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Illegal lending in the UK

Research report
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Illegal lending in the UK

Draft research report

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The opinions expressed are however those of the authors as is the responsibility for any inadvertent errors or omissions that remain.

Foreword

I am delighted to have been asked to write the foreword to this report. Those of us who have been involved in providing debt advice to clients have been all too aware of the activities of illegal lenders but until now there has been little written about this area and no systematic research about how they operate and, most importantly, any work on the experience of loan shark customers.

For 13 years in the 80's and early 90's I worked as a Debt Adviser, in both the West Midlands and the east end of London and in both areas illegal money lenders operated. My experience mirrors much of the research in this report. Ironically I learnt much of what I know about how loan sharks operated from a client of mine who had been a loan shark but because of his age and declining health, could no longer risk working on the council estate he had predominantly lent on. The loan shark had become "the victim" because he was too much of a target, (people knew he always had cash on him), and he was too frail to "nut through a wall", as I still remember him putting it, those clients who could not, or would not, repay the loan. He also noted that he never lent to anyone who he did not feel he could intimidate if he needed to and also told me that he was not averse to taking "payment in kind" from women who could not pay.

A particular trick I noticed in the West Midlands was that the loan sharks would target tenants of social landlords because in the event of non payment they would "repossess" the council or housing association property and move new tenants in at a market rent to clear the debt. These properties were often turned into crack houses or brothels, adding yet another chapter of abuse and deprivation to the story.

Again based on my experience, a number of my clients who used loan sharks had drug, or to a lesser extent, alcohol or gambling addictions, a fact which is borne out in the research. Some of the loan sharks who operated on the patches I worked on were also supplying drugs to the same clients. Clearly, to begin to solve this problem the cycle of borrowing to fund addiction must be broken. Added to this it is clear that there needs to be a source for easily accessible, legal, low-cost and low value loans. This is of course much easier said than done and it will be a far from easy problem to solve. In terms of actually putting the loan sharks out of business I think the specialist teams in Glasgow and Birmingham provide an excellent model for the rest of the UK. All of this is of course a huge challenge but the value of this report is that all of us involved in this area now have the empirical evidence with which to begin to solve this very significant social problem.

Finally, although it a depressing subject I am sure that anyone with an interest in this area will enjoy reading the report and I hope find themselves beginning to consider how we use its findings to tackle the problem.

Nick Pearson

National Money Advice Coordinator
adviceUK

Illegal lending in the UK

A research report by Policis and PFRC

Executive summary

The scale of illegal lending in the UK and concentrations of illegal lending

- We estimate that there are approximately 165,000¹ households using illegal money lenders in the UK, with around half of these in the most deprived areas²:
 - This represents 0.44% of the adult UK population, 3% of low-income households³ and 6% of households in the most deprived areas.
 - This compares to 2.3 million users of high-cost licensed home credit lenders in 2005, 6.15% of the UK adult population. On the most deprived estates, 50% of residents have used home credit lenders within the last 5 years.
- We estimate the total value of advances made by illegal money lenders to be some £40m p.a., with repayments to these lenders totaling circa £120m p.a.:
 - This compares to £1.5bn advanced by the high-cost home credit lenders and total repayments of £1.9bn made to these lenders in 2005.
 - Total annual advances by illegal money lenders represent less than 0.02% of total consumer borrowing in 2005.
- The distribution of illegal lending follows patterns of disadvantage nationally and also those of home credit exclusion, which itself is correlated with deprivation in most areas.
- Areas of concentration are thus deeply deprived social housing estates largely in urban conurbations.
- The majority of areas most at risk from illegal lending appear to be in Scotland, the North and the West Midlands, though pockets arise also in the South in parts of London (Newham, Tower Hamlets, Portsmouth and Plymouth) and in Wales (Swansea and the Rhondda). Detailed maps can be found in the report.

¹ This is based on claimed level of use and is therefore likely to understate the actual level of illegal lending use. The international comparisons are however similarly based on claimed levels of use.

² As measured by the top 5% of the government's index of multiple deprivation (IMD) scores.

³ Bottom quintile of household income.

Illegal lending in the UK – an international perspective

- The UK credit market is the largest and fastest growing in Europe and features a diverse credit market and a wide spectrum of pricing.
- In contrast to many European credit markets, lenders serve even the highest risk borrowers, including those with an adverse credit history, the over-indebted, the unbanked and even bankrupts.
- Absolute credit exclusion is minimal by international standards.
- It is this diversity and the accessibility of credit across the risk spectrum which fundamentally shapes the scale and nature of illegal lending in the UK.
- It would appear that illegal lending arises in a supply vacuum, with illegal lenders unequivocally the lenders of last resort. In all markets where data is available households borrow from illegal lenders because they have no other credit options.
- Illegal lending in the UK appears small-scale, with the incidence low relative to that in other major European countries.
- Previous research indicates that the incidence of illegal lending in Germany is two and a half times higher than in the UK and that in France is three times higher than in the UK.
- In all three countries illegal lending is concentrated among those who have experienced credit refusals from legitimate lenders.
- The lower incidence in the UK appears to be explained by higher risk borrowers in the UK having more legal credit options than is the case in either France or Germany.
- In the UK, the supply vacuum – and thus the opportunities for illegal lenders – appears not only to be smaller than in neighbouring European markets but to occur in a different part of the socio-economic spectrum.
- In advanced credit markets which have tighter regulatory environments (France, Germany, and Japan) illegal lenders target middle income, credit-impaired borrowers, who in the UK are served by sub-prime lenders.
- Users of illegal money lenders in the other markets cited are likely to be male and in work while those in the UK are overwhelmingly on welfare benefits and tend to be female.

Illegal lenders, their customers and modus operandi

- Users of illegal lending in the UK appear to be those unable to access credit from the high-cost “home credit” lenders, for a variety of reasons.

- Around one in five users of illegal lenders live in areas not served by the main home credit lenders. A little over half are home credit customers who have defaulted on or reached the limit of a credit line from the home credit lenders. Around a quarter are those who are considered too high-risk even for the high-cost lenders.
- The profile of those using illegal lenders is similar to that of home credit users in that most users are female, with families, and are aged 30–40. However there is a greater male bias and a greater tendency to disadvantage than is the case with home credit users.
- Illegal lender users have a greater tendency to chaotic life-styles than users of legitimate high-cost credit, with some three in ten having drug, alcohol or mental health problems. Conversely, this implies also that seven out of ten have no such problems.
- Most funds borrowed from illegal lenders are used for much the same purposes as home credit. However a significant minority spend funds obtained from illegal lenders on drugs or alcohol.
- Illegal lending occurs in close-knit, closed communities and lenders are often well known, with business built up through social networking.
- Most relationships between illegal lenders and their customers are based on fear and intimidation with lenders seeking to control their customers with a range of coercive practices.
- Intimidation and violence ensure that payments to lenders are prioritised while protecting lenders from reporting.
- Control is further reinforced by the taking of illegal securities, particularly those which control access to victims' income such as benefit books and cash cards.
- Non-payment can result in some borrowers becoming enmeshed in sexual exploitation and criminal activities, including drug dealing and prostitution.
- A range of illegal lender typologies has been identified. These range from a small minority of relatively benign lenders who share some characteristics of legal lenders to the violently coercive, with illegal lending as part of a wider criminal life-style. The latter appears to be the dominant model, although not all coercive loan sharks are involved in other criminal activities.
- Significantly, illegal lending does not appear to be the province of organised crime in the UK with most lenders one man bands or family affairs.

The cost of borrowing from an illegal lender

- Illegal lenders seek to control their victims primarily in order to create an ongoing income stream over a continually extended term, essentially for as long as it can be sustained.

- They therefore obfuscate both the cost of the loan and the terms on which it is made, through a range of mechanisms. The most important of these are disproportionate and often arbitrary penalty charges for missed payments and small “top up” loans – often to enable payments on the loan that might otherwise be missed.
- Paperwork is rarely provided and as a result, and in the light of the mechanisms just described, borrowers cannot calculate what they owe or for how long they may have to go on paying the lender.
- Amounts actually paid to the lender can bear little relation to the amounts advanced or to the borrower’s understanding of price at the outset.
- Sums advanced are low, averaging close to £250, but can also be very small sums (as low as £30-£50, particularly in Scotland) to be repaid the following week.
- On average, at the outset of the relationship the amount that it was anticipated would be repayable to the lender on an advance of £100 was £183, i.e. a total cost of credit (TCC) of £83, with little or no clarity on the term over which the loan would be repaid.
- In practice, actual total cost of credit was on average £185 per £100 advanced, approximately three times the cost of credit from the highest cost legal lenders and more than double what people expected to pay.

The cross-over between use of illegal lenders and other forms of credit

- Users of illegal lenders are markedly less likely than other residents of deprived estates to have any meaningful engagement with mainstream financial services.
- On deprived estates which are not served by the home credit lenders, illegal lenders are the leading source of cash credit.
- On similarly deprived estates which are served by the home credit lenders, home credit is the leading source of credit by a considerable margin.
- There is a significant degree of cross-over between use of illegal lenders and use of both high-cost licensed lenders and the Social Fund.
 - Around one in ten home credit users in the most deprived estates admit to using an illegal money lender.
 - A little more than half of those using illegal money lenders have had a home credit loan in the last year.
 - Half of those using illegal lenders have had a Social Fund loan in the last year.
- There is only patchy use of credit unions among either those using illegal lenders or at risk of doing so (i.e. those being turned down by the high-cost home credit lenders).
- That said, some credit unions, particularly in Scotland, have developed considerable expertise and experience in lending to very high-risk borrowers, including those using illegal lenders.

Policy implications

The nature of the challenge

- Illegal lending is clearly deeply damaging to victims and communities.
- It is important in formulating policy responses to recognise that a proportion of demand for credit is irreducible.
- Despite the relatively small-scale of illegal lending, because it occurs in pockets of deprivation, it is likely to be as widespread as are deprived micro-communities.
- Our judgement, on the basis of the evidence, is that the high-cost of home credit lending may not be a desirable feature of the model, but, by any measure, home credit lending is preferable to illegal lending.
- In seeking to reduce the cost of home credit through the operation of regulatory levers, the challenge for regulators is to balance the benefit for the majority in the form of lower prices against the risk to the minority who may be exposed to both greatly increased cost of credit and the collateral damage associated with illegal lending.
- Commercial credit appears to have reached the effective limit of supply to high-risk borrower types and there is little prospect of further extension of the risk pool.
- Commercial and regulatory pressures on the high-cost licensed lenders suggest a continued and even accelerated withdrawal from high-risk borrowers and locations, implying:
 - A potential increase in illegal lending
 - An unwillingness on the part of high-cost licensed lenders to fill the vacuum created by the removal of illegal lenders.

Creating alternatives to illegal lending

- Detection and enforcement is clearly an important component of the effort to combat illegal lending and the pilot illegal money lending teams have had some considerable success in prosecuting and removing illegal lenders, providing relief to both victims and the communities in which they live.
- The evidence suggests however that alternative supply is the most effective strategy in combating illegal lending.
- There is a clear need to create an alternative source of social lending to combat both existing illegal lending and the supply vacuum likely to arise in the wake of the continued withdrawal of the home credit lenders.
- The likelihood is that the home credit lenders will withdraw more rapidly than alternative sources of supply can be established or build scale.

- The most appropriate source of alternative credit may be an expanded and closely targeted Social Fund, not least because the Fund already has connections with many victims of illegal lending.
- An expansion of the budget for Community Care Grants might offer the most appropriate focus for additional funds.
- The danger is however that the Social Fund may not be sufficiently flexible to act as an alternative to illegal lending.
- The most promising approach may be to create specialist units supported by dedicated, ring-fenced funds, and working in partnership with other agencies.
- Some of the problems faced by those using illegal lenders are clearly so complex and multi-dimensional as to require a holistic approach in any case.
- Some credit unions clearly have considerable experience of high-risk borrowers and have much to contribute both in their own right and as part of multi-agency initiatives.
- With time, best practice based on the expertise of those credit unions which have the experience could be rolled out to other credit unions as part of the drive to broaden access to affordable credit and address financial exclusion.
- We would argue however that as yet most credit unions are not well placed to be positioned as a front-line alternative to illegal lending, with most serving a different universe to borrowers from illegal lenders and thus little experience of managing high-risk borrowers.
- Many developments within the movement which will ultimately facilitate growth and the widening of access to take in higher risk borrowers are either at an early stage or are confined to relatively few unions. Similarly much of the movement has yet to develop an effective technology infrastructure or maturity of scale. The impact of the changes to the pricing constraints under which the movement operates also have yet to be fully tested.
- With time, more credit unions may be able to serve much higher risk borrowers, but this is likely to require significant change to existing lending and risk management models.
- Whatever models are ultimately developed to act as a social alternative to illegal lending, the critical success factors will include a high degree of accessibility and pro-activity, combined with effective collection and default management.
- Advice and financial education will be important as a component of a long-term strategy to create awareness of the dangers of illegal lending but are unlikely to have an immediate impact on the incidence of illegal lending. There is however a clear need for advice for victims whose finances have frequently been hollowed out over an extended period.

Overall

- Given the difficulties inherent in the detection and enforcement of illegal lending and the significant challenges and costs associated with creating alternative sources of social credit, the most effective strategy for combating illegal lending would appear to be the maintenance of a regulatory environment which encourages legal credit options.
- Regulatory strategies for both illegal and high cost lending carry significant social risks if developed in isolation from wider social policy considerations.
- A regulatory strategy designed to maximise the availability of regulated credit would optimally be pursued in parallel with closely targeted support for those not likely to have access to it. To some extent the size of the universe of excluded individuals is a function of the approach taken by different regulators and the tolerance each has of high cost credit being extended to high-risk borrowers.
- In the UK, the regulatory environment seems to have both minimised illegal lending and resulted in it occurring among those groups which are in any case the focus of a number of wider social policy initiatives. Expanded social lending would appear to be the only realistic solution for those at risk from illegal lenders, and will need to be adequately resourced and funded if it is to work as an effective alternative to illegal lending and build the scale and accessibility that will be critical to success.
- It is clear however that illegal lending exacerbates many of the social ills that dog areas of deprivation, not only underlying poverty but also problems such as substance abuse, anti-social behaviour and high crime rates. Tackling illegal lending will also therefore contribute to addressing a range of other social policy goals.

Illegal lending in the UK

Draft research report

Section 1.0 Introduction and background

1.1 The policy background

The policy background for this research is the government's drive for greater financial inclusion and, within this, the development of a series of initiatives intended to tackle over-indebtedness and deliver more affordable credit to low-income households.

Against this background, a significant body of work has been undertaken to examine the legal sub-prime credit market, and in particular the activities of the high-cost home credit lenders⁴, and in implementing measures to address unfair lender practices and exploitative lending. Following a manifesto commitment to tackle loan sharks, one strand of the various initiatives being undertaken by the government has focused on identifying and tackling illegal money lending – that is, lending money without a consumer credit licence⁵.

Little has been known about the dimensions and nature of illegal money lending in the UK. Historically, efforts to prevent it have been piecemeal and, to the extent that few successful prosecutions have been brought, largely ineffective. As a practical first step in formulating policy solutions in a little understood area, a two-year pilot was set up by the Department of Trade and Industry (DTI), to form special units to deal with cases of illegal money lending. Two of these were officially launched in September 2004, one in Birmingham, covering the West Midlands, the other in Glasgow, covering Scotland.

The pilot has provided invaluable information about illegal money lending, and the issues associated with it. It has also delivered insights into how to support enforcement and the removal of illegal lenders while addressing the subsequent credit vacuum. This important practical step has gone some way to filling what is a significant knowledge gap on illegal lending, but it has necessarily been local and limited in remit.

In order to design effective policy solutions for tackling loan sharks at a *national* level, it is necessary to have a robust understanding of the scale and nature of illegal money lending across the UK, the drivers that lead people to use illegal money lenders and the needs of the victims of these lenders – all areas about

⁴ The home credit lenders provide high-cost loans to high-risk, largely low-income borrowers delivering funds and collecting repayments in borrowers' homes on a weekly basis through a network of, largely female, agents.

⁵ In the UK, the legislative framework controlling the provision of most consumer credit (in the forms of loans or goods and services bought on credit) is set out in the Consumer Credit Act 1974. The Act requires lenders to be licensed by the Office of Fair Trading and trading without a consumer credit licence is a criminal offence, which can result in a fine and/or a prison sentence. The Act also sets out requirements for the form and content of individual consumer credit agreements, in particular the information that consumers should receive about costs and charges. Following an extensive review of consumer credit law, a new Consumer Credit Act was introduced in 2006, which aims (among other things) to provide greater consumer protection.

which little has been reliably known. The DTI therefore commissioned Policis and the Personal Finance Research Centre (PFRC) to carry out quantitative and qualitative research to fill this knowledge gap.

1.2 Research objectives

The overall research aim was to establish the scale of the problem at national level, by mapping the scope and extent of illegal money lending in the UK (excluding Northern Ireland).

Within this, the project had a number of specific objectives:

- To establish where illegal money lending is geographically concentrated and the nature of those areas of concentration.
- To establish how far there is cross-over between use of illegal lenders and other types of lenders, including high-cost lenders and social and not-for-profit lenders.
- To identify, at high level, the different types of illegal money lenders operating in the UK.
- To examine the drivers behind illegal money lending in order to understand:
 - Why consumers use illegal money lenders
 - The experience of using an illegal lender
 - How most effectively to create viable alternatives to illegal money lending
 - How best to fill the immediate vacuum left by removal of illegal lenders.
- To understand the environmental barriers to enforcement and how most effectively to tackle illegal money lenders and provide support to victims.
- Overall, to provide the evidence base from which to design policy solutions for tackling illegal lending in the UK.

1.3 Report structure

Section 1 provides the policy background to and the objectives of the study. Section 2 gives an overview of the research methods used in the study. Section 3 moves on to examine the dynamic which shapes illegal money lending in the UK, including the structure of the licensed credit market and the role of high-cost legitimate credit in patterns of illegal lender use. It explores the cross-over between the use of illegal lending and other forms of credit, both commercial and non-commercial. Finally, it provides estimates of the scale and distribution of illegal lending across the UK. Section 4 focuses on illegal lenders and their customers. It outlines the characteristics of the people who use illegal lenders, and examines how illegal lenders operate. After describing a number of models of illegal lending, the chapter concludes by looking at the impact of illegal lenders on the communities in which they operate. Section 5 briefly summarises the findings and explores the policy implications of the research.

Section 2.0 Research methodology

The fact that the activity to be researched is illegal throws up a series of research challenges, creating difficulties and raising sensitivities across a number of dimensions, both in planning and executing research fieldwork. Indeed we encountered in the event a number of challenges and learned a number of lessons in undertaking the research. We here briefly describe the key considerations in research design, the research methodology which we employed for the each element of the project and the data sources and resources we used. A more detailed description of the research methodology is provided in section 6.0.

2.1 Rationale for our approach

The research was a fundamentally exploratory piece of work in that little was known about illegal lending in the UK. The DTI Trading Standards pilot teams had accumulated a body of knowledge and experience about lending in Scotland and the West Midlands, but beyond this there did not appear to be a central focus for expertise or a repository of information about illegal lending. Knowledge and experience appeared largely to be the province of individuals who happened to have encountered or taken an interest in illegal money lenders.

Illegal lending has not been the main focus of any academic research projects in the UK, although there is a body of work around credit use among low-income households that makes reference to illegal lending. This work and previous research undertaken both by ourselves⁶ and others⁷ indicated that illegal money lending was concentrated in low income households and was more likely to occur among the most vulnerable and least accessible members of society, often living in areas of significant deprivation. Our initial hypothesis was also that it would be most likely in areas of credit exclusion, particularly those not served by the highest cost licensed lenders.

Against this background we planned for a programme of domain expert interviews with individuals with knowledge or experience of illegal money lending, including of course the DTI pilot teams, to try and bring together the available expertise. We also decided to focus the consumer research on low income households, particularly those in areas of significant deprivation and in areas not served by the high cost licensed lenders.

We were fortunate also in having access to two pieces of relatively recent original research with nationally representative samples. These focused on credit use among low income households and contained questions about illegal lending use, allowing us to profile users of illegal lenders at a national level (details follow in description of sources). We decided therefore to focus the original research undertaken to support this project on saturation surveys undertaken within deeply deprived micro-communities, usually below the

⁶ Policis for DTI, The impact of interest rate controls in other countries, 2004.

⁷ Kempson and Whyley, 1999, Speak and Graham, 2000; Whyley et al, 2000; Jones, 2002; Whyley 2002.

radar of a nationally representative survey, in order to establish whether illegal lending was more prevalent in these areas than in low income households overall. The nationally representative data and the views of domain experts suggested that illegal lending is overwhelmingly an urban problem, although the research team and others have come across incidences of illegal money lending in rural areas also. For this reason it was decided to focus the saturation surveys exclusively in urban areas.

The primary focus of the research was to scale the incidence of illegal lending and to map likely concentrations at a national level. Given this objective, and the availability of a relatively large number of witness statements from the two illegal lending pilot teams, we focused the original consumer research on quantitative research methods.

2.2 Research methods

The research is informed by a substantial body of research, original and secondary. Taking into account the research design considerations described above, a combination of quantitative and qualitative research methods was used to meet the research objectives. Details of the methodology for each component of the research base can be found in the detailed technical appendix in section 6.

- Secondary analysis of existing data from two nationally representative quantitative surveys of people on low incomes. (See 6.1)
- Qualitative interviews with domain experts who have knowledge or experience of illegal money lending, at national, regional and local level. (See 6.2)
- Creation of a national map of credit exclusion at a micro-community level, based on an analysis of postcodes which are not served by the high-cost home credit lenders. (See 6.3)
- Analysis of various national datasets, particularly the local area level indices of multiple deprivation, integrated with, and mapped across, the map of credit exclusion. (See 6.4)
- Quantitative saturation surveys of micro-communities shown to have high concentrations of credit exclusion and/or to lie in areas where illegal lending is known to take place. (See 6.5)
- Examination of the witness statements supplied to members of the pilot teams by victims of illegal lenders, supplemented by a small number of in depth interviews with victims. (See 6.6)
- Secondary analysis of two nationally representative quantitative surveys of people on low incomes in France and Germany to enable international comparisons. (See 6.7)

2.3 Analysis and interpretation of survey results

We believe that the overall patterns and concepts we describe, derived from the research data, reflect the experience of using illegal lenders. They appear also to be consistent with the picture arising from the witness statements. Readers should bear in mind throughout however that, within the overall saturation survey sample of 750 respondents in five different areas identified as deeply deprived, the number of respondents who admitted to using an illegal lender was 45 (i.e. 6% of the total). Generally speaking therefore, in drawing on this data we have tended to refer to broad proportions rather than percentages in discussing results of analyses of those using illegal lenders. Where percentages are shown in the charts relating to users of illegal lenders and based on the data sourced from the saturation surveys, these should be treated with a degree of caution on account of the small sample base.

The same is true of the nationally representative samples, with 51 individuals admitting to their household using an illegal lender. Our analyses in relation to the witness statements are based on 109 statements. In total therefore our analysis is based on the experience, as reported in the survey responses and witness statements of some 205 individuals.

Section 3.0 The dynamic shaping illegal lending in the UK

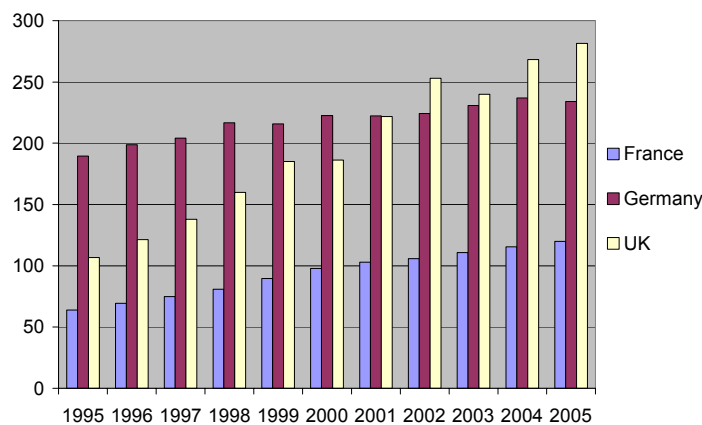
3.1 The licensed credit market in the UK

The UK credit market is the largest and fastest growing in Europe and features a diverse product mix and a wide spectrum of pricing

Discussion of the market for unlicensed lending in the UK first needs to be set against the context of the market for legitimate licensed credit. The UK commercial credit market is vibrant and diverse, being the largest, most highly developed and fastest growing in Europe (Charts 1a, b, & c). It is finely segmented and features a wide range of credit models and an extended spectrum of credit pricing, from very low to very high cost. There is both a ferociously competitive prime market and a large and rapidly expanding sub-prime market, including a very high-cost credit sector serving the highest risk borrowers.

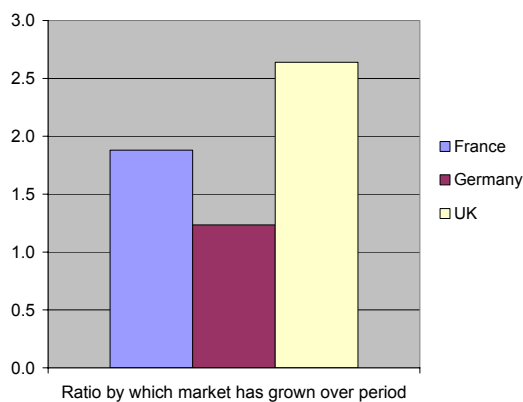
The UK credit market has experienced the most rapid growth in the EU

Chart 1a Credit Market Growth, France Germany, UK 1996–2005

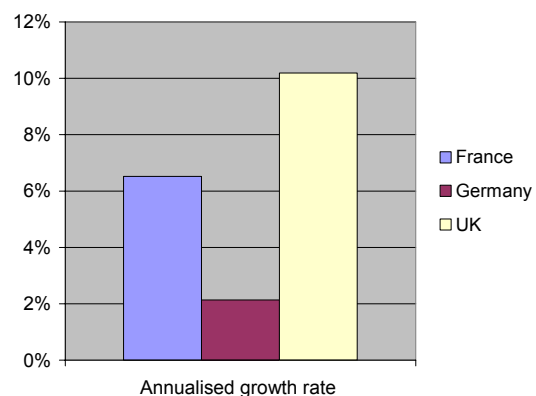


Source: Cadran de Cofidis, Bank of England, Bundesbank, Banque de France, OECD

Charts 1b & 1c Credit market growth and annualised % growth 1996–2005



Source: Cadran de Cofidis, Bank of England, Bundesbank, Banque de France, OECD



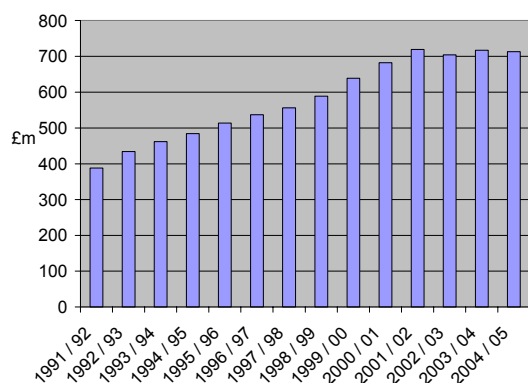
Source: Cadran de Cofidis, Bank of England, Bundesbank, Banque de France, OECD

There is a substantial social lending sector featuring both low-cost not-for-profit lending and interest-free government loans and grants

The commercial credit market sits alongside a not-for-profit sector which is substantial by international standards, though small within the context of both the wider credit market and sub-prime sector within it. This “Third Sector” lending is centred around credit unions and other community-based lenders. It has been the focus of considerable investment and political support in recent years. It seeks to provide an “affordable credit” alternative to high-cost private sector lenders for those on low-incomes. It has grown significantly on the back of this support (See Chart 3), but remains small relative to the high-cost private sector lenders. In addition, a large government social lending operation, the Social Fund, provides interest-free loans to benefit recipients and provides a significant proportion of lending to those on the lowest incomes, amounting to a little over £700m in advances in 2005 (Chart 2). The Social Fund is, however, cash limited and a significant proportion of applications are turned down or only partially funded either because of a lack of funds or because applications do not meet criteria.

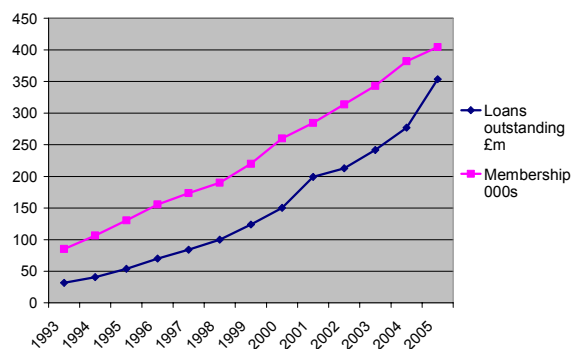
Social and not-for-profit lending has become an increasingly important part of the credit mix for those on low-incomes

**Chart 2 Social Fund advances
£m 1991–2005**



Source: DWP Annual Report 2005

**Chart 3 Credit Union lending
1993–2005**



Source: ABCUL Annual Report 2002/3 for years 1993 to 2000, ABCUL Annual Report 2004/5 for years 2001 to 2005

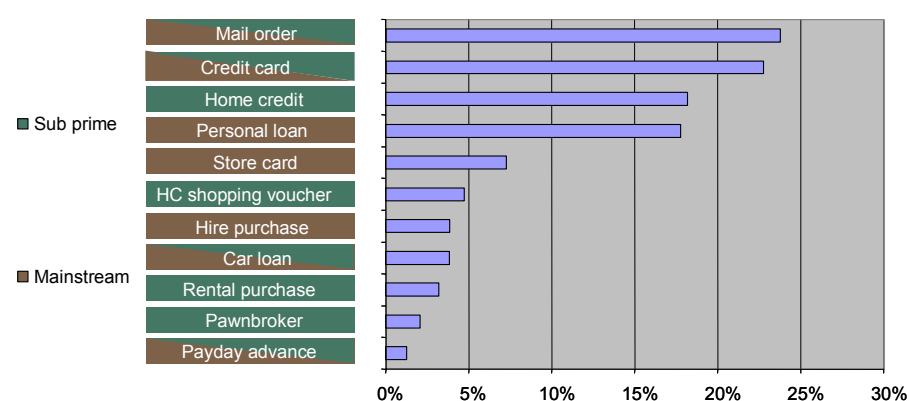
Commercial models range from high-tech, low-cost automated underwriting and service to high-cost branch-based and face-to-face, in-home distribution

An efficient and transparent credit reference sector enables technology-supported under-writing and credit scoring and thus low-cost, automated service, risk management and credit pricing models. In line with global trends, these are increasingly card and revolving-credit based. Pricing for card-based models is fine-tuned to risk and pricing structures are increasingly driven as much by borrower behaviour as by interest rates. There is also an important and growing secured-lending sector in which term loans predominate. This is primarily focused on near prime and sub-prime home-owners, with a high level of home ownership itself being a significant factor in both lender and consumer behaviour in the UK market.

The UK market also features a number of high-cost credit models, which tend to be relatively service-intensive, often involving face-to-face delivery, and which for the most part serve high-risk and credit impaired borrowers. These include both relatively-newly imported credit models, such as pay day lending and rent-to-own (from the US) and contemporary forms of pawn-broking (from Australia), and the large and long established domestic home credit sector, which, although shrinking and under pressure from newer credit models, still represents the single most important source of cash credit supply to low-income and high-risk borrowers in the UK.

In the UK high-risk borrowers use both new and traditional sub-prime product types

Chart 4 UK low-income⁸ credit users' product repertoires
 % using in last 12 months



Base: Low-income households
 Source: TNS Research for Policis 2004

Suppliers include both foreign and domestic lenders and large financial services groups cross-selling a range of products and focused mono-lines

UK lenders are both domestic and foreign owned players. Lenders include a diverse mix of supplier types selling through various configurations of distribution channels. They range from the major banks, both domestic and foreign owned, selling a full range of credit products across different market segments and multiple channels to the specialist product mono-lines (i.e. selling a single product line), often focused on a single channel. The latter category includes both direct, remote lenders, such as the US card issuers, who target different card propositions at various market segments, ranging from ultra-prime to sub-prime, and specialist lenders entirely focused on specific market segments, such as the pay day or home credit lenders, where distribution is face-to-face and based, respectively, on a branch network in the case of the pay day lenders and on in-home sales and payment collection, in the case of the home credit lenders.

Credit exclusion is minimal by international standards with this factor the key driver in the scale, nature and location of illegal lending in the UK

⁸ Low-income throughout means the bottom quintile of household incomes.

Given this diversity of products and pricing, absolute credit exclusion is minimal by international standards, with legitimate, licensed lenders serving consumers with a significantly wider risk profile than is the case in many credit markets. Those on very low and irregular incomes are able to access credit, albeit at a high price, as are those with a history of problem debt, including even bankrupts. Indeed, there are credit models serving even the unbanked, still a significant minority in the UK, and those whose numeracy, literacy, social skills or chaotic life-styles would preclude their making credit applications, whether written (i.e. paper-based) or electronic.

Moreover, for at least some of those on low-incomes and unwilling or unable to use high-cost credit, there are alternatives to commercial credit, such as the Social Fund and not-for-profit lenders. It is this very diversity of credit models and the relative accessibility of credit across the social spectrum that fundamentally shapes the scale and focus of illegal lending in the UK. It also explains the distinctive features of the UK illegal lending sector, which, though it shares some features with other illegal lending markets around the world, is different in many respects to those that appear to have developed in other advanced credit markets in Europe and elsewhere.

3.2 The drivers of illegal lending

Illegal lending arises where a supply vacuum exists, with illegal lenders unequivocally the lenders of last resort

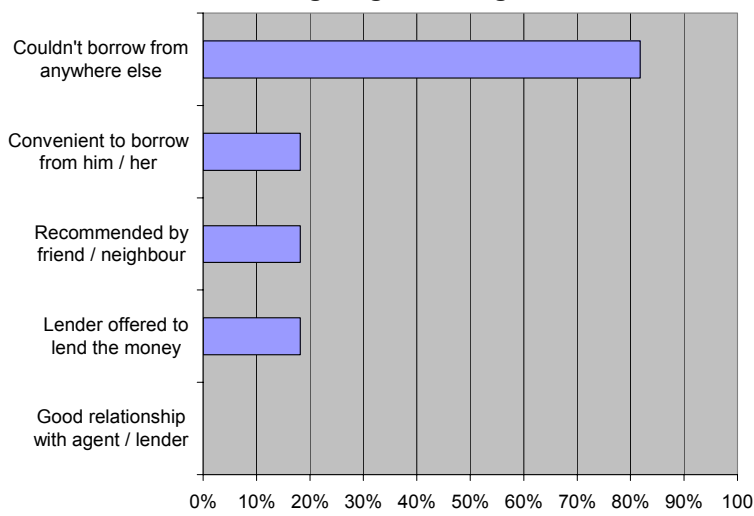
In the UK, as in other credit markets⁹, illegal lending arises in a legitimate supply vacuum, with illegal lenders unequivocally the lenders of last resort. The research undertaken to support this study indicates that use of illegal lenders is overwhelmingly driven by a lack of legitimate credit options, with borrowers turning to illegal providers only after all other potential sources of credit supply have been tried or exhausted. As will be discussed in section 4, a small sub-set of illegal lending in the UK seems to be associated with point of sale credit for black market goods and illegal drugs. However, the saturation surveys show that more than eight out of ten of those using illegal lenders in the UK (82%) claim that they do so because they have no other credit options. Those most at risk of using illegal lenders are those who have experienced credit refusals from legitimate sources. Previous studies in the UK have also shown that people on low-incomes invariably consider borrowing from an illegal lender to be the very last resort for raising money. The only attraction of borrowing from an illegal lender is that a request for a loan is rarely turned down (Whyley et al, 2000; Collard et al, 2001; Jones, 2002). In the UK those who have been refused credit by a legitimate lender are 20% more likely to use an illegal lender than other credit users while those who have been turned down by a high-cost lender are more than five times more likely than other credit users to turn to an illegal lender. As is the case with home credit, convenience and speed of access to funds, is a motivating factor for some. Conversely, the relative inaccessibility of Social Fund and credit union loans -which tend to take longer to deliver funds than either home

⁹ See Policis "Economic and Social Risks of Credit Market regulation" pp 47-48 for examples from Germany and France.

credit or unlicensed lenders - in part explains why some borrowers can favour home credit or illegal money lenders over social credit.

Borrowers turn to illegal lenders only when they have no other credit options

Chart 5 Reasons for using illegal lending



Base: Illegal lender users

Source: Policis / PFRC saturation surveys 2006

This pattern of illegal lending occurring in a supply vacuum is true of other credit markets, with those refused credit by legitimate lenders most at risk

This same pattern of illegal lending arising in a supply vacuum is evident also in other markets. Research undertaken by Policis in 2004¹⁰ provides evidence that illegal lending is concentrated among those experiencing credit refusals and / or shut out of the legitimate credit market in France and Germany also, a finding supported also by recent research in France (Babeau 2006). In both countries those who have acquired an adverse credit history or been refused credit by legitimate lenders are between three and four times more likely to use illegal lenders than other credit users with the same income and demographic profile.

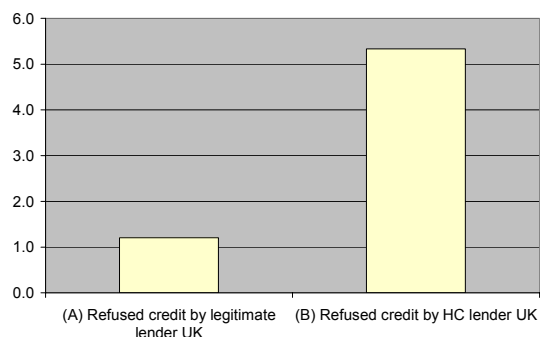
In Japan, which features one of the most highly developed, organised and visible illegal lending markets in the world, the same phenomenon can be observed. Borrowers from the fearsome, reputedly Yakusa-backed, illegal lenders are largely those who have been refused credit either because they are too high-risk for the legal lenders or because they have exhausted credit lines with legitimate lenders. Some three quarters of users of illegal lenders in Japan are individuals who have accumulated problem debt with consumer finance companies, and who find themselves unable to borrow from legitimate sources as a result¹¹.

¹⁰ Consumer research to support DTI report "The Impact of interest rate controls in other countries", undertaken in the UK, France and Germany.

¹¹ Source JFBA (Japan Federation of Bar Associations) 2002 survey of 1541 users of illegal lenders who sought assistance from JFBA counsellors.

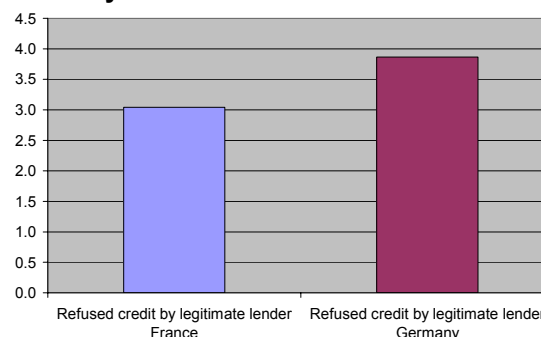
Those who have experienced refusals from legitimate lenders are most at risk of using illegal lenders

Chart 6 Increased incidence of using illegal lender relative to average for all UK



(A) Base: Low-income households UK
 (B) Base: Residents of most deprived estates
 Source: TNS research for Policis 2004

Chart 7 Increased incidence of using illegal lender relative to average for all France and Germany



Base: Low-income households in France and Germany
 Source: TNS research for Policis 2004

It would appear that the incidence of illegal lending in the UK is significantly lower than in markets where supply to high-risk borrowers is less extensive

The same Policis consumer research also suggested that in both France and Germany, the incidence of illegal lending among those experiencing credit refusals is significantly higher than in the UK, being two and a half times greater in Germany and three times greater in France. This reflects the greater degree of credit exclusion among the credit impaired in these countries relative to the UK¹². The price controls in both the French and German credit markets have in any case precluded the development of a high-cost sub-prime sector. Beyond this, however, in both countries the regulatory framework seeks to prevent those who have experienced credit difficulties from taking on more debt so that those with an adverse credit record will find themselves effectively shut out of the legitimate credit market. Registration on the SCHUFA¹³ (Germany) or FICP¹⁴ (France) adverse credit databases acts as an absolute barrier to borrowing from virtually all legal lenders in both markets. By contrast, in the UK people who are credit impaired are able to obtain credit, albeit at a cost that would be prohibited in France and Germany. There is clearly an argument to be made that the credit impaired and over-indebted should not have access to further credit. The evidence appears to be however, that the need, or at least the desire, for credit persists and that many of the impaired continue to seek credit, with some turning ultimately to illegal lenders.

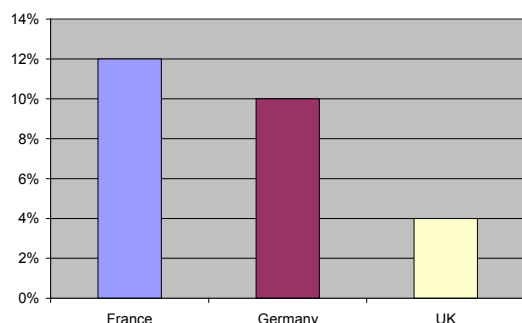
¹² See "Policis Economic and Social Risks of Credit Market Regulation 2006", pp 32-35 and Policis report for the DTI "The effect of interest rate controls in other countries" 2004, pp 35-38.

¹³ SCHUFA (Schutzgemeinschaft für allgemeine Kreditsicherung), an organisation of credit-granting organisations in Germany. This organisation pools data on all credits granted and especially on problem loans and the credit histories of individuals and companies.

¹⁴ FICP (Fichier des Incidents de Crédits aux Particuliers) administered by the Banque de France with delinquent incidents on current and credit accounts reported automatically by financial institutions.

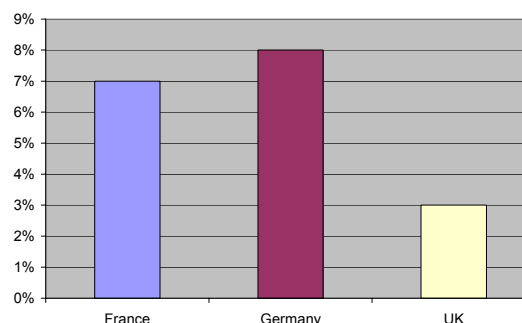
Illegal lending is significantly lower in the UK where high-risk borrowers have legal credit options

Chart 8a Incidence of Illegal lending among those experiencing credit refusals



Base: Low income households who have been refused a loan by legitimate provider
Source: TNS research for Policis 2004

Chart 8b Incidence of Illegal lending among the credit impaired



Base: Credit impaired individuals France, Germany and UK (SHUFA, FICP, UK adverse credit registered)
Source: TNS research for Policis 2004

In the UK the supply vacuum – and thus opportunity for illegal lending – is smaller than in other markets and occurs only among the most disadvantaged

The supply vacuum in the UK – and thus the opportunities for illegal lenders – appears to be not only smaller than in some other international markets but also to arise much further down the socio-economic spectrum, thus limiting not only the scale of illegal lending operations but also their potential value (for detail of estimated market size and value see section 3.5). Licensed commercial lenders in the UK appear to have reached virtually all those consumers who could profitably or practicably be served, albeit at a high-cost for high-risk borrowers. As a result, and in contrast to the other markets here discussed, illegal lending in the UK appears to be concentrated almost exclusively in the most deprived micro-communities, effectively among those individuals and communities which are too high-risk for, or inaccessible to, even the highest cost legitimate lenders. Illegal lenders in the UK appear to be lending small sums to some of the poorest individuals in society living in the most disadvantaged areas. Elsewhere illegal lenders lend larger sums to a wider cross section of individuals, typically higher risk low-to-middle income borrowers shut out of the legal credit market by dint of credit impairment or over-indebtedness.

In the UK users of illegal lenders are found much lower down the socio-economic spectrum than in other markets

The Policis consumer research in France, Germany and the UK showed that in all three countries use of illegal lenders is concentrated among those who have experienced credit refusals from legitimate lenders. This pattern is confirmed also in Japan, where research undertaken by the JFBA¹⁵ with victims of illegal lenders also indicates that borrowers from illegal lenders typically either have a history of credit problems or, without a reliable income,

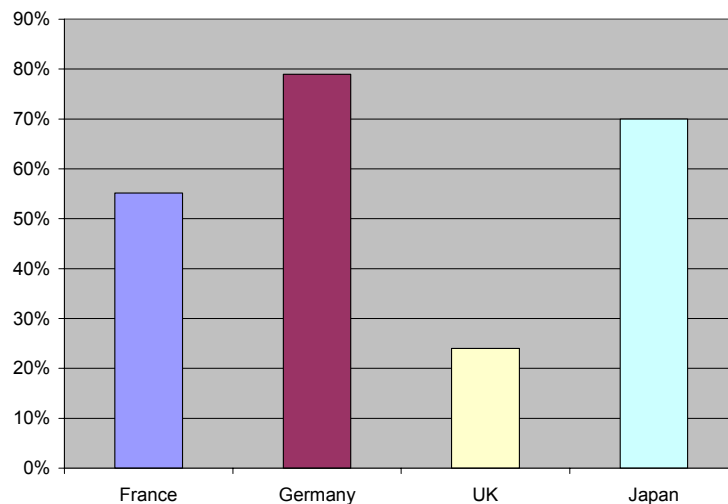
¹⁵ JFBA (Japan Federation of Bar Associations). This highly influential association of attorneys in Japan is the leading consumer activist group both campaigning for change to the regulatory framework governing the credit market and providing practical assistance and support to victims of illegal lenders.

are unable to access credit from legitimate sources. Indeed in Japan, sophisticated and high tech illegal lenders are said to actively target the over-indebted and those experiencing credit refusals, reportedly by dint of buying lists of those refused credit.

In France and Germany the profile of those experiencing credit refusals is significantly better off than in the UK. This reflects the greater access to credit in the UK for high-risk borrowers and the credit impaired and the difficulties that middle income borrowers who have experienced credit problems in Germany and France face in obtaining credit. As a consequence, users of illegal lenders in France and Germany are more up-market than users of illegal lenders in the UK, being more likely to be male, to be in work or to be short term unemployed. Users of illegal lenders in the UK are more likely to live in conditions of entrenched poverty and are overwhelmingly long-term unemployed, with the profile of illegal lender users having a strong female bias, being often single mothers living in social housing. In Japan over-indebted borrowers turning to the illegal market in the wake of credit refusals in the credit mainstream are markedly more diverse in profile than in the UK and are more likely to be male, in work or to have a history of employment, which in part reflects the greater equality and homogeneity of society in Japan.

In other illegal lending markets illegal lenders are able to target more affluent middle income credit-impaired or over-indebted borrowers in work

Chart 9 Proportion of users (%) of illegal lenders in work UK, France, Germany, Japan



Source: TNS research for Policis 2004 for France, Germany, and UK
JFBA research with illegal lender victims 2002, Japan

3.3 The role of high-cost credit in patterns of illegal lender use

The regulatory environment in the UK has resulted in some very high-cost credit models but minimal absolute credit exclusion

The regulatory environment in the UK provides for an “unfair credit test” designed to prevent exploitative and extortionate relationships, and lenders

are required to lend responsibly in order to be considered fit to hold a consumer credit licence. There are, however, no price controls, with lenders free to price credit according to their judgement on the risk represented by the borrower. There is also no prohibition on lending to individuals who have a history of problem debt. As discussed in section 3.1 this has resulted in some very high-cost credit for high-risk and low-income borrowers but minimal credit exclusion. The credit impaired (i.e. those with adverse credit history arising from default on credit agreements or persistent problems with late or missed payments) who are shut out of the credit market in some other European credit markets are served in the UK by sub-prime lenders. Many, largely low-income, individuals find themselves unable to borrow in the mainstream market but relatively few are unable to access legal credit at all, albeit that the credit available to high-risk borrowers is often very high-cost.

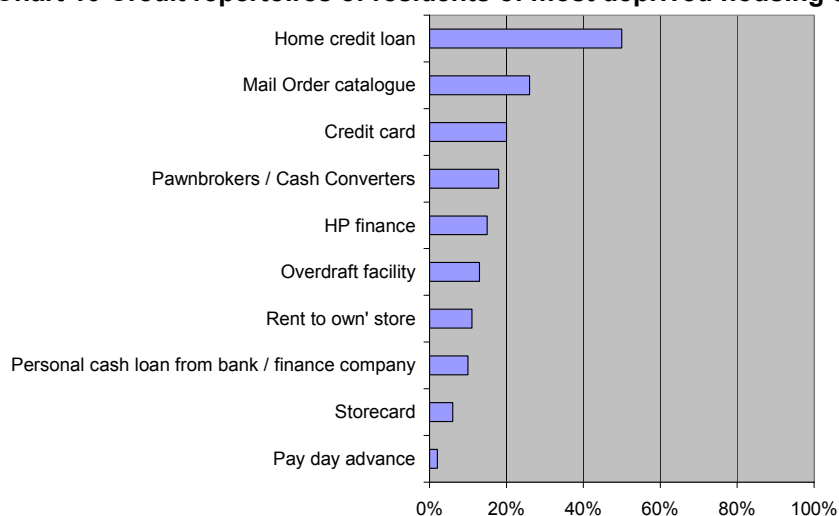
The relatively low incidence of illegal lender use in the UK is explained by the importance of high-cost legal lenders in servicing high-risk borrowers

The concentration of illegal lending in the most disadvantaged households in the UK seems to be primarily explained by the presence in the UK market of the high-cost home-credit or “door-step” lenders, which serve a broad spectrum of low-income borrowers, including those on benefits and with a history of credit problems. These lenders advance some £1.5bn annually to some 2.3 million customers each year, who for the most part live in social housing and disadvantaged areas. Lending is scaled to the incomes of customers, being typically a few hundred pounds (the average being a little over £400 in the most deprived estates and a little over £550 overall), with loans repayable in weekly installments over a short term, most commonly a little over a year. Loans are sold through a largely female agent force who assess loan applications, deliver borrowed funds and collect repayments in their customers’ homes. This type of credit, although popular with customers, is very high-cost, with borrowers typically repaying some £165 for each £100 borrowed, with small payments, circa £3 per £100¹⁶, collected weekly, most commonly over a 55 week term. Despite the growth of new product types, such as sub-prime credit cards, this type of credit is, by some considerable margin, the most important source of commercial credit on deprived housing estates. Indeed for many residents of these estates, home credit will be the only source of cash credit available to them.

¹⁶ Source: Competition Commission Table 3.1 Provisional Findings re Home Credit Inquiry, based on PPC 55 week product, which is said to represent more than half the market.

High-cost home credit is the most important source of credit on deprived estates by a considerable margin

Chart 10 Credit repertoires of residents of most deprived housing estates, UK¹⁷



Base: Users of commercial credit in last five years among residents of deprived housing estates

Source: Policis / PFRC saturation surveys 2006

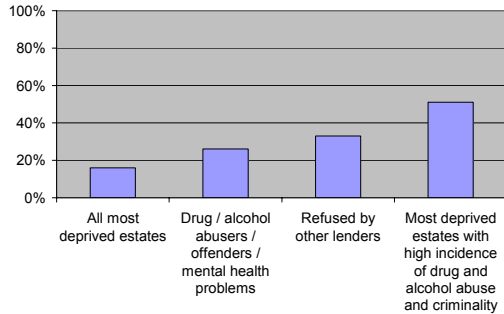
The higher the risk profile of the individual or area, the greater the importance of home credit as a source of supply

Broadly speaking high-cost credit becomes more important as a source of supply the higher the risk profile of the individual or area. Home credit is by far the most important source of credit in the most deprived areas, with the saturation surveys suggesting that around half (51%) of commercial credit users on these estates have used home credit in the last five years (see chart 10). As risk factors or the degree of deprivation and incidence of social problems associated with different areas increase, so too does the importance of home credit, being usually the only option for the highest risk groups (see Chart 11). Indeed, users of illegal lenders share many of the characteristics of home credit users on deprived estates, albeit with a more extreme risk profile (see Chart 12).

¹⁷ The reference to the most deprived estates throughout refers to areas with an Index of multiple deprivation (IMD) score of greater than 95 (These areas have an average IMD score of around 97.5, the same as the areas from our survey sample). The data rests on the research undertaken in five such deprived areas undertaken to support this project. For details see technical appendix.

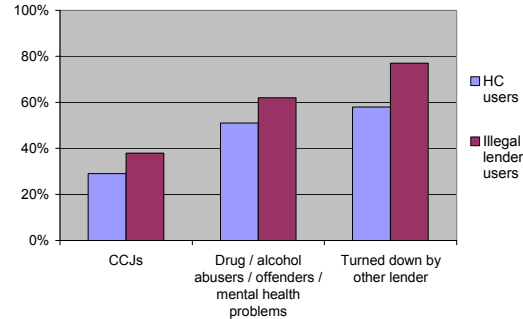
The higher the risk of the borrower the more likely it is that home credit is the only available legal credit option

Chart 11 Selected high-risk groups % using home credit in last 12 months



Base: Residents of most deprived estates
Source: Policis / PFRC saturation surveys 2006

Chart 12 % of users of home credit and illegal lenders with selected risk factors

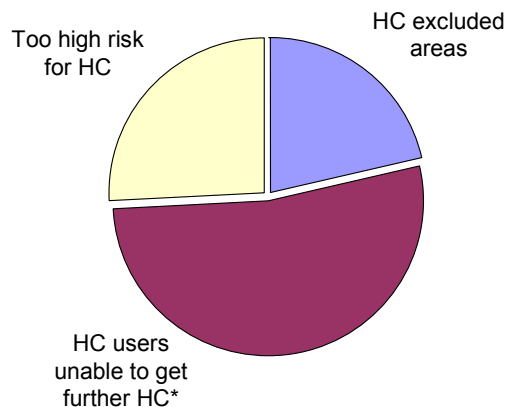


Base: Residents of most deprived estates
Source: Policis / PFRC saturation surveys 2006

Users of illegal lenders either live in home credit excluded areas, have problem home credit debt or are too high-risk even for the high-cost lenders

There appears to be a strong inverse relationship between patterns of use of these high-cost home credit lenders and patterns of use of illegal lenders in the UK. Borrowers from UK illegal lenders fall into three broad categories; individuals living in areas which are not served by the high-cost home credit lenders, individuals who have simply exhausted all legitimate credit lines, including those from home credit lenders, and individuals who are too high-risk for even the highest cost lenders to serve (the cross-over between use of illegal lenders and other forms of commercial and social credit is discussed in section 3.4).

Chart 13 Users of illegal lenders by access to and use of home credit



* end of HC credit line / defaulted on HC loan
Base: Illegal lender users
Source: Policis / PFRC saturation surveys 2006

In areas which are not served by the home credit lenders, credit use is depressed relative to areas with a similar demographic and deprivation profile

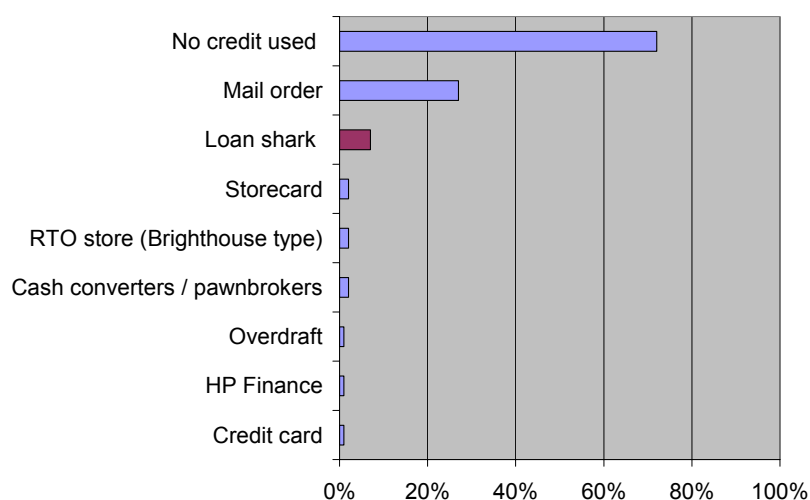
Some individuals living in areas which are not served by the home credit lenders are able to access other forms of credit. Where borrowers are in work, some are able to turn to the sub-prime credit cards. In recent years these cards have been taking market share of relatively low-risk low-income borrowers from the home credit lenders. Use of sub-prime credit cards appears to be higher in home credit excluded areas than in equivalent areas that are not excluded. For most borrowers in such areas, many of whom are long term benefit-dependent, there are few credit options other than the Social Fund, informal borrowing¹⁸ from friends and family or buying goods on mail order catalogues. It is clear that where the only option for cash credit is credit from an illegal lender, most potential borrowers will choose to do without credit. In areas not served by the home credit lenders, the incidence of those doing without credit is 50% greater than in areas served by the home credit lenders.

Most choose to do without credit or rely on mail order but for those desperate for cash, illegal lenders can be the only option

Most residents of home credit excluded areas do without credit (72% have used no credit in the last 12 months compared to 47% in areas served by the home credit lenders) or rely on mail order. For those desperate for credit, however, illegal lenders can be the only option for cash credit, being the most important single source of cash credit on home credit excluded estates.

In home credit excluded areas illegal lenders are the leading source of cash credit

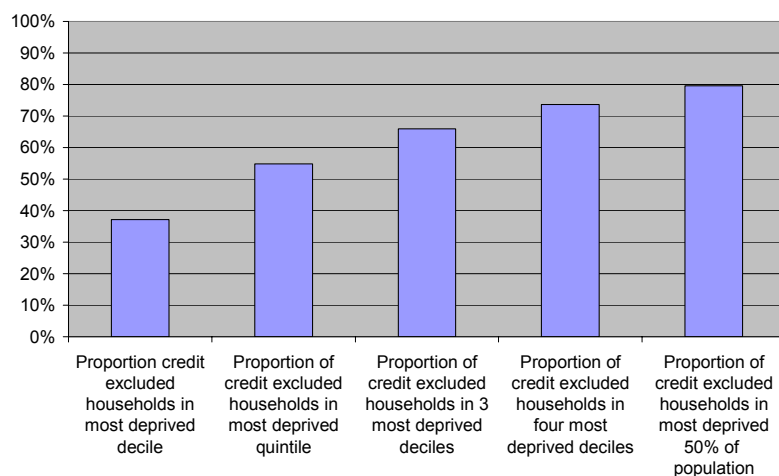
Chart 14 Credit used in last twelve months for those living in home credit excluded area



Base: Those living in home credit excluded areas
Source: Policis / PFRC saturation surveys 2006

¹⁸ For clarity, where we refer to informal borrowing throughout we are referring to borrowing from friends and family as distinct from unlicensed lenders i.e. those running a credit business without a consumer credit licence, the illegal lenders which are the subject of this study.

Chart 15 Home credit excluded households by degree of deprivation (based (IMD) scores)



Source: Home credit lenders customer data and indices of multiple deprivation

There is a close correlation between areas not served by the high-cost licensed home credit lenders and areas of entrenched poverty and deprivation and high crime

Analysis of post-codes not served by the major home credit lenders¹⁹ in conjunction with the UK government’s indices of multiple deprivation (IMD), designed to measure degrees of disadvantage, suggest that there is a strong correlation between areas of high deprivation and those which are not served by the high-cost home credit (See Chart 15). More than half of households in home credit excluded areas fall into the most deprived quintile of the population, with more than a third falling into the most deprived decile. Unemployment and low-incomes are endemic in these areas, being the principal component of the indices of multiple deprivation. There are also significant regional differences in the degree of deprivation associated with home credit excluded areas, with households in the North and Scotland being significantly more deprived than those in the South, where home credit exclusion is more likely to be associated with collection problems in tower blocks.

Home credit lenders tend not to serve areas where crime is so high as to pose a risk to the safety of collectors who frequently carry large sums in cash

Examination of excluded post-codes and the collection and bad debt data provided by the home credit lenders (for detail see methodology section) shows no meaningful correlation between home credit lender exclusion and collection performance, delinquency and bad debt. Areas which are not served are rather excluded by the lenders either on the grounds of safety or because the physical infrastructure of the built environment makes it difficult to collect weekly payments. The home credit lenders and their agents, who carry relatively large amounts of cash, are understandably reluctant to serve areas with a high incidence of street crime or drug use where there is a risk that

¹⁹ Analysis of post-codes not served by the home credit lenders was based on pooled data provided by the home credit lenders which detailed areas not served by the lenders specifically on safety grounds.

agents might be attacked and robbed. Equally, home credit lenders in England and Wales, though not in Scotland, are reluctant to provide loans to those living in housing types such as tower-blocks where physical access is problematic so that collection of repayments will be difficult to achieve.

Those living in home credit excluded estates may feel their only option is an illegal lender

“When you’re in a block of flats, it’s very difficult to get people to loan you money...I did try several times, Greenwood and Provi, but none of them would, to flats. At the time I felt I had nowhere else to go...”

“It was very, very difficult to get credit there (in flats) and so that was why we resorted to him (illegal lender). I couldn’t get car credit because the house was black listed. I was on the dole and couldn’t get a bank loan. Provi couldn’t help me or Greenwoods as I’d got no official income as such.”

(Borrowers living in Midlands tower blocks explaining their use of illegal lenders)

In England and Wales improved security in tower blocks has created barriers for illegal as much as legal lenders

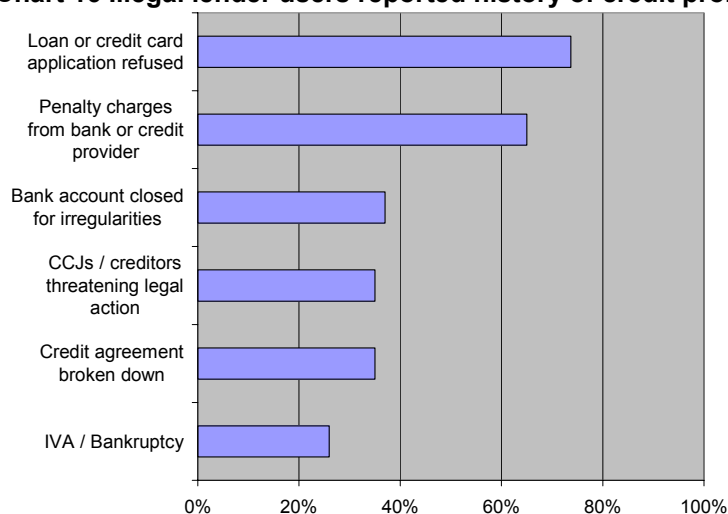
In Scotland, high-rise flats have been such a dominant feature of social housing historically that the high-cost lenders would have found it unduly restrictive not to operate in high-rise housing. In England and Wales by contrast home credit lenders have tended not to serve those living in tower blocks because it has proved difficult to gain access and collect repayments reliably. Historically therefore, outside Scotland, tower blocks have reportedly been fertile grounds for illegal lender activity. It would appear however that in recent years the government’s housing regeneration programme – and in particular the enhanced security introduced to high-rise housing – has made it more difficult for the illegal lenders to operate in tower blocks as these have become less accessible to unwanted or spontaneous visitors. As a result, the saturation surveys indicate that, within home credit excluded areas, there are now significant differences between low and high-rise housing in terms of the incidence of illegal lender use with those living in low-rise housing much more likely to use illegal lenders than their high-rise counterparts.

In areas that are served by home credit lenders, users of illegal lenders are either definitively credit excluded or have a history of problem debt

In areas that are served by the licensed high-cost lenders, users of illegal lenders appear more likely than other credit users either to be definitively credit excluded, in that they have used no form of commercial credit in the last five years, or to have a history of problem debt, including problems with high-cost lenders. In the quantitative research on deprived estates undertaken to support this project and in the nationally representative research with low-income households undertaken by Policis in 2004, illegal lender users reported a history of missed and late payments on credit accounts, default on credit agreements, current account delinquency, CCJs and even bankruptcy. Against this background it is perhaps not surprising that more than seven out of ten users of illegal lenders report experiencing refusals from legitimate lenders.

Illegal lender users often have a history of problem debt, with most recent problem debt likely to have been incurred with home credit lenders

Chart 16 Illegal lender users reported history of credit problems



Base: Illegal lender users who have used licensed lenders within last five years

Source: TNS research for Policis 2004

Borrowers from illegal lenders may have tried to borrow from licensed lenders and either encountered refusals or failed to cope with legal models

"I've applied for a credit card, but they just turn me down."

(Male, illegal lender user, Birmingham)

"They advertise them (loans) on the TV, or they drop leaflets. You try to get one and you can't."

(Female, illegal lender user, Birmingham)

"I've had catalogues but I've fallen behind on payments, ripped up a few letters and just forgotten about it."

(Male, illegal lender user, Birmingham)

3.4 The cross-over between use of illegal lenders and use of other forms of credit

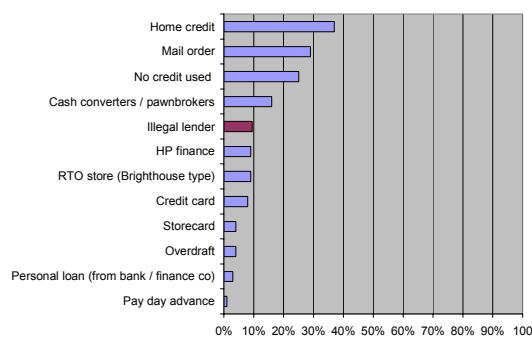
There appears to be a hierarchy of credit choices in these deprived estates with interest free Social Fund loans at the top and illegal lenders at the bottom

The saturation surveys suggest, as does previous research (Whyley et al, 2000) that there is a clear hierarchy of preference in credit choices for the residents of deprived estates, with interest free Social Fund loans at the top, various forms of commercial credit in the middle and illegal lenders at the very bottom. Those on qualifying benefits turn first to the government's interest-free Social Fund, which in 2005 provided a little over 40% more credit by value (i.e. money in the form of loans) to benefit recipients than did home credit

lenders²⁰. Those able to access and cope with cheaper forms of credit, such as sub-prime credit cards, choose these over home credit or other high-cost credit types. Indeed the quantitative research suggested that a relatively high proportion of individuals living in deprived estates had applied for the sub-prime credit cards that have been heavily promoted in the media targeting low-income households, with most experiencing refusals. The saturation surveys suggest that those unable to access cheaper forms of credit (i.e. those who have been refused by suppliers offering lower cost credit) turn to home credit in the first instance and, if they have something of value to pawn, to pawn-brokers²¹ where they are unable to access home credit. Only where they are unable to borrow from home credit lenders and have nothing of value to pawn, do borrowers turn to illegal lenders. The exception may be those for whom borrowing from illegal lenders occurs at point of sale of other goods (such as black market alcohol, cigarettes or even drugs – see discussion of lender typologies following).

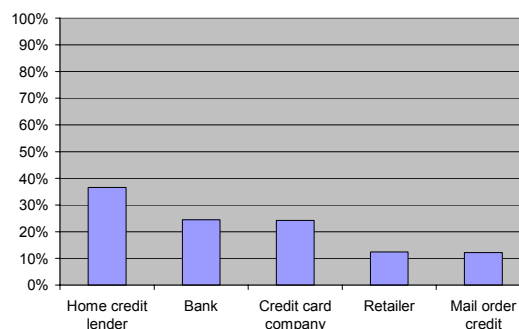
In areas served by the home credit lenders, those refused credit by other lenders turn first to home credit, followed by pawn or do without experiencing refusals

Chart 17 Credit used in last 12 months for those with credit refusals



Base: Those refused credit on deprived estates
Source: Policis / PFRC saturation surveys 2006

Chart 18 Illegal lender users – legitimate lender most recently had problems with



Base: Illegal lender users
Source: Policis / PFRC saturation surveys 2006

A significant degree of cross-over between high-cost and illegal lending

There is a significant degree of cross-over between home credit use and use of illegal lenders. According to the saturation surveys, slightly less than one in five of home credit users on the most deprived estates (18%) are prepared to admit that they or someone in their households have used an illegal lender while around half (53%) of users of illegal lenders claim to have used a home credit lender within the last twelve months. Those borrowing from illegal lenders in areas served by the high-cost lenders have often simply reached the end of their credit line with the home credit lenders or have failed to make the repayments on a home credit loan. Indeed, among illegal lender users, the highest incidence of recent problem debt was with home credit lenders. Faced with this situation most

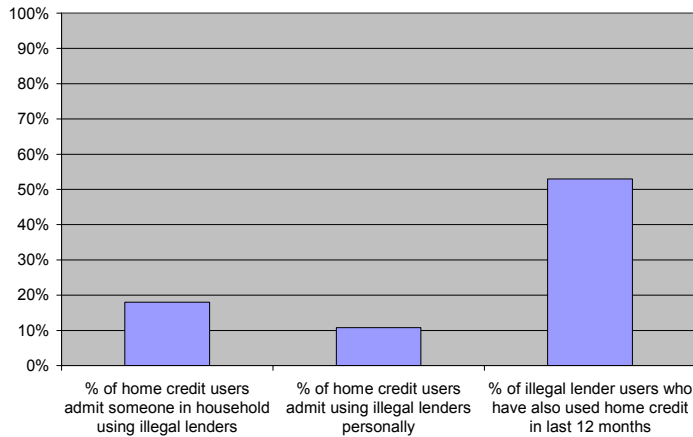
²⁰ Source DWP for Social Fund data and Policis estimates for HM Treasury and NCC, based on Taylor Nelson Research for Policis with nationally representative sample of benefit-dependent consumers 2004.

²¹ Previous qualitative work by the PFRC suggests that among users of pawnbrokers as a whole (as distinct from those who have been turned down for home credit) some use home credit in addition to pawn-broking while around a third of pawn-broker users use no other form of credit).

will do without credit or rely on mail order. However, for those seeking cash, illegal lenders can represent the only option for credit.

Around half of illegal lender users have used home credit in the last twelve months

Chart 19 The cross-over between home credit and illegal lending

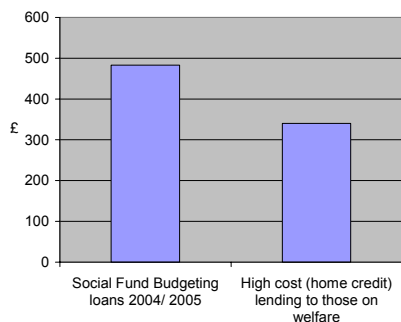


Base: Residents of deprived estates
Source: Policis / PFRC saturation surveys 2006

Significant cross-over between use of Social Fund and illegal lenders, with Social Fund second only to home credit as alternative source of credit for illegal lender users

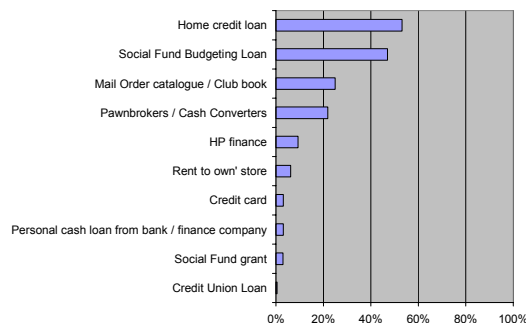
The Social Fund, which provides interest free loans to those on benefits who meet various qualifying conditions, would itself appear to act as a substantial bulwark against illegal lending in that it represents the single most important source of credit for those on welfare benefits. Important as it is, however, the Social Fund is, by its nature, cash limited and inflexible. As mentioned earlier, a significant proportion of applications to the fund are rejected. Given the pressure on the system, the Fund cannot meet all the credit needs of those on benefits. In the same way that the presence of the Social Fund may reduce but not prevent the incidence of borrowing from licensed high-cost lenders by those on benefits there is also a high degree of cross-over between use of the Social Fund and use of illegal lenders. The saturation surveys on deprived estates indicates that around half (50%) of users of illegal lenders had a Social Fund loan or grant within the last twelve months, making the Social Fund almost as important a source of alternative credit for users of illegal lenders as home credit.

Chart 20 Total value of social lending and home credit advanced to benefit recipients 2005



Source: DWP, ABCUL, Policis estimates based TNS research for Policis 2004

Chart 21 Commercial and social credit used in past 12 months by illegal lender users



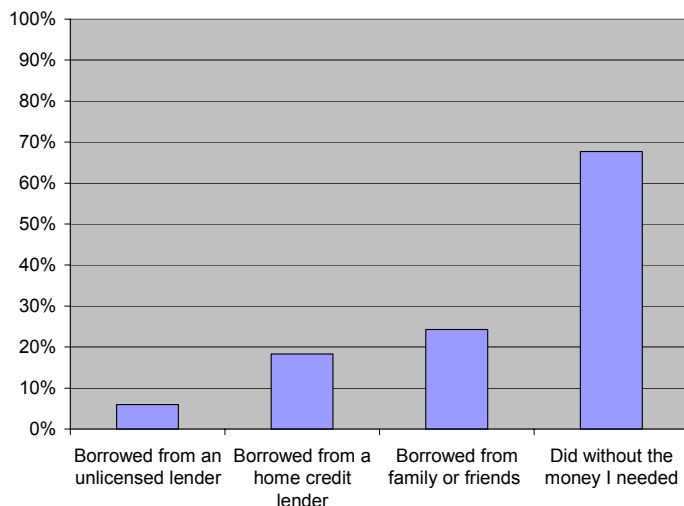
Base: Illegal lender users

Most of those turned down for Social Fund loans do without credit or turn to informal or legitimate lenders but some will resort to illegal lenders

A similar situation to that evident among those turned down by home credit lenders can be observed among those turned down for Social Fund loans. Again this is illustrative of the hierarchy of credit choices. The majority of those whose applications to the Social Fund are turned down either do without credit, or borrow informally from family and friends. Others, a little short of one in five (18%) will turn to the home credit lenders while a desperate minority (6%) will turn to illegal lenders²².

Those refused credit by the Social Fund turn to home credit lenders before resorting to illegal lenders

Chart 22 Outcomes of Social Fund refusals



Base: Those refused Social Fund loan or grant

Source: National Consumer Council / Policis Affordable Credit 2005

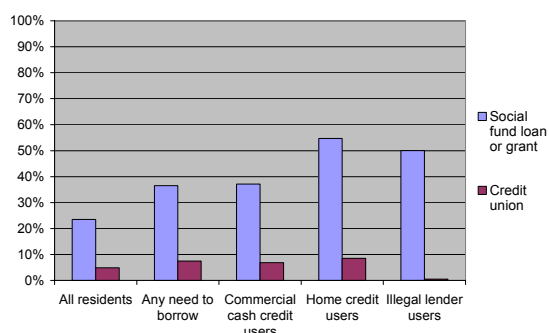
²² Source Policis and NCC research for Affordable Credit, based Taylor Nelson Sofres research with nationally representative sample of low-income households 2004.

Most credit unions are not serving the same universe as those using illegal lenders

Not-for-profit social lending in the form of credit from credit unions appears not to have the same role as either home credit or the Social Fund in the repertoires of those at risk from illegal lending. Indeed the saturation surveys indicate that credit unions appear to be serving a different universe, with borrowers from credit unions even on these very deprived estates being significantly more up-market than borrowers from either the high-cost lenders or the illegal lenders. Credit union borrowers had higher average incomes and were more likely to be in work than either home credit borrowers or illegal lender users. In marked contrast to the high degree of cross-over between loans shark use and use of the Social Fund and home credit, the incidence of credit union use among illegal lender users was very low. Earlier work also shows little overlap between users of credit unions and those using the Social Fund²³.

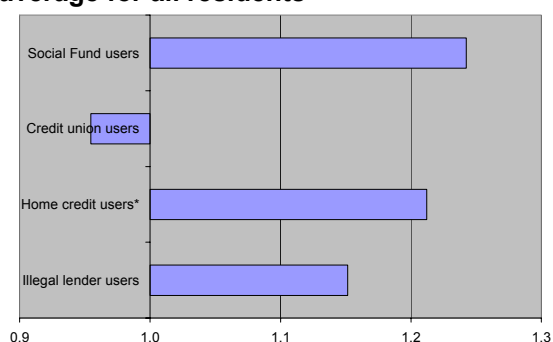
Credit union users are more likely to be in work than those using illegal lenders

Chart 23a Social lending use among different credit user types



Base: Residents of deprived estates
Source: Policis / PFRC saturation surveys 2006

Chart 23b Incidence of no-one working in household for illegal lender users relative to average for all residents



Base: Residents of deprived estates
1.0 = all residents of most deprived estates

Some credit unions, particularly in Scotland, appear to have considerable exposure to users of illegal lenders however

However, it is also true that some credit unions, particularly in Scotland, do have a customer base which has made significant use of illegal lenders, with these unions having developed considerable expertise in managing high-risk borrowers. One manager of a credit union on the outskirts of Glasgow estimated that up to a quarter of the membership were either currently using illegal lenders or had recently done so.

²³ Whyley, Collard and Kempson, Saving and Borrowing DWP 2000.

3.5 The scale and distribution of illegal lending

Estimates based on research are likely to understate the scale of illegal lending

Our estimate of the scale of illegal lending is based on two sources of data: first, the saturation surveys of deeply deprived estates undertaken to support this project and second, the findings from two earlier nationally representative surveys of low-income households that examined patterns of credit use, including the use of illegal lenders (for methodological details see sections 6.5 and 6.1). The former indicated that the incidence of illegal lender use was higher in areas of greater poverty while the latter both produced a very similar incidence among the low-income population more generally. Both sources of data are likely to understate the scale of the problem. We make no attempt here either to compensate for under-reporting or to comment on the likely extent of under-reporting. Estimates of the incidence of illegal lending do not attempt either to include any illegal lending that may be occurring among affluent consumer groups, though given the range of legitimate credit options available to these households in the UK, the likelihood is that any such incidence is low to the point of not being measurable by survey.

It is worth bearing in mind the possibility that under-reporting could be significant however. It was quite clear from the saturation survey fieldwork that people were reluctant, even afraid, to discuss illegal lending. Indeed, as it became known on the estates that the research was taking place, some individuals reported to researchers that they had been told not to take part and / or to deny any involvement in illegal lending. In some instances, the researchers themselves were threatened and followed.

The saturation surveys indicate that, broadly speaking, around twice as many people were prepared to admit to knowing people within the estate using illegal lenders as were prepared to admit to use among their own family and friends. Similarly around twice as many people were prepared to admit that their own social circle used illegal lenders as were prepared to admit that use was occurring within their own household. Only half of those willing to say that that someone in their household was using an illegal lender were prepared to admit that they had personally used an illegal lender.

There are approximately 1.4 million individuals living in areas of greatest deprivation and most at risk from illegal lenders

There are approximately 5.5 million households with income in the lowest quintile of national household income. Of these we have classified some 1.4 million as being in the most deprived areas, i.e. areas with a composite Index of Multiple Deprivation (IMD) percentile score of more than 95%.

There are an estimated 850,000 households in areas not served by the home credit lenders on safety grounds

There are in fact relatively few areas, even in some of the most disadvantaged estates, which are not served by the major home credit lenders. On the basis of an examination of non business addresses in those post-codes which are not served or significantly under-served by the home credit lenders, we

estimate that there are some 850,000 home credit excluded households in the UK, being some 3% of the total number of households.

Illegal lending occurs mainly in predominantly white areas and is prevalent in areas with a high incidence of crime, social problems and substance abuse

As earlier discussed, more people were prepared to admit to being aware of illegal lenders or to their friends and social circle using illegal lenders than were prepared to admit that they or someone in their own household had done so. Illegal lending appears also to be more prevalent in predominantly white areas and racially mixed areas (9% in predominantly white areas, with 27% of residents claiming awareness of illegal lenders operating) than in areas which are predominantly Black or Asian (1% in predominantly Black / Asian areas with only 5% of residents claiming awareness of illegal lenders operating). This may reflect differences between communities in illegal lending models however. The Trading Standards experience and previous research²⁴ suggests that this may be because such lending is more likely to be intermediated by brokers and go-betweens and that it is more likely to take place among more affluent sections of the community, being often effectively business lending. As discussed earlier, illegal lenders are better able to operate in low-rise housing than in high-rise flats in England and Wales though are commonly found in high-rise housing in deprived estates in Scotland. Finally the highest crime areas are most at risk as are areas where there is a high incidence of drug or alcohol abuse.

We estimate that there are some 165,000 UK households using illegal lenders, with half of these households being in the most disadvantaged areas

Taking all these factors into account and adjusting for biases in the sample base (see section 6.7 and figure 8 in technical appendix), we estimate that there are some 165,000 households in the UK using an illegal lender, of which a little short of 80,000 are in the most deprived areas of the UK. In other words, around half of the lending occurs in the 25% of low-income households that are in the most entrenched areas of poverty. This is the equivalent of 6% of households in the most deprived areas and around 3% of low-income households generally.

We estimate that the value of funds paid to illegal lenders to be circa £120m per year or circa £730 per victim

On the basis of average loan values reported by those using illegal lenders in the saturation surveys, we estimate the total value of funds borrowed from illegal lenders to be a little more than £40m p.a., with lenders collecting a little less than £120m p.a. from borrowers, implying a net cost of this credit of circa £80m p.a. or circa £480 per borrower. To put this in context, the high-cost home credit lenders lent a total of some £1.5bn to some 2.3 m largely low-income borrowers in 2005, who together repaid a total of some £1.9bn²⁵, implying a total cost of credit of £400m, or £170 per borrower. Of this, we

²⁴ A Herbert and E Kempson (1996) Credit use and ethnic minorities. London: Policy Studies Institute.

²⁵ Competition Commission Provisional Findings Home Credit Inquiry 2006.

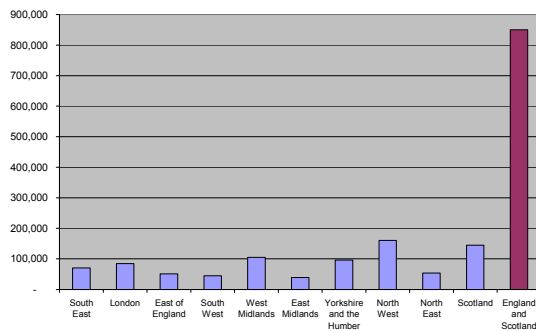
estimate some £340m is lent to those on benefits while total Social Fund lending to those on benefits in the same year was some £480m. Greater detail on pricing, including illustrative APRs and TCCs follow in the next section.

The distribution of illegal lending follows patterns of both intense deprivation and home credit exclusion

Given the concentration of credit exclusion and illegal lending in the most deprived estates, the national distribution of illegal lending follows the wider pattern of disadvantage and deprivation nationally. Exclusion arises primarily in urban conurbations and disproportionately in Scotland, the North East and West, and Yorkshire and the Humber, being lowest in the affluent South East, at 1.5% of all households and peaking in Scotland, at 5.5% of all households.

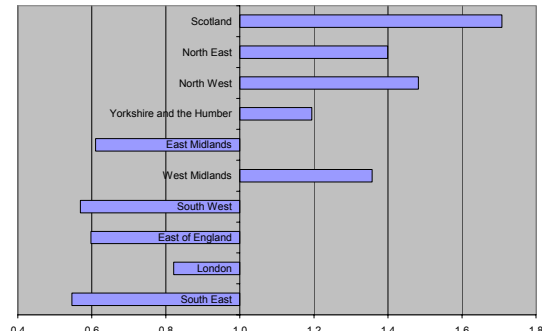
Home credit exclusion is disproportionately concentrated in Scotland and the North West where illegal lender activity is greatest

Chart 24a Credit excluded households by region



Source: Home credit lenders customer data

Chart 24b share of credit excluded households relative to share of population



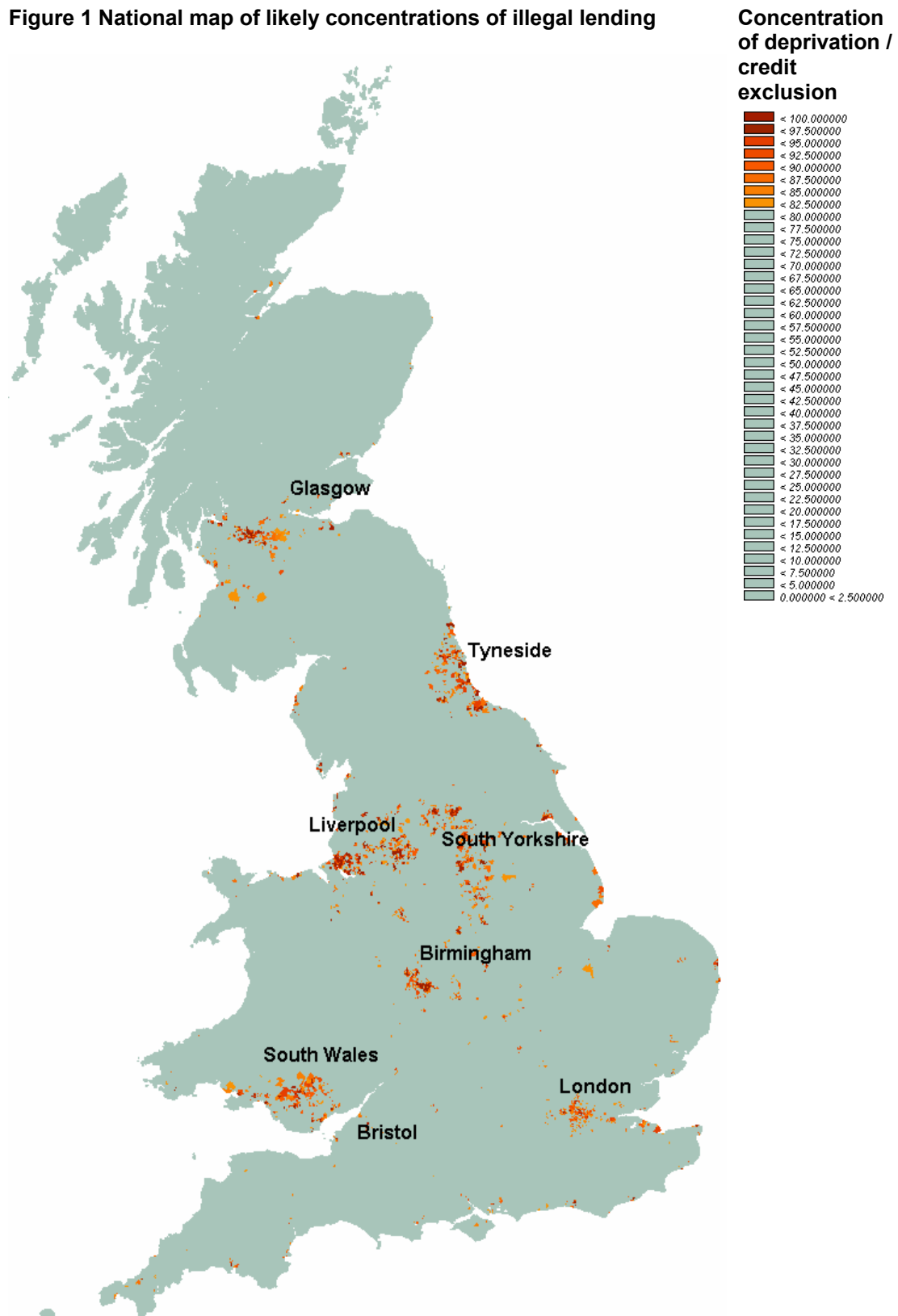
1.0 = share of credit excluded households is equal to share of population

The areas of greatest deprivation and credit exclusion are in the poorest micro-communities, predominantly in estates in Scotland, the North and Midlands

The national map of home credit exclusion and deprivation similarly shows the largest concentrations in Scotland, particularly Glasgow, the North, particularly parts of Liverpool, Manchester, Sheffield (Manor, Burngreave) and the Midlands (Nechells, Washwood Heath, Sandwell). In the South smaller concentrations exist in deprived boroughs in parts of London (Tower Hamlets, Newham), on the South and South West coast in Bristol, Southampton, Portsmouth, Hastings and Plymouth, while Wales has concentrations in Swansea and the Rhondda. At national level these areas of intense deprivation show up as micro-communities within largely urban areas. See Figure 1 which shows the national distribution of areas which are either home credit excluded or deeply deprived, likely to be concentrations of illegal lending. (For detail of methodology see section 6.8). These communities are those most at risk of illegal lending but it would seem likely that illegal lending occurs wherever there is a sufficient critical mass of individuals excluded from the licensed credit market, almost invariably in deprived housing estates.

Illegal lending is concentrated in deprived micro-communities

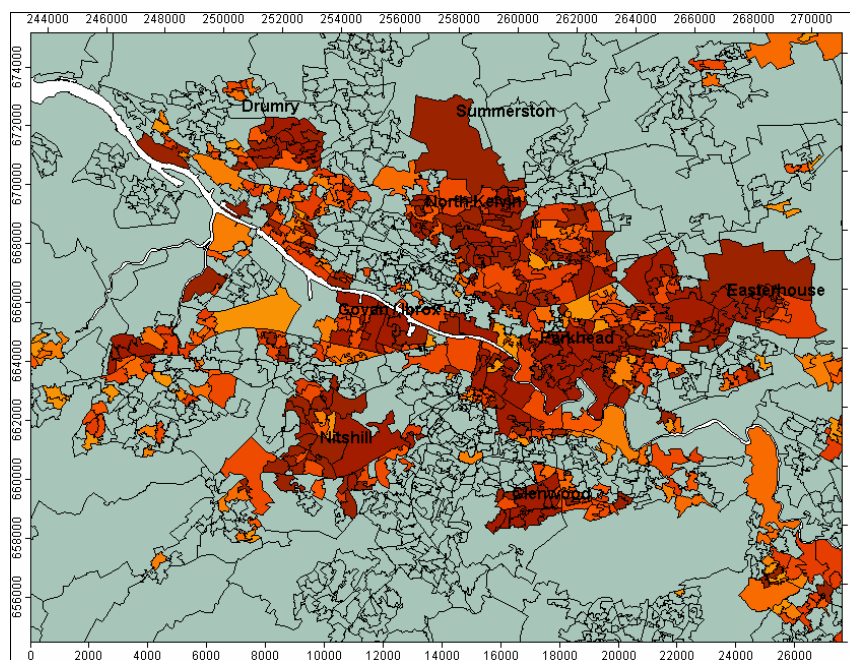
Figure 1 National map of likely concentrations of illegal lending



Concentrations of illegal lending occur in such small geographical areas that they need to be examined at very local levels. The maps that follow, featured in Figs 2 - 6, show concentrations of deprivation and, where it applies, credit exclusion and the high probability of illegal lending for Glasgow, Sheffield, Liverpool, Birmingham and the West Midlands and parts of London. As can be seen from the maps, within each of the major urban conurbations, the areas affected tend to be small. They are usually tightly-knit, micro-communities locked into a cycle of disadvantage that often spans generations. Although some of the most disadvantaged communities are concentrations of ethnic minorities, areas featuring illegal lending seem to be predominantly white.

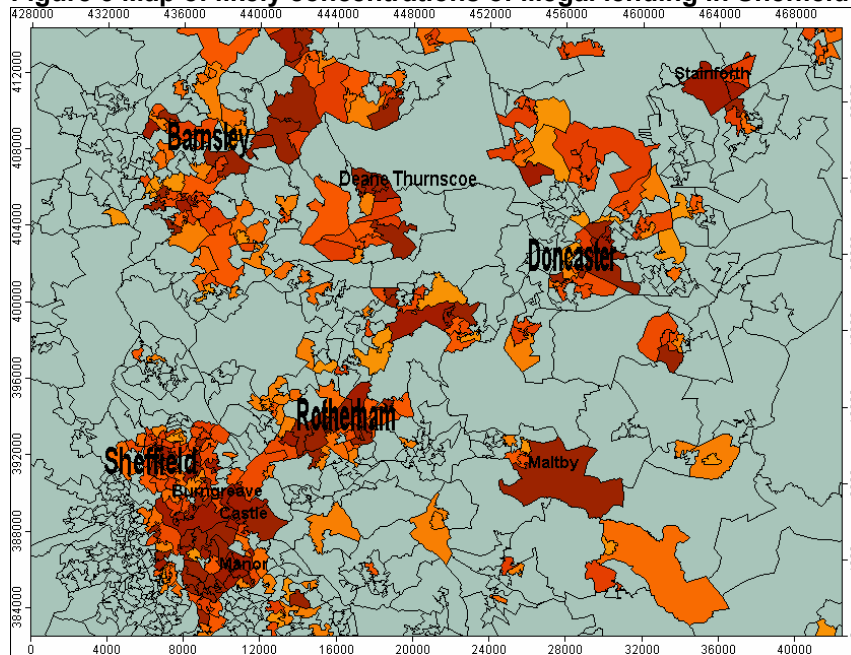
Glasgow features some of the most disadvantaged and high crime areas in the UK and so is fertile ground for illegal lenders

Figure 2 Map of likely concentrations of illegal lending in Glasgow



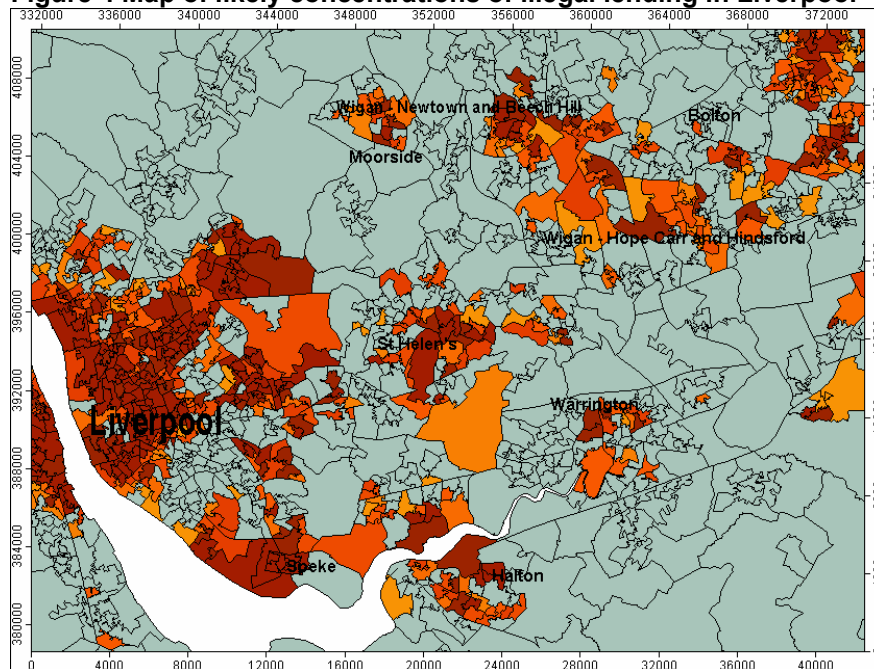
Deprived social housing estates in the North, particularly predominantly white estates, represent likely concentrations of illegal money lending

Figure 3 Map of likely concentrations of illegal lending in Sheffield



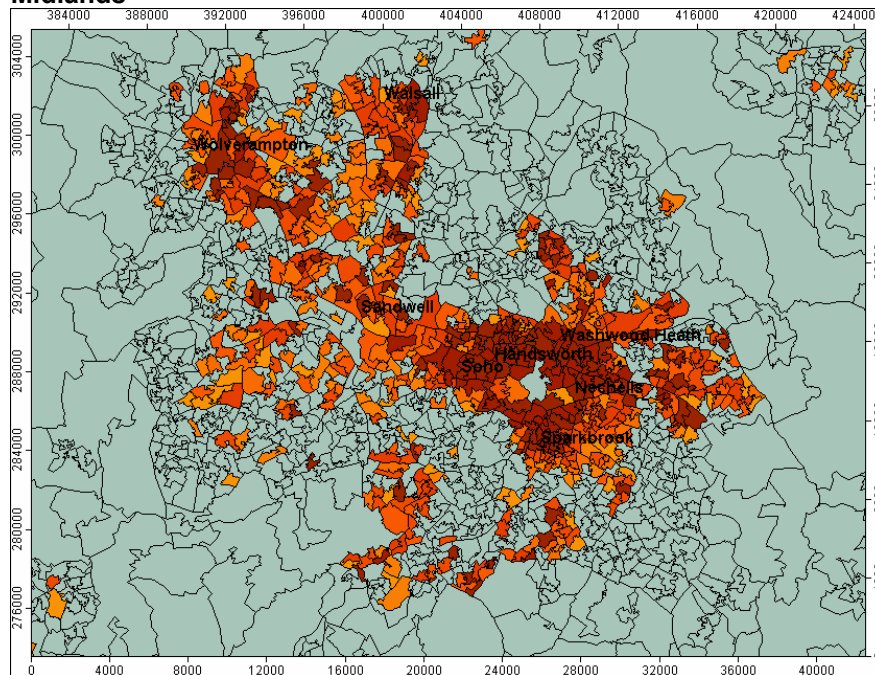
Liverpool contains some of the most deprived and ghettoised communities within which illegal lenders appear both active and well known

Figure 4 Map of likely concentrations of illegal lending in Liverpool



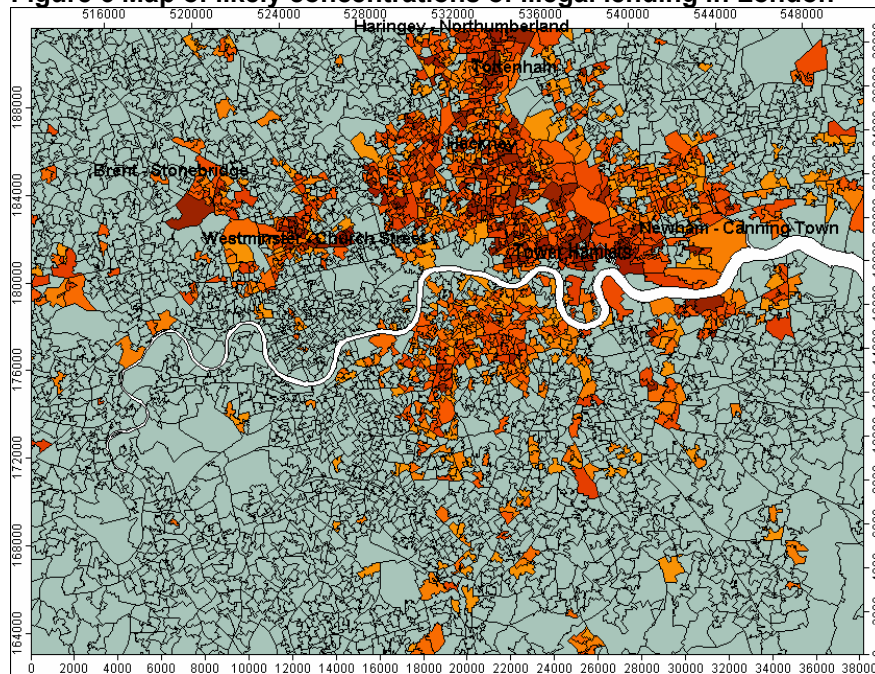
In the West Midlands illegal lenders reportedly operate in deprived estates across a wide area

Figure 5 Map of likely concentrations of illegal lending in Birmingham and the West Midlands



In the more affluent South East the incidence of illegal lending is lower than elsewhere but occurs in pockets of deprivation in East and South London

Figure 6 Map of likely concentrations of illegal lending in London



Section 4.0 Illegal lenders, their customers and the communities in which they operate

4.1 Illegal lender users

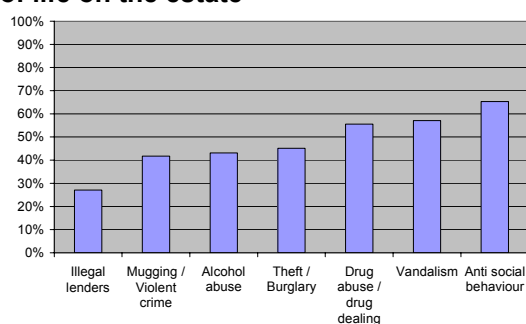
Illegal money-lenders are one factor in a range of crime and deprivation-related social problems in highly deprived neighbourhoods

As discussed in section 3.0, illegal lending in the UK arises in deeply-deprived micro communities. Such areas tend to feature a high degree of anti-social behaviour, vandalism and crime and have been a major focus of regeneration expenditure by the Labour government in the wider drive to address poverty and social exclusion. Despite these efforts, and significant improvements in such environments in recent years, a high proportion of residents taking part in the saturation surveys reported a variety of social problems as everyday features of life. Against this background, the operation of illegal lenders on these estates and the lack of access to banking and affordable credit were seen as just one facet of a range of enduring problems (See Chart 25a).

Broadly speaking, illegal lending is of less immediate concern to residents than high crime rates and the quality of life issues surrounding drug and alcohol abuse and anti social behaviour. That said, credit users, and particularly high-cost credit users were much more aware of illegal lenders operating on the estates and more likely to see the phenomenon as a problem (See Chart 25b).

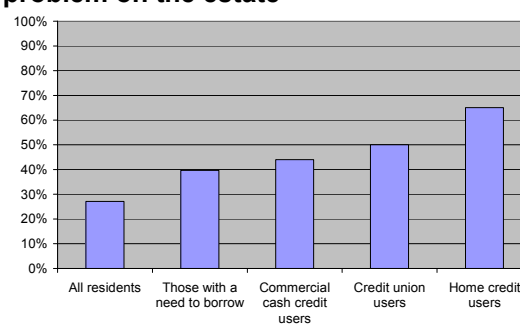
Illegal lenders part of wider picture of criminal and anti-social behaviour on estates and more likely to be seen as an issue by those with a need for credit

Chart 25a Perceived problematic features of life on the estate



Base: Residents of deprived estates
Source: Policis / PFRC saturation surveys 2006

Chart 25b Perception that illegal lenders a problem on the estate



Base: Residents of deprived estates
Source: Policis / PFRC saturation surveys 2006

The profile of illegal lender users is similar to that of home credit users

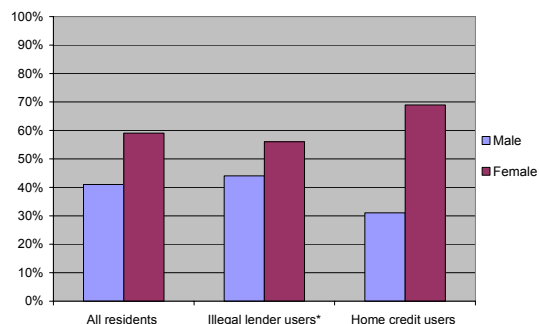
Data from both the saturation surveys and the witness statements from the illegal money lending teams in Birmingham and Glasgow, indicates that the profile of people who use illegal lenders is similar to that of home credit users – they tend to be women, mostly in their 30s and 40s, often lone parents bringing up families, and on low-incomes. Indeed, as discussed in section 3.4, there is a significant

degree of cross-over between the use of high-cost lenders, the government interest-free Social Fund and the use of illegal lenders.

Nearly three-quarters of the people who provided witness statements about using an illegal lender were women. And eight in ten of them were not in paid work. It may be however that those who came forward to give witness statements were among the most capable of the illegal lender user base. The saturation survey data confirms that women represent the majority of illegal lender users but indicates a stronger male bias than for home credit users in the same estates (See Chart 26a). This would appear to be explained by the male bias to drug and alcohol abuse in the areas surveyed. The saturation surveys suggest that there is a higher incidence of substance abuse, and indeed of chaotic life-styles more generally, among illegal lender users relative to users of other types of credit, both commercial and social lending.

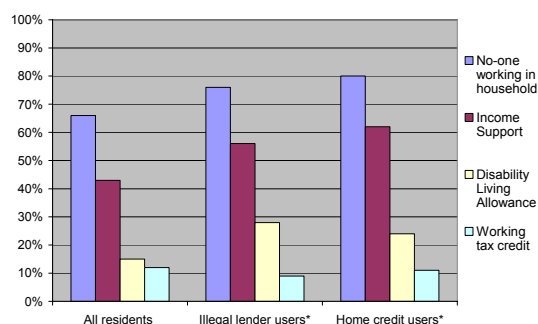
In comparison to home credit users illegal lender users have a greater male bias and a greater tendency to disadvantage

Chart 26a Gender profile of illegal lender users



Base: Residents of deprived estates
Source: Policis / PFRC saturation surveys 2006

Chart 26b Benefit profile of illegal lender users



Base: Residents of deprived estates
Source: Policis / PFRC saturation surveys 2006

Illegal lender users appear to be the most disadvantaged within deprived communities, with a high incidence of social problems, alcohol and drug abuse

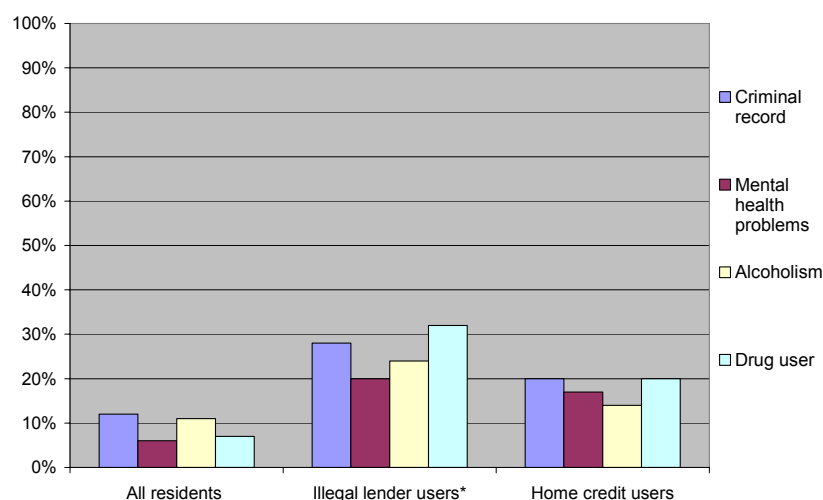
Indeed, even within the deprived communities described, users of illegal lenders appear to be among the most disadvantaged individuals, being more likely than either other residents as a whole or other credit users in these estates to have a variety of social problems. The profile of users derived from the saturation surveys in deprived areas and the nationally representative research suggests that poverty and benefit dependence is likely to be long term and that these individuals are less likely than all those on benefits to move in and out of poverty. Some three-quarters of illegal lender users have no-one working in their household, nearly one in three are on disability benefit and around a quarter are on incapacity benefits (See Chart 26b). Illegal lender users are not only more likely than other residents to be in receipt of disability benefits. They are twice as likely as all residents of deprived estates to have a criminal record or alcohol problems, three times as likely to have mental health problems and four and a half times as likely to have drug problems. The saturation survey data also suggested that there was markedly higher incidence of alcohol and drug problems among people who use illegal lenders in Scotland. This would seem to be supported by data from the index of multiple deprivation in Scotland which shows that the areas where the

saturation surveys were conducted generally had higher levels of alcohol and drug problems than was the case nationally.

This phenomenon of illegal lender users being highly disadvantaged is most marked on estates where the high-cost lenders also operate. The profile of users of illegal lenders living on estates which are excluded by the home credit lenders is closer to that of home credit users in estates which are served by these lenders.

Illegal lender users have a greater tendency to chaotic lifestyles than users of high-cost home credit

Chart 27 Social problems in household for illegal lender users relative to all residents and users of home credit



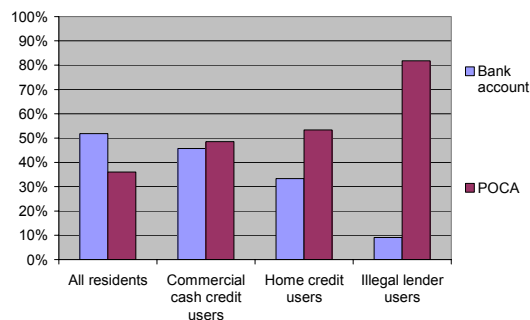
Base: Residents of deprived estates
 Source: Policis / PFRC saturation surveys 2006

Illegal lender users appear to be both exceptionally credit hungry and to have fewer credit options than other credit users.

Illegal lender users appear to be both exceptionally credit hungry and to have fewer credit options than other credit users. Possibly as a result of the background life-style factors just discussed, users of illegal lenders appear to be markedly more financially excluded than other residents – in the sense of having meaningful access to financial services. The saturation surveys indicate that users of illegal lenders are much more likely than other residents living in the same area to have a low functionality Post Office Card Account (POCA) rather than a current account (See Chart 28) while one in five have used no commercial credit in the last five years. Illegal lender users also appear to have a greater felt need for credit than other credit users – as measured by perceived frequency of the need to borrow (See Chart 29). The combination is a damaging one, exposing often vulnerable individuals to the temptation of borrowing from the illegal lenders who appear not only well placed to identify likely victims but also to actively target those desperate for cash.

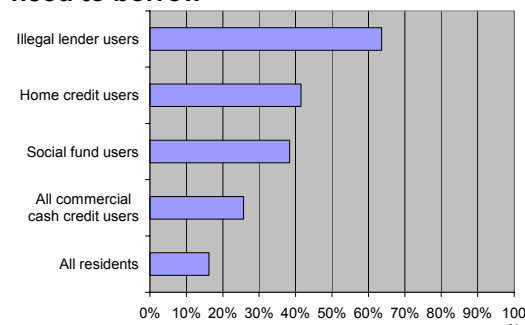
Illegal lender users appear to have little meaningful access to even basic financial services and to have a frequent need to borrow

Chart 28 % having current accounts or Post Office Card accounts



Base: Residents of deprived estates
Source: Policis / PFRC saturation surveys 2006

Chart 29 Proportion claiming a frequent need to borrow



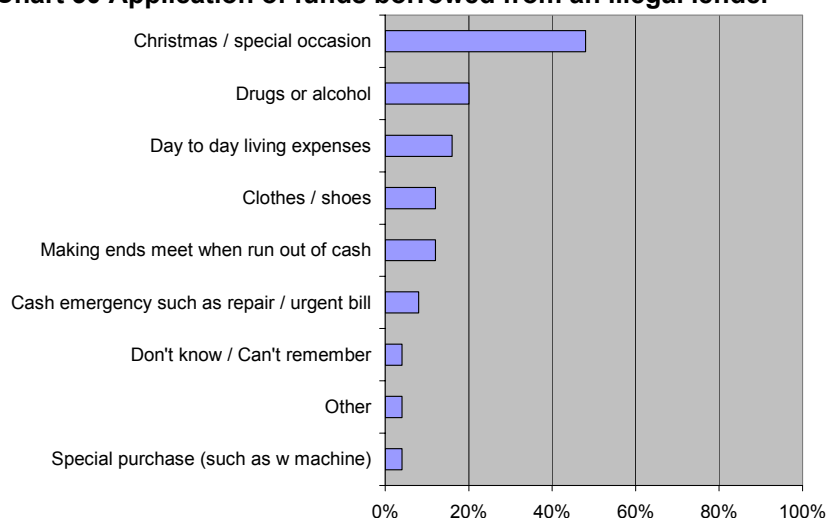
Base: Residents of deprived estates
Source: Policis / PFRC saturation surveys 2006

Use of money borrowed is similar to home credit but with one key difference – a significant minority of funds used to buy alcohol or drugs

The pattern of how funds borrowed from illegal lenders are spent would appear to support the thesis that users of illegal lenders are higher risk than other commercial credit users and have more chaotic life-styles than other users of high-cost home credit lenders. The use of money borrowed from illegal lenders is not dissimilar to that of money borrowed from home credit lenders more generally, in that funds tend to be used to defray expenses across peaks of expenditure, such as Christmas, to fund day to day living expenses and to meet cash emergencies. There is however one major difference between the application of home credit and illegal lender derived funds. Among illegal lender users a significant minority of funds appears to be used to purchase drugs and alcohol, this being the second most frequently claimed application of borrowed funds after Christmas. There is little reference in the literature to suggest that such expenditure is an important application of home credit funds.

The most important application of illegal lender derived funds is Christmas as is also the case for home credit sourced funds

Chart 30 Application of funds borrowed from an illegal lender



Base: Illegal lender users
Source: Policis / PFRC saturation surveys 2006

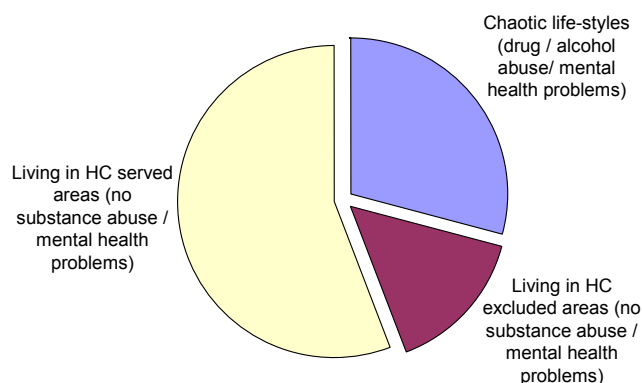
Only a minority of illegal lender users exhibit chaotic life-styles, most are simply unable to access legitimate credit

Given this background it would appear important in arriving at policy responses to try and distinguish between different illegal lender user types and particularly between users with more or less chaotic lifestyles. It is important to appreciate that those with significant social problems seem to represent the minority of illegal lender users, with most simply either living in a home credit excluded area or unable to access other forms of credit. It would appear that somewhere in the region of three in ten illegal lender users could be classified as having chaotic life-styles in that they admit to drug or alcohol abuse or claim to have mental health problems. Around one in five would appear to be living in home credit excluded areas. The balance, around half of all illegal lender users, live in areas served by the home credit lenders but are, for various reasons, not able to access home credit, primarily because they are at the end of a home credit line, are behind on home credit payments or have defaulted on a home credit loan. Given that somewhere between 35% and 45% of home credit customers either miss more than half of payments or never pay and that less than one in ten pay in full and on time, this would not seem surprising²⁶, in that home credit users on these estates will be among the highest risk customers within the home credit customer base. Some two thirds of illegal lender users living in home credit served areas have used home credit in the last twelve months.

²⁶ Competition Commission Remedies Statement in Home Credit Inquiry August 2006.

Most illegal lender users are either at the end of their home credit line or living in home credit excluded areas

Chart 31 Illegal lender user by type



Base: Illegal lender users

Source: Policis / PFRC saturation surveys 2006

4.2 The relationship between illegal lenders and their customers

Communities tend to be close-knit and hostile to outsiders with illegal lenders often well known within the estates on which they operate

The communities in which illegal lenders operate are often both close-knit and self-contained, in some cases effectively ghettoised. Such communities tend to be inward-looking, with residents knowledgeable about the activities and circumstances of others living in the estate. Both the work undertaken by the pilot Trading Standards projects and the research team's experience in undertaking the fieldwork indicates that visitors from outside the community are unusual and quickly noticed. The presence of strangers is rapidly communicated and residents are typically defensive and hostile towards outsiders.

Residents claim that on average three illegal lenders operate within their own community

The research suggested that illegal lenders are well-known within their communities and that residents tend to be aware of which of their neighbours are borrowing from illegal lenders. Among those prepared to give an answer in the saturation surveys, four out of ten (38%) claimed to be aware of individuals acting as illegal lenders on the estate currently (with this rising to 86% in Scotland), with residents estimating on average that three illegal lenders were operating on their estate at any one time. The witness statements collected by the illegal money lending teams in Glasgow and Birmingham suggested that in some instances (and this seemed to be particularly the case in Scotland), illegal lenders were a well-established feature of local communities, with some families well known as having been involved in illegal lending (and often other criminal activities as well) for some years.

Illegal lenders build their business through social networking within the community, with referrals to friends and family of borrowers key

Against this background, illegal lenders create and expand their business by means of social networking, building contacts and their loan books through referrals from existing borrowers. Three quarters of those who admitted to using illegal lenders in both the saturation surveys and the nationally representative research also claimed that their family and friends used illegal lenders. The witness statements collected by the illegal money lending teams in Birmingham and Glasgow indicate that word-of-mouth was the most common way in which people came to know about and use illegal lenders. People who used illegal lenders generally came into contact with them through partners, friends, family members or neighbours who borrowed from the lender.

“There’s a few that run round here where I live and she knows him through somebody else. It just goes around and people start using them.”

“Basically, it all started out that I met him through a friend and this friend told me he was a genuine bloke.”

“It’s through talking to people on the street. Quite a lot of people round here have had X as a money lender.”

“I got £200 and that was Christmas and that was how it started. And a week later he (husband) went and did the same.”

(Users of illegal lenders explaining how they had got in touch with a illegal lender)

In the UK, illegal lending is invisible outside the communities in which it occurs with overt promotion rare, low-key and highly localised

In contrast to illegal lending markets in some other countries where marketing activities can be highly visible and relatively sophisticated, in the UK such advertising and promotion as does take place tends to be discreet, small-scale and highly-localised. In a small number of witness statements, people described how they had contacted an illegal lender by answering an advert for cash loans that had been placed in a local shop window. In addition, most of the customers of one illegal lender knew him because he had previously worked for a licensed credit provider as their home credit agent.

“...they [illegal lenders] tend to live in the community anyway, so they all know who the single mothers are, they know who the people are who are claiming benefits, and a lot of it is word-of-mouth and local knowledge...they will come and offer you money and once you have done it once, you are on the hook.”

(Trading standards officer, Liverpool)

Illegal lenders are well placed to spot lending opportunities while hard pressed borrowers find it difficult to resist the temptation of proffered cash

Coming from the local community, illegal lenders often have the advantage of knowing who is most likely to be in need of credit and are thus well positioned either to target likely borrowers or to take advantage of opportunities as they arise. For their part, borrowers, often chronically short of funds and sometimes desperate for cash, tend to find it difficult to resist temptation when funds are offered.

“I was in financial difficulties. I needed a quick way of getting money. It’s on the spot. It’s there and then.”

“The thing about Lender A was that it was a quick £200 towards your Christmas shopping, for presents for the kids.”

“... just clearing the bills off – paying the gas, electric, getting a bit of food in, getting my drink in. I wasn’t getting anything outrageous. I’ve got nothing to show for it, just an empty purse at the end.”

“The other day I paid him off and he gave me another £200. I didn’t even ask him for it. I just took it, thought: I’ll get some more freezer stuff and have a night out.”

(Users of illegal lenders explaining why they borrowed from a illegal lender and how they used the funds)

For those able to maintain their payments, relationships with illegal lenders could be civil and even friendly

Lenders appear to vary considerably in their approach, in the type of customers they are prepared to lend to and in the way that they manage their customer base (for discussion of different lender types, see section 4.5). Some lenders positioned themselves as providing a community service and appeared to maintain relatively cordial relationships with their customers. The witness statements suggest that for some people - almost exclusively those who managed to keep up with their repayments - interaction with an illegal lender could be civil and business-like. Some borrowers – albeit a small minority – saw the illegal lender in a positive light, even considering the lender to be a friend.

“Basically, it all started out that I met him through a friend and this friend told me he was a genuine bloke.”

“He said. I do this. I help people.”

“He was quite a friendly person. He was quite calm about it. He was well mannered.”

“He did have his times when he was a great bloke. There were times when you’d say I need this and I need that. And he would say keep paying me for a few more weeks and I’ll see what I can do. I’ll give you £100 on top for not missing me.”

(Users of illegal lenders, Birmingham)

Illegal lenders’ relationships with their customers differs fundamentally from those of the home credit lenders

To the extent that they build business through referrals and collect small sums weekly from their victim’s homes, illegal lenders share some of the characteristics of the modus operandi of the high-cost, licensed home-credit lenders. As with the home credit lenders, illegal lenders rely on being an accessible and rapidly available source of cash and on customer referrals as a source of new business. There the resemblance ends however. Despite the evidence that some illegal lender : borrower relationships are cordial and that some illegal lenders actively seek to mimic the modus operandi of licensed

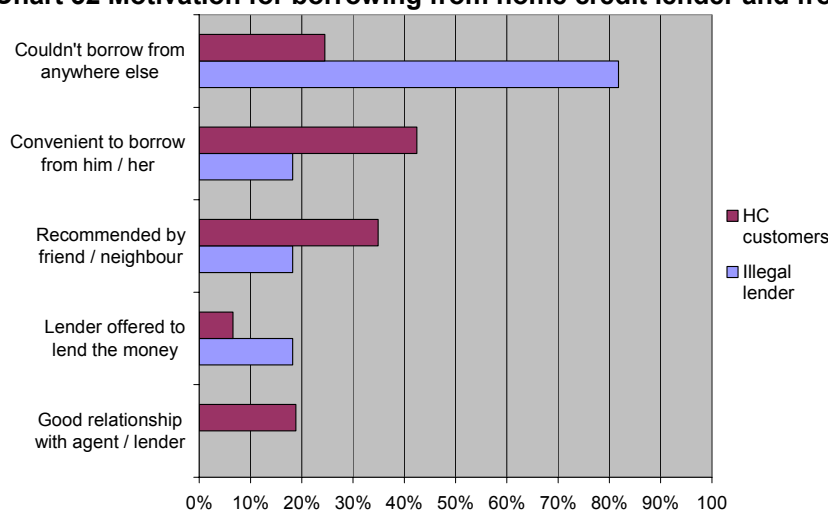
lenders, this was unequivocally not the case for the majority. Both the qualitative research and the saturation surveys suggest – and the witness statements given to the illegal money lending teams confirm – that relationships between borrowers and illegal lenders are in most cases intimidation-based.

In contrast to the home credit lenders, most relationships between illegal lenders and their customers are based on fear and intimidation

In marked contrast to borrowers’ relationships with the licensed home credit lenders, which can be positive, even friendly, illegal lenders sustain long term relationships with their customers and maintain collection rates through a regime of fear and the threat of violence (see Chart 34 and discussion of evidence following). According to the saturation surveys, even among those who had not experienced threats of violence or intimidation, none of the illegal lender users cited a good relationship with the lender as a reason for borrowing while this was the most significant factor for around a fifth of home credit customers (See Chart 32).

Home credit agents leverage their close relationships with customers to create sales opportunities while illegal lenders rely on borrower’ desperation

Chart 32 Motivation for borrowing from home credit lender and from illegal lender



Base: Home credit users and illegal lender users on deprived estates
 Source: Policis / PFRC saturation surveys 2006

Lenders seek to control their customers by creating a climate of fear and intimidation

From the lender perspective, generating a climate of fear among their customers not only ensures that the illegal lender becomes a priority creditor but makes customers deeply reluctant to report their activities to Trading Standards or the police for fear of reprisals. Indeed relationships based on fear and the threat of violence appear to be a key characteristic of illegal lending operations, wherever they arise, both in the UK and elsewhere²⁷.

²⁷ For evidence from Germany see Policis, Economic and Social Risks of Credit Market Regulation 2006, and from Japan (JFBA 2002).

Intimidation ensures that payments to illegal lenders are prioritised within over-stretched budgets while fear of reprisals protects lenders from reporting

Chart 33a How feel about reporting illegal lender

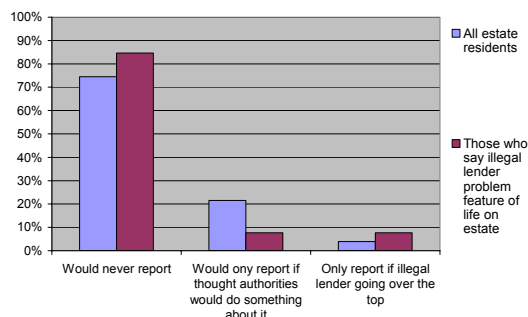
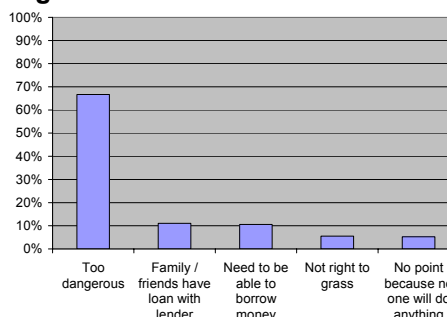


Chart 33b Reasons for not reporting illegal lender



Base: Residents of deprived estate, Liverpool

Source: Policis / PFRC saturation surveys 2006*

* Question not asked beyond 150 sample pilot survey

Illegal lenders use threats and violence to support the intimidation which enables them to collect from borrowers with limited resources

The qualitative research and the saturation surveys indicate that customer management was sustained by intimidation, with customers reporting a range of controlling practices underpinned by threats of various kinds (See Chart 34). It was also alleged in the witness statements provided to the illegal money lending teams in Birmingham and Glasgow that five of the seven illegal lenders prosecuted had used threatening behaviour or intimidation towards borrowers when they were unable to repay what they owed, with around a third (36%) of people who provided witness statements reporting being threatened or intimidated by lenders. This included threats to seize white and electrical goods and personal documents as well as threats of violence and verbal abuse. Earlier UK studies have also found evidence of illegal money lenders using intimidation and physical violence if borrowers were late with their repayments or had difficulty repaying what they owed (Whyley et al, 2000; Jones, 2002; Whyley, 2002). Instances of impersonation and forced entry to people’s homes have also been reported (Kempson and Whyley, 1999).

The threat of violence is used more often than it is applied but it is clear that illegal lenders exhibit violent behaviour where they deem it necessary

It would appear that in fact, the mere threat of violence or exploitation is in most cases sufficient to maintain control. The proportion of individuals who reported having personally experienced violence or being forced into providing sexual favours was low relative to the reported awareness of controlling and violent behaviour. Similarly, in examining the evidence from the illegal money lending teams, a relatively small number of people who gave witness statements (six out of a total of 109) reported that they had been physically assaulted by an illegal lender, with these allegations relating to three different lenders. In some cases, these assaults were reported to the police, in others they were not. The higher incidence of violence reported in the saturation surveys than was evident in the witness statements may simply mean that those who have been on the receiving

end of violence from an illegal lender are highly unlikely to come forward as witnesses, as they will have first hand and painful experience of the consequences of crossing their lender.

“He threatened to take my TV and everything...He said he’d send people to sort her out...I had £10 in my purse for the weekend. He took the last £10 out of my purse himself. Went through my purse.”

“He took (NAME – wife’s friend’s) washing machine and freezer.”

“He said: We’ve got ways of dealing with people who can’t pay. I’ve heard that he’s had a woman beat up through not paying once.”

“I felt threatened. He’s one of them blokes that can intimidate not even using force – the things he comes out with and the things he threatens you with.”

“He say’s he’ll use them as prostitutes. He’ll put them on the game.”

Illegal lenders can also deploy blackmail or require sexual favours or collaboration in a range of criminal activities in lieu of payment

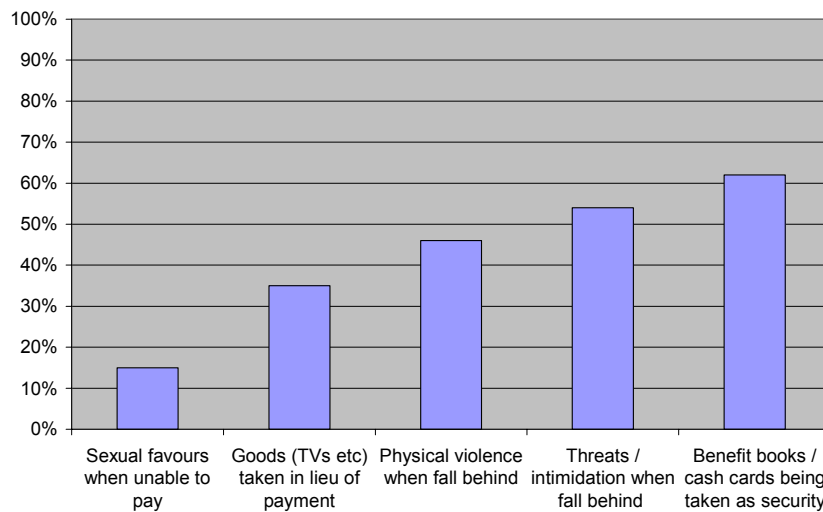
According to the Trading Standards illegal lending teams, blackmail is another way of extracting payments from borrowers – two illegal lenders who were successfully prosecuted in Birmingham were charged with blackmail as well as lending without a consumer credit licence. There were also reports from the domain experts of some lenders who offered to accept sexual favours from women customers in lieu of payment, and of sexually-related blackmail.

As one of the experts commented: *“It’s all about controlling the environment”*.

In some cases, the evidence from the illegal money lending pilots suggest that illegal lenders may even actively target vulnerable young women with a view to their sexual exploitation if they have difficulty repaying their loans. In addition, both the domain expert interviews and witness statements indicate that borrowers were sometimes made to carry out criminal activities by lenders – provision of alibis, participation in drug dealing, shoplifting, stealing to order and prostitution – as a means of repaying their debt.

Illegal lenders support collection with exploitative and coercive practices intended to reinforce their violent reputation and control of their customers

Chart 34 Reported collection management practice of illegal lenders



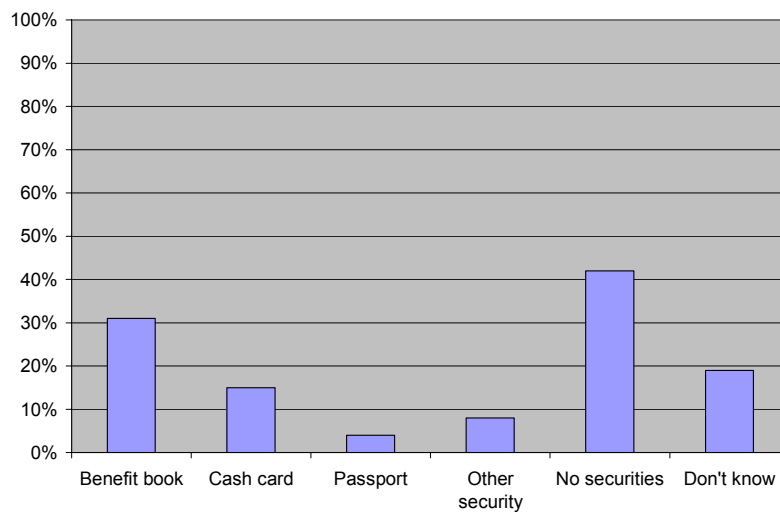
Base: Illegal lender users
Source: Policis / PFRC saturation surveys 2006

Control is sustained not only by intimidation but also by the taking of securities, most commonly benefit books and cash cards

The quantitative research suggested that some form of security was taken, usually in the form of a benefit book or cash card and pin, in around half of cases. By depriving borrowers of the means to access cash, lenders not only ensured that they were paid before other commitments or needs were met but also reinforced their control over their victims.

Some illegal lenders further reinforce their hold over their customers by controlling victims' access to their income

Chart 35 Securities reportedly taken by illegal lender



Base: Illegal lender users
Source: Policis / PFRC saturation surveys 2006

Illegal lenders have moved with the times, taking debit and POCA cards and their associated PINS as security for loans

The move (from 2003) to pay all state pensions and social security benefits directly into a bank account or Post Office Card Account (POCA), instead of through girocheques and payment books has not acted as a barrier to illegal lenders taking control of borrowers' access to their income. In a move with the times, illegal lenders now take debit and cash cards as security for loans, instead of benefit books as formerly. This was mentioned by some of the domain experts and also in the witness statements relating to four of the seven illegal lenders.

"...We've had reports of the Post Office cash cards being taken as security and so on...That is worse in a way than the old system where the post office counter staff knew who you were. With the PIN numbers there is no real personal check."

(Advice agency, Liverpool)

In some cases, witnesses reported that the illegal lender had taken the PIN for the card as well. In theory, therefore, the lender could access *all* the available funds in the account – although this did not seem to have happened to any of the witnesses who had passed their card and PIN to a lender. Instead, they generally reported being taken to a Post Office by the lender to withdraw the required amount of money.

Illegal lenders control victims primarily to enable them to leverage relationships into an ongoing – and continually extended – income stream

Illegal lenders' relationships with their customers are all about control because the primary objective of most illegal lenders is to leverage their customer relationships to create an ongoing income stream. The ability to sustain payment collection is thus a critical component of the modus operandi of illegal lenders. The victim statements, the views of the domain experts and the differences revealed in the saturation surveys between the term over which borrowers actually pay their lender in comparison to their original expectations (see section 4.4 on the cost of credit following) all illustrate this pattern. One of the most important features of the way illegal lenders appear to operate – and one of the key differences between the business models of legal and illegal lenders – is that illegal lenders do not set out to lend an agreed sum on agreed terms or over an agreed period so much as to create an income stream for the lender for as long as it can be sustained. The sums ultimately collected from the borrower can indeed often have little relationship with any sums advanced to him or her, depending rather on how long the lender can intimidate the victim into paying. This syndrome is evident in other illegal lending markets around the world also.

4.3 Illegal lenders modus operandi

Some illegal lenders operate a stand-alone credit business while for others lending is ancillary to other criminal activities

The domain expert interviews and the witness statements provided to the illegal money lending teams provide insight into the different models on which illegal lenders appear to operate. Some illegal lenders appear to concentrate on illegal lending as their primary line of business while for others lending is complementary to other activities, some of which are criminal (see section 4.5 following for a detailed discussion of lender types and lending models). In some cases credit is advanced at point of sale of counterfeit goods, black market alcohol or drugs. In others illegal lending is rather part of a wider criminal life-style and a means of leveraging or re-cycling the proceeds of other criminal activities. Funds obtained from fraud, drug dealing or the sale of black-market or stolen goods, for example may be lent out to further increase the value that is generated from the original criminal activity.

In contrast to many other illegal lending markets, illegal lender operations in the UK are typically one man bands or family affairs

Generally, illegal lender operations appear to be small-scale by international standards and to largely lie outside the realm of organised crime. Operations tend to be either one-man bands or family-run businesses. Around four out of ten payments are collected by the lender him/ herself rather than by assistants or third parties, either from the borrowers' home or at the home of a friend or neighbour who also owed money. Repayments are sometimes collected by other people, such as 'runners' who work for the lender or members of the lenders' family. In other cases, borrowers reported that they themselves occasionally acted as 'sub-collectors', collecting repayments from several of their friends and neighbours who also owed money to the lender. The witness statements collected by the illegal money lending teams indicate that payment day is often timed to coincide with the day that the borrower receives their wages or, more commonly, their benefit income.

Illegal lenders share some of the features of high-cost home credit lenders in that loans are advanced in home and small payments collected weekly

In some respects, some aspects of the modus operandi of the illegal lenders are not dissimilar to that of the high-cost licensed home credit lenders. Both lender types have adapted their operations to suit the budgeting patterns, life-styles and circumstances of their customer base, with a view to maximising the likelihood of collections and reducing default – while creating new sales opportunities. In these largely benefit-dependent communities, residents are likely to be paid weekly and budget on the same basis. Both the high-cost home credit lenders and the illegal lenders tend therefore to collect funds weekly and do so primarily in the borrowers' home. Both lender types prefer to collect small sums weekly in the knowledge that borrowers are more likely to

be able to budget for a weekly sum than to put away a larger sum collected less frequently.

As with the home credit lenders, illegal lenders maximise their collections by aligning their collection patterns to customers' weekly budgeting

Chart 36a Payment collection method

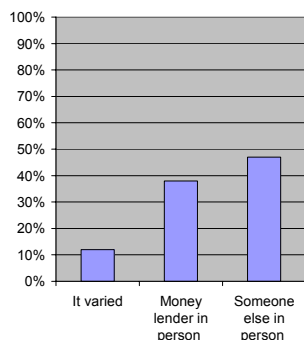


Chart 36b Payment collection venue

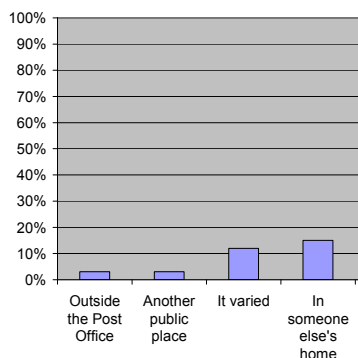
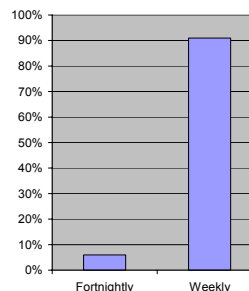


Chart 36c Frequency of payment



Base: Illegal lender users
Source: Policis / PFRC saturation surveys 2006

Advances are typically small-scale, averaging approximately 60% of those extended by home credit agents

Generally, individual advances appear to be small-scale, with illegal lenders apparently making judgements on how much to lend to individuals based on their assessment of their customers available resource. The saturation surveys indicated that the average loan was for around £250, significantly lower than the equivalent for high-cost home credit loans in these estates, at a little over £400 and also lower than the average Social Fund Budgeting Loan, which in 2004-2005 was £405 (Department for Work and Pensions, 2005). The witness statements given to the illegal money lending teams indicated that the amounts people borrowed varied depending on the lender, but were generally in the region of £100 to £500. A few people borrowed far larger amounts – up to £1,700 in one case.

Illegal lenders appear to adapt terms and amounts advanced according to their judgements on borrower risk and the sustainability of collection

There is also some evidence, both from the DTI pilots and the quantitative research, that some lenders operate a form of risk-based pricing, or vary the sums advanced or the terms over which loans are collected according to their assessment of the borrower's potential risk. The saturation surveys suggest that drug users and alcohol abusers are advanced smaller sums than other borrowers and that they are required to repay in higher installments over shorter terms, perhaps reflecting illegal lenders' judgements on the relative risk of the borrower and the sustainability of the collection term.

In addition, there was evidence from the witness statements that some illegal lenders (mainly operating in Scotland) made very low value, very short term loans, ranging from £10 to £50. People borrowing these small sums of money were generally expected to pay back the full amount plus interest in one repayment, usually a week or so after they had borrowed it.

Illegal lenders may satisfy themselves that borrowers have the resource to make payments by means of documentary evidence of available income

Lenders appear to seek to satisfy themselves that the borrower has the income stream to repay their loan – or at least the means to justify the lenders' investment in an ongoing income stream. Some borrowers who provided witness statements reported that lenders checked ID and benefit books, others, as indicated in the earlier discussion on control mechanisms, that lenders took benefit books or cash cards and PIN numbers as security, ensuring control of, or at least access to, their victims' future income.

“When you have a loan first, you actually sit in his car, show him the books. He won't come up to yours. You have to go down to him.”

“He came to the bottom of the flats one day and the friend who introduced me to him, called me down. I took myself down and he said ‘Do you have the book and that? I took my SS benefit book down with me. Took my NI number off me and gave me a loan of £400 first time.”

“I just had to give details like my income support and child benefit book...she (friend) showed it to him and he gave her the money and passed it to me.”

Some illegal lenders pass themselves off as legitimate and provide paperwork to support the deception

Some illegal lenders may represent themselves as legal lenders or even go so far as to pose as legitimate agents of the licensed, high-cost home credit lenders. Instances have been reported to the illegal money lending teams of rogue home credit agents targeting former customers or even of current agents lending on the side of a legitimate book, though the evidence is that such instances are rare.

These lender types, i.e. those which seek to mimic licensed lenders or who fraudulently present themselves as agents of licensed lenders, seem to be more likely to provide their customers with credit agreements and payment records. In these cases the provision of paperwork both supports the illusion of legitimacy and makes it more credible if the lenders subsequently threaten borrowers with the prospect of court appearances, bailiffs, repossession or bankruptcy.

Considerable differences in risk profile of illegal lender portfolios, with higher risk customer bases being associated with a greater degree of intimidation

The data collected by the illegal money lending teams suggest that there are considerable differences in the risk profile of different lenders' "portfolios", with some illegal lenders making advances only to those they were confident would repay without having to exert undue pressure. This type of lender, the witness statements would suggest a relatively small minority, was more likely to be making loans at an agreed price and over agreed terms. Other illegal lenders' portfolios seemed to have a wider risk profile and contained more high-risk individuals. The loan books operated by these lenders appeared to require a greater degree of intimidation to sustain effective collection management as threats and violence were more likely to be associated with this type of operation.

Illegal lenders who present as loan sharks are unlikely to provide payment records

According to the witness statements very few people who had used an illegal lender received any written documentation relating to the loans they had received. The confusion created in borrowers' minds as a result was made worse because few borrowers kept records themselves either. Indeed, the qualitative research indicated that even where borrowers did keep records and attempted to keep track of, or ascertain, what they owed, their calculations bore little resemblance either to the sums which the lenders demanded or those which lenders claimed as still "owing".

The relatively few lenders which sought to mimic the modus operandi of licensed lenders were more likely to provide paperwork. A handful of people who borrowed from one lender remembered signing some type of agreement when they took out their loan while another lender usually gave people a receipt for the money he had lent them. It was also common for these two lenders to give borrowers a payment card, on which the lender usually (but not always) recorded the repayments they had made.

Illegal lenders who make no bones about being loan sharks or who are more closely aligned with criminal activities (see discussion of lender types in section 4.5 following) appear much less likely to give borrowers any form of contract or statement, in part because the provision of paperwork will constitute evidence that could subsequently be used in any prosecution and in part because such lenders actively seek to obscure how much the borrower owes the lender at any point.

Customers are quite clear on the distinction between illegal lenders and home credit agents, not least because regulated lenders provide paperwork

One of the original concerns in undertaking the research was to discover whether borrowers in disadvantaged communities are able to distinguish between illegal and legal lenders. The saturation survey data, the qualitative interviews and the witness statements suggest that borrowers are quite clear on the differences between the two lender types, i.e. between licensed home credit lenders and illegal lenders. The exception may be the relatively rare cases in which illegal lenders fraudulently impersonate legitimate home credit agents.

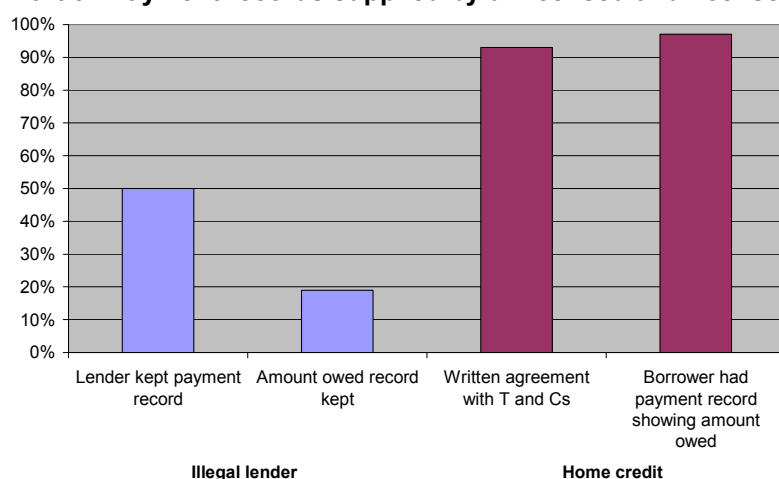
The distinctions rest primarily on the modus operandi and customer management practice of the two types of lender and the clarity of pricing associated with home credit loans. It would appear that the provision of the paperwork required of regulated lenders, together with various branded materials, such as branded payment books or illustrations for example, also plays an important part in underlining the legitimacy of licensed lenders. The saturation surveys suggest that around half of borrowers from illegal lenders believed that their lender kept a record of their payments, while only one in five customers reported being given a record of the amount that they paid or owed. This contrasts sharply with the pattern among customers of home credit lenders, in which customers overwhelmingly remembered receiving credit agreements and payment records.

In the saturation surveys, the research team sought to clarify whether customers of unlicensed lenders were able to distinguish between licensed

agents of the home credit lenders and illegal lenders in part by asking customers of home credit agents the name of their supplier and whether they had received a written contract at the outset of the agreement and had an up to date weekly payment record in their possession. Respondents who claimed to be home credit customers were invariably able to identify their supplier (overwhelmingly one of the major home credit lenders) and in almost all cases could recall the paperwork associated with the loan. More than nine out of ten recalled receiving a written agreement at the outset of the contract with some 96% claiming to have a payment record showing how much was owed at any one time. Given the contrast between this and the pattern among those who claimed to be using unlicensed lenders (in many cases of course also home credit customers), it would seem that borrowers are well able to distinguish between loans sharks and licensed lenders (See Chart 37).

Customers of illegal lenders rarely have written payment records or any clarity on what they owe or the terms on which they are borrowing

Chart 37 Payment records supplied by unlicensed and licensed lenders



Base: Home credit users and illegal lender users on deprived estates
 Source: Policis / PFRC saturation surveys 2006

4.4 The cost of credit from an unlicensed lender

Illegal lenders seek to obfuscate the cost of credit and the conditions attached to loans in order to continually extend the term and increase the price

Illegal lenders’ desire to create an ongoing – and continually extended – income stream is the key both to the dynamic underpinning the modus operandi of the lenders and to the way in which the cost of borrowing is presented and credit priced. Illegal lenders appear to deliberately render pricing and the terms and conditions attached to their lending opaque to the point where it is near impossible for even the most capable borrower to understand.

“Really, it is only the loan shark who knows who has paid what and how much they still owe, and even if they were paying it off, they then just go and give them more, so it is just like a perpetual drain.”

(Trading standards officer, Liverpool)

Borrowers become trapped in a cycle of permanent debt with repayments to the illegal lenders becoming an entrenched feature of household budgets

The witness statements suggest that many people who borrowed from illegal lenders seemed to be stuck in a cycle of perpetual loan repayment, with little idea of how much they had actually repaid, or how much they were still supposed to owe. In discussing the cost of credit from an unlicensed lender it is important therefore to bear this syndrome in mind. In essence, by using a variety of devices, lenders collect payments from their victims for as long as is sustainable, with this extended collection resting on intimidation-based relationships and a climate of fear, as discussed at some length in section 4.2.

For users of illegal lenders the key criteria in assessment of affordability is the level at which weekly payments are set

Among those on very tight budgets the level of loan repayments each week is the most important determinant of whether credit is seen as affordable. Generally, as previous research has shown, affordability is a more important consideration for low-income credit users than the total cost of credit (see, for example, Collard and Kempson, 2005). Illegal lenders appear to take full advantage of this mind-set and set repayments at a level likely to be judged by the borrower as “affordable”, albeit significantly higher than those made to high-cost home credit lenders.

Illegal lenders take advantage of this mind-set – setting weekly repayment levels at high but affordable levels

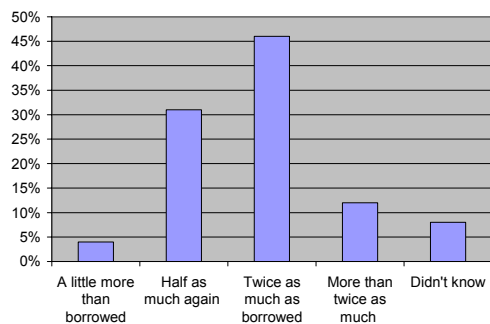
In presenting the cost of credit, illegal lenders seemed to operate a general ‘rule of thumb’ in calculating the repayment amount, so that it tended to be between £5 and £10 per week for each £100 borrowed. In other words, if someone borrowed £300, their expectation would be that they would repay between £15 and £30 per week. The saturation surveys suggested that average weekly payment to an illegal lender was £21, compared to £11 paid to home credit lenders. The witness statements confirm this pattern but indicate that some borrowers are paying significantly more. Weekly repayment amounts generally varied from between £5 per week to around £50 per week, depending on the size of the loan.

The illegal lenders present the cost of credit as more expensive than borrowing from a high cost home credit lender but not dramatically so

From the witness statements it would seem that illegal lenders presented their charges at the outset of the loan as anywhere between £40 and £100 on top of every £100 borrowed. The amount individuals expected to pay for their credit varied, but the saturation surveys suggested that three in ten anticipated the cost of credit being around half as much again as originally borrowed while close to half expected to pay back twice as much as they borrowed. On average, the saturation survey data suggests that at the time the loan was first taken on, borrowers expected to pay back an average of £183 for each £100 borrowed. This cost, though clearly very expensive in comparison to mainstream credit prices, is not dramatically different from the £165 per £100 borrowed which is the cost of the most popular home credit

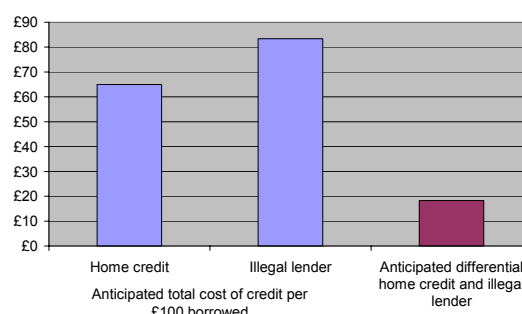
product on the market. This would imply a perceived differential of some £18 per £100 or an additional 28% for borrowing from the unlicensed lender compared to the cost of home credit.

Chart 38a Expectations on cost of borrowing from illegal lender



Base: Illegal lender users
Source: Policis / PFRC saturation surveys 2006

Chart 38b Anticipated differential between cost of borrowing from illegal lender and home credit



Basis for Home Credit product is PPC 55 week loan representing 50% of market

Even at the outset there is little mention of the loan term with few borrowers appearing to understand that this represents a critical component of cost

There appears to be little mention of the term of the loan at the point when loans are first advanced by the lenders. The witness statements suggest that people who borrowed from illegal lenders usually had an idea, initially at least, of the amount they believed they were expected to repay in total and of the value of the weekly repayment they would have to make to the illegal lender. The witness statements hardly ever mentioned the period of time over which they were supposed to repay their loan however. Of the 109 witness statements that were analysed, only 11 people (10%) mentioned the term of their loan.

A variety of mechanisms, such as roll-over loans and disproportionate penalty charges are used to extend the term of the loan and inflate prices

A variety of mechanisms are deployed to extend the term of the loan which together make it very difficult for borrowers to understand how much they have borrowed, how much they have repaid, what they owe to the lender at any one time or how long they will have to keep making payments. These mechanisms work to escalate the debt so that individuals pay lenders over a continually extended period and often very much longer than originally anticipated.

Late or missed payments are frequently punished with disproportionate and often arbitrary charges

The witness statements and domain expert interviews indicate that charges for late payments varied between illegal lenders. In some instances there seemed to be a rationale behind the amount of the 'penalty' charge, for example, an extra week's repayment for every missed payment. In others, the amounts seemed to be completely arbitrary. People who borrowed from one illegal lender, for example, were often told they would have to pay an additional £50 on top of their outstanding loan for each missed or late payment. In some cases missed payment charges could be as much as £500.

“What I didn’t realise was the extortionate amounts of interest that he put on there, especially when you’re having £50 (as penalty for missing payment) put on there. And after a couple of weeks he was literally putting on hundreds if you didn’t pay.”

“I tried to sort things out face-to-face and he’d say ‘I think I’ll stick £200 on because I feel like it. I can’t be bothered. I’ll put £100 on.’”

(Users of illegal lenders, Birmingham)

“One woman, she’d had a loan of £500. She was paying back at £25 a week, and had been paying it for two years, and according to the [lender’s] book she still owed a grand.”

(Illegal money lending team, Birmingham)

Borrowers can even be held responsible for missed payments on loans to friends and family they have introduced to the lender

It appears that in some cases borrowers can be held responsible for the debts or missed payments of those whom they introduced to an illegal lender. From the witness statements, in the case of two illegal lenders, a small number of witnesses reported that they were held responsible by the lender for the debts of other borrowers – usually people they had introduced to the lender. As a result, they were pressed to make payments on behalf of these other borrowers when they defaulted on their loans.

Illegal lenders offer further advances before loans are repaid and “top up” loans to enable borrowers to repay when they would otherwise miss

According to the witness statements, most people who borrowed from an illegal lender had taken out at least two loans, with it being fairly common for borrowers to take out second and subsequent loans (sometimes coaxed by the lender) before they had finished paying off their last loan. This made it difficult to keep track of the exact number of loans they had had, with little understanding also of the terms on which new borrowing had been taken on. In some cases, ‘top-up’ loans were offered to borrowers as a means of enabling them to repay an existing loan (or loans) from the lender. The tendency is thus for debt to escalate in a way which borrowers neither anticipate nor understand. The obligation to the lender becomes entrenched as part of the household budget and ongoing repayments become a permanent feature of borrowers’ finances.

Loans are frequently re-financed on exorbitant terms so that debt escalates to the point where it becomes a permanent condition

“He (loans shark) was saying, borrow a little bit more and it’ll pay off the other one. It was just building up and up. He (son) didn’t realise how much he was owing out until it came to the paying back. He never had any money. It was awful.”

“Every time it was, ‘Here you are (NAME), I’ll give you another couple of hundred on top’. Then it was interest on top of that. It was double and double and double. If you can’t pay it back, have another loan to pay this one off. You were never out of debt.”

The total cost of credit anticipated at the outset of the borrowing can often bears little relationship to the price ultimately paid

From the domain expert interviews and the witness statements, it is clear that charges varied between illegal lenders, and also that charges varied between people who borrowed from the same illegal lender. This appears both to reflect lenders' judgements on the relative risk represented by the borrower (with drug addicts appearing to pay more than other borrowers for example) and differences in the length of time for which lenders were able to intimidate different borrowers into paying. It is quite clear from the witness statements and from the saturation surveys however that in most cases the amounts that individuals borrowed often had little relation to the sum they eventually paid the lender or to the cost of credit anticipated when the loan was taken on. In both sources, borrowers reported that the real cost of credit from an illegal lender was very much greater than was anticipated at the outset.

Average actual cost of credit per £100 borrowed was some £185, more than twice the price anticipated at the time of taking on the initial loan

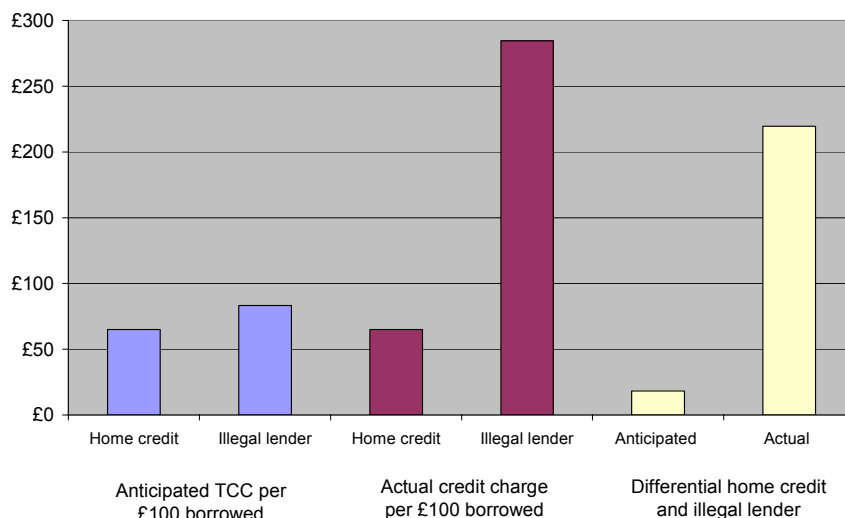
Respondents to the saturation surveys reported an amount actually paid to the lender on average of some £285 per £100 received, the resulting cost of credit of £185 per £100. This is on average a little more than twice the cost originally anticipated and around three times the cost of the same loan from the licensed high-cost home credit lenders.

The smallest loans made over very short periods, more common in Scotland, can be even more expensive

The witness statements also provided insight into the pricing of very small-scale loans made over very short periods of time, which seemed particularly to be a feature of the modus operandi of illegal lenders in Scotland. These lenders tended to tell borrowers that the charge was 50% interest on a weekly basis – this meant that if someone borrowed £10 one week, they could expect to repay £15 the next. If borrowers are unable to pay, penalties and compound interests on these loans can mean that even small borrowing can rapidly spiral out of control. (See case study 2 following).

The cost of credit from illegal lenders is not only much higher than from a licensed lender but also much less predictable

Chart 39



Base: Illegal lender users

Source: Policis / PFRC saturation surveys 2006

Basis for Home Credit product is PPC 55 week loan representing 50% of market

Clearly, on the basis of cost of credit reported by victims in their witness statements and in the saturation surveys, the costs of borrowing from an unlicensed lender can be incredibly high. Indeed previous research has indicated that Trading Standards officers report Annual Percentage Rates (APRs)²⁸ in the thousands and even millions (Baird, 2001). In the worked examples that follow, we have calculated both the Total Cost of Credit (TCC) and the APR for a loan from an illegal lender of average value and for the low-value, short term loans made by some illegal lenders in Scotland. The concept of APRs in this context, however, may not be particularly useful both because of the arbitrary nature of charges and because of the often elastic nature of the term of the loan. For these reasons, and because regulators have recently commented in examining home credit pricing that APRs²⁹ are not necessarily a good measure of price for short term loans, in comparing the cost of borrowing from the high-cost, licensed home credit lenders and illegal lenders in Chart 39 above, we have used TCC rather than APR.

Individual cases illustrate how relatively small loans and initially affordable payments can escalate to become unmanageable, ultra- high-cost debt

The following two examples have been pieced together from the witness statements to try and give some sense of the real financial costs of borrowing from an illegal lender. These cases are chosen as typical for a case of average loan value and for one of the very low value loans encountered in Scotland.

²⁸ The Annual Percentage Rate is a measure of the cost of each credit agreement, taking into account all the charges made under the agreement, and expressed in the form of a yearly measure.

²⁹ The Competition Commission Home Credit Inquiry Statement of Remedies, 2006.

Case study 1: A loan of £300 from an illegal lender in Birmingham

- Mrs. A took out a loan of £300, and was initially told she would have to repay a total of £680 at £20 per week. When she missed some repayments, the lender added on £300 to the amount she owed. From her witness statement, she seems to have repaid at least £780 (more than two and a half times the original loan amount of £300), and was told by the lender that she still owed another £220 (although in the event she did not have to pay this, as a result of the lender's arrest).

TCC (Total cost of credit) = £700. APR (Annual percentage rate) = 1,669%

Case study 2: A small loan of £40 from a illegal lender on a Glasgow estate

- Miss B took out a loan of £40 from an illegal lender in Glasgow, and was told she would have to repay £52 the following week. She could not afford to repay this, however, and so was told to pay £12 a week 'interest' on the loan. She had taken out the loan around December 2005, and was still repaying it in March 2006. It is not clear from her statement whether or not she had missed any payments over this time. Assuming she had not, and that she had paid every week for the past 12 weeks, this would amount to £144 in total in penalty interest payments (almost three times the original loan amount), though it is more than likely that at least some payments had been missed. She had been told by the lender that she still owed the 'full amount' of £52 on top of what she had paid thus far.

TCC (Total cost of credit) = £156. APR (Annual percentage rate) = 84, 149, 939%

4.5 Models of illegal lending – lender typologies

This section attempts to bring together some of the descriptions of illegal lender behaviour already discussed and to place this in the context of differences between illegal lender types and the relative importance of different illegal lending models within the market.

A spectrum of illegal lending models that are more or less exploitative of individuals and damaging to communities

The lender typologies and models of illegal lending here described rest on the domain expert interviews and the witness statements from the Glasgow and Birmingham illegal money lending teams. The research team identified a number of different ways in which illegal money lenders operate, which vary mainly in the scale of their operation, the extent to which they use threats, intimidation and violence to enforce debts, and the extent to which they are involved in other criminal activities. This corresponds broadly with a spectrum that is more or less exploitative of the victims and more or less damaging to communities, with different lender types occupying different positions on the

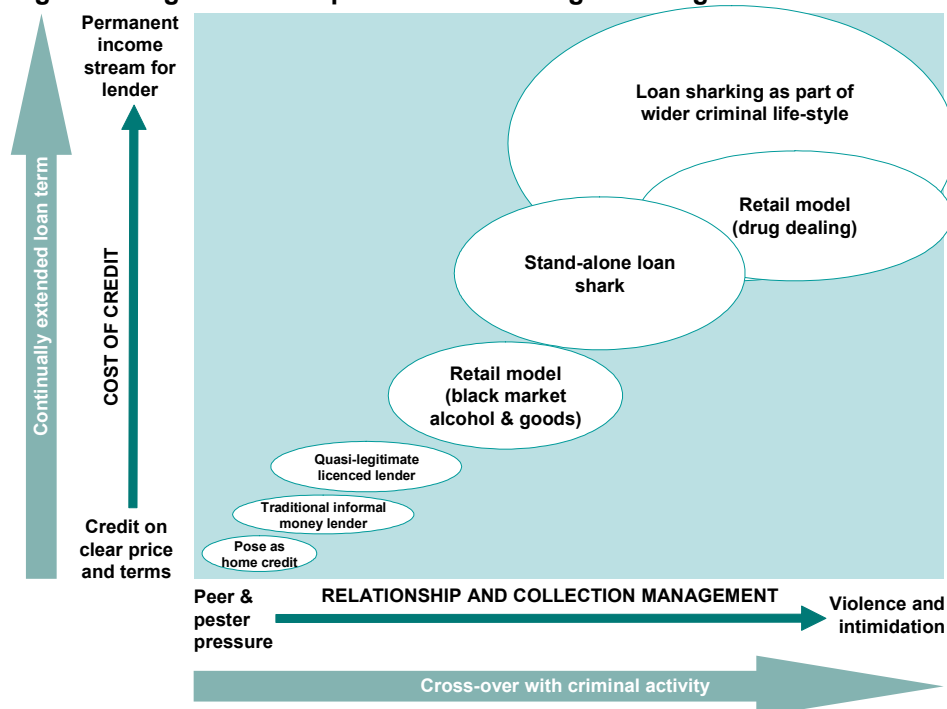
spectrum. (See Figure 7). On the evidence of the witness statements, we believe that the coercive model represents the dominant lender type.

At one end of spectrum relatively benign lenders can mimic the modus operandi of licensed lenders while at the other lending is embedded in criminal activity

At the simplest level, all illegal money lenders share two characteristics – they do not have a consumer credit licence and their customers generally tend to be people who would find it difficult to access credit from a licensed lender, usually because they have very low or unstable incomes. However, there the similarities between lender types end. At one end of the spectrum, there seem to be a group of illegal lenders who could be described as ‘relatively benign’ – they generally do not use coercion to enforce outstanding debts, and are not involved in any other criminal activities. Some of them may mimic the characteristics of regulated lenders, mostly by providing borrowers with credit agreements and/or repayment records. They may also structure their loans and loan repayment in a similar way to a regulated lender. At the other extreme, illegal lending forms an integral part of wider and larger-scale criminal activities. The lenders tend to be ‘career criminals’, and the profits from illegal lending may be used to finance other criminal activities such as drug dealing. Violence is a key characteristic in the enforcement of debts.

In the middle, there is a group of lenders that are involved in other criminal activities such as selling counterfeit goods, black market alcohol or cigarettes. Threats and intimidation are a common way of enforcing debts among these lenders, and some of them may also use violence. Each of these three general categories of lenders is represented in Figure 7 diagrammatically and discussed in detail below. It should be noted, however, that this is not a hard and fast categorisation of illegal lenders, and there is likely to be some degree of overlap between the categories.

Figure 7 Diagrammatic representation of illegal lending models



Illegal lending within ethnic minority communities appears to take place entirely within the community

Although there is evidence from previous research³⁰, from the saturation surveys and from the domain experts that illegal lending takes place among ethnic minority communities, it remains an area about which relatively little is known in terms of the possible models of lending. The saturation surveys suggest that it is significantly less common among predominantly low-income Asian / Black communities than in predominantly white low-income communities. The evidence from Trading Standards officers and from the domain experts suggest that this may be because such lending is concentrated within middle income borrowers within ethnic communities. Previous research³¹ has also suggested that illegal lending in ethnic minority communities may rest on go-betweens and brokers to a greater extent than in white communities. It appears in any case to be policed and enforced entirely within the community. There is some evidence that in these instances illegal lending can take place as a way of financing the set-up of small businesses.

4.5.1 The ‘Relatively benign’ illegal lenders

From the domain expert interviews, we identified two types of lender who fall into this general category.

- Traditional informal money-lender
- Quasi-legitimate unlicensed lender

The first is a community-based sole trader, who generally conforms to the image of a *traditional informal money lender*. These lenders are often (but not always) women, who lend money on a small-scale within their local communities, usually to other women who are bringing up families on a low-income. They generally rely on peer and pester pressure to recoup the money they are owed.

“Some [illegal lending] is what I would call traditional, friendly, usually female loan sharks, which is sort of door-to-door, or neighbour-to-neighbour...A sort of informal money lender, who normally works in the pestering expectation of repayment, rather than threatening violence. So they’re sort of a step down from the Provi³².”

(Advice agency, Liverpool)

The second type is the quasi-legitimate illegal lender who seems to share some of the characteristics of regulated lenders in terms of providing customers with credit agreements and informing them of the terms and conditions of their loan. They may have had a consumer credit licence in the past, which has since lapsed, or they may never have bothered to apply for a licence. Others are, or have been, agents for licensed home credit providers,

³⁰ A Herbert and E Kempson (1996) Credit use and ethnic minorities. London: Policy Studies Institute.

³¹ Ibid

³² Provident Financial, a listed company and the largest of the home credit lenders in the UK, widely known as “Provi” to home credit customers.

who make loans illegally to their former home credit customers. Some of these lenders may threaten or intimidate their customers if they are unable to pay what they owe, but this seemed to be relatively uncommon.

The scale of lending among these two types of lender is likely to vary widely. Information from the illegal money lending teams indicates that *quasi-legitimate lenders* may have up to 100 customers at any one time, so small relative to most home credit rounds. It seems likely that community-based sole traders will have rather fewer customers.

4.5.2 Coercive illegal lenders

Coercive lenders appear however to be the dominant model

These lenders are those which most clearly occupy the loan shark territory of popular imagination, being exploitative of their victims and highly coercive, often violently so, with lending operations frequently aligned with criminal activity and lenders themselves enmeshed in a wider criminal life-style. This is the category of lenders about which we know most, suggesting that the ways in which they operate are perhaps the most prevalent models of illegal lending. Although there is considerable variation among this category of lenders in terms of the scale of lending and their involvement in other criminal activities, they share one common aim – to create a regular flow of income from borrowers over as long a period as possible.

“...it’s about the lender securing a regular income. So they don’t want you to pay it back, they want to know that they’re getting £30-£40 a week off certain individuals and that just continues.”

(Illegal money lending team, Glasgow)

We have identified three broad types:

- The illegal lender operating a stand-alone lending business
- The retail model in which lending is ancillary to sales of tax free alcohol, cigarettes, counterfeit goods etc
- Criminal life-style model in which lending is integrated with other forms of criminal activity

There is considerable cross-over between these lender types. To some extent the modus operandi of the lender depends on the individual, the risk profile of the customer base and the extent to which the operation is large scale or linked to criminal activity or a criminal family or associate network. At the less extreme end lenders may simply be seeking to maximise the income stream that can be generated and sustained from their largely disadvantaged victims while at the other lenders may actively target vulnerable individuals in order to draw them into a criminal life-style or for sexual exploitation.

The largest illegal lending operations appear to have the greatest involvement with criminal life-styles

The scale of lending among this category of illegal lenders seems to range, at one end, from those lenders who mainly operate on their own, perhaps with a small number of accomplices who act as 'runners' or debt collectors. At the other end, there are illegal lenders who operate as part of a larger network – they may belong to a criminal family, for example, or have a network of associates. From the domain expert interviews, it seems likely that the larger the operation, the more heavily involved illegal lenders are in other criminal activities such as selling black market goods or drug-dealing.

A stand alone lending business can be highly lucrative with the proceeds relatively easily turned into legitimate assets

The lender operating a stand-alone business appears to be motivated by illegal lending as a relatively low-risk business (the chance of apprehension has been minimal historically) which is both lucrative and readily scaleable. Recent cases in Birmingham and Glasgow indicate that these types of lender may have anywhere between 40 and 100 customers at any one time. This type of lender may have legitimate assets – the Trading Standards illegal money lending teams had uncovered evidence of lenders' remortgaging their own residential property to provide the seed capital for lending for example and tends to be associated with rapidly expanding operations. Alternatively, the lender might also be running a quasi legitimate business or may present as doing so. Examples uncovered by the pilot team included a security and debt collection firm. This type of lenders is also more likely to commute profits into other assets, such as residential property. Evidence from the West Midlands indicates that illegal lending can indeed be a highly lucrative business. At the time of his arrest, one lender had loaned out £280,000, and expected a return of £802,000. Another lender expected a return of around £70,000 over the course of one year on the loans he had made. Similarly, an illegal lender who was prosecuted in Luton was believed to have made more than £250,000 between May 2003 and June 2004³³.

Illegal lending can rather be an ancillary business to the sale of black market goods

In the retail model, illegal lending is integrated into a wider operation in which black market alcohol, cigarettes or counterfeit goods are sold around the estates. Lending occurs at point of sale, with lenders taking advantage of the opportunity to further leverage profits from the sale of the goods. In some cases this type of lending and the associated black market activities may not be associated with other criminal activities. A more damaging version involves lending ancillary to sales of drugs, including class A drugs. Some stand alone illegal lending reportedly also occurs in pubs and pub car parks.

³³ <http://news.bbc.co.uk>, 'Fagin-like' loan shark convicted, BBC News story published on 11/10/2005.

At the most damaging end of the spectrum, illegal lending is part of a criminal lifestyle with lenders seeking to enmesh victims in criminal activities

The link with drug-dealing spans the cross-over between illegal lending and wider criminal activities. Trading Standards report that many lenders seem to have a broadly criminal life-style, being involved in activities ranging from fraud and burglary to prostitution. Illegal lending activities may be used both to recycle and leverage the proceeds of other criminal activities and to facilitate such activities, by for example, recruiting those with payment difficulties into drug dealing, shop-lifting or prostitution.

The extreme end of illegal lending reportedly involves organised crime or even paramilitary organisations

Although rather outside the remit of this study, which is focused on lending to individuals, at the extreme end of illegal money lending, there is some evidence of illegal lending by and between criminals to fund criminal activities, for example, the large scale purchase of drugs, counterfeit goods or even arms. The sums involved are likely to be very much larger (tens of thousands rather than a few hundred pounds). These cases are much more likely to involve organised crime and to involve more serious violence in the event of default. Reported instances involve, for example, gang-related illegal lending among the Chinese community and illegal lending by and among paramilitary groups in Northern Ireland (see Silke, 2000). This is of course the area about which there is the least information.

“...they are far more fearsome, they don't mess about. If someone doesn't pay them, they get a visit and when they get a visit it isn't, 'You're going to pay or else', it's a thump. They open the door to a thump. They just don't mess about.”

(Illegal money lending team, Birmingham)

4.6 The impact of illegal lenders on the communities in which they operate

Payments to illegal lender can hollow out already stretched budgets to the point where essentials are foregone

The escalation of debt and of weekly payments by means of penalty charges and roll-over loans can put a severe strain on borrowers' finances, particularly if the borrower has had several loans that had been rolled into one and / or has been making payments to the lender for a considerable time. The witness statements suggest that what starts as a seemingly manageable regular repayment can soon escalate beyond the borrowers' means so that the household becomes unable to afford essentials such as food, bills or rent because payments to the lender are prioritised over other spending. Moreover, it was not uncommon for both partners in a household to be repaying loans to an illegal lender which represented a significant proportion of their household income. The witness statements indicate that some debtors borrowed money from their family to pay off their debts. A few talked about

pawning jewellery or selling goods so that they could afford to repay what they owed, while others had to cut back on their day-to-day spending to meet their regular repayments. This syndrome can be profoundly damaging, deepening the cycle of deprivation and exposing already disadvantaged families to inadequate nutrition, fuel poverty and even the risk of homelessness.

“We had nothing to live on for that complete week. I was literally without food, gas, electricity or anything. I just had to drag myself through the week without anything.”

(Customer of illegal lender, Birmingham, with multiple disabilities, who paid £500 a month out of her benefits to repay her loan)

“We had to go hungry to make sure he was paid.”

(Borrowers from illegal lenders West Midlands)

Those unable to repay can find themselves drawn into criminal activity exacerbating the problems of areas that already suffer a high level of crime

As noted earlier, the evidence from the illegal money lending teams suggests that those unable to pay may find themselves under significant pressure to become involved in a variety of unsavoury or criminal activities. These ranged from providing sexual services to the lender, through prostitution and drug-dealing to stealing, either to generate the funds to repay the lender or even to the lenders' order. Alternatively or additionally, individuals might be required to provide support to criminal activities – storing stolen goods, registering vehicles in their name or providing false alibis. By these means, those lenders with a wider involvement in criminal life-styles both extended and supported their other criminal activities and consolidated their control over those who borrowed from them. Trading Standards officers claim that removal of lenders results in a wider reduction in crime in the areas in which the lender previously operated.

“...when you can't pay them back because you can't afford to, you have to go and nick to order. Or you have to go and do something else. They've then got control over you.”

(Illegal money lending team, Birmingham)

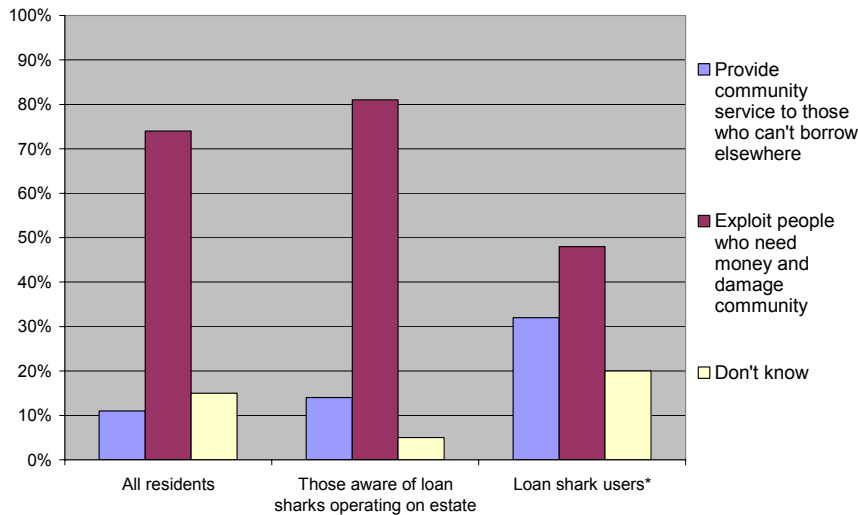
“...a bloke owed a couple of hundred pounds...very quickly the pay-back was either money or drug dealing, and this individual did the drug dealing for a year...they used the money lending as a way of locking someone in...and because he was white, they used him as a dealer in a white estate in the city, where the black drug dealers can't go.”

(Police, Bristol)

Residents of deprived estates unequivocally see illegal lenders as damaging communities and exacerbating existing social problems

Residents as a whole are unequivocally of the view that illegal lenders exploit those who need money, with eight out of ten agreeing that illegal lending damages not only individuals but the wider community.

Chart 40 Perceptions of impact and role of illegal lenders within community



Base: Residents of deprived estates
 Source: Policis / PFRC saturation surveys 2006

Users are more ambivalent and can see illegal lenders as providing a service to those with no other credit options

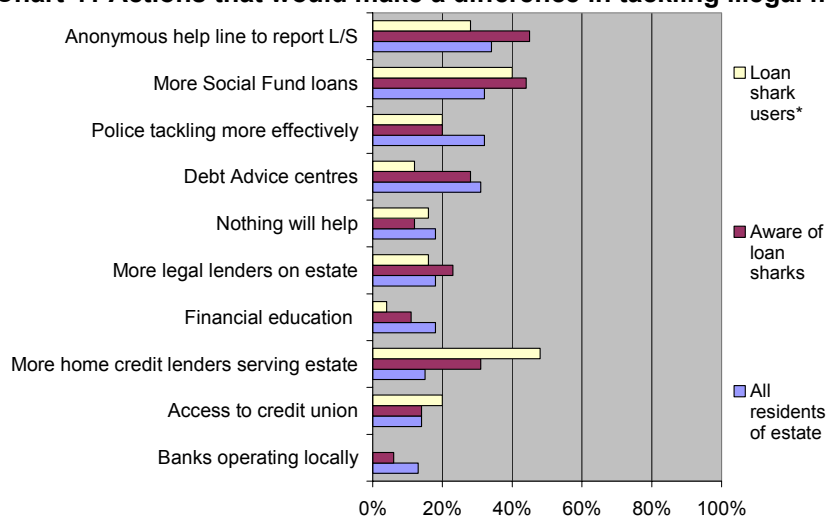
Users of illegal lenders themselves are more ambivalent than residents as a whole, being more likely to take the view that illegal money lenders provide a community service to those unable to borrow elsewhere.

Residents as a whole called for enhanced enforcement and for improved education and advice but illegal lender users showed little enthusiasm

Residents as a whole called for more effective enforcement and financial education and advice as the way forward. Anonymous help-lines to report illegal lenders were seen as the one enforcement measure that would really make a difference. Users of illegal lenders themselves were far less sanguine on policy solutions generally and showed little enthusiasm for either debt advice or financial education.

Community calls are for anonymous reporting and more effective enforcement

Chart 41 Actions that would make a difference in tackling illegal money lenders



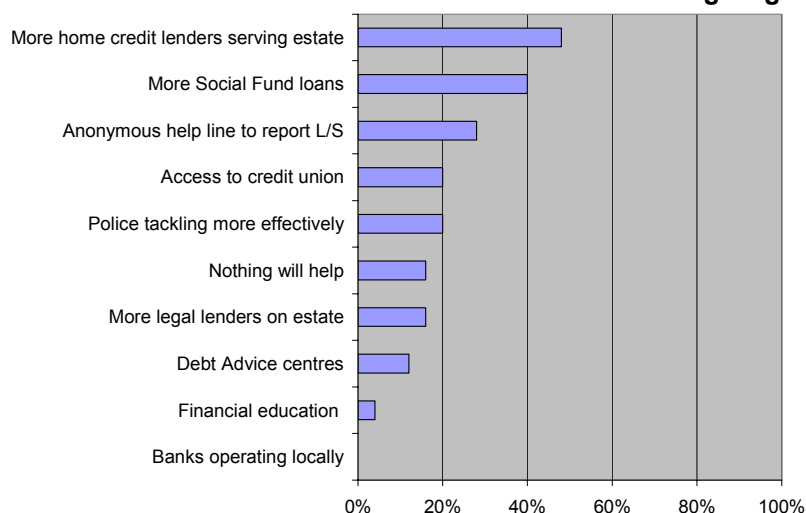
Base: Residents of deprived estates
Source: Policis / PFRC saturation surveys 2006

Illegal lender users unequivocally see the solution as greater access to legal credit

Illegal lender users themselves overwhelmingly saw the availability of legal credit options as the key to addressing illegal lending. The importance of rapid access is reflected in the pattern whereby illegal lender users saw greater availability of home credit as more important in combating illegal lenders than greater access to either the interest-free Social Fund or low-cost Credit Union loans.

For illegal lender users, perceived solutions lie with greater access to legal credit

Chart 42 Actions that would make a difference in tackling illegal money lenders



Base: Illegal lender users
Source: Policis / PFRC saturation surveys 2006

A lack of basic financial capability endemic among the most disadvantaged will have a role to play in increasing vulnerability to illegal lenders

A national baseline survey of financial capability commissioned by the Financial Services Authority (FSA), the UK financial services regulator, indicates that many people, regardless of background or income, lack the ability to manage their finances effectively. In particular, consumers were generally poor at choosing financial products. Not surprisingly, those who were more likely to be on low-incomes (including lone parents, unemployed people and people unable to work through sickness or disability), were least likely to be able to make ends meet (Atkinson et al, 2006). This would seem to be borne out by the experience of the pilot teams.

The specialist pilot teams saw financial education and debt advice playing a role in both the short and long term

As part of their work to tackle illegal lending the illegal money lending teams in Birmingham and Glasgow routinely refer people to free debt advice services to receive advice and help with any financial difficulties they may have, which are often a direct result of using an illegal lender. This may involve negotiating reduced repayments with their remaining creditors, or exploring alternative solutions such as debt write-off or personal insolvency. It is not possible to know how many people who were referred by the specialist teams decided to take up this service. Alongside specialist advice services, the illegal lending teams in Birmingham and Glasgow considered that financial education more generally had an important role to play in tackling illegal lending, particularly over the longer term. In their view, greater emphasis was needed to make sure that people could understand the cost of borrowing from different sources of credit and were better able to manage what money they had.

“I think it comes down to financial education in schools, to try and stop it [illegal lending] happening so much in future. I don’t think people are very good at handling money, there are too many products, too many things, too many pressures on people to deal with.”

(Illegal lending team, Glasgow)

“Most of them [people who use illegal lenders] are, shall we say, intellectually naïve with regard to financial matters, on the basis that they don’t know whether or not it’s a good or bad deal they are getting.”

(Illegal lending team, Birmingham)

Section 5.0 Policy Implications

The research provides, for the first time, a substantial body of evidence on illegal lending to inform policy formulation in this challenging and hitherto little understood area. Before discussing the policy implications we first pull together briefly the key findings and conclusions that can be drawn from this study about the nature and scale of illegal lending in the UK and the impact of this lending on communities.

Illegal lending in the UK is small-scale and is significantly lower than in other large European credit markets

A key finding is that illegal money lending in the UK is small-scale, both in absolute terms and relative to the size of the legal credit markets, both high-cost and overall. We estimate that some 0.44% of the adult UK population use illegal money lenders, compared to 6.15%³⁴ who used high-cost lenders in 2005. We estimate that total annual advances by illegal money lenders represent less than 0.02%³⁵ of total consumer borrowing in 2005. The incidence of illegal lending in the UK seems also to be significantly lower than is the case in some other large European credit markets, such as those of France and Germany. Possibly as a result, and in striking contrast to illegal lending in some other advanced credit markets internationally, illegal money lending in the UK does not appear to be the province of organised crime.

Opportunities for illegal lenders are limited in a regulatory environment in which even the highest risk borrowers have legal credit options

The corollary to illegal money lending in the UK being small-scale, and the second key finding of the study, is that users of illegal money lenders in the UK are more disadvantaged than those found elsewhere. In other markets with regulatory environments that do not allow lenders to price for risk or which preclude lending to those with adverse credit history, illegal lenders are able to lend to middle income borrowers shut out of the legal credit market by dint of over-indebtedness or credit impairment while in the UK such borrowers are served by legitimate lenders in the sub prime market. Indeed we conclude that both the small-scale and focus of illegal lending in the UK appears primarily to be explained by a lack of opportunities for illegal lenders, itself to a large part contingent on the existence of high-cost lenders willing to lend to high-risk borrowers. Opportunities for illegal lenders as lenders of last resort are limited in a credit market in which even the highest risk borrowers have legitimate credit options, albeit often at very high-cost.

³⁴ Total UK adult (18-64) population in 2005 was 37.3m. We estimate the number of illegal lender users to be 165,000 and the number of high cost lender users to be 2.3m.

³⁵ Illegal advances £40m compared with total consumer credit outstanding in June 2006 amounting to £212bn according to Bank of England.

Illegal lending is deeply damaging to victims and exacerbates the worst aspects of poverty in some of the most disadvantaged communities in the UK

However, even if, in relative terms, illegal lending is small-scale in the UK, it is clear that where it occurs it is deeply damaging, both for individual victims and the communities in which they live. Equally, even though illegal lending is concentrated in disadvantaged micro-communities, these pockets of deprivation are wide-spread so that illegal lending is likely to be widespread also. The research which underpinned this study and the witness statements given to Trading Standards officers provide evidence that the activities of illegal lenders exacerbate the worst effects of poverty, hollowing out the budgets of the poorest families and degrading the quality of life, not only for victims but for all residents of the deprived estates on which they operate – not least by providing a reportedly significant stimulus to crime. A key finding therefore is that illegal lending is clearly an exploitative criminal activity that unequivocally damages its victims and which works against key social policy goals in some of the most disadvantaged areas in the UK.

In no sense are illegal lenders simply unlicensed versions of high-cost lenders nor are high-cost lenders licensed versions of illegal money lenders

The term “loan shark” is sometimes used indiscriminately by some sections of the media and other commentators to describe both unlicensed illegal lenders and high-cost licensed lenders, with little differentiation made between the two lender types. Against this background, it is worth being explicit that there is a clear distinction between the modus operandi and impact of regulated high-cost lenders compared to those associated with illegal money lenders. The research underpinning this study indicates that illegal money lending bears little resemblance to the activities of the regulated lenders. Some aspects of the modus operandi of the home-credit lenders and that of the illegal lenders share superficial similarities in that both tend to operate in areas of social housing, extend high-cost credit to low-income households and advance funds and collect repayments in borrowers’ home. There the resemblance ends.

The research makes clear both that illegal money lenders are not simply higher cost versions of licensed lenders (though on average the cost of borrowing from an illegal lender is roughly three times that of borrowing from the highest cost legal lenders) and that, conversely, the high-cost home credit lenders are not simply licensed versions of the illegal lenders. Indeed, the survey respondents themselves were very clear about differentiating between legal and illegal lending activity. Possible confusion between the two had been a significant concern on undertaking the research, but this was not borne out in the event, with the exception of those cases where illegal lenders were impersonating home credit agents.

Licensed home credit lenders are high cost but popular with customers, lend on transparent terms and are tolerant of payment difficulties

Home credit, although undoubtedly very high-cost, has been found to be popular with customers, on the basis of a number of surveys³⁶, with collection management sustained through positive personal relationships. An agreed sum is lent at a transparent price on the basis of agreed terms, with contracts and payments made reflected in written documentation. The home credit model also assumes a high incidence of account irregularity and debt write-off, with those unable to repay met for the most part with flexibility. Very few home credit customers in default are pursued by debt collectors or through the courts.

Illegal lenders charge three times more than home credit lenders and are coercive and exploitative, damaging individuals & exacerbating both crime and poverty

Illegal money lenders, by contrast, not only charge significantly more for credit than home credit lenders but credit is offered on terms that are deliberately opaque, and unlikely to be supported by written documentation, with the lenders' modus operandi being to collect payments over a continually extended period for as long as is sustainable. This is made possible only by controlling customers through a climate of fear and a range of coercive practices, including violence, intimidation and the taking of illegal securities that prevent victims accessing their income. Those unable to pay may be drawn into wider criminal activities, such as shop-lifting, drug-dealing and prostitution. Alternatively, they may find themselves facing demands for sexual favours in lieu of payment or they may be required to provide support for criminal activities, such as the provision of false alibis, for example.

However undesirable the cost of home credit, regulated lenders are preferable to illegal lenders and appear to moderate the scale of illegal lending

Against this background, it would seem quite clear that, from a consumer protection perspective, the regulated lenders are strongly preferable to illegal money lenders. This appears unequivocally to be the view of consumers also even though there is a high degree of cross-over between both high-cost home credit, use of the Social Fund and use of illegal money lenders, the evidence is that there is a clear hierarchy in credit choices, with illegal lenders as absolutely the last resort. Indeed, on estates where illegal money lenders represent the only source of cash credit, the incidence of those doing without credit is much higher than on estates which are served by the high-cost lenders. It would seem implausible that the need for credit in these areas is any less than elsewhere.

In considering policy responses it is important to recognise that a proportion of demand is irreducible

Nonetheless it is important to recognise that in the absence of other legal credit options, not only will there always be a core of borrowers who turn to illegal lenders but that those who do without credit in these circumstances may well also suffer as a result.

³⁶ Most recently Provisional Findings in the Home Credit Inquiry, The Competition Commission 2006.

In a highly developed consumer society demand for credit and a desire to participate in consumption will arise in every section of society, including the most disadvantaged. Moreover, a number of studies have provided evidence³⁷ that the poor need credit to manage peaks of expenditure, address unexpected cash emergencies and to fund major purchases, perhaps to a greater extent than the more affluent. In considering how best to develop policy responses, it is critical to recognise that at least some of the demand for credit in disadvantaged neighbourhoods appears to be irreducible.

The commercial credit market in the UK would appear to have reached the practical limits of supply to high-risk borrowers

The commercial credit market in the UK would appear to have reached the effective limit of those consumer types who could practicably or profitably be served by commercial models. There would seem little prospect of the risk pool being further extended and indeed the prospect is for quite the reverse, and a shrinking of home credit supply. The trend within the home credit market is for the withdrawal of the lenders³⁸ from the highest risk borrowers in order to focus on more profitable customers, to lend larger sums at lower cost and to diversify into new markets and products types. As the better off home credit customers migrate to newer and cheaper product types and database technology improves lenders' ability to identify more or less profitable customers, the lenders are moving away from the cross-subsidy model which historically underpinned credit market pricing. Some providers have been quicker or better placed to do so than others. The market shares of the major providers home credit lenders in the most deprived estates – when compared to those for the market as a whole – indicate that for many lenders the process of withdrawal from the highest risk borrowers is already well advanced. The commercial and regulatory pressures are such that this trend is unlikely to reverse any time soon. In effect the most probable outcome is an acceleration of the existing trend. Against this background, the most likely prospect is for the further diminution of home credit supply to the high-risk borrowers and high-risk locations that are most at risk from illegal lending.

The commercial pressures are such that the supply of home credit to high-risk borrowers will decrease, bringing with it an increase in illegal lending

From the perspective of the user, both home credit and the Social Fund act as (preferred) alternatives to borrowing from an illegal money lender. This would imply that any change in the supply of home credit – or indeed the Social

³⁷ Kempson and Collard, *Affordable Credit Policy* Press 2005

National Consumer Council, *Affordable Credit* 2005

Polcis for the DTI, *The effect of interest rate controls in other countries* 2004

Kempson E, *Life on a Low Income*, York Publishing 1996

Kempson E, Bryson A, Rowlingson K. *Hard Times: How Poor Families Make Ends Meet*, Policy Studies institute, 1994

Berthard R, Kempson E. *Credit and Debt*, Policy Studies Institute 1992

³⁸ Competition Commission Inquiry into Home Credit, Working paper on "Customer turnover, multi-sourcing and switching", http://www.competition-commission.org.uk/inquiries/current/homecredit/working_paper_01.pdf

Cattles plc Annual Report and Financial Statements 2004, p8

Fund - would be likely to impact on use of illegal money lenders. Leaving aside the Social Fund, on this basis, we conclude that the numbers at risk from illegal money lending are likely to increase, given the trends in the home credit market. A proportion of that unmet demand arising as a consequence of the continuing withdrawal of home credit supply is likely to be satisfied by the increased use of illegal lenders.

The specialist teams have had some significant successes in removing illegal lenders, creating both relief for victims and reduced crime in the community

Historically lenders have been able to operate with little fear of either detection or enforcement. This may change if new approaches to detection and enforcement are rolled out nationally. The specialist illegal money lending teams set up on a pilot basis by the DTI have had some considerable success³⁹ in removing illegal money lenders, at least in the areas in which each operates. Both teams have been able to build up a series of effective cases for prosecution and a significant number of illegal lenders have been convicted or are awaiting prosecution. Lenders have received substantial sentences which have been widely covered by the media, hopefully increasing the deterrent effect and creating a perception that illegal lending is not only a serious crime but one which is likely to be prosecuted and which the courts will take seriously. The qualitative research and witness statements suggest that the removal of the lenders has had a positive impact on the lives of victims, with debtors relieved from the considerable stress and worry about making ongoing payments to the money lenders. The Trading Standards teams also suggest that, subsequent to the removal of an illegal money lender, there may be an appreciable reduction in crime in the areas where these lenders have operated.

Home credit lenders are unlikely to extend their activities to take on increased demand implied by more effective enforcement and the removal of illegals

If, as earlier discussed, the likelihood is for an increase in illegal lenders in the wake of withdrawal of the home credit lenders, the need for specialist illegal money lending teams such as those that have been established by the DTI on a pilot basis in Birmingham and Glasgow is likely to grow also. More effective removal of illegal lenders will by definition create a supply vacuum however. In discussing policy options for addressing the vacuum, it is worth noting that the same logic that has driven the home credit lenders to withdraw from the areas and individuals most at risk from illegal lenders would also imply that high-cost licensed lenders more generally are unlikely to extend their activities to take on any increased demand for credit created by the removal of an illegal lender. Approximately half of those using illegal lenders are either defaulting home credit customers or those at the end of a home credit line. Alternatively they are too high-risk for even the high-cost lenders or living in areas that are too dangerous for the home credit agents to serve. Against this background there would appear to be no commercial incentive for the home credit lenders to take on these borrowers.

³⁹ We have not commented in any detail in this study on the work undertaken by the Trading Standards specialist money lending teams, currently funded on a pilot basis by the DTI, because these operations are the subject of a separate research and evaluation exercise.

Challenge for regulators is to balance a benefit for the majority – of lower prices – against the risk of higher costs and collateral damage for the minority

The home credit industry has been the subject of intense regulatory scrutiny, most recently by the Competition Commission which has provisionally concluded that, as a result of price insensitivity on the part of customers and a lack of effective competition in the market, the lenders are over-charging their customers – relative to the justifiable costs of capital and delivery and an appropriate profit margin – by some £100 m p.a. or approximately £10 per home credit contract. In formulating policy responses, the challenge for regulatory authorities is to balance the potential for benefit to the majority of home credit borrowers – in the form of lower home credit prices – against the damage likely to be done to the minority of high-risk borrowers who may be left exposed to the risk of illegal money lending. As the combination of regulatory pressure on home credit pricing and the defection of the most reliable borrowers to cheaper products causes lenders to move away from the cross-subsidy model and the highest risk borrowers, a minority segment of the most disadvantaged home credit customers may find themselves effectively excluded from the commercial credit market. Those needing or determined to borrow nonetheless may face the greatly increased cost of credit and the collateral damage to both individuals and communities associated with borrowing from illegal lenders.

There may be a limited window of opportunity in that the licensed lenders are likely to withdraw faster than new sources of social credit can be built

In that part of the market most at risk from illegal lending, there appears to be a shrinking number of - increasingly risk averse - licensed suppliers and thus a growing pool of high-risk borrowers who are unlikely to be served by commercial sources. The only prospective new entrants appear to be illegal lenders, potentially on a larger scale than currently. Against this background, and in the context of the most deprived estates, the key challenge in many ways is less about the cost of licensed credit than ensuring sources of legal credit supply. Given the trends in the licensed home credit sector, there is a clear need to create an alternative source of supply in some form of social lending. The danger in the current situation is that an effective social lending operation may take some time to establish and scale, while the high cost lenders would seem likely to withdraw from the market faster than alternative sources can be established. There would seem therefore to be a limited window of opportunity in which to act, particularly if the withdrawal of home credit lenders accelerates.

The question for policy makers is the form which alternative social lending might most effectively take

The question for policy makers is the form which alternative social lending might most effectively take if it is to play a role in combating illegal lending and providing affordable credit on the most disadvantaged estates. The obvious candidates for alternative forms of supply would appear to be the Social Fund on the one hand and credit unions and CDFI's (Community Development Finance Institutions) on the other.

A targeted and focused expansion of the Social Fund may be the most effective vehicle for an alternative to illegal lending

The most effective route to the provision of an alternative source of credit to those at risk of illegal lending, would appear to be a closely targeted expansion of the Social Fund, not least because a high proportion of users of illegal lenders are already borrowers from the Fund. Provision would need to be designed specifically to address the needs of individuals most at risk from illegal lending and focused on those areas identified as likely concentrations of illegal lending.

Initiatives built around Community Care Grants may provide the most appropriate vehicle for a focused expansion of the Fund

We are conscious of the recent increases in funding for both the Social Fund CCG (Community Care Grant) and BL (Budgeting Loan) budgets. However, without adequate funding for any initiative designed to tackle illegal lending there is little prospect of the Social Fund acting as a viable alternative to it. Any additional increases in funding would need to be carefully focused and highly targeted if they were to be effective. To this end, an increase in the CCG budget might provide the most appropriate focus for additional funds and activity in that the people applying for Social Fund grants will in many cases fit the profile of those most at risk from illegal lending⁴⁰. From the perspective of any evaluation of the likely funds required, it will perhaps be important to factor into calculations the likelihood that demand will increase above current levels as the withdrawal of the home credit lenders plays out.

Ring-fencing funds and setting up specialised units could perhaps enable the Social Fund to be more responsive and provide more accessible funds

One of the drivers of use of both illegal money lenders and home credit is that these lenders can provide rapid access to funds. To be effective, any alternative to these credit sources would need to offer a degree of accessibility. We recognise that this is difficult to achieve within the context of a system such as the Social Fund and that changes have recently been made to the Social Fund to make it more responsive and equitable in terms of outcome, but there might be scope for doing more. We are also conscious of the constraints implied by a centralised, postal-based system. However, it may be possible to create rapid-access funds by setting up specialist units targeted on areas most at risk and by ring-fencing sufficient funds from the Social Fund or CCG budget to ensure that such units were adequately funded and resourced. Such a move, particularly if allied to partnerships with other disciplines and agencies, could also address some of the practical issues which might otherwise work against the responsiveness and flexibility that would be a critical factor in success.

⁴⁰ National Consumer Council Affordable Credit, 2005

Kempson and Collard, Affordable Credit, Policy Press, 2005

Kempson E, Collard S and Taylor S, Experiences and consequences of being refused a Community Care Grant, DWP 2003

Success will require innovation and pro-activity, ideally in the context of a holistic approach to the problems of the most disadvantaged

Success in combating illegal lenders through the medium of a targeted Social Fund based operation would indeed require innovation in delivery and the introduction of a degree of pro-activity and accessibility that is not currently associated with the Fund. Any initiative based around the Fund would stand the best chance of success if conceived as part of a holistic approach to the complex and multi-dimensional problems which figure largely in the dynamic underlying both illegal lending and anti-social behaviour and crime in deprived areas more generally.

Policy focus thus far has been on introducing victims to credit unions as a means of filling the supply vacuum

Policy focus thus far has been on credit unions as an alternative credit source, with a number of credit unions established in areas where illegal lenders are known to be operating. Victims of illegal lenders have also been introduced to credit unions by the specialist DTI pilot teams following removal of illegal lenders. It has yet to be ascertained whether these introductions have resulted in victims finding a sustainable alternative source of credit or whether these initial relationships have snowballed to bring in other members of the community at risk from illegal lenders⁴¹.

Some credit unions have developed considerable expertise in lending to very high-risk borrowers and will have much to contribute to multi-agency initiatives

Some credit unions, particularly in Scotland, have acquired considerable experience of lending not only to users or ex users of illegal lenders within their own membership but also to very high-risk borrowers more generally, since these unions tend to operate in communities with a high degree of social problems and deprivation. Such unions will have valuable experience to contribute both to any multi-agency initiatives to combat illegal lending but also to the development of best practice models of managing high-risk borrowers for the movement as a whole.

With time, elements of best practice could be rolled out more widely both within the context of multi-agency initiatives and to other credit unions

With time, more credit unions and indeed third sector lenders more generally may well develop the scale, infrastructure and skills to take on these very high-risk borrowers. For the present we would argue that seeking to position credit unions as a whole as an alternative to illegal lenders is not only unrealistic but potentially a distraction at this stage. It would be better to concentrate efforts on those unions with some depth of experience in the area so that elements of best practice can be brought together with expertise from as diverse a range of agencies and organisations as possible.

A number of developments are enabling the credit unions to widen access to affordable credit and reach out to new, higher risk groups

A number of positive developments within the movement will enable credit unions to reach out to higher risk borrowers than are currently served and to

⁴¹ This is the focus of a separate research project.

make a step change in the nature and breadth of financial services offered. One of the most important of these developments is the drive to integrate a fully fledged banking facility into the service offer to members. Some credit unions have also moved away from the traditional link between saving and borrowing - which has acted as a significant barrier to using credit unions for people on low-incomes⁴². Developments in the policy arena⁴³ and recent government investment⁴⁴ in third sector lenders should also accelerate both growth within the movement and progress towards the wider provision of affordable credit and greater financial inclusions of the disadvantaged.

Many credit unions are not serving the same universe as illegal lenders however

We would question, however, whether the majority of credit unions are yet well placed to be positioned as a front-line alternative to illegal lending, at least at this stage in their evolution. On the basis of the data from the saturation surveys in deprived areas and the nationally representative surveys with low income households, it is striking that credit unions appear to have relatively little contact either with users of illegal lending or those most at risk from illegal lending (i.e. those being turned down by the high-cost lenders and by the Social Fund). Previous research⁴⁵ has also suggested that users of credit unions and the Social Fund can be very different, with users of credit unions appearing to have more stable lives and finances than users of the Social Fund, even where users of credit unions are very poor.

Many credit unions may not be well placed as a front-line alternative to illegal money lending and lack the experience to manage high-risk borrowers

Against this background, and in contrast to the position with the Social Fund, we would suggest that it would be a significant stretch for many credit unions to serve a borrower type of which many in the movement have had little experience. The evidence is that a significant minority of those using illegal lenders have life-styles that are chaotic, so much so that the seasoned and risk tolerant home credit lenders are increasingly unwilling to serve these borrowers. Seeking to accommodate this type of borrower within many of the current credit union models would seem likely to expose credit unions without relevant experience to a degree of risk that could even compromise the stability and viability of some unions.

⁴² These unions are adopting "capacity-based lending", where loans are granted based on the member's ability to repay, their circumstances and credit history rather than the amount they have saved with the credit union.

⁴³ Alongside access to banking and the provision of face-to-face debt advice, increasing the availability of affordable credit is one of the key components of the government's strategy to promote financial inclusion (HM Treasury 2004).

⁴⁴ To this end, in 2005 the government established a Growth Fund of £36 million to increase the provision of affordable credit (in the form of personal loans) to people on low-incomes living in areas of high financial exclusion. Credit unions, community development finance institutions (such as Moneylines) and other community-focused Industrial and Provident Societies are eligible to bid for funding to develop their services to the target group. Beyond this a further £45 million has been allocated to fund the further development of free face to face debt advice.

⁴⁵ Whyley, Collard and Kempson, *Saving and Borrowing for DWP*, 2000.

The impact of changes to the price constraints under which the credit unions have operated have yet to be tested

Most credit unions have traditionally served a much narrower risk profile than the home credit lenders, far less the illegal money lenders, for a number of reasons. To a large degree, we would argue that these constraints continue to apply to many unions. The price restrictions that have applied to the movement historically have been an important factor in constraining the movement's appetite for risk. The recent changes in the price ceiling applicable to not-for-profit lending⁴⁶ are as yet very new. The extent of the flexibility afforded by these changes is therefore almost entirely untested. We would argue that the risk profile of much of the movement would be most effectively extended only on a gradual basis as the movement experiments with, and learns from, new pricing structures and risk management practices

The movement as a whole has yet to build up the scale to enable cross-subsidy of high-risk borrowers by better-off members

Many unions have also yet to build up enough scale to serve high-risk borrowers through cross-subsidy by their better-off customers. If such cross-subsidy is to be achieved, success will be most likely through pursuing the current policy of focusing on expanded services for the existing membership and widening access to credit union services incrementally as skills and capacity increase and the technology infrastructure can be put in place.

Many of the new developments are also at an early stage and some are in any case confined to a few larger unions

Important as the many positive developments within the movements are, they do not yet add up to an increased and widely-spread capacity to serve a new category of very high-risk borrowers. Many of the developments described are at an early stage or are confined to a few larger unions. At present, capacity-based lending is only operated by some of the larger 'modernised' credit unions (Jones 2005). Smaller credit unions (which comprise the bulk of credit unions in Britain) continue to retain the link between savings and borrowing, which would preclude almost all those at risk from illegal lending.

Any alternative to illegal lending will need to be accessible, pro-active and close to the community

Whatever the structure around which measures to combat illegal lending are ultimately built, the research offers a number of cues as to critical success factors. To be a realistic alternative to the majority of people who currently use illegal money-lenders, lenders would need to be actively promoted and offer a service that is quick, easy and convenient. The relatively slow access to cash credit associated with both credit unions and the Social Fund (as compared to home credit or illegal lenders) appears indeed to be one of the key reasons why home credit is seen by users of illegal lenders as a more effective alternative to illegal lenders than either credit unions or the Social Fund. A pro-active and outreach-based approach is probably required, with agencies becoming embedded in the communities they seek to serve.

⁴⁶ The statutory ceiling on the lending rate for not for profit lenders has been increased, from 1% per month on a reducing balance (equivalent to 12.68% APR) to 2% per month (25.4% APR), a move announced in December 2005, specifically with a view to facilitating the movement being able to service higher risk borrowers

Effective collection management would be critical to success and may even require a move closer to the modus operandi of the home credit lenders

Equally, in order for alternative lenders to serve high-risk borrowers, they will need to have in place effective methods for collecting loan repayments and managing default. In effect it may even be necessary for lenders to move closer to the modus operandi of the home credit lenders. If so, any such moves would be likely to imply significant additional cost and it would take some time to acquire new skill-sets and know-how. In this connection we note that the Joseph Rowntree Foundation has recently announced its intention to fund the development of a business case for a not-for-profit home collected credit service, the results of which should shed interesting light on whether such a model might act as an alternative not just to high-cost home credit lenders but in some cases to illegal lenders also.

Education and advice will have a role to play in increasing awareness of the dangers and consequences of using illegal money lenders

Enhanced education and increased access to financial advice will also have a role to play in combating illegal lending, not least in promoting awareness among potential borrowers of the dangers and financial implications of using illegal lenders. There have been a number of initiatives to try and improve financial literacy among consumers in the UK, though these have tended to be small in scale and un-coordinated. More recently, the FSA has taken the lead on developing and implementing a national strategy to lift the level of financial capability across the UK population, so that people are better able to make decisions and take responsibility for their finances. Several action programmes are being undertaken to deliver the strategy, including financial education for children at school, for young people and for new parents (FSA, 2006). It may be possible to focus one strand of any initiatives targeting areas with a high degree of deprivation and financial exclusion on the specific issues and dangers associated with the use of illegal money lenders.

Advice will also be required to help victims manage their finances in the aftermath of the removal of an illegal money lender

In the aftermath of the removal of an illegal lender, many victims whose finances may have been hollowed out by payments to the money lender will benefit also from access to advice in the effort to stabilise their finances and build the basis for sustainable use of credit going forward. It may be however that those most at risk from illegal lenders are also those most resistant to advice. It was noticeable in carrying out the research with both victims and front line agencies, that policy makers and professionals were far more convinced than illegal lender users of the efficacy of financial advice in the effort to tackle illegal lenders. For those already using illegal lenders, the view was clearly that any such support would be far less effective than increased access to legal sources of credit, commercial and otherwise.

A holistic approach involving partnership between a number of agencies may be the only effective solution for those with multi-dimensional problems

The profile of customers of illegal lenders and the dynamic which underpins the use of illegal lenders suggests that the provision of money advice and alternative sources of credit is unlikely of itself to address fully what appears in many cases to be a complex set of multi-dimensional problems. At least some of the people who use illegal lenders face complex and intractable problems that will largely lie outside the remit of the illegal lending teams and, at a national level, the Department of Trade and Industry. The most effective approach to addressing the underlying problems may be a holistic one, involving partnership between a number of agencies, including health, and social services, with illegal lending regarded as one facet of the larger set of social problems afflicting both individuals and the communities in which they live.

Detection and enforcement is always likely to be challenging and resource and cost intensive, with inherent limits to effectiveness

Despite the considerable successes of the illegal money lending pilots in identifying, prosecuting and removing illegal lenders, it is important to recognise in discussing ways forward that detection and enforcement is always likely to be challenging. The experience of the Trading Standards illegal lending teams suggest that successful enforcement is time and resource intensive and requires both significant funding and political support. Given the nature of the crime, the closed communities in which illegal lenders operate and the understandable reluctance of victims to report lenders or provide witness statements, there are also limits to what can be achieved. The illegal money lending teams report that some illegal lenders are very difficult to identify, far less remove. Sufficient evidence to prosecute is simply too hard to come by, given the fear instilled in victims and the problems associated with long term witness protection. Against this background, it would seem that at least some illegal lending will not be amenable to enhanced enforcement.

The pilot illegal money lending teams appear to be addressing an important need that would appear difficult to tackle by other means

Further research is being undertaken to establish the long term impact on victims and the community of removal of illegal lenders and to quantify any knock-on effects on criminal activity in areas where lenders have been removed. Clearly time will tell also on the extent to which more effective enforcement will have a deterrent effect in reducing the incidence of illegal lending (though any evaluation should bear in mind the likely prospect of an increase in underlying demand earlier discussed). However, the evidence thus far is that, despite the difficulties of the task and the intractable nature of some aspects of the problems associated with illegal money lending, the pilots are addressing an important need and that the projects have benefited both victims and the wider community.

The most effective strategy in combating illegal lenders would appear to be the maintenance of a regulatory environment which minimises their opportunities

Overall therefore, given the difficulties inherent in the detection and enforcement of illegal lending and the significant challenges and costs associated with creating alternative sources of social credit, the most effective strategy for combating illegal lending would appear to be the maintenance of a regulatory environment which encourages legal credit options. There are clearly limits however to what even an efficient and competitive market can deliver and there will always be a pool of borrowers that even the most risk tolerant commercial lenders will not serve.

Commercial credit to the highest risk borrowers will always be high cost but regulated lending will always be less damaging than illegal lenders

Moreover commercial lending to high-risk borrowers will invariably come at very high cost, indeed at a cost so high as to be regarded as socially or morally unacceptable by many stakeholders in the policy debate. As this study has demonstrated, however, the alternative may be unregulated black-market lending at much greater cost and on very significantly worse terms and without the benefit of any form of consumer protection other than the final back-stop of criminal prosecution of the lender, an outcome, as just discussed, often difficult or impossible to achieve in any case.

Regulatory strategies for both illegal and high cost lending carry significant social risks if developed in isolation from wider social policy considerations

There are considerable social – and indeed economic – risks inherent in different approaches to credit market regulation, with considerable potential for unintended effects. Strategies to address illegal lending need to be developed therefore not only within the context of regulatory policy for the credit market but in the context of wider social policy around social and financial inclusion. A regulatory strategy designed to maximise the availability of regulated credit would optimally be pursued in parallel with closely targeted support for those least likely to get access to it and thus most at risk of exposure to illegal lending. The size of this universe of commercial credit-excluded individuals at risk from illegal lending will be a function of the approach taken by different regulators and the degree of tolerance each has for high cost lending. In the UK the regulatory environment has minimised the opportunity for illegal lenders and the universe is small-scale, if wide-spread.

Tackling illegal lending would appear likely to contribute to the achievement of wider social policy goals on deprived estates

However, partly as a result of this scale, illegal lending in the UK occurs in areas and among groups, which though relatively difficult to reach, are also the focus of a number of important social policy goals. These include the drive for social and financial inclusion and addressing anti-social behaviour and high crime rates on deprived estates and thus moderating the impact of poverty and inequality of opportunity. It is to be hoped that the clear connection between illegal lending and the exacerbation of all of these social

ills as a barrier to social policy goals, will go some way to making the case for effective funding to combat it.

Efficient enforcement has an important role to play but will always have limited effectiveness in the face of deeply resilient demand

Consistent and adequately resourced enforcement will have an important role to play in preventing those most at risk from falling prey to illegal lenders and in providing relief to victims already enmeshed in illegal lending. However it would appear that there is a limit to how much can be achieved by enforcement when demand appears so consistently resilient even in the face of deeply undesirable credit options.

Social lending appears the only solution for those too high risk for commercial lenders or who can be served only at a price that is socially unacceptable

Ultimately, if deeply vulnerable individuals are not to fall prey to illegal lenders and poverty and crime are not to be further exacerbated by the activities of such lenders, the only viable option is to develop social lending alternatives to illegal money lenders, focused on the deeply deprived communities in which these lenders operate. In addition any such operation will need to target also those very high-risk borrowers which the high cost home credit lenders are increasingly unwilling to serve.

Multi-disciplinary teams focused on individuals and areas most at risk and supported by a targeted extension of the Social Fund offer greatest potential

In the UK those individuals and communities at risk from illegal lending appear to face a series of deeply entrenched and in some cases potentially intractable problems, with illegal lending only one aspect of life-styles and communities which are impoverished and degraded. Against this background we believe that the way forward will rest not just on specific initiatives such as the work of the illegal money lending teams, though these will be important, but more fundamentally on a targeted extension of the Social Fund, especially Community Care Grants. We would argue that success in meeting this difficult and complex challenge is most likely within the context of specialist units and multi-disciplinary teams focused on individuals and areas most at risk.

Section 6.0 Technical appendix

6.0 Detailed methodologies for the various research components

6.1 Secondary analysis of existing data

The research began with secondary analysis of two recent surveys undertaken for Policis by Taylor Nelson Sofres that asked people on low incomes about patterns of credit use and money management and their difficulties with debt. The first of these surveys comprised 1,070 nationally representative consumers in the lowest quintile of UK household incomes, who were interviewed face-to-face in their homes during December 2003. The other was a nationally representative sample of 640 consumers in the lowest quintile of UK household incomes or dependent on benefits, who were interviewed in their homes during December 2004. Respondents were specifically asked whether they or anyone in their household had used an illegal money lender, whether anyone in their social network had used an illegal lender and if they were aware of illegal lenders operating in their areas.

As mentioned above, the data were re-analysed in order to establish a high level estimate of the number of people using illegal lenders among low income households, which could then be validated and extended by other elements of the research. In addition, it allowed us to examine in considerable detail the personal characteristics, circumstances, attitudes and behaviour (as it relates to money management, the use of credit and application of funds) of those using illegal lenders. We were able to explore their access to credit - including all forms of commercial credit, social lending (credit unions and the discretionary Social Fund) and informal borrowing from friends and family. Moreover, the data provided information about the reasons why people borrow, the value of their borrowings and any history of problematic credit use and of credit refusals.

6.2 Qualitative interviews with domain experts

The second stage of the study comprised qualitative interviews with domain experts who have knowledge or experience of illegal money lending, identified by approaching various Trading Standards officers, police and credit unions in likely areas and then through snow-balling techniques. In total, we were able to collect information from 17 organisations across the UK. These included the two specialist illegal money lending teams in Birmingham and Glasgow, trading standards departments, the police, credit unions, community-based financial inclusion services, advice services, and local authorities.

The interviews with the illegal money lending teams in Birmingham and Glasgow were carried out face-to-face. Based on their case files, the teams were able to provide detailed information about the nature and extent of illegal lending in Scotland and the West Midlands, the different types of illegal

lenders, where and how they operated, their customers, and the impact they had on both customers and local communities.

The remainder of the interviews were carried out by telephone, and mainly provided information about the locations in which illegal money lending was happening, or was likely to be happening, as well as some details about the types of illegal lenders and their customers.

From these interviews, and the information contained in the witness statements, we were able to develop a conceptual map of the different types of illegal lenders and how they operated. They also provided additional information about the scale of illegal lending activities upon which to build.

6.3 Creation of a national map of credit exclusion

On the assumption that those not served by the highest cost lenders would be unlikely to be served by other lenders types, we took areas which were regarded as too dangerous to serve by the home credit lenders as a proxy for credit excluded areas. A number of large home credit lenders, together representing a significant share of the market, supplied aggregated data, drawn from customer databases. This data was provided to us on the condition that it would be aggregated and analysed only in aggregate and that, for reasons of commercial confidentiality, the data from individuals lenders would not be shared with either competitors or third parties. Data was provided at postcode level indicating areas which were not served or significantly under-served by the home credit lenders in the twelve months preceding the research (prior to January 2005), together with data in relation to poor collection performance, bad debt and debt write-off. This data was pooled to create a database of poor home credit collection performance and home credit exclusion, which was subsequently used to create a detailed national map of credit exclusion within micro-communities across the UK.

6.4 Integration of the indices of multiple deprivation with the map of credit exclusion

The quantitative nationally representative surveys had indicated that home credit excluded households and those using illegal money lenders were among the most disadvantaged. We therefore set out to ascertain the degree of cross-over between exclusion and deprivation and to create a national map of credit exclusion and deprivation. Each postcode could as a result of the exercise described in 6.3 above be classified as excluded or not and could also be attributed the Indices of Multiple Deprivation (IMD) percentile score of the surrounding area (Super Output Area – Lower Layer in England and Wales and Data Zone in Scotland). Deprived households were identified using a combination of the indices of multiple deprivation (IMD) and the all fields postcodes database (AFPD). Each of the different indices of multiple deprivation (England, Scotland and Wales) were divided up according to percentile ranking based on their combined index score. This produced indices which were compatible in relative terms if not in absolute terms. The effective assumption made was that similarly ranked areas in England and

Scotland, for example, had similar absolute levels of deprivation. The indices of multiple deprivation were then combined with the indices of credit exclusion to provide an integrated index of exclusion and deprivation which was mapped across the UK (excluding Northern Ireland) to create a map of exclusion and deprivation. This composite map of credit exclusion and deprivation formed the basis upon which to develop estimates of illegal lending at micro-community level, using the outputs from the saturation surveys described in the following section 6.4. The detail of how estimates were arrived at is described in section 6.7 following.

6.5 Saturation surveys in areas of credit exclusion, areas of intense deprivation and known concentrations of illegal money lending

Quantitative saturation surveys were conducted in small-scale localities (generally a particular set of tower blocks or a particular estate) in five areas of the UK – Birmingham, Glasgow, Liverpool, London and Sheffield. Two sources of information were used to select the micro-communities that were surveyed within these five areas, the composite map of home credit exclusion and multiple deprivation (described previously) and the local knowledge of agencies on the ground. The micro-communities that were selected deliberately comprised a mix of low rise and high rise housing, since the domain expert interviews had suggested that this was a factor in creating the conditions for illegal lending (with different dynamics operating in Scotland and England and Wales). We aimed to include some communities that were predominantly white, and others that were more ethnically mixed. In total, 725 interviews were carried out across these communities.

The first 150 of these interviews were conducted on a housing estate in Liverpool, with the aim of testing the questionnaire and the methodology. The fieldwork was conducted over four days, and the rate of refusals increased significantly on the second day onwards. Members of the fieldwork team were also threatened and intimidated. For this reason, the Liverpool pilot data did not used in the calculation of the incidence of illegal lending overall although responses to individual questions were employed in other analysis throughout. As a result, the survey questionnaire was considerably shortened (the final questionnaire used in the main body of the fieldwork is provided at the end of this section). It was also decided to 'blitz' the fieldwork in the remaining communities in as short a time as possible, to minimise the risk of threats and intimidation to both the fieldwork team and local residents. Even so, the fieldwork team had similar experiences in some of the other communities, most notably in London. They also had difficulties gaining entrance to blocks of flats and tower blocks in some areas because of heightened security measures such as concierge services and locked access at each floor. Our assumption is that the enhanced security did not create bias in the survey results on the grounds that both home credit agents and illegal lenders would also face in gaining access.

6.6 Examination of witness statements and depth interviews with victims

Members of the research team were given access to the witness statements provided by victims to the DTI pilot illegal lending teams. 109 Witness statements were examined in all, supplemented by a small number of depth interviews with victims, facilitated by the pilot teams. The interview tapes were transcribed and the content of these and the witness statements transferred to a thematic grid designed to enable the systematic analysis of qualitative material.

6.7 Estimating the scale of illegal lending

A diagrammatic representation of the scaling methodology can be found at the conclusion of the Technical Appendix as Figure 7.

The estimates of the scale of illegal lending in the UK were arrived at using both the nationally representative data and the saturation surveys of deprived areas. We undertook a series of manipulations to apply the survey results to the universe of deprived households across the UK and to those areas which we had identified as effectively credit excluded. The saturation surveys contained a number of biases, because we had deliberately selected some areas of credit exclusion and some areas with a high concentration of ethnic minorities. Exclusion and ethnic profile data (the latter derived from the census) were used to correct for relevant bias in the survey sample. A final element was the use of existing nationally representative survey data to cross-check and validate the survey results as well as providing us with a means of estimating incidence levels for low income households not covered by the saturation surveys. Separate results were calculated for excluded postcodes and non excluded postcodes and for households where the dominant ethnic group was White on the one hand or Asian or Black on the other.

The quantitative research, both the nationally representative surveys, and those undertaken in deprived areas, indicated that there was a higher incidence of illegal lending in the most deprived areas compared to the low income population (bottom 20% of household incomes) as a whole. At a national level, some 3% of households claimed to have used an illegal lender, compared to some 6% in deprived areas.

In selecting a universe to which to apply the proportions derived from the saturation surveys, the main objective was to construct a universe of deprived households with the same characteristics as the sample. The average percentile IMD score of the sample was 97.52 and we selected as our universe for the “most deprived estates” the group of areas in the UK which had the same average percentile IMD score. This was done by testing and selecting a “cut-off” IMD score so that the averages were the same. In the event an average score of 97.52 was achieved in all areas with an IMD score of 95.08 or more and these were the ones included in the “most deprived estates” universe.

The other universe of interest was the “lowest quintile” group of areas, meaning those areas which were within the 20% most deprived in the UK. The IMD percentile score cut-off for these areas was just under 80%, so the “other lowest quintile” universe used in the scaling up exercise comprised areas with IMD percentile scores between 80% and 95%.

In order to calculate numbers of households for given postcodes and Super Output Areas/Data Zones the number of addresses for each postcode contained within the AFPD was used. Postcodes with only business addresses were discarded, along with postcodes with no addresses at all. The remaining addresses in the AFPD became a proxy for households throughout the UK. The total number of “households” so obtained was 27.5 million. The number of “lowest quintile” households was therefore around 5.5 million. The number in “most deprived estates” was around 1.4 million and subtracting these from the “lowest quintile” total gave a number of “other lowest quintile” households of around 4.1 million.

The survey sample was chosen with credit exclusion and ethnic composition in mind, so both excluded and ethnic minority households were over-represented in the final sample. The incidence of illegal lender usage was calculated both for excluded and non excluded households in the sample and these results were reweighted to reflect the actual proportions of excluded and non excluded households in the “most deprived estates” universe based on information provided by a number of home credit lenders. A similar exercise was carried out for ethnic bias using ethnic profile information on different areas derived from the census data sets.

In arriving at the scaling calculations, the reweighted illegal lending incidence percentages were applied to the universe of “most deprived estates” to produce an estimate of households making use of illegal loans. For the other “lowest quintile” households not covered by the quantitative research, use was made of a number of nationally representative surveys carried out in recent years which found that the incidence of illegal lending usage among low income households was around 3%. Given that the incidence in the “most deprived estates” was around 5.5% and that these areas represented nearly exactly one quarter of all “lowest quintile” areas it was possible to work out that the incidence of illegal lending in “other lowest quintile” areas was just over 2%, allowing us to estimate the number of households affected in these areas. The resulting total of just under 165,000 represented an incidence level of around 3% of households in all “lowest quintile” areas, consistent with the nationally representative surveys overall.

The nature of the research meant that some respondents found it difficult to answer questions about illegal lending. It is likely therefore that there was a degree of under-reporting which would point to a higher incidence of illegal lending than that published in this report. Faced with an absence of comparable data gathering exercises other than the nationally represented surveys we decided that our incidence level of 5.9% was approximately double the 3% resulting from the surveys and so confirmed our starting hypothesis that illegal lending would be more concentrated in the most deprived estates. We acknowledge that our estimate of illegal lender use is probably a conservative one. However, in the absence of alternative data to

base an uplift on, we were reluctant to depart from the survey data, particularly given that three nationally representative surveys of those on low incomes had generated very similar results for the incidence of those claiming to use an illegal lender. This approach also has the advantage of facilitating international comparisons.

6.8 Mapping likely concentrations of illegal lending

In order to assist in the selection of areas to be surveyed and give some geographical representation of the likelihood of illegal lending across Great Britain a series of maps were produced on a number of different basis'. The maps were produced using Geographical Information Services (GIS) software on the basis of electronic geographical information produced by National Statistics and the Scottish Executive. This information was merged with the post-code level credit exclusion data and the indices of multiple deprivation to produce a first set of maps based on an index combining composite deprivation and the degree of credit exclusion. Both measures were combined in a 50:50 ratio to produce a combined deprivation-exclusion index. The IMD information transformed into percentile score information, and the exclusion information was simply the percentage of households in a particular area living in postcodes not serviced by the home credit providers. This combined index served to direct which areas would be most likely to have illegal lenders in operation alongside information from agencies on the ground. We found a reasonable level of correlation between deprivation and credit exclusion in Scotland and the North of England but only a limited level of correlation in the Midlands. Based also on advice given to us by agencies on the ground we decided to base future maps mainly on levels of composite deprivation.

The approach for the maps in the present report is wholly based on relative levels of deprivation as giving the best indication of illegal lending activity. It is important to note that these maps should be treated as estimates for the areas most likely to have illegal lending operating. For this particular project there was insufficient information available to map actual incidence as this would have required a much more substantial and widespread survey effort.

6.9 Estimating APRs and TCC

The estimation of APRs and Total Cost of Credit (TCC) figures in the report was carried out using a spreadsheet model. TCCs were calculated as a simple subtraction of the loan amounts actually received by the borrower from the total actually paid to the lender. In effect what are being subtracted are the capital repayments so that the TCC only comprises interest, fees and any other charges applied to the loan. The APRs in the report were calculated using a time-weighted internal rate of return on a weekly basis which was then annualised. While this means that small loans appear to have disproportionately high APRs it should be borne in mind that these loans may have only been meant to be for a week or so and that a weekly interest rate of 30% sounds relatively more reasonable than its annualised equivalent which is over 8 million percent.

6.10 Analysis and interpretation of survey results

We believe that the overall patterns and concepts we describe, derived from the research data, reflect the experience of using illegal lenders. They appear also to be consistent with the picture arising from the witness statements. Readers should bear in mind throughout however that the sample base of those who have used illegal lenders is less than 100 respondents so that %s should therefore be treated with a degree of caution. The number of respondents within the saturation surveys admitting to using an illegal lender was 45, while that within the nationally representative surveys was 51. Where caution should be employed in interpreting the results, this is indicated below the relevant charts.

6.11 International comparisons

We make comparisons in the incidence of illegal lending between the UK and France and Germany and also make reference to illegal lending in Japan.

The data on the incidence of illegal lending among low income households in France and Germany is derived from face-to-face interviews undertaken by Taylor Nelson Sofres for Policis in October and November 2003 with a representative sample of 2717 low income consumers falling into bottom 20% of household incomes in each territory.

The reference to the profile of victims of illegal lenders in Japan is derived from work undertaken in 2002 by the Japanese Federation of Bar Associations with 1541 users of illegal lenders, who visited JFBA offices.

Figure 8 Illegal lending Scaling Methodology

