

A graphic of four hands in different colors (green, red, orange, and blue) reaching towards the center of the page. The hands are stylized with a textured, slightly distressed appearance.

Gateway to **Affordable Credit**

Report of the Affordable Credit Working Group



CHANGING MINDS • CHANGING LIVES

About The Carnegie UK Trust

The Carnegie UK Trust works to improve the lives of people throughout the UK and Ireland, by changing minds through influencing policy, and by changing lives through innovative practice and partnership work. The Carnegie UK Trust was established by Scots-American philanthropist Andrew Carnegie in 1913.



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Contents

Chairs' Introduction	2
About the Affordable Credit Working Group	4
Visual Executive Summary	6
Executive Summary	8
Summary of Recommendations	13
1. Outcome Statement	14
2. Principles to guide the Outcome Statement	21
3. Understanding the non-mainstream credit market and models	23
4. Developing the business models of community lenders	30
5. Securing investment in affordable credit	39
6. Brokering partnerships to deliver affordable credit and build financial inclusion	43
7. Recommendations to achieve the Outcome Statement	48
8. Summary of recommendations	57

Chairs' Introduction

The right to borrow money, whether we use credit cards, overdrafts, car loans or mortgages, is one that many of us take for granted. Access to credit in Scotland is not, however, a level playing field. For decades, many of the poorest members of our society have been unable to borrow money through the same channels as the majority of the population. Low incomes, a lack of credit history and limited take-up of other financial products, such as bank accounts, have been impenetrable barriers to mainstream borrowing for many citizens. Instead, those who are excluded often turn to high-cost alternatives, such as doorstep lenders or payday loans to meet their credit needs. As a result, credit is most expensive for those who can least afford it, compounding the financial inequalities in our society.

Our vision

The vision of the Affordable Credit Working Group is that everyone in Scotland, wherever they live, should have access to more affordable forms of credit, which reduce the cost of borrowing for those outside of the mainstream, support financial inclusion and promote equality and fairness.

Our report presents a route map for how this can be achieved. Our findings are the result of intense discussion, debate and deliberation amongst our expert Group, comprising senior representatives from the public, private and charitable sectors.

It has been a great privilege to Chair these stimulating sessions and this process.

The prize on offer is significant. Reducing the cost of credit has the potential to save hundreds of thousands of pounds every year for people in our poorest communities. We want our report to be a call to action to all those who can make a difference.

We have sought in the report to present a thorough, realistic appraisal of the challenges to achieving our goal and provide ideas and suggestions about how these challenges might be overcome. Our package of recommendations, under the four categories of Leadership; Development and Investment; Partnership; and Insight, provide a framework through which change can be delivered.

A step-change is required in how public policy addresses access to credit. This is a complex, often emotive, issue that deserves serious attention and priority. We are recommending the creation of a national Affordable Credit Action Group to lead the change process. We are delighted that the Very Reverend John Chalmers has agreed to convene the Action Group, bringing a strong 'moral authority' to this often contested and sensitive policy issue. The role and leadership of government is also, of course, critical – both at national and local level. But these proposals cannot be achieved by one organisation or one sector alone. They will require collaborative working between many different organisations nationally and locally over a considerable period of time.

The need for practical action

We need more practical action to help deliver the changes that we seek. There is much good practice already in Scotland and this should be built upon. We are recommending the deployment of an additional development resource at national level, to provide a mechanism through which progress can be achieved on critical issues – bringing new investment to the community finance sector, brokering new partnerships with public partners and the financial service industry and supporting local areas to find the right affordable credit solutions for them.

Public, private and charitable organisations all have a stake in this agenda and have a critical role to play. It may be through the provision of premises for the delivery of affordable credit services; innovative investment models; or the development of clear referral pathways. Only through cross-sector cooperation can we achieve the outcomes that we want.

We recognise, of course, that achieving change will not be easy. Public policy has long grappled with whether, and how, it might deliver more affordable credit to our most disadvantaged citizens and communities. Indeed, there are some who argue that people with low incomes should not borrow at all. But it is a fact that people *do* borrow money, and often have an urgent, compelling need to do so. The challenge for public policy must therefore be to find the optimal arrangements for providing people with access to credit should they require it – while restricting access where it is not appropriate and never mistaking access to credit as a substitute for decent wages or decent welfare benefits.

The opportunity

We believe that the solutions lie in developing Scotland's successful credit union and Community Development Finance Institution (CDFI) sectors. These lenders offer alternative credit products on a not-for-profit basis to disadvantaged customer groups at far lower rates than the commercial non-mainstream sector. However, to date they have been unable to develop a viable, at-scale product offering and are barely visible on charts of non-mainstream loan volumes or customer numbers. They each face a range of barriers to growth, including the fact that it is inherently expensive to provide

small, short-term loans quickly to those with a poor credit history and limited resources. There is much that can be done. With appropriate development support, brokerage, partnerships and investment there is real potential for Scotland's community lenders to grow and flourish, delivering affordable credit to many more people across the country. We want to see more CDFIs, more credit union members and more investment from a range of sources in each of these sectors.

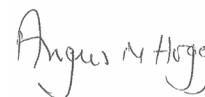
Scotland has a genuine opportunity to lead the way on this agenda in the UK. The forthcoming devolution of additional welfare powers, the ongoing work to create a Fairer Scotland and the range of wider financial inclusion initiatives already taking place provide an ideal framework for the growth of more affordable credit – and in turn, affordable credit has a critical role to play in supporting each of these policy agendas.

It is our sincere hope that this report, and the analysis and ideas presented in it, will provide the map through which these goals can be achieved and make a valuable contribution towards improving the financial wellbeing of our most disadvantaged communities.

A special acknowledgement goes to Douglas White, Head of Advocacy at the Carnegie UK Trust, for his insight and energy, and for expertly leading the drafting process on such a complex and contested policy area.



Jeremy Peat
Co-chairs, Affordable Credit Working Group



Angus Hogg
Co-chairs, Affordable Credit Working Group

About the Affordable Credit Working Group

The Carnegie UK Trust has been working to explore how to make affordable credit available to people across the UK. In March 2015 the Trust published a discussion paper, 'Meeting the Need for Affordable Credit', to widen public debate on this important issue. The report was presented to a roundtable of key stakeholders.

The publication of the paper led to the establishment of an Affordable Credit Working Group. The group was co-chaired by Jeremy Peat, OBE (University of Strathclyde International

Public Policy Institute) and Angus Hogg, MBE (Chair, Carnegie UK Trust) and comprises members with a wide range expertise from across the public private and charitable sectors.

The Trust convened four meetings of this group between May 2015 and September 2015. The meetings focussed on: investor models and mechanisms for developing and growing the not-for-profit community finance sector; investment; partnerships; and financial inclusion wraparound. This report has been informed by the content of these meetings.

Affordable Credit Working Group Members

Jeremy Peat, OBE (Co-chair)

Visiting Professor, University of Strathclyde, International Public Policy Institute

Jeremy spent 12 years as RBS Chief Economist and eight years as Director of the David Hume Institute. He remains a member of the Competition and Markets Authority. He had extensive experience working for the Scottish and UK Governments, including Scottish Office and HM Treasury, and worked internationally as an economist.

Niall Alexander, Financial Inclusion Consultant

Allison Barnes, Scotland Manager, Money Advice Service

Sharon Bell, Head, StepChange Scotland

Jamie Black, Consumer Affairs Manager, Royal Bank of Scotland

Kevin Cadman, Chief Executive, Grameen in the UK

Leah Cameron, Project Manager, Money Advice Scotland

Angus Hogg, MBE (Co-chair)

Chair, Carnegie UK Trust

Angus is Chair of the Carnegie UK Trust's Board and past Chair of Carnegie Dunfermline and Hero Fund Trusts. He was formerly a Managing Director of a manufacturing company and is a Business Consultant and Company Director and is a long standing Elder of the Church of Scotland.

Very Rev. John Chalmers, Principal Clerk to the General Assembly of the Church of Scotland

Sharon Collard, Professor, The Open University

Alastair Davis, Chief Executive, Social Investment Scotland

Martyn Evans, Chief Executive, Carnegie UK Trust

Russell Hamblin-Boone, Chief Executive, Consumer Finance Association

Joseph Henson, Senior Researcher, Centre for Social Justice

Karen Hunter, SRT Project Coordinator, Church of Scotland

Donald Jarvie, Head of Business, Scotland's Futures Forum

Rev. Dr. Martin Johnstone, Secretary, Church of Scotland's Church and Society Council

Yvonne MacDermid, Chief Executive, Money Advice Scotland

Dr. Murdo Macdonald, Policy Officer, Church of Scotland

Sharon MacPherson, Chief Executive, Scotcash

Susan McClelland, Deputy Chief Executive, Scotcash

Frank McKillop, Policy Manager (Scotland), Association of British Credit Unions Scotland

Eric Munro, Director of Community Finance

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Stephen Pearson, Senior Adviser, Virgin Money

Ray Perman, Director, David Hume Institute

Neil Ritch, Deputy Director Scotland, Big Lottery Fund

Michael Ross, Development Manager, Young Scot

Yvonne Strachan, Head of Equality, Human Rights and Third Sector, Scottish Government

Robert Tamburrini, Chief Executive, ng homes

Douglas Thomson, Consultant

Paul Vaughan, Head of Community and Corporate Development, Fife Council

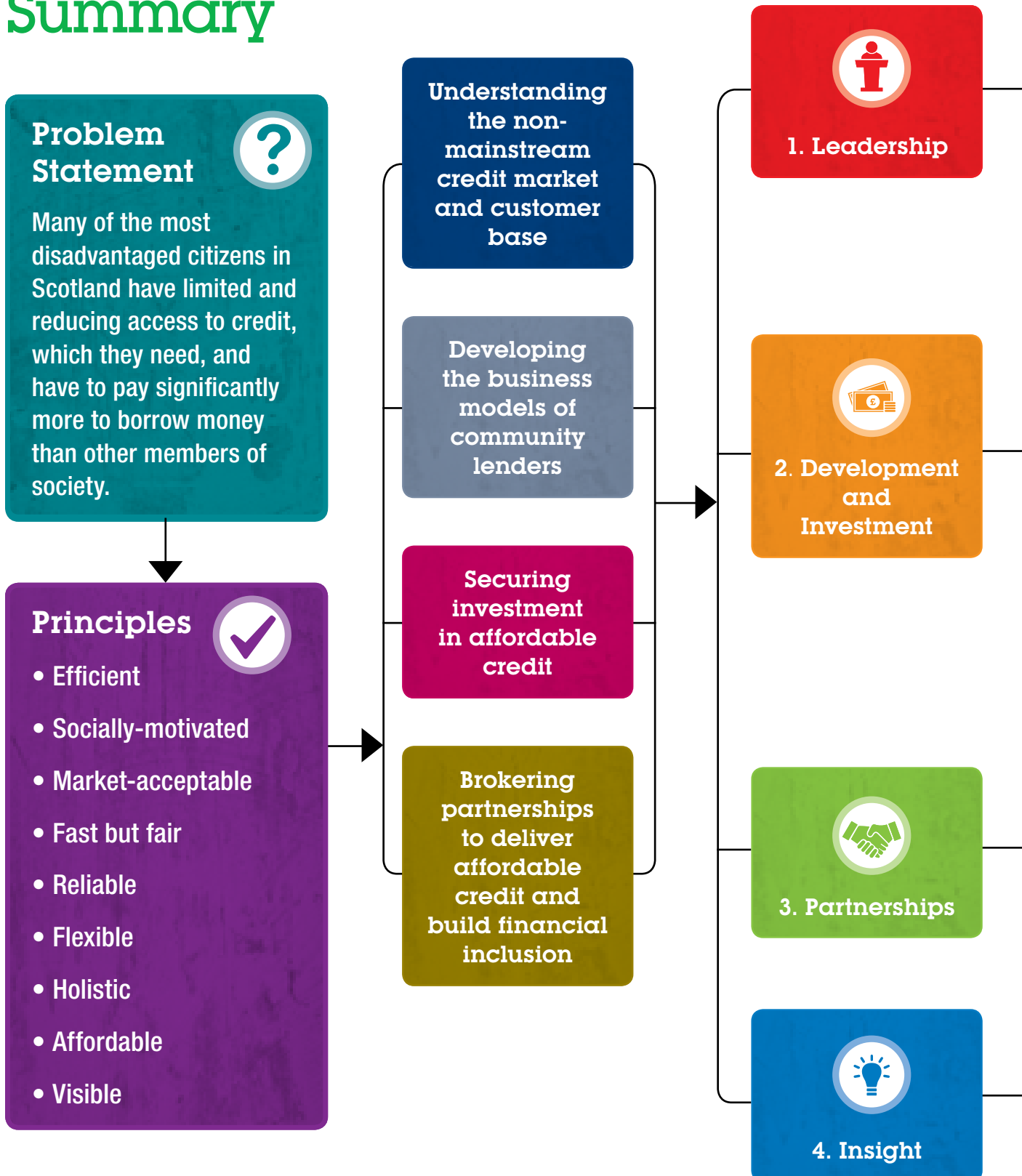
David Walker, Trustee, Carnegie UK Trust

Douglas White (secretariat), Head of Advocacy, Carnegie UK Trust

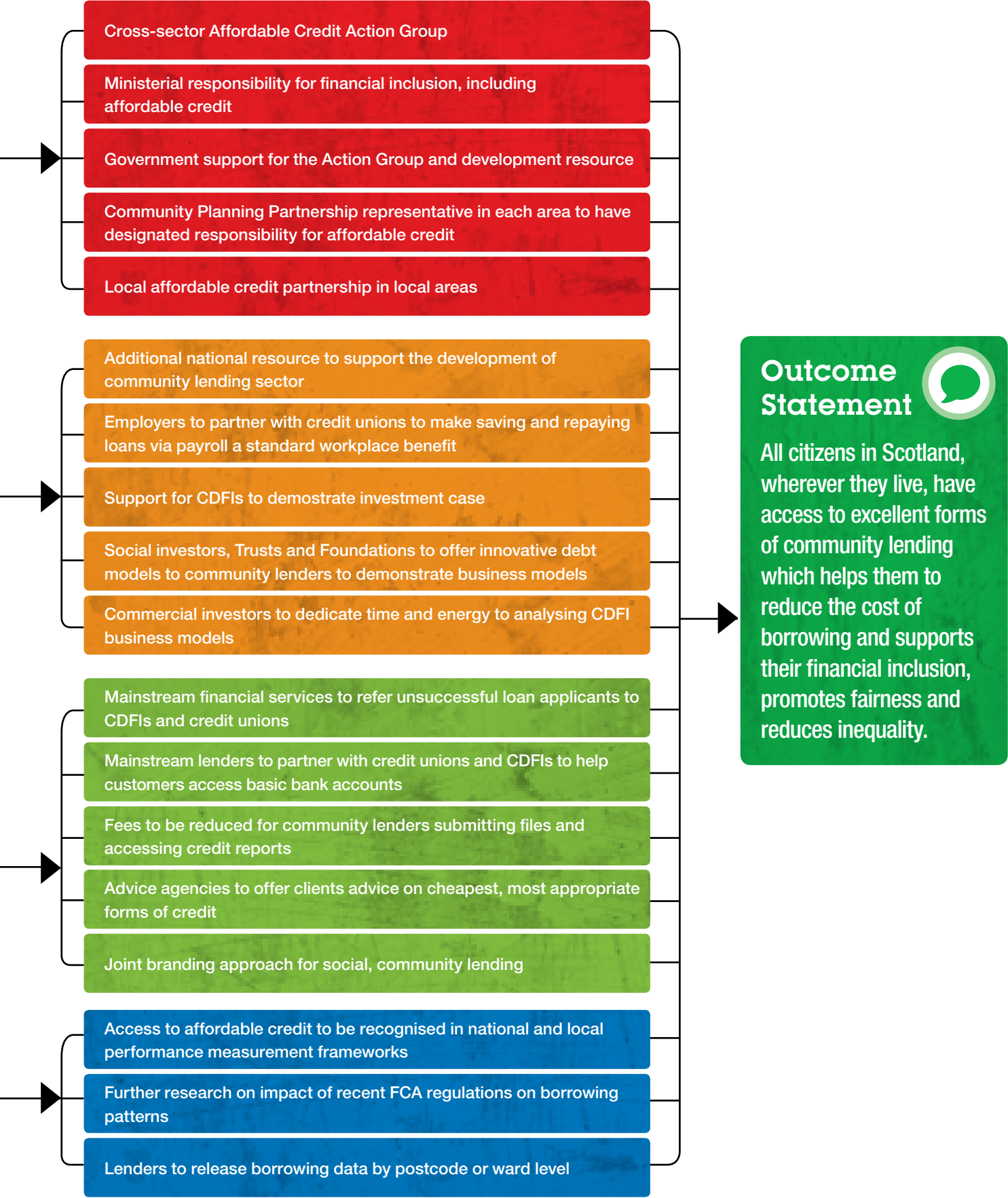
Jenny Peachey (secretariat), Policy Officer, Carnegie UK Trust

Visual Executive Summary

With the right principles, good analysis,



leadership, partnership and investment we can create a positive outcome



Executive Summary

Our vision

The Affordable Credit Working Group was established by the Carnegie UK Trust to identify how to significantly improve access to decent, cheaper, more affordable credit to people across Scotland.

Our Outcome Statement is that:

Outcome Statement



All citizens in Scotland, wherever they live, have access to excellent forms of community lending which helps them to reduce the cost of borrowing and supports their financial inclusion, promotes fairness and reduces inequality.

This contributes to the following National Outcomes:

Relevant National Outcomes



- We have tackled the significant inequalities in Scottish society
- We have improved the life chances for children, young people and families at risk
- We have strong, resilient and supportive communities where people take responsibility for their own actions and how they affect others

The context

The question of how to provide reliable, affordable short-term credit for citizens and communities with low incomes and little or no credit history has long been a difficult and complex public policy issue. There are real moral dilemmas about who should be able to borrow money and how this access should be provided.

The routes through which many people – often the poorest members of society – currently borrow money are far from optimal. Their small-scale, short-term, immediate borrowing needs are often met by a commercial high-cost credit market that serves those who are unable to access cheaper, mainstream financial products such as bank loans.

Recent regulations have significantly reduced the activities of many high-cost commercial lenders. These changes are highly welcome and bring many benefits for citizens. However, unless alternative, more affordable forms of supply are scaled-up, there is a risk that some people may increasingly be forced to meet their borrowing needs elsewhere, from friends and family who may be able to ill-afford such loans, or from illegal lenders. There is evidence to suggest the demand for credit is like to become more acute in the coming years.

The Working Group is clear that improving the availability of cheaper, more affordable credit has the potential to significantly improve people's quality of life. We nevertheless recognise that short term loans are not suitable for everyone. Affordable loans are not a substitute for decent wages or a decent welfare system. The wider supply of more affordable credit is one part of a package towards creating a more socially just society.





Scotland has a strong credit union sector and is home to the award-winning Community Development Finance Institution (CDFI), Scotcash. At present however, these alternative community lenders are extraordinarily small in comparison to the commercial high-cost credit market. We believe that the solutions to widening the availability of affordability credit lie in growing our credit union and CDFI sectors.

Scotland is ideally placed to lead the UK in identifying and testing solutions to deliver more

affordable credit on a viable basis, at scale. The forthcoming devolution of additional welfare powers to the Scottish Parliament, the ongoing work on a 'Fairer Scotland', and the good practice already taking place across a range of financial inclusion initiatives offer a compelling context of policy and practice in which this work can take place.

Our principles

The Working Group identified nine core principles that must be central to Scotland's approach to widening access to affordable credit. We believe that credit must be:

-  **Affordable**
Customers can afford the weekly or monthly repayments
-  **Efficient**
Cost to customer minimised
-  **Fast but fair**
Lending quickly but not to those who can't afford to borrow
-  **Flexible**
Can adapt within reason to a customer's repayment needs
-  **Holistic**
Credit provides a gateway to financial inclusion
-  **Market acceptable**
Financially sustainable in the long-term
-  **Reliable**
Accessible when the customer needs it
-  **Socially-motivated**
Delivered by organisations with a social, not-for-profit ethos
-  **Visible**
Customers are aware of and understand the service on offer

The strategic challenges

Achieving our Outcome Statement is not straightforward. Public policy makers have long struggled with how best to develop affordable, at scale credit services to those on low incomes, with limited or poor credit histories. There are many good local examples of successful not-for-profit affordable credit services. The challenge is how to deliver these much more widely, so that many more people in Scotland can benefit.

If this is to be achieved, then a number of key challenges must be properly recognised and understood:

The profile of customers who borrow from short-term high-cost lenders and community lenders is more diverse and segmented than many people realise. This necessitates solutions that provide a range of products and delivery channels to meet different needs and preferences.

Delivering short-term high-cost credit is inherently expensive. Instant, small, short-term loans – typically less than £500 to be repaid within a year – to customers with few resources and limited credit records will necessarily incur an APR that is higher than mainstream lenders. However, due to reputational risks there is often a reticence among policy makers to support lending services where loans appear to have a high APR, even when delivered on not-for-profit basis.

The priorities that citizens excluded from mainstream financial services attach to a loan offer are not necessarily the same as other borrowers. Issues such as trust in the lender; flexibility in repayments; speed of access to the loan; simplicity of the application process; customer service; and integrated support are often just as important, if not more so, than the price of the loan.

The factors which determine the cost of providing a loan are varied and interdependent. They include issues such as the loan term; loan value; staff conversion ratios; delivery channels; overheads; level of risk; arrears; the cost of investment capital; and the cost of attracting new customers. Community lenders must balance all of these issues when seeking to deliver a sustainable affordable credit service.

Community lenders must grow exponentially to deliver affordable credit across Scotland. These lenders currently face significant and different barriers which prevent them from operating at scale.

Credit unions are by far the largest community finance sector lending money to disadvantaged groups. There are over 100 credit unions in Scotland, with total of 375,000 members. The Credit Union Expansion Project is currently supporting a number of credit unions across the UK, including six in Scotland, to reduce the costs of lending through technological and delivery improvements. This should enable credit unions to lend to more financially excluded customers, by making such loans more financially viable and by attracting more affluent borrowers to cross-subsidise loans to more disadvantaged groups.

Credit unions have a number of other strengths they can contribute to the growth of affordable lending in Scotland. The sector has a strong volunteer tradition, which reduces its cost base; has good access to loan capital with £450 million in savings; provides the cheapest non-mainstream loans available within their 42.6% APR cap; and credit unions are improving their responsiveness to customers through the development of new technologies, including an automated lending decision tool and online and mobile lending tools.

However, the sector also has challenges in its capacity to scale up affordable credit delivery. It is a diverse sector, with every credit union independent and different – and not all have a desire to extend their reach to more disadvantaged groups. The model being tested through the Expansion Project of attracting more affluent borrowers to enable cross-subsidy to disadvantaged groups is not yet proven. Lending capacity within credit unions is not always fully exploited – with Scottish credit unions currently holding £100 million in savings that could be out on loan. The money that credit unions lend belongs to their members – and credit unions continually need to ensure that the balance of their loan book generates a sufficient return for savers.

The CDFI sector in Scotland is far smaller than the credit union sector, with Scotcash in Glasgow, the only personal lending CDFI currently in operation. CDFIs are generally more expensive than credit unions but they have a strong social ethos and target loans at disadvantaged groups at much lower rates than commercial lenders. They are not restricted by a loan cap and often include wider financial inclusion advice and support alongside their loan product offering. Although Scotcash are presently the only personal lending CDFI there is a strong, supportive network of CDFIs offering services to businesses and social enterprises.

The main challenge for the CDFI sector if it wishes to grow is attracting sufficient external investment to develop its infrastructure and recruit and train skilled personnel. Unlike credit unions, CDFIs do not hold savings and therefore rely on external investment to provide their loan capital. The cost of this capital must be priced into their loans. Public sector grants can provide such capital in the early stages of CDFI development but to become financially sustainable CDFIs must be able to demonstrate their viability, without subsidy, to commercial investors. Proving this viability, and attracting investment, can be difficult but it has been achieved by CDFIs in the UK. The journey to financial sustainability is likely to be a long one for most CDFIs and requires supportive partners in the public sector and amongst social and commercial investors.

Effective partnership is essential in assisting the growth of affordable credit and ensuring its provision is a gateway to wider financial inclusion. This partnership may come from financial service providers, public services or the charitable sector. Many, excellent examples of joint working between different organisations exist at local level. For example, CDFIs providing identification processes to allow customers to open basic bank accounts; local authorities, housing associations and charities providing premises through which affordable credit providers can offer loans; or banks referring customers to local credit unions. The challenge is to replicate such examples more widely – and many potential partners are under financial pressure and may lack capacity to assist.

Our recommendations

Overcoming the strategic challenges to achieve the Working Group's goal requires a cross-sectoral approach. No one sector or organisation can achieve the necessary progress on its own – national and local government, civil society, the financial services industry, consumer groups and community finance providers all have vital roles to play.

We have made 18 recommendations to improve access to affordable credit in Scotland and achieve the Outcome Statement. All of these recommendations are important and are designed to work together, as a package, to achieve change.

The recommendations are categorised by four areas of activity:



Leadership

Improving the recognition and status of affordable credit in Scotland and providing a focal point for activity



Development and Investment

Bringing new resources and supporting the mechanisms by which CDFIs and credit unions can develop and grow, enabling them to build their infrastructure and reach many more customers



Partnerships

Brokering new relationships between public service providers, commercial partners, charitable organisations and CDFIs and credit unions



Insight

Enhancing our understanding of how people access credit

Summary of Recommendations



Leadership

1. Establishment of an 'Affordable Credit Action Group' for Scotland
2. A Minister in Scottish Government to have responsibility for financial inclusion, including affordable credit, as part of their brief
3. Scottish Government representative to join the Affordable Credit Action Group and the Government to consider what support it might offer to the deployment of the additional development resource for affordable credit
4. A Community Planning Partnership representative in each local area to have designated responsibility for affordable credit
5. The establishment of a local 'affordable credit partnership' as part of the Community Planning structures in each area



Partnership

11. Mainstream financial providers to have referral arrangements with local credit unions or CDFIs for customers who are declined a loan
12. Providers of fee-free basic bank accounts to have partnerships with a local credit unions or CDFIs for identification verification, allowing credit union and CDFI customers to open a basic bank account
13. Fees to be reduced for community lenders submitting files and accessing credit reports
14. Advice agencies in Scotland to offer clients advice on where they can go to access the cheapest, most appropriate forms of credit
15. Credit unions and CDFIs to work together to develop joint kitemark to promote all social, community lending across Scotland



Development and investment

6. Deployment of additional, national resource to support the growth of Scotland's community lending sector
7. Employers to partner with credit unions to make saving and repaying loans via payroll deduction a standard workplace benefit
8. Support for CDFIs to help them demonstrate their investment case to potential investors
9. Social investors, Trusts and Foundations to offer CDFIs innovative investments and debt structures, focusing on building the case for further investment, demonstrating the business model and leveraging in large scale commercial investment
10. Commercial investors to dedicate time and energy to analysing CDFI business models and determining how they can best support these lenders to grow



Insight

16. Attention to be given to how improved access to affordable credit can best be measured and recognised within relevant measurement frameworks at national and local level
17. Further research to be undertaken in Scotland on the impact of the new regulations from the Financial Conduct Authority on people's borrowing patterns
18. Lenders to release, as far as data protection allows, data on borrowing by postcode or ward level in Scotland



1. Outcome Statement

Outcome Statement



All citizens in Scotland, wherever they live, have access to excellent forms of community lending which helps them to reduce the cost of borrowing and supports their financial inclusion, promotes fairness and reduces inequality.

Relevant National Outcomes



- We have tackled the significant inequalities in Scottish society
- We have improved the life chances for children, young people and families at risk
- We have strong, resilient and supportive communities where people take responsibility for their own actions and how they affect others

Why affordable credit matters

The supply of reliable and affordable short-term credit for hard-pressed citizens and communities has long been a highly challenging and complex public policy issue.

Debates on this subject can become emotive and highly charged. It is a regularly expressed view that the opportunity to borrow money should not be available to those with the fewest resources, or that people on low incomes should abstain from borrowing if the costs involved in doing so are severe. Alternatively, many others query why those with the lowest incomes have to pay significantly more than everyone else to borrow money – part of the poverty premium – when they can least afford to do so. Regardless of differing opinions on the subject, it is clear that many of the poorest members of our society do borrow money on a regular basis and that this borrowing is often, and increasingly, driven by need.

It is also clear that the routes through which many people borrow money at present are far from optimal. The small-scale, short-term borrowing needs of our least affluent citizens and communities are often met by the commercial high-cost credit

market. This market serves a significant customer base that is generally unable to access cheaper, mainstream financial products. In contrast, community finance providers in Scotland – currently more than 100 credit unions and one personal lending Community Development Finance Institution (CDFI) – offer loans to similar customer groups at a much lower price. However, these community finance providers are extraordinarily small compared to the commercial sector. Despite being amongst the most advanced community lenders in Europe, these providers have so far been unable to offer a viable, at-scale alternative.

The Affordable Credit Working Group was established by the Carnegie UK Trust to identify how we can significantly improve access to decent, cheaper, more affordable credit for those most in need in Scotland.

The Group is clear in its view that improving the availability of cheaper, small, short-term loans¹ – typically amounts less than £500 repaid within a year – to those who can afford to repay them would be a highly positive public policy outcome. It would save significant sums of money for disadvantaged communities across Scotland, greatly improving people's quality of life and setting people on the road to financial inclusion.

Key Facts



375,000
credit union
members in
Scotland



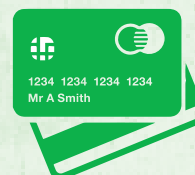
£20 million
CDFI annual
lending



940,000
households
in Scotland in
relative poverty



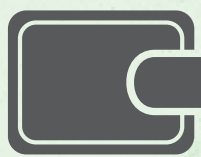
£5 billion
size of high-cost
commercial credit
market in 2013



£20 billion
increase in
UK credit card
borrowing in 2014



2 million
people in UK with
no bank account



**£700
million**
credit union
annual lending



**1 personal
lending
CDFI**
in Scotland



£450 million
savings held by
credit unions
across the UK



£135
average saving
on a £400 loan
from Scotcash
CDFI repaid over
32 weeks, versus
via home credit



100+
credit unions in
Scotland



54%
reduction in
payday loans
issued between
Q1 2014 and
Q1 2013

Case study – Caroline



Caroline has four children and always felt stressed when it came to Christmas and summer holiday time, as she knew it was going to be added expense she just couldn't meet. A friend told her about Scotcash and although she felt embarrassed and nervous about approaching a loan company for the first time, she felt she had no other option but to give it a go. Caroline's first loan with Scotcash was to help her buy her children's Christmas presents.

Caroline said: 'My loan officer put me at ease instantly, as she was friendly and understanding of my situation. When I was told I was accepted, the relief and pressure that was lifted from me was priceless.'

Caroline has been using Scotcash for a few years now for summer holidays and Christmas. Knowing she can come to Scotcash at these times and get financial help has taken the pressure off her and she doesn't have the worry of how she will cope with the added expense at these times.

'I can actually enjoy these times with my family now,' she said.

'Because the payments are spread out and affordable, this has freed up some of my money which now lets me put all four of my kids into clubs, whereas before I could only afford to put in two at a time. For anyone in a similar situation to me, I would say give it a go – it is life changing!'

In adopting this approach, the Group recognises that there is a high social and economic cost to *not* providing more affordable credit. Poverty diminishes opportunity and life experience, with those who have the lowest incomes experiencing higher levels of ill-health and often having less resilience to meet challenges². In this context, financial exclusion can have detrimental effects on a person's ability to fulfil basic needs, manage financial shocks and participate in their community, society and economy³. Providing affordable credit is therefore about more than lending money. It is about improving consumers' and citizens' wellbeing by saving them money⁴, making it possible for them to have an improved quality of life and helping money to be retained in communities.

Delivered responsibly, affordable credit can bring wider economic benefits to local areas and ultimately contribute to Scotland's wellbeing.

The Working Group is clear in its view, however that small, short-term loans are not the right

solution for everyone. Responsible lending will by necessity exclude certain individuals from borrowing money. We do not advocate the universal promotion and availability of credit, even when provided on a cheaper, socially-motivated basis. Affordable loans are not a substitute for decent wages or decent welfare benefits. The development of a better credit market must be viewed as only one tool in a suite of possible social policy interventions that can be deployed to tackle poverty and low income and improve fairness.

Furthermore, we do not see improved access to more affordable credit as an end in itself. When people seek access to credit, their need can be urgent and must be addressed immediately. But the provision of credit also provides an opportunity to engage people in a process that improves their financial inclusion more broadly. Having met a customer's initial credit needs, socially-motivated, community lenders are ideally placed to support their customers. They can significantly improve customers' overall financial

position by facilitating access to a range of other services, including bank accounts, welfare and debt advice, income maximisation, budgeting services, savings schemes, fuel advice and signposting to other support services.

The adoption of this holistic, preventative approach can help people to become more financially secure and ultimately improve their quality of life and standard of living. Credit must therefore be seen both as a critical need in its own right and as the gateway to wider financial and social inclusion.

The growing need for affordable credit

The need and demand for small, short-term loans has existed in communities across Scotland for decades. Following the financial crisis at the end of the last decade however, evidence shows that people increasingly relied on this short-term credit to pay for day-to-day essentials⁵. As unemployment and underemployment rose, incomes reduced and the cost of living increased, while at the same time access to mainstream loans became more difficult as providers tightened their lending criteria.

In the years following the financial crisis, the commercial high-cost credit sector in Scotland and the rest of the UK flourished, as the trends described above began to take hold. The growth of this sector became the subject of fierce public criticism, with accusations of poor lending practices, excessively high lending charges and exploitation of the most vulnerable.

In response, the Financial Conduct Authority (FCA) introduced new measures in April 2014. These included stricter regulatory rules on repayment and collection methods, increased scrutiny on affordability and creditworthiness, and substantially more resources to monitor and enforce these rules. In January 2015 the Financial Conduct Authority introduced a cap on the total cost of credit (TCC) on the loans issued by payday lenders to reduce the cost of short-term credit for consumers.

A new credit landscape

These very welcome measures have markedly altered the landscape of the UK's commercial high-cost credit market. Providers have shifted 'up stream' to focus almost exclusively on 'near-prime' borrowers. Meanwhile, those borrowers with the poorest credit histories and thinnest credit files have increasingly seen their applications declined and many previous customers are being rejected, even if they have been reliable customers for the lender in the past. The outcome of these new regulations aimed at tackling lending behaviour deemed to be exploitative has been to decrease the numbers of loans made. The Consumer Finance Association (CFA) reports that 54% fewer payday loans were issued in the first quarter of 2014, compared to the same period in 2013⁶. Overall, the Consumer Finance Association has estimated that the market has contracted by almost 70% as a result of new regulations. Provident Financial Group (PFG), although unaffected by the cap, announced that their lending volumes in 2013 had reduced from 1.8 million customers to 1.5 million⁷. In February 2015 they announced that they had reduced their home credit numbers by almost 500,000 to just over 1,000,000. This represents a 44% reduction in two years⁸, which the company describes as, '*The shedding of marginal customers and the corresponding focus on better-quality established customers.*'⁹ Supply is being withdrawn to those with the poorest or thinnest files. The Consumer Finance Association reports that on average just 13% of loan applications are approved. However, people's need for short-term credit remains – and a plethora of indicators suggest that this need is likely to be sustained, or even grow, in the coming years.

The demand for credit

UK borrowers from across the prime to sub-prime spectrum continue to seek credit. Bank of England figures show that unsecured consumer credit in the form of loans, credit cards and overdrafts, increased by a further £1.5 billion in November 2015 – up from a £1.2 billion monthly average over the previous six months. Total outstanding unsecured consumer debt has risen

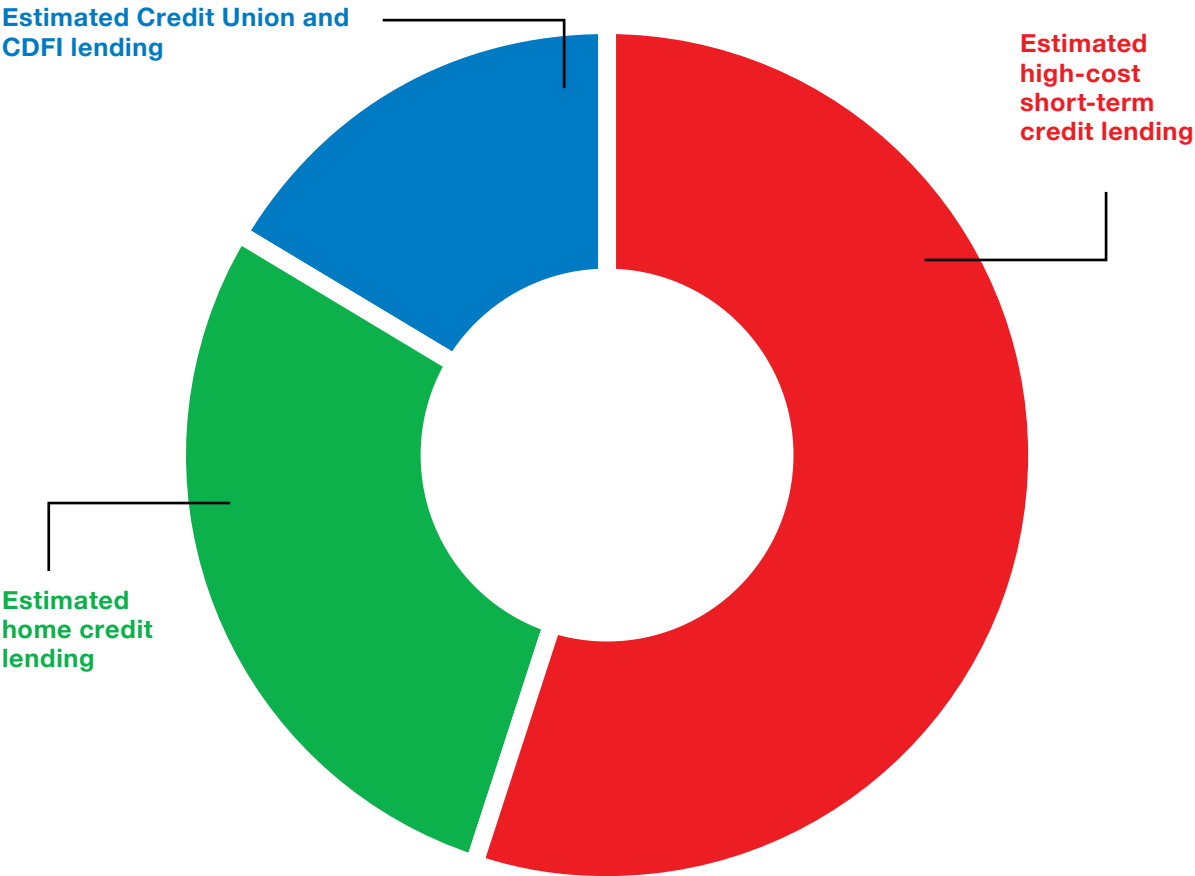
by nearly £10 billion in the past year, to over £178 billion¹⁰. Meanwhile, further reductions to welfare benefits will place even greater pressure on the household budgets of those on the lowest incomes. The Office of Budget Responsibility predicts that by 2020 the level of household debt will be at a similar ratio to incomes as to before the financial crisis¹¹. Fundamental shifts in the labour market mean that over a third of temporary workers in the UK cannot find a permanent job¹², compared to only a quarter in 2008¹³, with lower levels of job security potentially impacting on people's ability to secure and repay loans. The tightened lending criteria that many lenders introduced in the wake of the financial crisis remain, now underpinned by regulation, while the increased use of technology and data to scrutinise creditworthiness will likely further restrict access to loans for some customers. There are fears that the new regulations which

have shrunk the commercial high-cost credit market will spawn a growth in illegal high-cost lending¹⁴, including illegal online lending. There are also concerns that more people are now borrowing money from family members and friends who can ill-afford to make such loans and where the social and emotional impact of failure to repay is often severe.

The scale of the challenge

In 2013 payday loan and home credit companies served nearly five million customers across the UK, providing £5 billion-worth of loans via a range of different products. Despite the significant contractions that have occurred in 2014 and 2015 in the supply of commercial high-cost lending following the new Financial Conduct Authority regulations, these remain substantial markets.

Figure 1: Commercial and community non-mainstream lending¹⁵



In contrast, the aggregated sums across the credit union and CDFI sectors in the UK are barely visible on graphs of non-mainstream lending. Credit unions in the UK – by far the larger of the two community finance sectors serving disadvantaged communities – lend £700 million annually across 360 institutions, with reported savings deposits of over £1 billion. The majority of these deposits and loans are from and to customers whose incomes would place them outside of a definition of ‘financially excluded’, although the Credit Union Expansion project is seeking to increase significantly lending volumes from credit unions to the most disadvantaged. Meanwhile, personal lending CDFI in the UK currently only lend in the region of £20 million annually in small-sum credit to financially-excluded individuals.

While everyone who currently uses commercial high-cost credit lenders could be financially better off if they were to borrow from a credit union or CDFI, it is recognised that not all those who borrow from the commercial high-cost credit sector are necessarily vulnerable or financially excluded.

Extending community lending provision to the most disadvantaged in society is the key priority for the Working Group. In 2013/14, 940,000 households in Scotland were defined as being in relative poverty after housing costs were taken into account (a net income below 60% of the median)¹⁶. We anticipate that this would be the primary market for any extension of affordable credit services in Scotland – recognising, of course, that not all of these households would need or desire credit and that many will have access to mainstream financial products.

The window of opportunity for Scotland

In this challenging context Scotland has a genuine opportunity to find and test solutions and lead the way across the UK in addressing this long-standing and difficult public policy issue.

The Financial Capability Strategy for Scotland, published by the Money Advice Service in January 2016, recognises the importance of improving access to affordable credit as a key aspect of financial inclusion – and highlights the work of the Affordable Credit Working Group in seeking to identify effective solutions¹⁷.

The forthcoming devolution of additional welfare powers to the Scottish Parliament will allow Scotland greater flexibility in the approaches it adopts to ensuring that all citizens have access to sufficient income. Addressing the affordable credit question in this context would allow Scotland to consider the issue as part of a broader social policy approach to improving the availability of resources in its most disadvantaged communities, supporting a coherent set of policies to support those who need more money to make ends meet. The Scottish Government’s ‘Fairer Scotland’ conversation and expressed commitment to social justice, inclusive growth and fairness provides a clear framework in which these complex policy issues can be addressed holistically.

There is already significant good practice in Scotland that can be built upon. As highlighted above, Scotland has a strong legacy of social, community lending. It ranks fourth in Europe for credit union membership while its only personal lending CDFI, Scotcash in Glasgow, recently won the Giordano Dell’Amore Microfinance Good Practices Europe Award. Meanwhile, through the Scottish Financial Health Service, Scotland has a co-ordinated a one-stop-shop of information and contacts which allows individuals to access appropriate financial advice depending on their circumstances, financial education (which deals with a range of issues including budgeting, taxation and life stages) and information on local credit unions. Financial inclusion, capability and advice services are delivered or coordinated by a number of other key organisations, including the Money Advice Service, Money Advice Scotland, the National Debtline, Citizens Advice Bureau and welfare rights services. The Big Lottery Fund is currently developing a major investment

across five local authority areas in Scotland to help reduce debt as a barrier to social inclusion and improve money-management skills among disadvantaged people in workless, lone parent or low income households. Other important policy initiatives are also taking place, such as the HM Treasury and Financial Conduct Authority review of the financial advice market.

Finally, the rapid developments in digitisation of public services, such as the development of Mygovscot, a citizen-led, online portal, provides the opportunity to consider how wraparound services can become part of a wider initiative to make Scotland's affordable credit and financial inclusion services more convenient and simpler to use.

While the remit of the Working Group focused on Scotland, it is our hope that the analysis presented here can also offer value to the other jurisdictions across the UK. Furthermore, if Scotland is able to

take effective action to significantly improve the availability of more affordable credit then there will likely be significant opportunities for policy sharing and learning with other areas.

This report

This report sets out how Scotland can take advantage of these opportunities and significantly improve access to cheaper, more affordable credit for those who need it.

Section 2 describes the Working Group's Principles that guide our recommended approach to delivering the outcome statement. Sections 3 to 6 consider the strategic challenges that must be addressed if the outcome is to be achieved. Section 7 describes the actions and leadership required for the delivery of the outcome

2. Principles to guide the Outcome Statement

The Working Group's vision is that all citizens in Scotland, wherever they live, should have access to excellent forms of social lending which helps them to borrow for less and supports their financial inclusion in the widest form.

To help deliver this outcome statement the Group has identified the following Principles which we believe should be central to Scotland's approach to widening access to affordable credit.

-  **Affordable**
Customers can afford the weekly or monthly repayments
-  **Efficient**
Cost to customer minimised
-  **Fast but fair**
Lending quickly but not to those who can't afford to borrow
-  **Flexible**
Can adapt within reason to a customer's repayment needs
-  **Holistic**
Credit provides a gateway to financial inclusion
-  **Market acceptable**
Financially sustainable in the long-term
-  **Reliable**
Accessible when the customer needs it
-  **Socially-motivated**
Delivered by organisations with a social, not-for-profit ethos
-  **Visible**
Customers are aware of and understand the service on offer

The principles explained

Given the significant reductions in public expenditure across the UK since the financial crisis and the further planned reductions in spending over the next decade, the long-term success of any scale-up of affordable lending services is dependent upon this expansion being achieved on a financially-sustainable basis, with limited support from the public purse. This means that organisations delivering affordable credit must become self-sustaining through the delivery of their loan books and other financial products, and by their ability to raise capital from savers or from commercial or social investors. Income generated must exceed expenditure, and in the long-term should fund expenditure without the need for any subsidy. The Working Group does recognise, however, that this is a long-term vision. In the short to medium-term we envisage that community finance providers will require financial support in terms of grant and/or soft loan aid to start up new operations and build their infrastructure, with subsidy gradually reducing over time until commercial sustainability is achievable.

Delivering for the customer

While the solutions must be market-acceptable, the needs and circumstances of customers must be of paramount importance to affordable credit services. This means that organisations delivering these services must operate on a socially-motivated basis with a not-for-profit ethos. Similarly, the approach to lending must be to ensure that it is affordable for customers; that the cost to customers is minimised to keep loans as cheap as possible, while covering costs with an acceptable margin for reinvestment;

and that robust credit checks are in place to ensure that loans meet responsible, affordable lending criteria. The type of credit products offered should clearly meet the borrowing needs of customers – this means that lenders should be reliable and should win borrowers' trust and repayment arrangements should allow an appropriate degree of flexibility, taking into account weekly or monthly fluctuations in customers' finances. Advances in financial technology are rapid and may assist in lowering the costs of collection procedures.

It is also important that affordable credit services are clearly visible to those who may benefit from them, with a strong brand and a high level of recognition and understanding of their products amongst the potential customer group.

Credit and financial inclusion

Finally, and crucially, it is essential that approaches to widen access to affordable credit in Scotland understand the importance of credit itself, but also approach the provision of credit as an opportunity to improve the overall financial position of customers. This means that alongside offering loans, affordable credit providers must also provide a clear, effective gateway to financial inclusion more broadly. For example, by supporting access to basic bank accounts, encouraging opportunities for saving, fostering financial education and providing access to debt and welfare benefits advice or budgeting and income maximisation services. Through this supportive approach, the by-products of offering – and declining – affordable loans produce significant wider benefits for individuals and society.

3. Understanding the non-mainstream credit market and models

If we are to develop effective approaches to widen access to more affordable credit in Scotland, we must first properly understand the market for non-mainstream lending and, crucially, the profile and preferences of customers who borrow from these lenders. We must also recognise that the type of credit we are describing is very expensive to deliver.

A diverse market

Customers of non-mainstream loans – delivered by both commercial and social lenders – are often characterised as a relatively homogenous group, with an assumption that the transfer of customers between different types of products – for example from payday lenders to credit unions – is a relatively straightforward process. In reality, the situation is much more nuanced and complex than this portrayal.

There are a number of companies and products that make up the commercial high-cost credit market, serving ‘sub-prime’ and ‘near-prime’ customers. These companies are well capitalised, price for risk in their lending and, of course, as commercial organisations have to include a profit margin. The most common forms of commercial high-cost lending are payday (both online and retail) lending, home credit lending and pawnbroking. Together, these markets serve approximately five million customers in the UK and are estimated to account for around £5 billion-worth of loans annually. The Competition and Markets Authority found that total payday loan revenue in 2012/13 was £1.1 billion, with 10.2 million loans issued, worth £2.8 billion. There were 1.8 million payday loan customers in 2012/13¹⁸.

Additionally, there was estimated to be £1.2 billion to £1.5 billion-worth of loans issued to between 2.4 million and 3 million home credit customers in the same year¹⁹. While there are no new figures available, the Competition and Markets Authority recorded a 68% reduction in lending since April 2014. There are also rent-to-buy retail credit (Brighthouse and Perfect Home), pawnbroking loans and the continued use of catalogues.

The people who use high-cost credit are often portrayed as the most vulnerable in society. Detailed analysis of the high-cost credit market, however, reveals that while this is true to some extent, it is not true of all customers across these markets. Young people, women, people on low incomes, those living in the most deprived neighbourhoods, social housing tenants and single parents are disproportionately represented amongst users. However, commercial high-cost credit providers also serve those in employment and on higher incomes, with lending models based on easy-to-access, instant, often digitally supplied credit, proving attractive to a wide customer base. Only 37% of online payday loan customers have been defined as ‘vulnerable’ in comparison to 77% of home credit customers²⁰.

Commercial customers and community lenders

There are often differences in the customer profile of commercial high-cost borrowers and those who use community lending services.

For example, there have historically been differences in the customer profile of those who

use credit unions and those who use payday loans or home credit: analysis by the Association of British Credit Unions Ltd in 2006 showed more than 70% of credit union members were aged over 40, while around 50% of payday loan customers and 40% of home credit customers were under 35. Furthermore, 6% of households in Scotland with an income over £30,000 used a credit union, while only 3% of households in lower-income brackets did so²¹. Nearly half of credit union customers owned their own home, compared to only around a fifth of those who took payday loans or home credit²². It is important to note, however, that these figures pre-date the Department for Work and Pensions Growth Fund of 2006 to 2010, which significantly increased the number of financially-excluded people borrowing from credit unions.

There is also significant diversity within the credit union sector itself. While some of Scotland's largest and most heavily-capitalised credit unions draw a substantial portion of their membership from people in relatively well-paid public sector employment, the majority of the country's credit unions are smaller, community-based credit unions focused on providing access to credit and encouraging a savings habit among the customer group who might otherwise (or simultaneously) be drawn to high-cost lenders.

There is therefore some overlap between the customer groups of different lenders. Those who use community credit unions, Community Development Finance Institutions (CDFIs) and home credit products for example, often have a very similar demographic profile. However, recognising the nuances in the markets for non-mainstream credit is essential to forging effective policy solutions. In order to meet the different needs and circumstances of different consumers, it is clear that public policy interventions looking to develop affordable sources of non-mainstream credit must provide a variety of products and delivery channels, to meet different needs and preferences.

The importance of a customer focus

While a significantly expanded affordable credit market may need to serve a broad and diverse customer base, a common trend across many of the customers who use different types of non-mainstream credit products – whether delivered commercially or socially – is a desire for quite a different set of products and services than those offered by mainstream lenders. If the affordable credit sector is to expand successfully, it is essential that these borrowing preferences are properly understood and that products are designed appropriately to meet customers' needs.

Consumer advocacy is a well-established field and there is a legacy of consumer principles and rights that ensure customers of any service will be protected and supported. A consumer-led approach to affordable credit will facilitate the protection of customers – ensuring their opportunity to access and choose from a range of products and services, and to do so safely. It also places emphasis on the right of consumers to be represented in decision-making (about a service or product) and to access redress should they be subject to unsatisfactory goods or services. In this way, putting the customer first will enhance the experience for those accessing credit. First, at the moment of transaction by treating them as a valued and respected equals in a relationship. Second, by further facilitating mechanisms to ensure customers are protected.

Valued product features

Table 1 highlights the features of credit products valued by non-mainstream credit customers.

Of course, the price of a loan also clearly matters to non-mainstream credit customers. However, Table 1 highlights that this feature of a loan product is far from the only consideration which customers take account of when borrowing –

Table 1: Value attached to features of credit

Product Feature	Why it matters
Trust	<p>Non-mainstream credit customers with limited potential sources of credit are often keen to maintain a relationship with their lender and not risk jeopardising this for a new lender. This is the case even if they can save money by switching provider. Those on the lowest incomes who don't want to risk disrupting their finances are the most reluctant to switch lenders. In particular, home credit users are reluctant to disrupt their personal relationship with staff²³.</p> <p>Customers may turn to credit unions and CDFIs if they have lost trust in mainstream financial services as a result of penalty charges on credit products. The feeling that mainstream financial services prioritise generating a profit above the customer's needs compounds this mistrust and contributes to the trust placed in the social lending sector²⁴.</p>
Flexibility	<p>Those on the lowest incomes tend to experience the greatest degree of financial instability and so value the flexibility that many non-mainstream lenders offer – for example, the ability to miss a payment – in contrast with the more rigid requirements of mainstream credit providers²⁵.</p>
Speed	<p>For payday customers, getting money quickly ranks as the most important factor in choice of loan, with the total cost of getting the loan ranked only fifth²⁶.</p>
Simplicity	<p>Related to speed of access is a preference for a simple, non-intrusive application process. The often fairly-rigid loan application process of mainstream lenders, with the need for example of a proven credit history, often doesn't work well for this customer group²⁷.</p>
Payment schedule	<p>People on low incomes often prefer to repay their loans in cash on a weekly or fortnightly basis. This better suits the frequency of their income, be that through benefit payments or work²⁸. If they can afford this weekly or fortnightly repayment then this often matters more than the overall price of the loan.</p>
Customer service	<p>The face-to-face nature of the service and the effort taken to explain the terms of their loans are highly valued by credit union and CDFI customers. They similarly appreciate the ability to call or meet the same member of staff in the event of a problem or with a query. This is not felt to always be possible with larger lenders, such as banks²⁹.</p>
Integrated support services	<p>For CDFI customers, the focus on additional services such as benefit claims, employment support services and debt advice are regarded as more beneficial than advice provided in mainstream financial institutions on mortgages or investment portfolios³⁰.</p>

and indeed, is rarely the most important factor. Most customers in the high-cost credit market are aware that it is an expensive way of borrowing small sums of money³¹ but the other factors described in Table 1 often override this³².

The issues described here also emphasise how customers in the short-term credit market do not necessarily want or value the same product features as other consumers of financial products. Indeed, research shows that existing financial services are often not designed for the specific interests of low-income customers³³ and between seven and nine million people in the UK are deemed to be underserved by financial services³⁴.

Avoiding prejudice

It is crucial, in considering the expansion of affordable credit services, that the needs and preferences of those who might take advantage of these services are prioritised. This means that suitable and desirable financial products should provide for those that need them and that those who borrow from community or social lenders must be treated as a valued cohort of customers, rather than as unfortunate recipients of social welfare.

Policymakers must put to one side their own borrowing preferences and prejudices and not make assumptions about what they – or the wider public – think that potential affordable credit consumers want or need. At the same time, it should be understood that in many cases these consumers' different approach to borrowing may often be driven through an urgent need for finance, rather than a fundamentally-alternative perspective. The long-term goal must be to help many more citizens become more financially secure and capable, so that they are able to enjoy a wider array of credit options where comparators such as price can be given a higher priority.

Loans not for everyone

It is also important to re-emphasise our view that loans are not the right solution for everyone. Non-mainstream providers of short-term credit must have a clear process for providing access to other sources of advice and help for those who they are not able to lend to. Given the social focus of credit unions and CDFIs, and the range of support they can offer, the aspiration of public policy should be to support these providers to become a much more viable and widely available choice for those excluded from the mainstream credit market. Their holistic approach can help build consumers' financial capability to a level where they may, in the future, enjoy a wider range of credit options and have the luxury of considering differentiators such as price when choosing the right loan for their circumstances.

Factors influencing the cost of lending

Having identified the different features of credit products that borrowers from non-mainstream lenders find particularly valuable, we also need to consider the costs involved in providing this type of credit. This understanding is critical to any effort to scale up affordable lending models more widely across Scotland.

Firstly, it's important to note that there are a wide variety of factors that underpin the business of any lender – mainstream or non-mainstream, commercial or community – and which determine the type, range and scale of credit products that the lender is willing or able to deliver. These factors are interdependent and should be considered collectively.

Credit unions and CDFIs will have strengths and weaknesses in relation to each of these factors, which will impact accordingly upon their ability to expand their services to a significantly-larger customer base.

Table 2: Factors that determine the cost of lending

Factor	Definition
Loan term	How long the loan is for and the frequency of repayments (weeks/months)
Value of loan	How much the loan is worth
Price of loan	Rate charged for the loan – interest applied, APR and other fees
Volume	Number of loans issued per week/month/year
Staff conversion ratio	Number of customers interviewed per loan issued
Delivery channel	Whether loans are made and managed face-to-face, by telephone or online
Overheads	Running costs including premises, technology, staff
Risk	Credit reference checking and other measures associated with risk assessment
Arrears	% of loans issued written off as bad debt
Portfolio at Risk (PAR)	Delinquent loans that will, or can be predicted to, become arrears
Cost of capital	Cost of attracting and rewarding savers or repaying investment in the business – determined by % over base and terms of repayment
Costs of customer acquisition	The cost of growing a customer base, taking into account length and type of engagement required, borrowing levels, bad debt and infrastructure roll-out
Other	Compliance costs, chasing of bad debt, regulatory fees, back office software

Why the type of credit we are interested in is expensive to deliver

It is often not well understood that lending to people who want short-term, small-sum cash loans is an inherently expensive business, due to the nature of the customer profile and the type of credit that customers seek. If we are to successfully deliver cheaper, more affordable credit to a significantly increased number of people in Scotland then it is essential that there is a proper recognition and appreciation of this point. The type of credit we are considering in this report will never be ‘cheap’, but our aim is that it should be as cheap as possible, while delivered sustainably in the long-term.

Table 3 explains why this type of credit is expensive to provide.

Table 4 supplied by 1st Alliance Credit Union in Ayrshire will not be untypical, it amplifies the challenges of sustaining small, short-term loans on mainstream interest rates, due to the fixed costs involved in providing a loan.

The APR challenge

The fact that non-mainstream lending is more expensive than mainstream lending is reflected in the interests rates charged on loans, usually presented as Annual Percentage Rate (APR). These interest rates appear incredibly high compared to APRs charged by banks for mainstream loans. This has led to a public perception that charging high APR for loans is inherently exploitative and unaffordable, and APR remains a key source of public concern.

Table 3: Why credit is expensive

Feature of credit we want to provide	Why this makes credit expensive
Delivery to a customer group excluded from mainstream lending products, by virtue of low income and/or a limited or poor credit history	Customers are more likely to miss payments or not pay back their loan at all. This means that to break-even, significantly higher margins are required to cover the costs of 'bad debt'.
Short-term loans of small amounts of money	Costs for lending, with respect to administration, set up and operating costs are largely fixed and do not vary proportionately to the size or term of the loan ³⁵ . Mainstream lenders, such as banks, are able to reduce the cost of credit by primarily only loaning large sums over longer periods. The cost of administering this type of loan is proportionately much smaller than it is for short-term, small-sum loans (further illustrated in Table 4).
A highly personalised, fast service	To ensure that they meet their commitment to lend responsibly, and to help build customers' commitment to borrow responsibly, community lenders tend to favour lending on a face-to-face basis, at least for a customer's first loan, rather than via telephone or electronically. This produces additional costs in terms of staffing and premises.
Loans often provided on a cash basis rather than electronically	Increased administration costs.
Marginal returns	Lending even large volumes of predominantly low-value, higher-risk loans returns relatively-small margins.

The Working Group wishes to minimise the cost of borrowing to disadvantaged groups in Scotland. However, we recognise that there are significant limitations in the use of Annual Percentage Rates as an indicator in understanding the affordability of the types of small, short-term loans sought by many disadvantaged customers. This is because an APR is an annualised measure, beneficial when comparing mortgages or longer term loans, but not particularly useful when comparing short-term loans as Table 5 illustrates:

The table shows that despite the very different Annual Percentage Rates, the amount of money a customer repays is in fact the same. It is the term over which a loan is repaid that produces the high – or low – APR.

The practical challenges in bringing down the cost of a small, short-term loan coupled with the negative public misperception of a high APR can mean that those otherwise interested in supporting responsible delivery of affordable credit may be reluctant to do so. This is because while affordable credit products delivered by community or social lenders are significantly cheaper than those offered by commercial providers, the APRs involved in these products are still high compared to mainstream lending. Credit union loans, for example, have a statutory APR cap of 42%; loans from Scotcash in Glasgow have an APR of 89%, while loans from Moneyline CDFI in Lancashire have an APR of 166%. These lenders can and do, however, save significant sums of money for their customer groups, who would otherwise likely borrow from commercial high-cost lenders or even illegal lenders.

Table 4: Cost of Lending

Loan amount	Interest rate	Term (months)	Repayment per month	Total interest	Cost to Lend	Surplus/loss
£250	3.0%	3	£88	£15	£51	-£36
£250	3.0%	12	£25	£52	£51	£1
£400	3.0%	3	£142	£25	£51	-£26
£400	3.0%	12	£40	£83	£51	£32
£1,000	3.0%	3	£354	£61	£51	£10
£1,000	2.0%	12	£95	£135	£51	£84

Table 5: Impact of APR on short-term loans

Borrow	Repay	Total Charge for Credit (TCC)	Term (months)	Repayments per month	APR
£100	£120	£20	48	£2.50	9.6%
£100	£120	£20	36	£3.33	13.0%
£100	£120	£20	24	£5.00	19.8%
£100	£120	£20	12	£10.00	41.3%
£100	£120	£20	6	£20.00	89.5%
£100	£120	£20	3	£40.00	203.7%
£100	£120	£20	1	£120.00	791.6%

Risk appetite

The challenge for policymakers is to develop a suitable risk appetite to overcome the reputational challenges around relatively-high APRs; recognise that this is not the key issue for the customer group; and support interventions that help to develop products that people want, focusing on responsible lending and affordability, whilst making a significant positive difference for some of Scotland's most disadvantaged communities.

4. Developing the business models of community lenders

An excellent base

The ambition of the Working Group is that all citizens in Scotland should have equal opportunity to access small, short-term affordable loans, should these be appropriate.

We believe that the most viable route to achieving this goal is through Scotland's credit unions and Community Development Finance Institutions (CDFI). Scotland already has one of the most vibrant arrays of community lenders in Europe, delivering a range of affordable credit products to customers. Credit union membership in Scotland is the fourth highest in Europe, while Glasgow is home to the award-winning personal lending CDFI, Scotcash.

However, despite this excellent base, community lending alternatives in Scotland remain extraordinarily small in comparison with the commercial high-cost credit market.

To identify what action may be required to deliver sustained affordable lending on a significantly increased scale in Scotland, we need to understand the business models of different types of community lenders; and consider how these models might support an expansion of affordable credit services, delivering the range and type of credit products that customers want.

In analysing these issues, the Working Group recognises the significant and important work that has already been undertaken, and is ongoing, to support and develop credit unions and personal lending CDFIs in Scotland. This work is well supported by representative bodies for the two sectors, such as the Association of British Credit Unions Ltd for credit unions and Responsible Finance (formerly the Community Development Finance Association) for CDFIs. It is essential that any additional activity that the Working Group recommends builds upon and is delivered in synergy with current activity.

Credit unions

Scotland has a successful credit union movement. There are over 100 credit unions in Scotland, with 375,000 members, including approximately 7% of the adult population. There is a particular concentration of credit union membership in Glasgow, where 160,000 citizens are credit union members. In 2014, Scottish credit unions made approximately 110,000 loans worth a total of £170 million.

Credit unions have a central role to play in expanding affordable lending to a far larger number of citizens across Scotland. The sector has many strengths, which it can offer to this process and it will be a key partner in achieving the outcome statement.

When considering the potential for the credit union sector in Scotland to scale up and deliver affordable credit to a far larger number of people, it is essential that the primary purpose of the sector, and its core operating model, is properly understood.

Common bond

Credit unions were originally established to encourage positive financial behaviour, promoting saving and providing access to affordable loans. They are co-operatively owned membership organisations. Each credit union has a 'common bond' which people must meet to become a member – typically this means living in a particular geographical area (which can be quite large); being an employee of a specific organisation; being a member of a professional group; or being part of another member organisation. In simple terms, credit unions provide a mechanism through which money can be pooled and circulated, in the form of loans and returns, amongst a group

Case study – Alison



“Alison turned to 1st Alliance for help having run up considerable debts with high cost credit providers and door step lenders. 1st Alliance were able to pay off her debts and put in place a repayment plan that was affordable and manageable. With these arrangements in place, Alison has not only cleared her debts, but established a savings pattern and has now built up substantial savings.

When Alison first contacted 1st Alliance, she was regularly gambling and recognised that this was the root of many of her problems. As well as clearing her debts, the credit union provided her with a current account and, through ABCUL, a pre paid card with restrictions on use. This changed her pattern of behaviour and, long term, proved to be a solution to her gambling problems. Having her current account with the credit union also meant that her financial management generally could be considered, with staff able to see if there were any transactions taking place out with the agreed arrangements, and Alison was able to easily access further financial support when needed. Several members of Alison’s extended family have now joined the credit union, on the back of the positive support they have given.”

of members with a common interest. Interest charged on loans provides a return for those with savings. As member-owned businesses, this return is normally a dividend, the value of which depends on the overall performance of the credit union. Profits generated by credit unions are used to build loan capital, develop services for members and provide returns for savers. Traditionally, credit unions required members to save before they could borrow, with loan values related to the amount that members had saved. This is no longer the case for all credit unions, with some now lending to new members without prior savings, subject to a credit check.

Critical to the credit union business model is the understanding that users of credit unions are members, not customers – and credit unions therefore need to take into account the interests of all members when making lending decisions. This supports a socially responsible approach, but it can make some credit unions reluctant to expand lending services to ‘riskier’ customer groups, as this may impact on the returns generated for other members.

Case study



1st Alliance was formed from two smaller credit unions in 2004, and currently serve members throughout Ayrshire, as well as working with social landlords registered in the area. They currently have over 4500 members, and lending of over £1,629,770, and hold savings to the value of £2,188,371. In addition, they have junior savers accounts containing over £160,000.

A diverse sector

When analysing the business model for the credit union sector, it is also important to recognise that this model is far from uniform. Credit unions across Scotland range significantly in size and scale. Some large credit unions may hold millions of pounds in assets and deposits, run a large loan book and employ teams of professional staff. Credit unions such as Scotwest, NHS Credit Union Ltd and the Transport Credit Union, for example, have a track record of making four and five-figure loans. However, another significant part of the credit union sector in Scotland is made up of small, community-based organisations which are entirely volunteer-run, with small loan books and only a few thousand pounds of deposits and assets. The capacity and desire of each of these different types of credit union to serve a wider, far larger, customer base, varies significantly.

Case study – Christopher



“Christopher was unable to access a basic bank account and did not have any access to credit. When his gas and electricity were cut off because of outstanding debt, as well as not having enough funds to pay the debt, he was facing additional charges because he could not pay through the supplier’s preferred method of direct debit. When he turned to Drumchapel Community Credit Union, they provided him with a pre-paid card and debited enough on the card to clear the outstanding debt, meaning that he could make a quick payment over the phone, and also avoid charges that had had been facing as a result of his lack of account. His gas and electricity supply resumed that day.”

Credit union expansion project

Credit unions are by far the largest community lenders to those who are financially excluded. However, despite this excellent base, the sector has historically found it difficult to deliver the type of small, short-term loans of £500 or less on the scale that is required.

As Ratnam Maheswaran, Policy Manager at the Department for Work and Pensions Credit Union Expansion Project, explained in 2013³⁶: *‘The Credit Union Feasibility Study found the average unit cost to a credit union to deliver a loan was £108, that the maximum income a credit union makes on a typical £500 loan is £68.00, resulting in a shortfall to the credit union of £40. This illustrates that the average gross income from a £500 loan does not match the costs involved in making that loan. For loans of less than £500 the shortfall to the credit union is even greater.’*

At the time of these figures, the credit union interest cap was 2% per calendar month on a reducing balance. This cap has subsequently been raised to 3% per month (42.6% APR) but there are still challenges in making such loans at a lower cost than the returns generated.

Case study



Drumchapel Community Credit Union was formed in 1970 – the first of its kind in Scotland – has over 2440 members from throughout the city of Glasgow. It has assets of over £3 million.

Reducing the cost of lending

The credit union movement is now engaged in a significant programme of activity, developing mechanisms to help tackle this type of shortfall. Since 2013, the Credit Union Expansion Project (CUEP), delivered by the Association of British Credit Unions Ltd and supported by a £38 million investment from the UK Government, has been underway to support this process, with the aim of attracting one million new credit union members by 2019.

The ethos behind the Credit Union Expansion Project is to support the UK’s credit union sector to find sustainable mechanisms that will enable it to lend much more widely to those who are financially excluded. The programme aims to do this by supporting credit unions to: reduce the costs involved in making loans; improve accessibility and convenience for borrowers; and make larger loans and attract more affluent borrowers to support the cross-subsidy of an increased number of small loans to those who are financially excluded. There is very limited appetite in the credit union sector in Scotland for increasing the credit union interest rate cap to improve the sustainability of loans – the focus is on cost reduction, cooperation and improved accessibility.

Specific initiatives involved in the Credit Union Expansion Project include:

- The development of an automated lending tool, which customers can access online or via their mobile phone, to speed up loan decisions and reduce the costs involved in

this process. Since 2014, nine credit unions in Scotland have been using this tool.

- A new operating system, built on the same banking platform as a number of UK challenger banks and several large credit unions in North America, enabling credit unions to carry out real time processing of

transactions for the first time, opening up a range of new access to channels to members. This will be adopted by 36 UK credit unions in 2016, including six in Scotland.

A further analysis of these strengths and challenges for the growth of the sector is set out in Table 6.

Table 6: Strengths and Weaknesses of Credit Unions in scaling up affordable credit

Strengths	Challenges
A strong volunteer tradition, with 2,000 volunteers currently supporting credit union operations across Scotland, compared to 385 employees. This significantly reduces operating costs and therefore enables cheaper loans to citizens.	The use of volunteers can restrict the development of more 'professional' services, meeting customer expectations.
Good access to loan capital – Scottish credit unions currently hold approximately £450 million in savings	Lending capacity is not always fully exploited – £100 million is currently being held in Scottish credit unions which could be out on loan
The Credit Union Expansion Project (CUEP), which is supporting six credit unions in Scotland, is helping credit unions to attract more affluent members and make larger loans to these members. The interest on these loans could cross-subsidise a significant expansion by the credit union sector into lending to 'riskier', more disadvantaged citizens.	This is a two-stage journey. It is not yet clear whether such a model will prove effective and views remain divided across credit unions about whether they can or should seek to significantly extend their operations to less affluent citizens.
Credit unions are subject to an interest rate cap on their loans, which is set at 3% a month on a reducing balance, or 42.6% APR. Only a small minority of credit union loans are charged at this rate, with the vast majority of credit union loans charging much lower rates. Credit union loans are cheaper than those offered through other social lenders such as CDFIs and credit unions can break even on a lower APR than CDFIs because they don't have to pay to access capital; some may make use of volunteers; and they can cross-subsidise loans to the financially excluded via larger loans to wealthier customers.	The Credit Union Expansion Project is supporting credit unions to reduce the cost of lending, with the aim of supporting the sector to sustainably serve those who are financially excluded, within the current interest cap. The programme is in relatively early stages and it is not yet proven whether the reductions in the cost of lending will be sufficient to enable credit unions to provide small, short-term loans to disadvantaged customers at the scale that is required across Scotland.
As part of the Credit Union Expansion Project, an automated lending decision tool is being developed, along with online and mobile lending tools. This will help credit unions reduce their overhead costs and provide a faster, more responsive service for members.	

Digital opportunities

Digital technology poses a challenge and an opportunity to delivering more affordable services to short term credit customers. The correlation between financial and digital exclusion³⁷, with particularly high levels of digital exclusion experienced by older citizens, those who are unemployed and social housing tenants³⁸, means that those who most need to access credit may not be able to do so digitally.

However, the provision of good quality financial products, designed to meet their specific borrowing needs, could incentivise and support people to get online. Tech solutions might, for example, support service design, loan application processes or risk management activity for service providers. Current FinTech innovations include apps to help build better money habits, advance a percentage of earnings, understand our financial situation and help build up on alternative credit score³⁹. Apps could also provide user-friendly methods of accessing or monitoring the status of loans or provide the means through electronic money institutions to lower the costs of collecting repayments. In this way, delivering services digitally could be an opportunity to reduce the extent of both financial and digital exclusion. Community lenders need help, however, to take advantage of these opportunities.

Community Development Finance Institutions

Alongside credit unions, the CDFI movement is the other key community lending alternative in Scotland. The reach of these institutions, both in Scotland and across the UK, is far smaller than that of credit unions. Indeed, across the UK there are currently only around a dozen personal lending CDFIs, which in 2013 lent a total of £19 million to 40,000 customers.

There is currently one personal lending CDFI operating in Scotland – Scotcash in Glasgow. It has won numerous awards recognising its commitment to affordable credit and financial inclusion, including the Europe-wide Giordano Dell'Amore Microfinance Good Practices Europe Award 2015 and the 2008 Guardian Public Services Award. In 2013-14, Scotcash made approximately 1,800 loans in Glasgow worth a total of £870,000. Fife Council, West Lothian Council and Falkirk Council are currently considering options for the development of a new CDFI covering the three council areas.

Although there is only currently one personal lending CDFI in Scotland, there are others that serve different purposes. Social Investment Scotland (SIS) provides loans to social enterprises while DSL Business Lending provides

loans to small and medium-sized enterprises. Social Investment Scotland is operating nationally across Scotland and at scale and there are aspects of this infrastructure, such as policies, procedures and governance mechanisms, which could potentially be used to support further development of personal lending CDFI models.

While the personal lending CDFI movement is very small, it faces significantly fewer restrictions on its operations than credit unions. It is unencumbered by additional interest rate caps, aside from the standard Financial Conduct Authority regulations. This means it can price to recover the costs of lending, even for small-value loans of £500 or less. CDFIs also do not require a common bond while having an explicit focus on serving financially excluded groups. This means that as customer-facing businesses, rather than membership organisations, they are not required to take account of potentially competing interests of different client groups – although the primary focus on financially-excluded groups can limit the opportunity to cross-subsidise across different customer markets, presenting a challenge to sustainability.

Like credit unions, CDFIs have an interest in promoting financial inclusion in a wider sense, rather than focusing only on providing access to more affordable credit, by offering linked saving products, money advice and bank accounts

Case study: Scotcash



Scotcash provides access to affordable small-sum loans, basic bank accounts (via Royal Bank of Scotland (RBS)) and money advice. It was established in 2007 as a result of a strategic, city-wide approach to financial inclusion, which included representation from Glasgow City Council, Glasgow Housing Association and other key stakeholders. The group overseeing the strategy was interested in financial inclusion in the round and considered how to develop capacity and the key gaps in providing access to affordable credit. A CDFI model was considered the best way to tackle the issue. The interest rate restrictions faced by credit unions were seen as a significant challenge in providing small-sum loans to excluded individuals.

Scotcash was initially supported by a variety of partners: Glasgow City Council, Glasgow Housing Association, Glasgow Community Planning Partnership and RBS among others. The partnership model was crucial in establishing Scotcash and ensuring its success. Funding partners such as the Scottish Executive, RBS and Department of Work and Pensions provided the loan capital and covered the running costs for the first few years. Though the loan capital currently continues to be recycled, Scotcash plans to look at recapitalisation in 2020/2022.

Partnerships have also been critical in securing wraparound services. For example, Scotcash has been afforded 'trusted partner' status with RBS. This enables Scotcash to accept the ID and address verification necessary to process the opening of RBS basic bank accounts. Again, Scotcash works with Citizen's Advice Bureau (CAB) to provide advice on income maximisation, budgeting and debts and arrears. CAB staff work in Scotcash premises to deliver this service and their posts are funded by a grant from Glasgow City Council. This provides a pro-active preventative model of intervention breaking the cycle of debt.

Scotcash is currently making a profit that covers some, but not all, of its operating costs. In order to move to a sustainable model, the CDFI has a five-year sustainability plan focused on growth. The plan focuses on the need to: have a more innovative approach to service delivery; take services out to the community; provide online services; diversify their products; and have a national approach. It was noted that although there is debate in the sector about whether or not CDFIs should broaden their customer base to include wealthier customers, Scotcash is not currently considering this approach. Scotcash regards partnerships as crucial in their ability to operate – for example, Scotcash operates out of ng homes which helps them reduce their operating costs.

Although Scotcash aspires to move customers towards mainstream financial products and services, there is a tension between this ambition and the fact that customers have built up trust with Scotcash and are therefore reluctant to go elsewhere – even if other options are available to them.

Access to capital is the main challenge to expansion.

Case study: Moneyline



Moneyline is the largest personal lending CDFI in the UK. It consists of 18 stores and works with vulnerable customers from the lower income deciles. In 2014 it issued 18,500 loans worth £8.3m. Since 2002, when it began trading, it has issued 100,000 loans worth £50m. The loan volumes have been reached over 4,000 days, a sum that payday lenders and home credit can lend in around four days.

Moneyline was established with a grant from the ERDF and SRB funds in 2001. Moneyline later received further grant funding in 2005/6 from the Department of Work and Pensions (DWP) Growth Fund. The grant enabled Moneyline to under-price the true cost of lending, at £19 for every £100 loaned, when it started up. The under-pricing was also partly due to an APR cap placed by the DWP on loans that was made possible by the Growth Fund.

When the period of grant funding came to an end in 2012/13, Moneyline raised the price of credit to £50 per £100. This equates to an APR of approximately 166%. This APR was required to cover the costs of lending for Moneyline. The £50 price charged for a £100 loan was broken down to cover costs as follows: £20 covered staff costs, £10 went towards overheads, £10 covered bad debt costs, £7 went towards cost of capital (interest on its investment loans) and £3 went towards other costs. These figures may vary for other lenders depending on their delivery channel, staff salaries, loan-to-application conversion, default rate, admin/processing ratio, operational costs and frequency of missed payments.

The alternative to increasing the price of the loan was a gradual decline where breaking-even was always just out of reach – a situation that would be unattractive for substantial external investment, and would lead to the eventual closure of Moneyline.

In addition to the grant from DWP in 2009 Moneyline raised repayable bond finance with a number of trusts and charitable foundations. In 2012 Moneyline raised over £2 million in repayable social loan investment from Big Issue Invest and the RBS Micro loan fund and These investments were made on the loan trajectory moving toward sustainability, rather than evidential sustainability. As a result of this, potential investors would have concluded that income from loans was not covering expenditure. Therefore most investors would either invest relatively small amounts or not invest at all.

Increasing the price of a loan did not meet adverse customer reaction. Furthermore, the result of increasing the price of a loan – and going on to lend £8.3m through 18,500 small loans – was that in 2014, Moneyline was able to detail to investors that their pricing model covered cost. Specifically, though the 2014 accounts showed a loss due to the old loan book rather than the new re-priced one, the trajectory for 2015 and beyond was of a sustainable model wholly covering costs. The reaction from investors has been positive and the ability of Moneyline to persuade commercial investors that their capital can be both financially and socially rewarding has greatly improved the chances of substantial commercial funds being levered into the expansion of Moneyline.

The sustainability challenge

Establishing a sustainable, long-term business model, which does not rely on grant funding, has proven to be highly challenging for CDFIs across the UK. This is arguably the most pressing issue that must be addressed if the sector is to be in a position to expand exponentially in order to deliver affordable credit products to many more people across Scotland.

Unlike credit unions, CDFIs do not hold customer deposits through which they can fund their loan book. This means that for the model to be financially sustainable in the long-term, these institutions must be able to raise loan capital through investment from mainstream commercial lenders or social investors. The price of this borrowing is then built into the cost of the loans on offer, in the form of interest charged to customers.

In reality, all CDFIs in the UK have, to date, had some form of public investment which has subsidised their loan book during the early years of their operations. In Glasgow, the running costs and loan capital of Scotcash have been supported by grants from the Scottish Government, Department for Work and Pensions (DWP) and Royal Bank of Scotland, while the Big Lottery Fund has provided grant funding for wrap-around financial inclusion services. In Lancashire, Moneyline, the largest CDFI in the UK, subsidised its loan book with grants from the DWP Growth Fund.

These start-up grants for CDFIs have been critical in helping the initiatives establish their operations and build a customer base, as well as reducing the loan costs for customers for an initial period.

However, the Working Group heard clear evidence from both commercial investors and CDFIs themselves that if the CDFI sector is to expand, it needs to do so on the basis of a financially sustainable model in the longer-term, that will attract investment from commercial and social lenders. CDFIs need this investment to:

- Provide additional loan capital, enabling them to extend their loan books and reach more people
- Expand their infrastructure – including the

face-to-face and digital outlets through which they can reach customers

- Recruit, train and remunerate skilled staff to deliver their services

Sufficient resources to achieve these objectives will not be available from either public or charitable funders, given the scale of the challenge and the potential size of the affordable credit market which CDFIs could aim to reach.

Raising capital

To raise capital from commercial or social investors, CDFIs need to be able to demonstrate that they have a sustainable business model.

This is already challenging for CDFIs by the very nature of their business – lending small sums of money to a disadvantaged customer group, often with poor or limited credit histories and a high risk of bad debt. However, in the past, CDFIs, such as Moneyline, have found it very difficult to demonstrate to potential investors that their model is financially robust if it includes within it a subsidy in the form of government grants. In particular, investors have not looked favourably upon arrangements where the cost of the loan offered by CDFIs to customers is subsidised in some way. The presence of this subsidy within the core business operating model often leads investors to conclude that they are not sufficiently confident that the CDFI has a viable business model that will deliver a return on their investment.

This means that while grant support from public and charitable partners has a vital role in helping CDFIs become established, it can actually become a serious disadvantage when a CDFI reaches a point where it needs commercial investment in order to expand. The challenge for established CDFIs seeking to expand and provide affordable credit to more people is to hone their business models so that all costs in the supply of a loan are accounted for in the price charged to customers and to then demonstrate to investors the viability of their model. Moneyline, based in Lancashire with outlets across the North West of England and South Wales, has now achieved such a model, while Scotcash in Glasgow has a five-year plan to achieve such sustainability.

It is also important to recognise the further costs and challenges associated with any potential CDFI expansion. A particular challenge is around the additional costs involved in supporting new customers, who the CDFI has not supported previously. These customers are likely to have a higher level of bad debt than existing customers – Moneyline, for example, calculates the bad debt ratio for new customers at 14% compared to 5% for repeat customers. In addition, Moneyline has found that new customers are initially likely to borrow less than existing customers, which then generates a lower interest return for the CDFI in the short term (although clearly a necessary step to growing a larger customer base). Again, new

customers will almost always need face-to-face advice – which is more expensive to provide – in the first instance, so that the CDFI can robustly and responsibly determine whether they are eligible for a loan. (There is greater flexibility in offering loans electronically or via telephone to previous customers.) Finally, in rural areas where there is lower population density, developing a sustainable model with a sufficiently large customer base may be more challenging still.

The strengths and weaknesses of CDFIs in the expansion of affordable credit are summarised in Table 7.

Table 7: Strengths and Weaknesses of CDFIs in scaling up affordable credit

Strengths	Challenges
CDFIs have a social ethos and deliver significantly cheaper loans than commercial high-cost lenders	CDFI loan products are generally more expensive than those offered by credit unions
Committed to serve disadvantaged communities and not restricted in approach by need to balance potentially competing interests of different customers	Focus on disadvantaged groups limits opportunity for cross-subsidy between different customers, increasing cost of loans as high-risk customer profile and likelihood of bad debt has to be accounted for in loan pricing structure
CDFIs are not restricted in their operations by an additional interest cap or by the need for customers to save before borrowing, giving them greater flexibility to expand	The CDFI sector is currently tiny and needs to expand hugely to provide a viable, accessible alternative to the high-cost commercial credit market
CDFIs are not restricted by a requirement to serve a particular group or geographic area, potentially making it easier for them to extend their operations	To grow rapidly, CDFIs require significant investment to develop its infrastructure and recruit, train and remunerate skilled personnel
Government has been willing to provide capital to CDFIs across the UK to help them establish and develop	Public sector investment is not a sustainable business model for the long-term
Access to loan and development capital can be – and has been – secured by CDFIs from social and commercial investors, reducing demands upon the public purse	Repayment of this investment has to be priced into the cost of loans and therefore increases prices for customers
A financially viable CDFI model, which is significantly cheaper than commercial high-cost credit lenders and doesn't rely on public or charitable investment, can and has been achieved	Financially sustainability can take a long time to achieve and is not yet commonplace across the sector

5. Securing investment in affordable credit

The previous chapter outlined the importance of external investment in growing community finance in Scotland. This is particularly important for Community Development Finance Institutions (CDFI), who do not have access to capital in the same way as credit unions, who hold savings on behalf of their members. However, investment is also important to the credit union sector for staff, product and infrastructure development.

In this section, we consider current or previous investments in community finance providers and the opportunities and barriers for future investment.

Department for Work and Pensions investment

The most significant external investment in the UK's community finance providers over the past decade has come from the Department for Work and Pensions (DWP). Their Growth Fund, which operated from July 2006 to October 2010, enabled a significant change in the credit union and CDFI sectors through the provision of loan capital and a revenue attached subsidy. The Growth Fund was the biggest single influence on increasing loans to financially excluded individuals across the UK.

The Growth Fund enabled 317,798 loans, investing over £137 million across 150 credit unions and participating CDFIs to provide low-income households with affordable credit, as a substitute for the high-cost commercial alternatives. The investment led in turn to significant increases in loan volumes and subsequent credit union membership growth.

The objective of the Department of Work and Pensions Growth Fund contracts were to improve access to affordable credit by building the

capacity of community lenders to serve financially excluded households. It aimed to disrupt the role and impact of commercial high-cost credit on borrowers. Loan capital was provided to contracted organisations alongside a revenue subsidy.

The subsequent evaluation of the programme states that the: *'Growth Fund has led to substantial savings for borrowers, but this effect has come through both reducing interest payments as well as shortening the period over which loans are repaid. Results across the various models are consistent with an interest rate saving of between £130 and £150 per borrower, with total interest savings (over the lifetime of credit) of between £377 and £425.'*⁴⁰

'Eight in 10 Growth Fund borrowers were in the two lowest income quintiles and 77 per cent of all applicants were not in paid work. One in five applicants did not have a current or basic bank account, and only four per cent of applicants said they were already a credit union member or CDFI customer at the time of their Growth Fund loan application.'

Following the end of the Growth Fund contracts in 2012, the Department of Work and Pensions maintained its commitment to community finance by establishing a £38m Credit Union Expansion Project (CUEP) with objectives to:

- Attract one million new credit union members by 2019.
- Increase access to affordable credit so that members save an additional £1 billion in interest payments compared to the charges they would otherwise have paid to high-cost commercial lenders between the start of the project and 2019.
- Deliver this expansion in a way that makes them financially sustainable.

Other investments in loan capital for community finance providers

Other than the Department of Work and Pensions Growth Fund, the direct allocation of loan funds is not commonplace amongst community lenders. However, in the past few years a number of community finance organisations have accessed some additional loan capital to support their lending activities. In some cases, this finance has been provided in the form of a grant, in others a repayable loan.

Significant loan capital (several million pounds) was provided by local authorities and Housing Associations to establish most personal lending CDFIs with Moneyline, Scotcash and My Home Finance all receiving loan capital investment, often as grant, to start up or expand. Scotcash, the only CDFI in Scotland, received its initial loan capital from Glasgow City Council, Royal Bank of Scotland and the Department of Work and Pensions.

Santander invested loan capital into Fair Finance, a London based CDFI, stating in their evidence to the Financial Inclusion Commission in 2014 their rationale as: 'From Santander's perspective, Fair Finance's business model clearly worked and the loan finance we provide can be effectively deployed through the organisation to provide more customers with a fair and sustainable source of borrowing to payday lending. The quality of loans Fair Finance originates provides the basis for external leverage which accelerates their growth. Under this model they have access to loan finance (from Santander and others) in addition their own capital generation.'

Royal Bank of Scotland established a £6,000,000 micro finance loan fund (now increased to £10,000,000) which has provided loans to a number of personal lending CDFIs, including Moneyline, Fair Finance, Lancashire Community Finance and London Rebuilding Society. Other banks have made investments or, are on the cusp of making investments to a number of personal lending CDFIs.

Just Credit Union received £100,000 from Telford and Wrekin Council to meet the needs of customers who might otherwise seek payday loans.⁴¹

These are highly welcome initiatives and other commercial investors should be encouraged to consider how they might support future community lending activity.

In addition to the provision of loan capital, a number of loan guarantee schemes have been trialled locally and nationally since the early 2000s. Many of these initiatives were short-lived, other prominent ones were not hugely successful. For example, John Lamidy, former Director of the Consumer Credit Association and former CEO of the Consumer Finance Association, in his evidence to the 2014 Financial Inclusion Commission proffered this view: '*The 2003 Loan Guarantee Scheme set up for credit unions was a disaster. The idea was that a loan guarantee scheme is a fund which is used as a reserve to cover any losses arising from high risk loans. With such a scheme, a credit union could make instant or debt redemption loans to low income people without putting its own members' savings at risk. However, fewer than half loan guarantee schemes were a success and only 17.6% of original founders were willing to replenish the fund.*'⁴²

Other forms of investment in community finance organisations

Whilst external investment in loan capital for community finance is relatively rare, providers have accessed a range of other financial support often in the form of grant funds, or one-off financial commitments, for staffing, premises or wrap-around financial inclusion services.

From 2010 to 2014, Barclays' £1 million Community Finance Fund supported credit unions and CDFIs through grants to undertake a range of activities to support increased lending activity, including kitting out of premises and

refitting of vacant premises amongst other initiatives.

Big Lottery Funds throughout the UK have supported a number of community banking and financial inclusion initiatives although these mostly relate to money and debt advice and financial capability. For example, the Improving Financial Confidence (IFC) initiative is a £31.7 million from the Big Lottery Fund, which funds 37 projects in England to help people increase their confidence in managing their money. This initiative focuses predominantly on social housing tenants who are the most likely to be financially excluded. In Scotland, the Big Lottery Fund has given Scotcash a grant of £1 million to support its financial inclusion wraparound activities.

Future investment considerations

The above investments have been hugely important to the development of community finance providers in Scotland and the UK. However, the reality is that these providers still only serve a very small proportion of all those accessing non-mainstream credit. If they are to grow to support many more people in Scotland, significant further investment will be required – to provide loan capital, develop a sophisticated, far-reaching delivery infrastructure and recruit, train and properly remunerate professional staff.

This level of investment is beyond what public and charitable funders will be able to provide – although it is clear that investment from these sectors has a critical role to play in helping to establish new community finance initiatives.

Credit union membership growth

For credit unions, the route to further investment is to attract new members, take more deposits and make more loans – all of which provide additional resources to further expand the loan book. Another opportunity is to invest as many of their existing

funds as possible in additional loans, which will serve more customers and attract further interest for reinvestment. The Credit Union Expansion Project is helping to achieve significant progress in these areas – and the challenge for the credit union sector will be to consider how to build on this important programme and extend the benefits to credit unions throughout Scotland. Policymakers need to consider the levers available to them to support and encourage the credit union movement to take advantage of these opportunities.

New investment in CDFIs

For CDFIs, the key objective is to attract sufficient, appropriate commercial investment to support its growth. To raise capital, CDFIs need to be able to demonstrate the sustainability of their business model, which as demonstrated in previous sections, is often far from straightforward. The Working Group advocates a blended funding approach to support sustainability. The following considerations were identified by the Working Group as requiring attention, if the objective of securing additional capital is to be achieved:

Understanding the role of government investment: Recognition by both national and local government that early investment support is critical in paying initial running costs or providing guarantees to underwrite loans. At the same time, there must be an understanding that at a certain point in a community finance organisation's life cycle such public investment becomes detrimental to raising commercial capital and can act as an inhibitor to further growth. Early support is critical, ongoing support is ultimately detrimental if scale is desired.

The role of social lenders: The need for more innovative forms of social investment and innovative forms of debt structuring, to enable community lenders to access the type of long-term capital (without the requirement of a quick return) that they need and leverage in further investment from the commercial sector by demonstrating the viability of the business model.

The importance of support/incubation: CDFIs need support to help them move through the lending cycle, recognising which type of funding/investment they need at which stage, enabling them to gradually become financially sustainable over a period of time.

The value of brokerage: Many potential investors may find the business models of community finance organisations unclear and difficult to invest in for a variety of reasons – the high risk customer group; in-built subsidies in the business model; the difficulty of separating the lending and other financial inclusion aspects of the business; the limited number of comparator businesses to provide precedent; and the lack of uniformity across community finance providers in how it operates. There is therefore a real need for brokerage between CDFIs wishing to attract investment and investors themselves – to codify community lending business practices and models and rate how ‘investment ready’ these are.

The involvement of commercial lenders: Commercial investors, such as Royal Bank of Scotland, have provided finance to support the growth of community lending in the UK. Their engagement is to be commended. However, if the sector is to grow to the scale required to meet the needs of those excluded from mainstream services, then significantly more commercial investment will be required. There is an onus on CDFIs to make a clear, compelling case for investment. However, there is also more that can be demanded of commercial lenders, with new initiatives such as the establishment of the Banking Standards Board and the work of the Banking Futures Working Group, potentially providing platforms to galvanise support and capital.

6. Brokering partnerships to deliver affordable credit and build financial inclusion

Figure 2: Partnership for affordable credit



The final strategic challenge identified by the Working Group relates to the importance of strong partnerships, both in the delivery of affordable credit itself and in ensuring that affordable credit is a gateway to wider financial inclusion.

Partnerships to support the delivery of affordable credit

Credit unions and Community Development Finance Institutions (CDFIs) across the UK have strong partnerships with local organisations

which are critical to the delivery of their affordable credit services. In particular, a number of housing associations and other partners, public and private, provide facilities for CDFIs and credit unions at low or no charge, usually with a declared aim to increase membership of these institutions through improved visibility. For example:

Essex Savers Credit Union operates outlets from Housing Associations and Barclays Bank premises.

My Home Finance operates their services from the offices of at least 11 Housing Associations.

Moneyline operates from Housing Associations and libraries across Stoke-on-Trent.

Scotcash operates from bespoke offices within ng homes and other Glasgow social landlords.

Referrals

Meanwhile, referral schemes from housing associations to credit unions are fairly common, such as the one operated by 1st Alliance and Irvine Housing Association. Many of these initiatives and partnerships are ad hoc, locally developed and often driven by particular personalities within the respective organisations. It is likely that to achieve the outcome statement set out by the Working Group, such partnerships would need to become much more systematic and widespread across Scotland.

Credit and social justice

Nevertheless, there are a number of reasons why such partnerships may be mutually beneficial

and there is considerable potential for their further development. As we articulated in the opening section of this report, the Working Group believes that access to more affordable credit is a vital part of the wider social justice agenda in Scotland. If this point is accepted – and we recognise that this is not universal – then any organisation with an interest in social justice may have a role to play in supporting the delivery of affordable credit services. This might include:

- Housing associations
- Advice agencies
- Churches and faith groups
- Libraries
- Health professionals
- Social workers
- Charities and social enterprises
- Regulators
- Community workers
- Businesses with a corporate social responsibility agenda

Each of these organisations might be able to help develop the growth of affordable credit services in their local area by either referring clients to a community lending provider or by offering community lenders access to their premises at a reduced rate to deliver services on an outreach basis. This could play a vital role in raising the profile and increasing the reach of community lenders in Scotland.

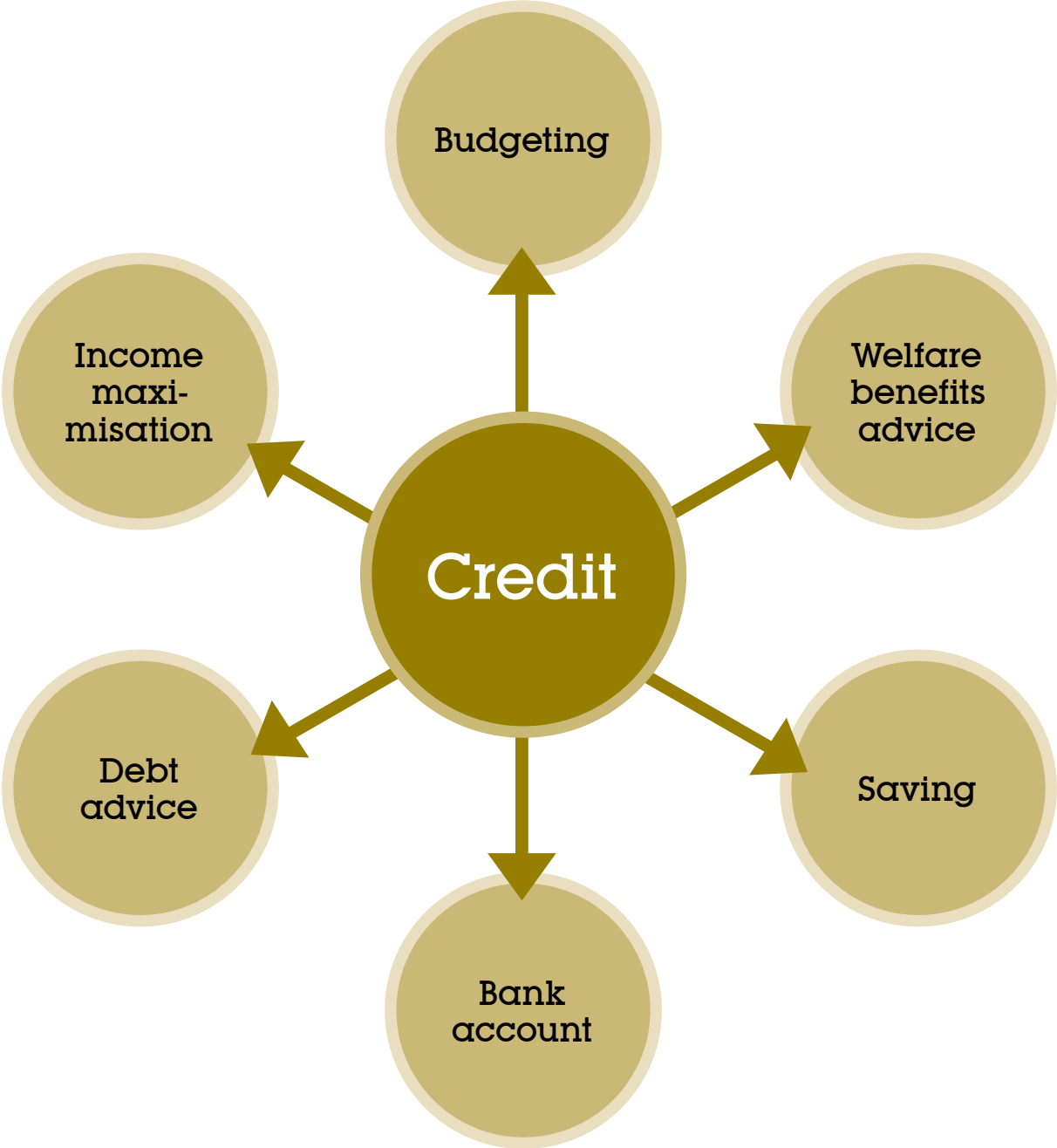
At the same time, it must be recognised that the development of such partnerships is not always straightforward. Many of the potential partners listed above are under increasing financial and time pressure themselves and their resources and ability to support affordable credit initiatives may be limited. In addition, public agencies must ensure they are compliant with state aid rules when offering rent-free premises to community lending businesses. It is also essential that the value and sustainability of these partnerships is clearly detailed in business models for community lenders seeking external investment.

Credit as a gateway to financial inclusion

When people access a social, community lending service or a high-cost commercial non-mainstream lender, it is rare that credit is their only financial inclusion need. It is one of the underpinning principles of the Working Group that as well as being important in its own right, credit should serve as a gateway through which an organisation can help to improve a customer's financial position more widely.

There are a number of issues that must be taken into consideration when examining the potential role of affordable credit as a prism through which a person's wider financial needs might be met. Firstly, it must be recognised that when someone seeks a small, short-term loan, this need is likely to be urgent. Therefore, meeting this need by either providing a loan or by making an assessment that it would not be appropriate to lend is the first task that any affordable credit service must fulfil. Only then can the service begin to consider the customer's

Figure 3: Credit plus support



other possible financial needs – such as access to bank facilities, saving, income maximisation support, debt advice, budgeting services or welfare benefits advice. We note however, that the provision of such advice is likely to be highly challenging in situations where a loan has been refused and where the person's most immediate priority is to access cash. Community lenders are also clear that the tone in which any advice is offered has to be appropriate and a paternalistic approach avoided.

Many community lenders already have arrangements in place to support their customers' access to different types of financial support.

This includes, for example, loan advisors who are also trained to give debt or benefits advice; arrangements with banks to undertake verification processes to help customers open basic bank accounts; referral systems to debt charities; or the presence of advice agencies in-branch.

All of this is highly positive. The Working Group heard evidence, however, possibly reflecting the tensions around the supply of small, short-term loans to disadvantaged groups, that providing affordable credit can sometimes be viewed as a less desirable or worthy endeavour than some other financial inclusion services, such as saving, debt advice or income maximisation. This is reflected, for example, in limited funding being provided to advice agencies to enable them to inform people about their credit choices and select the most appropriate one for them. While funding for advice on debt, benefits or budgeting is commonplace, this is less so for credit.

In addition, similar to access to premises, it is essential that community lenders seeking external investment can clearly demonstrate the separation in their business model between the costs of processing and managing loans and the costs involved in wider financial inclusion support. The latter do not generate a return and therefore will not secure investment capital. This work will therefore need funding from public or charitable sources – but the separation must be clear within business models or commercial investors are likely to be deterred.

Cross-financial service partnerships

The final area where partnership is required is between different financial providers – including between different types of community lender and between community lenders and mainstream financial services.

The community lending landscape in Scotland is currently fairly disparate, with credit unions and CDFIs serving different geographical areas or interest groups. CDFIs and credit unions often serve quite different demographic groups, but referrals between the two different sets of providers are relatively rare. This is partly because there is currently only one personal lending CDFI in Scotland, but also because there is an intrinsic tension in such a referral system – given that all community lenders are very small compared to the commercial market and therefore need to attract and retain as many customers as possible to generate income and grow their business.

Nevertheless, if we are to achieve the significant increase in scale in community lending that the outcome statement requires, it is likely that more joint working between different types of community lender will be necessary.

Meanwhile, the Credit Union Expansion Project is developing a number of shared resources – particularly in relation to technology – that will be available across the sector. This is highly beneficial and it is important that a mechanism continues to exist for the development of such joint initiatives once the project is completed.

Partnerships with the financial services industry are also important – but again, there may be tensions between referrals to and from these organisations and community lenders due to competition for customers. However, there are some areas where co-operation can be achieved. In Leeds, Lloyds Bank refers declined loan applicants to Leeds City Credit Union to identify if they can provide a loan or some other form of financial support. Meanwhile, Responsible Finance has undertaken significant work with the

British Bankers Association to establish a national referral scheme to enable small businesses that don't qualify for a bank loan to be referred to a local CDFI. Existing arrangements such as these should be commended and built upon.

Referrals can also take place from community lenders to mainstream financial services, to help improve the financial position of the customer. For example, in Glasgow, Scotcash undertakes an identification verification process for its customers to enable them to open basic bank accounts – thus giving them access to a mainstream financial product and building their level of financial inclusion. With nine mainstream banks now offering fee-free basic bank accounts, there may be scope for similar partnerships to be established between other community lenders and banks.

Finally, partnership can exist with Credit Referencing Agencies. At present, some community lenders don't submit details of the loans they make to customers to credit checking agencies, or use the credit reports provided by these agencies, as they have to pay a fee to do so. This fee would then have to be added into the cost of the loan, increasing the cost for the customer. However, this situation means that when citizens do borrow from a community lender, this does not count positively towards their credit history – thus denying them the opportunity to build up their credit score and potentially become eligible for cheaper sources of credit in future.

7. Recommendations to achieve the Outcome Statement

Overview

At the start of the report we set out our Outcome Statement which is:

Outcome Statement



All citizens in Scotland, wherever they live, have access to excellent forms of community lending which helps them to reduce the cost of borrowing and supports their financial inclusion, promotes fairness and reduces inequality.

We believe that the key to achieving this goal is to significantly grow Scotland's credit union and CDFI sectors, enabling these not-for-profit providers to reach many more customers than they are currently able to. This means increasing the number of CDFIs in Scotland; increasing credit union membership; and bringing new resources to CDFIs and credit unions through external investment and new members.

However, this is a highly complex and contested area of public policy. The strategic challenges set out in this report are significant. There are real moral dilemmas about who should be able to borrow money and how this access should be provided. There is no financially sustainable way of delivering instant, small, short-term loans to a disadvantaged customer group at scale, at mainstream market rates. There are significant reputational risks involved for policymakers in supporting even socially-motivated community lending services. The business models of different community lenders are often not straightforward and growth is difficult to

achieve. The Working Group recognises that it will take committed work over a number of years to address these issues. The problem of limited access to affordable credit for the most disadvantaged groups in society has existed for many years and cannot be solved overnight.

Nevertheless, we believe that with a better understanding of the complexities of the issues involved, a focus on delivering for the potential customers of affordable credit and a shared commitment to change, real improvements can be delivered, helping many more citizens across Scotland to access cheaper, more affordable credit – saving money for those who need it the most. No sector can achieve the necessary progress on its own – national and local government, civil society, the financial services industry, consumer groups and community finance providers themselves all have vital roles to play.

Much of what we wish to achieve has already been accomplished in microcosm, on a project-basis or in some local areas. What we wish to do is establish a route map through which the outcome we seek can be delivered at scale, across Scotland.

The recommendations

We are making 18 recommendations to improve access to affordable credit in Scotland and achieve the Outcome Statement.

All of these recommendations are important and are designed to work together, as a package, to achieve change. The recommendations flow from the strategic challenges described in this report and are categorised by four areas of activity:

- **Leadership** – improving the recognition and status of affordable credit in Scotland and providing a focal point for activity
- **Development and Investment** – bringing new resources and supporting the mechanisms by which CDFIs and credit unions can develop and grow, enabling them to build their infrastructure and reach many more customers
- **Partnerships** – brokering new relationships between public service providers, commercial partners, charitable organisations and CDFIs and credit unions
- **Insight** – enhancing our understanding of how people access credit

The recommendations are described in detail below.



1. Leadership

Strong public leadership is critical if we are to significantly increase the number of citizens in Scotland with access to cheaper credit. Access to more affordable credit must be recognised as a highly important public policy priority, within the appropriate suite of social policy interventions to improve the incomes of those most in need. There must also be a proper understanding of the risks involved – both reputational and financial – in undertaking activity in this area, and a proportionate risk appetite that recognises the far-reaching social and economic benefits that might be achieved.

The Working Group has been hugely impressed by the pioneering work already undertaken on this agenda by many organisations in Scotland, and elsewhere in the UK. However, given the complexities of the challenge we face and the scale of our ambition, we believe a step-change in the priority attached to affordable credit is required. As a society, we need to greatly increase the focus we give to affordable credit and raise its status as a core area of public policy. Leadership applies across all sectors.

Banks, community lenders, advice agencies and civil society organisations can all do more to promote the importance of affordable credit – both internally and by working together to communicate these messages more widely amongst policymakers, practitioners and the general public.

There has never before been a coherent, shared, cross-sector approach to advancing affordable credit in Scotland. Such approaches have been delivered in different local authority areas, but never previously at a Scotland-wide level. The establishment of such a co-ordinated, partnership approach can increase the strategic priority being attached to this critical issue; help avoid duplication of efforts between different actors working on different but similar initiatives in different locations; improve sharing of best practice and learning from each other; and provide new opportunities to tackle big issues at scale.

An Affordable Credit Action Group for Scotland Recommendation 1

We recommend the establishment of a cross-sector Affordable Credit Action Group for Scotland.

Over an 18-month period, the Group should have a clear remit and focus to support activity that delivers the following objectives:

- Develop a clear operational model for deployment of the additional resource recommended in this report to add value to existing interventions and support the growth of CDFIs and credit unions
- Develop a robust, working financial model for new CDFIs
- Identify new opportunities for financial technology solutions to support the growth of CDFIs and credit unions in Scotland
- Broker new partnerships with public sector, commercial and civil society organisations to support the growth of CDFIs and credit unions

- Establish new investment arrangements for CDFIs with trusts, foundations, social investors and commercial investors
- Support the development of payroll deduction schemes for credit union loans

These objectives should deliver the following outcomes:

- Increase the number of people borrowing from credit unions and CDFIs in Scotland
- Increase credit union membership
- Increase the number of CDFIs operating in Scotland

In addition, the Group should be the key forum for affordable credit discussions in Scotland. It should:

- Provide a new strategic focus for affordable credit, highlighting the importance of this issue across a wide range of social and economic agendas
- Demonstrate how effective practice in improving access to affordable credit can be extended across Scotland
- Offer a 'safe space' in which senior representatives from the different sectors with a stake in this agenda can share insights, opportunities and concerns

The following sectors should be represented on the group:

- Scottish Government
- Local authorities
- Community Planning Partnerships
- Advice sector
- Financial services industry
- Financial technology industry
- Credit unions and their representative body
- CDFIs and their representative body
- Housing associations

There should also be a clear mechanism by which the voices of those citizens who might benefit from improved access to affordable credit services are heard through the Group.

We believe that the Group should be convened by a non-governmental organisation. However, given the often highly charged, emotive nature of access to credit and the complexity of some of the moral dilemmas involved, it is critical that the Group can bring a 'moral authority' to these issues. The Church of Scotland is playing a leading role in efforts to improve access to affordable credit, through for example the establishment of a Church credit union. We believe that with its premises, expertise and resources, the Church can play an even more important role in furthering efforts to develop community lending services in future.

To that end, we recommend that the Action Group is both convened and chaired by the Very Rev John Chalmers, Principal Clerk to the General Assembly of the Church of Scotland, who as Moderator in 2014-2015, was actively involved in encouraging thinking and research in the provision of affordable credit. The Carnegie UK Trust has indicated that it would be prepared to provide the Secretariat to support the Group.

**Ministerial responsibility
for Financial Inclusion
Recommendation 2**

Alongside the Affordable Credit Action Group, the Scottish Government has a critical leadership role to play in supporting affordable credit in Scotland, building on the positive leadership it has already taken on credit unions and financial inclusion.

Clear indications that affordable credit is an important area of policy; 'giving permission' to others to take on some of the reputational risks around APRs; and encouraging, enabling and supporting activity at local level; are important steps that government can take.

To help support this we recommend that a Minister in Scottish Government should have a clear responsibility for financial inclusion, which would include affordable credit, as part of their brief. We are not suggesting that this should

be a standalone portfolio – rather than financial inclusion should be recognised specifically as an area of responsibility within an existing, relevant portfolio

Scottish Government leadership Recommendation 3

Alongside the assignment of portfolio responsibility for financial inclusion, we recommend that the Scottish Government is an active participant in the drive to improve access to affordable credit. To that end, we recommend that a Government representative should join the Affordable Credit Action Group and the Government should consider what support it might offer to the deployment of additional development resource for affordable credit.

Local Community Planning Partnership leadership Recommendation 4

The solutions to providing more affordable credit will be local – even if supported by strategic leadership and resource at national level. This is of critical importance, as different solutions will be required in different local areas. Community Planning Partnerships have a vital leadership role to play, in setting the direction of travel for their area, building on local financial inclusion strategies.

To help support this we recommend that a leading Community Planning Partnership representative in each local area should have a designated responsibility for affordable credit added to their brief. Again, this would be specific recognition within an existing brief, rather than a standalone portfolio.

Local Affordable Credit partnerships Recommendation 5

To advance activity of the issues set out in this report in a clear, strategic way at local level we recommend the development of a local ‘affordable credit partnership’ as part of local Community Planning structures in each area.

The partnership would involve the local financial inclusion sector – credit unions, CDFIs, advice services – and social justice partners such as housing, health and social work. The clear focus that the Community Empowerment Act helps to give community planning for reducing inequality provides an important strategic framework for activity on promoting affordable credit. It will be essential that these partnerships do not add an additional, unwelcome, layer of bureaucracy to already busy organisations, but have a clear focus on action and the ‘art of the possible’. Lessons might be drawn from current affordable credit partnership activities around the UK, such as Sheffield Money. Particular priorities for local partnerships would be to facilitate the role of partners such as housing associations, churches and faith groups, libraries, social workers, health professionals, charities in referring citizens to local social community lenders as appropriate; facilitate the provision of premises by social justice partners for the delivery of affordable credit services by local credit unions or CDFIs; and foster positive links between local community lenders.

In line with our recommendations in relation to the national Action Group, we recommend that there must be a mechanism at local level for ensuring that in the development of affordable credit solutions, the voices of those who might benefit from those solutions are heard.



2. Investment and Development

There is a clear, urgent need for additional, practical, on-the-ground expertise and resource to help grow community lending in Scotland.

Community lenders across Scotland are the key to improving access to more affordable credit for citizens. But these services are currently extraordinarily small in comparison to the commercial high-cost credit sector. If it is to grow to provide a genuine, viable, at-scale alternative, then significant development work will be required across a multitude of issues. This includes: accessing external investment for loan capital and infrastructure growth; developing use of technology to reduce the cost of lending and improve the customer experience; brokering partnership arrangements with key civil society groups to support delivery; co-ordinating activity within local areas; learning from each other and sharing best practice; developing staff skills and confidence; procuring pro-bono support from partners in the financial services industry; building links with advice agencies and banks to provide financial inclusion wraparound support.

All of this is time-consuming and often technical. It presents real challenges for small organisations, with limited resources to carry out even day-to-day operations in the way that customers increasingly expect. Dedicating the required time and expertise to these issues – which are central to growth – is simply not possible at present for most community lending providers in Scotland.

Considerable knowledge and expertise about how to support and grow community lending already exists in the credit union and CDFI sectors, both amongst lenders themselves and through the representative bodies for credit unions and CDFIs, such as the Association of British Credit Unions Ltd and Responsible Finance. Meanwhile, successful national organisations and resources such as Social Investment Scotland, the Scottish Financial Health Service, the Money Advice Service, Money Advice Scotland, Citizens Advice and the National

Debtline, provide a vital framework and resource for furthering financial inclusion across Scotland.

Additional development resource Recommendation 6

Given the scale of the challenge outlined in this report, we believe there would be great value in building on the excellent base of current activity with additional resource at national level, to help facilitate the further development of affordable credit services.

This resource should be deployed to achieve the following outcomes:

- Stronger relations with the financial services industry
- Improved pathways through which the business models of CDFIs can be verified and deemed ‘investment ready’, via the use of new templates and codes
- More employers willing to consider partnership opportunities with credit unions to offer saving and loan products via payroll deduction
- More personal development and training activities available to CDFI and credit union staff
- New technological solutions tested, demonstrated and implemented by CDFIs and credit unions
- More sharing of best practice and joint working between community lenders
- New strategic partnerships brokered between community lenders and civil society organisations at national or local level
- More Community Planning Partnerships assessing the right affordable credit model for their area and establishing pan-region partnerships where appropriate
- Increased marketing and promotion of the benefits of community lenders, demonstrating how they deliver the type of loan products that customers desire
- New partnerships with key organisations such as advice agencies and banks, including through pro-bono support

The focus of the resource would not be to create a single, national solution to affordable credit –

but to augment existing structures to support local areas, providers and initiatives develop effectively by offering expert help and guidance across key issues. This would enable action at local level, helping local areas to make decisions about what they wish to achieve. Careful thought and consideration would be required to ensure that the additional resource augmented existing services effectively, building on and working in tandem with these.

There should be close alignment between the work of the Affordable Credit Action Group and the additional development resource, with the Action Group playing a key role in directing the focus of the development resource.

Employers and Credit Unions **Recommendation 7**

For credit unions, a key route to further investment and growth is to attract new members, take more deposits and make more loans – all of which provide additional resources to further expand the loan book.

To support this, we recommend that policymakers should continue to support the credit union movement, including encouraging employers across Scotland to consider the opportunities available to them to partner with credit unions to make saving and repaying loans via payroll deduction a standard workplace benefit.

Support for CDFIs to attract investment **Recommendation 8**

Support should be provided to CDFIs to help them more clearly demonstrate to potential investors the case for investment and the workings of their business models, including the impact of any public sector or charitable funding support on their overall sustainability

Unlike credit unions, CDFIs do not hold savings from members or customers. They require

external investment to grow and make many more loans to a far larger number of people. The funds are also required to help community lenders professionalise their services and build an infrastructure with the necessary reach – all of which is essential if the sector is to become an effective, viable alternative to the commercial high-cost credit market.

Achieving access to capital has proven challenging to CDFIs for a number of reasons. There is a need to improve the investment case that CDFIs can make to commercial and social investors, to encourage such investors to look at the sector more carefully, better understand its business models and provide the appropriate investment at the right time that will allow the sector to grow. Investors also need to consider whether they see investment in personal finance community lenders as a fully commercial investment that they expect to generate a market return; as part of their corporate social responsibilities; or somewhere in between. It may be useful to establish clear pathways for community lenders moving between these different types of investment.

Trusts, foundations, social investors and CDFIs **Recommendation 9**

We recommend that trusts, foundations and social investors should seek to offer CDFIs innovative investments and debt structures, focusing on building the case for further investment, demonstrating the business model and leveraging in large scale commercial investment

Commercial investors and CDFIs **Recommendation 10**

Commercial investors should commit to dedicate time and energy to analysing CDFI business models and determining how they can best support these lenders to grow – through a mixture of commercial investments and corporate social responsibility resources.



3. Partnership

As we have highlighted throughout the report, improving access to affordable credit cannot be achieved by any one sector in isolation. Growing Scotland's credit union and CDFI sectors requires innovative new partnerships with others. This includes mainstream financial services, credit reference agencies, advice providers and between credit unions and CDFIs.

Referrals from mainstream financial service providers **Recommendation 11**

In some local areas, mainstream financial services refer declined loan applicants to local credit unions or CDFI, to identify if they may be able to provide a loan or offer another type of service. Meanwhile, a referral scheme to local CDFIs is in place for small businesses who are declined loans from banks.

We recommend that all mainstream financial services in Scotland should have a similar referral arrangement with local credit unions or CDFIs, providing such a referral does not place an unreasonable expectation on these organisations to approve credit.

Basic bank accounts **Recommendation 12**

There is local good practice of partnerships between community lenders and banks which permit community lenders to undertake an identification verification process for their customers, enabling them to open a basic bank account. This is an excellent example of access to affordable credit providing a gateway to wider financial inclusion.

We recommend that all providers of fee-free basic bank accounts should have a similar arrangement with a local credit union or CDFI. This work should forge appropriate links with activities being undertaken by organisations such

as Young Scot, whose National Entitlement Card is accepted as identification for young people by a number of major banks.

Credit references **Recommendation 13**

There are currently aspects of the credit reference system which can hinder citizens who borrow from either community lenders in building a positive credit rating. Specifically, many community lenders do not engage with credit agencies because of the fees involved in doing so. This means that the successful repayment of a loan doesn't count towards their credit history.

We recommend that credit checking agencies should to waive fees, or reduce to notional costs-only, for community lenders accessing credit reports and submitting credit files – to help customers build up a credit history.

Credit advice **Recommendation 14**

High quality advice across a range of financial inclusion matters is available to citizens throughout Scotland on issues such as debt, saving, welfare benefits, income maximisation and budgeting. However, advice on where to secure the best, most appropriate form of credit is less widely available.

We believe that this situation should change. As we set out in the outcome statement, people *do* borrow money, therefore it makes sense for free, impartial, high quality advice to be available to people to help them select the optimal borrowing source.

We recommend that advice agencies in Scotland should seek to, and be funded to, offer clients advice on where they can go to access the cheapest, most appropriate forms of credit, alongside advice on other financial inclusion issues.

Affordable Credit kitemark Recommendation 15

Achieving the outcome statement requires a significant number of people in Scotland to change their borrowing behaviour. It would mean people breaking often long-standing relationships with high-cost commercial lenders, or moving away from other less optimal borrowing practices to instead borrow money, when they need it, from community lenders. If such a change is to be delivered, the promotional messages around the affordable borrowing opportunities have to be appropriate, while a high degree of joint working will be required across organisations with a shared interest in this area to help enable people to make the change.

In terms of key messages, we have highlighted in this report the importance of a number of different features of a credit product that make it attractive to those who might otherwise borrow from high-cost lenders – in particular, its affordability, speed, flexibility, reliability and trustworthiness. At the same time, the fact that the affordable credit product will save people money should be a major selling point – and it is essential that clear, accurate figures are attached to exactly what these savings might be so that people can make an informed choice.

To maximise the effectiveness of these messages, we believe that a single brand is required for credit delivered by community lenders in Scotland.

We recommend that credit unions and CDFIs should work together to develop a joint kitemark to promote all social, community lending across Scotland, improving recognition and visibility for consumers. Such a kitemark must clearly build on the strong existing brand of the credit union movement and the important recent work that has taken place to rebrand CDFIs as 'Responsible Finance Providers' and would require appropriate systems for development and monitoring.



4. Insight

To grow credit unions and CDFIs in Scotland, we need to continue to build our knowledge and understanding of credit. This means improving how we recognise the importance of affordable credit in relation to other social and economic issues; and better understanding how people borrow money – by geography and from what providers. This latter point is particularly important given the significant recent changes in the regulation of high-cost credit and the potential impact of this upon borrowing patterns.

Measurement of affordable credit Recommendation 16

We know that in policy terms, what gets measured matters. If progress against a particular social or economic policy issue is not measured, then that issue is unlikely to be treated as a priority and improvements can be more difficult to achieve.

At present, key national, regional and local performance frameworks rarely include a comprehensive set of outcomes and indicators against which progress on affordable credit can be measured.

We recommend that consideration should be given to how improved access to affordable credit can best be measured, which should then be recognised within relevant measurement frameworks at national and local level. Options might include measuring people's awareness of local community lenders, or the proportion of people living within a particular proximity of their nearest credit union or CDFI. The construction of appropriate, effective indicators requires attention, thought and a clear development process and we recommend that this work should be undertaken.

Research on impact of new regulations

Recommendation 17

We have a strong understanding of the functioning of the high-cost credit market, but there is still work to be done in this space which would aid the growth of Scotland's credit unions and CDFIs. In particular, it is not yet clear, aside from the data from organisations such as the Consumer Finance Association, what the full impact has been of the new regulations from the Financial Conduct Authority on people's borrowing patterns.

We recommend that further research is undertaken on this issue in Scotland, as this will provide an up to date picture of the market for more affordable credit.

Publication of data

Recommendation 18

Our knowledge of borrowing levels within individual communities remains limited, with most published data at a more macro level.

The release of data from all lenders on a postcode or ward basis in Scotland would provide an in-depth picture of borrowing in Scottish communities, which would be hugely valuable in supporting credit unions and CDFIs to understand their market better and target resources accordingly.

We recommend that as far as data protection allows, this data is published.

8. Summary of recommendations



Leadership

1. Establishment of an 'Affordable Credit Action Group' for Scotland
2. A Minister in Scottish Government to have responsibility for financial inclusion, including affordable credit, as part of their brief
3. Scottish Government representative to join the Affordable Credit Action Group and the Government to consider what support it might offer to the deployment of the additional development resource for affordable credit
4. A Community Planning Partnership representative in each local area to have designated responsibility for affordable credit
5. The establishment of a local 'affordable credit partnership' as part of the Community Planning structures in each area



Partnership

11. Mainstream financial providers to have referral arrangements with local credit unions or CDFIs for customers who are declined a loan
12. Providers of fee-free basic bank accounts to have partnerships with a local credit unions or CDFIs for identification verification, allowing credit union and CDFI customers to open a basic bank account
13. Fees to be reduced for community lenders submitting files and accessing credit reports
14. Advice agencies in Scotland to offer clients advice on where they can go to access the cheapest, most appropriate forms of credit
15. Credit unions and CDFIs to work together to develop joint kitemark to promote all social, community lending across Scotland



Development and investment

6. Deployment of additional, national resource to support the growth of Scotland's community lending sector
7. Employers to partner with credit unions to make saving and repaying loans via payroll deduction a standard workplace benefit
8. Support for CDFIs to help them demonstrate their investment case to potential investors
9. Social investors, Trusts and Foundations to offer CDFIs innovative investments and debt structures, focusing on building the case for further investment, demonstrating the business model and leveraging in large scale commercial investment
10. Commercial investors to dedicate time and energy to analysing CDFI business models and determining how they can best support these lenders to grow



Insight

16. Attention to be given to how improved access to affordable credit can best be measured and recognised within relevant measurement frameworks at national and local level
17. Further research to be undertaken in Scotland on the impact of the new regulations from the Financial Conduct Authority on people's borrowing patterns
18. Lenders to release, as far as data protection allows, data on borrowing by postcode or ward level in Scotland

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Notes

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The Carnegie UK Trust works to improve the lives of people throughout the UK and Ireland, by changing minds through influencing policy, and by changing lives through innovative practice and partnership work. The Carnegie UK Trust was established by Scots-American philanthropist Andrew Carnegie in 1913.

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