



## **Mainstreaming Financial Inclusion**

**Planning for the future and coping with financial pressure:  
access to affordable credit**

**March 2010**

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## Introduction

1. The Government has committed to helping consumers plan for the future and cope with financial pressure, identifying access to affordable credit as a key element of this plan.

2. At the heart of the Government's work to promote access to affordable credit has been support for third sector lenders. While real progress has been made, coverage remains incomplete and capacity is limited compared with the potential demand. The Government has identified third sector lenders as having a key role to play in provision of affordable credit to low-income households, and provided almost £100 million through a Growth Fund to expand the capacity and coverage of credit unions and CDFIs to provide them with affordable loans.

3. As the Growth Fund comes to maturity, it is necessary to examine who it is reaching, what its limits may be and what, if anything, should be done for those whom it is unable to sustainably serve.

4. Taskforce members have reviewed the available evidence and identified a number of key questions that we would ask ministers to consider when making decisions about future policy on access to affordable credit. This paper outlines those questions, along with the Taskforce's recommendations in each case, and summarises the evidence that has been used to form the advice.

- What is the scale and scope of current unmet need for affordable credit among low-income households?
- What is the scale and scope of the Growth Fund's ability to respond?
- Should affordable credit policy continue to focus on delivery via the third sector?
- What supplementary models of delivering affordable credit to low income households exist? Should the Government support these and if so, to what extent? What should be the definition of "affordable"?
- What should be the roles and responsibilities for future oversight and delivery of affordable credit?
- Should there be greater restrictions on the supply of credit to low income households?

## Summary of advice

- There remains a significant unmet need for low value, affordable loans among low-income households.
- The Growth Fund has been extremely effective at meeting that need, but with limited reach it has so far only been able to meet a very limited proportion of existing demand.
- Over 240,000 loans have been made at a net cost of £66 per loan in administration costs. This has saved up to £200 per loan for the borrowers compared to the cost of borrowing the same amount from a doorstep lender.
- **Growth Fund will need further resources to maintain its current lending capacity if it is to keep within the targets set for default while lending under the 2% per month rate cap for credit unions.**
- Continued oversight and support for contractors, as currently provided by the Growth Fund team, is vital to ensure the ongoing success of the initiative.
- Affordable credit policy should continue to focus on delivery via the third sector because, despite investigation, no viable alternatives have been identified
- **The Taskforce recommends that Government should continue to take action to increase the supply of affordable credit**
- The three main avenues to explore in further improving access to affordable credit should be:
  - extending the reach of Growth Fund
  - reducing costs to, or increasing the revenue of, Growth Fund providers
  - consideration of new third sector initiatives that provide loans with the features that are sought by low income borrowers
- The Taskforce believes that there is no case for introducing an interest rate cap on unsecured credit until there is an adequate alternative supply of affordable credit. Attention and resources would therefore be better focussed on improving the supply of affordable credit rather than introducing further restrictions to supply.
- Although some progress has been made on the commitment from the major high street banks to support provision of affordable credit, the level of substantive support that has actually been provided falls well short of initial expectations.
- **The Taskforce recommends that, if a satisfactory level of voluntary support is not achieved, the Government should seek to**

**place the banks' commitment on more a formal footing going forward.**

- **More generally, the Government should also consider bringing the wider lending community into such a commitment**
- There is a range of other ways in which the Government could act to support expanded provision of affordable credit. These include:
  - Looking again at the potential to extend Community Investment Tax Relief to personal lending CDFIs when the CITR scheme comes up for state aid renewal in 2012.
  - Giving the proposed Social Investment Wholesale Bank an objective to improve the supply of affordable credit in the highest priority areas of the country
  - Using local authority and RDA funding for credit unions and CDFIs as a lever to raise standards in the third sector and encourage lending to low-income households, based on learning from Growth Fund
- The Government should note the results of the current evaluation of the Growth Fund and take these into account when making decisions on future policy

## **What is the scale and scope of current unmet need for affordable credit among low-income households?**

5. There is good evidence from a range of sources that there is still a demonstrable need for affordable credit in low-income households. However, in order to make recommendations on how best to meet this need, it is necessary to establish the level of change in household finances in recent years, particularly in light of the recession, and to segment the differing needs of various groups.

6. Low income consumers need small value cash loans, typically from £100 up to £750, which can be obtained quickly, can be repaid in weekly instalments – flexibly and without unexpected charges. The ability to repay in cash is likely to be appreciated – or via Paypoint or the Post Office. The more of these criteria that any proposed product is able to meet, the more attractive it is likely to be to low-income consumers.

7. While the Growth Fund and the Social Fund together have the capacity to address some of the need, their current limitations of scale mean that there is a significant segment of the population, living on low incomes, without access to mainstream credit or other sources of affordable credit. A summary of the evidence of demand for affordable credit is given in **Annex A**

8. The Taskforce believes that there is still a significant unmet need for small-sum affordable credit among low-income households. This includes new demand as a result of the recession and the credit crunch, as evidenced by increases in the customer base of non-standard lenders over the last year and changes in the nature of demand<sup>1</sup>.

9. Although the overlap between the customer bases of the different lenders makes it difficult to assess the number of individual borrowers, there is good evidence to suggest that at least 3 million households are using high cost credit to borrow at least £3bn in low value loans per annum (see Table 1, Annex A). In addition, a further £260m is being lent annually by payday lenders, although little of this is likely to be to the most vulnerable households<sup>2</sup>.

10. Beyond the c.£750m available through the Social Fund and Growth Fund, low-income borrowers who do not have access to a third sector lender have very limited options – family and friends, the high cost sector, or illegal lenders. Therefore the Taskforce believes that the Government should continue to take action to increase the supply of affordable credit.

## **What is the scale and scope of the Growth Fund's ability to respond?**

11. The Taskforce notes that the Growth Fund provides a valuable service that will have the capacity, by 2011, to provide up to 200,000 loans per annum to the financially excluded. Alongside the approximately three million Social Fund loans that are currently being made annually<sup>3</sup>, the Growth Fund

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<sup>1</sup> Growth Fund contractors have reported substantial increases in the number of applicants who are already over-indebted.

<sup>2</sup> Estimate from Consumer Finance Association – see Annex B

<sup>3</sup> Social Fund annual report

<http://www.official-documents.gov.uk/document/cm76/7677/7677.pdf>

addresses the needs of a limited portion of those who are unable to access mainstream credit.

12. While there may be capacity to expand this over time as the sector continues to grow and professionalise, it will be necessary in the meantime to investigate alternative delivery channels that have the potential to provide the scale and reach necessary to significantly extend access beyond the limits of current providers – and also to consider what it is possible to do for those whom the current Growth Fund model will never be able to sustainably serve.

13. Nevertheless, the experience gained delivering Growth Fund has benefited both third sector lenders and consumers and has increased out understanding of lending responsibly in this high-risk market. Through steady improvements in working practices and infrastructure, delivery costs have been significantly reduced over the life of the project, from £169 per loan at the start of the Growth Fund to £66 per loan in 2008/09<sup>4</sup>. Moreover, Growth Fund borrowers taking a loan of £300 can save up to £200 compared to borrowing the same amount from a doorstep lender.<sup>5</sup>

14. In the medium term, the Growth Fund will continue to need further resource to cover revenue costs associated with delivering the loans in order to ensure that the lending capital is not eroded over time and that a lasting impact is assured. It is vital for the continued successful delivery of the initiative that central oversight and support, as currently provided by the DWP Growth Fund team, is not lost.

### **Should affordable credit policy continue to focus on delivery via the third sector?**

15. Leaving aside Social Fund, the Taskforce believe the available evidence suggests that the third sector is currently the only realistic provider of affordable credit for low-income households. There is, however, a need to look at other models and delivery channels, and to join up with other Government initiatives. In particular, it is essential to look at Growth Fund in conjunction with the Social Fund – and at what is needed beyond where Growth Fund and Social Fund can reach.

16. However there is scope for contribution by Government, and the private sector, towards ensuring provision of affordable credit in ways other than participating in direct delivery.

17. All policy action so far on provision of affordable credit has focussed on delivery via the third sector and this has concentrated attention almost entirely on credit unions and CDFIs. As the limitations of the current Growth Fund model become better understood, it is reasonable to reconsider the extent to which other third sector delivery channels could be utilised. In addition, consideration needs to be given to the role that the Growth Fund has played in the development of the third sector lending industry itself – whether it has helped the sector to progress or not. The evaluation of the Growth Fund due to report this summer will provide valuable evidence on this and other aspects of the initiative.

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<sup>4</sup> Affordable Credit Subgroup response to the OFT review of high cost credit

<sup>5</sup> Provident Financial currently (Feb 2010) quotes total repayment of £546 for a loan of £300 over 52 weeks

## Mainstream Banks

18. The mainstream banks have no appetite to enter the market for low-value loans, as noted in the final report of the Third Sector Credit Working Group.

19. We believe that this is highly unlikely to change, especially in the current economic climate. Indeed, the banks have been withdrawing further from lending into the lower-income market over the past few years, with most closing down or placing heavy limitations on sub-prime subsidiaries and investment in sub-prime lending businesses.

20. However, in evidence given to the Treasury Select Committee in 2006, the mainstream banks' CEOs did define their role in the market for affordable credit as supporting third sector growth. In a 2007 meeting with the Chancellor, the banks committed to support expanded third sector provision of affordable credit in a number of high priority areas identified by the Taskforce.

21. Too little action on this commitment has been taken by the banks – while some have acted, others have not. The Taskforce recommends that, if a satisfactory level of voluntary support is not achieved, the Government should seek to place the banks' commitment on more a formal footing going forward.

## Government

22. The Social Fund is another important source of credit to low-income households, and is targeted specifically at the most vulnerable. In order to ensure that it continues to serve those in the greatest need there are, necessarily, restrictions on access. Budgeting loans are only available to households in receipt of certain benefits, and applicants have to specify what they will use the loan for (although no actual checks are made). Furthermore, resources could be subject to pressures from expected public spending cuts as the country emerges from recession.

### **What supplementary models of delivering affordable credit to low income households exist? What should be the definition of “affordable”?**

23. The Taskforce believe that the Growth Fund has successfully delivered small-sum loans to a significant number of households who would previously have been excluded from affordable credit. But it has been costly to deliver, and most credit unions would be unable to continue to provide the service at the price level imposed by the 2% per month interest rate cap without further revenue support and the ongoing guidance and oversight provided by the Growth Fund team.

24. Similarly, without the revenue support currently provided by Growth Fund, it is probable that most CDFIs would have to raise the cost of loans made with recycled capital in order to continue lending sustainably to the same customer base.<sup>6</sup> Credit unions would have to substantially reduce their lending in this market, to the level at which they could sustain it through internal subsidy.

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<sup>6</sup> Current interest rates charged by CDFIs for Growth Fund loans range from 22%-38%, and the average is 24% (data from the CDFA).

25. The chief executive of the UK's biggest credit union trade association suggests that even a 60% APR would not be enough to cover all the costs of lending to Growth Fund customers, within a 10% default target. The current evaluation of the Growth Fund initiative will provide assessments of the true cost of making Growth Fund loans and of the risk-based or commercial rate interest that would be required to maintain the Growth Fund service on a sustainable and unsubsidised basis.

26. A number of opportunities exist to expand access to credit for vulnerable households. However care should be taken to learn from past experiences of what and has not worked. In particular, attempts to create sustainable lending initiatives without taking into account the well-evidenced costs of serving this market, or the product features that are important to the target borrowers should be viewed with caution. Any successful initiative will need to offer most of the following features:

- Simple, straightforward and speedy access
- Clear indications of who would qualify for a loan, enabling applicants to have confidence that they will not be refused
- Repayment system suits household budgeting strategies (e.g. frequency of repayment matches income)
- Lender understanding and recognition of borrower's financial circumstances
- Cash based system
- Trust in and familiarity with providers, products and procedures
- Small loan amounts (under £500)
- Repayment discipline (e.g. quick contact if payment missed)
- Repayment flexibility (e.g. some ability to miss or reduce payments when absolutely necessary)
- No (or low) penalties or charges for default

27. Effective credit control procedures are also essential, and even some high cost lenders have failed for this reason. Furthermore, decisions will need to be taken on where exactly the limit of the definition of 'affordable' should be when providing credit opportunities to low-income households.

28. Affordability in this context is not based on overall price. It is inherently expensive to lend to this market, and the question is over how that cost is met and by whom. In looking at any product which seeks to extend provision beyond the current reach of Growth Fund, careful consideration should be given to how well the features of the proposed product match the features that low-income households want. Lessons should also be drawn from international experience in delivering similar initiatives on ways of reducing the cost of delivery or linking with other initiatives to increase revenue.

29. A brief outline of each of the three main avenues to explore in further improving access to affordable credit are as follows (full details are in **Annex D**) :

- extending the reach of Growth Fund lenders and new ways of raising capital

One of the greatest limiting factors of the Growth Fund has been geographical coverage, and the proportion of the population that are able to access Growth Fund lenders. However several changes and initiatives are underway that have the potential to significantly extend the reach of Growth Fund and thereby expand access to affordable credit.

- reducing costs to, or increasing the revenue of Growth Fund providers

Cost of delivery has also been shown to be high, therefore methods for reducing costs or for increasing the revenue of Growth Fund providers could provide another route toward wider access to Growth Fund loans.

- new third sector initiatives

30. Over the course of the last year, several proposals have emerged for alternative affordable credit delivery models, aimed at serving the needs of low-income households, along with a range of private sector products and recommendations from charities and other interest groups. These include:

- Barnardo's "Family Finance Service"
- National Housing Federation's "MyHome Finance Service"
- Joseph Rowntree Foundation report "Is a not-for-profit home credit business feasible?"
- Reports on low-income households from Save the Children, Oxfam and the Resolution Foundation

The proposals are described in the relevant section of **Annex D**.

31. Some examples of initiatives that have been shown in the past not to be successful include (seen **Annex E** for further details):

- loan guarantee schemes
- schemes where tenants borrow directly from a social landlord
- unsubsidised lending to vulnerable households at low rates of interest

### **What should be the roles and responsibilities for future oversight and delivery of affordable credit?**

32. Without doubt, the oversight of HM Treasury as a single co-ordinating body in the delivery of affordable credit policy over the last six years has enabled a strategic approach to the delivery of affordable credit, both in focussing efforts on the areas of greatest need and avoiding overlapping provision. A consumer-focussed overview going forward would be a great

benefit to future development of affordable credit policy and the Taskforce recommend that ministers consider specifying a single department or body to fulfil this role. In deciding where this responsibility should lie, consideration should also be given to linking it to the need for oversight in other areas of financial inclusion.

33. The Taskforce endorses continued action to work towards the long-term goal outlined by the Third Sector Credit Working Group in 2007, of a sustainable third sector, able to serve the market for affordable credit, including financially excluded clients, through commercially-secured deposits and investments.

34. To quantify, the Working Group estimated that this would consist of 1m affordable loans worth £400m made per annum by lenders covering at least 200 LA areas with above average demand for credit.

35. Affordable credit policy post-2011 will need to address roles and responsibilities of a wide range of stakeholders including Government, the third sector, the banks and regulators. A range of potential roles and responsibilities are outlined below.

36. The evidence so far clearly shows that Growth Fund has succeeded in providing affordable loans on a large scale to borrowers who previously either had no other credit options, or who borrow at high cost. Continued funding for third sector lenders is vital to ensure that Growth Fund can expand, or can at least maintain its current lending capacity rather than recede.

37. There is further action that could be taken in the future to stimulate the provision of credit to low-income households, such as raising the 2% per month credit union interest rate cap, and giving the proposed Social Investment Wholesale Bank (SIWB) an objective to improve the supply of affordable credit for low-income households.

#### Central government

38. **Government** should continue funding for the provision of affordable credit to ensure the increased access that Growth Fund has enabled does not erode, and take action to encourage further investment in third sector lending.

39. Consideration should also be given changes in legislation that could enhance the sector's ability to lend sustainably to low-income households – such as raising the 2% per month interest rate cap for credit unions, and extending Community Investment Tax Relief to cover personal lending through CDFIs.

40. If a satisfactory level of voluntary support for third sector lenders is not achieved from the banks, the Government should seek to place their commitment on more a formal footing going forward.

41. The Government should remain alert to opportunities to secure additional funding to support affordable credit by widening the group of potential funders. In particular, if evidence emerges that sub-prime lenders are withdrawing from the market for small value loans to low-income households, ministers could

seek a similar commitment from them to that made by the banks (i.e. to fund third sector lenders to provide loans to the households that they themselves are unwilling to serve).

### Banks

42. **Banks** should take substantive action to fulfil their commitment to support the development of the third sector lending community.

43. It should be recognised that, in addition to direct provision of capital for on-lending, such support could include assisting professionalisation of the third sector through:

- co-ordinated voluntary placements of experienced staff on boards of third sector lenders
- providing pro bono advice to third sector lenders
- provision of subordinated loans at low rates to Growth Fund lenders that have demonstrated the capacity to sustainably serve the financially excluded

### Third sector lenders

44. **Third sector lenders** should continue circulation of Growth Fund capital and seek to develop and test new lending models to serve customers not reached by current affordable credit products. They should also explore opportunities to improve efficiency, and new ways of raising capital or cross-subsidising loans to lower-income borrowers.

### Local authorities

45. **Local authorities**, as key funders of third sector lenders, have a major role to play in achieving the Government's objectives on affordable credit. Local authority funding for credit unions and CDFIs should be used to raise standards within the sector and to encourage lending to the financially excluded, learning from the the experiences of the Growth Fund. Without effective understanding by local authorities of the financial inclusion agenda, and the lessons of Growth Fund, this source of funding for credit unions will continue to be an obstacle rather than an aid in improving provision for low-income households.

### **Should there be greater restrictions on the supply of credit to low income households?**

46. It has recently been argued by some that a cap on APR, or an inclusive cap on the total cost of credit, could be an effective way to reduce the cost of borrowing for low income households.

47. The Taskforce believes that there is clear evidence from a number of sources that the APR is not a helpful method of assessing the expense of low-value, short-term credit facilities. This was noted by the Competition Commission in their study of the home credit market in 2006.

48. For households where flexibility in payments is a priority, forms of credit that incorporate financial penalties (which are not included in APR calculations) for missed or delayed payments will often turn out to be more costly than products with a high APR where there are no such penalties, but the costs are rolled into the regular payments for the loan.

49. Products that are structured around penalties for missed payments are also less transparent and hit users at the time they can least afford an additional payment. The imposition of a cap could, therefore, lead to less transparency of costs for users and result in products that are ultimately less affordable.

50. Furthermore, following recent changes to overdraft charging policies at high street banks, short term, low value borrowing through an overdraft can be almost as expensive (or in some cases more expensive) than a sub-prime loan taken over the same period.

51. The Taskforce is also concerned that an inclusive interest rate cap could reduce the options available to the most vulnerable borrowers, increasing opportunities for illegal lenders to fill the void. A wide range of research and evidence on this topic summarised in **Annex F**.

52. The Taskforce believes that there is no case for introducing an interest rate cap on unsecured credit until there is a sufficient alternative supply of affordable credit, as it would lead to less transparency of cost to consumers, as providers seek to restructure their products to bring the headline rate of interest within the cap. It is likely that some providers would simply cease supplying the market.

53. Attention and resources would therefore be better focussed on improving the supply of affordable credit and ensuring responsible lending provisions are adhered to rather than introducing further restrictions to supply.

## Annex A – Demand for small-sum credit in low-income households

### Current demand for high cost credit

1. Interim findings from the OFT's review of high cost credit suggest that 6% of households would find it difficult to get £250 for an immediate need, and 16% would find it difficult to get £750. Around 10% of the adult population suggested that they would require credit for an unexpected £250 expense.<sup>7</sup>
2. Experian's credit supply and demand mapping refresh shows that Growth Fund has had a positive impact in many of the high priority areas where new provision has been established. Preliminary results from the new mapping exercise show that the supply and demand mismatch has been reduced in 46 of the high priority areas. However changes in the economy and in income distribution, along with improved data means that some of the priority areas now have a greater need, while others have been newly identified as being a high priority for new provision.
3. In 2007, Datamonitor estimated that the non-standard unsecured lending market had shrunk to £8.2 billion of advances, from a peak of £12.9 billion in 2004. They put the UK non-standard population in 2007 at 7.2 million people (11.7% of the total population or 18.8% of the 18-65 population), and predicted a steady increase in the non standard population to 2012, to just under 8 million.<sup>8</sup>
4. In October 2009 the Taskforce's Affordable Credit Subgroup wrote to the major trade associations for high cost lenders in the UK asking their response to a number of questions about their perception of the level of demand for small-sum credit, and any changes over the past year (see **Annex B** for a full list of the questions) and the organisations contacted.
5. The figures in the table on the next page are an estimate of current demand, based on a range of information, including responses to the Taskforce from trade bodies, annual reports of leading companies and - where available - external assessments of market size by analysts, the Competition Commission and others.
6. Recent emerging findings from Friends Provident Foundation commissioned research on the new demand landscape for credit provision to low income households indicates that in addition to the sources listed below almost 40% of low income households, and 30% of users of non-standard credit, use overdrafts as a source of credit.<sup>9</sup>
7. Over the course of 2008/9, many of the high street banks changed their overdraft policies in response to the then ongoing OFT investigation into the fairness of charges for authorised and unauthorised overdraft usage. However, the fees for borrowing small amounts for relatively short periods of time through "instant overdraft" services or even through pre-arranged overdrafts can be both costly and complex. (see below for further details).

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<sup>7</sup> Annex A to the OFT's interim research report for the Review of High Cost Credit.

<sup>8</sup> Datamonitor, *UK Non standard Unsecured Personal Loans report 2008*

<sup>9</sup> Ibid

**Table 1 – Sources of credit for low-income households**

Credit type	Typical loan size	Typical APR	Typical total cost of credit	Estimated market size (all figures are per annum)		
				No. of loans	No. of customers	Value of loans
Home credit	£300	275% - 500%	£85 per £100 borrowed	6m	2.3m	£1.5bn
Pawnbrokers	£150	c. 100%	£30 per £100 borrowed	Up to 6m	600,000	Up to £900m
Rent-to-own	£500	29%	£100 per £100 *	600,000+	300,000+	£300m
Agency mail-order	£500	0-29%		0.5-1m	0.5-0.6m	£250-300m
Social Fund	£200	0%	£0 per £100 borrowed	3m	-	£620m

\* including optional and compulsory insurance, which are taken up by 85-90% of customers<sup>10</sup>

Payday lending has expanded significantly in the last few years, but from a very low base. Recent evidence suggests that payday loan customers are distinct from the lowest-income and most vulnerable credit-seeking households.<sup>11</sup>

<i>Payday loans</i>	<i>£230</i>	<i>1000% +</i>	<i>£25 - £30 per £100 borrowed</i>	<i>2m</i>	<i>500,000</i>	<i>£260m</i>
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8. The Government is also a significant provider of credit to low-income households through the Social Fund. In Budget 2009, the Government announced an additional resources for the Social Fund, totalling £125 million in 2009-10 and £145 million in 2010-11, to cope with increased demand as a result of rising unemployment. In 2008 the Social Fund provided 3 million loans worth approximately £650 million.

9. In early October, letters were sent to high cost credit trade associations asking them if they would be willing to share any information that they were able to regarding the provision of low value credit to low-income, high-risk

<sup>10</sup> Brighthouse correspondence with Taskforce secretariat

<sup>11</sup> The new demand landscape for social lending – emerging findings, Policis 2010

customers – a number of specific questions (copied below) were included to outline the type of information that was being sought. A copy of the subgroup's response to the OFT review of high cost credit was enclosed, and the trade associations were asked if they would be willing to share their responses.

10. The **Finance and Leasing Association** responded that overall new business by members was down 17% in July 2009 compared with the same month in 2008, and that this was true in all categories, except for store instalment credit. We believe that this is significant because store instalment credit is likely to be for significantly smaller amounts than motor finance or loans secured against the home. In many cases there is greater security for the lender than with credit cards or standard loans as the goods may be repossessed if the borrower defaults.

11. Nevertheless, even access to store instalment credit appears to be tightening, with the annual rate of growth to September 2009 falling to 1%, down from 4% in the year to July 2009. The 3-month rate of growth fell from 4% in the three months to July 2009 to -3% in the three months to September 2009.<sup>12</sup>

12. The **Consumer Finance Association** were unable to provide precise volumetric data, but estimated that around 2 million pay day loans are made in the UK in a 12 month period, and suggested that demand for non-standard credit should be calculated by assessing the number of self-employed and unemployed households from ONS statistics – giving a total of around 9.5 million.

13. Over the past year, several sub-prime providers have reported greatly increased custom. **Brighthouse**, a provider of consumer goods to low-income households on a 'rent-to-own' basis, currently have 177,000 customers.<sup>13</sup> In January 2010 the company reported that rising unemployment and squeezed credit conditions had caused their customer base to surge, driving a 21 per cent gain in total revenue to £50.5m, from £41.7m the previous year, and that they aim to expand their 190 stores to 650.<sup>14</sup> Their target consumer group is estimated to be 5.2 million 'credit-constrained' households.<sup>15</sup>

14. The home credit market noted similar movements. **S&U** reported in March 2009 that after several years of slight decline, the number of weekly customers had increased by 2,000. Their October 2009 interim report noted an increase of a further 2,000 customers for home credit and "some evidence of a return to home credit by customers who had migrated to more remote forms of consumer finance"<sup>16</sup>

15. **Provident Financial** reported that they had deliberately slowed the rate of new customer growth in 2009 by being more selective in lending to new

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<sup>12</sup> FLA quarterly lending statistics

<sup>13</sup> Brighthouse correspondence with Taskforce secretariat

<sup>14</sup> Financial Times, January 11 2009 <http://www.ft.com/cms/s/0/830a2692-fe17-11de-9340-00144feab49a.html>

<sup>15</sup> Brighthouse internal report by OC&C Strategy Consultants, using Datamonitor information on non-conforming lending but tailored for Brighthouse

<sup>16</sup> S&U Interim Report October 2009 <http://www.suplc.co.uk/pdf/Interim%20Report%2009.pdf>

customers and by tightening the underwriting standards applied when re-serving existing customers. Even so, customer numbers rose 4% from the same point in 2008.<sup>17</sup>

16. The **National Pawnbroking Association** estimated annual loan book of pawnbrokers in the UK to be approximately £900 million and growing around 10% per annum.<sup>18</sup>

#### Sample charges for short-term overdraft usage

17. HBOS charges for an arranged overdraft are :

- £1 per day (o/d under £2500)
- or £2 per day (o/d over £2500)

For low value, short term borrowing, this is can potentially be higher cost than some subprime loans. For example:

- borrowing £300 for 52 weeks from an HBOS arranged overdraft would cost  $£1 \times 52 \times 5 = £260$  – slightly more than a Provident loan of the same amount for the same period (which would cost £246).
- To borrow £100 for 3 weeks would cost  $£1 \times 5 \times 3 = £15$  – approximately the same as a loan from a leading high street payday lender.
- To borrow the same amount for 7 weeks from an HBOS arranged overdraft would cost  $£1 \times 5 \times 7 = £35$  – compared to £30 from the payday lender.

Unarranged overdrafts are even more costly, at £5 per day. Additionally, this assumes that the charges only apply to working days – if they also apply to non-working days then the cost will be higher still.

18. Santander's "Instant Overdraft" fees are complex to assess, as they depend on the number and the size of the transactions that have been counted as an "instant overdraft request". However, in the two examples given on their website, the customer pays:

- £80 in fees plus 28.7% EAR interest for borrowing £220
- £85 in fees plus 28.7% EAR interest for borrowing £400

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<sup>17</sup> Provident Financial interim management statement October 2009  
<http://www.providentfinancial.com/index.asp?pageid=45&newsid=1494>

<sup>18</sup> OFT Review of High Cost Credit - Interim research report

## **Annex B – Correspondence with consumer credit trade associations**

Questions sent to consumer credit trade associations:

*What products provided by your members are available to consumers seeking low value loans?*

*Are you able to provide any estimate of the total size of the market for these type of products to be? Any of the following would be helpful:*

- *estimate of total value/no. of loans being made by all providers in this market*
- *estimate of total level (by volume or value) of consumer demand for this type of product*
- *estimate of the total value/no. of loans being made by your members in this market*

*To the best of your knowledge, has there been any significant change in:*

- *the level of demand for these types of products over the least year?*
- *the performance of existing loan portfolios for this type of product over the last year?*
- *the acceptance criteria for loan products of this type over the last year?*

*If so, are you able to estimate the level of change in any of these areas?*

### Summary of responses received

#### **National Pawnbrokers Association**

Replied to state that they do not hold the type of information that the subgroup requested. Des Milligan (president) stated that the association had attempted some years ago to co-ordinate central reporting of key data such as number of loans made, but because of the commercial sensitivity of the data, members would only agree to it if the data was collected and collated by an independent, external agency (e.g. KPMG).

#### **Consumer Finance Association**

Sent copies of response to OFT review of high cost credit, and to the OFT consultation on their Guidance on Irresponsible Lending. John Lamidey (president) noted that the CFA believes that the OFT review and guidance will mitigate disproportionately against small sum fixed term loans and effectively skew the market even more towards larger, longer loans or running account contracts, with significantly decreased access, choice and ability to switch for those on low and lower middle incomes – and that those on lower middle incomes may find access even harder than those on low incomes as a result.

CFA members offer customers who are in work and who have bank accounts short term loans, small sums from £50 to £800 (average c.£230), that are due to be repaid in one or two instalments within two months.

CFA's best estimate is that around 2 million pay day loans are made in the UK in a 12 month period. Estimate that CFA members account for 70% of the payday loan market.

CFA reply on level of consumer demand was slightly confusing, but appears to suggest that demand for low value loans is just under 10 million consumers, and estimates that payday loans currently constitute about 0.5% of the unsecured consumer credit market (presumably by value, although they do not specify).

Data on performance and loan volumes are not collected centrally, but anecdotally evidence suggests that:

- applications for payday loans are rising, but acceptances are not rising at the same rate
- Acceptance criteria have remained constant over the past year.
- payday loan repayment has remained good, with default in single percentage figures

CFA considers that the concept of a short term, small sum loan is becoming more attractive to consumers generally (payday loans are not designed for those on the lowest incomes, but for those on lower middle incomes - averaging around £18,000 a year - who are in work and who have bank accounts) since the indebtedness risk of longer term loans, or particularly running account credit contracts, seem to less attractive to consumers in an economic downturn.

### **British Cheque and Credit Association**

Sent copies of response to OFT review of high cost credit, and to the OFT consultation on their Guidance on Irresponsible Lending.

Noted the pressure on consumer credit industry at present, in responding to the various consultations and proposed legislation as well as implementation of the Consumer Credit Directive. Suggested contacting OFT to see if they could share any of the information requested from the responses to their questionnaires that BCCA members have sent.

Committed to follow up with 'brief' responses to the questions raised where possible, but nothing received as yet.

### **Consumer Credit Trade Association**

Do not hold the specific information requested, but will contact members with a view to obtaining what they can and will revert 'as soon as they receive any substantive replies'.

### **Finance and Leasing Association**

- Difficulties in accessing wholesale funding are restricting the availability of credit in the UK

- While the consumer credit market appears to have stabilised, for FLA members lending remained down by almost £11 billion compared to 2008.
- Extensive regulatory reform across the consumer credit market could adversely affect the cost and availability of some credit products in the future.
- A proportionate approach to regulatory change would avoid the small-sum credit sector facing increased operating costs which do not reflect the risk of provision.

New business written by FLA members was 17% lower, year-on-year, in September 2009, and new consumer finance business in the three months to September was 14% down on the same period last year.

	Sept 09	% change	3 months to Sept 09	% change	12 months to Sept 09	% change
<b>Total FLA consumer finance (£m)</b>	4,782	-9	13,014	-14	53,331	-17
<b>Store cards (£m)</b>	206	+1	604	-14	2,606	-13
<b>Credit cards (£m)</b>	2,634	-9	7,827	-9	32,622	-8
<b>Store instalment credit (£m)</b>	201	-3	585	-2	2,520	+1
<b>Secured loans (£m)</b>	46	-67	145	-71	775	-79
<b>Car finance (£m)</b>	1,408	+9	3,005	-3	10,721	-14

## Consumer Credit Association

Taking longer than expected to collate the data as two larger members, Morses Club, (London Scottish Bank home credit business), and Shopachek, (Cattles), experienced financial difficulties earlier in the year and are only just starting to lend aggressively in the market again.

## Rent-to-own

Officials met with representatives from the leading rent-to-own chain in the UK, Brighthouse, and sought a response from them to the same questions.

- Brighthouse currently have 170,000 customers and in 2008/9 issued 333,000 loans totalling £206m. Approximately 5% of applications are declined at the application stage.
- Like for like sales have been up by around 9% year on year. Generally existing customers have performed in line with expectation in 09/10.

Some more specific questions relating to the Brighthouse business were also asked, and the key information from this is that:

- Brighthouse confirmed that a relatively small number of customers use their price-match promise but noted that they check prices weekly against the other national high street retailers.
- Approximately 50% of customers will complete their contract and purchase the item.

- Around 89% initially purchase Optional Service Cover and 85% purchase Damage liability cover.
- Customers incur on average three late fees per year, per agreement.
- 70% of customers pay in cash, 29% pay by debit card and 1% pay by other means.

## Annex C – Learning from Growth Fund

1. Since 2006, Government strategy on affordable credit has focussed on building the capacity and coverage of the third sector as a provider of low-value affordable loans to the financially excluded. This has been carried out through a DWP administered 'Growth Fund' which has contracted with individual institutions to deliver the service with specified performance targets. Many aspects of the Growth Fund initiative have been innovative and ground-breaking whereas other aspects have not met expectations.

2. The Growth Fund has enabled a significantly increased number of loans to be made to low-income households through third sector lenders. Since its inception in 2006 it has enabled 225,000 loans worth £98 million to be made.<sup>19</sup>

### Processes

3. A key strength of the Growth Fund initiative has been the highly targeted approach, led by detailed research to identify the areas of greatest need followed by contracting with organisations specifically to deliver to those areas. This has enabled the limited resources available to be directed so as to deliver the greatest impact.

4. Using mapping research to identify the areas of greatest mismatch between supply and demand, high priority areas of the country were identified and Growth Fund provision was directed towards these areas. Preliminary results from updated mapping research conducted in 2009 shows that Growth Fund has improved the supply and demand mismatch for affordable credit in 19 of the 25 red alert areas identified by the Taskforce in 2006, and in 27 of the 56 amber alert areas.

5. Another major element of the Growth Fund model has been the use of contracting agreements between DWP and the third sector lenders who receive Growth Fund money. This has had a wide range of effects, many of which could be replicated in future with similar initiatives, or in some cases could be incorporated into completely different projects to achieve similar results.

6. Entering into a contracting agreement, with all of the statistical and financial monitoring and reporting processes that have accompanied the contracts, has also acted as a driver for other business process improvements in the third sector. Furthermore, the contracts have enabled DWP to ensure that consistent data is collected from all service providers on a regular basis, and made available centrally.

7. The knowledge that consistent failure to meet the performance targets could lead to funds being redistributed has acted as strong incentive to achieve and maintain a high level of performance – and this has been supported by assistance from DWP Service Development Managers to help struggling contractors to implement changes that can help them to achieve the targets. In addition, investment in staff training and in infrastructure that have accompanied the Growth Fund capital have provided further support.

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<sup>19</sup> DWP Growth Fund statistics

8. There is evidence that in some instances, the contracting approach has driven a concentration on the sustainability of the Growth Fund money, which has consequently given contractors a new perspective and sometimes a reality check on the future direction of their organisations – and has also helped drive business process improvements that have benefited not only the Growth Fund performance, but also the wider business of the contractor.

9. Centralised collection of effective management information has been key, not only in driving up performance of individual contractors, but also in enabling an ongoing strategic oversight of the progress of the initiative as a whole, allowing potential difficulties to be identified and addressed at an early stage.

10. Ultimately, the majority of contractors perceive the Growth Fund to be a very positive Government initiative, as a result of many of the features described here. Growth Fund has also led to a wider network of beneficial partnership agreements across the Third Financial Sector creating new opportunities for growth and expansion.

### Resource

11. Another element essential to the success of the Growth Fund initiative has been the provision of training for staff at contracted organisations to ensure that the organisation has the skills and facilities necessary to administer the loans, and to monitor and report performance effectively, and funding for infrastructure upgrades (refurbishment of premises to make them fit for purpose).

12. ABCUL's e-learning facility was developed as one output of the Growth Fund training and development program. The platform enables credit unions to professionalise their staff, board and volunteers whilst avoiding the time and cost of transportation to a physical venue. Growth Fund credit unions are also able to recover the course costs. Furthermore, the platform contributes to the sustainable development of the sector as new courses can be devised and added at little cost as and when they are devised after Growth Fund expires.

13. The existing training materials will also continue to be available after Growth Fund expires, creating a permanent legacy of resources that will benefit not only Growth Fund contractors, but any institution in the sector that wishes to develop their staff's capacity and skills, including new providers that emerge after Growth Fund has finished.

### People

14. The Growth Fund would also have been unable to achieve the level of success that it has managed without the considerable resource of the DWP Growth Fund team, in administering the contracting processes, collating and distributing the management information, and supporting contractors.

15. A vital element within the Growth Fund team, without which the outcome of the initiative could have been very different, are Service Development Managers, whose responsibility has been to manage the individual

relationships with contractors, check that they are on track to meet performance targets and to support them in getting back on track if they are not.

16. In many instances, the Service Development Managers have been agents of change, in terms of growth, efficiency and impetus of change within the contracted institutions. This has been an invaluable asset to the initiative, especially as there was wide variation in the ability of the institutions contracted with to adapt to the often unfamiliar processes involved in risk-based lending to vulnerable customers.

### Institutions

17. Contractors often benefited much more widely from Growth Fund than simply accessing additional lending capital – the specific targeting of Growth Fund money drove increases in reach and geographical coverage that may otherwise have not been undertaken. Furthermore, accessing Growth Fund has in some cases increased the confidence of boards to back further expansion.

18. Local partnerships with other organisations were also improved and strengthened, bringing a greater appreciation of the benefits of partnership working and improving the level of service experienced by customers.

### Limitations

19. Nevertheless, the experience of delivering Growth Fund has highlighted some limitations and potentially negative impacts. First of all the Growth Fund model has some clear limitations in terms of pace of growth, owing to the focus on working with organisations ranging from very small to medium size. Consequently Growth Fund provision tackles a relatively small proportion of the total need for affordable credit, through a model requiring a relatively intensive approach.

20. Difficulties can also be raised when working with organisations whose decision making capabilities are strongly influenced by Board Members whose values and agendas are markedly different from those of the Growth Fund – thus even where there is nominal acceptance of the goals of the initiative, it can be difficult or even impossible to implement necessary actual changes to policy and practise at the institution that are required to meet the performance targets.

21. Another major challenge has been around the development of new or extended provision in areas with limited or no coverage, which has proved to be more protracted than expected and required intensive resource commitments from the Growth Fund team.

22. Some contractors have also raised objections to certain elements of the Growth Fund requirements suggesting, for example, that the reporting requirement can be too onerous and bureaucratic. Also that time restrictions do not allow for serving clients who do not have a bank account as it can take too long to open one, and that no financial allowance is made for administering declined applications.

23. Furthermore the interest rate cap on credit union lending, combined with the limited resources for administrative subsidy places very defined limits on the proportion of the credit excluded population that can be served through this channel.

24. A full evaluation of the Growth Fund initiative is currently in progress which will, as part of its findings, calculate the estimated commercial rate of interest that would need to be charged for unsubsidized Growth Fund loans – but it is clear that Growth Fund is also not self-sustaining as it stands, and needs continuing subsidy in order to maintain even its current level of lending with no expansion.

25. At current rates, a typical Growth Fund loan costs a total of £66 to deliver.<sup>20</sup> If no further investment were made, and given a maximum 2% per month interest charge (28.6%) APR that a credit union can charge, and current write off rates of approximately 7%, the total Growth Fund loan capital would steadily erode. Assuming 2.5% annual rate of inflation, the number of loans per year that the Growth Fund capital would be able to sustain would diminish from its current 200,000 per annum to less than 100,000 p.a. within seven years, to less than 50,000 p.a. in 14 years.

26. This is in contrast to a demand, as estimated by the Third Sector Credit Working Group in 2007 (i.e. pre-recession) of 1 million loans per annum, to the value of £400 million.<sup>21</sup>

27. The Growth Fund has made significant progress toward this goal, however without continued funding at least to cover contractors' revenue costs, it will recede rather than expand. While some institutions with Growth Fund have reached a stage where they can continue to recycle the money without capital erosion, many will need more time and more support before they are able to do the same.

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<sup>20</sup> ACSG response to OFT consultation on high cost credit / DWP management information.

<sup>21</sup> Financial Inclusion Taskforce's Third Sector Credit Working Group final report

## **Annex D - Supplementary models for delivering affordable credit to low-income households**

### Extending the reach of Growth Fund

1. Some credit unions have begun to investigate **alternative methods of funding**, such as use of subordinated loans from charitable foundations or from banks. Subordinated loans have the potential to improve the capital holdings of the credit union and to expand their lending capacity, however relatively few loans of this type have been made – possibly because cheaper public funds have been available, making funding through subordinated loans less attractive. However questions also remain over whether a sufficient supply of investors exists for this to be a scale solution. Esmee Fairbairn Foundation have, through ABCUL, initiated preliminary investigation into appetite for and attitudes toward this style of funding among credit unions.
2. **Expanded Credit Unions** will become possible following the Legislative Reform Order that is currently going through Parliament. This will permit the formation of larger credit unions with greater flexibility of membership and will also ease the ability of credit unions to merge, despite having different common bonds. Credit unions will also be permitted to have corporate members, whether in the form of companies or local unincorporated associations, such as parent teacher groups. The greater penetration of credit unions into their communities should make it easier for them to reach both those in need and potential investing members. It will also provide more options for credit unions to cross subsidise this work with other internal customers.
3. A consultation is underway covering the possibility of Northern Ireland credit unions being regulated by the FSA, with access to the Financial Services Compensation Scheme and the Financial Ombudsman Service. With an average size significantly greater than those in GB and access to 50% of the adult Northern Ireland population, there is significant potential for NI credit unions to increase their impact serving low-income groups.
4. **ABCUL / Post Office partnership** There has been some discussion of the potential for a partnership between ABCUL and the Post Office, through which credit union products are made available at Post Office counters. The trusted brand of the Post Office combined with the product range of credit unions could bring new visibility to the Growth Fund and dramatically increase the supply of lending. There would need to be a centralized approach to handling lending through a call centre approach so that customers could contact their credit union through the Post Office. This could vastly extend the reach of credit unions concerned, however the capacity to supply additional loans would have to be tackled separately.
5. Likewise there is potential for personal lending CDFIs to partner with their local Post Offices on a similar basis, but with the same proviso regarding the capacity to fund additional lending.
6. In 2008 the Government announced **extending Community Investment Tax Relief (CITR) to personal lending CDFIs** would not be the most effective means of supporting an expansion in the supply of affordable personal loans at that time. However, it was noted that the issue would

remain under review as other options for increasing coverage and capacity of third sector lenders were considered.

7. Given the large scale changes in the capacity of the personal lending CDFI sector, the general availability of consumer credit, and in the fiscal position since this decision, the Taskforce recommends that Government should look again at this possibility during the upcoming review of CITR in advance of the state aid renewal deadline of 2012.

8. In the 2009 Pre-Budget Report, the Government announced a commitment to take forward further work towards the creation of a new **Social Investment Wholesale Bank**, which would aim to increase financial inclusion by supporting Community Development Finance Institutions and credit unions. The Taskforce believe that the Social Investment Wholesale Bank should be specifically tasked to support expanded provision of affordable credit in the high priority areas identified by supply and demand mapping research. This could be achieved through grants or subordinated loans to better performing Growth Fund contractors or to viable new third sector lending initiatives.

#### Reducing costs/increasing revenues for Growth Fund providers

9. A number of initiatives have been trialled in other developed economies seeking to improve access to small-sum credit for low-income households. Some of these experiences may offer lessons for the UK in how coverage could be extended, or costs of delivery reduced or subsidised in order to extend access further.

10. Examples include the co-operation in Australia between the charity-run "NILS" (No Interest Loans Scheme) and a nationwide chain of stores run by another charity, selling refurbished white goods. If a similar partnership could be found for Growth Fund lenders, margins from the sale of the white goods could potentially subsidise some of the cost of delivering loans.

11. In addition, the Australian scheme also ties in with a Government subsidy program for energy efficient goods, enabling households who use one of a number of selected third sector loan schemes to make their purchase to have a AU\$100 rebate taken off their total repayment.<sup>22</sup> This illustrates another potential avenue for extending reach of Growth Fund, by building effective links other with existing Government subsidies and rebate schemes – which could have the dual benefit of assisting the partner schemes to achieve full utilisation.

12. **ABCUL centralised credit union back office.** Establishing a centralised back office model, would bring greater visibility to credit unions, allow longer opening hours through a helpline, improve the standardization of the core offering, and allow national generic marketing. It would also aim to achieve economies of scale for local credit unions reaching sustainability at a lower level.

#### New ideas

13. **Barnardos** are proposing to pilot a 'family finance service' (FFS) which provides bank accounts and loans to low-income households in justifiable

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<sup>22</sup> [http://www.resourcesmart.vic.gov.au/for\\_households/rebates\\_3740.html](http://www.resourcesmart.vic.gov.au/for_households/rebates_3740.html)

need of credit, alongside advice and support for over-indebted households. The project would be undertaken in partnership with a high street bank who would, on referral from the FFS open a basic bank account for the customer and provide them with a loan. The loan would be guaranteed by Barnardo's (although this would not be disclosed to the borrower).

14. It would provide loans of £300 - £1000 at APRs of 4% above base rate, for a maximum term of 12 months. Loans would be repaid by monthly direct debit from the bank account set up for the customer. There would be fees for missed payments and in the event of default, the bank would be repaid from Barnardo's guarantee fund and the FFS would take on the loan from that point.

15. To avoid large-scale defaults and write-offs that had afflicted similar projects previously, Barnardos propose that the service would not contain any reference to the charity at any point but would be branded universally as the Family Finance Service (FFS). FFS would seek to use DWP's Eligible Loans Deduction Scheme, enabling direct recovery from benefits, to further limit losses. It is envisaged the project would be funded by a combination of fee income from the loan service and public funding for the advice services provided alongside the loan service.

16. The **National Housing Federation** have proposed setting up a service called "MyHome Finance. This envisages a team of centrally-recruited Loan Officers and support staff employed by a financial services institution who would be located in areas of potential demand either in standalone offices provided by Housing Institutions or embedded into the Housing Association offices themselves.

17. The project would begin with a four-year roll-out starting with a pilot programme in the West Midlands with 5 offices, then scaling up to 160 towns and cities servicing a population of some 27 million. It would aim to be lending £88 million by year six of the project, with average loan of £500 and an expected APR of around 50-60% (total repayment of £25 per £100 borrowed).

18. **Joseph Rowntree Foundation** commissioned a study that reported in 2009 on the feasibility of setting up a not-for-profit home credit business. The report gained significant attention, but the findings have frequently been misrepresented or misunderstood.

19. The study found that the essential elements of the traditional home credit service – 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.

20. Even on a not-for-profit basis, to make the service financially sustainable the cost of home credit would be high. The model suggested the initiative could reach break-even in ten years, and cover its running costs in year five.

21. With an £18 million subsidy, the APR on an average 56-week £288 loan, provided on a not-for-profit basis, would be 123 per cent (compared with 183 per cent commercially), bringing customer savings of £50 (£117 yearly, or around £2 per week). With a £90 million subsidy a 100 per cent APR could

be achieved, meaning customer savings of £72 per loan (£170 yearly, or around £3 per week).

22. It is questionable whether even this level of saving would be sufficient to attract existing home credit customers away from their current providers, given the level of customer loyalty inherent to the sector.

### Other suggestions

23. A number of other organisations have made proposals on how the cost of credit for low-income households should be tackled.

24. **Save the Children** have recommended introducing a Community Reinvestment Act to boost low-interest lending to low income households, an extension to the Social Fund and developing a voluntary code of practice for high-interest lenders to tackle bad practice in the sector.<sup>23</sup> They also call for the Government to set out 'how they will build on the success of the Growth Fund'.

25. Their recommendations for a code of practice on high cost credit include ensuring that quoted APRs incorporate all charges and fees, restrictions on administration fees or penalty interest rates, and signposting to financial advice and support.

26. **Oxfam** have recommended setting an interest rate cap, in order to prevent exploitation of people in vulnerable situations and action to crack down on unscrupulous lending. They also recommend that Government should promote and fund credit unions, and there should also be wider eligibility for social-fund hardship loans, making them more responsive to people's needs and providing a genuine alternative to commercial credit in emergencies<sup>24</sup>

27. **The Resolution Foundation** have also called for Government to take a pro-active role in "encouraging and shaping a more diverse affordable credit market"<sup>25</sup> – referencing opportunities such as a Post Office Bank, and the National Housing Federation's MyHome Finance proposal as opportunities to do so.

### 'Peer to peer' lending

28. Some stakeholders have suggested that internet based 'peer-to-peer' lending, that circumvents the mainstream financial services sector could be an alternative source of affordable credit for low-income households. However the market leader in, **Zopa**, is unsuitable for a number of reasons:

- The minimum loan amount of £1000 is too high
- The fixed £118.50 application fee is too high
- It is only available to those with bank account
- Internet only access could be a significant barrier for low income households

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<sup>23</sup> A bleak winter in store for Britain's poorest families (November 2009), Save the Children - [http://www.savethechildren.org.uk/en/docs/supporter\\_brief\\_debtupdate.pdf](http://www.savethechildren.org.uk/en/docs/supporter_brief_debtupdate.pdf)

<sup>24</sup> Close to Home: UK Poverty and the economic downturn, Oxfam, March 2009

<sup>25</sup> Closer to Crisis: how low earners are coping in the recession, Resolution Foundation, 2009

Other internet-based peer-to-peer lenders are likely to have similar barriers.

29. In 2006 Notting Hill Housing Trust conducted a pilot loans program in conjunction with Zopa, offering their residents access to Zopa loans on the basis of a credit score built from their rent repayment history. However the scheme was wound down after no residents took out any loans through the initiative.

### **'Rent to buy' businesses**

30. The market leader in this area is **Brighthouse**, who offer white goods and consumer electronic products on a weekly payment basis, branding itself as "your weekly payment store". Although APR is relatively low, costs are inflated by premiums on the usual retail price, optional service cover, and damage liability cover (which can be compulsory for customers without home contents insurance). A "Cash Price" guarantee is offered if the customer can find an identical product within ten miles of the shop for a lower price – however in practice the models and brands, or specific bundles available are often exclusive to the chain, or have been discontinued in high street retailers.

31. While Brighthouse are easily the market leader, the wider home appliance rental purchase sector includes a number of other providers. Some other companies operate in this sector but many of them appear to struggle to sustain the business model. Two have entered administration in the last three years – Homebuy plc and Dial-A-TV, who had approximately 140,000 customers between them.

32. **Buy As You View (BAYV)** operate on the basis of a coin-meter attached to a television, whereby the customer pays off the price of their purchase by 'buying' a number of hours of television viewing. BAYV have just under 100,000 customers.<sup>26</sup>

33. They operate on a very similar basis to Brighthouse, with inflated product prices alongside a 49.9% APR and a number of ancillary charges for service cover and damage/theft insurance.

34. The biggest commercial models in this market are of course, the **home credit** providers and the **catalogue/mail order** credit providers. Again these offer simple and quick access to credit, with few checks and with a clear weekly payment mechanism. However they are costly – with home credit providers incorporating the cost of their agent workforce, as well as the cost of the approximately 25% of non-payers into the basic product price resulting in a high APR and total cost of credit.

35. Catalogue/mail order credit providers typically offer lower APR, but sell goods at a significant mark-up to the high street cost.

### **International experiences**

36. In addition to the Australian schemes, in **the USA** some products have been developed by credit unions specifically to appeal as a lower cost

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<sup>26</sup> "Buy As You View's £6m Investment to go green", BAYV website, February 3, 2010.

alternative to sub-prime products in the market, for example Pennsylvania Credit Union Association offers “Better Choice” loans marketed as a “Smart Alternative to payday loans”.

#### The nature of the unmet demand

37. Low income consumers need small value cash loans, typically from £100 up to £750, which can be obtained quickly and without intrusive or lengthy credit checks, and preferably to be repaid by a small weekly payment – flexibly and without unexpected charges. The ability to repay in cash is likely to be appreciated – or via Paypoint or the Post Office. The more of these criteria that any proposed product is able to meet, the more attractive it is likely to be to consumers.

38. When the OFT asked users of alternative credit products the reasons for choosing that product, the interest rate and the total cost were secondary considerations to most respondents other than those who used credit cards. The most important were speed of access and affordability of repayments. Features rated as of similar importance to the interest rate and cost were trust in the company involved, lack of complicated form-filling and (especially for home credit users) being confident of non-refusal.<sup>27</sup>

39. The summary table below indicates which features valued by low-income consumers are offered by each of the new third sector initiatives identified above:

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<sup>27</sup> Annex A of OFT’s interim research report for the Review of High Cost Credit

**Table 2**

Features sought by low-income borrowers that are available in new third sector initiatives  
 (Source: Affordable Credit, PFRC 2005 and NCC Home Credit report 2004)

	NHF "MyHome Finance"	Barnardo's Family Finance Service
Simple, straightforward and speedy access	✓	✓
Confidence that will not be refused	✓	✗
Repayment system suits household budgeting strategies (e.g. frequency of repayment matches income)	✓	✗
Understanding and recognition of their financial circumstances	✓	✓
Cash based system	✗	✗
Trust in and familiarity with providers, products and procedures	✗	✗
Small amounts (under £500)	✓	✓
Repayment discipline	✓	✓
Repayment flexibility	✓	✗
No penalties or charges for default	✓	✗

## **Annex E – Learning from unsuccessful projects**

### Loan Guarantee Schemes

1. Fife council piloted a loan guarantee scheme whereby low-income households were provided with loans. The scheme suffered heavy losses as it was seen as a 'soft' source of money – and other similar experiences suggest that where loans are associated with a charity or Government funding, this has a significant and negative impact on repayment.
2. The Fife experience was referenced by Barnardo's as pertinent in their design of the Family Finance Service, where the service is branded separately from the charity and the public authorities, to attempt to ensure that it is not seen as 'soft money' that does not have to be repaid.

### Loans at unsustainably low rates

3. A number of housing associations have trialled loan schemes that have been unsuccessful due to over-optimism about the rate of interest that can be sustainably charged when dealing with the sums and the customers concerned. Although they succeeded in the short term in providing very cheap loans (at as low as 6% APR), lending capital was very quickly eroded meaning that the schemes generally had to be closed.

### 'Social collateral' loans

4. There have been attempts to form loan schemes based around the concept of 'social collateral', along the lines of schemes that have been successfully used in developing nations (such as, for example, the Grameen Bank). This involves small groups of individuals within a community each taking out a loan, with the group as a whole responsible for repayment of the whole sum. As such, if one group member is short, or cannot pay then the rest of the group has to make up the difference.
5. This provides flexibility within the group for some missed payments, and there is a strong incentive to repay since the borrowers social peers will not only be aware if a payment is missed (the "social collateral"), they will be impacted by it financially as well since they will need to cover the shortfall. Theoretically this encourages members of each group to support each other in their budgeting and taking care of their finances.
6. In practice, this approach has yet to be successfully replicated by any UK organisation on a sustainable basis, and would potentially face significant barriers to overcome in regulations on data protection and on structuring an enforceable group loan agreement under current credit legislation.

## **Annex F – Evidence on interest rate caps**

1. Over the past few years, several organisations and campaigns have focussed on the cost and the practices of some of the suppliers of credit to low-income households. In particular, there have been a number of calls for to introduce a legal cap on the interest rate (either the APR or the Total Cost of Credit) that can be charged for loans (Oxfam<sup>28</sup>, New Economics Foundation<sup>29</sup>, and Debt on Our Doorstep).

2. The issue of interest rate caps has been examined on a number of occasions by a wide range of agencies. In the UK, there was a substantial investigation at the time that the Consumer Credit Act was being reviewed, and BIS (then DTI) commissioned independent research from Policis into the impact of interest rate controls in other countries.

3. Policis noted that in countries with interest rate controls, providers tended to develop products with that met the interest rate restrictions but had significant additional costs – and were frequently less transparent. They also found that the incidence of illegal lending was higher in countries with rate caps than in the UK.

4. In 2006, the Competition Commission considered rate caps as a remedy in their investigation of the home credit market. A number of high profile consumer bodies including Which?, Citizen's Advice Bureau, the Money Advice Trust and the National Consumer Council and ABCUL wrote to the Competition Commission at the time, stating their opposition to a rate cap because "an interest rate cap would not deal with any of [the] underlying causes of high charges and we believe that it would not help widen access to more affordable credit."

5. The Competition Commission themselves concluded that "[a] cap would be complicated to design and would require significant monitoring effort." However, they also stated that they would continue to consider price caps should other remedies fail, and noted that a cap could "be effective in addressing the customer detriment"

6. More recent responses from consumer groups to the OFT's review of high cost credit make similar points. In their emerging findings, the OFT themselves note that "even inclusive interest rate caps can be circumvented", pointing to experiences in Australia, Canada, the USA and Germany. Examples of circumvention include provision of cross-border loans, and restructuring credit transactions as different financial arrangements to avoid legislation.<sup>30</sup>

7. CGAP (Consultative Group Against Poverty), an international policy and research centre based in the World Bank have consistently strongly opposed interest rate ceilings on the grounds that they suppress the development of microfinance stating, for instance, "Many countries have established interest rate ceilings to protect consumers from unscrupulous lenders. Governments often also face political or cultural pressure to keep interest rates low. Despite good intentions interest rate ceilings generally hurt the poor by making it hard

<sup>28</sup> Close to Home: UK Poverty and the economic downturn, Oxfam, March 2009

<sup>29</sup> Doorstep Robbery, New Economics Foundation 2009

<sup>30</sup> [http://www.of.gov.uk/shared\\_of/reports/consumer\\_credit/oft1150s.pdf](http://www.of.gov.uk/shared_of/reports/consumer_credit/oft1150s.pdf)

for new microfinance institutions to emerge and existing ones to stay in business.”<sup>31</sup>

8. The case in favour of interest rate caps is usually presented as being a way of ensuring outcomes such as :

- low-income households paying a more reasonable price for credit
- preventing low income-households from devoting significant proportions of income to credit repayments
- preventing sub-prime lenders from making ‘excessive’ profits from lending to low-income households

9. However the some of the more prominent recent evidence and arguments presented in support of caps have significant flaws. For instance, the New Economic Foundation’s “Doorstep Robbery” report repeatedly asserts that low-income households use high-cost credit to cover basic living expenses, without presenting any data or evidence to back this up, or to suggest what proportion of high-cost borrowing is used for this purpose as opposed to for emergency expense, or to obtain consumer goods.

10. The report also overestimates the number of people in the UK without access to bank credit, by using the total number of basic bank accounts open as part of their measure of the number of households with access to credit – taking no account of multiple account-holding (e.g. people who have a basic bank account as well as a full current account, or more than one basic bank account).

11. Furthermore the report deduces that Policis’ assessment of the level of illegal lending in France and Germany ‘may be overstated’ on the basis not of any empirical evidence, but because a number of selected experts, who have repeatedly supported the introduction of rate caps, affirm that it is so. The report even suggests that no illegal lending takes place at all in Germany - however research shows the contrary.

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<sup>31</sup> The impact of interest rate ceilings on microfinance\* Donor Brief No. 18, May 2004