on the lowest incomes. This research has shown, however, that there are high costs associated with lending to people on low incomes who have a high risk of default. An interest rate ceiling could do nothing to reduce these costs. Instead, the APR would be reduced by displacing these costs elsewhere, for example in the form of charges for default – the last thing that low-income borrowers would want. It is also likely that more credit would become tied to the purchase of goods and consumers would be faced with high price mark-ups as retailers seek to recover the costs of supplying credit. Both of these would result in the total costs of borrowing being less transparent. Finally, there is a danger that lenders would move out of this market altogether, leaving poor people even more prey to unlicensed lenders.

Alongside research commissioned by the DTI on the impact of interest rate ceilings in other countries (Policis, 2004), this provides further support for the government's decision not to

introduce an interest rate ceiling as part of its review of the Consumer Credit Act.

The government White Paper on the reform of the Consumer Credit Act includes proposals to widen the current definition of an extortionate credit bargain to include unfair terms and practices as well as the cost of credit. Unfair practices could include the lender misleading or coercing the borrower by using pressurised selling techniques or the use of aggressive debt collection. In assessing whether costs are fair or not, the level of default interest, charges and costs will be taken into account as well as the original cost of credit. In addition, unfair credit transactions will be handled by a new alternative dispute resolution system operated by the Financial Ombudsman Service, a move designed to make it easier for individual consumers to seek redress (DTI, 2004b)[14]. These proposals were included in the Consumer Credit Bill which was introduced in the House of Commons in December 2004.

Together, these reforms should produce a more effective means of tackling extortionate credit and exposing unfair costs and practices. If cases against lenders are upheld, they may be forced to revise their costs, terms and conditions. Borrowers would then benefit from lower costs and a more transparent market. Alternatively, lenders who are found to be engaged in extortionate credit practices may move out of the market altogether, along with others who fear the risk to their reputation that a challenge would bring. This may have a disproportionate impact on small lenders and, as a result, could introduce significant competitive distortions, particularly in local credit markets.

In addition to its reform of the extortionate credit legislation, as mentioned earlier the government has launched a pilot enforcement scheme to deal with cases of illegal moneylending, with the aim that more cases will be brought to court (see page 7). As the extent of unlicensed lending in the UK is not accurately known, it is difficult to assess the impact that this will have on low-income borrowers. While a clampdown on illegal lending will help the most vulnerable borrowers, it will not increase the availability of more affordable credit, and may put greater pressure on the Social Fund for those who are eligible to use it.

[14] The Financial Ombudsman Service will not, however, deal with price issues (that is, interest rates or APRs), as these are considered to be part of the commercial judgement of the lender.

Regulation of credit unions

From July 2002, credit unions in Britain have come under the regulation of the FSA. As a result, the financial requirements for credit unions are more rigorous, as are the standards for key staff running credit unions. In addition, credit union members now enjoy greater consumer protection should their credit union become insolvent or if they have an unresolved complaint against their credit union.

As well as providing greater protection for members, the aim of bringing credit unions under a tighter regulatory regime was to enable the credit union movement to strengthen and expand. There have, however, been casualties. Some smaller credit unions have closed, while others are expected to merge (Datamonitor, 2004). Consequently, the number of registered credit unions fell from 686 in 2002 to 665 in 2003.

The Social Fund

For those who are eligible, the Social Fund Budgeting Loan scheme is an important source of borrowing. As discussed in Chapter 1, the government has allocated an additional £90 million to the discretionary Social Fund budget as a whole[15] over the three years to 2005/06. The first instalment of £20 million was made in 2003/04, divided equally between loans and Community Care Grants. During the year a further £20 million was added to the loans budget, funded by an increase in loan recoveries and an underspend carried forward from the Social Fund account of previous years. Together this brought the total gross loans budget for 2003/04 to £578 million; and the Community Care Grant budget to £118 million. Analysis carried out for this study by Policis indicates that, although it will help increase access to the Social Fund, the additional £90 million still falls short of

[15] As well as Budgeting Loans, the discretionary Social Fund comprises Crisis Loans and Community Care Grants.

the amount that is needed. This is discussed in more detail later in this chapter.

Other recent changes to the Social Fund Budgeting Loan scheme that have been announced include a reduction in the standard repayment level from 15 to 12% of income, making loans slightly more affordable, and the end of the 'double debt' rule, which has been a source of confusion for users of the scheme (see Chapter 1). Administrative changes have also been implemented to try and ensure that resources are targeted at those who have the greatest needs. These changes will undoubtedly make a difference to users of the Social Fund. To make the Social Fund more comparable with other sources of credit, however, repayment levels would need to be reduced further, to between 5 and 10% of income.

Other options for widening access to affordable credit

Customer loyalty and resistance to switching among low-income borrowers make the development of a completely new credit product impractical. A more effective approach is to build on the providers that already exist: the home credit companies and other sub-prime lenders; credit unions and other not-for-profit loan schemes; and the Social Fund. We did not, however, set out to identify the 'best buy' among the sources of credit potentially available to people on low incomes. Instead, we have tried to identify the potential for widening access to more affordable credit through reducing the cost of commercial credit, increasing the availability and sustainability of not-for-profit lenders and extending access to the Social Fund.

Reducing the cost of commercial credit

Finding a way of reducing the costs of lending in a high-risk market should lead to lower charges for borrowers. It could also widen access by encouraging firms back into this market that have curtailed their lending to low-income borrowers. Of all the options this would, potentially, have the largest impact given the heavy reliance on high-cost commercial credit by people on low incomes.

The round-table meeting focused on the scope for reducing the cost of credit, without increasing the risk of default. Three main areas of possible cost reduction were discussed:

- set-up costs, including administrative costs of recruitment and setting up the loan, and screening applicants;
- costs of administering repayments; and
- other costs associated with managing risk.

This discussion showed that the scope for reducing costs is limited and lies mainly in minimising the costs of managing risk, through the frequency and method of payment collection:

- moving to monthly rather than weekly repayments; and
- using automated payments rather than collecting the money in person.

The scope for moving to monthly payments seems to be limited. People on benefits usually receive their income weekly or fortnightly; only a very small proportion are paid monthly. Consequently, most people on low incomes choose to budget by the week and, as we saw in Chapter 3, given the choice they would repay their credit commitments the same way. Some lenders have found that monthly payments can greatly increase the risk of default among people on the very lowest incomes.

There is, however, some scope for moving to automated payments, but it would mean putting safeguards in place to minimise the risk of default. Two options were discussed in interviews and at the round table: direct deduction of loan repayments from benefit income and direct debits.

Direct deduction of repayments from benefit is very popular among people who borrow from the Social Fund. At the present time, in addition to Social Fund loans, payments can also be deducted at source for fines, rent arrears, current utility consumption and utility arrears. There is a limit on the total sum that can be deducted (25% of income) and an order of priority for creditors.

Adding other loan providers to the list of creditors able to access direct deductions seems an attractive proposition. Closer examination has, however, identified a number of potential problems. The present systems could not cope

with a large increase in the number of direct deductions, and substantial investment would be required to accommodate such an increase. There would, in any case, be problems collecting payments when people move off benefit – indeed the DWP is now experimenting with the use of debt collection agencies to recover money owed to it, including money owed to the Social Fund. Finally, there may well be political opposition to a government agency collecting payments for commercial credit companies. Even if a fee was charged, the government might be accused of encouraging borrowing among people who could least afford it. Notwithstanding these difficulties, it is a possibility that might usefully be explored further.

The other option is to collect loan repayments by **direct debit**. There are two potential difficulties with this. First, many people who pay the most for credit lack a bank account offering direct debit facilities. Without Universal Banking, widening access to cheaper credit in this way could deepen the effects of financial exclusion. Although the move to paying benefits and pensions directly into bank accounts was designed to increase engagement with banking, the introduction of the Post Office Card Account has reduced its impact. This account has very limited facilities – operating more like a stored value card than a bank account. So it does not offer direct debit facilities nor is it likely to do so in the immediate future. Second, experience shows that there is a much higher incidence of failed direct debits among people on low incomes.

As we have already seen, one not-for-profit lender requires all loans to be repaid by direct debit, with some success. Their approach differs from previous experiments with direct debits by commercial providers in two key respects. First, customers can pay weekly if they wish and, second, there is a procedure for dealing with direct debits that customers know are going to fail.

From the outset, it is made clear to people who borrow from this lender that they must ensure that there are adequate funds in their account to cover the direct debit or they will face high bank charges. If a borrower anticipates that they will have insufficient money in their account to cover the direct debit, they are told to contact the lender four working days before the direct debit is activated. Arrangements are then made either to reschedule the loan or for the money to be paid the following week. Only a minority of borrowers (around 2% each month) phone to say they either cannot afford to pay at all or that they cannot afford to pay the full amount. It should be noted that this lender declines six in ten loan applications, but, even so, the rescheduling rate is not high.

If a borrower develops a pattern of missed direct debits, they will be asked to come in and discuss ways of rescheduling the loan. If this fails, then steps are taken to recover the money owed through debt collection agencies or, if necessary, through the courts. As this lender has only been operating for just under three years, with a current loan book of around 800 customers, it is too early to say how successful this approach will be. At present, it seems to be working without major problems or too much additional cost, but it relies heavily on borrowers acting promptly and responsibly.

An alternative is to remove the risk of default at source. We explored, with APACS[16], the possibility of direct debit payments being triggered by the receipt of wages or benefits into a bank or building society account, so as to mimic direct deduction at source. At present, customers must nominate a day for payments to be debited and most people give themselves some leeway from the receipt of their income. The problem of failed direct debits therefore relates partly to the unreliability of direct credits to accounts and partly to people leaving insufficient income in their account to cover the direct debit. It is exacerbated by the time taken to clear payments into the account, and at least one of the main high street banks has increased the clearing time for cheques paid into its basic bank accounts from four to six days. Paying direct debits as soon as direct credits have cleared would help tackle these problems.

It would seem that the bank automated clearing system (BACS) cannot link direct credits and debits in the way that we envisage without substantial further investment. BACS members are already committed to implementing a major programme to upgrade the system to cope with

[16] APACS operates the clearing system for all electronic payments such as direct debits and standing orders.

future demands and achieve faster clearing times. It would be unreasonable to expect them to invest further in a system that was designed solely to benefit lenders and borrowers in the low-income credit market. However, the system we envisage could deliver benefits to other BACS members, including the banks and building societies that own it. The benefits would, of course, have to be offset against lost revenue from the charges for failed direct debits.

It is clear from our interviews that some commercial companies would consider moving back to providing loans to people who are not in steady full-time work if loan repayments could be collected either through direct deduction or a more certain method of direct debit. Credit unions and other not-for-profit lenders would also be attracted to these methods of collecting payments as they would reduce their costs and make financial sustainability more attainable.

One commercial lender, which currently operates a policy of cost-reflective pricing, estimated that repayments deducted at source could reduce charges for a £500 loan to an APR of about 40%. The not-for-profit lender described on page 33 also estimated that their loans would be fully sustainable at an APR of 40%. Both figures allow for face-to-face screening of customers to determine whether to lend at all and also to set a realistic repayment level. At an APR of 40%, high-risk customers without steady employment could borrow at rates that are similar to other sub-prime customers.

We therefore feel that the government should discuss further the practicalities of adapting the BACS system with BACS Payment Schemes Limited. In its Pre-Budget Report in December 2004, the government announced that it was considering arrangements whereby commercial and not-for-profit lenders could, in certain circumstances, apply for repayments to be made by deduction from benefit where normal repayment arrangements have broken down (HM Treasury, 2004d). We feel, however, that it should also explore the possibility of making direct deductions from benefit where repayment arrangements with creditors have not broken down.

Beyond the ideas for automated credit repayments, no other suggestions were made for reducing the costs of risk management. There was little support for loan guarantees among the round-table participants or the credit providers who were interviewed. There is also only limited scope for cutting the set-up costs associated with loans. The round-table discussion focused on the possibility of using automated credit checks through credit reference agency searches and credit scoring, as used in the prime market. It was clear that these could only be used as an adjunct to face-to-face screening – which just about all lenders (commercial and not-for-profit) saw as an integral part of lending in a high-risk market (see Chapter 3). Not only does face-to-face contact minimise the risk of default but both commercial and not-for-profit companies have found it essential to building a relationship and ensuring repeat use – which is essential when set-up costs have to be spread across more than one loan. At best, automated screening could be used to identify the people at the extremes that would either certainly be offered a loan or would definitely be turned down. The more expensive face-to-face screening could then be undertaken only for people where the lending decision is not clear-cut. The cost savings of greater use of more extensive external data would, therefore, not be large.

Widening access to not-for-profit lenders

Despite recent expansion in the not-for-profit sector, we are still a long way from having a national, coordinated and sustainable network of lenders that meets the needs of people on the lowest incomes. The main challenge for not-for-profit lenders is to reach a size where they can achieve economies of scale, including the provision of centralised back office and accounting facilities. The suggestions for reducing cost in the commercial sector, discussed earlier in this section, could also minimise the level of subsidy required by not-for-profit lenders. This would both increase their likelihood of sustainability and ensure more rapid growth of this sector.

The move towards larger, more professionally run **credit unions** with shop-front premises will, in the longer term, benefit existing members and may attract new members. In partnership with one of the high-street banks, ABCUL has piloted the use of PEARLS, a monitoring system that provides financial ratios and a business planning tool for credit unions. Initial results from the pilot

have been encouraging, with participating credit unions showing increased membership numbers and a higher volume of savings along with a decreased reliance on grant funding. ABCUL has also promoted the merger of employee-based and community credit unions in order to provide better access for people living or working within the common bond of the credit union, and to achieve economies of scale (Brown et al, 2003).

ABCUL has always asserted that the function of credit unions is to serve all communities, not just poor communities. In contrast, **community development credit unions**, which originated in the US, are targeted specifically at low-income households. Among supporters, they are seen as a means of tackling financial exclusion by widening access to credit and other financial services (Brown et al, 2003).

Community development credit unions are still in their infancy in Britain. South East Birmingham Community Credit Union, the first community development credit union in Britain, was launched in 2002. It resulted from the merger of three credit unions, and operates from shop-front premises. The Birmingham Credit Union Development Agency (BCUDA) provides back office administration and account servicing for it and all other community credit unions in Birmingham.

Despite these positive developments, credit unions will continue to have only limited appeal for people on very low incomes as long as savings remain the basis for securing a loan. Some credit unions have experimented with instant access loans, which require no pre-saving and are secured by a loan guarantee fund. As discussed earlier, recent research indicates that loan guarantee funds require close management, which many credit unions are not currently in a position to provide (Jones, 2003). Other credit unions have made changes to their lending policies to make it easier for members to access loans, as part of the PEARLS pilot project.

A further hurdle for credit unions is the fixed APR of 12.68%. Even given the fact that loans are generally underwritten by members' savings, credit unions that want to become more financially self-sufficient, and have paid staff, will be unable to do so while charging this rate of interest. They would certainly not be able to provide instant access loans without heavy subsidy. Understandably, the idea of credit unions charging a higher rate of interest is a contentious one, and any change would require secondary legislation. However, if credit unions (indeed community-based loan schemes generally) are to compete seriously with commercial lenders, they will have to do so from a position of financial sustainability.

The newer **community-based loan schemes** that have been established in several areas of the country do not require borrowers to save before they take out a loan. Their loan capital is provided through partnerships with banks and they are free to set their own rates of interest. The organisation interviewed for this study charged in the region of 24 to 31% APR depending on the term of the loan and whether or not the applicant was a new or existing customer – rates that attracted criticism from some quarters. To be completely self-financing, however, they calculated that an APR of around 40% was required. This depended on borrowers being able to repay their loans by direct debit.

The challenge for these schemes is again one of scale. One expert on community finance estimates that they can only be viable if they serve a population of between 250,000 and 500,000 people. This suggests that, at the very least, services have to be provided on a subregional basis.

One way for not-for-profit lenders to achieve this type of scale while retaining a presence in poor communities may be through partnership arrangements. BCUDA has recently developed the Birmingham Community Banking Partnership, supported financially by one of the high-street banks. The aim of the partnership is to bring together the best practices of credit unions and community-based loan schemes in order to deliver affordable financial services to the poorest households, including savings facilities, credit and budgeting advice (*Regeneration and Renewal*, 2004).

Alternatively, lenders could work in partnership with housing associations, whose tenants are overwhelmingly on low incomes. Some of the newer community-based loan schemes already have this type of arrangement with their local housing provider.

Extending access to the Social Fund

As we saw in Chapter 2, the Social Fund was popular among eligible low-income borrowers. In the interviews and at the round table, creditors felt strongly that people on very low incomes should not have to borrow money commercially to pay for essentials. Instead, their needs should be met entirely by grants and loans from the Social Fund. There seems to be little justification for widening access to the Social Fund to people in regular low-waged employment as they increasingly have access to less costly credit from the sub-prime market. There is greater justification for extending coverage of the scheme to people on disability benefits who have no other source of income.

At present, the Social Fund has a cash-limited budget and many people are not aware of the help they could receive. In 2003-04, the Social Fund made 1.25 million Budgeting Loans, 1.06 million Crisis Loans and 256,000 Community Care Grants. The quantitative analysis carried out by Policis indicates that about a quarter (an estimated 1.27 million) of people of working age (18-64) living in eligible UK households had received either a Social Fund loan or a Community Care Grant in the previous 12 months.

Previous research has shown that there is considerable unmet need for Social Fund Budgeting Loans and Community Care Grants (Whyley et al, 2000; Kempson et al, 2002; Kempson et al, 2004). Policis has attempted to assess the extent of this unmet need using survey data. To do this, it estimated the total level of borrowing from all commercial sources by people in the lowest household income quintile who had no full-time earnings coming into their home. A total of 440,000 people had borrowed around £210 million in the previous year for reasons other than discretionary spending. The majority of these people had used high-cost credit sources.

Arguably, most of this need should have been met by the discretionary Social Fund. The Secretary of State for Work and Pensions has already announced that the discretionary Social Fund budget will be increased by £90 million over a three-year period to 2005/06 (DWP, 2004). Our estimates suggest that this amount would have to be more than doubled if these needs were to be met in full.

Any further increases to the Social Fund budget should continue to be divided between loans and grants. There is a strong argument for better funding of Community Care Grants, so that they can meet the high priority needs of vulnerable members of society (Kempson et al, 2004). This would include automatic grants in certain circumstances, such as when people leave residential or institutional care or are rehoused to more suitable accommodation. Currently, around six in ten of the people who apply for a Community Care Grant are unsuccessful and eight in ten of successful applicants received less money than they had applied for – typically getting between a quarter and a half of the amount they had requested (Kempson et al, 2004).

In the interviews and at the round table we explored various ways of widening access to the Social Fund. The one that found most favour was to capitalise the fund either from general taxation or through a partnership with banks or building societies, in much the same way as they currently provide loan capital for some of the community-based loan schemes. It is possible that individual banks or building societies may be interested in this proposition. Alternatively, it could be achieved by the government negotiating an industry-wide initiative, as it did with Universal Banking Services. This additional capital in the fund could be lent interest-free as at present. Alternatively, the Social Fund Budgeting Loan scheme could be developed so that applicants have an initial credit limit that is interest-free, after which they could borrow at affordable interest rates.

Conclusion

Whatever shape it takes, some intervention is required to ensure that poor people have access to affordable credit. Left to its own devices, the commercial market will continue to move away from lending to the poorest people. Many of the proposals to tackle high-cost credit, while well-intentioned, could accelerate this process and leave poor people with even less choice and higher costs. Linked to this, the Competition Commission's investigation into the home credit market is likely to have significant implications

for the supply of commercial credit to low-income households in the future.

This study indicates that up to 6.2 million people of working age in the UK could potentially benefit from the wider availability of more affordable credit. The two areas for development that would have the biggest impact are a system of guaranteed automated payments and further expansion of the discretionary Social Fund. Both would have an immediate impact nationwide. They require substantial investment, but this could be met through a public–private partnership.

Automated payments (through direct deductions from income or direct debits) have the greatest potential to reduce the costs of both sub-prime commercial lenders and not-for-profit credit providers. Some commercial lenders have indicated that they would pass these reduced costs on to their customers in the form of cheaper credit. In the case of not-for-profit providers, reduced costs would make sustainability easier to achieve. Of the two options, an improved direct debit system would have wider benefits and would also be more inclusive.

For the poorest people, the most appropriate solution lies in further increases to the discretionary Social Fund budget – either from taxation or using capital provided by the banks. Our analysis suggests that these increases need to be substantially more than the government has pledged. There is also a strong case for extending coverage of the Social Fund to people on disability benefits who have no other source of income.

There is also real potential for meeting need through not-for-profit lenders. The move towards larger, more professionally run credit unions and the prospect of regional community-based loan schemes, run in partnership with commercial banks, seem particularly promising. The government's plans to establish a growth fund for not-for-profit lenders, announced in December 2004, are also encouraging.

References

Barton, A. (2002) *Unfair and underfunded: CAB evidence on what's wrong with the Social Fund*, London: National Association of Citizens Advice Bureaux.

Belsky, E. and Calder, A. (2004) *Credit matters: Low-income asset building challenges in a dual financial service system,* Working Paper BABC 04-1, Cambridge, MA: Harvard University Joint Center for Housing Studies.

Berthoud, R. and Kempson, E. (1992) *Credit and debt: The PSI report*, London: Policy Studies Institute.

Brown, M., Conaty, P. and Mayo, E. (2003) *Life saving: Community development credit unions*, London: New Economics Foundation.

Collard, S. (2002) *Ending fuel poverty and financial exclusion: A market feasibility report*, London: Ofgem.

Collard, S. and Kempson, E. (2003) *Pawnbrokers and their customers*, London: National Pawnbrokers Association.

Collard, S., Kempson, E. and Whyley, C. (2001) *Tackling financial exclusion: An area-based approach*, Bristol: The Policy Press.

Community Development Finance Association (2004) *Inside out: The state of community development finance 2003*, London: Community Development Finance Association, (www.cdfa.org.uk/resources/index.php).

Competition Commission (2004) *March UK Ltd and the home shopping and home delivery businesses of GUS plc. A report on the merger situation*, Cm 6102, London: The Stationery Office.

Datamonitor (2004) *UK non-standard and sub-prime lending 2004*, London: Datamonitor.

Dominy, N. and Kempson, E. (2003) *Can't pay or won't pay? A review of creditor and debtor approaches to the non-payment of bills*, London: Lord Chancellor's Department.

DTI (Department of Trade and Industry) (2000) *Switching suppliers: A research study*, London: DTI.

DTI (2003) *Fair, clear and competitive: The consumer credit market in the 21st century*, Cm 6040, White Paper, London: The Stationery Office.

DTI (2004a) 'No interest rate ceiling – for now', Press release P/2004/315, 26 August.

DTI (2004b) 'Modern dispute system to resolve credit problems', Press release, 18 August 2004.

DTI/DWP (Department for Work and Pensions (2004) *Tackling over-indebtedness: Action Plan 2004*, London: DTI.

DWP (2004) *Annual report by the Secretary of State for Work and Pensions on the Social Fund 2003/2004*, London: The Stationery Office.

Herbert, A. and Kempson, E. (1996) *Credit use and ethnic minorities*, London: Policy Studies Institute.

HM Treasury (1999) *Access to financial services*, London: HM Treasury.

HM Treasury (2004a) *Budget 2004, prudence for a purpose: Building a Britain of stability and strength*, London: The Stationery Office.

HM Treasury (2004b) *Child poverty review*, London: The Stationery Office.

HM Treasury (2004c) *2004 spending review: New public spending plans 2005-2008*, Cm 6237, London: The Stationery Office.

HM Treasury (2004d) *Promoting financial inclusion*, London: HM Treasury.

Johnson, R. and Johnson, D. (1998) *Pawnbroking in the US: A profile of customers*, Washington DC: Credit Research Center, Georgetown University.

Jones, P. (2002) 'Access to credit on a low income', Unpublished report, Manchester: The Co-operative Bank.

Jones, P. (2003) *Credit unions and loan guarantee schemes*, Liverpool: Liverpool John Moores University.

Kempson, E. (1996) *Life on a low income*, York: York Publishing Services Limited.

Kempson, E. (1998) *Savings and low-income and ethnic minority households*, London: Personal Investment Authority.

Kempson, E. (2002) *Over-indebtedness in Britain*, London: DTI.

Kempson, E. and Jones, T. (2000) *Banking without branches*, London: British Bankers' Association.

Kempson, E. and Whyley, C. (1999a) *Extortionate credit in the UK*, London: DTI.

Kempson, E. and Whyley, C. (1999b) *Kept out or opted out? Understanding and combating financial exclusion*, Bristol: The Policy Press.

Kempson, E., Bryson, A. and Rowlingson, K. (1994) *Hard times? How poor families make ends meet*, London: Policy Studies Institute.

Kempson, E., Collard, S. and Taylor, S. (2002) *Social Fund use among older people*, DWP Research Report 172, Leeds: Corporate Document Services.

Kempson, E., Collard, S. and Taylor, S. (2004) *Experiences and consequences of being refused a Community Care grant*, DWP Research Report 210, Leeds: Corporate Document Services.

OFT (Office of Fair Trading) (2004a) *Consultation on a market investigation reference on home credit* (OFT747b), www.oft.gov.uk

OFT (2004b) *Response to the super-complaint on home credit made by the National Consumer Council* (OFT747a), www.oft.gov.uk

Policis (2004) *The effect of interest rate controls on other countries*, London: DTI.

Regeneration and Renewal (2004) 'Brum community bank secures a £100k boost', 7 May.

Rowlingson, K. (1994) *Moneylenders and their customers*, London: Policy Studies Institute.

Social Exclusion Unit (1998) *Bringing Britain together: A national strategy for neighbourhood renewal*, London: Cabinet Office.

Social Security Committee (2001) *Social security third report*, London: Social Security Committee.

Speak, S. and Graham, S. (2000) *Service not included: Social implications of private sector service restructuring in marginalized neighbourhoods*, Bristol: The Policy Press.

Treasury Committee (2003) *Transparency of credit card charges*, London: The Stationery Office.

Whyley, C. and Brooker, S. (2004) *Home credit: An investigation into the UK home credit market*, London: National Consumer Council.

Whyley, C., Collard, S. and Kempson, E. (2000) *Saving and borrowing*, Department of Social Security Research Report 125, Leeds: Corporate Document Services.

A

Appendix A: Focus groups with low-income borrowers

Five focus groups were held with low-income borrowers aged between 25 and 64, who were recruited door to door.

The groups included a mix of men and women. Most had dependent children living at home. Two groups comprised low-waged workers in receipt of Tax Credits; participants in the remaining three groups received Income Support, Jobseeker's Allowance or Incapacity Benefit. Three of the groups were held in the north west of England, the other two in the south west, in areas that had either a credit union or a community-based loan scheme.

The focus groups were carried out with the aid of a topic guide (see later in this appendix). All the groups were tape-recorded, fully transcribed and analysed thematically.

Affordable credit for low-income households

Focus group discussion guide

- study financed by the Joseph Rowntree Foundation;
- to develop a new source of credit for people who live on low incomes;
- purpose of group is to begin to identify with you what features you would like it to have – and what you wouldn't want;
- will then talk to potential providers and the government;
- and meet again with any of you who are interested to discuss the outcome of these talks;
- we are interested in hearing everyone's views – you should not be afraid to say what you think – there are no right or wrong 'answers'.

Introductions

Brief discussion of main sources of credit – people's use; their attractions and drawbacks (20 minutes approx)

- Mail order
- Home credit
- Pawnbroking
- Social Fund
- Credit unions
- Other sources?
  - Sale and buy back
  - Rental purchase
  - Payday loans

Ranking key features of affordable credit (20-30 minutes)

Which are essential; which desirable?

- Knowing the total cost of borrowing in advance
- Affordable repayments
- Being able to pay off the loan early
- Payment method, including use of payment distribution systems
- Flexibility if unable to pay
- Provider (friendly but professional)

Any other essential features?
Any features that would be undesirable?
What would a 'silver service' look like?

Views of other possible features:

- Payment protection insurance
- Willingness to open current account to access credit

Discussion of total cost (20-30 minutes)

- What is more important, affordability or total cost?
- What about using security for loans (for example savings, valuables)?
- Which of the features would they be prepared to pay extra for?
- What is the most they would pay for a 'silver service'?
- Where would they make compromises to reduce cost?
- What is the minimum service they would accept?

CLOSE

Get names, addresses and phone numbers of those willing to meet again

B

Appendix B: Round-table participants

Advice UK

Association of British Credit Unions Limited

British Bankers' Association

British Cheque Cashers Association

Building Societies Association

Consumer Credit Association

Department for Work and Pensions, Family Poverty and Financial Exclusion division

Department of Trade and Industry, Cross-market Interventions

Finance and Leasing Association

HM Treasury, General Insurance, Mutuals and Inclusion Team

HM Treasury, Welfare Reform

HM Treasury, Work Incentive and Poverty Analysis

Mail Order Trade Association

National Pawnbrokers Association

Office of Fair Trading, Consumer Credit Policy

People for Action