



OFFICE OF FAIR TRADING

Vulnerable Consumers and Financial Services

**The report of the
Director General's Inquiry**

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by John S Bridgeman, Director General of Fair Trading

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Bibliography

Appendices

The appendices set out the detailed findings of the research which the OFT commissioned in support of its general inquiry into vulnerable consumers and financial services. Some of this analysis is unlikely to be of great interest to more general readers. Nevertheless, for those who would like more background information, each of the appendices is available as a separate publication, free of charge, from the OFT, PO Box 366, Hayes, UB3 1XB, or on the OFT's website: <http://www.offt.gov.uk>.

- 1 *Distributional Issues in Welfare Assessment and Consumer Affairs Policy* by Dr Richard Vaughan, Department of Economics, University College, London
- 2 *Vulnerable Consumers, Financial Services and Estimating the Costs and Benefits of Regulation* by Dr Paul Klumpes, Department of Accounting and Finance, Lancaster University
- 3 *Job Insecurity amongst the Vulnerable: Is it increasing?* by John McDonagh of the Office of Fair Trading
- 4 *Report on a Survey of Consumers of Financial Services* by Peter Atkinson of the Office of Fair Trading.
- 5 *Qualitative Research into Ethnic Minorities and Financial Services*, the report of focus group studies on behalf of OFT by Ethnic Response

FOREWORD

by the Director General of Fair Trading

Much consumer policy and regulation appears to assume that all consumers are the same. They are not. Some through for example disability, ethnic origin or education, may experience greater difficulty than others in obtaining the information they need on particular goods and services. Others, due to their relatively low and uncertain incomes, may suffer disproportionate losses when markets fail; or they may simply not consume what many of us would consider essential services. In initiating an inquiry into vulnerable consumers and financial services, I was therefore keen that we should not only develop a clearer idea of what is meant by consumer vulnerability but we should also apply this understanding in a practical way to a sector where I have concerns that the problems of vulnerability and exclusion might be severe: the financial services sector.

It is often claimed that those who fail to take up even the most basic of financial services have done so out of choice. My scepticism of such claims has been confirmed by the analysis and research in this report. The take-up of bank current accounts, household insurance and short-term credit is inconsistent with the exercise of any meaningful choice. In the case of long-term savings, the means simply do not exist for those who can afford only to save modest amounts to earn an acceptable return. When concerns about who benefits from financial services regulation and who pays for it are added to these findings, the conclusion that financial regulation, in its widest sense, has failed to reflect the interests of vulnerable consumers is almost inescapable.

The report concludes with a number of recommendations intended to address these deficiencies by promoting the supply of more appropriate financial services and improving their regulation. The most important recommendation is, however, that in assessing the benefits that flow from any regulatory or policy initiative intended to benefit consumers, government, regulators and those responsible for self-regulation should be take far more account of consumers' relative incomes. This would represent a fundamental departure from current practice and would do much to safeguard the economic interests of vulnerable consumers.

John S Bridgeman
Director General of Fair Trading

SUMMARY

This inquiry builds on the concept of consumer detriment set out in the OFT's earlier research paper on *Consumer Detriment under Conditions of Imperfect Information* (1997). In that paper many consumer problems were shown to be due to deficiencies in consumer information and understanding and to limitations in the goods and services that are available. The resulting consumer detriment represents a loss of economic welfare for the consumer very similar to that arising from the exploitation of market power. But this earlier research left unanswered a number of questions, which are addressed in this report. The answers help to identify what it means to be a vulnerable consumer, how this vulnerability arises with respect to financial services and what can be done to improve the situation.

Research commissioned from Richard Vaughan of University College, London (Appendix 1 to the report) applies the basic concept in the earlier paper to provide a theoretical framework for the common sense conclusion that a loss of £10 is much more significant to someone with an income of £100 per week than the same amount for someone with an income of £1000 per week. Applying this simple model, it becomes clear that vulnerability and exclusion are both to a considerable extent associated with low income. This makes a strong case for weighting consumer losses inversely to income in order to attach a greater importance to the problems of the vulnerable.

Vulnerability is not exclusively determined by low income. Consumers can be rendered vulnerable also by higher search costs and particular difficulty in assimilating information. An OFT research report *Vulnerable Consumer Groups: Quantification and Analysis*, published in 1998, looked at the distribution of certain groups, whose members might be so susceptible: the unemployed; those suffering from a long term illness or disability; those with a low level of education; members of ethnic minorities; older people (over retirement age) and the young (under working age). While significant overlaps between these groups were found to exist, they still represented, together with those on low income, some 70% of the population. Consumers who were members of such groups were, however, twice as likely to experience low income; and four fifths of those with low incomes were also members of these groups. The significance of low income and also the volatility of income is therefore stressed in this report.

Research by John McDonagh of the OFT shows that those on low incomes are also more likely to experience volatile, ie, uncertain incomes, and this volatility has been increasing in the past few years. Consumers on low and volatile incomes are more likely to have to terminate financial products early, and this early termination is costly. It also impacts more heavily on those with low income. Yet there is little indication that the providers of financial services have been adapting their products in response to this development. When individual circumstances change, many financial services are not sufficiently flexible.

In his research, Richard Vaughan also looks at what is meant by *exclusion*. For many types of service, consumer choice is not about how much to buy, but whether to buy at all. When this decision is determined, not through the exercise of choice, but as a result of a consumer's

level of income, the consumer experiences *income exclusion*, or the non-consumption of essential goods and services. Dr Vaughan goes on in his paper to develop the concept of the *exclusion curve*, a plot of the proportion of the population in a particular income band that consumes a particular service. The report concentrates on four basic services, banking, home contents insurance short-term consumer credit, for which exclusion curves proved useful, and long-term savings, for which they are not appropriate.

In an increasingly cashless society, life can be difficult without a bank account. Consumers without bank accounts may have to pay to have a wages cheque cashed. They may also pay more for services like gas and electricity and find that some financial services are no longer available for cash. However, for those with modest incomes the risk of becoming overdrawn and incurring high charges is a powerful disincentive to operating an account. This could be made easier to operate if on-line facilities were available to check balances before transactions were set in motion, so as to avoid the risk of unintentioned access to credit and the high charges associated with it.

Vulnerable consumers are more likely to lack home contents insurance but find it difficult to replace anything lost through flood, fire or theft. Such consumers would benefit from a basic home contents policy particularly if regular payments could be made through a bank account.

Selective access to short-term consumer credit is another important part of managing on a very restricted budget. Long-term savings may not be a high priority for many vulnerable consumers, but to the extent that vulnerable groups are able to make some provision for the future, they would benefit from access to simple, flexible products which give them access to the higher long-term returns available from investing in equities. Passively managed investment has the potential for distribution through low cost channels that cannot be utilised by actively managed investment that relies on largely specious claims about superior investment performance to stimulate demand.

Regulation in the UK exists to protect the integrity of the financial system and the interests of consumers who may have difficulty in understanding services which are frequently complex. Little attention has, however, been paid to who benefits most from such a system. Research commissioned from Paul Klumpes of Lancaster University looked at the regulatory system in a wider context, including its fiscal implications. He found that the system had been benefiting more wealthy consumers at the expense of those on lower incomes. The policy implication is that the new regime taking shape under the Financial Services Authority (FSA) should take more account of low income consumers. This conclusion is independent of, but consistent with, Dr Vaughan's similar finding.

If financial exclusion is not to be increased, any proposals to substitute private insurance for social welfare programmes will need careful consideration. The example of mortgage payment protection insurance (MPPI) indicates some of the potential difficulties.

People with disabilities need to be able to challenge discrimination in the terms they are offered to access financial services. Differences in terms should reflect only clearly

substantiated variations in the risks to which suppliers are exposed. Generally, financial service providers have responded well to the Disability Discrimination Act, but powers to challenge discrimination need to be strengthened.

There are strong feelings that many ethnic minority groups face problems additional to those common to all vulnerable groups. Focus group research published with this report provides a useful insight into how members of ethnic groups see the provision of financial services.

In Chapter 7 the various strands of research and inquiry are brought together. The overall conclusion is that the needs of low income consumers should be given greater weight. This can be achieved by weighting the benefits accruing to low income consumers in inverse proportion to consumer income when undertaking Cost Benefit Analysis of policy and regulatory initiatives affecting consumer welfare (Recommendation 1) and through the FSA's not overlooking the needs of low income consumers in reviewing and consolidating its rules and regulations (Recommendation 4). Suppliers, encouraged by FSA, are asked to make greater efforts to ensure that flexible products are available at reasonable cost (Recommendation 2).

Exclusion from key financial services is addressed by the provision of more suitable products and by encouraging institutions capable of reaching low income consumers (Recommendation 3).

Other recommendations cover:

- the need for banks and building societies to offer access to a basic, on-line, low cost current account through the Post Office and other retailers (Recommendation 3.1);
- the potential for Post Office Counters automation is examined (Recommendation 3.2);
- the need for operators of social housing to consider arranging contents insurance for their tenants (Recommendation 3.3);
- the need for long-term savers to be given access to the equity risk premium (Recommendation 3.4);
- the need to identify and remove obstacles to the work of credit unions (Recommendation 3.5);
- the potential for employee mutuals (Recommendation 3.6);
- the need to strengthen powers to challenge discrimination against disabled people (Recommendation 5) and against ethnic minorities (Recommendation 6).

1 CONSUMER WELFARE, CONSUMER DETRIMENT AND FINANCIAL SERVICES

1.0 Introduction

100 In *Consumer Affairs: the way forward* (1998), the Office of Fair Trading (OFT) describes the objective for its consumer affairs work as being to maximise consumer welfare by:

- protecting consumers by preventing abuse;
- empowering consumers by giving them access to information and redress; and
- promoting competitive and responsive supply.

101 This objective is subject to an important qualification: in aiming to maximise consumer welfare, the OFT should seek to use its limited resources to ensure that the interests of the more vulnerable consumers are protected. This prompts two important questions:

- which consumers are the most vulnerable; and
- where the balance should be drawn between maximising the welfare of consumers generally and protecting the interests of those considered the most vulnerable.

The present report addresses these questions in relation to financial services and, in the light of the conclusions reached, considers how the welfare of vulnerable consumers might be improved.

102 Many consumer problems can be attributed to difficulties in obtaining the information needed to make rational decisions. These issues are explored in some depth in OFT Research Paper 11, *Consumer Detriment under Conditions of Imperfect Information* (1997). This research recognised that there are limits to the information which consumers can take in, that these limits will vary between individuals and that just providing more information is not necessarily the answer to solving consumers' problems. The paper argued that consumer detriment arises when the information consumers assimilate falls short of the information they need in order to reach rational decisions. Of particular relevance to financial services, the research pointed to situations where it might be preferable to seek to simplify the product on offer in the interest of ensuring consumer understanding rather than attempting to educate consumers in a number of very complex issues. It was this thinking which contributed to the recommendations in recent OFT reports on pensions and health insurance.

- 103 Measuring consumer detriment, in however broad brush a way, is an essential and integral step in identifying the sources of the detriment and in devising ways in which it can be reduced or eliminated. Improving the quantity and quality of information provided to consumers and the ease with which they can understand it can generally only be achieved at a cost. That cost must be allowed for in estimating the detriment.
- 104 When the present inquiry was initiated, it was recognised that consumer detriment could impact more severely on some groups than on others. There is a closer examination of what is meant by ‘vulnerability’ in Chapter 2. The remainder of this looks in more detail at the economic assumptions and implications underlying the concept of ‘consumer detriment’. Dr Richard Vaughan of University College, London, was accordingly asked to undertake an examination of the consequences for consumers of a shortfall in information, paying particular attention to the distributional issues identified, but not answered, in the earlier research paper. Dr Vaughan’s paper, *Distributional Issues in Welfare Assessment and Consumer Affairs Policy*, forms Appendix 1 to this report.
- 105 Dr Vaughan’s analysis starts from the basis that, given full information, consumers will maximise their economic well-being by choosing the best combination of goods and services at the prevailing prices within the constraints of their overall budget. He then looks at what happens when that information is deficient. He shows that, depending on the circumstances in individual situations, consumers will make inappropriate purchases, sometimes buying too much of some products and sometimes too little. In this way, consumers experience a loss in economic well-being similar to the effects brought about by monopoly. It is this loss which is termed ‘consumer detriment’ - a loss which has received very little attention in the economics literature.
- 106 Dr Vaughan’s initial analysis concerns the welfare loss by an individual consumer. As he points out, this depends on income.¹ An extra £10 paid by a consumer with an income of £100 per week will not generally result in the same welfare loss as an extra £10 paid by another consumer with an income of £1,000 per week. The question then arises as to how an aggregate measure of consumer detriment can be arrived at. One solution is to ignore such distributional issues and treat losses incurred by all consumers as equivalent, regardless of income. The rationale for this is that distributional issues are already addressed by the structure of taxes and social security benefits. In practice, taxes and social security benefits cannot distinguish between those consumers who suffer a particular consumer detriment and others who do not. A better solution, therefore, would be to weight the consumer detriment in relation to the incomes of the consumers when applying cost benefit analysis (CBA) to policy and regulatory initiatives intended to reduce or eliminate such consumer detriment. This would have the effect of giving a higher priority to the problems of consumers with limited incomes in the assessment of the costs and benefits of such regulatory

1 This arises from the well-established micro-economic principle of marginal utility of income.

and policy initiatives. Evidence for a precise weighting is limited,¹ indicating the need for further research. Nevertheless, the continued disregard of income in many CBA assessments of regulatory and policy initiatives is insupportable.

- 107 The OFT's paper *Consumer Detriment under Conditions of Imperfect Information* drew attention to the complexity of many financial services and the presence of commission generated for those who sell them. For many of these products the learning process is slow and inhibited by a product's characteristics. Comparisons are difficult, purchases are infrequent and wrong choices can have potentially large effects on consumers. These are all reasons why, in the case of some financial services, selling practices are subject to statutory regulation while, for others, a regime of self-regulation applies. Regulation is considered further In Chapter 4.

1 In addition to the evidence discussed by Dr Vaughan in paragraph 4.7 of Appendix 1, the value of a statistical life may provide an indication of the elasticity of welfare with respect to income and hence to weighting. The concept of the value of a statistical life and the estimates that exist are discussed and analysed in *The Optimisation of Consumer Safety*, a forthcoming research paper produced by the Department of Trade and Industry.

2 VULNERABILITY

2.0 What is vulnerability?

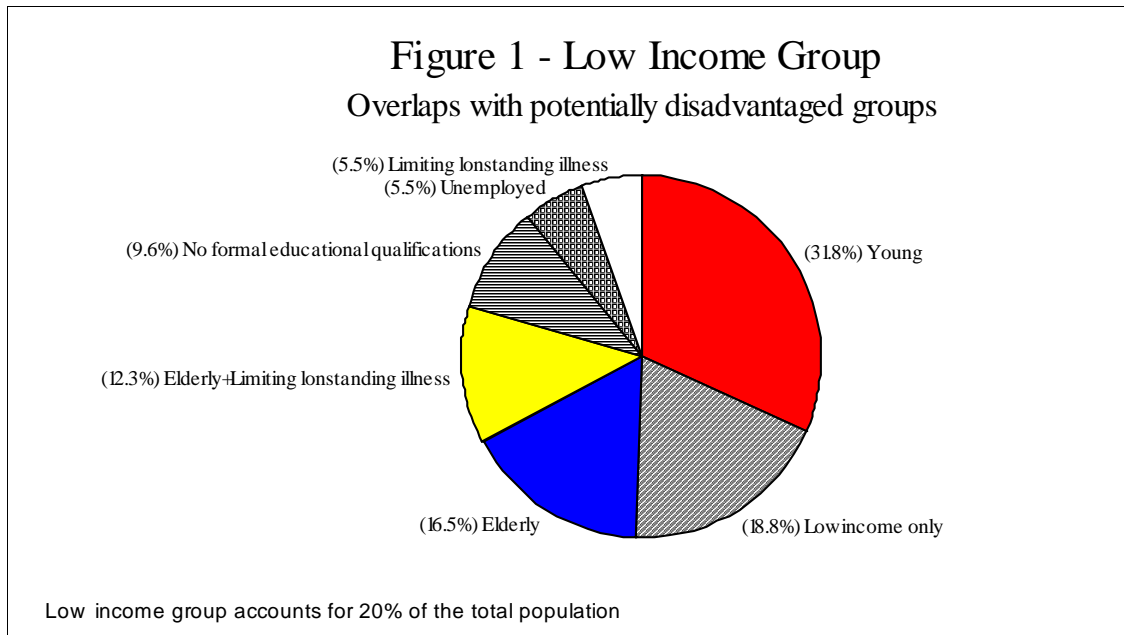
200 Most of us have felt vulnerable at one time or another when faced by a new consumer situation. We can recall not having or not understanding the information we felt we needed and possibly afterwards regretting an ill-considered decision. We may feel that we have been positively misled by the information we were given. Vulnerability to, or detriment suffered from, inadequate information is relative and this report is concerned with those who are particularly vulnerable. Such vulnerability can be increased by higher search costs as a result, for example, of a disability that restricts mobility. Often it can be quite difficult simply to identify where information can be obtained. Other causes of difficulty may include the individual consumer's level of education and general understanding of financial services. Language and cultural difference can also impose a barrier to understanding the information that is available. These problems are explored in Chapters 5 and 6 and in Appendix 5.

2.1 Who is vulnerable?

201 The OFT's Research Paper 15, *Vulnerable Consumer Groups: Quantification and Analysis* (1998), studied seven categories of the population which might be considered in some situations to be vulnerable. In addition to those on low income, it identified a further six non-mutually exclusive categories:

- the unemployed;
- those suffering from a long-term illness or disability;
- those with a low level of educational attainment;
- members of ethnic minorities;
- older people; and
- the young.

Using data from the *Family Expenditure Survey* and other sources, the extent of these groups and the overlap between them was explored. In total they were found to represent some 70% of the total population of the United Kingdom- which was clearly *not* a meaningful estimate of the prevalence of vulnerability in the population as a whole. Of greater interest was the considerable overlap that was observed between the various groups. Consumers who are members of the potentially vulnerable groups are twice as likely to be on low income; and four-fifths of the members of the low-income group were also likely to be members of at least one of the potentially disadvantaged groups (figure 1).



In a number of cases the strong association between low income and the other potential disadvantages for consumers may, of course, reflect a causal link. Members of several of the groups rely on modest state benefits or tend to be employed in low-paid jobs. Members of some ethnic groups tend to be over-represented in low-paid jobs and in poorer neighbourhoods (Richard Dorset, 1998, and Berthoud, 1998). Analysis of the Labour Force Survey (1994) found that Indian and black males earned on average 10% less than white males, and Pakistanis and Bangladeshis one third less.

202 There has been much research on the particular problems faced by those on low incomes. Of particular relevance is a report from the Policy Studies Institute which argues that people who live on low incomes are not an underclass but have the same aspirations to jobs, housing and income as others in the community (Kempson, 1996). They therefore face stark choices between cutting back on essentials - which certain financial products may be - or falling into debt. Low-income households frequently get behind with household bills and get into debt. The management of family budgets places considerable strain on relationships, with parents often going without in order to provide for their children. Employment can be an important way out of low income (Appendix 3). While an examination of the roots of poverty is beyond the scope of this report, it does address the problems faced by low-income consumers and the steps which could be taken to reduce or eradicate those problems.

203 Low income and poverty can be defined in relative or in absolute terms (Goodman and Webb, 1997). One approach is to define low income as being a certain part of the income distribution at any point, say the lowest 10% (the bottom decile) or the lowest 20% (the bottom quintile). 'Income' may refer to personal income or, more usually, to household income, standardised for household composition. Low income may also refer to income which is, say, below the level provided by income support.

- 204 Alternatively, low income can be based on the level of spending necessary to maintain a minimum standard of living. While this level may provide a convenient starting point or benchmark, it is more often used for lobbying. The disadvantage of this approach is that it fails to adjust for changes in the general standard of living. It is the relative income approach which has been adopted in the analyses reported in Appendix 3. These show that over the last 20 years the distribution of income - of which earnings are one component - has widened.
- 205 Whatever the definition employed, there is extensive evidence that income inequality has increased over the 1980s and 1990s (Goodman and Webb, 1997). In 1979 the bottom decile for male earnings was 64% of the median; by 1995 this ratio had fallen to 45% (OECD, 1996). In 1979 a person in the bottom decile of earners earned around 40% of a person in the top decile. This is now under 30%. The bottom decile income group is actually worse off in *real* terms after housing costs: in 1994/95 real income was 8% lower than in 1979. The same is true if the analysis is confined to a particular section of the population, such as pensioners. Work for the *Working Group on Pensioner Incomes* shows that, since 1979, inequality among pensioner incomes has increased, particularly among single pensioners.
- 206 Earnings provide the most important source of income, making up - on average - two-thirds of all income. But the composition varies for different income groups: for lower-income groups, for example, earnings make up one-fifth of income while, for those in high-income groups they form as much as 70% of income. The gap for those in low-income groups is filled by social security benefits. Despite this, however, it is earnings and, ultimately, employment that remain the key components of income and, most importantly, of the volatility of income. The level of pension and investment income is, of course, closely correlated with income from previous employment. Analyses of the *British Household Panel Survey* (Social Trends, 1998) show that getting a job is the major cause of movement out of the bottom income decile (the lowest tenth of income). Nevertheless many of those who move out of the lowest income categories subsequently fall back again - for example because the job was a only temporary.

2.2 Volatile income and vulnerability

- 207 It is not only the prevalence of low incomes that has increased since 1980. The research work summarised in Appendix 3 demonstrates that income has become more volatile - that is to say it changes more quickly. For those with low incomes, this tendency is more marked: individuals in the bottom quarter of the income distribution are one and a half times as likely to lose their job as someone in the top quarter. Furthermore, the research shows that job tenure rates at the bottom of the income distribution have actually declined over the last 20 years. Moreover, spending on financial services is generally financed out of residual income - the income that remains after essentials have been purchased.

208 The problem of volatile income is crucial to financial services. A stable employment history is important - both to obtain many financial services in the first place and to secure the best value from the services that are purchased. Failure to keep up contracted payments for many insurance and savings products, for example, can leave consumers with heavy losses. Not only do low-income consumers need flexible products, that need has been increasing. The next section presents some figures that show the persistency for certain financial products, while Chapter 4 asks if either the financial services industry or the regulatory regime which influences its structure has responded to that need.

2.3 Persistency as a particular problem for low-income consumers

209 Many financial services products are designed for long-term commitment and require continuous contributions and hence continuous employment to maximise the benefits. One of the most obvious is the endowment life assurance policy which pays out a sum assured, with or without various bonuses, at the end of a period of years - say 10, 15, or 25 years (or on the earlier death of the policyholder). Where the consumer is obliged to stop paying into the policy before its term ends, returns can be very poor or, in the early years, even negative. This is due to the recovery of sales and distribution costs from the initial premiums paid by the consumer, a practice known as 'front end loading'. All types of financial product require substantial effort to sell and set up the contract. The complexity of some products and the consequent regulation of selling practices to protect the unwary adds to these costs. The Director General's report on pensions argued for simpler products which would be both easier to sell and require less regulation. The aim was to cut those costs which bore disproportionately on consumers who could only afford low or varying contributions. An important element in that simplification was the use of passive fund management. Consumers generally susceptible to the mistaken belief that a particular investment manager can consistently deliver superior returns. Low-income consumers are more likely to be excluded by the high cost of the distribution channels required when products are sold on the basis of largely specious claims about superior investment performance.

210 We wanted to find out more about why consumers, particularly those on low incomes, failed to keep up their premium payments. Respondents in our survey were asked their reasons for stopping payments. A high proportion mentioned reasons associated with affordability. For those who terminated mortgage-linked endowments, 50-55% cited this cause, while for endowments not linked to a mortgage the figure was 65-75%. Those questioned said that this was mainly because they needed the surrender value of the policy for other purposes, or because they were unable to find the premiums from their reduced income. Failure to keep up with premiums may require the consumer to liquidate the investment, whatever the cost in terms of reduced return. Our survey found that households with very low incomes were more likely than respondents generally to have stopped a life insurance policy prematurely.

This is not altogether surprising: as shown in Appendix 3, low-income consumers are likely to have lower job tenure rates.

- 211 Industry-based research by the Life Insurance Market Research Association (LIMRA, 1996) also confirms our findings that those who terminate life assurance products early are indeed from lower income groups. Such consumers will suffer also a greater loss of welfare than comparable consumers with a higher income. Companies participating in the survey provided LIMRA with the status of each policy sampled in 1993 and 1994 to identify those policies that have since lapsed. The LIMRA survey (summarised in Table 1) showed that persistency rates were better for buyers earning higher incomes. Consumers in these higher social classes tended to have more stable employment patterns and were more financially aware, and hence maintained their premiums or contributions.

TABLE 1: LAPSE RATES BY INCOME

	<i>1993 Buyer Study 25-month lapse rate</i>	<i>1994 Buyer Study 13-month lapse rate</i>
£0 - £5,199	19.1%	13.4%
£5,200 - £10,399	20.7%	12.7%
£10,400 - £15,599	18.9%	10.2%
£15,600 - £20,799	17.9%	7.9%
£20,800 - £25,999	12.7%	7.1%
£26,000 - £31,199	15.5%	5.9%
£31,200 and over	11.9%	3.8%

Source: LIMRA

- 212 For an endowment life assurance policy, one means of mitigating the effects of low persistency would be to convert a paid-up policy (for a lesser sum assured) or to sell it on the second-hand (traded endowment policy) market. These strategies do, at best, provide only a partial remedy. A complete remedy can be achieved only by the availability of products that are flexible so as to reflect the very changes in personal circumstances which have caused policies to be terminated early and that are sold on the basis of cost rather than promises of superior investment return. How this might be achieved is discussed in Chapter 7.

3 EXCLUSION

3.0 Exclusion

300 One of the key debates of the middle and late 1990s has been the issue of social exclusion. Whereas earlier analysis concentrated on ‘poverty’ - a lack of the material resources, especially income, necessary to participate in society - social exclusion is a more comprehensive formulation and refers to the on-going process of being shut out, fully or partially, from any of the social, economic, political and cultural systems which determine the social integration of an individual in society (Walker, 1997). And, in addition to social exclusion, Richard Vaughan describes two, related, forms of *economic* exclusion in his report in Appendix 1:

- **Price exclusion** - At given income an individual freely chooses not to consume goods or services because the market price are above the maximum they would be willing to pay. This willingness will be partly determined by individual preferences; and
- **Income exclusion** - This refers to the revealed non-consumption goods or services arising from low income.¹

301 Across a wide range of goods and services that can be supplied in small quantities, consumers on low incomes can match their outlay to their means by choosing to make only modest purchases: but, when it comes to certain financial services which are available only in discrete amounts, there is generally no such option. For such services as bank accounts and home contents insurance, consumers either have the product or they do not. Consumer choice is not about how much to buy but whether to buy at all. A more detailed analysis is set out in Appendix 1 where Dr Vaughan develops the concept of the *exclusion curve*. This is a plot of the proportion of the population in a particular income band consuming a product against that income band. Exclusion will be clearly revealed by a curve that rises sharply before levelling out. When there is no income exclusion, that sharp rise will not be observed: instead, the proportion within each income band consuming the service will increase more steadily with increasing income. While exclusion curves cannot be applied indiscriminately in this area, they nevertheless, proved to be a useful tool in assessing income exclusion in three of the four services that were examined during the course of the inquiry.

302 Arguably, there are four financial services that stand out as those which most of today’s consumers are likely to regard as essential: money transmission; home contents insurance; short-term consumer credit; and long-term savings. Each is discussed individually in the sections that follow, but they are not of course mutually exclusive to each other. Money transmission services, for example, are integral to the

1 In reality, the *willingness* to pay (price exclusion), partly determined by income.

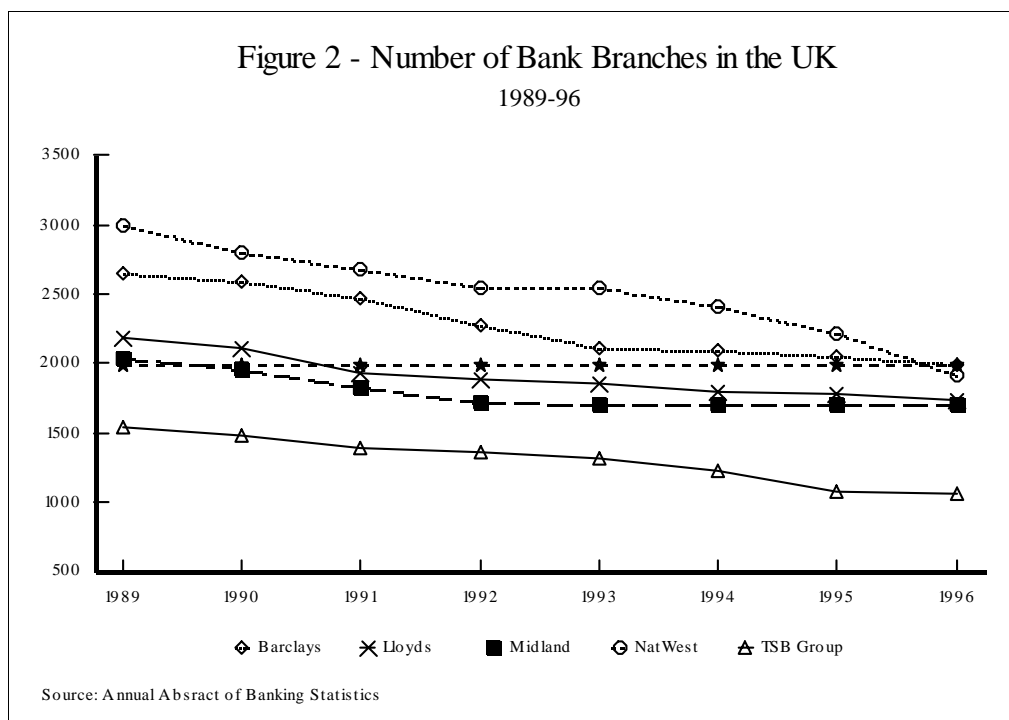
operation of a bank current account and cannot be economically undertaken without one; and a bank current account provides a number of valuable ancillary services, one of which could be acting as a gateway to other financial services. For some consumers, other forms of insurance - such as mortgage protection insurance - might be considered essential. Here, long-term savings covers saving to provide for retirement or for some family event like a daughter's wedding, rather than to replace the washing machine or the refrigerator.

3.1 Cash transmission and banking

- 303 Although the majority of transactions are still made in cash, it is becoming increasingly difficult for consumers to be without cash-transmission and banking services - such as debit cards, direct debits, standing orders and automatic credit transfers. Research by the Association for Payment Clearing Services (APACS, 1998) shows that the proportion of employees paid in cash is now around 12%, compared to 58% in 1978, and that having a bank account is, therefore, increasingly a condition of employment (Pratt et al, 1996).
- 304 A growing number of goods and services can be acquired *only* through the use of such means, while others may be bought on better terms than if purchased with cash. A wide range of goods and services may now be obtained by telephone through call centres which provide retailers with a relatively low-cost method of distribution. The most common method of payment for these is by means of a debit or credit card. It follows that customers without these services are usually denied the opportunity to use call centres.
- 305 The relative expense to utility companies of processing bill payments is reflected in the discounts offered to consumers who pay in certain ways. The Government's green paper on utility regulation (DTI, 1998) revealed that those gas consumers who settled their accounts by direct debit, on average, paid 12% less than those who used pre-payment meters and 7% less than those who paid on receipt of a quarterly bill (DTI, 1998). The corresponding figures for electricity consumers were 8% and 3%. As competition increases, consumers who pay by direct debit may receive still larger discounts. Indeed, the green paper reported that in areas where the domestic gas market was open to competition, new entrants were seeking to attract consumers with pricing structures which offered potential direct debit payers a 30% discount.
- 306 The DTI green paper reported that 50% of pre-payment meter users were single-parent families, while a similar proportion were on incomes of £12,000 or less. These groups figure heavily among those who do not have bank or building society accounts that would permit them to pay by direct debit - although there would be particular advantages to them of settling utility bills in this way - advantages that are likely to become stronger still. An apparent reluctance to use this method may reflect the fear of incurring high charges should funds in the account become too low. This has more to do with the way bank accounts operate than with the direct debits system as such.

- 307 Where preferential terms are not given to consumers of money transmission services, extra cost is borne by someone else. Benefit payments (including payment of the state pension) may be made by giro or order book to be cashed at Post Offices or by automatic credit transfer (ACT) to a bank account. The recipient receives the same amount regardless of the means of payment, but administration charges for the Benefits Agency vary enormously. ACT is made available to benefit recipients at the moment, but the take-up among such recipients is only 30%. Reasons for preferring payment in cash include the ease of budgeting on a weekly basis and problems in accessing payments through a bank - particularly if the account should be overdrawn.
- 308 While those using cheaper bill-payment systems are rewarded with discounts, we are not aware of any inducements that are offered to encourage recipients to take their payments by cheaper means. Apart from savings to the paying organisation, the wider gains from encouraging the use of a bank account are significant. Recent research has suggested that current accounts are also instrumental in gaining access to other financial services, some of which may also be regarded as essential (Kempson, 1997). Many other financial services can be accessed by consumers who are able to pay by direct debit. This applies particularly where monthly premiums are offered as an alternative to annual payments.
- 309 The consumer survey carried out in connection with the present inquiry found some evidence that individuals without a bank account were less exposed to direct sales approaches. Nearly one-half of those consumers without a current account in the household had not received any approaches advertising financial services in the previous fourteen months, compared to less than one-fifth of those who had active current accounts. Furthermore, in terms of the number of products for which sales approaches had been received, low-income and very-low-income households, those in social renting and those in single-pensioner households were less likely to have received such approaches. Of course, it is in the interests of advertisers to target not merely those who are most likely to purchase the service being promoted but also those with the resources to spend large amounts on it. While junk mail can be a nuisance, such direct advertising does have an important information content and it is not obvious that there are alternative sources from which those without access to banks could pick up the necessary information.
- 310 We have been told that the costs of running a current account are often not met by the revenue earned (interest on balances or charges levied) on that single product. In the United Kingdom, current accounts are offered more as loss leaders, providing banks with an opportunity to sell other services to customers. Whatever the cause, our survey certainly confirms that ownership of a bank account is associated with consumption of other financial services. In a statistical analysis, the possession of a current account was shown to have a significant positive effect on the probability that an individual would both hold other financial products and be approached with offers.

- 311 In the past, banks relied on a large geographical network of branches as a means of distribution and also as administration centres. Improvements in information technology have changed the way in which, not only banks, but the entire financial services industry administers its business and distributes its products. In general terms, decision making and administration have moved from the branch to regional and central offices. Around 10-15 years ago, decisions on whether to grant credit were typically made locally by individual branch managers. These days, such applications are assessed centrally using credit-scoring systems.
- 312 The extensive branch network has been costly to maintain. In the 1980s, the operating costs of British banks were estimated to account for 65% of their gross income (OECD, 1992). In contrast, the cost of operating a telephone banking service has been estimated as less than 50% of a traditional branch-based service (KPMG, 1998). It is not surprising, therefore, that new entrants have elected to establish their banking services with centralised administration of accounts - in some cases operated without branches. In a competitive response, those banks with established branch networks have sought to contract them.
- 313 Figure 2 illustrates the numbers of bank branches that closed between 1989 and 1996. Over the seven-year period, the total fell from 13,708 to 11,051, a drop of more than 22%. Branch closures occurred at a greater rate in rural areas, reflecting additional costs (Gentle et al, 1996). But there have also been extensive closures in urban areas away from main commercial centres. Separate research conducted in both Birmingham and London has shown that bank branch closures have particularly affected deprived areas. In Birmingham, by the early 1990s, five of the 39 electoral wards had no bank or building society branches, while a further six wards each had only one. But 28% of the city's population lived in the relevant areas - including



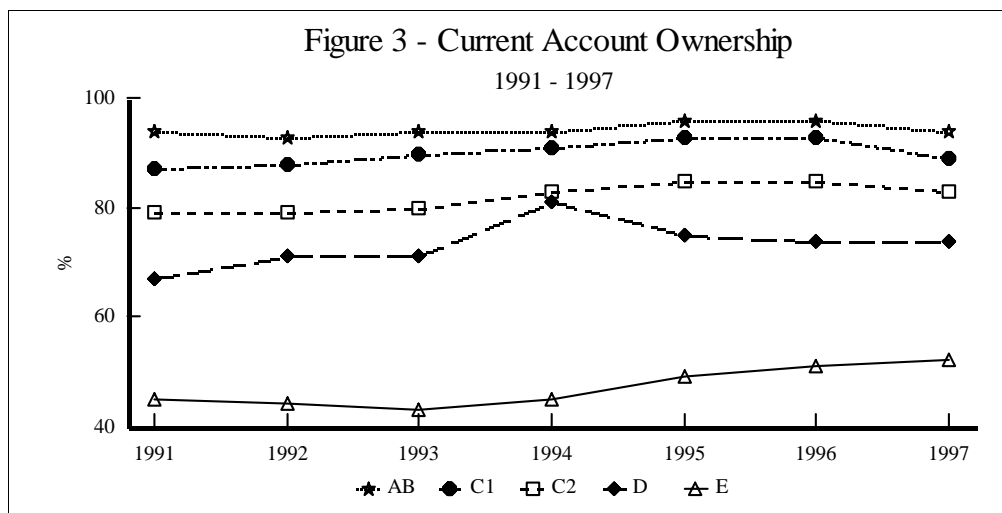
some of its poorest inhabitants (Conaty and Mayo, 1993). Similarly, in London, bank branch closures between 1990 and 1995 were found to be concentrated in deprived wards (Kaut et al, 1997). Among residents of those areas, bank closures have added to the disillusionment with financial products.

- 314 To the extent that branch closures essentially stem from fundamental trends in technology and competition, there is unlikely to be any significant reversal in this process in the future. As the Campaign for Community Banking Services shows, bank closures can impose costs, particularly on local communities. Those who live in rural areas face additional resource costs when using public or private transport to visit their nearest bank branch in a neighbouring town. In extreme cases, individuals may close their accounts because of branch closures, again leading to a snowball effect as the banks lose both customers and the opportunity to sell them other financial products. The withdrawal of financial services in deprived areas can also hurt attempts at economic regeneration, especially when small businesses are involved (Layen and Thift, 1993). To the extent that banks present social benefits, there could be an argument for some public policy response to bank closures.
- 315 The effect of bank closures on consumers has been partially offset by other developments. There has been a significant growth in the number of cash dispensers (Automated Teller Machines, or ATMs). In 1986 there were only 9,106 ATMs in Great Britain; by 1996 there were 17,320. Telephone banking, introduced by Midland Bank as First Direct, has expanded rapidly. The prospects for fully electronic banking are highly rated. Nevertheless, we have some concern whether these developments will serve many vulnerable consumers, particularly those with low incomes. The majority of ATMs are installed by bank branches, so that those areas that not served by a branch are unlikely to benefit from the provision of an ATM either. It has also been suggested that most of the ATMs that are located away from bank branches are, in any event, not situated in poorer areas (Thrift and Leyshon, 1997). Moreover, the range of services which can be transacted at an ATM is limited and, in the case of those ATMs not operated by a consumer's own bank, are commonly confined to cash withdrawals and balance statements.
- 316 As regards telephone banking, it has been shown that people living in those areas that are most affected by bank branch closures are also those least likely to have access to a telephone. A 1992 study of a Newcastle council estate revealed a household connection rate of only 26% (Graham and Marvin, 1996). Our present survey found that, whereas nationally 8% of consumers had no telephone, 40% of those consumers who had no bank account also had no telephone. There is also a clear relationship between social class and access to technology. Only 8% of the poorest fifth of households own a computer, compared to 57% of the richest fifth (Office for National Statistics - ONS - 1997).
- 317 In addition, there is some evidence that those affected by bank branch closures would not consider using newer methods of distribution. A 1996 survey revealed that a

majority within all socio-economic groups would prefer to obtain information about financial products by visiting a normal branch than by another means, such as a telephone service. Those from lower socio-economic groups C2, D, and E, however, displayed a far greater reluctance than others to the idea of using different distribution channels, such as the telephone or ATM (KPMG, 1997) .

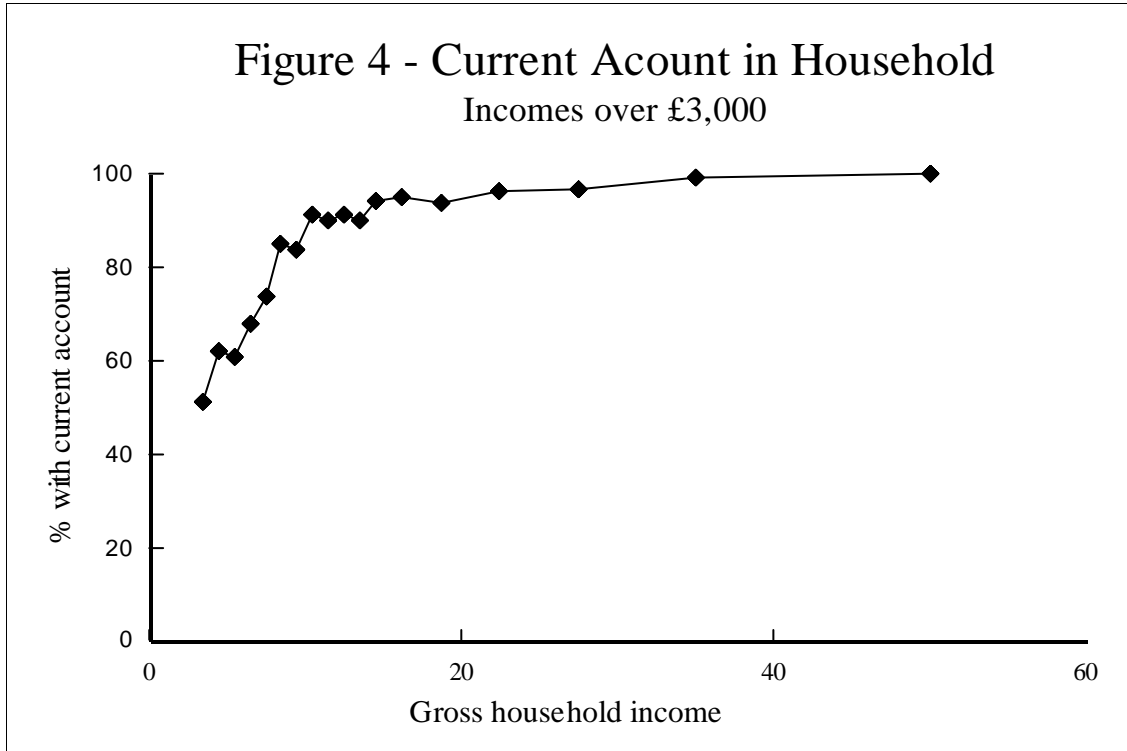
- 318 PayPoint is a recent development to enable a wide range of bills to be settled in local shops. Established in April 1996, with backing from a number of utilities and including TV Licensing, PayPoint terminals are currently installed in over 6,000 agents in retail outlets throughout the UK, projected to rise to 7,000 by the end of 1998. Over 20 key organisations are now using PayPoint services.
- 319 Another alternative to banks is the network of 19,000 post offices operated by Post Office Counters Ltd (POCL). Not only are they more numerous than the 11,000 branches of the banks (which, in any event, tend to be sited in clusters), but post offices have a much wider geographical spread in rural areas and suburban shopping centres. Only 600 offices are directly owned and operated by POCL, with the vast majority being run on an agency basis, commonly by traders who operate them alongside their own businesses. Around 80% of post office transactions are undertaken through such agency outlets. The range of services provided is very wide and can include postal services for Royal Mail, payment of benefits for state agencies, issue of licences and collection of fees (such as road tax, TV licences, passports), acting as agent for banking and insurance, bill payment services for utilities and other customers of Girobank and POCL, international money transfers and access to National Savings products. While POCL is not itself a bank, it acts as an agent in making services available through its network. In addition to a long-standing relationship with Girobank, now a subsidiary of Alliance and Leicester, POCL has arrangements with a number of other banks including the Co-op Bank and Lloyds TSB. At present transactions are all paper based. A system of automated point-of-sale technology is, however, currently being developed, with the potential to reduce costs, increase the level of service and widen still further the range of transactions which could be undertaken.
- 320 The network is well situated to meet the needs of many of the vulnerable groups covered by this report. As recipients of all manner of state benefit, many such consumers will use post offices on a regular basis. Surveys indicate they have a high level of confidence in the Post Office as a service provider and value the personal contact with counter staff. Nine million customers use post offices for the payment of bills by cash or cheque. Nevertheless, the potential to broaden this activity substantially must depend on progress with the automation project.
- 321 We see money-transmission services as an integral part of most bank and building society current accounts. Ownership of a current account has grown in recent years among all socio-economic groups. But ownership remains low among socio-economic groups D and, especially, E (figure 3). The consumer survey undertaken in

connection with the present inquiry found that 86% of the households in the population owned a current account. Other surveys have indicated slightly differing levels of ownership. We believe that these differences might be explained by slightly differing definitions of the term 'current account' and whether the basis of access is measured in terms of individual adults or of households. What seems indisputable, however, is that the growth in the ownership of current accounts has stopped during the last few years.



322 Research has suggested that only a minority of those without bank accounts have actually been refused one (Kempson, 1998). Our inquiry has generally supported this view. But it would be unwise to underestimate the problem. The banks that responded to our question on the matter revealed that between 13% and 41% of applications for conventional current accounts were turned down in the most recent 12-month period. In total, of 2.7 million applications received, 650,000 were refused - or just under a quarter. The main reason for refusal related to the opportunity, in conventional current accounts, for users to gain access to unauthorised credit by means of cheques supported by cheque-guarantee cards and from those debit-card transactions that are not subject to prior authorisation. Understandably, banks seek to reduce their exposure to the misuse of current accounts and generally refuse those applicants who are not considered to be creditworthy. Alternatively, facilities on an account may be so restricted as to make it of little practical use. A number of initiatives suggest that a bank account without access to credit would be both useful to consumers and workable in practice.

323 An exclusion curve for current accounts, based on our survey, is shown in Figure 4. This curve is consistent with the contention that current accounts are subject to income exclusion. Put another way, existing products are not suitable for many low-income consumers. Below an income of about £12,000 the suitability of the type of bank account presently available appears to decline rapidly.



324 Consumers without bank accounts not only face additional costs, both when they receive and when they pay out money, they lose contact with a wide range of other financial services for which a bank account provides a gateway. We can therefore conclude with some confidence that lack of access to a bank account constitutes consumer detriment.

325 We note that developments in technology are leading to rapid changes in the financial system. The growth of the Internet and telephone banking have increased variety and improved customer service, and, in principle at least, they present potential benefits for the vulnerable. With the long-term costs of the Internet projected to fall, it is anticipated that its use will expand as it becomes more widely accessible. Nevertheless, among vulnerable groups, access to such technology remains low - for both financial and non-financial reasons. There are many individuals who lack the necessary educational and technological skills that are necessary to gain any benefit from the new facilities. The low level of telephone ownership among those without bank accounts has already been mentioned. Surveys consistently show that low-income consumers value face-to-face contact for transactions and are not comfortable using newer technology-based systems (see for example Kempson and Whyley, 1999, forthcoming). Thus, while new technology could be important in the future, for the present its potential is limited.

3.2 Insurance¹

326 Efficient insurance markets need information. Underwriters need to be able to assess risks: consumers need to be informed about appropriate products.

Underwriters' assessment of risk is based on historical actuarial data about the event to be insured. Consumers can suffer detriment when:²

- differences occur in premiums not related to expected cost of the insured event; or
- premiums do not adequately reflect differences in risk.

327 For most consumers, home-contents insurance is particularly important since it provides the means to replace goods that have been lost in the event of a burglary, a fire, or some other domestic disaster. Important recent research by Whyley, McCormick, and Kempson (1998) has indicated that about 80% of UK households are covered by such insurance. Our own survey produced a similar figure and confirmed that take-up varies substantially among different groups. Among the households that had no home-contents insurance, young families, lone parents, and households with low income, those where the head was unemployed, and those with little or no savings featured disproportionately. Tenants and households who lived in inner cities and economically or socially deprived areas were also found to have low take up rates. Our survey found that 93% of home owners insured the contents, compared with only 51% of those who lived in rented or local authority housing. Thus it was the people who were often least well placed to stand the risks who were without cover.

328 Around half of those survey respondents who did not have home-contents insurance had allowed policies that they had once held to lapse - mainly because of financial pressures (Kempson et al, 1998). But, arising out of its consumer survey, the OFT found a number of reasons why such households remain without contents insurance.

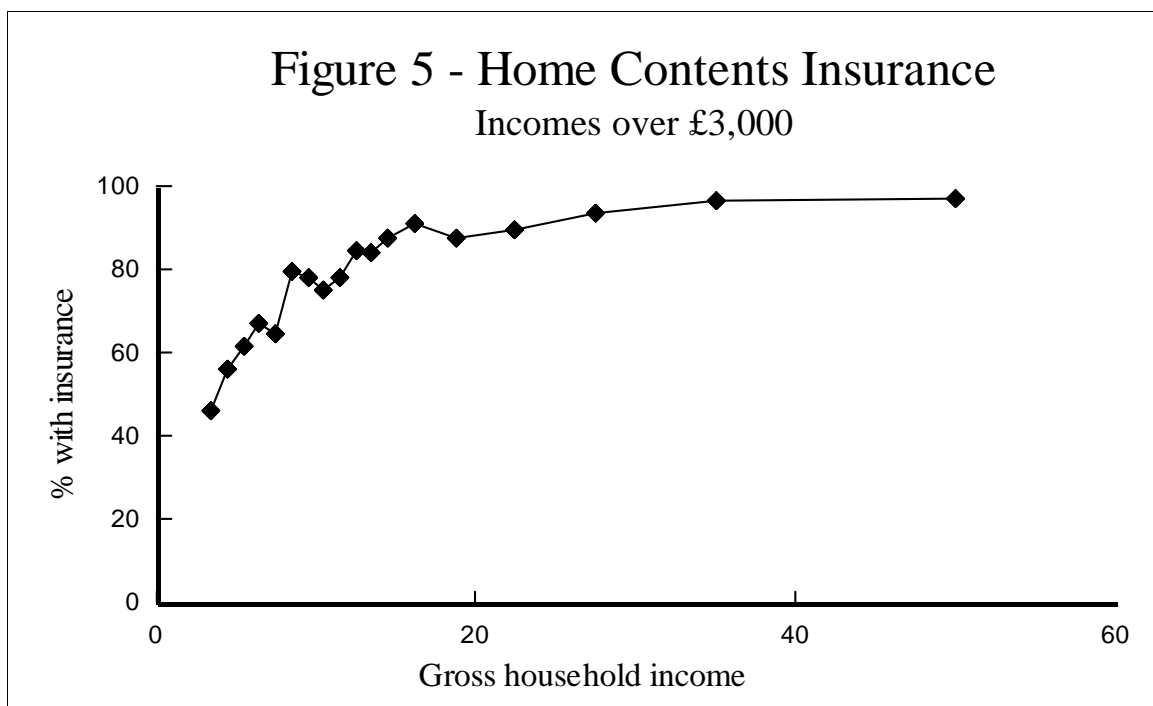
- Insurance is often said to be sold, rather than actively bought - but the insurance industry tends to neglect the bottom end of the market and does not approach those in the lower social classes (however they are defined) to the same extent as home owners. For example, 65% of respondents with a university degree had received an approach to buy home-contents insurance, compared to just 29% of those with no qualifications at all.

1 Dr Vaughan looks at insurance in a micro-economic framework in Appendix 1.

2 Squires (1998).

- The products are not designed for low-income consumers. High minimum sums insured, high excesses, a move away from indemnity insurance and catastrophe-only insurance were all significant factors
- Risk assessment has become increasingly sophisticated. It is now not uncommon for risk to be assessed on a street-by-street basis. While the effect is to improve the efficiency of the market in the sense that the positive correlation between risk and premium is strengthened, people who live in areas of high crime (who tend to be those on lower income and tenants), and who arguably need insurance the most, are now faced with higher premiums. Measures to reduce the cost of insurance need to concentrate both on reducing the risks which such consumers face and reducing the administrative costs of providing them with cover. We are aware of initiatives taken by a number of housing departments to provide affordable contents insurance for tenants alongside measures to improve physical security and reduce risk.
- Many of those households that do not have home-contents insurance are also without access to a direct-debit facility. The scope for such people to pay premiums in weekly or monthly, affordable instalments is, therefore, substantially reduced. Research has shown that the cost implications of collecting premiums on the doorstep have led the majority of such suppliers to withdraw the service to restrict its availability. Home service companies and mutuals nevertheless continue to target the lower end of the market, in the absence of competition from remaining suppliers.

329 The exclusion curve for home-contents insurance (figure 5) shows a relatively rapid increase in take-up for incomes of less than £20,000, providing some evidence that



consumers do suffer income exclusion. In the light of our own survey data and that collected by Whyley, McCormick and Kempson, we would support their conclusion that:

The mainstream market for home contents insurance in Britain is more open and less segmented than we expected when we began this research project. We found little evidence of strategies to exclude low income households because of their address for example . . . The market is a highly competitive one . . . [but] the industry is missing out on significant business opportunities by failing to compete as keenly for uninsured households . . . The key to successful competition will often be to sell low-cost, simple products on a high volume basis. The most effective route appears to be through partnerships with intermediaries: credit unions, housing associations, and particularly local authorities. These serve as gatekeepers to a large majority of the uninsured.

- 330 The question of what might be done to encourage simple low-cost products and the growth of low-cost distribution channels capable of reaching low-income consumers is addressed in Chapter 7.

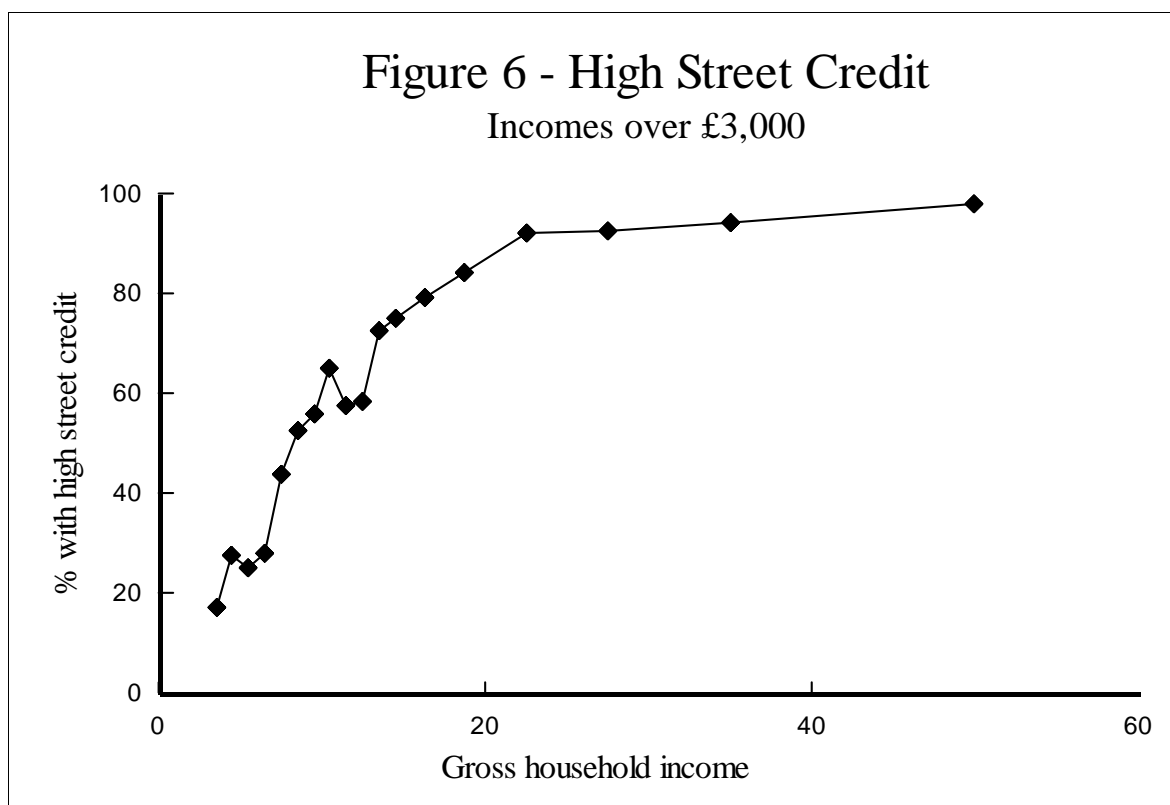
3.4 Short-term consumer credit

- 331 Consumer credit enables consumers to smooth consumption when income or expenditure varies, perhaps unexpectedly. The importance of this facility cannot be over-estimated. Credit markets allow an individual to reach a higher level of satisfaction in response to income changes. The desire to smooth consumption in this way is very strong.¹
- 332 Consumers on low incomes commonly rely on credit to buy essential consumer goods which many people take for granted. But their sources of credit are extremely limited. A recent report by the Monopolies and Mergers Commission (*The Littlewoods Organisation PLC and Freemans PLC (a subsidiary of Sears plc)*, MMC, 1997) drew attention to the fact that mail order was an important source of credit for those on low incomes.
- 333 Assessment for mainstream credit has changed over the last 10-15 years. The use of credit-scoring systems is now commonplace. Credit offers are frequently 'subject to status'. Computer-based systems use statistical techniques to predict the likelihood of applicants actually repaying a loan. Applicants complete questionnaires with details of their address, marital status, employment, housing tenure, credit history, existing commitments, and other personal data. A bank will weight the responses according to

1 Shocks to income can be unexpected, as in *Permanent Income type* models (Friedman, 1957), or predictable, as in *Life-Cycle* models (Ando-Modigliani, 1963).

information about past debtors to arrive at a total score. If the total is greater than a prescribed number the application is successful. Individual providers prefer this system of rationing credit to raising the interest rate charged for those applicants who are perceived to represent a higher risk,¹ leaving such higher-risk consumers to others bodies that charge higher rates of interest. The market tends to be segmented, according to the nature of the business undertaken, for example as between status and non-status lending.

334 As in the case of the other facilities they offer, the banks and other high-street sources of credit are moving away from serving the credit needs of low-income consumers. The shrinking branch network, a more systematic assessment of credit risks, and the imposition of relatively high minimum loan values have further reinforced this tendency. Alternative forms of credit for which risk is priced more individually, including non-status lending and even that provided by unlicensed loan sharks, have expanded to fill this need, but the exclusion curve for traditional forms of high-street short-term credit nevertheless suggests that there is significant income exclusion (figure 6).



335 Credit unions in the United Kingdom are mutual savings and loan institutions that are owned and run by members who share some common bond - such as working for the

1 Moral hazard and adverse selection have been extensively looked at in the literature (see, for example, Stiglitz and Weiss).

same employer. Members save by subscribing for non-transferable shares deposited with the credit union. Members may take out loans, typically up to £5,000 in excess of their share holding, at a maximum interest of 1% a month. Research has shown that membership is relatively small and is narrowly focused. There are currently around 600 credit unions with a total membership of 200,000, mainly in the North of England and in Scotland. New registrations average 50 a year. HM Treasury has recently unveiled a package of reforms aimed at boosting their coverage. They include measures to allow credit unions to borrow from external sources and to offer interest-bearing accounts. In the context of the present inquiry, however, the question that has to be asked is not so much whether they can increase membership, but whether they can make serious inroads into financial exclusion.

336 A new form of mutual body has been proposed in a recent Demos report by Leadbeater and Martin (1998). This is the employee mutual, which would help people, particularly those on low incomes, to find work, improve their skills, and help them to manage their working lives and personal finances. The authors argue that, by the year 2007, with government support, it would be possible to create a national movement of at least 250 employee mutuals, with a membership of half a million or more. If one accepts these projections, employee mutuals would appear to possess a greater potential than credit unions to provide low-cost distribution channels for low-income consumers. But, as the authors recognise, the way in which trade unions would respond to such an initiative is of vital importance. As set out, the current proposals envisage only a limited role for trade unions and, for that reason, they seem unlikely to secure union support. In our view, if the full potential for employee mutuals is to be exploited, this weakness in the proposals should be addressed.

337 Research on the problems of those on low incomes shows that the amounts of credit they require is generally small. The only practicable remedy for this apparent income exclusion is to encourage emerging and new forms of low-cost distribution. The key is whether such initiatives can reach the vulnerable. How this might be achieved is discussed in Chapter 7.

3.5 Long-term savings

338 To obtain the maximum gain from long-term savings consumers need to be able to save in ways which allow investment in equity markets and thus capture the significant equity premium, of around 6% compared with a risk-free rate of around 3% in real terms.¹ The implication of a premium of this size on the amounts generated by long-term savings is very significant: for example, investing £1 a year over a period of 40 years at 3% will accumulate to £75.40, but investing the same sum over the same period at a rate of 9% will accumulate to £337.98 - or 4.5 times more.

1 This means that the expected return on equity investment is the sum of the risk-free rate, 3%, and the equity-risk premium, 6% - 9% in total. For one considered view on the magnitude of the risk-free rate and the equity-risk premium, see Chapter 5 of *Equity - Gilt Study*, by Barclays Capital, 1998.

339 The Director General's report on pensions (1997) argued that the equity risk premium is most efficiently secured by investing in a passively managed fund. Not only is passive fund management less expensive than active fund management but, more significantly, it has the potential to avoid the high distribution costs associated with persuading consumers to invest in particular funds on the basis of what amount to specious claims about superior investment performance. The report also showed how exposure to equity risk could be improved by systematically reducing the proportion of the investment held as equities, as the savings mature. These arguments have some relevance to forms of long-term savings other than pensions. It is therefore notable that, while a requirement for passive fund management is not an explicit requirement in the Treasury's specification for the Cost, Access and Terms (CAT) standard for Individual Savings Accounts (ISAs), suppliers have commented that, given the proposed ceiling for management fees, passive fund management may be the only profitable way for suppliers to market equity-based ISAs. Such an outcome could have positive results for consumers on lower incomes.

4 FINANCIAL REGULATION

4.0 The present system in context

- 400 Regulation of consumer products carries a cost which, through the operation of the price mechanism in a competitive market, should ultimately fall upon consumers. From society's point of view, the costs of regulation should not outweigh the benefits. If this approach is not followed then regulation, however well-intended, will reduce consumption or exclude some products and their consumers from the market altogether.
- 401 Regulation may take the form of controlling the competence of those who supply goods or services, or it may circumscribe the way in which they may describe or supply their products. The regulation of suppliers may relate to the business unit as a whole, while individual practitioners may be required to demonstrate and maintain a certain level of professional competence. In practice, regulation frequently incorporates both elements. Those who are in control of a firm have to demonstrate fitness while those actively engaged in production and distribution have to pass some test of competence or be supervised by someone who will take responsibility for the product. Under the regulatory framework, there is normally provision for those businesses or individual practitioners who fall short of the required standards to be disciplined and for consumers who are damaged as a result of incompetence or maladministration - including the sale of unsuitable products - to receive some form of redress.
- 402 All such regulation sets up barriers to entering the markets affected. Only authorised firms may operate in certain trades or professions, and only suitably qualified individuals are allowed to undertake particular tasks. In some instances, regulation may work in ways that tend to favour incumbent suppliers to the exclusion of new entrants - although it is a common perception of businesses subject to regulation that they are over-regulated and of consumers that they are under-protected, relative to the social optimum.
- 403 Regulation may be statutory or it may be voluntary (self-regulation), and it may take the form of very precise rules or of general principles. Failure to follow regulations may have an effect on individual consumer contracts - for example, by making them unenforceable in the courts, or the subject of a claim through some other form of redress or means of resolving disputes. When suppliers persistently fail to meet the standards required of them, they may be subject to legal action, or the threat of the revocation of a licence or some other authorisation to trade.

4.1 Regulation in the United Kingdom

- 404 The system of financial services regulation in the United Kingdom is complex - and has been made more so by the proliferation of mechanisms set up both before and after the implementation of the Financial Services Act 1986. Under the terms put forward in the Financial Services and Markets Bill (FSMB), currently before Parliament, the greater part of this regulation will be brought under the control of the new Financial Services Authority. The main exception is consumer credit, which will continue to be regulated by the OFT under the Consumer Credit Act 1974.
- 405 There are a number of concerns that can justify the regulation of financial markets. A key consideration, however, is that such regulation is concerned with prudential matters: the stability of the financial system as a whole and, within that system, the stability of the individual suppliers of products, including banks, building societies, and insurance companies.¹ Such regulation manifests itself in requirements for minimum levels of reserves, solvency margins and so on, requirements which can be monitored on a regular basis to ensure that consumers are protected and that confidence is maintained. It extends to arrangements to protect depositors or investors in the event of insolvency. Examples are regulation under the Banking Acts and the authorisation procedures under the Insurance Companies Act 1982 and the Financial Services Act 1986.
- 406 Regulation concerned with selling practices and contract terms is less straightforward. The OFT research paper *Consumer Detriment under Conditions of Imperfect Information* specifically drew attention to financial services as a market where information problems could lead to consumer detriment. The complexity of the products on offer and the extent to which consumers rely on advice given by the supplier have provided the rationale for the introduction of a multiplicity of rules and regulations. In addition to general consumer protection law, the Unfair Terms in Consumer Contract Regulations 1994 (SI 1994/3159) regulate the wording of contracts to redress the imbalance between retailers and consumers, and the Consumer Credit Act regulates the provision of credit including by moneylenders, pawnbrokers and hire-purchase traders.
- 407 The Financial Services Act created a regime for both wholesale and retail markets which required authorisation and introduced the self-regulatory organisations (SROs) to which firms that offer different forms of financial services have to belong. The various SROs then made their own rules governing, for example, the information that must be provided on particular contracts, advertising, and the duration of the cooling-off periods allowed. This regime is now being altered to extend the potential scope of regulation and to unite all the regulatory bodies within the new Financial Services Authority.

1 This can loosely come under 'externalities': to the extent that problems of one institution can throw doubts on another, externalities and a justification of regulation exists.

408 *Polarisation* - a relatively fresh concept which developed from rules made under the 1986 Act - requires sellers of investment products to be either company representatives or tied agents, who can sell the products of one provider only, or independent financial advisers (IFAs), who can make recommendations from the full range of products that are available. For many financial products, distribution - getting the product to individual consumers - is a significant up-front cost component of every sale. The result is that sales with advice carry high up-front costs, which - on top of other distribution costs - are largely independent of the amount invested and hence represent a much larger proportion of relatively small savings or of irregular contributions. In evidence presented to the current inquiry, a number of smaller providers drew attention to the disproportionate effect that regulation imposed on them, and on the consumers they service. It is, however, beyond the scope of this report to investigate the efficacy of the consumer protection afforded by the regulation of selling practices.

4.2 The US Community Reinvestment Acts

409 The United Kingdom has no equivalent of the requirements laid on certain financial institutions in the United States to disclose information on the extent to which they serve particular social groups. Concerns about exclusion and the marginalisation of low-income communities in the USA have been addressed by active government policy. Its cornerstone is the Community Reinvestment Acts of 1977 and 1989 (CRAs), where banks, and savings and loan institutions have an affirmative obligation to meet the credit needs of the community, consistent with the safe and sound operation of the particular institution concerned.

410 In addition, in the USA, related legislation - such as the Home Mortgage Disclosure Act and the Fair Housing Act - covers the provision of mortgages and insurance. The US experience of such schemes is generally favourable: evidence suggests that most of the business undertaken is actually profitable. On the face of it, disclosure appears to be the driving force of the success of the CRAs. Legislation does not actually put any formal requirements on the banks as such. But by bringing the details of their lending practice into the public domain, the banks become subject to public scrutiny, monitoring by regulators, and other powerful incentives to take account of the needs of the community that might otherwise be neglected.

411 Whether such regulation would be a success in a UK context is uncertain. While the CRA experience may hold certain lessons for suppliers about the advantages that could accrue to them from supplying a wider range of consumers, these measures grew out of the particular social conditions of the USA in the 1970s. In our view, they are not a panacea for reducing exclusion in the different social conditions of the United Kingdom in the 1990s.

4.3 The costs and benefits of regulation

- 412 Guidance published by the Cabinet Office Better Regulation Unit (1998) and by the Treasury (1996) sets out broad criteria for judging the benefits of any system of regulation against its cost by means of a cost-benefit analysis. The draft Financial Services and Markets Bill requires the FSA to consider the degree of protection that is appropriate in particular circumstances, having regard to the differences in risk and the expertise of different consumers, and to publish cost-benefit analyses of its regulations.
- 413 Frequently it is incremental changes in an existing pattern of regulation that have to be addressed, rather than the setting up from scratch of a whole regulatory framework. In the field of financial services, while no-one would advocate a complete lack of prudential regulation, the task of identifying the level of regulation which gives the best balance is not an easy one. The impact of regulation on suppliers is often difficult to distinguish from normal or good business practice. While the conceptual issues are clear, the main practical problems relate to demonstrating any causal relationship between the practices which regulation requires and the resultant benefits to consumers.

4.4 The costs and benefits of the overall regulatory framework

- 414 The OFT commissioned Dr Paul Klumpes of the University of Lancaster to undertake an analysis of financial regulation in the United Kingdom and sought to reconcile the opposing perspectives of market failure and regulatory capture (and his study forms Appendix 2 of this report). Dr Klumpes uses a model developed by Becker (1983) to estimate the costs and benefits of regulating financial services in the United Kingdom over the past decade. According to Becker, individuals belong to particular groups - defined by occupation, industry, income, geography, and other characteristics - that are assumed to use political influence to further the well-being of their members. Competition among these pressure groups for political influence ultimately influences the equilibrium structure of taxes, subsidies and other political favours.
- 415 For three products - pensions, mortgages, and savings products - Klumpes analyses the direct and indirect costs and benefits, and welfare distribution effects. He finds that there are large transfers between interest groups, such as, for example, tax subsidies to product users from the generality of taxpayers. He also finds that consumers who use such products - particularly the wealthy - are directly subsidised by the generality of UK taxpayers, and that, in turn, intermediaries are subsidising the regulators through compliance costs.
- 416 The direct policy implication is that financial regulation in the United Kingdom needs to be rebalanced, with more resources being devoted towards low-income consumers - who, for one reason or another, do not have equal access to various products. The policy implication is further reinforced by Dr Vaughan's findings that more weight must be attached to regulation which helps low-income consumers.

417 In fact there are positive signs that this is beginning to happen. The inadequacies of tax-exempt special savings accounts (TESSAs) and personal equity plans (PEPs) as savings vehicles for those on low incomes were generally acknowledged long before the decision was taken to replace them with individual savings accounts (ISAs). In his paper, Dr Klumpes quantifies the large distributional transfers associated with TESSAs and PEPs between taxpayers and richer consumers. He finds that there is a considerable transfer of wealth, with more sophisticated consumers benefiting from the tax relief. The OFT believes that a policy response, similar to that adopted for savings, is needed for such financial products as pensions, insurance, and mortgages.

418 The need to redesign financial products, as has happened with savings, will doubtless become more important as the boundaries of the welfare state are redefined. The restriction of Income Support for Mortgage Interest (ISMI, the state benefit for mortgage payers), is one area where this is already happening - and which could well be subjected to analysis within the framework posited by Klumpes (and Vaughan). As the following section demonstrates, the restriction of ISMI has had considerable distributional effects as between taxpayers and low-income mortgagors, and this is consistent with a Becker-type approach. As Dr Vaughan argues (see Appendix 1), however, for there to be a proper economic appraisal of such distributional transfers, they should be *weighted*. An analysis within the framework suggested would seriously question such restrictions, and would conclude that regulation needs to be tailored more towards low-income borrowers.

4.5 The welfare state and financial services

419 Although the role of the welfare state is not generally seen to be a regulatory one in the sense that has been discussed in the present report, benefits *are* closely related to taxation and regulation. It is therefore convenient to cover them here. This section looks at the implications for vulnerable consumers of financial services in the light of a strategy of increasing self-reliance and the substitution of services that are provided on a commercial basis for those that have previously been supplied by the state. A prime example of this trend is private Mortgage Payment Protection Insurance (MPPI).

420 MPPI is designed to cover mortgage interest payments in the event of unemployment, or sickness or an accident which renders the policyholder incapable of work. In the present context, MPPI is of particular interest because entitlement to the state benefit for mortgage payers, ISMI, was restricted in scope in October 1995. It is possible, therefore, to make an in-depth examination of the effects of the contraction of welfare provision on MPPI itself - and the consequences for vulnerable consumers. Although this is merely one example, it raises a number of issues that would be relevant to the wider debate.

421 Prior to October 1995, home-owners with a mortgage who also claimed income support were entitled to receive half the interest payments for the first two months of a

claim and full support thereafter. Restrictions introduced from October 1995 meant that those who took out a mortgage before that date would no longer be entitled to ISMI for the first eight weeks of a claim. For the following 18 weeks, they now receive 50% of their mortgage payments in income support and, following that, full support. Anyone with a mortgage taken out since October 1995 has not been entitled to *any* income support for a period of 39 weeks, but does receive full support thereafter. Other conditions were introduced at the same time - for example, support would not be given for interest on loans of more than £100,000.

- 422 The take-up of MPPI does not appear to have increased following the changes to ISMI. Since April 1996, the pay-outs from MPPI policies have been tax free. There is no evidence that the previous upward trend has been influenced significantly by changes in ISMI (Ford and Kempson, 1996). At present, industry estimates suggest that between 20% and 25% of mortgagors have MPPI policies.
- 423 Any organisation providing insurance faces the twin problems of moral hazard and adverse selection. Thus, in cases for claims arising from unemployment, most providers insist on registration with benefit offices to offset any potential moral hazard that might arise. But the difficulty presented by adverse selection is harder to deal with. On MPPI products, there has been little risk pricing: regardless of the individual applicant's personal circumstances, most providers quote a flat fee per £100 of the monthly interest payments for which protection is being sought. Instead, they have attempted to confront the problems posed by adverse selection through exclusion. For example, most policies exclude anyone who has not been in continuous full-time employment for a certain period (typically six months) immediately prior to the application. But the practice of policy exclusion raises the spectre of mis-selling. Research suggests that a significant minority of claims have been denied on the grounds that - in the particular circumstances of those claims - the policyholders were excluded from cover.
- 424 Concern about low take-up has resulted in the development of a standardised product, designed to ensure that private provision dovetails with public provision. Thus there should be no gaps in protection, or overlaps where consumers are, at the same time, protected under the state and by private policies. The last point is important, because buying unnecessary cover involves paying higher premiums. Under the proposals that have been put forward, anyone who had not been in continuous full-time employment for a period of at least six months would continue to be excluded from MPPI cover. A disproportionately large number of those who fall into this category are, in any event, likely to be on low incomes. Where cover is provided, a waiting period of 60 days and a benefit period of 12 months have been suggested. The waiting period might be thought to be on the high side. Vulnerable policy holders might find it difficult to cover mortgage payments for two months from their savings alone.
- 425 Insurance which covers unemployment presents the problem that claims by policyholders in general are likely to be positively related. Risks cannot be pooled in

the same way as can many other risks. In periods of recession, large numbers of people are likely to be made redundant at the same time. Claims are likely to be both more numerous and for longer periods. In order that the providers can reflect the overall economic climate in the premiums they set, the projected standardised MPPI product would allow them to raise their charges after giving policyholders 30 days' notice of the proposed increases.

- 426 Doubts have been expressed about whether MPPI costing around £5 per month per £100 of mortgage monthly payments represents good value for money. In order to determine this point, research was undertaken by Burchardt and Hills (1997), who - using data from the British Household Panel Survey - compared the hypothetical cost of a policy which offered full protection against one covering unemployment only. Various restrictions were imposed that were similar to, or more generous than, those featured in many existing policies. Allowance was also made for the six-month continuous-employment provision. At a time when the industry average for MPPI cover was £4.02 per £100 covered per month, the figure calculated for the hypothetical product was £1.77. There is some empirical support for this latter figure. During the course of the present inquiry, we were advised that one building society provided MPPI for £1.50 a month, while another was reported as providing it free of charge (although the costs were doubtless recovered elsewhere).
- 427 At present, most MPPI policies are sold by mortgage lenders at the same time as the mortgage is arranged. It is possible that, were other insurers to enter this market, premiums would become more competitive, while they might also pay greater attention to risk differentials as an alternative to the imposition of exclusions. But the effect of the economic cycle on risk might well deter entry. For consumers, those at greater risk of unemployment or sickness might find themselves being asked to pay higher premiums rather than being excluded from the market by policy terms. Although such a solution would be more efficient in overall economic terms, those at a high risk who were also on low incomes could still find themselves effectively excluded - but by cost rather than through a refusal to supply.
- 428 Public insurance schemes in the United Kingdom are funded by national insurance contributions and tax receipts. As such, public insurance tends to be funded proportionately or progressively - the sums paid by individual contributors are proportionate to their income (and may even increase disproportionately as incomes rise). But private insurance, as previously noted, is priced according to risk. Thus, even if risk were spread evenly over the population as a whole, a move from public to private insurance would tend to be regressive. If risk is skewed towards lower-income groups and private insurers are able to reflect that, either in the premiums they charge or through exclusions, a move from public to private insurance coverage will become still more regressive. Research indicates that there will be a net transfer from mortgagors to tenants, outright owners, and non-householders, because it is solely mortgagors who would fund a private scheme. Furthermore, lower-income employees - those in the bottom quintile - are twice as likely to lose their jobs than those in the

top 25%. The common MPPI exclusion of individuals who have not been in continuous full-time employment for six months therefore affects low-income mortgagors disproportionately.

5 DISABILITY

5.0 Background

500 For a variety of reasons, many consumers with a disability who want to purchase financial services find it more costly than others to obtain and assimilate the information they need. In many cases, they face access problems. For example, banks and other premises may have no wheelchair access nor facilities to help the hard of hearing or the partially sighted. And the services offered may be unsuitable for disabled people or simply more expensive *because* of their disability.

501 According to the latest estimates from the Office of National Statistics (ONS), more than half of the long-term disabled are 'economically inactive' - that is to say they are not participating in the labour market for one reason or another (ONS, 1998). While, in principle, the spread of new technology in the workplace would appear to offer many disabled people improved employment prospects, there are barriers that currently prevent the realisation of that potential- as has been pointed out by Barnes, Thornton and Campbell (1998). Such barriers include a lack of emphasis on new technology by major funders of employment initiatives, inappropriate training schemes that provide skills which are too basic to meet employers' requirements, and negative attitudes on the part of work colleagues and employers.

502 To the extent that disabled people also have low incomes they are likely to experience the same problems as any other consumers on low incomes. But, in addition, the long-term disabled tend to have higher living costs as a direct consequence of their disability. There are broadly two types of disability-related expenditure: disability-specific, such as wheelchairs, and disability-enhanced, such as medicine (Disablement Income Groups, 1998). A survey carried out by the Sheffield Citizens Advice Bureau Debt Support Unit (1995), found that sick and disabled people were likely to have experienced difficulties with credit. A vicious circle may emerge: difficulties with credit lead to poverty, leading to an increased need for credit. These situations can be exacerbated by the actions of creditors, betraying a lack of understanding disabilities.

5.1 Evidence of exclusion

503 The experience of disabled people can be analysed in qualitative and quantitative terms. This report has pointed to the link that exists between the possession of a current account and access to other financial products. We were therefore disturbed to find that, according to our consumer survey, 21% of disabled people did not have an active current account, compared with only 4% of those who were not disabled.¹ Following on from this, it was therefore scarcely surprising to find that disabled

1 The registration of disabled people under the Disabled Persons Act ceased on the introduction of the employment provisions of the Disability Discrimination Act on 2 December 1996.

people were less likely to own a wide range of financial products, relative to the national average. Twenty-nine per cent of those who were disabled did not have home contents insurance, compared with 10% of the able-bodied. Disabled people also had a lower take-up, relative to the national average, of high-street credit, Post Office savings schemes, and other insurance products. While these findings may be partly explained by the disproportionate number of disabled people who fall in low income groups, that is insufficient to provide a complete explanation of the effects that were observed. For example, of the survey respondents who were defined as having 'very low' income, 56% of those who were not disabled had active current accounts, compared to just 39% of those who were.¹

- 504 An earlier survey by the Royal National Institute for the Blind (RNIB) highlighted the dissatisfaction felt about key financial services by disabled consumers. For example, 75% of respondents expressed substantial dissatisfaction with formats suitable for sight-impaired consumers for insurance policy documents (RNIB, 1997). Plainly, insurers could learn from banks and building societies who scored an 85% satisfaction rating for the same question. Our own survey of providers found that one of the few areas where respondents were able to provide a 'yes' answer was in the provision of braille and large-print brochures. On the other hand, only 5% of ATM users in the RNIB survey were satisfied with their accessibility.
- 505 The code of practice on Part 3 of the Disability Discrimination Act (see section 5.2) states that 'insurers will be able to justify less favourable treatment only if it is based on actuarial or other statistical data or other information on which it is reasonable to rely'. Meetings with interested parties provided the OFT with much anecdotal evidence on the everyday problems that many disabled people face with financial services, particularly with life insurance. It was suggested to us that insurers discriminate against disabled people in ways which are not actuarially justified by differences in risk. One case brought to our attention concerned an individual with intermittent Multiple Sclerosis (MS) who had been offered unfavourable terms for life assurance, even though the condition did not affect the would-be policyholder's expected lifespan. The actuarial data used to justify these terms were more than 50 years old. The use of a blanket approach to various illnesses - such as cerebral palsy - is a cause for concern. We believe that, while it is legitimate for insurers to discriminate on the basis of disability, they should make every effort to distinguish between serious and less-serious conditions and apply relevant and up-to-date actuarial data when assessing the risk.
- 506 People with impaired vision face particular problems in relation to physical access and verification of transactions. The OFT is aware that some lenders insist that visually-impaired clients engage solicitors to witness signatures. This is inappropriate: the

¹ In principle, logistic regression should allow the effects to be analysed. Unfortunately, the sample size was too small to obtain meaningful results.

consumer's understanding of the document is not in question - it is simply their ability to read it.

507 These examples illustrate a few of the everyday problems faced by disabled people. The result is consumer detriment and income exclusion.

5.2 The existing framework and its shortcomings

508 Since December 1996, the Disability Discrimination Act has placed a duty on service providers not to discriminate against disabled people. Although it has acknowledged that the legislation is flawed in some ways, the Government has resolved to implement the rights set out in Part 3 of the Act, since they will be of some immediate benefit to disabled people seeking access to goods, facilities, and services. But this is seen as a holding operation until such time as the Disability Rights Commission comes up with recommendations on how to establish the comprehensive and enforceable rights for disabled people to which the Government is committed.

509 The rights of access implemented initially under the Act made it unlawful to treat a disabled person less favourably than other people. The subsequent extension of these rights, however, will require much more of businesses, wherever it is reasonable, and where such action would enable disabled people to use the services on offer, to adjust the way they provide their goods, facilities, or services. The Government announced on 9 June 1998 that the new provisions are to be introduced in two stages:

- **First stage** - From October 1999, the providers of services will be required to make reasonable adjustment to their existing policies, procedures, or practices which exclude disabled people. One example is the exclusion from restaurants of blind people with guide dogs through the rigid application of a 'no dogs' policy. In order to facilitate access to their services, providers will also be required to have available auxiliary aids and facilities - such as the provision of information on cassette and the installation of induction loops. And, where there has been a physical barrier to supplying the service provided, they must find a reasonable alternative method of delivery - if a surgery is inaccessible for a disabled patient, for example, a GP could arrange to visit;
- **Second stage** - From 2004, service providers will have to have taken reasonable steps to have removed, altered, or otherwise avoided any physical barriers that had previously prevented access by the disabled. The installation of wheelchair ramps in premises which are currently accessible only by steps would be an obvious example.

510 In the course of our survey, we approached a wide range of financial service providers and asked them how they would be responding to the requirements of the Act. While it was clear that much useful work had been undertaken and more was planned, in our view there remain a number of areas to which insufficient attention has yet been paid.

Some of them - such as the more extensive provision of cash points suitable for the visually-impaired, wheelchair access to bank branches, and other aids for disabled consumers - will doubtless be addressed when section 21 of the Act is implemented. In particular, this section should improve the accessibility of a range of products to those who are visually-impaired - and who are perfectly capable of understanding agreements but who currently have difficulty in reading them.

511 In guidance issued in 1995 by the Department for Education and Employment (DfEE), suppliers were advised that 'if someone is legally appointed to act on behalf of the disabled customer, for example under a power of attorney, you could not treat that person less favourably under the Disability Discrimination Act simply because the disabled person could not understand the agreement'.

5.3 The way forward

512 In its application to financial services, the wording of the Act is somewhat generous to suppliers, and indicates that discrimination can be justified in the following limited circumstances.

- The Act allows suppliers to discriminate in order to secure the health or safety of any person, including that of the disabled person. Spurious health and safety reasons provide no defence against non-compliance.
- Suppliers are not required to contract with disabled persons who are incapable of entering into a legally enforceable agreement or of giving their informed consent. But any such a refusal should be reasonable and based on clear evidence.
- Suppliers may be able to justify refusing to serve particular individuals, or providing them with a lower standard of service, if the service that can be provided to other customers would otherwise suffer.
- While it would normally be unlawful to charge the disabled more than anyone else for the same service, it can be justified where the service is individually tailored to a customer's needs and the particular requirements of the disabled person resulted in increased costs.

513 Consequently, if, *in the opinion of a supplier*, a potential deal meets certain conditions - as when it is thought that it would cost more to accommodate a disabled person than someone who is able-bodied - discriminatory treatment is held to be justified. If that opinion is wrong, however, suppliers have been advised that they 'are not expected to be an expert on disability. The courts will accept your decision if you genuinely believed one of the reasons applied and it was reasonable for you to do so'. This could provide suppliers with the opportunity to dispute matters rather than complying with their obligations. Similarly, in the case of insurance, the Act states

that an insurer can charge a disabled person a higher premium if it has reliable information that individual represents a higher level of risk. But there is no obligation on the insurer to disclose this information to the prospective policyholder.

- 514 The Act's imbalance between suppliers and disabled consumers is also reflected in the absence of any requirement that suppliers should undertake any staff training. As explained in paragraph 509, the Act requires the providers of services to install auxiliary aids (such as induction loops to assist the users of hearing aids), but says nothing about whether staff should be trained in their use. For example, it has been put to us that 'it is rarely understood that loop systems make a conversation available to anybody wearing a hearing aid who happens to be in the room'. Without suitable training for staff operating such systems, the privacy of disabled consumers could be severely impaired. Service providers are nevertheless responsible for the activities of their staff insofar as they may fail to implement the provisions of the Act.
- 515 The OFT supports the Government's proposal, put forward in a recent White Paper (DfEE, 1998), for the establishment of a Disability Rights Commission (DRC) along similar lines to the Commission for Racial Equality and the Equal Opportunities Commission. The suggestion that the DRC should be responsible for arranging and monitoring an independent conciliation service to ensure that the disabled do have access to goods, services, facilities, and premises is particularly welcome. We also hope that the DRC will work with the insurance industry to promote good practice, as part of its specific function to provide a central source of information and advice to disabled people, to business, and to the public and voluntary sectors.
- 516 The DRC would be even more effective if it had sufficient powers and resources - including the necessary technical expertise - to investigate the actuarial information insurers use to adjust the quotations they give to disabled consumers. The conduct of insurers is regulated by voluntary codes of conduct and guidance issued by the Association of British Insurers (ABI). In our view, these codes and guidance should require the actuarial information on which decisions are based to be reliable and up to date. Self-regulation could only be strengthened if the DRC were given explicit powers to challenge, on an industry-wide basis, such actuarial information and the interpretation placed upon it.

6 FINANCIAL SERVICES AND ETHNIC MINORITIES

6.0 Background

600 Existing legislation is very clear about the provision of financial (or indeed any) services to ethnic minorities. Section 20 of the Race Relations Act 1976 states:

it is unlawful for any person concerned with the provision (for payment or not) of goods, facilities or services to the public or a section of the public to discriminate against a person who seeks to obtain those goods, facilities or services.

But even where there is no overt racial discrimination, in the field of financial services there are a number of reasons why it might be expected that non-white groups could face more problems than those who are white. The OFT research paper on consumer detriment pointed to the fact that the search costs of shopping around for information are higher for individuals who do not readily understand English - a particular problem for those (of whatever race) for whom it is not their first language. In the case of financial services, which tend to be complex in nature and prone to the use of jargon, the inherent language problems can be exacerbated. Moreover, much of the information that is produced by the industry assumes a basic knowledge of UK institutions which even second-generation ethnic minorities may not have acquired.

601 Consumer detriment associated with ethnic origins is not confined to the provision of information. Much also depends on how the providers of services use the information they have about their potential customers and whether individual customers would get a different response if they were a member of an ethnic minority. Much will depend on the way the supplier has been contacted in the first instance and on such factors as the extent to which a particular minority is represented among the supplier's staff.

602 This report has described how low incomes and volatile incomes are inter-related, and how they can expose consumers to detriment. Some ethnic minorities tend to be over-represented in semi-skilled and unskilled manual jobs, part-time jobs and in low-income groups. For example, the Labour Force Survey (1994) found that, on average, Indian and black males earned 10% less than white males, and Pakistanis and Bangladeshis one-third less. There is also a high proportion of lone parents - over 45% - among Afro-Caribbeans, who tend to be in low-income groups. A more recent analysis by Richard Berthoud, published while this report was in preparation, produced some very similar findings (1998). It is certainly possible, that because of a general perception that their economic position is insecure, that many members of

ethnic groups are viewed by suppliers as a high risk when it comes to the sale of such services such as credit or insurance.¹

6.1 Evidence

- 603 The primary objective of the research described more fully in Appendix 5 was to focus on the difficulties that certain ethnic groups, particularly those on low incomes, experience with financial services, and to evaluate those difficulties in qualitative terms. There were three inhibiting factors that stood out as being of particular importance: institutional, cultural, and economic.
- 604 The significance of cultural factors came out in several ways. Muslims abide by the rules of *Halal* which forbid interest to be given or taken on loans of money. Our study confirmed the cautious approach that, on religious grounds, Muslims take to interest-bearing credit, and which was noted by Gildon (1992). Another important factor - particularly when it comes to understanding decisions on pensions and attitudes to the sources of credit - is the extended family. Moreover, to the extent that some members of particular ethnic minority groups intend to return to their country of origin when they retire, they may not choose to invest in, say, a pensions scheme which is based in the United Kingdom.
- 605 Economic and institutional factors were found to be important. While some survey respondents saw themselves as being particularly vulnerable to exclusion because of their economic status within the community at large, it was more worrying to find that others believed themselves to be disadvantaged in otherwise similar circumstances by comparison with members of the white community. There was a widespread feeling that financial institutions did not understand or trust ethnic groups. A typical response was: 'they ask you more'. There was also a clear perception that members of ethnic groups were more likely to be asked for identification than white people. The research also highlighted the importance that the members of some groups attached to having a mortgage and the reluctance of others to buy life insurance and pensions.
- 606 The focus group work revealed, in a way which simple numbers cannot do, some of the everyday problems ethnic minority groups faced when dealing with financial products. It was evident that ethnic groups as a whole saw themselves as disadvantaged in comparison to the white community when dealing with financial products. Ethnic minority members believe that they pay higher premiums than they should for home contents insurance because of the inner city areas in which many live and because of perceptions of them on the part of insurance companies. (For an in-depth analysis see Appendix 5.) The picture is, however, more complicated than this.

1 This is, of course, a very sweeping statement. There is evidence of second-generation ethnic minorities moving up the socio-economic scale. The numbers in professional occupations and with children in private-sector education are increasing (Adonis and Polland, 1997: see also Berthoud, 1998).

Ethnic groups are not homogeneous. Whilst there are cultural, institutional and economic similarities, there are also differences between them.

- 607 There was a general feeling of a 'lack of understanding'. A typical response was that 'colour made a lot of difference'. Many respondents were convinced this was due to straightforward prejudice, although this was to varying degrees. While some felt they had 'black' stamped on them, others were prepared to believe that 'out of ten people a lot won't be prejudiced'.
- 608 Inadequate spoken English also came out as a barrier to owning a financial product. The jargon-filled nature of many financial contracts intensified this problem. There were particular concerns about the 'diplomatic language' that providers used. One respondent differentiated between normal or everyday English and a higher, more formal, English. Not surprisingly this affected consumer confidence when dealing with financial matters though it is fair to point out that such problems are not unique to particular ethnic groups.
- 609 While cultural problems came out strongly, the economic position of many ethnic groups was just as important. Typically, respondents had similar problems to other low income groups, with many feeling that products were biased towards those with higher incomes. This was a concern voiced by many Afro-Caribbeans, particularly women. In many cases language was not the problem, but money was. The need for flexible products came out strongly: 'when you are unemployed you should be able to pay less' was one concern. In particular, members of ethnic minorities see buying life insurance as a risky business. Saving is a high priority for many ethnic minority members but there is tendency to feel constrained to straightforward savings accounts. In part this was a reaction against the more complex products. Again whilst such problems are in no way peculiar to ethnic groups, there was an underlying suspicion based on experience of discrimination generally.
- 610 Our consumer survey confirmed that non-white groups had lower consumption of a wide range of financial products, compared with white groups. Only 18% of the population as a whole had no home contents insurance, compared with 47% of the non-white population. Similarly, 43% of the non-white population had no savings account, compared with only 20% of the white population. Kempson and Whyley (forthcoming) also find that members of ethnic minorities make comparatively little use of such common financial products as pensions and insurance. They report that only 6% of whites have no financial products, compared with 16% of blacks and 14% of Pakistanis and Bangladeshis. Nevertheless, they believe that these figures can largely be explained by the social background of the ethnic groups, rather than discrimination per se. Herbert and Kempson (1994) came to similar conclusions. They concluded that 'the Afro-Caribbeans, Pakistani and Bangladeshi groups were remarkably similar to other low-income households in the population as a whole, both in their level of borrowing and in their reasons for doing so'. Nesbitt (forthcoming)

finds a worryingly high degree of ignorance about pension decisions among ethnic groups by comparison with a control group of otherwise similar whites.

611 Taking our survey findings as a basis, we undertook a statistical analysis (regression analysis) to allow us to control for such factors as low income. This indicated that ethnic status was not a significant variable in predicting whether an individual had insurance or savings products. But it *was* a significant variable in explaining whether or not individuals were likely to receive a sales approach - the odds were much lower for those who belonged to an ethnic minority group.

6.2 Interpreting the findings

612 The OFT believes that, in a competitive market, it would be extremely difficult to discriminate systematically against individuals solely on the grounds of ethnic origin when assessing credit and insurance risks for an institution. Insurance premiums and access to credit are calculated using increasingly sophisticated risk-assessment methods. As ethnic minorities make up a disproportionately large element of low-income groups, it might be expected that they would have greater difficulty in gaining access to financial products. This would not, however, amount to 'discrimination' in the traditional sense, but would simply indicate that there was much less competition for their custom. Recent research (Dorset, 1998) analysing the geographical distribution of ethnic minorities in the United Kingdom underscores the popular perception that ethnic groups tend to be over-represented in poorer areas: Pakistanis and Bangladeshis, in particular, are more likely to live in deprived wards.

613 Research by the National Fair Housing Alliance in the USA found that most homes in African-American and Latino neighbourhoods were virtually excluded from insurance coverage. There was evidence that companies' marketing practices were designed to avoid doing business in racially and ethnically identifiable neighbourhoods, and that premiums appeared to be based at least in part upon the racial make-up of the neighbourhood and not on the risk presented by the property. This is consistent with our regression analysis that finds that ethnic groups in the United Kingdom are similarly less likely to be approached with offers of financial products.

614 The OFT believes that the increasingly sophisticated methods of risk assessment in use today indirectly present ethnic groups with a number of problems. If, say, as a result of the experiences of friends and family, minority groups sense that they are typically perceived as high risk, they may choose not to apply for such products, on the assumption that they would be automatically excluded. They may well feel that they will be discriminated against because of their colour, rather than because of their financial situation. If these kinds of problem are not to be exacerbated, suppliers must consider providing would-be customers with a proper explanation of how credit scoring works.

- 615 Without such clarification, a vicious circle is likely to emerge. Since comparatively few members of ethnic minority groups apply for mainstream financial services, the suppliers of such services know very little about them and they turn to money lenders within their own community. Since they remain outside the financial mainstream, their credit rating does not improve.
- 616 It seems reasonable to suppose that any under-representation of ethnic minorities among the staff of financial institutions will also tend to underpin notions of discrimination on the part of prospective customers. Research by Herbert and Kempson (1994) and Kempson (1998) has shown that, in approaching such bodies, people prefer to deal with someone who belongs to the same ethnic group as themselves.
- 617 Research among ethnic minorities by the Policy Studies Institute has indicated a number of ways in which these groups rely on credit outside the social structure. Of particular interest are those informal systems of community-based credit among the Pakistanis and Bangladeshis in a number of deprived areas. Such systems depend on the functioning of a number of ethnic and cultural factors which are not unlike the *common bond* operating in a credit union. Taken together these allow for a system of relatively low cost credit to operate with an acceptable level of default. This prompts two questions: firstly, whether these arrangements in communities recently arrived in the UK will persist among second and third generations; and secondly, whether it would be possible to learn from these arrangements and build on them.
- 618 As many members of ethnic minorities have personal and social circumstances which make them poor risks for insurance and credit and are of limited interest to producers of services such as banks or savings accounts, considerable numbers of them experience broadly similar problems. Explanatory material often fails to take account of cultural factors which may inhibit understanding. Lack of access to financial products leads to a restricted choice set. The net result will be non-consumption (exclusion) or consumption of poor value services, most notably costly or inappropriate credit arrangements, including types from lenders outside the formal economy. There is evidence of a niche market of providers who arrange credit for people with limited knowledge of English (Kempson et al, 1994; Rowlington, 1994).
- 619 Many suppliers of financial services have systems in place which should ensure compliance with section 20 of the Race Relations Act 1976. More effort should, however, be taken not only to ensure that such systems are effective but to communicate this fact to ethnic minority consumers. As with discrimination against disabilities, FSA rules should ensure that providers take proper steps to eliminate and prevent discrimination against ethnic minorities.

7 CONCLUSIONS AND RECOMMENDATIONS

7.0 Striking the right balance

700 In determining who comprise vulnerable consumers, we have drawn on earlier research by OFT which identifies what is meant by consumer detriment and which groups of consumers might be particularly disadvantaged. This research recognised that there are limits to the information which consumers can assimilate, that these limits will vary between individuals and that just providing more information is not necessarily the answer to solving consumers' problems. Of particular relevance to financial services, the research pointed to situations where it might be preferable to seek to simplify the product on offer rather than attempting to educate the consumer in a number of very complex issues.

701 Low income is a unifying factor across many potentially disadvantaged groups. The fact that some consumers have low incomes is not a problem that we can address in this report. However, it is recommended that low income consumers should be given greater weight in policy and regulatory decision than is implied by their limited spending on the service concerned and the detriment, in simple cash terms, that they suffer. In making this recommendation, we note that there are precedents in government policy on health and safety. The recommendation could be effected by amending the guidance in *Appraisal and Evaluation in Central Government* (H M Treasury, 1997).

Recommendation 1: that, in assessing consumer detriment and applying Cost Benefit Analysis (CBA) to policy and regulatory initiatives affecting consumer welfare, not only the OFT but other government departments, regulators, and those responsible for self-regulation should give greater weight to the detriment suffered by low income consumers.

Further research is needed to improve the accuracy of estimates of the elasticity of welfare with respect to income which determines the appropriate weighting, but, as an interim measure, it is recommended that the weighting should be in inverse proportion to consumers' income.

702 Financial service providers have generally failed to respond to the growing volatility of incomes. In particular, savings products that require regular payments by the consumer often yield poor value if they are discontinued when personal circumstances change. The resulting losses are more likely to be incurred by lower income consumers. The clear need is for more flexible, low cost savings products that include provision for suspending contributions or waiving premiums when the consumer's circumstances change.

Recommendation 2: that, encouraged by the FSA, suppliers should make greater efforts to ensure that flexible products are available at reasonable cost.

Recommendation 3: that exclusion from key financial services be addressed both by provision of more suitable products and by encouraging institutions capable of reaching low income consumers to do so.

This last recommendation applies in different ways to the four services.

7.1 Basic banking services

703 There is a need for an account which would help consumers to manage modest resources on a tight budget. Developments in on-line services make it possible to eliminate the consumer's exposure to the risk of overdrawing and incurring substantial charges. Thus it is now possible to conceive a low cost account providing money transmission services (sending and receiving). The Banking Code might be employed to specify such an account.

Recommendation 3.1: that banks and building societies offer a basic, on-line, low cost current account on which it is not possible to incur high charges for unauthorised credit.

704 Such accounts should be widely accessible in a way in which accounts serviced through the existing bank branch network or at home by telephone are not. Post Offices are both more numerous than bank branches and more evenly distributed geographically. But the high cost of present paper-based systems in handling transactions precludes such systems from delivering what low income consumers need. The provision of on-line banking services in post offices, whether on an agency basis or directly by the corporation could meet this need. Such services might be provided in conjunction with ways of reducing the administrative cost of a wide range of other transactions, including the payment of social security benefits.

705 In principle, any retail outlet with on-line access would be capable of delivering such services, but only outlets with a presence in areas close to our vulnerable groups would have any serious impact. Most existing (non financial) retailer-based banks do not as yet provide a full range of banking services. Further technological developments, such as electronic purses, ATMs which are capable of delivering a wider range of services, and telephone or interactive TV banking may also facilitate low income access provided they are more user friendly than existing facilities. However, unless the penetration of these developments is almost universal, there is a risk that exclusion could actually be widened.

Recommendation 3.2:

- a that banks and building societies offer access to the basic, on-line, low cost current account through post offices and other retailers;**
- b that the potential for post office counters automation, including any developments to enable electronic payment of social security, to provide on-line, low cost current accounts be examined.**

7.2 Home contents insurance

706 New distribution channels are needed if home contents insurance is to reach low income consumers. In addition, terms should be more appropriate to low-income consumers, including lower minimum sums and with payment options more suited to weekly budget cycles. The question of encouraging new forms of distribution that can meet the needs of low-income consumers is discussed below. A number of social housing organisations already provide access to such policies, often in conjunction with measures to improve physical security and thus reduce risk. There is scope for extending this far more widely. As with bank accounts there is a potential for the development of local access through on line services.

Recommendation 3.3: that in addition to retail outlets (see recommendation 3.2), operators of social housing consider arranging contents insurance for their tenants.

7.2 Short-term credit and short-term savings

707 Access to a bank account also provides access to short-term credit and short-term savings facilities, both by establishing financial standing and providing a ready means of making payments. Those who rely on cash have to rely also on a restricted range of credit which exacerbates problems of managing on a tight budget. They are not looking for extensive credit, indeed many would prefer to manage without it. Opportunities for saving may also be limited. There is a potential for credit unions, and the informal arrangements used among some ethnic minorities to be expanded. However many of these are dependent on local initiatives, the establishment of common bonds and a community of interest. For that reason they seem unlikely to have a widespread impact.

7.3 Long-term savings

708 Chapter 4 examined the impact of regulation on vulnerable consumer groups. While not suggesting that consumer financial services should be deregulated, there should be a hard look to establish those aspects of regulation which deliver worthwhile benefits in terms of both overall confidence and the protection of individual consumers. This particularly applies to the regulation of long-term savings products which may have increased fixed costs in ways which impact disproportionately on those with low or volatile incomes (see recommendation 4).

709 The OFT's Pensions Report recommended the use of passive methods of fund management as a means of widening access to the equity premium. The introduction of ISAs and proposed Stakeholder Pension provide an opportunity to move in this direction. Realistically, neither ISAs nor Stakeholder Pensions seem likely to fill the needs of those on the very lowest incomes. Their success in serving the needs of the other vulnerable groups described in this report will depend in part on improving access to the essential gateway of basic banking services.

Recommendation 3.4: that government and regulators facilitate access to the equity risk premium by encouraging passively managed funds and, where possible, discouraging the sale of actively managed funds to low income consumers.

7.5 New distribution channels

710 There is a wider role for existing retail outlets, with a potential to overcome income exclusion from financial services, including an expanded role for post offices.

711 There is a potential for credit unions to have a wider role in delivering financial services to vulnerable consumers, although the need for a community of interest or common bond and the limited extent to which they do this at present suggests that this potential could be limited. Nevertheless, any obstacles to this wider role should be identified and, where practicable, removed.

Recommendation 3.5: that obstacles to credit unions delivering financial services to low income consumers be identified by government and, where practicable, removed.

712 Employee Mutuals are a new form of mutual body recently proposed by Demos. They would have the potential, given government and trade union support, to reach large numbers of low income consumers. The proposals do, however, envisage only a limited role for trade unions and, for this reason, seem unlikely to achieve this.

Recommendation 3.6: that the potential, with appropriate trade union participation, for employee mutuals be evaluated by government and trade unions, not least in relation to their potential for delivering low-cost financial services to their members.

7.5 Regulation

713 Regulation places a disproportionate burden on products with low premium or contribution rates. Significant parts of regulation impact on the process of selling financial products and add to the up-front costs which fall disproportionately on low contribution or low premium products. The Pensions Report pointed to a potential to

reduce the level of regulation where products can be simplified. Provided their design is suitable, we see no reason why ISAs and Stakeholder Pensions should not be available with lighter regulation.

- 714 There is evidence that regulation is not adequately reflecting the interests of many of the vulnerable groups covered by this report. The Financial Services and Markets Bill require regulation to be proportionate to the problems which it seeks to address.

Recommendation 4: that in reviewing and consolidating rules and regulations inherited from the previous self-regulatory regime, FSA seek to identify those elements which add value to consumers, and the needs of low income consumers and those who, because of low income, do not consume the services, are not overlooked.

- 715 UK legislation to implement the EC Money Laundering Directive is claimed to be having a disproportionate effect on vulnerable consumers by increasing the cost of, and in some cases actively discouraging, the opening new accounts, for example by requiring documentation which some vulnerable consumers have been unable to provide. Accepting the need to combat financial crime, it would be timely to examine the operation of the implementation of Directive.

- 716 Changes in the pattern of welfare provision under which individual insurance is substituted for state benefits could widen the set of 'essential' financial products. An example already in place is provided by changes to income support for mortgage interest (ISMI) and increased reliance on mortgage payment protection insurance (MPPI).

7.6 Disability discrimination

- 717 Financial service providers have generally responded well to the Disability Discrimination Act (DDA), but more remains to be done. Powers to challenge discrimination need to be strengthened.

Recommendation 5: that the new Disability Rights Commission is given powers to investigate action taken under the DDA Section 21, and to investigate actuarial information used by insurers to give quotes for disabled consumers; and that the ABI should ensure through codes of practice that this information is reliable and up to date.

7.7 Ethnic minorities

- 718 Ethnic minorities can face all of the problems in the provision of financial services experienced by others with similar circumstances (employment status, income, family structure etc). Nevertheless our research and research by others has identified that many ethnic minorities feel strongly that they face additional problems. Financial service suppliers, including intermediaries, need to implement a formal compliance

procedure to ensure non-discrimination at the point where decisions are taken. We are, however, not persuaded that disclosure similar to that required in the USA under the Community Reinvestment Act is required.

Recommendation 6: that suppliers have procedures in place to ensure compliance with non-discrimination on grounds of race; that minimum standards be underwritten; and that compliance be monitored under existing codes of practice issued by the ABI, the British Bankers Association and the Council of Mortgage Lenders, and under rules and regulations issued by the FSA.

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