affordable credit

a model that recognises real needs

National Consumer Council research consistently finds that the poor pay more, or get less, for essential goods and services. The resulting market-based exclusion deepens disadvantage and reduces the effectiveness of welfare and social inclusion policies, such as benefit payments, tax credits and local regeneration.

Achieving financial inclusion is an essential element of the solution to social exclusion and poverty. And access to affordable credit is a key part of this – though not having a bank account that allows automated payments acts as a major barrier. Social Fund loans are one source of affordable credit, but, for a variety of reasons, they are not accessible to all.

This factsheet presents new research findings to stimulate the development of a policy agenda of market-based solutions for a new model of affordable credit.

Key findings:

Many low-income consumers spend a high percentage of their limited budget on borrowing, risking a dangerous debt spiral:

- low-income consumers pay on average £129 a month in interest – 11 per cent of their income.

Market-based provision of loans for those on low incomes is very expensive:

- people on benefits borrow an estimated £330m a year from home credit, with interest payments alone amounting to an estimated £140m.

The social fund is failing many people:

- one in four people turned down are forced to turn to doorstep lenders and unlicensed loan sharks.

There needs to be a new cross-sector approach, on a coherent and coordinated basis.

Low-income consumers need credit, but the mainstream credit market is inappropriate for many people due to the design of products and the way in which they are delivered. This results in exclusion from the credit choices and interest rates that are available to more affluent borrowers. One in five consumers – 7.8m people – are denied access to high-street credit.

The government's safety net for those on the lowest incomes, the Social Fund, is only open to a limited number of people. The worst-off in society often fall back on the most expensive forms of credit. While this can be due to poor credit history, in many cases it is simply because some of the features of high-cost credit products are more important to hard-pressed borrowers than the financial consequences.

A solution to this enduring problem is needed. To be a realistic alternative to high-cost credit options, an affordable credit model would need to replicate some of the product and delivery features that appeal to home credit customers, and offer low interest rates.

Going forward

The government, led by the Financial Inclusion Taskforce, should:

- **recognise the features of credit that meet the needs of those on low incomes;**
- **recognise the potential for an explanded Social Fund loans scheme to become the building block for an effective affordable credit model;**
- **establish the real cost of delivery of the high-cost credit products currently used by low-income consumers, and determine whether it can be done more cheaply and efficiently; and**
- **explore the potential for a partnership of the public, private and voluntary sectors, to allow the more cost-effective delivery of an affordable credit model.**

policis

NCC National Consumer Council
Making all consumers matter

A new model of affordable credit

The Treasury's 2004 Spending Review put financial inclusion firmly back on the political agenda. It set out government intentions to tackle financial exclusion in three priority areas: banking, affordable credit and free face-to-face money advice. The Spending Review also led to the creation of the Financial Inclusion Taskforce (formally launched in February 2005, on which the NCC is represented) to monitor progress and a Financial Inclusion Fund to finance initiatives.

This level of political support and financial investment provides an unparalleled opportunity to make financial inclusion a reality. One way of doing this is by creating an affordable and accessible credit model to provide an alternative to home credit, and other high-cost options.

Borrowing by those on low incomes is a necessity, not a luxury

For low-income consumers without savings, borrowing is often the only option. The amounts they borrow may be small, but without a financial safety net their need for credit is urgent.

The design and delivery gap

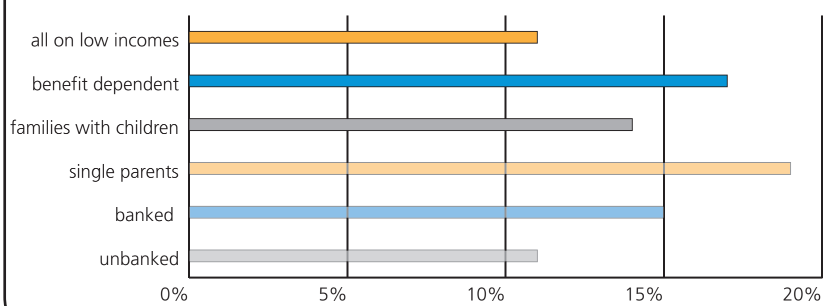
The design and delivery of mainstream credit fails these consumers for a variety of reasons, including:

- a lack of trust or familiarity with providers;
- application procedures which are difficult for some, such as form-filling;
- the frequent need for access to a telephone or the internet;
- lack of certainty over the likelihood of an application being successful;
- higher minimum loans than the £150 average that low-income consumers tend to borrow;
- the need for a bank account to receive the loan and make repayments;
- monthly repayments that do not fit with budgeting cycles;
- penalties and hidden charges; and
- the serious legal consequences of defaulting.

Limited credit options

Almost eight million people are denied access to high-street credit. This leaves people on low incomes with little choice but to use the alternative credit market. As a result, a substantial proportion of their income – currently an average of £129 per month, equivalent to eleven per cent of their monthly income – goes on servicing high-cost borrowing. For benefit recipients the amounts involved are even higher.

Percentage of monthly income servicing debts



Source: Policis/NCC survey, 2005

About the research

The research was carried out in January 2005 and was based on a nationally representative sample of 1,520 low-income consumers, aged 18 to 64, and excluding full-time students.

'I wasn't working. I found it very difficult trying to cope with the money and with having two small children as well. So I decided to have loans, which helped me a lot.'

Co-habiting female, 37, dependents, now works part-time

'The largest amount I have ever borrowed would have been £200 for Christmas.'

Co-habiting female, 37, dependents, now works part-time

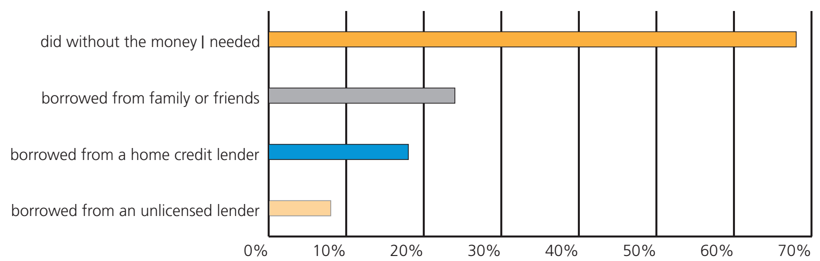
State-funded interest-free loans are essential for the poorest

Social Fund budgeting and crisis loans are the government's safety net for the most vulnerable people in society. They are interest-free and usually repaid by deduction from benefit payments. Loans are made from cash-limited budgets according to local priorities. As a result, there is no certainty that an application will be successful – even if the applicant qualifies for a loan. Also, successful applications often result in a loan of less than the amount requested, leaving the applicant to do without or make up the shortfall some other way.

Many eligible applicants' credit needs are not met by the Social Fund

More than one in five applications for budgeting and crisis loans are unsuccessful. Yet almost 50 per cent of crisis loan refusals are overturned on appeal, indicating that people with genuine needs are being turned away. The majority of people who are rejected from the Social Fund simply do without, but one in four have to borrow from high-cost doorstep lenders and unlicensed loan sharks.

Next step for those refused loans

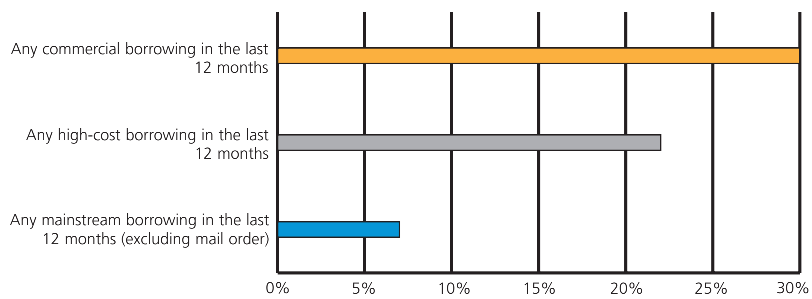


Source: Policis/NCC survey, 2005

The poorest people pay the most for credit

Nearly a third of those on the lowest incomes have to use commercial credit – even those who have successfully applied to the Social Fund. Just under two in ten had borrowed from high-cost lenders, such as home credit companies. Fewer than one in ten had borrowed from high-street lenders.

Low-income borrowing



Source: Policis research 2004 for DTI, *The impact of interest rate ceilings in other countries.* These analyses were originally worked up for Kempson and Collard, *Affordable Credit*, 2005

Crisis loans

Helps meet expenses in an emergency or disaster. For example, providing money for food if a benefit payment has not been made. Applicants do not have to be receiving benefits. A crisis loan is often a small amount, an average of £77 in 2004.

Budgeting loans

Helps meet costs for larger, necessary, but often one-off expenses that the applicant does not have the savings to finance. For example, a cooker, or advance rent payments. Applicants have to be in receipt of income support, job seekers allowance (income-based) or pension credit. The average loan in 2004 was £384.

Official Social Fund loan statistics for 2004/05

- **1,621,000 Budgeting Loan and 1,334,000 Crisis Loan applications were made**
- **377,000 Budgeting Loans and 304,000 Crisis Loans were unsuccessful**

Figures for Great Britain 1st April 2004 to 31st March 2005. Source: Department for Work and Pensions

Benefit recipients are paying the price of high-cost loans

In 2003, we estimate that £330m of borrowing from home credit companies was by people in receipt of state benefits. They paid an estimated £140m in costs for this credit.

The sub-prime credit market caters for low-income consumers

Alternative credit, also referred to as the sub-prime credit market, is often a good fit with low-income consumers' complex needs, though it is expensive compared to mainstream credit.

There are a range of products and providers including: home credit (also known as doorstep credit or weekly collected credit); cheque cashers and payday lenders; pawnbrokers; agency mailorder catalogues; buy-back stores; some retailers (mainly local); and some sub-prime credit cards.

Datamonitor estimates that there are now around nine million consumers defined as 'non-standard' by lenders, and all new non-standard lending amounted to £16bn in 2004.

Home credit is popular, but very expensive

Home credit is by far the most significant form of lending in the sub-prime credit market. It is worth £2bn per year and serves an estimated three million UK consumers, most of whom are on low incomes. This form of credit is very popular among users – although many know that it is an expensive way to borrow – because of its affordable weekly payments, with no hidden or extra costs, and the facility to reschedule payments without charge should the borrower encounter temporary financial difficulty.

Despite this popularity home credit loans are expensive (the average APR is 177 per cent). Also, the NCC has raised a number of concerns about the way the industry operates in a 'super-complaint' to the Office of Fair Trading in 2004. The super-complaint was referred to the Competition Commission, who are currently conducting an inquiry into the market. The Commission's conclusions – due in April 2006 – are set to determine if there are any competition concerns in the home credit market that may adversely affect consumers.

Features of home credit valued by customers

Payment management	**% agreeing**
Without the home visit it would be harder to manage my repayment	64
If I couldn't pay weekly, it would be harder to manage my repayments	64
Reasons for borrowing home credit	**% agreeing**
Because they are understanding if I miss payments	68
It costs more, but it's difficult to manage without weekly collection	75

Source: Policis/NCC survey, 2005. Base: home credit users only.

'Credit cards... there is, like, a minimum payment – £5. That is how much you have to pay, so you keep paying interest all the time, don't you? In some ways it is easier to have than loaning from Provident. But [with Provident] you are paying the £10 and you know what you have to pay and it stays the same all the time.'

Married male, 34, dependents, works full-time

'It is very easy to apply for a store card or a credit card... [With] one store card, you pay like £40 on the statement and they end up charging you £20 interest on top of that. And, if you are late with the payment, then you get charged another £20 – so they are making double back what they have borrowed you.'

Co-habiting female, 37, dependents, works part-time

'I don't like credit cards. I don't like to use them because that will get you into debt even more.'

Co-habiting female, 34, dependents, works part-time

'I needed the money at the time. But if I look back now, I suppose it is quite high really – the repayments. But when you need something desperately you have to do it to get it. '

Single female, 36, dependents, not working

Credit cards could trap users in an unpredictable debt spiral

Recently, sub-prime credit cards have become popular among some low-income consumers. They are made available to consumers with low credit scores or a poor credit history. Research shows that this type of 'revolving' credit can be inappropriate for people on very low incomes for a number of reasons:

- credit card balances, repayments and charges lack the transparency of fixed-term loans;
- automated systems of penalty charging and debt recovery do not offer the flexibility needed by people on very tight budgets;
- balances can increase unpredictably to levels that are difficult to reduce, especially if they are only making the minimum repayment; and
- although APRs on sub-prime credit cards are lower than for home credit loans, evidence from the US shows that, with costs and charges, they can end up being more expensive.

The devastating long-term impact of spiralling debt and ongoing formal debt recovery proceedings on already vulnerable consumers cannot be underestimated.

Third sector lending is only part of the solution

Credit unions and Community Development Finance Institutions (CDFIs) provide third sector, or not-for-profit lending, but on a limited scale, despite significant public sector investment. These institutions make loans at lower rates than the alternative credit market (typically between 12–30 per cent APR).

The proposed removal of the interest rate cap on credit union loans would allow credit unions to meet the credit needs of a wider membership. Yet, despite encouraging progress over the years, third sector lenders have so far proved unable to achieve the level of scale, sustainability and professionalism necessary to offer a universal solution to credit exclusion. While third sector lending can play a key role in an affordable credit model, the need for commercial sector involvement must not be overlooked

A commitment to increasing access to affordable credit

The Treasury has set out a plan of action for government to increase the availability of affordable credit in *Promoting Financial Inclusion*. To date, plans for reform and investment in the social fund have been outlined, and proposals to stimulate and facilitate the development of third sector lending have been put forward.

Our suggestions for the features of a new affordable credit model are in the box, right. A model which delivers these features could be built around direct deductions from benefits. And, for the working poor, who account for the majority of home credit users, this could be done through adaptations to the tax credit system and, potentially, a revitalised model of basic banking.
A system of direct deductions for credit repayment is attractive to many benefit recipients.

Affordable credit needs to offer:

- **Access to loans that are:**
  - simple and transparent and available for any purpose.
- **Lenders that:**
  - are familiar and perceived to be trustworthy;
  - understand low-income consumers' circumstances;
  - do not penalise borrowers for occasional missed repayments; and
  - will not pursue people through the courts who are genuinely unable to repay.
- **Application procedures that:**
  - are simple, accessible and non-judgemental;
  - can accommodate numeracy and literacy problems; and
  - result in quick and relatively predictable decisions.
- **Loans that are:**
  - small;
  - short-term; and
  - available in cash.
- **Repayments that:**
  - are set at an affordable level;
  - are compatible with a household budgeting cycle;
  - combine the discipline of weekly home collection with occasional, penalty-free missed payments; and
  - can be deducted direct from income.

- **An affordable credit model must be part of a coherent financial inclusion strategy**
  Affordable credit has to meet real credit needs and be developed as part of a coherent approach to achieving financial inclusion. As part of this, we have argued for a re-think of basic bank accounts.
- **A consumer needs-based approach is required**
  It is essential that the reasons why the poor – often knowingly – pay more for high-cost home credit are recognised, understood and respected. Developing less costly products that do not meet their needs and simply educating them about the cheaper alternatives that are available is not enough.
- **There is a continued need for state-sponsored interest-free loans**
  Social Fund loans should be recognised as the building block for an effective affordable credit model. The potential for expanding these loans to low-income workers must be explored.

Building the business case

It is vital to establish the real cost of delivery of the high-cost credit products currently used by the poor and explore whether an affordable credit model could mimic the features valued by those on low incomes. One option for delivering affordable credit in a cost-effective way is through a partnership of the public, private and voluntary sectors.

A successful financial inclusion strategy will build on what has worked for those on low incomes to deliver a genuinely accessible model of affordable credit.

Next steps

Over the coming months, we will be working with a range of partners and stakeholders to develop detailed proposals for a new model of affordable credit.

Contact us

Please contact our financial inclusion team.

Nicola O'Reilly
National Consumer Council
20 Grosvenor Gardens
London SW1W 0DH

financialinclusion@ncc.org.uk

020 7881 3000

About Policis

Policis is a social and economic research consultancy focused on the public sector. We bring robust research and authoritative, independent analysis to public debate, supporting a range of stakeholders in developing evidence-based policies.

About the NCC

The NCC makes a practical difference to the lives of consumers around the UK, using its insight into consumer needs to advocate change. We work with public service providers, businesses and regulators, and our relationship with the DTI – our main funder – gives us a strong connection with government. We conduct rigorous research and policy analysis to investigate key consumer issues, and use this to influence organisations and people that make change happen.

Check our website at www.ncc.org.uk for our latest news.

PD 31/05

July 2005

References for this factsheet can be found at:

www.ncc.org.uk/moneymatters/factrefs.pdf