Is a not-for-profit home credit business feasible?

Findings
Informing change

March 2009

Commercial home credit is long established, with large numbers of customers on low incomes. Customers value many of its features highly, but the cost is high. This study tested the commercial feasibility of a not-for-profit home credit service.

Key points

- Demand for a new, not-for-profit service would be high, but would risk disproportionately attracting customers with payment problems. Maximising the number of good payers would be crucial to success.
- The essential elements – weekly home collection, a single price underpinned by cross-subsidy and payment flexibility, and debt recovery for people who genuinely cannot pay – cannot be separated without undermining the model's viability.
- Recruiting and retaining good collection agents would also be critical. Agents' effectiveness and remuneration depend on having sufficient density of collection round.
- The business model developed adapted the operating experience of commercial providers to a social model. It would achieve break-even in ten years, and cover its running costs in year five.
- Even on a not-for-profit basis, to make the service financially sustainable the cost of home credit would be high.
- With an £18 million subsidy, the APR on an average 56-week £288 loan would be 123 per cent (compared with 183 per cent commercially), bringing customer savings of £50. But to achieve a reduction to a 100 per cent APR would require a £90 million subsidy. Customer savings would increase to £72 per loan (£170 yearly on an average annual loan frequency of 2.34).
- This may be insufficient to attract good payers. Cross-subsidy would be required from other products such as insurance, savings and cheque-cashing.
- Existing third sector lenders had limited appetite for delivering the service. A stand-alone provider would seem to offer the best delivery option.

The research
By Elaine Kempson, Anna Ellison, Claire Whyley and Paul A Jones

Background

Commercial home credit is long established, with large numbers of customers on low incomes. Despite criticism of the high cost of loans, home credit has many features that its customers value highly. This study tested the commercial feasibility of a not-for-profit home credit model, drawing on data analysis, in-depth interviews, market testing and workshops with lenders.

Consumer perspective

Demand for a not-for-profit service is likely to be high and relatively stable, especially among those already using commercial home credit. However, it is likely to be highest among those with existing payment problems. The demand would be for a product closely resembling the existing commercial model, including repayments collected weekly and a flexible approach to missed or late payments.

Evidence was mixed on the ease with which a new not-for-profit lender might attract existing users of commercial home credit companies. Potential customers would have a strong desire to deal with a known and trusted lender, which could pose a challenge to a new entrant unless they already had an established reputation. Existing users are also not as credit-constrained as might be expected. Although there was little evidence of shopping around, four in ten commercial home credit customers use more than one company at a time. Two important barriers would, however, make it harder for a new lender to attract customers from commercial companies: the close relationship between customers and their agent, and high levels of satisfaction with existing lenders.

The types of customers most likely to be attracted to a new lender are those with a high risk of payment problems. There is, therefore, a real risk of disproportionately attracting potential bad payers. The success of a new entrant would rest on the ability to manage this issue, especially in the early days.

Commercial home credit lenders

Lenders were united in their view that it is not possible to separate the key elements and still have a viable business. From their perspective, the essential elements of a service are: home collection; a single price underpinned by cross-subsidy, both among customers and over an individual customer's 'life cycle'; and flexibility regarding payment and debt recovery for people who cannot rather than will not pay.

Missed and partial payments are endemic to home credit customers: around a third of all payments are missed each week. A common definition of a good 'quality' customer was someone who makes six in ten of their repayments on time.

Acquiring new business is a major challenge for commercial home credit providers, as customer turnover levels are high and increasing, reflecting the competition for 'quality' customers. Retaining good payers is essential, as is recruiting new customers with a similar propensity to pay. Lack of demand is not a problem, but finding good customers is becoming more difficult. Traditionally, the key sources of new business have been agent referrals and recommendations from existing customers, but both are diminishing. Consequently, other recruitment methods (such as canvassing) have to be used. These are more costly and run a greater risk of adverse selection of customers. This would have significant implications for a new lender; alternatives such as referrals from social organisations would need to be maximised.

Good agents are critical to successful home credit businesses. They offer the best method of recruiting new customers and are a key source of repeat business. Their detailed knowledge of their customers is an important input to lending decisions. They build a rapport and personal commitment with customers that is reflected in a commitment to pay. Without their persistent visits to people in default, a significant proportion of the money lent would not be collectable. However, agents represent a major cost to home credit companies.

Most agents are women working part-time, usually self-employed. Most of their commission (85 per cent) is based on collection. On average, agents have 130 customers in their round, and to provide an adequate income they typically aim to serve between six and ten customers an hour. Density of collection round is thus a critical factor in determining agents' effectiveness and remuneration.

Good agents fit into the community they serve. They are self-motivated, professional and numerate, with a maturity of outlook. Consequently, recruiting agents who possess the right qualities is challenging but essential. So, too, is retaining good agents, as new agents and new rounds require subsidy. New agents are more dependent on systems and controls, particularly for bad debt management.

On the whole, agents' safety and fraud are not major problems, but only because commercial companies have learnt how to mitigate them. A new lender would need to learn from their experience.

Building the business model

The study developed models for return on investment, cost of delivery and pricing, drawing on the evidence above. Core underlying assumptions for the business model were:

- low-value loans over short terms (similar to those offered by commercial lenders);
- a single fixed price with no penalties for late/missed payments or extended terms;
- weekly in-home collection, with some flexibility around payment irregularity;
- using agents paid solely by commission on collections made; and
- limited debt recovery.

It was decided that it would be inappropriate for a not-for-profit provider to incentivise sales of new loans to existing customers, but that the new lender could draw on various social agencies to recruit customers. Both these elements were included in the model.

Two generations of the business model were developed. The first assumed that the service would be run by existing third sector lenders, who wanted to include transitioning users to their mainstream loans – i.e. moving customers, over time, onto other forms of credit if possible. So this was included as a core assumption in the model. The second-generation model was based on a stand-alone service and did not include this assumption.

The target market for the not-for-profit model would be broadly equivalent to the customer base of the major commercial home credit lenders. As risk of default is clearly a critical factor in the financial dynamics of the business, the study constructed a risk-based profile using 16 segments of customers, broadly aligned with the risk profile of commercial home credit customers. This was one of the key drivers of the model. Average commercial home credit values and frequencies of loan were ascribed to each segment.

Likewise, other detailed assumptions were based on commercial experience in this market, including: levels of new business, customer turnover and retention; agent recruitment costs; levels of agent turnover and retention; and density and size of round. Agent remuneration would be based on commission linked to collections, with minimum target earnings of £10 an hour.

Customer recruitment would be via a mix of channels, including: direct response (20 per cent), personal approach by agents (30 per cent), referral by other customers (20 per cent), through the acquisition of agents from competitors (10 per cent), plus referrals from other social organisations. Different channels were assumed to have different costs and acceptance rates, and to have different effects on density of collection round.

Being based on a newly established force of agents, it was also assumed that bad debt levels would be higher than in an existing commercial home credit company. This effect was exacerbated in the first-generation model, which assumed that better-paying customers would be transitioned out of home collection.

Finally, it was assumed that scale would be critical to success. Both generations of the model were based on achieving just under 20,000 customers in year one, rising to around 300,000 in ten years.

Business model outputs

Even on a not-for-profit basis, the cost of home credit would be high in order to make the service financially sustainable. The first-generation model (based on existing third sector lenders) had a break-even APR of 129 per cent on an average 56-week loan of £288, compared with a current advertised APR of 183 per cent for one major commercial lender. The second-generation model (based on a stand-alone lender and no transitioning of customers) had a slightly lower break-even APR of 123 per cent for a similar loan. Both models would become cash positive by year five, given an investment of £18 million. It was assumed that public subsidy or social business investment would cover this investment and the cost of lending capital. If this were not the case, the APR would be significantly higher.

On the second-generation model, an APR of 123 per cent would imply a customer saving of £50 on an average 56-week loan of £288, compared with commercial home credit. This would equate to a little under £1 a week.

In a social lending context, an APR of 123 per cent might be unacceptably high. But the models showed that if APR were reduced to 100 per cent, the investment required over ten years would rise sharply, to nearly £90 million. Customer savings on the average loan of £288 over 56 weeks would be £72 (£1.29 a week on repayments), compared with using a commercial home credit provider. With an average frequency of 2.34 loans a year, this would translate to a saving of just under £170 a year.

Such savings may not be sufficient to attract 'quality' borrowers from existing providers. So it would be important to explore ways of achieving cross-subsidy through offering other products, such as insurance, savings and cheque-cashing. Cross-sales of such products have not been successful when offered by commercial home credit lenders, but a not-for-profit business might have advantages here through links to other financial inclusion initiatives. There may also be opportunities to cross-sell advice and financial capability services, which would be separately funded and would effectively part-subsidise credit provision.

Delivering a not-for-profit home credit service

The original assumption was to operate the new service through existing third sector lenders – credit unions and community development finance institutions (CDFIs). Discussions of the business model with these providers indicated that they were broadly supportive of the initiative and agreed with the underpinning assumptions. However, they had limited appetite for becoming involved in its delivery.

The high APR was a major concern, especially when seen alongside the relatively small cash saving to customers. Credit unions are, in any case, restricted by legislation from charging an APR in excess of 26.82 per cent. Third sector lenders were also concerned about potentially high levels of default. The experience of serving financially excluded borrowers under the Financial Inclusion Growth Fund has created a new appreciation of the challenges involved in serving high-risk borrowers.

After many years of subsidy, some third sector lenders are moving towards financial sustainability, and there were fears that involvement in a high-risk home credit service could jeopardise this. With many competing demands for new services for people who are financially excluded, third sector lenders saw developing a home credit service as a diversion, and likely to work against efforts to scale up the sector.

In view of these reservations, a stand-alone not-for-profit provider would seem to offer the best way forward. More work would be needed to investigate the feasibility of this and the type of body that might be set up to deliver the service. One possibility would be a stand-alone CDFI, owned by a group of third sector lenders or one of the two main trade bodies – ABCUL (Association of British Credit Unions Ltd) and CDFA (Community Development Finance Association). Another option would be to establish a new friendly society.

About the project

The customer perspective was obtained through secondary analysis of four existing nationally representative datasets of low-income borrowers and the home credit section of the Financial Resources Survey. In-depth interviews were held with senior executives from commercial home credit companies in the areas of marketing, finance, strategy and corporate affairs. Market testing with three third sector lenders included detailed discussions with staff, directors and volunteers, followed by three workshops, a telephone conference and individual interviews with a wider group of lenders in the sector.

For more information

The full report, **Is a not-for-profit home credit business feasible?** by Elaine Kempson, Anna Ellison, Claire Whyley and Paul A Jones, is published by the JRF. It is available as a free download from www.jrf.org.uk.

For further information about the study, contact Professor Elaine Kempson, Personal Finance Research Centre, School of Geographical Sciences, University Rd, Bristol BS8 1SS. Tel: 0117 928 8634,
e-mail: e.kempson@bristol.ac.uk

Published by the Joseph Rowntree Foundation, The Homestead, 40 Water End, York YO30 6WP. This project is part of the JRF's research and development programme. These findings, however, are those of the authors and not necessarily those of the Foundation. ISSN 0958-3084