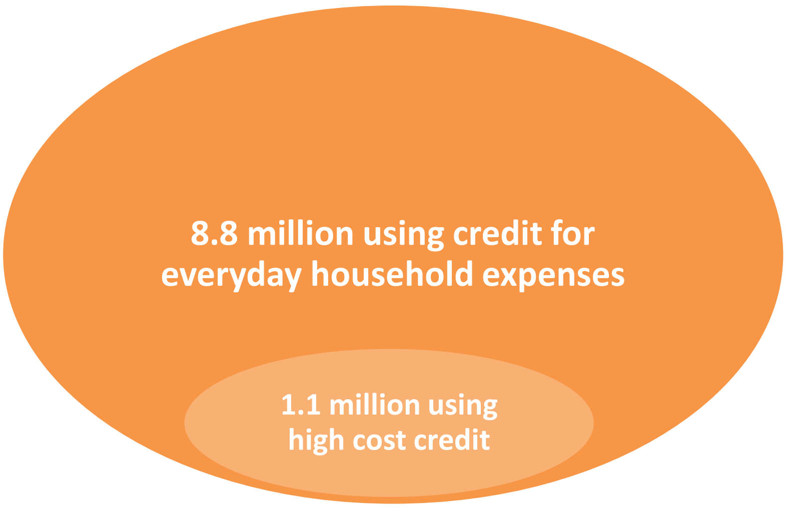
The high cost of credit

A discussion paper on affordable credit alternatives

Executive Summary

There are too many families on tight budgets who have to turn to credit, including high cost credit, as a 'safety net' to meet the costs of everyday essentials. These households are particularly likely to be struggling to manage and vulnerable to falling into problem debt.

Our new research finds that an estimated 8.8 million people in Great Britain have turned to credit to pay for their everyday household expenses in the last year.[1] Of these, 1.1 million of them are using a form of high cost credit including payday/instalment loans, doorstep loans and rent-to-own stores.[2]



The regular use of high cost credit to meet essential costs can severely damage the already tight budgets of families who are struggling to manage. Moreover, having to repay loans with high interest rates and charges can significantly increase the risk of these households falling behind and spiralling into problem debt.

This paper discusses the alternatives to high cost credit for those who have to borrow to meet the cost of essentials. Credit unions have been championed by government as low cost alternatives to high cost lenders but the scale of community lending is inadequate to meet the need. Commercial approaches have also been promoted as alternatives to high cost credit including FinTech, employer based loans and the widening of mainstream bank provision. Nonetheless, if they are to be financially sustainable, both commercial providers and community lenders are constrained in who they can lend to, and tend to exclude more 'high risk' borrowers.

Those considered ‘high risk’ are likely to be the more financially vulnerable, on the lowest incomes and either unemployed or in insecure employment. An expansion of the currently available affordable credit provision therefore may not provide access to all those who use high cost credit for essentials. Moreover, state provisions like the Social Fund, which was used by those on the lowest incomes, are no longer providing the safety net it once did. The more financially vulnerable are less likely to have their needs met without having to pay an exorbitant cost. Therefore, they have to turn to products that not suited to their needs and are high cost, putting them at risk of financial difficulties.

There is a need for clear and coordinated action to build more accessible and affordable credit alternatives for the most financially vulnerable. Suitable provision for these households would have to both meet their needs but also be sufficiently low cost so they can manage repayments without the risk of falling into financial difficulties.

One way to provide lower cost credit for higher risk borrowers would be by finding another way to manage risk other than through price. Achieving this is unlikely to be possible without some form of government underpinning to mitigate the risk of potential losses and to attract other sources of funding. Therefore we recommend that **the Government introduce or underwrite the development of a new scheme for low and no interest loans to help the most financially vulnerable who struggle to safely access any form of commercial credit.** This paper explores international examples of where this has been successful such as the American State and Federal support of community banking, and the Australian example of Good Shepherd Microfinance. However it is achieved, reducing the reliance of many of our most financial vulnerable households on high cost credit to cover the cost of basic essentials is central to creating a more financially inclusive society.

Who uses high cost credit?

Exploring who would benefit from more alternatives to high cost credit involves examining who is currently turning to this form of borrowing. Households using high cost credit are not one homogenous group although they are generally credit-restricted and on lower incomes. There are considerable variations within this group, for example, online payday loan consumers are generally different from doorstep loan borrowers. The FCA found that payday loan consumers were more likely than the general population to be male, younger (average age 33), employed full-time and on lower than average incomes (around £18,000 per year as opposed to the average of £26,500).[3] In contrast, doorstep loan customers are predominately middle-aged, female, in part-time/casual employment, and among the lowest earning fifth of adults.[4]

Nonetheless, overall consumers of high cost credit tend to be those on low incomes and if in work they are often in insecure jobs with irregular work patterns.[5] Research in Wales found that high cost credit borrowers were likely to be young families, less well-off and not be homeowners.[6] The Office of Fair Trading's (OFT) review of high cost credit also found that consumers generally have lower than average levels income and in many instances have a poor or no credit history that restricts their access to mainstream lenders.[7] Consumers with a 'thin' or no credit history may have never borrowed or be new to credit, likely to be younger people or those new to the country. Those with a poor credit history will have missed or made late repayments, been declared bankrupt or taken up other insolvency options or had a County Court Judgement (CCJ) against them. Therefore, high cost credit borrowers tend to be an overlapping group of those on low incomes and those excluded from mainstream credit.

Among those on low incomes that use credit, FCA research found two distinct groups who have to borrow from high cost lenders for essential expenses: 'survival' borrowers and 'lifestyle' borrowers.[8] The boxes below provide more detail on who these groups are. These are helpful definitions apart from that the implications of lifestyle borrowing suggest it is a 'lifestyle choice', whereas needing money for a child's birthday or for larger purchases like households goods would still be considered by many as essential spending. The Joseph Rowntree Foundation's 'minimum income standard' on what members of the public consider households need in order to reach a minimum acceptable standard of living includes household goods as well as presents and celebrations for social and cultural participation.[9] Therefore we have renamed lifestyle borrowers 'emergency' borrowers.

Survival borrowers

Tend to use credit often to supplement their incomes and meet day-to-day essential expenses. These borrowers were generally on persistently low incomes and felt they had ‘no option’ but to borrow due to this lack of income. They were often younger, receiving benefits, apprenticeships or on minimum wage, insecure employment either part-time or on zero hours contracts. Their credit use can be characterised as:

- Tending to use high cost credit: including home credit, payday loans and rent to own due to ease of access and low weekly payments;
- Unfamiliar with using mainstream options (overdrafts, bank loans, credit cards): lack of familiarity with these products as few in this group have a bank account. For those that do have a bank account, there was an expectation (based on assumption or experiences) that they would not be approved due to being on a low income and/or having a poor credit history;
- Using credit unions: Most were not aware of them but some had been referred to them by support workers etc.

Emergency borrowers

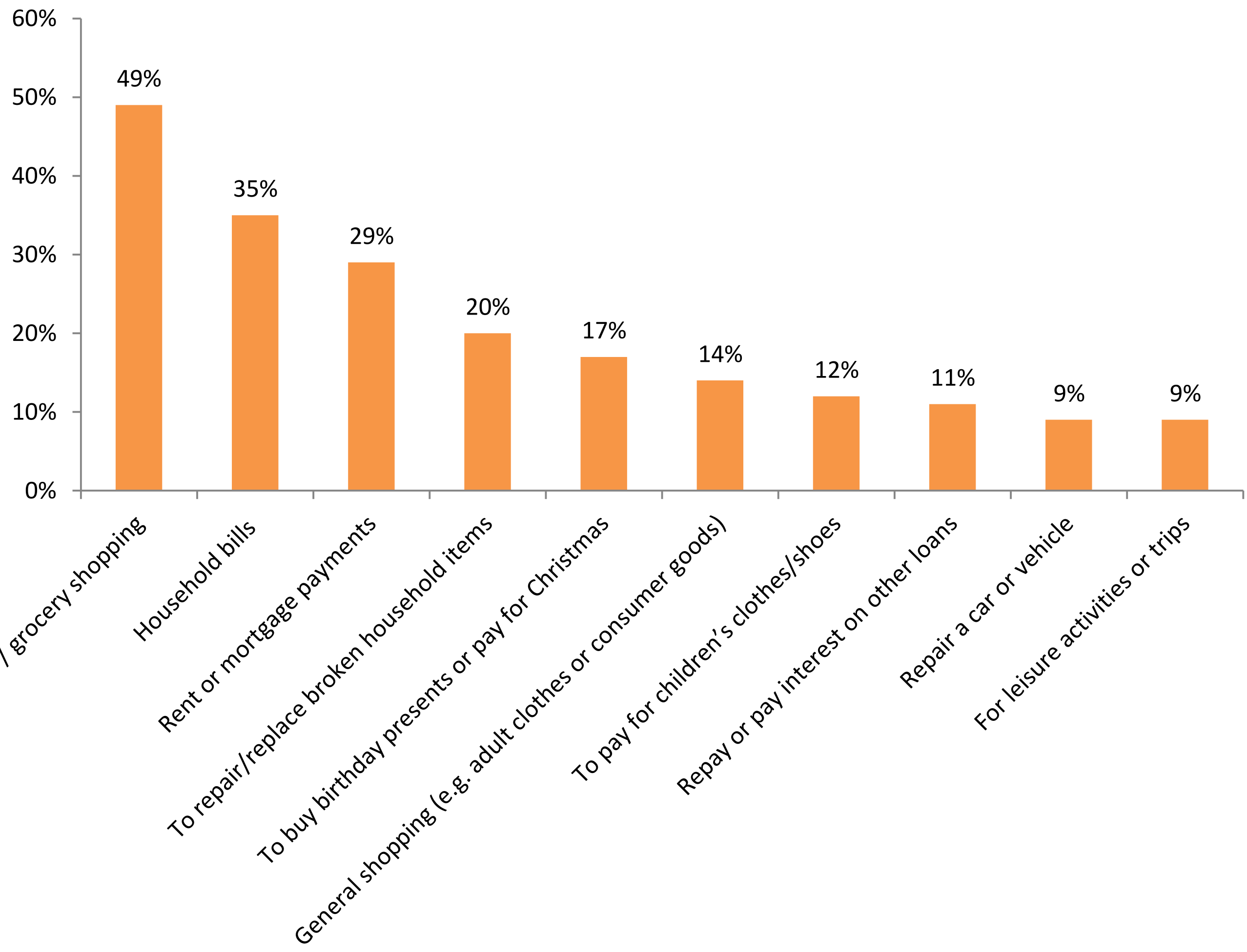
These people are likely to have experienced a recent reduction of their income (income shock) or an unexpected cost. They have sufficient income for day-to-day costs, but have very little left for emergencies or discretionary spending. Therefore they will occasionally use high cost credit for larger purchases or one-off events e.g. household goods and special events like children’s birthdays or Christmas. This group:

- Sometimes use high cost credit: this group are likely to have used home credit to supplement income when occasionally feeling squeezed, rent-to-own seen as very high cost but sometimes used in emergencies. Payday loans are viewed negatively and are not used;
- The are more likely to find mainstream options are often excluded as unavailable to them, or they assumed these options to be unavailable due to employment situation or because of previous rejections or past credit problems;
- Do not use credit unions and most had never heard of them.

Why are people using high cost credit for everyday essentials??

Our new research finds that 1.1 million are people using high cost credit for essentials, and just under half are using this credit to pay for everyday food and grocery shopping (49%). Just over a third are using it to cover the costs of essential household bills like fuel or water (35%), and over a quarter are turning to high cost lenders to keep up with housing costs (29%). A fifth are using it to replace or repair household goods (20%), and just under a fifth are using it cover special one off events (17%).

What high cost credit was used for:[10]



Those on lower incomes with tight household budgets can struggle to meet the cost of everyday essentials when they have emergency or larger purchases to cover. Previous research with StepChange clients who used payday loans found that many turned to this form of credit as they had little other choice. Clients are often left deciding between defaulting on a payment, not having enough money to pay for essentials like feeding their family and using costly credit to keep up.[11] As the quotes below illustrate: [12]

“Because it was that or the children didn’t eat.”

“Had to repair car so I could work.”

“Desperately needed to pay a bill.”

The University of Bristol Poverty Premium Study also found that it was typically those that felt they had no other options that used high cost credit. Their low incomes and constrained budgets meant they could not pay in cash. These people also have limited access to mainstream credit as nearly half (46%) of all those using high cost credit were financial excluded.[13] Some of these households may have had ‘thin’ credit files, however many will have had an adverse credit history so are not eligible for mainstream lending. One of the people they interviewed in the University of Bristol study explains her constrained choices:

"I can't just go to (high street retailer) and say I want that, I just can't.
So I have to go for these weekly... I have to do (rent to own)...
the kids have to starve if anything like the oven breaks." [14]

Research for the FCA has also found that consumers turned to high cost credit such as doorstep lending, payday loans or logbook loans as a ‘last resort’ when mainstream forms of credit were maxed-out or considered inaccessible.[15] Our clients have also told us about how they have turned to high cost credit after being unable to access other sources of credit:[16]

“As my credit rating was non-existent I had no option but to use doorstep lenders who were only too keen to 'help'.”

“When I needed help I looked at lots of different options but in the end the only thing I could get was a payday loan.”

“I had bad credit and couldn't get low APR but would have liked to.”

Why using high cost credit can cause problems?

Those having to turn to high cost credit to meet essential expenses, particularly if they are using it on a regular basis, are at greater risk of falling into financial difficulties and debt. Problem debt is primarily driven by persistently low and insecure incomes and 'income shocks' that can deteriorate a household's finances.[17] These shocks can include employment changes like losing a job or life events such as divorce. Following one or multiple income shocks, household with low levels of financial resilience with no available savings will often have to turn to credit to get by.[18] Our previous research has found those who had to turn to credit were twenty times more likely to fall into problem debt and it was the use of high cost credit which tipped the greatest proportion of people into financial difficulty.[19]

The terms and features of high cost credit can mean that they lead to spiralling debt problems and stress and anxiety, particularly for those on low or insecure incomes. Those who take out a high cost loan, but then find they struggle to make the repayments, can face high rates of interest and charges building up quickly which can spiral into unmanageable debts. For example, the FCA research into payday loan use found that the impact of charges on borrowers in default was significant because financial difficulties are compounded as charges increase leading to higher financial distress and lower levels of welfare.[20] The features of high cost credit can also exacerbate consumer harm as the commercial demands to recover defaults can lead to some egregious debt collection practices. For example, at the peak of the payday loan market in 2013, some of our clients were left with nothing in their bank account as continuous payment authorities were used by payday lenders to recover the full debt, which often had a detrimental impact on their stress levels.

Recent action has been taken to tackle the consumer detriment caused by high cost credit including the FCA rules and price cap on payday lending in 2015. These measures resulted in fewer people getting into arrears with this type of product.[21] Nonetheless, there is still more to be done as the FCA are currently reviewing the impact of this cap and looking at consumer detriment in other high cost credit markets.[22] Although product focused regulatory action can lead to improvements, there are still other broader issues of consumer detriment that need to be tackled.

A major issue in the current credit market is that those that can least afford it have to pay a premium to access the funds they need to meet their essential costs of living. For example, rent to own borrowers are predominately cash-constrained so have few alternative ways to purchase essential household goods like washing machines. [23] This in turn leads to weak competitive pressure on prices and means these households face prices more than double those available through mainstream retail channels. [24]

Accessing credit is a significant element of the poverty premium where people on low incomes are paying more for essential goods and services compared to those on higher incomes. The University of Bristol's recent study found that the average overall cost of the poverty premium was £490 per household per year, but households that used high cost credit that were subject to the highest premiums.[25] Those using doorstep loans were paying an additional £540 per year on average, £520 for subprime loans, £315 for rent-to-own stores, and £120 for payday loans. [26] The study found just over one in six low-income households (16%) used high cost credit and they were most likely to be of working age, have two adults and not eligible for mainstream credit. [27] These households struggled to afford basic essentials for example, buying clothes or shoes for their children or keeping their home warm. To meet the costs of these essentials, they paid often very high rates of interest and charges reducing their already constrained budgets further.

Families using high cost credit are therefore both paying the highest poverty premium and face the greatest risk of falling into problem debt. There is a clear need for other alternatives for these families to avoid the harm that having to use high cost credit for essentials can cause.

What alternatives are there to high cost credit?

The options available for credit-restricted households on low incomes to access affordable credit are community lending, including credit unions, and Community Development Finance Institutions (CDFIs) or support through their local welfare provision. There has also been new initiatives and proposals to expand the provision of new commercial alternatives to high cost credit.

Community lending:

The government has championed community lenders as alternatives to high cost credit. They have invested £38 million in the Credit Union Expansion Project (CUEP), launched in 2013 to modernise and grow the sector including offering more affordable loans.[28] There have also been innovations in community lending sector to provide more alternatives to high cost lenders. For example, London Mutual credit union developed an affordable payday loan product that has since expanded to Glasgow and the social enterprise Fair For You which provides a nationwide online not-for-profit alternative to rent-to-own. [29] Moreover, in some areas local authorities have partnered with community lenders to improve access to affordable credit including Sheffield Money and more recently Lincoln Money.[30]

Local welfare provision and budgeting loans:

The Government previously provided access to emergency support for essentials, in the form of Social Fund crisis loans and community care grants. Crisis loans were interest free loans for urgent living expenses that could be repaid back via benefit deductions (or in a minority of cases directly from cash).[31] They were available to anyone who did not have enough money to cover an emergency need, and were accessible to both those in work on a low income and out of work (unlike Budgeting Loans). Community care grants provided non-repayable help for people to live independently in their community e.g. covering furniture for a mother fleeing domestic violence. They were only available to those that receive certain out of work income replacement benefits.[32] These elements of the discretionary Social Fund were abolished in April 2013 and replaced by local authority-run local welfare provision in England and Scottish and Welsh welfare funds. These local and devolved schemes usually do not give cash grants or loans as they typically provide vouchers for essentials like food, fuel or provide household goods.[33] Budgeting loans (or Budgeting advances in Universal Credit) are a remaining element of Social Fund and provide help with essential lump sum expenses for those who have been on certain means-tested benefits for the previous 6 months.[34] They are ineligible for those who are in work or have not been out of work for long enough to qualify.

Commercial initiatives:
Commercial approaches include Financial Technology (FinTech), widening major bank provision and employer based loans. The Social Market Foundation has recommended that employers take a more proactive role in supporting financial resilience of their employers including providing credit facilities.[35] They have suggested that as many payday loan users are working, their employers could be offering them access to loans, either directly or through third parties that could be repaid through wage deductions.[36] FinTech companies in the UK and America have been developing these types of salary advance loan products for employees.[37]

FinTech is being championed more widely by government to improve competition in and access to financial services for all consumers.[38] The All Party Parliamentary Group for FinTech upholds that it will ease access to affordable loans as online aggregation is improving financial information about borrowers, and giving lenders a better understanding of the risk of default.[39] It has also been proposed that major banks could provide competition to high cost credit. Citizens Advice has suggested that banks could have a more flexible approach to arranged overdrafts to offer these customers an alternative to payday loans.[40] Another suggestion of bank involvement, from The Centre for Social Justice, recommends a 'back banking' scheme within Universal Credit to enable retail banks to lend to claimants and have them repay through deductions from their benefits.[41]

The question remains whether the growing provision of community lending, developing commercial initiatives and local welfare schemes provide sufficient and suitable alternatives for those using high cost credit for essentials.

Discussion: Will this alternative affordable credit provision meet the need?

What constitutes 'affordable' credit has mainly been defined in general terms to mean 'less expensive' than high cost products that usually have annual percentage rates (APRs) of over 100% APR.[42] However, it is not just a question of interest rates as to be 'affordable', the features of the credit product must be to be repaid in a sustainable and manageable way that does not push the borrower into financial difficulties. Therefore affordable credit has also been defined as credit that is appropriate and affordable for people on low incomes.[43]

The following looks at whether the current alternative affordable credit provision will meet the needs of those using high cost credit for essentials. It identifies a significant gap as some 'survival' and 'emergency' borrowers are not being appropriately served by the current credit market and are unlikely to be in the near future.

The reach and accessibility of community lenders:

The growth of community lending has widened access to lower cost credit in recent years with credit unions tripling their asset base and doubling membership over the last decade.[44] Despite this expansion, community lending alone cannot currently meet the need for affordable credit alternatives for those using high cost credit for essentials and is unlikely to meet this need in the future without significant investment.

The reach of community lenders is currently limited as the size of the credit union loan book is only approximately 10% of the size of the commercial high cost credit market and CDFIs are limited to just a few geographical areas.[45] The Financial Inclusion Commission also identified a substantial gap between demand for community lending, estimated as £3.5 billion per year and the supply, around £0.5 billion worth of loans.[46] There is also the issue of lack of awareness of community lenders with research finding less than a quarter of those on low incomes were able to identify the main purpose of a credit union.[47] Moreover, as FCA research found practically all of those using high cost credit for essentials had not used community lenders. Most emergency borrowers had not heard of credit unions and only a few 'survival' borrowers had heard of them as they had been directly referred.[48]

Even where people may have heard of them, community lenders may not be able to sustainably lend to some of those using high cost credit for essentials now or in the future. Credit unions have stated they should not be positioned as "exclusively an alternative to payday lenders" as they need to attract a range of members in order to develop sustainably.[49] A study undertaken to help credit unions become more financially sustainable found that currently their membership is largely made up of lower incomes households on either below £15,000 (known as Tier 3) and between £15,000 and £30,000 (Tier 2).[50] They found that to be financially sustainable, credit unions had to increase their loan to asset ratio and avoid a deterioration of 'credit quality' by attracting more low to middle income (Tier 2) borrowers.[51] A business model relying only on loans to the lowest income (Tier 3) households was found to be unsustainable.[52]

Research into the potential for a not-for-profit home credit lender also found there were limits to third sector lenders meeting the credit needs of the 'highest risk' lowest income consumers when aiming for financial sustainability.[53] These higher risk borrowers are those who are likely to be rejected for credit union loans. The Treasury Committee found that around 50-80% of people asking to borrow from credit unions are refused for not being creditworthy depending on the risk appetite of the community lender.[54] Therefore there is a group of households, likely to be those 'survival borrowers' on the lowest incomes that credit unions might want to help but can find it difficult to lend to.

CDFIs generally serve this more financially vulnerable group, as their clients are typically unemployed, welfare recipients, on households incomes of under £15,000 a year and unable to access mainstream credit.[55] CDFIs are designed to help more of these higher risk borrowers as they are not subject to the interest rate restrictions that apply to credit unions, giving them the flexibility to price according to risk and cover costs. By law credit unions cannot charge more than 3% a month on the reducing balance of a loan (an APR of 42.6%).[56] CDFIs in contrast have an average interest rate of 129%.[57] This is significantly lower than most high cost credit lenders and CDFIs offer other lending features more suited to those on low and variable incomes like longer payment terms (8 months on average[58]) and payment holidays. However, an APR over 100% is still considerably higher than average APR of mainstream credit sources e.g. standard credit card annual interest rates typically range from 12% to 25%.[59] Therefore those on the lowest incomes still have to pay a premium to access credit even from not-for-profit providers.

Moreover, although CDFI lending has grown considerably since inception, going from lending around £2 million in 2007 to nearly £20 million to around 37,000 individuals in 2016, this is still a small proportion of the credit market compared with high cost credit lenders.[60] The scale and reach of CDFIs are particularly limited with only ten across the country that specialise in personal lending to individuals. [61] Therefore, CDFIs provide improved access to lower cost credit for some financially vulnerable borrowers in some areas but they are currently severely limited in scale and there may still be poverty premium issues with this lending.

Overall, despite expansion of community lenders, the sector is currently only partially accessible to those who need alternatives to high cost credit as it has limited reach, and there are some high cost credit borrowers, often the most financially vulnerable, that community lenders can struggle to sustainably lend to. Further expansion of community lenders could go some way to expanding access to affordable credit. However, this would need to be a major expansion with significant investment. Research has found that levels of community lending would have to expand by around 4.5 times to approximately £2 billion a year to meet the credit needs of low-income households.[62]

The UK government has itself recognised that in order to expand further, community lending will need significant investment. A Cabinet Office study identified that community lenders have limited access to the capital they require to scale and they recommend social investors should be meeting this demand for investment.[63] However, it is questionable whether social and private investment can alone meet this need for capital and whether it should be expected to.

Community lending in the US

A study from Harvard University compared relatively small levels of community lending in the UK with the US which has developed a large and effective community lending sector.[64] They found that in the US, the sector is not expected to be fully financially sustainable and has been able to grow due to a combination of investment including significant subsidies from federal government and other initiatives at state and local level. They conclude that to strengthen the community lending sector in the UK, the government would need to invest directly and set up a Finance Fund that could be matched by private investment (see the box below for more details).

Lessons from the US community lending sector

Many community lenders in the UK are aiming to offer more affordable credit by scaling up their services through raising capital. However, the problem as the Cabinet Office found is that the sector can struggle to find new capital as their low margins and relatively small scale can make it difficult for solely commercial investors to justify the investment.[65] The Harvard University study found that CDFIs are severely constrained by a lack of capital and credit unions lack capitalisation for fund for on-lending.[66] They found the ability of community lenders in the UK to attract capital and repay their creditors (private or social investors in the case of CDFIs or individual depositors in the case of credit unions) is impaired by expected losses on loan portfolios based on the relatively high default rates of the client base.[67]

In comparison in the US, community lenders, CDFIs in particular, have been able to raise capital through 'substantial subsidies over a long period of time' and are not expected to sustain operations of a significant scale without regular support from both government and foundations.[68] For example, the CDFI Bond Guarantee Program allows CDFIs to borrow at essentially the same rates as the government up to a cap.[69] Therefore in the US community lenders have only been able to grow through a mix of government subsidy, social and private investment. The Harvard University study recommended that the UK government create a fund (of around £200 million) that can be matched (at a ratio of 4:1) by private and/or social investment to capitalise the community lending sector. This layer of grant capital provided by government would work as type of loan guarantee scheme to cover community lenders for customers that default. It would also catalyse larger quantities of private capital and social investment as it would provide protection against losses. Similarly the trade association for CDFIs in the UK has also called for a loan guarantee scheme supported by government, banks and social investors to allow for a proportion of defaulting customers.[70]

The lesson from the US is that community lenders, CDFIs in particular, that serve the highest risk and most financially vulnerable client groups should not be expected to deliver on a significant scale and be fully sustainable on a commercial basis. Therefore, the community lending sector in the UK would need significant investment including government subsidy in order to grow sufficiently to improve access to more affordable credit provision.

What about commercial alternatives to high cost credit?

FinTech

FinTech could improve access to affordable credit for some of those who currently use high cost credit, particularly those that have 'thin' credit files or no credit history. The APPG on FinTech states that this new technology eases individuals' access to affordable loans by improving the way that lenders assess creditworthiness.[71] This is through online aggregators allowing better sharing of financial information to give lenders improved understanding of the risk of default and therefore better pricing of credit, e.g. for those on irregular incomes.[72]

In contrast those with poor credit histories are less likely to have improved access to affordable credit through FinTech. Improvements in the financial information available will not overcome the barrier that these borrowers will be considered too 'high risk' to lend to. Lending to this segment of the population is inherently more risky and more costly than mainstream lending as the Harvard University study explains 'if these clients were sufficiently viable and profitable then mainstream profit-making financial institutions would be serving them'.[73] Responsible Finance (the trade association of CDFIs) also outlines how the significant cost of entering the market means that new FinTech players are not able, without any incentives (for example, financially or through other encouragement from government), to provide services for the more financially excluded who are usually higher risk. Although CDFIs are likely to be predisposed to questioning the reach of FinTech, they do have a point that FinTech provision may not be accessible to the most vulnerable who are the most likely to have to regularly use high cost credit for essentials.

The commercial way to achieve profits is by not lending to more high risk potential borrowers and targeting the 'most promising', least financially vulnerable individuals of those who are not served by banks.[74] This group are more likely to be considered near prime customers rather than sub-prime. Near prime are generally those who may have a thin credit history or have a mildly adverse credit history (e.g. have missed a small number of payments or have an inconsistent address history).[75] Whereas those considered sub-prime are ineligible for mainstream and near prime credit as a result of their employment status (unemployed or in insecure employment), low household income or recent adverse credit history (e.g. have been bankrupt or had arrears in the past).[76] Therefore FinTech is likely to be more incentivised to target near prime customers rather than sub-prime borrowers.

This leaves a significant group of individuals who are likely to be considered sub-prime that are more financially vulnerable and are excluded from this lending. FinTech is likely to widen access to more affordable credit for some but will not be able to lend to the more financially vulnerable, higher risk borrowers that are more likely to be using high cost credit for essentials.

Employer based lending

Other commercial providers, for example employer based lending are also similarly likely to be able to help more near prime, lower risk borrowers. Having access to employer based lending is clearly contingent on whether the employer offers this provision with current estimates suggesting that around 700,000 employees have access to this.[77] Some of the employers offering this type of access are large public sector organisations and private sector employers, for example utility companies.[78] Smaller employers with limited HR capacity will find it more difficult to offer access to this lending provision so employees are likely to be excluded. Moreover, the nature of this type of lending means that it provides access to those in salaried, stable employment and is less likely to be able to provide for the self-employed, unemployed or those in temporary, less secure work. Again, this group are more likely to also be considered sub-prime and 'survival' borrowers on the lowest, more irregular incomes.

Extending mainstream bank provision

Mainstream bank credit could also offer an alternative for lower risk, more near prime borrowers. Research from what was the Department for Business, Innovation and Skills found that a quarter of online payday loan users were eligible for mainstream credit.[79] Citizen Advice research also found that banks could lend to between 10-40% of their customers who have borrowed from payday lenders.[80] They concluded that mainstream banks could absorb some demand from payday loan customers.

However, this leaves a group of high cost credit borrowers that banks are unwilling to lend to, including those who have poor credit records and would fail an affordability check for further lending. These borrowers are likely to again be the more risky, sub-prime customers and to fall into the survival and emergency borrower groups identified by the FCA. [81] These groups were not able to access mainstream bank lending as they had either had past applications rejected due to adverse credit histories, or they assumed they would not be eligible or they are unbanked.[82] Therefore mainstream banking provisions are also unlikely to be accessible to many of those borrowing from high cost lenders for essentials who have poor credit histories or are on unstable incomes.

There is also the question of whether some of the commercial provision is suitable for particularly financially vulnerable customers. The structure and features of revolving credit products like overdrafts and credit cards can mean that they can lead to persistent debt problems for those who turn to them regularly to pay for essentials. For example, those who can only afford to make the low minimum repayments on their credit card can get locked into expensive and long term debt.[83] Another example is those that are regularly near to or charged for going over their overdraft limit can see the interest and charges spiralling into unmanageable debts.[84] Therefore even those who can access mainstream credit could find that the pricing structures of these products are unsuitable for their borrowing needs and can exacerbate their financial vulnerability.

Overall, expanding commercial provision of alternatives could meet the needs of some high cost credit borrowers but is unlikely to be accessible for those considered too high risk and sub-prime. Moreover, in some cases commercial provision may not be suitable for the more financially vulnerable as features of mainstream lending can precipitate debt problems. Those who use high cost credit now, and have relatively stable and secure incomes but 'thin' credit histories, would be considered more near–prime and could be eligible for commercial alternatives from FinTech, through their employer or from major banks. However, the more financially vulnerable, sub-prime group, including those 'higher risk' survival and emergency borrowers with poor credit histories who are in insecure employment, and on the lowest incomes, will still struggle to access commercial alternatives to high cost credit.

The safety net for those on the lowest incomes:

Previously the Discretionary Social Fund provided a relatively large 'social lending safety net' for this more financially vulnerable, sub-prime group, as over a fifth (21%) of those in the lowest income quintile used it.[85] In an emergency anyone on a low income could apply for a Crisis Loan to meet an immediate short-term need and repay it with no interest through deductions from their benefits. Since localisation of the Social Fund there has been a debate around whether this safety net has been weakened.

There are indications that this may be the case as the funding for local welfare provision has been reduced and has an uncertain future. The government has not provided a separate ring-fenced grant for local welfare provision from 2015/2016 onwards and there are no duties on local authorities to provide this support.[86] In contrast, both the Scottish and Welsh schemes have had their funding protected.[87] The National Audit Office (NAO) found that many English councils are struggling with tight budgets and some are not able to afford to continue to offer their own local welfare provision schemes.[88] They raised concerns about the consequences of this gap in provision particularly its likely impact on vulnerable people.[89] In addition, what remains of the Social Fund, Budgeting Loans have restrictive criteria as they are only eligible to those that have been receiving out-of-work benefits for more than six months. Reform of the Social Fund therefore means it is unlikely to provide the social safety net for those on the lowest incomes that it once did.

The market failure in affordable credit provision:

This all suggests that there is a failure in the credit market as it is currently structured. A core group of particularly financially vulnerable consumers are not having their needs met without the considerable risk of falling into financial difficulties. The table below looks in further detail at which groups, affordable credit provision is able to help, and who may not be able to access this.

	What alternatives to high cost credit can they access:	**What provision will they not be able to access:**
Emergency borrowers: Likely to be mostly sub-prime but some could be near prime.	- Some community lenders particularly credit unions if accessible. - Employer based lending where their employer offers this.	- Unlikely to be eligible for mainstream bank lending. - May not meet the thresholds for local welfare provision.
Survival borrowers: Likely to be all sub-prime.	- In an emergency if they are referred to local welfare provision. - CDFI loan if available in their local area.	- Mainstream bank lending, some credit unions and employer based provision unlikely to be able to lend to them as they would be outside the risk appetite for these providers.
The heavily indebted: A mix of sub-prime and near-prime.	- Local welfare provision: in an emergency if they qualify - Budgeting loans: if they met the qualifying conditions.	Should not be eligible for any other credit sources. In need of free debt advice.

Community lenders and employer based lending are providing lower cost alternatives for some low income households. With greater investment and support, this existing provision, along with wider mainstream bank provision, could potentially help more avoid high cost lenders.

However, there is still a group of more financially vulnerable borrowers whose needs are unlikely to be met by the current credit market without pushing them into financial problems. These include emergency borrowers whose employers do not offer credit facilities and who would not qualify for mainstream bank lending and survival borrowers who cannot access a local CDFI or their local welfare provision. This suggests a market failure for this core group of more financially vulnerable, sub-prime borrowers who have to borrow to meet the cost of essentials and can only access high cost credit that is likely to increase their risk of falling into financial difficulties.

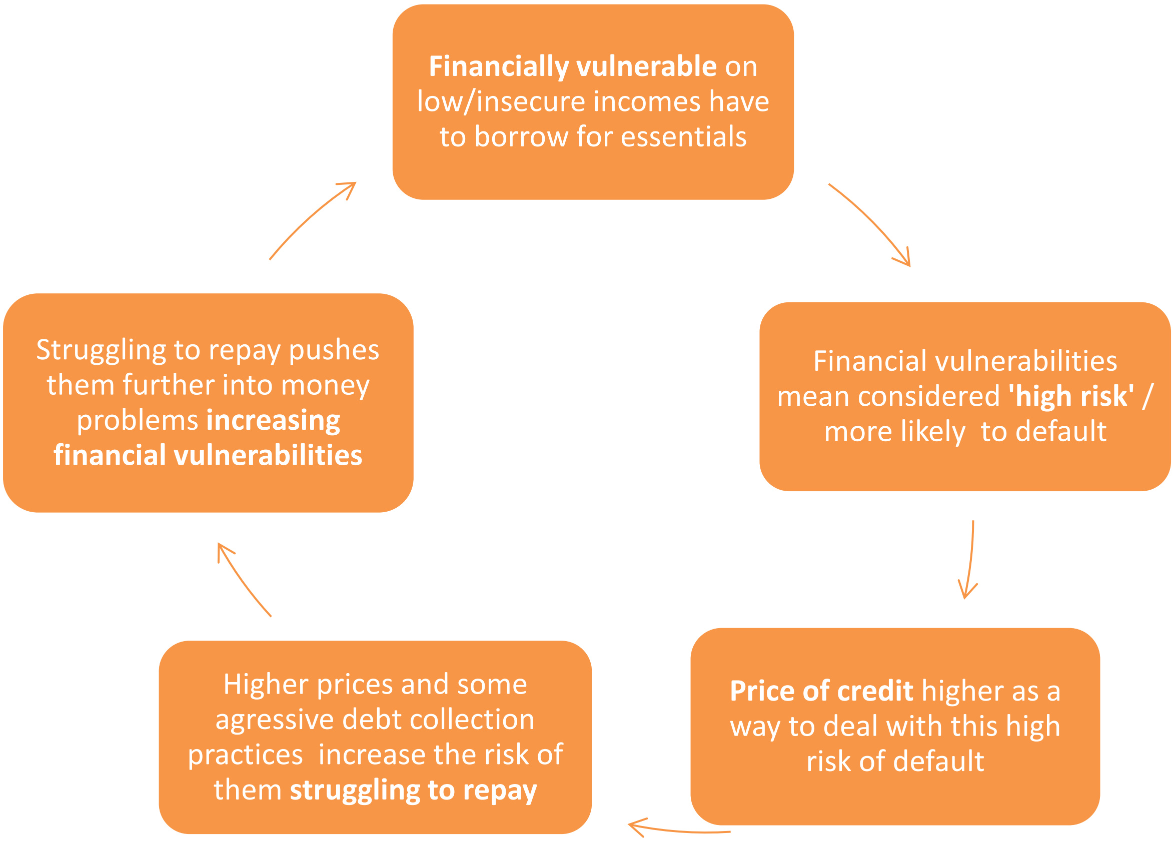
Conclusion

What is needed to tackle this market failure and widen the scope of affordable credit alternatives?

In order to address this market failure, this group of borrowers need to be able to access credit to meet the cost of everyday essentials via a more suitable source than high cost credit. The FCA definition of a well-functioning credit market is one where "all consumers are well-informed and actively able to choose between available products that suit their needs and be 'able to use them in an optimal way'".[90] Therefore credit provision for the most financially vulnerable borrowers must be accessible, understandable, designed to meet their needs and crucially not structured to put them at risk of falling into financial difficulties.

The difficulty is that meeting the borrowing needs of people on lower incomes is inherently expensive for a number of reasons. Firstly, lower income borrowers usually need relatively small amounts for short periods of time and have to make weekly repayments in cash.[91] These factors all make lending to this group more costly as the price of lending is generally fixed so the charges for borrowing are high in relation to the amount borrowed, and cash collection handling also has associated costs.[92] Moreover, borrowers on low incomes are more likely to experience a destabilising income shock or change in their circumstances and are more likely to be in insecure, low paid employment meaning they have a higher risk of defaulting on their loan. Incorporating the costs of higher levels of potential defaults also pushes up the interest rate charges for customers. [93]

This explains why even ostensibly more affordable community lenders, like CDFIs have an average interest rate of 129%.[94] This also explains why mainstream lenders have been averse to entering this market as it is considered too risky and not profitable.[95] Therefore the principal type of lending available to those on lower incomes who need to borrow for essentials is expensive high cost credit. [96] This constitutes a serious market failure as those on the lowest incomes who need to regularly borrow for essentials can only access credit at a high cost that is likely to increase their risk of falling into financial difficulties, or they have to go without those essentials. This market failure is explored below:



Addressing the wider policy failure that some of those on low incomes have to borrow to meet the cost of essentials would involve a significant programme to ensure more secure and sufficient incomes. Nonetheless, addressing the current credit market failure would need an improvement in the access to and provision of suitable, affordable credit. This would involve establishing what cost structure is 'affordable' and what features are suitable for these borrowers and exploring how more affordable rates can be achieved in a sustainable and scalable model of provision.

Firstly, in order to be truly affordable for low income borrowers, any credit provision will need to not push them into financial difficulties. Their low incomes mean they are on generally tight budgets and are unlikely to be able to afford to repay the full amount in a short period of time with significant additional interest added. Small repayments spread over a longer period of time with either very low or no interest are more sustainable. Moreover, many of those on low incomes are more susceptible to income shocks and changes in circumstances as they are more likely to be in insecure work and have fluctuating incomes. Affordable credit provision for this group would also need to be flexible and include no missed repayment charges and payment holidays. Therefore, the provision suitable for this group would be no or very low interest loans that can be flexibly repaid over a longer period of time. Then the question is how this type of provision can be accessible at an affordable rate. One way to achieve an affordable rate would be to find another way to manage risk other than through price. The key problem is funding to lend to this higher risk group at low cost interest rates is not forthcoming as it is not commercially viable. The Harvard University study identified that there is not just a lack of capital to fund this lending but a lack of *suitable* capital.[97] They found that a “first loss layer” of grant capital to underpin and cover for customers that default on the loan is needed.[98] This type of guarantee can also encourage private capital and social investment as it provides a protection against losses for these investors. The lesson from the US, as the Harvard researchers found, is that it is only possible to provide affordable rates to the more financially vulnerable with a mix of government subsidy and private and social investment.[99] A type of government funded ‘loan guarantee scheme’ underpinning lending to the more financially vulnerable may therefore be the only way to ensure it is suitably affordable.

Therefore, in order to provide more affordable alternatives to high cost credit for those that are using it for essentials, some form of no or very low interest loan would be required. This lending would also need some form of underpinning by government funding to protect against potential losses.

One way to expand accessible no-interest loan provision for the financially vulnerable would be to revive the solely government funded Social Fund. Previous research has found that the Social Fund was popular among eligible low-income borrowers as it provided no-interest loans for emergency essential costs.[100] University of Birmingham academics have recently called for the re-introduction of a reformed Social Fund that could provide low cost credit for essential items.[101] Widening the remit of the surviving element of the Social Fund, Budgeting Loans, to include shorter-term emergency loans for essentials for those all those on low incomes (not just those on means tested benefits) could be a way to do this.[102] This would achieve the aims of broadening no-interest loans as a social lending safety net but would inevitably need considerable government investment. This would have to involve reversing the funding cuts and restoring the Social Fund to its previous budget, total funding for local welfare assistance schemes reduced by £150 million (in real terms) compared with equivalent expenditure on the discretionary Social Fund in 2010.[103]

Nonetheless, the investment needed to achieve this does not just have to come from the state. The community lending experience in the US indicates that government underpinning can facilitate private and social investment. There also an international example of where partnership between government, private sector and charity has expanded provision of affordable credit for the financially vulnerable. In Australia, Good Shepherd microfinance provides a range of programmes for those on low incomes including a no-interest loans scheme (NILs). [104] This started as a local scheme in 1981 and following significant funding from the National Australia Bank and the Australian Government has become a nationwide scheme that helps over a 100,000 people a year.[105]

These people using NILs are on low incomes (they must earn under A$45,000 – around £26,000) and cannot access credit from mainstream sources as they are three times more likely to be severely financially excluded (55%) than the average Australian (17%).[106] The loans are for between $300 - $1200 for essential goods and services including white-goods, furniture and education expenses. The repayment rate is on average 95% percent, suggesting that low income borrowers are not higher risk if the product has affordable, sustainable repayments built in.[107] Good Shepherd find that the relationship between local microfinance workers and borrowers and the principle of ‘circular community credit’, where funds are recycled back for future applicants in the community, ensures they have high repayment rates. It is also likely to be down to the manageable structure of repayments. Borrowers make repayments typically once a fortnight over a 12 to 18 month period, and if a repayment is missed there are no charges and a NILs worker will engage in a follow up procedure.[108] The evaluation of the scheme found that it had significant positive impact by improving the socio-economic outcomes of clients, increasing their savings levels, decreasing their stress and anxiety, as well as diverting them away from high cost credit products.[109]

The NILs scheme has been imported to the UK, on a local basis with the Tenbury no-interest loans scheme launched in 2013.[110] This allows borrowers facing financial difficulties to borrow up to £400 to buy essentials and make flexible repayments for up to two years.[111] It is funded through a voluntary donation and the local council and has expanded to nearby Ludlow. This is still a relatively small scale operation supported by local partnerships but indicates how this scheme could be implemented in the UK.

Whether it is provided through direct government intervention or in partnership with the private sector, the most financially vulnerable are likely to benefit from greater access to provision of no or very low interest loans as an alternative to using high cost credit for essentials. Government leadership is needed in order to solve this market failure in alternative affordable credit provision and expand the provision of social lending safety nets. Therefore we recommend that **the Government introduce or underwrite the development of a new scheme for low and no interest loans to help the most financially vulnerable who struggle to safely access any form of commercial credit.** This could involve the government funding and managing this directly via a reformed and enhanced Social Fund. Or it could be achieved in partnership with commercial lenders and the voluntary sector, following the Australian example of Good Shepherd Microfinance.

This paper is intended to facilitate the discussion of these issues and set out the case for additional action. To take this forward, further research is needed to look in more detail at:

- Who are the families who are using high cost credit to meet essential costs in terms of demographics, income levels and employment status? This would include looking at the different segments within this group e.g. more near-prime and more sub-prime;
- The numbers of individuals/households in this group, each segment and the level of lending demand they represent;
- Explore which of the segments of this wider group could be served by further expansion of community lending and those that would be within the eligibility criteria for commercial lenders such as FinTech, mainstream banks and employer based lending;
- Understanding the extent and nature of the most financially vulnerable group whose needs are not likely to be suitably met by the market.

The next steps on this are to convene a group of academics and researchers to take this research forward. On the policy side, it would require the Government to work together with other stakeholders, including the FCA, community lenders, relevant charities, major banks and other relevant private sector groups on this issue. This would involve exploring how changes to the social lending safety net could be mitigated and how to improve access to and provision of affordable and *suitable* alternative provision for those using high cost credit for essentials.

For families on tight budgets struggling to meet their essential costs, the current economic outlook is not promising. Stagnant wages, rising inflation, the freezing of working-age benefits and increasing consumer borrowing has led to concerns about the new prolonged squeeze on household incomes.[112] It is unlikely that the over a million using high cost credit for essential living expenses will reduce in the near future. **There is a need for clear and coordinated action to build more accessible affordable credit alternatives for the most financially vulnerable.**

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