Carnegie UK TRUST

CHANGING MINDS • CHANGING LIVES

Meeting the need for affordable credit

Discussion paper

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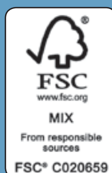

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Foreword

The lack of access to reliable, affordable sources of credit is a serious problem for our poorest communities. Over the past years we have seen the proliferation of extortionately priced loans. The high cost credit industry (payday lenders, home credit companies, pawnbrokers and rent-to-buy retailers) flourished unchecked. Many people have become trapped in a spiral of debt from which it is impossible to escape. Since the financial crisis began in 2008 these problems have intensified as people's need for credit has increased but the mainstream lending options available to them have reduced even further.

As a result of public pressure very welcome regulations and interventions have now been introduced to tackle the exploitative behaviour of so much of the market and reduce the power of these high interest lenders. Interest rates have been capped, lending rules tightened and some of the most damaging lending practices exposed and punished.

At the same time however, reducing the availability of the poor quality credit is only one part of the solution. The demand remains and good credit supply is elusive. People's need for credit in the form of small, short-term loans is unlikely to diminish simply through the removal of particular products and lenders. A responsible short-term credit market that offers people the products they want at a price they can afford to pay remains an absolute necessity.

Credit unions can contribute to a long term solution, as can high street banks and other mainstream lenders. But there is no straightforward or quick fix. The type of credit required to meet the demand can be necessarily expensive and difficult to administer. The

range of customers who wish to access these products is much more diverse than might initially be anticipated. Identifying the funding and revenue streams required to develop an affordable credit service that can be delivered at scale presents a considerable challenge. There is hope though and this paper sets out some of the options.

I would like the debate about these issues widened. Policy makers need to give serious, proper consideration to viable solutions for the short and medium term, as well as the long-term. We need to place our most hard pressed communities' need for reliable, accessible and affordable credit at the heart of the solutions.

This discussion paper by the Carnegie UK Trust sets out the challenge and the opportunity that we face and provides a valuable platform on which this debate must take place.

Right Reverend John Chalmers

Moderator of the General Assembly of the Church of Scotland

Summary

The question of how to ensure that people have access to affordable sources of credit has long been a contested and often emotive public policy issue. The way we talk about access to credit and the ability to borrow is complex and challenging. Never more so that when thinking about the more vulnerable.

Those with the lowest incomes are the least likely to be have access to mainstream credit such as bank loans or credit cards. They instead rely on a myriad of non-mainstream legal money lenders where the cost of borrowing is significantly higher. This throws up many challenging policy questions. When people need to borrow for basic essentials is this really a question of affordable credit or rather a problem of income and benefit rates? Is it right that those with the least resources have to pay more to borrow money? Should everyone have the right to borrow money anyway? What terms and conditions are defined as 'affordable'? What are the ethics and motivations of different credit suppliers? What are the appropriate policy levers to bring about change in either the supply of or demand for credit? The 'moral compass' on these issues is rarely clear.

In this discussion paper we address one critical aspect of these debates – how best to meet the ongoing need for credit amongst those unable or unwilling to access mainstream products? Too often this is presented as a binary issue, with a clear problem and solution. However, the issues involved are far more subtle than the dominant public policy narrative might suggest.

The problems associated with many non-mainstream, high cost money lenders are well-established. New rules and regulations and a new 'cap' on credit have been introduced to the high cost credit market,

significantly restricting the operations of many of these suppliers. These are highly welcome policy interventions to reduce exploitation by the more irresponsible short-term lenders. One estimate suggests that there will be a reduction of around £750 million per annum in high cost loans[1] and another estimate forecasts that 160,000 fewer people will take out payday loans[2].

While these changes are extremely welcome, the need for credit amongst those who formerly accessed high cost loan products will remain. How can this demand be met? A revived credit union sector is proposed by many policy makers as a viable alternative to the high cost credit market. This strategy appeals in the long-term. However, focusing solely on this approach ignores many of the complexities of the high cost credit market, in terms of operating models, the different backgrounds of customers who use different loan products and issues of scale. When these issues are analysed in depth it is clear that a range of affordable alternatives are required.

We therefore need to widen the debate about the cost of credit and how to develop affordable options for those unable to access mainstream sources of finance.

[1] Europe Economics, A New Consumer Credit Regime: Benefits, Compliance Costs and Firm Behaviour 3 October 2013

[2] FCA CP14/10: Proposals for a price cap on high-cost short-term credit, July 2014

01 The rise and restriction of high cost credit

Since the financial crisis began in 2008 the debate about access to credit has become a major public policy issue. Job losses, reduced incomes and the rise in the cost of living all mean that a growing number of people now rely on short-term credit to pay for day-to-day essentials[3]. At the same time, banks have tightened their lending criteria and access to mainstream forms of credit has contracted considerably. The result has been that the high cost credit market has flourished, providing the access to finance that people need, but at interest rates that many find unpalatable. The growing high cost credit sector has been the subject of fierce public criticism, with accusations of excessively high charges, poor lending practices and exploitation of the most vulnerable.

[3] Personal Finance Research Centre (PFRC), University of Bristol, (2013), The impact on business and consumers of a cap on the total cost of credit

The public policy response to these issues has been swift, robust and effective:

- In April 2014, as responsibility for the consumer credit market moved from the Office of Fair Trading to the Financial Conduct Authority (FCA), new measures were introduced including: a change from regulatory guidelines to stricter regulatory rules on repayment and collection methods; increased scrutiny on affordability, creditworthiness and forbearance; and substantially more resources available to monitor and enforce these new rules.
- The UK Government has recently introduced a total cap on credit (TCC) on the loans issued by payday lenders. The aim of such a cap is to reduce the cost of short-term credit for consumers. The cap came

into force in January 2015. It takes the form of a 'pincer movement' of a daily cap of 0.8% within a total cost cap of 100%. This means that a £100 loan issued over one day cannot cost more than 80 pence. If the borrower does not meet their repayments a £15 default cap is imposed, and then interest applied up to but not exceeding 100% of the original sum borrowed.

These new rules and regulations are already bringing about significant change in the dynamics of the high cost credit market in the UK and are helping to tackle exploitation. The Consumer Finance Association (CFA) report that 54% fewer payday loans were issued in the first quarter of 2014, compared to the same period in 2013.[4] The FCA estimate that only three online payday lenders and one retail payday lender will be active in the market post 2015[5]. Loan product ranges will contract as both very short loans (under 14 days) and loans on a term longer than 3 or 4 months are less appealing to lenders. More significantly, the group of potential borrowers eligible to apply for these products will narrow[6]. Provident Financial Group (PFG) announced that their lending volumes in 2013 had reduced from 1.8 million customers to 1.5 million[7] and in February 2015 they announced that they had reduced their home credit numbers by a further 500,000 to just over 1,000,000. This represents a 44% reduction in two years[8]. The reduction is primarily driven by the exclusion of new borrowers, with a focus instead on repeat and stable customers[9]. The Chief Executive of the CFA, Russell Hamblin-Boone believes that the high cost credit market is moving from "*sub-prime to near prime*".[10]

[4] Russell Hamblin-Boone, CEO, CFA, remarks to North Ayrshire Council payday lending evidence hearings, July 2014

[5] FCA Technical Annex Supplement to CP 14/10 July 2014

[6] Personal Finance Research Centre (PFRC), University of Bristol, (2013), The impact on business and consumers of a cap on the total cost of credit

[7] http://www.iii.co.uk/research/LSE:PFG/news/item/1003172/final-results

[8] http://www.iii.co.uk/research/LSE:PFG/news/item/1393316/final-results?context=LSE:PFG

[9] http://www.iii.co.uk/research/LSE:PFG/news/item/1003172/final-results

[10] Russell Hamblin-Boone, CEO, CFA, remarks to North Ayrshire Council payday lending evidence hearings, July 2014

02 The need for access to credit remains

Appropriate oversight of the consumer credit sector is clearly critical in order to provide the necessary level of customer protection from the damaging or aggressive lending practices that have been seen from some lenders in the high cost credit market. The new regulations are therefore very important in tackling some of the costs and potential detriment experienced by consumers in this market.

However, the new restrictions on supply may not result in a corresponding drop in the demand for credit. In the current economic and lending context, people's need, or desire, for short term, non-mainstream loans will remain.

With fewer legal, albeit high cost, credit options available to them there are concerns that those who are excluded from mainstream credit – often the poorest or most vulnerable people in society – may increasingly be forced to turn to illegal money lenders for finance. There is some debate on this issue. The FCA estimated in July 2014 that there would be 160,000 people a year who would no longer be able to get payday loans[11]. By November 2014, noting that "*many people have already been denied credit as a result of changes firms have made to their lending criteria in response to FCA regulation*" the FCA indicated that 70,000 people would no longer be able to access high cost credit due to the forthcoming price cap. The FCA has suggested that "*there is a low risk of illegal money lending use as a result of the cap*" but recognises that "*the consequences for consumers of turning to illegal money lending could be severe, even if the risks are low in terms of*

[11] Financial Conduct Authority (FCA) (2014) Proposals for a price cap on high-cost short-term credit – consultation paper, page 11

number of people affected"[12]. Research on the scale of illegal money lending carried out prior to the new restrictions on the high cost credit market suggested, however, that borrowing from these sources was on the increase. In 2010 it was estimated that over 310,000[13] people were using illegal lenders as a source of credit compared to only 165,000 in 2006[14]. Meanwhile, research published by Policis in January 2015 highlighted that *"illegal money lending thrives in a credit vacuum and tends to be concentrated in those who have lost access to credit."* The report raised concerns of a rise of illegal moneylending to serve unmet demand in the new regulatory regime and suggests that this illegal lending may be increasingly online and in large part offshore[15].

There may be other unintended consequences of the new restrictions on credit supply. For example, if people are unable to access finance themselves, they may seek to borrow money under family or friends' names to source the credit that they need. In addition, price controls in the form of interest rate restrictions or a cap on credit have not been found to necessarily reduce the cost of credit for consumers. In some cases where caps have been set fairly high, high cost credit providers who were previously charging rates below the level of the cap have increased their rates towards the cap. There is also a danger that pricing may become less transparent and understandable for consumers.[16]

A major public policy challenge therefore remains. What can be done to develop alternative solutions which ensure that people's need for credit is met in a way which is accepted as both ethical and affordable?

12 Financial Conduct Authority (FCA) (2014) Proposals for a price cap on high-cost short-term credit – consultation paper, page 11

13 Policis (2010) Interim Evaluation of the national illegal lending projects

14 Policis (2006) Illegal lending in the UK

15 Policis (2015) Transfer to the new consumer credit regime – The impact for firms, consumers and the credit market

16 Personal Finance Research Centre (PFRC), University of Bristol, (2013), The impact on business and consumers of a cap on the total cost of credit

03 Understanding the high cost credit sector

To address this question properly, we must have a clear understanding of the high cost credit market and the customer base that uses it.

The high cost credit sector is made up of a number of different types of products. The most common of these are payday, (both online and retail) home credit lending and pawnbroking which are estimated to account for **£5** billion worth of loans and serve 5 million customers. This roughly breaks down as **£2.8 billion worth of** payday loans to 1.8 million customers[17] and between £1.2-1.5 billion worth of loans to 2.4m to 3 million home credit customers.[18] Beyond these two markets are pawnbroking loans, rent-to-buy retail credit (BrightHouse and PerfectHome) and the continued use of catalogues.

3.1 A diverse customer base

Popular opinion often characterises high cost credit consumers as being the poorest and most vulnerable people in society. However, analysis of high cost credit market data reveals while this is true of some, it is not true of all customers in this market. In addition, there are significant differences in the demographic profile of users of different financial products within the high cost credit market. Understanding these nuances is vital if we are to devise effective policy solutions:

[17] Competition & Markets Authority (2014) Pay-day lending market investigation: provisional findings report

[18] Provident Financial Group, Annual report 2013

Table 1: Demographics of high cost credit users

The UK net median income is £17,100. The median incomes for payday customers are £16,500 for online and £13,400 for retail.[16] The lowest income decile in the UK has a net income of £8,800. Nearly 50% of home credit customers are in the bottom two deciles.[17]
Around three-quarters of online payday loan customers and two-thirds of retail payday loan customers are in full-time employment, compared to only a quarter of those who use home credit or a third of those who use pawnbrokers[18]
Only 37% of online payday loan customers have been defined as 'vulnerable' compared with 77% of home credit customers[19]
Around a quarter of online payday loan customers would be able to access mainstream credit, compared to only 10% of home credit customers[20]
Around 40% of payday lending customers are female[21] and just over a third have dependent children, while two-thirds of home credit customers are female and more than half have dependent children[22]
The average loan taken by home credit customers is £500,[23] while the average online payday loan is £290 and the average retail payday loan is £180[24]

[19] Competition & Markets Authority (2014) Payday lending market investigation: provisional findings report

[20] Policis and Friends Provident, quoted in OFT report 2010

[21] Personal Finance Research Centre, University of Bristol, 2013

[22] Personal Finance Research Centre, University of Bristol, 2013

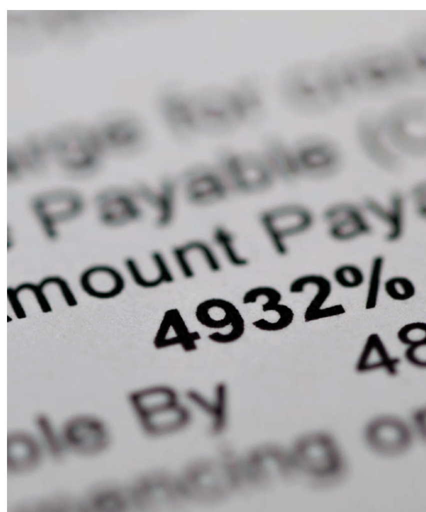
[23] Personal Finance Research Centre, University of Bristol, 2013

[24] TNS BMRB "Research into the payday lending market: report for Competition Commission (TNS) Jan 2014

[25] Consumer Finance Association, 2012 and Provident Financial Group investor analysis, 2010

[26] Provident Financial Group Annual Report 2013

[27] Competition Commission, 2013



Commercial high cost credit providers have a sophisticated understanding of their customer profile and their customers' needs and preferences. Analysing these figures, it is clear that any public policy intervention which seeks to develop more affordable sources of non-mainstream credit to meet ongoing demand must provide a range of products which cater for the very different circumstances and demands of different groups of consumers.

An expanded credit union sector is often highlighted by policy makers as a possible alternative to commercial high cost lenders. This is clearly the right long-term strategy. However, analysis of the credit union customer profile compared to those using payday loans or home credit suggests that in the short-to-medium term it may be a significant challenge for credit unions to adapt and provide for these customers:

Table 2: Demographics of credit union members

Nearly half of credit union customers own their own home, compared to only around a fifth of those who take payday loans or home credit[28]
6% of households in Scotland with an income over £30,000 use a credit union while only 3% of households in lower income brackets have a credit union account (although it should be noted that 7% of households in the 15% most deprived areas use a credit union)[29].
More than 70% of credit union customers are aged over 40. In contrast, around 50% of payday loan customers and 40% of home credit customers are under 35.

[28] ABCUL, 2006; Competition Commission 2014; Provident Financial Group 2010

[29] Scottish Household Survey, 2012

Moreover, credit unions themselves have indicated that they cannot always provide the solution. In their response to the FCA Payday loan cap proposals ABCUL state:

> *"Credit unions are often cited as a solution to the growth of payday lending in the UK. However while credit unions do seek to serve those who are unfairly excluded from access to affordable credit, there are clear limits to what credit unions are able to, or should do, in terms of directly competing with payday loan products. The challenge credit unions face today is in building a sustainable business model, from the foundation of a diverse membership base, by developing a compelling offer for the customer*[30]*"*

3.2 Non-mainstream credit is expensive

One of the major causes of concern about the high cost credit market is the high interest rates lenders charge, usually presented as Annual Percentage Rate (APR). These rates appear extraordinarily high when compared to the APRs charged by banks for mainstream loans.

However, using APR as a means to compare loan offers between banks and the high cost credit sector (or indeed within the high-cost credit sector) is the wrong way of analysing the type of loan product generally offered in the high cost market. High cost credit loans are, on the whole, short term so an annualised measure is not a useful representation of the actual price of the loan for the customer, as Table 3 below illustrates:

[30] Mark Lyonette, CEO, ABCUL, letter to Dr Diana Tlupovsa responding to FCA payday loan cap consultation (September 2014)

Table 3: 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%

In each of these circumstances the actual amount of money the customer has to repay is the same. It is the duration of the loan rather than the amount repaid which produces the extremely high APR.

Nevertheless, credit in the non-mainstream market is often considerably more expensive than it is from mainstream lenders. There are a number of reasons for this:

- **Fixed lending costs**: The costs of lending, in terms of administration, set up and operating costs, are largely fixed and do not vary proportionately to the size or term of the loan.[31] A mainstream lender such as a bank can significantly reduce the cost of credit to the consumer by only loaning larger sums (£1,000 minimum) over longer periods (12 months minimum). The cost of administrating this type of

[31] Joseph Rowntree Foundation, (2005), Affordable Credit for Low Income Households

loan is proportionately much smaller than it is for the short term, small sum loans offered in the high cost credit market. By way of example, the 1st Alliance Credit Union in North Ayrshire report that it costs them **£51** to issue and administer a loan. As Table 4 illustrates, this means that small sum, short term loans are unsustainable at mainstream interest rates, particularly to high risk borrowers:

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	3.0%	12	£95	£135	£51	£84

- **High risk customer base**: Banks further reduce costs for their customers by only lending to those who they assess as being unlikely to default, according to strict criteria. This means they do not have to significantly increase the cost of loans to each customer in order to cover for those who may not repay. In contrast, high cost credit lenders generally serve higher-risk customers who are more likely to miss payments or not pay at all meaning that higher margins are required to cover the costs, or the risk, of 'bad debt'.

- **Use of cash**: High cost credit lenders often deal in cash rather than using electronic processes – this increases the administration costs of providing the loan, particularly in the home credit market where costs of agents also needs to be covered.

In terms of public policy, these are critical points. High cost credit customers tend to want short term, small sum loans, often processed in cash or on their doorstep. These customers are also more likely to default on repayments than consumers in the mainstream market. Providing this type of credit is inherently expensive. While policy solutions may be developed to make credit more affordable for customers, policy makers must recognise that this type of lending will always be significantly more expensive than mainstream credit products.

3.3 Price is not the main driver in choosing a loan

For many customers in the non-mainstream credit market, the price is often not the main factor in choosing a loan product. Despite the high level of public concern about the costs of credit in the high-cost credit sector, most customers in this market are aware that it is an expensive way of borrowing small sums of money.[32] However, there are a number of other factors that are often more important:

- **Speed of access**: For people without access to mainstream credit the immediate need for short-term funds is often critical. Same day transfer is very popular with borrowers despite the extra cost this entails. For payday customers 'speed of getting the money' ranks as the most important factor in choice of loan, with the total cost of getting the loan ranked only fifth[33]. Two

[32] Joseph Rowntree Foundation, (2005), Affordable Credit for Low Income Households

[33] TNS BMRB, research into the payday lending market (Competition Commission) Jan 2014

recent experiments with 'same day' money transfer options back up these findings:

- A payday lending pilot run by London Mutual Credit Union offered customers credit at £2 per £100 for 30 days. They issued almost £700,000 of these loans in the year-long pilot through almost 3,000 loans. For an additional £11 the borrower could receive their loan funds on the same day – 86% of customers took up this option[34].
- East Lancs Moneyline a social business Community Development Finance Institution (CDFI) introduced a 'same day' transfer option in April 2014, for a cost of £7. To date 75% of borrowers have chosen this option.

- **Affordable repayments:** For high cost credit consumers the affordability of the loan repayments is another important consideration in choosing a credit source. This is particularly the case for those on low-incomes who are looking to repay their loans in

[34] The Financial Inclusion Centre, An evaluation of London Mutual Credit Union's pilot scheme (2013)

cash on a weekly or fortnightly rather than a monthly basis. This better suits the frequency of their income, be it through work or benefit payments[35].

- **Flexibility and fit with need:** Despite its high costs, short-term high cost credit is often seen by borrowers to better match their needs. People on the lowest incomes tend to experience the greatest degree of financial instability and so value the flexibility and simplicity that high cost credit loans offer in contrast with the more rigid requirements of mainstream credit providers[36]. Missed payments with home credit do not result in additional fees, so a borrower has fixed costs. If people have fluctuating incomes they may be unable to commit to a longer term loan, for example over three or five years, even if this is available at a lower rate.

- **Trust in lender:** Once people have found a reliable credit source and are content with the service they receive, they tend to stick with that provider and are reluctant to switch, even where a cheaper alternative could save them money. When people have limited potential sources of credit they are often keen to maintain a relationship with their lender and not risk jeopardising this for a new lender who may not be available to them in future. The greatest resistance to switching lenders has been found amongst those on the lowest incomes who don't want to risk disrupting their finances. Home credit users in particular are reluctant to disrupt the face-to-face relationships they have built up with staff[37].

[35] Joseph Rowntree Foundation, (2005), Affordable Credit for Low Income Households

[36] Personal Finance Research Centre (PFRC), University of Bristol, (2013), The impact on business and consumers of a cap on the total cost of credit

[37] Joseph Rowntree Foundation, (2005), Affordable Credit for Low Income Households

04 Possible policy solutions

What then might be done to develop new, more affordable sources of credit for those excluded from mainstream loan products? Policy responses in this area have, to date, been less coherent than responses designed to restrict credit supply – perhaps unsurprisingly given some of the complexities and challenges described above.

4.1 Credit unions

Credit unions have a vital, strategic role to play in reducing people's reliance on high cost credit in the longer-term. Credit unions are a form of co-operative bank that have strong social objectives. They are not-for-profit organisations that offer a limited range of services to their members, including providing a critical mechanism that enables people to save small amounts of money on a regular basis[38]. Credit unions also increasingly look at the wider financial circumstances of individuals and can offer access to advice and support on issues such as debt, budgeting and saving to help improve their members' financial situations in the longer-term.

The Association of British Credit Union Limited (ABCUL) reports that there are approximately 400 credit unions operating across England, Wales and Scotland providing a total of £690 million in loans[39]. These credit unions vary greatly in size and nature – from multi-million pound institutions to small community led, volunteer run unions with small loan books.

Credit unions are currently subject to an interest rate cap on the amount they can charge.

[38] New Economics foundation (2012) Credit Unions: International Evidence

[39] http://www.abcul.org/media-and-research/facts-statistics

Currently this is set at 3% a month on a reducing balance, which means they have a maximum chargeable annual rate of 42.6% APR. These figures are substantially lower than those set by commercial providers in the high cost credit market.

Given these benefits, it is clear that growing and developing the credit union sector as a powerful, viable alternative to high cost commercial credit providers is a good long-term strategy. There has been considerable government support in recent years for credit unions as an affordable credit alternative. Under the last Labour Government, funding was made available to the sector through the DWP Growth Fund. This support has continued under the current UK Government which introduced a credit union expansion project, providing £38million to the sector over 3 years to grow and modernise, with targets of 1 million new customers and increased lending to £1 billion by 2019. The Prime Minister stated in Parliament in 2013 that:

> *“we must give more support to credit unions in our country, which I think is one of the best ways of addressing the whole problem of payday loans and payday lending.*[40]*”*

There are a range of ways in which credit unions can help to tackle high cost credit. Although their customer profiles differ, there is a cohort of people who currently use high cost credit providers who could benefit from switching to a credit union. These customers are likely to be those who have higher household incomes and are potentially able to save and therefore fit with the traditional credit union model. To attract these customers policy makers and credit unions need to continue to raise awareness and the profile of the sector. Attracting a greater number of higher income customers will also provide credit unions with

[40] http://www.publications.parliament.uk/pa/cm201314/cmhansrd/cm130612/debtext/130612-0001.htm#130612-0001.htm_spmin24

additional resources which may then make it easier for them to provide more short-term loan products to vulnerable customers.

However, despite the cheaper loans offered by credit unions and ongoing government support and investment there has not yet been a mass migration to the sector from commercial high cost lenders.

There are a number of reasons for this:

- As the evidence has shown, customers using commercial non-mainstream credit products such as payday loans and home credit are different from the traditional credit union customer base, which is generally made up of people higher up the 'credit curve'.
- The credit union model limits the ability of the sector to provide the type of loans that those who use commercial high cost lenders demand. As described above, this customer base requires immediate access to small, short term loans, processed with minimal bureaucracy, online or on the doorstep. This type of lending is intrinsically expensive – particularly as there is also a high risk of default. Credit unions' capped lending price of 3% a month means that at present, they are not positioned to sustain this type of loan book.
- The size of the credit union sector loan book is only about 10% of the size of the commercial high cost credit market. Trying to scale up the sector so that it can compete with these providers is a huge challenge.
- Most credit unions still require new customers to save before they can borrow. This can be off-putting for many people, particularly those on the lowest incomes, as they are least likely to have any savings or be in a position to be able to save. In addition, this model does not fit with top priority of payday loan customers, which is the speed at which they can access credit.

- There are competing views about the future direction of credit unions within the sector itself. The largest credit unions, which have the loan capital (through member deposits) and efficiency in systems, might be described as "able but not willing" to deliver small sum, short term credit to high risk customers. In contrast, the smaller credit unions, those who might be described as "willing but not able" to do so, lack the larger value, longer-term loans on their books to make such lending a viable proposition.

There are therefore limits in the extent to which credit unions can meet the substantial demand for credit amongst those excluded from mainstream products in the short-to-medium term. Given the ongoing demand for short term loans, and the reduction in availability of such loans for consumers, it is vital that other players in the not-for-profit arena are considered when formulating solutions.

4.2 Community Development Finance Institutions

Community development financial Institutions (CDFIs) are, like credit unions, not-for-profit lenders who provide a range of loan products primarily aimed at people unable to access mainstream credit. Unlike credit unions however, they do not require people to save before they can borrow and there are no restrictions on the rates of interest that they can charge. This greater flexibility in their model potentially makes CDFIs a realistic and viable option for developing new affordable credit solutions to meet demand in the medium term.

However, the sector is smaller than the credit union movement and is tiny in comparison to the commercial high cost credit market. There are currently only 10 personal loan CDFIs operating in the UK. In 2013 they lent £19 million to 40,600 people (compared to £5 billion of loans provided by commercial

high cost lenders), saving these customers an estimated £7.8 million in interest repayments that they would have incurred had they used a commercial alternative[41].

CDFIs are already supporting some of the most vulnerable and financially excluded people within society, and there are significant overlaps between the CDFI customer base and the home credit segment of the commercial high cost credit market. Similarly to this market, the majority of CDFI customers are female, under 35, have dependent children and live in rented accommodation[42]. However, around two-thirds of CDFI customers are unemployed, compared to a figure of around 10% of customers using commercial providers. This suggests that while CDFIs are playing a vital role, providing access to finance for some of the poorest and most vulnerable people, they would have to make significant adjustments to their model to be an attractive proposition to those currently accessing commercial high cost credit.

Nevertheless, the flexibility within the CDFI model may allow them to make such an adjustment.

The biggest challenge to growing the CDFI sector is that of financial sustainability. At present some CDFIs are finding that the level of demand for their services threatens to outstrip the resources that they have available to lend. To effectively compete with commercial providers CDFIs would need to significantly increase their scale and diversity of their product range. This would require considerable investment in the sector to provide it with the necessary loan capital to serve a much larger customer base. The sector would also require significant development capital to build

[41] Community Finance Development Association (2013) Inside Community Finance

[42] Moneyline, 2014

the required infrastructure and recruit, train and properly remunerate skilled personnel. The sector is currently unable to raise sufficient funds from commercial lenders, who are wary of a business model based on high-risk customers. Growing the sector would therefore require investment from alternative sources, including the public sector, civil society or from financial markets. Appropriate mechanisms would also need to be found for securing and delivering such capital. Other options to support the growth of the CDFI sector – for example access to premises through which an affordable loan service could be provided – could also be explored with potential partners such as local authorities or housing associations.

The average interest rate currently being charged by personal CDFIs is 69% APR[43]. The largest CDFI in the UK, East Lancs Moneyline, charges a representative APR of 144.99%.

Whilst this may appear high, particularly when compared to the 42.6% maximum APR of credit unions, it is still significantly lower than rates offered by commercial providers in the high cost credit sector. If the sector could be grown, then these rates could potentially reduce in future due to increased economies of scale and a wider spreading of risk. This supports the findings from the DWP Growth Fund Evaluation, which suggested a break-even APR of 70% for not-for-profit lenders.

[43] Community Finance Development Association (2013) Inside Community Finance

4.3 Other options

In a recent report the progressive think-tank IPPR called for the establishment of an 'Affordable Credit Trust' (ACT) funded with a levy from lenders themselves with £450m. The proposed ACT would be:

> *"a democratic, non-state body with the purpose of capitalising and mobilising a diverse range of local not for profit institutions that lend small amounts at affordable rates to ordinary people…with the core duties of spreading access to affordable short term credit and protecting people from unsustainable personal debt.[44]"*

The benefit of this proposal is that it recognises the shortage of loan capital as a critical issue for the not-for-profit sector and proposes a mechanism for addressing this. This appears to be a sensible approach, although the ability of high cost credit lenders to contribute to the levy may reduce as a result of the new regulatory restrictions currently being introduced.

In July 2014 the Centre for Social Justice published its own report on the issue of affordable credit, "Restoring the Balance". In this report the CSJ called on the UK Government to support social finance providers by investing in a new Social Finance Investment Platform pump-primed by government that might be able to attract subsequent peer-to-peer investment.[45] Whilst the CSJ provides different options for increasing access to affordable credit, like IPPR, it clearly recognises the critical need for loan capital as central to the growth of the social lending sector.

[44] Matthew Lawrence and Graeme Cook, "Jumping the Shark: Building Institutions to Spread Access to Affordable Credit" (ippr) April 2014

[45] The Centre for Social Justice "Restoring the balance: Tackling problem debt" (CSJ) July 2014

In March 2015 the Financial Inclusion Commission recommended a package of measures to improve financial inclusion in the UK, across banking and payments, credit and debt, savings and pensions, insurance, financial capability and leadership. The Commission concluded that the credit gap for those unable to access mainstream loans is likely to be widened by new regulations in the high cost credit sector and recommended the promotion of *"measures to make community finance institutions more sustainable, such as government lifting the APR cap on credit unions, lenders and investors developing a better understanding of business models and risk, and community lenders attracting a wider customer base"*[46].

[46] Financial Inclusion Commission (2015) "Financial Inclusion – Improving the Financial Health of the Nation"

4.4 Going beyond credit

It is important when considering potential solutions to examine not just what forms of more affordable credit might be developed but to also consider what additional services might be attached to different models to help improve the financial circumstances of customers in the longer term. A number of credit unions, CDFIs and even commercial high cost credit lenders have begun delivering or signposting a range of financial inclusion support services alongside their loan products. This type of support might include advice on issues such as debt, welfare benefits, budgeting and saving.

It is clearly critical that the growth of more affordable credit options also considers these issues and identifies mechanisms through which such support can be provided alongside more affordable loans, with the central aim of reducing reliance on high cost credit in the longer term.

05 Next steps

As the evidence in this paper demonstrates, this is a highly challenging and complex policy area. None of the potential solutions are likely to be achieved simply. There are a number of critical policy questions and issues which must be addressed:

- Are public policy interventions to support the supply of credit for those on the lowest incomes appropriate?
- What is the relationship between such interventions and public policy on issues such as income and benefit levels?
- How to overcome hostility to the inherently high price of type of credit sought by those who currently use commercial high cost lenders – immediate, short-term, small sums of money delivered via a personal service that meets their needs?
- How to source and secure the multi millions of loan and development capital required to grow the not-for-profit sector to enable it to deliver this type of lending at a scale anywhere near comparable with commercial operators? What investors might be interested in operating in this space? What mechanisms would be required to secure and deliver this funding?
- Are the solutions that we seek likely to be commercially viable in the medium to long-term or will some form of ongoing public subsidy be required? What other types of public support might be provided?

- What leverage might be exercised over the banking sector to support the growth of not-for-profit lenders, including expertise and resources ?
- What opportunities exist for pilot projects to test out different models or approaches and identify what works and what doesn't?
- How can the power of digital technology be harnessed to help deliver more affordable credit options?
- How do we grow the affordable credit sector in tandem with the provision of a wider package of financial inclusion support, including advice and support on saving, budgeting, debt and welfare benefits?

Many of these issues will require a long-term programme of intervention to tackle seriously, going beyond traditional election cycles. We therefore need to continue to widen the policy debate around these challenges and bring together all of those who have an interest in finding the right solutions to increase the availability of more affordable credit for those who need it.

Notes

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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