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What sort of credit can help low income households?

A segmentation of the need for affordable credit

Introduction

Too many families on low incomes have to turn to high cost credit as a ‘safety net’ to get by - taking out a payday loan to pay for the families’ weekly food shop or using costly rent-to-own stores to buy a replacement washing machine, for example. Regularly relying on high cost credit puts added pressure on already tight budgets and leaves households particularly vulnerable to falling into problem debt.

Research from StepChange Debt Charity found that an estimated 1.1 million people used high cost credit for everyday household costs in 2016.[1] A recent update of this research found that this has increased in 2017 to an estimated 1.4 million people.[2]

1.1 million using high cost credit for everyday household expenses in 2016

1.4 million using high cost credit for everyday household expenses in 2017

Our recent discussion paper explored what alternatives there are for those who use high cost credit to meet the cost of essentials.[3] This found that the alternatives championed by the Government, community lenders including credit unions and responsible finance providers[4], are currently of inadequate scale to meet the need.

The FCA found that around 4 million people used some form of high cost credit annually, at a value of over £8 billion.[5] Whereas the total value of lending from responsible finance providers in 2016-17 was £22 million to around 55,000 consumers.[6] Credit unions have increased their number of members recently to around 1.8 million but are still limited in reach.[7]

Moreover, community lenders and commercial providers of alternatives to high cost credit are constrained in who they can lend to in order to be financially sustainable and to have a viable business model. The discussion paper found that this means these lenders can struggle to meet the needs of more ‘high risk’ borrowers who are likely to be more financially vulnerable, on the lowest incomes and either unemployed or in insecure employment.[8] The paper called for coordinated action to build more accessible and affordable credit alternatives for this more financially vulnerable group.

The discussion paper found that it was generally those on low incomes with poor or thin credit histories that were most likely to be using high cost credit for essentials. This briefing seeks to take this further by exploring who these lower income, higher risk borrowers are and what type of affordable credit alternative is suitable for them. Those living on low incomes are not one homogenous group and have to borrow money at different times for varying needs. To explore what solution would suit these different households, we need to look more closely at those on low incomes and what their needs for borrowing are.

Segmenting low income households using the Minimum Income Standard

The Joseph Rowntree Foundation's (JRF) Minimum Income Standard (MIS) provides a useful framework for looking at who is living on a low income and what their borrowing needs are. The MIS is based on what the public think people need for an acceptable minimum standard of living. This provides a conception of low income as people need an income above the MIS to meet their needs and achieve an acceptable standard of living.

In 2017, the Minimum Income Standard rates[9], as calculated by JRF, were as follows:

Household type	Income (before tax) needed to achieve the Minimum Income Standard (MIS)
Single person	At least £17,900
Couple with two children	At least £20,400 each
Lone parent with a pre-school child	At least £25,900

JRF found that 30% of the population, approximately 19 million people are in households with incomes below the MIS.[10] Within this, there are three main groups:[11]

1. Just below MIS: This group are considered to be 'just about managing' and are getting by day-to-day but are under pressure. They find it difficult to manage unexpected costs and life events. Living just below the MIS may not cause immediate difficulties and material needs are likely to be being met but opportunities and choices to participate fully in society are constrained. It is estimated that there are around 8 million people who could be classed as living just below MIS.[12]

2. Living on 75% of the MIS: these people do not have enough income to meet their needs and are falling substantially short of a decent standard of living. The threshold of 75% of MIS approximately corresponds to the official poverty line in the UK (60% of median income). People in this group are having to juggle insufficient financial resources and are much more likely to experience deprivation. This means they are unable to afford essentials such as a warm home and are also likely to miss out on things considered socially important such as the ability to celebrate special events such as birthdays and Christmas. [13] They also can easily get behind with household bills or incur debt, putting extra pressure on their constrained incomes. According to JRF, there are 11 million who live this far below the MIS.[14]

3. Destitution: This group of people cannot afford to eat, keep clean or stay warm and dry. The JRF define people as destitute if they or their children have lacked two or more of six essentials (e.g. shelter, food etc.) because they cannot afford them or their income is so extremely low that

they cannot purchase them for themselves.[15] For example, sleeping rough for one or more nights or having fewer than two meals a day for two or more days.[16] They are in the most severe difficulties and JRF researchers found their income is not measurable as expressed as a percentage of MIS. JRF estimate that there are 1.25 million people in the UK who experienced destitution at some point during 2015.[17]

Borrowing on a low income: what alternatives to high cost credit are available?

The households living below the MIS provides a framework to explore the use of high cost credit for essentials and what alternative affordable credit is available to these three groups.

Although not all those on low incomes use credit, with some choosing to go without or borrow from family or friends, many households with constrained budgets need to turn to credit occasionally to cover essential costs. These ‘periodic needs’ include anticipated one-off events or expenses such as paying household bills and unexpected expenses such as white goods breaking down.[18] Periodic needs also includes coping with expenses after an income shock, for example, from job loss.[19] Some more financially excluded households have to turn to high cost lenders to meet these needs. The University of Bristol found that just over one in six low-income households used high cost credit and they were more likely to be those that were unable to access mainstream credit sources.[20]

The question is what alternative affordable credit options are available to these households and what is suitable for their needs and ability to repay. Households that use high cost credit generally have lower than average levels of income and in many instances have a poor or no credit history that limits their access to mainstream lenders.[21] Financially excluded households living below the MIS therefore currently have a limited pool of affordable credit options available to them.

The main source of affordable lending is community lenders such as credit unions and responsible finance providers. Credit unions provide a range of financial services including personal loans for members with a ‘common bond’, typically based on their local area or workplace. Responsible finance providers have a social mission and provide short-term and low value personal loans at a lower interest rate than high cost lenders. However, as mentioned, these forms of lending may not be suitable for all groups of lower income households.

This briefing therefore uses the MIS framework and FCA research to explore what the borrowing needs of each of the three groups are what type of affordable credit is available and would be suitable for them:

Just below MIS

Those households living just below MIS are getting by day to day but can find it difficult to manage unexpected costs. They are therefore likely in some circumstances to have to borrow to meet these. This aligns with the FCA research findings on 'lifestyle borrowers' who occasionally use credit, including high cost lenders, for larger purchases or one-off events, for example, replacing a broken boiler or for their children's birthdays.[22]

This group should in most cases have some disposable income to be able to afford to repay some form of low cost credit product to cover occasional unexpected costs or events. Although they may be excluded from mainstream credit, they may still meet the creditworthiness assessments for credit union loans and responsible finance providers as they will have some disposable income with which to repay the loan.

Nonetheless, even though they may be eligible for these types of lending there are still barriers to greater availability and awareness of this affordable credit provision. One of the barriers to the take-up of credit unions services is low awareness of these lenders and their purpose.[23] Moreover, credit unions do not have the same levels of expenditure to invest in advertising and marketing as commercial lenders. There could also be geographical or practical barriers to accessing these lenders as they may not be available in the local area or through an employer.

The expansion and scaling up of community lenders could provide greater access to this form of affordable credit for this group. There has been support and investment from Government and others in the expansion of community lenders including the £38 million credit union expansion project. There are a range of on-going projects to continue this expansion and explore how to overcome the barriers to expansion for these lenders. This includes the new fund from the Carnegie Trust[24], the Affordable Lending Portal[25] and Responsible Finance's research programme[26]. The FCA is also undertaking work to overcome the barriers to expanding community lenders as alternatives to high-cost credit.[27] These are welcome as scaling up community lenders should provide greater access to affordable credit for these households that should have some disposable income and ability to repay lower cost loan products.

However, even with a considerable expansion of community lending there is still a group for whom interest-bearing credit is not viable. Where households have very little, if any, disposable income then it is unlikely that they would meet the creditworthiness assessments for credit unions and other community lenders. The community lender could not responsibly lend to them as with such low levels of disposable income they would struggle to be able to afford to repay the loan. This is highlighted by the fact that between 50-80% of people asking to borrow from credit unions are refused for not being creditworthy, depending on the risk appetite of the lender.[28] This highlights the need for different solutions for many of those living below the poverty line.

Living on 75% of the MIS

Those living on 75% of MIS, and below the poverty line, do not have enough income to meet their needs and are unable to afford everyday essentials. They are therefore more likely to need to borrow more regularly to cover the cost of these essentials. This aligns with the FCA research findings on 'survival borrowers' who often use credit, particularly high cost credit, to supplement their incomes and meet day-to-day essential expenses.[29]

Households in this group are unlikely to be able to repay most forms of commercial credit however low cost it is, as they have a lack of disposable income and are likely to be already falling behind, for example, with essential bills. Credit unions in particular can face difficulties in lending to this group as serving the lowest income population can hinder their goal of achieving financial sustainability.[30] As the FCA also outlined, there is a varying risk appetite and capacity amongst credit unions to lend to higher risk consumers.[31]

Responsible finance providers may be able to offer this group loans 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 to cover costs. However, there is still the concern that those with very little disposable income would struggle to repay even these lower cost loans. Moreover, only around ten of these responsible finance providers across the country offer personal lending to individuals, with others focused on small business lending.[32]

Access to affordable credit for those households living below the poverty line is therefore currently particularly limited. Moreover, efforts to expand community lending may not solve this as they are unlikely to be suitable for this group. As outlined above, some households will struggle to repay even lower interest loans as they have precarious finances and a lack of disposable income.

A different approach, more tailored for this group, would be the use of no interest loans. This type of interest free lending is more likely to be suitable for this group so they can afford to repay in manageable instalments. These loans can also be repaid over a longer period (e.g. around a year) and have flexibility on repayments that are also more suitable for those with low and insecure incomes.

The question is **how to build a scheme of no-interest loans suitable for those with precarious household budgets in the UK.** Some have suggested this could be achieved by the Government establishing a single fund to bring together and extend the current state provision of interest-free credit.[33] This would involve a one-off investment into this new fund and the extending of eligibility criteria for Social Fund Budgeting Loans so that they are available to all those who receive Universal Credit.[34]

In our discussion paper, we put forward another model for a scheme of no-interest loans based on the Australian Good Shepherd Microfinance No-Interest Loans Scheme (NILs). This is a partnership between the Australian Government and a major bank to provide finance for the loan capital and running costs of the NILs scheme, as well as other financial products. Whilst we recognise there is further work to be done to develop what a UK no-interest loan scheme would look like, who would support this and how it could be funded, there is a clear need for this to be considered if we are to meet the needs of this lower income group.

Destitute

Within this final group, any type of credit is inappropriate as they are facing destitution and cannot afford the absolute essentials such as feeding their family or keeping a roof over their heads.

The JRF research into the experiences of people facing destitution asked about whether they had borrowed to make ends meet. This found that some people in this group couldn't borrow as they had such poor credit ratings, while others were reluctant to borrow from high cost lenders due to the risk of getting into debt problems.[35] Some had borrowed from payday lenders and experienced unmanageable repayments, a very small number had borrowed from illegal loan sharks and a couple had heard of credit unions but they were not seen as flexible enough for those in emergency need.[36]

For those households who are destitute, credit and any form of borrowing are not appropriate as this group would struggle to afford to repay even a loan with no-interest. They will have emergency, priority needs and therefore would need access to grants and support services. Currently, some destitute households will have the option of food banks or other charities but some will just be going without. The question for this group then is not what affordable credit alternatives are available but what support is accessible for people with emergency needs.

In terms of accessing support from the State, households facing destitution may be able to access support from local welfare provision provided by English local authorities and the local welfare funds devolved in Scotland and Wales. These replaced the centrally administered discretionary Social Fund including Crisis Loans and Community Care Grants. The JRF research indicates that local welfare provision is playing a fairly significant role with one third of destitute service users receiving support from their local scheme.[37] However, the experiences of this were highly variable with some receiving positive, straightforward help that met their needs, whereas some only got inadequate support or were turned down.[38]

A major concern with local welfare provision is that it is not providing consistent and adequate support to those with emergency needs due to funding restrictions. The UK Government has not provided a separate ring-fenced grant for local welfare provision from 2015/2016 onwards and there are no duties on local councils to provide this support.[39] In contrast, both the Scottish and Welsh schemes have had their funding protected.[40]

The consequences of this is, as the National Audit office found in January 2016,[41] that some English councils had stopped or reduced their scheme because there was no longer specific grant funding. A study from 2017 also found that nearly two-thirds of English local authorities had either closed their local welfare provision schemes or are only offering a 'skeleton' service.[42] Moreover, the JRF research raised concerns about the shift towards more localised and varied forms of state-funded welfare and found that there has been an increased reliance on charities and faith groups to meet the basic needs of those in destitution.[43] There have been calls for the Government to urgently review the funding and operation of local welfare provision across England and to take action to ensure emergency support is available to those in financial crisis and experiencing destitution.[44]

Conclusion

It is clear that one type of affordable credit alternative will not meet the needs and be suitable for all of those living below the MIS. Those facing destitution need access to very different types of provision than those that are 'just about managing'. Therefore there is a need for a mixed and expansive provision of affordable credit alternatives and grant based emergency support.

Those households who are living just below the MIS need to be aware of and able to access affordable credit provision in their local areas or nationally. The growing and continued expansion of community lending should provide them with the access to lower cost loans for occasional one-off or unexpected costs. There is ongoing work by the FCA and others to increase the scale and capacity of community lenders. A **sustained and long-term programme to expand provision of community lending** would help to ensure those living just below the MIS have greater access to alternatives to high cost credit.

For those households that are living in poverty, below 75% of MIS, there is a need for a more tailored solution to reduce the numbers of them turning to high cost credit for essentials. Access to affordable credit alone cannot solve the challenges of poverty. However, providing access to some form of borrowing for one-off and larger purchases at affordable prices can prevent struggling households from falling into or exacerbating problem debt. This group need access to very low cost credit that they are able to repay over a longer term period with built in payment flexibility. This could be achieved by **the UK, and devolved, Governments leading the development of no interest loan provision** either by reshaping the Social Fund or by working with business partners to create a UK scheme similar to the Good Shepherd Microfinance scheme in Australia.

Finally, for those who are facing destitution, credit is not likely to be the answer. Households in this situation are very unlikely to be able to afford to repay any type of loan and therefore should not be being lent to. Their acute, urgent needs mean they must have access to grants and wider service provision. This would require **increased and more secure funding and the ring-fencing of local welfare provision** to ensure those facing destitution have access to crisis grants.

The diagram on the following page illustrates this:

Living just below MIS:
Could access affordable credit from community lenders e.g. credit unions

Need: Sustained programme to expand provision of community lenders

Living below the poverty line - 75% of MIS:
Even with more community lenders, they would still struggle to access affordable credit

Need: Government to lead development of no interest loan provision

Destitution:
Any form of even affordable credit would not be suitable.

Need: Access to grants. Increased funding of local welfare provision to provide crisis grants.

Any programme to increase access to affordable alternatives cannot treat those who use high cost credit for essentials as one homogeneous group. The next steps to take this forward should include policymakers using this segmentation as a framework to design provision tailored for each of these groups. This would involve Government working with the third sector, the FCA and business stakeholders to develop what is needed for each group and how it can be sustainably delivered and funded. There would need to be consideration of joined-up provision to ensure households are able to access credit that is affordable and most suitable for their needs. Only a coordinated and effective programme will ensure that there is adequate provision of affordable credit alternatives for low income households in different circumstances.

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For more information visit the StepChange Debt Charity website www.stepchange.org.
For help and advice with problem debts call (Freephone) 0800 138 1111
Monday to Friday 8am to 8pm and Saturday 8am to 4pm, or use our online debt advice tool, Debt Remedy.

Email: policy@stepchange.org
Web: www.stepchange.org
Twitter: @stepchange

[1] StepChange commissioned YouGov plc to conduct general population research. Total sample size was 3,204 adults. Fieldwork was undertaken between 15th-19th December 2016. The survey was carried out online. Figures have been weighted and are representative of all GB adults (aged 18+).
[2] StepChange commissioned YouGov plc to conduct general population research as above: Total sample size was 5,052 adults. Fieldwork was undertaken between 13th - 18th December 2017.
[3] StepChange Debt Charity (2017) The high cost of credit: A discussion paper on affordable credit alternatives
[4] Also known as Community Development Finance Institutions (CDFIs)
[5] Financial Conduct Authority (FCA) (2017) High cost credit review FS17/2 technical appendix table 4
[6] Responsible Finance (2017) Annual Industry Report 2017
[7] Bank of England (2017) Credit Union Annual Statistics 2016
[8] StepChange Debt Charity (2017) The high cost of credit
[9] Joseph Rowntree Foundation (2017) A Minimum Income Standard for the UK in 2017, Available: https://www.jrf.org.uk/report/minimum-income-standard-uk-2017
[10] Joseph Rowntree Foundation (JRF) (2017) Households below a minimum income standard: 2008/09 - 2014/15
[11] Ibid
[12] Ibid
[13] JRF (2016) Destitution in the UK
[14] JRF (2017) Households below a minimum income standard: 2008/09 - 2014/15
[15] JRF (2016) Destitution in the UK
[16] Ibid
[17] Ibid
[18] Kempson, E., & Collard, S. (2012). Developing a vision for financial inclusion for the UK.
[19] Ibid
[20] University of Bristol (2016) Paying to be poor: Uncovering the scale and nature of the poverty premium
[21] See: Office of Fair Trading (2010) Review of High cost credit, page 5 and University of Bristol (2016) Paying to be poor
[22] FCA (2014) Consumer credit and consumers in vulnerable circumstances
[23] Consumer Focus (2012) Credit where credit's due: the provision of credit union services through post offices
[24] Accessible: www.carnegieuktrust.org.uk/news/new-carnegie-uk-loan-fund-will-support-affordable-lending-financially-excluded-households/ accessed 29 January 2018
[25] Accessible: www.affordableloans.credit/Home/About accessed 29 January 2018
[26] Coventry University Research Centre for Business in Society (2017) Consumers, Credit and Scaling Affordable Lending: A Literature and Evidence Review
[27] FCA (2018) High cost credit review update
[28] Mark Lyonette (Chief Executive of ABCUL) in response to Q59 at the Treasury Committee Access to basic retail financial services inquiry oral evidence session on Thursday 3 November 2016. Accessible: www.parliament.uk/business/committees/committees-a-z/commons-select/treasury-committee/inquiries1/parliament-2015/access-to-financial-services-16-17/publications/
[29] FCA (2014) Consumer credit and consumers in vulnerable circumstances
[30] University of Birmingham CHASM (2015) Briefing Paper BP9/2015 Credit Unions in the UK – balancing social benefit with economic viability
[31] FCA (2018) High cost credit review update
[32] Responsible Finance (2017) The industry in 2016
[33] End Child Poverty (2017) Feeling the Pinch: furnishing your home with rent-to-own
[34] Ibid
[35] JRF (2016) Destitution in the UK
[36] Ibid
[37] Ibid
[38] Ibid
[39] London Councils (2014) Local welfare provision briefing; Available: https://www.londoncouncils.gov.uk/our-key-themes/tracking-welfare-reforms/resources/local-welfare-provision-one-year
[40] The Welfare Funds (Scotland) Act 2015 means the Scottish Welfare Fund will continue and in 2015 the Welsh Government announced over £8 million to keep their Discretionary Assistance Fund intact
[41] National Audit Office (2016) Local Welfare Assistance
[42] Centre for Responsible Credit (2017) The decline of crisis and community care support in England: why a new approach is needed
[43] JRF (2016) Destitution in the UK
[44] Centre for Responsible Credit (2017) The decline of crisis and community care support in England: why a new approach is needed