Reaching the poor:
The intractable nature of financial exclusion in the UK

A CSFI Report



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Preface

It is hard to know where to start thanking the people responsible for this report. Perhaps with the Archbishop of Canterbury himself – who, when he was Bishop of Durham, dipped into his "back pocket" to fund a preliminary study into how the diocesan network of churches could be used to build a new form of credit union infrastructure. Perhaps the Association of Corporate Treasurers and Ruffer & Co who, as long ago as 2014, provided modest seed funding for a Financial Inclusion Fellowship at the CSFI.

To all of them, we are grateful.

I am also grateful to our Fellow, Christine Allison, who sat on the Archbishop's Task Group and who was the principal author of this report. However, it is not by any means the product of a single pair of hands. Although Christine did most of the heavy lifting, there are important contributions that I should like to recognise from Sir Sherard Cowper-Coles, Russell Hamblin-Boone, Rod Shearing, Dr Malcolm Brown, Matt Bland, Kenny MacLeod, Gareth Evans, Mick McAteer and David Barclay. In addition, my former colleague, Harry Atkinson (who has since move on to bigger things at NESTA), contributed the important chapter on what financial technology can do for the financially excluded.

Beyond that, my Co-director, Jane Fuller, worked closely with Christine to impose a structure on a mass of material that periodically threatened to get out of hand. And, of course, many thanks to Sir Hector Sants – who, in addition to chairing the Task Group, has contributed a foreword that gets to the heart of the problem.

The result is a broad-brush review of recent progress in financial inclusion, and of the problems that remain. My own take-away is that, for all the genuine progress that has been made (and it should not be minimised), there remains an intractable problem of how to deal with the least advantaged, most excluded people in society – those who are not just unbanked, but perhaps unbankable. In that sense, the (very) poor will be "always with us" – but we can at least chip away at the edges of the problem, and improve conditions and prospects for those who are one or two steps up the ladder of financial inclusion.

Andrew Hilton
Director
Centre for the Study of Financial Innovation

CSFI

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Reaching the poor: The intractable nature of financial exclusion in the UK

Foreword

The importance of maintaining momentum in addressing the challenges posed by financial exclusion has never been greater. Thankfully, awareness across policy makers and those capable of tackling the issue is at a high level thanks to the work, among others, of the credit union movement, the Financial Inclusion Commission, parliamentary committees, and the Archbishop of Canterbury and his Task Group.

However, although the importance of having an inclusive finance sector is widely recognised, there remain some critical areas of debate where a consensus has yet to be formed. This CSFI publication seeks to further understanding of these key areas. Looking at the topics addressed, I would highlight the following central themes.

Regulation: The current regulatory regime focuses on consumer protection and competition, but does not, in my view, adequately recognise the different needs of the excluded and vulnerable. The presumption is that if the consumer is at risk, the response should either be to prohibit the product, or to place responsibility on the firms to reduce the risk. This approach does not recognise the specific needs of those in distress. Furthermore, the regulatory philosophy could be seen as ignoring the adverse consequences of no action. For further significant progress to be made in protecting the vulnerable and helping those in distress, a new regulatory philosophy needs to be articulated. The Financial Conduct Authority, under Andrew Bailey, has highlighted the issue in the recent consultation document on its mission (www.fca.org.uk/mission). I very much hope that this exercise will encourage greater regulatory engagement.

Community finance: A healthy and balanced financial sector, addressing the needs of all in society, needs a diversified industry with a strong mutual component. The UK is still some way from achieving this and further initiatives by both the authorities and the industry are needed to address the challenges.

"Fintech": Much has been written about "Fintech". The evolution of technology has clearly opened many new opportunities in respect of both the delivery and nature of financial services. The degree to which this can benefit the excluded has yet to be fully explored.

A culture of saving: Central to a healthy financial system is a culture of saving, both to promote resilience to unexpected events and to provide for retirement. The UK has failed to achieve these goals. This reflects both policy failings and the lack of commercial incentives.

As well as my prior role with the Archbishop's Task Group, I am chair of StepChange Debt Charity, the UK's largest specialist debt advice and solutions charity. Along with many others, StepChange has been pressing policymakers for action to support financial resilience. The bedrock of this is saving. Saving reduces reliance on welfare and high-cost credit, and builds independence. StepChange's research shows that £1,000 of savings roughly halves the chances of a family falling into problem debt. The Government's

"Help to Save" scheme is starting to plug the gap in tax-incentivised saving for low-income groups, which has persisted for so long. The challenge for all parts of the industry is to build on Help to Save to extend that vital savings provision to more people.

In conclusion, I observe that the new Prime Minister has made it central to her Government's mission to improve the chances and choices of people who are struggling to manage, and to remove obstacles that hold them back. This requires bold joined-up action across departments and agencies to boost financial inclusion and resilience, and to tackle underlying vulnerabilities. This report will help frame this vital work and I urge all in financial services to engage with the challenge of financial exclusion.

Sir Hector Sants
Former Chair of The Archbishop of Canterbury's Task Group on responsible credit and savings, and current Chair of StepChange Debt Charity.

Introduction

There is a problem – one that successive British governments have begun to tackle, but that persists despite their best efforts. The UK is a world leader in financial services, yet many of its citizens – and many who have moved here in more recent years – are excluded from, or are unable to engage productively with, the financial services essential to lead a full life.

There is a problem...

In the first decade of this millennium, a good deal of progress was made: the number of people without bank accounts halved and there were a number of innovations to increase financial inclusion. These included prepaid debit cards, ATMs that were equipped to dispense small (£5) notes and banks that agreed to refer customers with poor credit records to credit unions and community development financial institutions (CDFIs, now called responsible finance providers). Yet serious problems remain:

- more than a million adults in the UK still do not have a bank account;
- 50% of households in the bottom half of the income distribution do not have home contents insurance;
- about 2.5 million people use expensive and largely unregulated home credit (doorstep loans);
- at its peak in 2012, an estimated two million people took out short-term, small-value payday loans; and
- more than 400,000 households use the extremely expensive "rent-to-own" sector to purchase essential household goods.

Many people – politicians, church leaders, academics – have spoken out against the ills of financial exclusion, and there is no shortage of ideas as to how to arrest it. Reflecting this, a reconstituted Financial Inclusion Commission (see Box 1), building on the work of the Financial Inclusion Taskforce (2002-2011), reported in the spring of 2015 and made 22 policy recommendations covering banking, payments, credit and insurance. Before that, in July 2013, the Archbishop of Canterbury (who is himself a former member of the Parliamentary Commission on Banking Standards) added his voice to the many opponents of the payday lending industry. His initiative led directly to tighter regulation, including a price cap on this segment of the short-term credit market. The House of Lords has established a Select Committee on Financial Exclusion, and think-tanks, universities, consumer groups, government departments, specially convened taskforces in Scotland and Wales (as well as in England), along with parts of the financial services industry, have all played an active role in the debate and in making recommendations for reform.

Box 1: The Financial Inclusion Commission

"The Financial Inclusion Commission came together in 2014 as a group of independent experts from politics, industry, NGOs and regulators, committed to raising the profile of financial inclusion and placing it back on the public policy agenda following the dissolution of the Financial Inclusion Taskforce in 2011. The Commission worked with policymakers and a wide range of stakeholders to come up with deliverable policy proposals. The ultimate aim of the Commission is to make itself redundant, by encouraging politicians from all sides to take forward its ideas and lead on the issue, to ensure Britain becomes a truly financially inclusive society.

"The initial focus of the Commission was to assess the lay of the land. The publication of its landmark report in 2015, entitled "Financial Inclusion: Assessing the Financial Health of the Nation", gave a clear picture of the problems, direction of travel and potential solutions. Of the 22 policy recommendations, covering banking, payments, credit and insurance, a key theme emerged: there was a lack of leadership and coordination. The research phase was crucial in providing a basis on which to campaign for changes to policy, which is under the control of different government departments and works differently across the regions and nations of the UK. In this respect, the Commission helped instigate a more holistic approach to tackling financial exclusion.

"Since launching its research, the Commission has championed financial inclusion through a variety of campaigns and events. Political advocacy has been core to the work, helping to secure a commitment to financial inclusion in the manifestos of the four main political parties ahead of the 2015 General Election, which demonstrated a cross-party consensus on the issue's importance. More recently, the Commission welcomed Sadiq Khan's commitment, as part of his election campaign to become Mayor of London, to promote financial inclusion.

"Also of note is the House of Lords Committee on Financial Exclusion, instigated by one of the Commissioners, Lord (Archy) Kirkwood, which launched a call for evidence in July 2016. The inquiry will pick up where the Commission left off in 2015 and examine the role of the financial services industry in helping those who are currently excluded, as well as assessing the role of charities, government and regulators.

"Influencing policy change has been critical to maintaining momentum. In December 2015, the Commission led a campaign to secure funding for teams to tackle illegal money lending in England and Wales. In March 2016, building on a recommendation in the 2015 report, research was produced on the benefits of extending the Debt Arrangement Scheme. In May, the Commission launched the FCA's Occasional Paper on Access to Financial Services. In a keynote speech, the then Economic Secretary to the Treasury, Harriett Baldwin MP, expressed her commitment to helping foster a financially inclusive society.

"Where next for the Commission? In order to drive forward its recommendations, leadership from government is critical. It has welcomed the new Prime Minister's commitment to an inclusive approach to social and economic issues and is seeking to work with the new administration. It said: "At a crucial time for the United Kingdom, innovative policy ideas are essential and our pitch to the government is clear: we are here to act as a sounding-board for financial inclusion policy ideas. Our ultimate vision is for the government to adopt our recommendation that financial inclusion be made a central policy priority for government departments, overseen by a Minister for Financial Health. As such, we look forward to the day when there is no need for a Commission like ours, in a Britain where access to financial services is open to all."

The Financial Inclusion Commission's Vision 2020

"The Financial Inclusion Commission wants to see a financially inclusive UK in which every adult and child can enjoy decent financial health. We want financial services that are accessible, easy to use and meet people's needs over their lifetime. We want people to have skills and motivation to use financial services, and to benefit meaningfully from them. This means a UK in which:

- Every adult is connected to the banking system, through having access to – and the ability to make full use of – a transactional account of his or her own;

- Every adult has access when necessary and appropriate to affordable credit from responsible lenders;

- Every adult is encouraged and enabled to save, even in small or irregular amounts...to build up resilience against financial shocks;

- Every adult has access to the right insurance cover for his or her needs, at a fair price;
- Every adult has access to objective and understandable advice on credit, debt, savings and pensions, delivered via the channel most suited to that individual;
- Every adult and child receives the financial education he or she needs, starting in primary school and carrying on throughout life and into retirement."

Sir Sherard Cowper-Coles,
chairman, Financial Inclusion Commission

In a small way, the CSFI has also been active. Not only does it have a mandate to look at innovation, it also recognises that combatting the evils of financial exclusion is a genuine business opportunity – one in which it may be possible to "do well by doing good".

Since 2013, the Centre has organised 17 roundtables to discuss various aspects of financial inclusion and exclusion (see Annex 1). Some of them were held with To Your Credit (now the Just Finance Foundation) and fed into the work of the Archbishop's Task Group on Responsible Credit and Savings. Even before then, the Centre had looked at informal lending and money transmission, and had worked with the Archbishop of Canterbury when he was Bishop of Durham on the possibility of using churches within the diocese as the basis for a network of credit unions.

So, we have form.

We also have a Financial Inclusion Fellow, Christine Allison, who is the principal author (and editor) of this report. She is a former senior manager at the World Bank in Washington, with a PhD in development economics and a special interest in SME and micro-lending. For her, looking at financial inclusion and exclusion in the UK context has been a new experience.

The main message of this report is clear.

Although a good deal of progress has been made, much of it piecemeal, there is a huge amount still to do. Many people at the bottom of the UK's socio-economic pyramid have barely been touched by the initiatives launched to date. Indeed, what becomes clear very quickly to anyone who looks at the problem is that most of the efforts to reduce financial exclusion benefit those who are already on the way to financial inclusion – who have a job, who have (or could obtain) a credit rating, who

are already interacting with the official sector. Binding them more tightly into the formal financial system is undoubtedly a good thing – and much that follows focuses on how to do it and/or how to do it better. But we must also recognise that there is a substantial section of British society that is, and for the moment appears likely to remain, locked out of even those initiatives described here. In other words, a lot of people remain stuck outside the system.

This report offers a commentary on key aspects of the state of financial inclusion in 2016 and on the direction of travel. It includes contributions from practitioners and other experts in the field, and the themes include new initiatives and innovations, competition and regulation, and the tension between the need that providers see for financial sustainability and the particular circumstances of low/volatile income customers. Some of the issues raised have been around for years, while others reflect the changing face of financial services – and of British society. In a nutshell, this report suggests that the mainstream financial services industry, including credit, savings and insurance providers, have still not found a way consistently to meet the needs of customers with low or volatile income.

"Social acceptability" vs. financial viability

However, there is hope. It is our belief that alternative providers, of which there are many, including some exciting new initiatives, have considerable potential. That said, it remains a challenge to address the problem in a manner that is both socially acceptable and financially viable.

Box 2: Insights from emerging markets

"For banks that integrate financial inclusion into operations, digital payments are the main gateway for new customers, starting with transactional accounts to make and receive payments. The payments often involve employer/wage and government/benefit payments as well as payments between individuals. This starting point means that banks often start with under-banked (more than unbanked) customer segments in the low-income and informal population and build their strategies around deepening inclusion for those customers. They cross-sell products that meet these customers' needs such as savings, credit, insurance and pensions. Many banks are also launching e-money products, mainly for the unbanked, and e-commerce purchases and phone recharging in a convenient, cheap and secure way."

Extract from the Centre for Financial Inclusion/Institute of International Finance report – Insights from banks in emerging markets, July 2016

It may be that we will have to look abroad for models – not least to poorer countries, where banks have been active in addressing financial exclusion and play a leading role in providing financial services to under-served populations. China is an excellent example of how to use digital technology to expand coverage rapidly. In many emerging markets, banks treat inclusion as a key business strategy with a timeline to achieve break-even. A few do this under their corporate and social responsibility protocols but, in the main, CSR covers complementary services such as financial education. For most, financial inclusion is a business opportunity.

Chapter One: What is financial inclusion?

Holding a (transactional) bank account is often used as the top-line indicator of financial inclusion, since a bank account is the most fundamental of financial services. Not only does it make everyday financial transactions possible, it also acts as a gateway to other products and services, such as insurance, credit and mortgages. Genuine financial inclusion is a broader concept, however, as demonstrated in the FIC's 2020 vision (see Box 1). It requires access to fit-for-purpose financial services that are easy to use, reflect the growing complexity of personal circumstances and meet people's changing needs over a lifetime. It also requires consumers to have the tools – skills and motivation – needed to manage their financial and economic lives. In summary, financial inclusion implies:

- access to a full suite of financial services, including credit, savings, insurance and payments;
- suitable and flexible products and services that are convenient to use; and
- sufficient financial capability for consumers to interact effectively with product providers, and to make informed choices.

Many of those currently excluded from conventional financial services have been excluded for reasons of low income, a criminal background, past insolvency, a poor credit rating and/or inadequate residence/identification documentation. But some who might qualify choose not to have a relationship with a bank. This may be because the products on offer are unsuitable. It may reflect cost/price deterrents, or a lack of access (including lack of technology or connectivity). It may even reflect the fear of unpleasant treatment by the bank.

The cost of financial exclusion

An inability to access financial services inevitably undermines people's ability to take responsibility for their own financial wellbeing, and it exacerbates other facets of exclusion. Consumers shut out of mainstream financial services are open to exploitation, criminal scams and illegal money lending, or loan sharks. They also suffer a "poverty premium" – the additional cost incurred for various transactions and services by people without full access to financial services. Pay-as-you-go mobile phone contracts and utility payments, along with high-cost credit and insurance, are the main areas where such additional costs are incurred.

Box 3: Financial exclusion and financial stress – some facts and figures

Financially excluded people pay a 'poverty premium' that is calculated at up to £1,300/year. On top of that:

- an estimated two million people took out a high-cost short-term loan in 2012;
- up to 8.8 million are over-indebted (600,000 contacted StepChange, the debt charity, in 2015);
- an estimated 400,000 low-income households rely on "rent-to-own" schemes;
- 13 million people do not have enough savings to support them for a month if they were to experience a 25% cut in income;
- 50% of households in the bottom half of the income distribution do not have home contents insurance; and
- The number of people using food banks rose from 60,000 I 2011 to over 1 million in 2015

In summary, 15 million people are estimated to demonstrate one or more signs of financial distress.

"In 2015, more than one third of people would be unable to find £200 at short notice; 22% would have to borrow the money or sell/pawn a possession… These figures show a deterioration from 2014. However, there are some positive signs for personal finances, with people cutting back on spending, and some improvement in saving levels." University of Birmingham, Financial Inclusion Report, October 2015

A report from StepChange, the debt charity (*Safe Harbours*, January 2015), called for a formal "breathing space" on personal debt, giving people who seek advice a period of 12 months in which interest and charges are frozen and enforcement halted. It argued that this would prevent temporary financial problems from becoming entrenched. "Poor and inconsistent treatment of those struggling with debt is making many people's financial problems worse," the report said. A survey of 1,800 of the charity's clients showed that people with debt problems were routinely being hit with higher interest costs and other charges that make recovering from their difficulties

Poverty feeds on poverty...

harder. The findings also highlighted the way aggressive enforcement and demands for unaffordable repayments could lead to a vicious cycle of deepening debt and greater hardship.

At the end of July 2016, the FCA published the findings from its own credit card market study. This revealed further financial stress – with two million cardholders in arrears and/or in default on their payments, and a further 1.6 million making only the minimum repayment (and thereby incurring high interest charges). Not surprisingly, problems are particularly acute among lower income groups, which are targeted for higher cost cards.

> In Sheffield, around 34,000 people have at least two payday loans at any one time; around 20,000 are borrowing from doorstep lenders; around 20,000 people are using pawnshops; and around 3,000 people are using rent-to-own shops.
>
> Sheffield Money, 2016

Recent governments have tried to address financial exclusion, with some success. But, for every two steps forward, it sometimes seems as though the solution itself causes a step back.

One of the genuine innovations has been the basic bank account – an idea borrowed from the US.

Box 4: The Archbishop of Canterbury's Task Group on Responsible Credit and Savings

"Justin Welby, a former member of the Parliamentary Commission on Banking Standards, is no stranger to the world of finance. In July 2013, he spoke out against the payday lending industry and said he would like to see Wonga "competed out of business". His strategy was to help expand the more ethical and less exploitative competition, in particular credit unions, which provide small loans to their members. This would be done by enabling church buildings and schools to be used to extend the reach of credit unions, by encouraging church members with the right expertise to work with credit unions, and for the soon-to-be-established Church's own credit union to play a leadership role.

"The Archbishop established a Task Group to set out an agenda. Meeting for the first time in early 2014 under the chairmanship of Sir Hector Sants, the Group concluded its work in December 2015. The 12 members were drawn from the Church, community finance,

money advice and financial services. They sought areas where the Church and its community could make a difference in helping people to manage their money, concentrating on practical, deliverable initiatives. This reflected a finite timeframe (of two years), while accepting that the broader aim of putting the Church at the heart of a fairer financial system, developing a stronger community sector and embedding sound money management would all take longer.

"Churches and dioceses across the country have responded enthusiastically and creatively to the Archbishop's call to support credit unions. Impact on the ground goes well beyond the Task Group's own activities with, for example, credit union 'pop-ups' in church halls.

"The Task Group's own initiatives include:

- The *LifeSavers financial education programme* and network of savings clubs, initially in CofE primary schools, gradually expanding to other schools (with funding from the government and Virgin Money). The aim is to promote sound financial education and savings habits in young children.

- The *Church Credit Champions Network*, connecting churches to credit unions and promoting credit union membership. This involves the training of credit "champions" who are attached to a church and undertake a range of outreach activities.

- *Debt awareness and signposting*, developed in partnership with the Money Advice Trust.

- *Churches' Mutual Credit Union*, launched in February 2015, for clergy and Church employees. As a new credit union, the CMCU is able to pilot new ways of doing business, including suggestions to improve the FCA's credit union approval process. The CMCU plans to expand its "common bond" to broaden its membership.

- *Informal support* to other new responsible financial services providers – including short-term credit providers, rent-to-own firms, small business lenders and the Fairbanking Foundation.

"The first two initiatives will be managed through a new *Just Finance Foundation* – a charitable company under the patronage of the

Archbishop. This will ensure continuity of effort, provide a vehicle to raise additional finance and facilitate further expansion of the programmes.

"The Archbishop's alignment with a fairer financial system, especially a system that works better for low-income and vulnerable people, goes beyond the work of the Task Group. His comments on the payday lending industry helped change public opinion, making way for tighter regulation of that sector. Indeed, it could be argued that the reason payday lending looks so different today from its height in 2012-13 is the regulatory changes and the price cap that the Archbishop and the Task Group demanded. This has been largely beneficial. However, while efforts to highlight the need for more responsible credit alternatives have been sustained, it is fair to say that, so far, the responses of regulators and the industry lack the creative energy required to make the credit union sector more substantial and to build meaningful, ethical alternatives. It is vital that the momentum created in the past two years is not lost and that the pursuit of a fairer financial system continues to benefit from national leadership."

Christine Allison,
Member,
The Archbishop of Canterbury's Task Group on Responsible Credit and Savings

The basic bank account...

These are fee-free bank accounts that allow people to store money and make payments – but offer no overdraft facility or in-credit interest. In addition to access through bank or post office counters, the account holder is provided with a debit card, can make transactions online as well as in store, and set up direct debits and standing orders. The EU Payments Directive set a deadline of September 2016 for all EU banks to provide payment cards to their basic bank account customers. Access to ATMs has also been improved over the years.

Such bank accounts are designed for people with poor credit histories. The intention is that they should provide a gateway to basic financial services. A catalyst has been the link to the UK government's introduction of Universal Credit, which requires people to have transaction accounts to receive benefits and make payments. By 2013, according to BBA data, 9.3 million people in the UK had basic bank accounts. Nevertheless, while the number of people described as "unbanked" has been falling for years, it is still estimated to stand at more than one million.

The financial inclusion element of basic bank accounts is clear from the eligibility criteria. These accounts must be provided to those ineligible for a full bank account, regardless of whether they were previously unbanked. A bank can refuse to open an account for an eligible customer – but only if it is concerned that he or she will use it unlawfully or abuse staff, or if reasonable requirements for opening a bank account (including identification and consent to a credit search) are not met.

All UK banks must now offer these accounts by law, and an industry agreement with the largest providers aims to ensure that they really are fee-free. This certainly tends to be the case as long as the account is in credit, and banks can stop payments if funds are insufficient. Fees have, however, been charged for failed payments or for an inadvertent dip into the red. Under an agreement between the Treasury and nine banks and building societies, some of these penalties were scrapped in 2015.

It is not surprising that it has been political pressure, rather than market forces, that has driven the roll-out of basic bank accounts, since they are typically loss-making. Administration costs almost always outweigh income available from providing other services, such as overdrafts, that charge interest or incur fees. According to the Treasury in 2014, it was costing the industry approximately £300 million a year to provide basic bank accounts.

An obvious question is: What more can be done?

Chapter Two: The problem of short-term credit

As the limitations of basic bank accounts show, the nub of the problem for the financially vulnerable is credit and debt – what they already owe, their capacity to borrow more and their lack of a sound record in managing debt.

Income volatility drives short-term credit

Demand for ready access to short-term credit, typically for relatively small sums, remains buoyant and shows no sign of diminishing. The reason is that, in the absence of savings, many poorer people need credit to deal with the lumpiness of income and expenditure. This has been exacerbated by changes in work patterns that have seen fewer people in permanent employment with a regular salary, increasing numbers of self-employed people – including some on zero hour contracts – and people moving in and out of part-time employment and benefits.

After transactional bank accounts (a problem that one hopes has been addressed by basic bank accounts), access to short-term credit is probably the most important financial service for poorer customers – and, not surprisingly, the UK consumer credit market is one of the largest in Europe.

Credit cards and bank overdrafts have traditionally been the most widely used sources of short-term credit, and for the banked population they remain hugely important. However, a recent FCA study has emphasised that credit card debt is not without its problems. These include aggressive marketing, raising credit limits when people are barely creditworthy and egregious extra charges. The Competition and Markets Authority's (CMA) review of overdrafts revealed a similar problem of excessive charging for unauthorised overdrafts.

Next in scale are payday lending and home credit (doorstep lending). At their peak a couple of years ago, annual loans by payday lenders totalled around £5 billion and served some two million consumers. In addition, home credit/doorstep lenders served about three million people. Pawnshops, rent-to-own shops and logbook loans, with cars as security (common in the US), are other sources of high-interest short-term credit. All of these are highly problematic. Worse still, beyond the legal, regulated market are illegal money lenders, the "loan sharks".

At the more ethical end of the market, a small number of credit unions (see Chapter 4) and responsible finance providers (see below) offer short-term credit on much better terms, but for the moment, they remain minor players in this space.

For all of these providers of short-term credit, there is considerable market segmentation, with income/assets, credit ratings, age, gender and location all playing a role as to what type of credit is available. Typically, however, the demand for short-

term credit increases with financial instability – and the cost of such borrowing also increases dramatically.

The question of how to provide reliable, affordable short-term credit for citizens and communities with low incomes and poor credit scores has long been a difficult and complex public policy issue. There are real moral dilemmas about who should and should not be able to borrow money, and how this access should be provided. However, there is wide agreement that the routes through which many low-income people currently borrow money are far from optimal. Given that they are unable to access cheaper, mainstream financial products, their small-scale, short-term, immediate borrowing needs are all too often met by highly commercial, high-cost credit providers. Advertising and asymmetric information, which exploits the borrower's lack of knowledge, also play important roles in ensuring that borrowers gravitate to a high-cost option.

Payday lenders and loan sharks

Payday lending is probably the most egregious offender of consumer exploitation in recent times.

The payday lending scandal

As an industry, it came to the UK from the US in the late 1990s, but was relatively unknown until the 2008-09 financial crisis. As British households tried to cope with income shocks and the withdrawal of more standard credit, payday lending – especially the online version – took off. A typical loan might be around £250. It would be taken out for a month or less, and around 70% of borrowers would repay the loan within the prescribed timeframe. Unfortunately, interest rates could be astronomic – even if it is widely accepted that APRs can be misleading. Under a regulatory requirement to provide a representative annual percentage rate of interest, Wonga, for instance, gave an example in 2013 of an 18-day £150 loan with an APR of 5,853%. That was not atypical. Despite this, consumers were attracted to the convenient and prompt service, with an online application often putting money into a bank account within minutes. Not surprisingly, payday lending – in particular Wonga, with its hugely effective advertising campaign – quickly caught the attention of the media, MPs, consumer groups and debt charities, as well as the Archbishop of Canterbury. Apart from the high APR, their concerns included hidden charges, the lack of affordability checks, and the manner in which some payday firms went about collecting their payments. They were widely seen as part of the problem, not the solution – and, indeed, they contributed to an increase in unaffordable debt that ultimately led the FCA to tighten regulation and impose a price cap. The so-called "merchants of misery" were duly reined in.

Following the furore over payday lending, the FCA took over the regulation of consumer credit on 1 April 2014, and one of its first acts was to launch a thematic review of payday and other high-cost, short-term lending. It brought in new rules from July that year, including limiting loan rollovers to two times and proposing a price cap. From the beginning of 2015, the following restrictions were imposed on the payday lenders:

- an initial cost cap for interest and fees of 0.8% per day;
- fixed default fees capped at £15; and
- a total cost cap of 100% – i.e borrowers must never have to pay back more in fees and interest than the amount borrowed.

There has also been a market investigation of payday lending by the CMA, which has fed into the FCA's continuing work on the high-cost, short-term credit sector. Further rules are due to come into force in December 2016, focused on price comparison websites.

... led to big industry changes

As a result, the industry today is markedly different from the headline-grabbing one of a few years ago. A number of lenders exited the market in 2014 when the first wave of new regulation came into force, and that has continued, with many opting not to apply for full FCA authorisation under the new regime. Indeed, one estimate suggests that as many as 90% of pre-2014 lenders will have left the market by the end of 2016, largely small non-compliant lenders.

The other major change has been in product offering. Few short-term providers are now offering single payment loans, primarily because they are almost certainly unprofitable under the new pricing regime. Instead, larger instalment loans, spanning a number of months, are now available. Guarantor loans, where family and friends guarantee a loan, are another growth area. They generally offer a lower interest rate than payday loans, as the perceived risk of default is less.

What are the implications of these industry adjustments for consumers?

At its peak, the UK payday lending industry was making just over 8 million loans a year, worth around £5 billion, to more than 2 million borrowers. The market was broadly divided into two, with online lending accounting for about 80% of the market and physical shops 20%. That is changing. Many commentators believe that High Street payday lenders will soon be a thing of the past, since a business model that combines high overheads with high-risk borrowers is unsustainable under the new price caps. Moreover, the online short-term credit market – which typically serves more creditworthy borrowers, those in employment and those with bank accounts – is transforming itself with more transparent pricing, instalment loans and variable repayment schedules.

According to the Consumer Finance Association (CFA), one of the main trade associations for online short-term lenders, more than 90% of loan applications are currently being rejected and lending volumes are down by 70% from their peak. This largely reflects tighter affordability checks, such that only those with better credit records are granted loans.

That, of course, is a mixed blessing. For those denied a loan, a CFA/YouGov poll found that more than a quarter subsequently failed to pay some form of bill or make a credit repayment, a tenth ran up an unauthorised overdraft at a bank while others simply delayed the planned purchase. A small number admitted that they had borrowed from an unlicensed lender. Only a very small percentage (2%) turned to the potential safe harbour of a credit union.

Is there a better 'mouse trap'?

By July 2016, around 50 firms had received full FCA authorisation to offer new-style high-cost short-term credit (compared with the 247 that had applied by the February 2015 deadline, and 400 that had originally had a payday licence). Among these are new firms with new products, which are building on the innovation brought to the market by the likes of Wonga.

A few stand out. One such new entrant is Provident Financial Group's Satsuma. Launched in 2013, it claims to be "best in class" on price (costing £40/£100 borrowed compared with Quick Quid £72), loan amount (up to £1,000), flexible repayment terms (monthly and weekly) and no hidden costs (such as missed payment fees). Like the majority of online lenders, however, Satsuma is cherry-picking: it is targeting younger borrowers in full-time employment, who need short-term loans to manage their lives. In that sense, it complements Provident's more traditional (but equally controversial) face-to-face doorstep lending business, which continues to serve less creditworthy customers. The company has also launched a pilot guarantor loan product, offering larger sums of money over a longer period to borrowers whose own credit record is wobbly, but where a friend or relative can provide a back-up guarantee on repayment.

Another new entrant to the online short-term credit market is Uberima, which offers interest-charge-only loans (i.e. no other charges) of up to £1,000, again with flexible repayment terms. Uberima claims its loans undercut Wonga by around 25% on cost.

New entrants such as Satsuma and Uberima are generally an improvement on first-generation payday lenders. However, according to observers such as Policis (an independent social and economic research consultancy) and the CFA, there is still a danger that some of the new on-line entrants to the market will operate illegally, outside UK regulation. They are the contemporary version of the loan shark and could add to consumer detriment.

Evidence for this comes primarily from the US, where a rise of illegal lending activity has been reported in those states with the most restrictive regulation of short-term credit.

US experience is not that encouraging...

Policis offers the following warnings for the UK, based on US experience:

- The future of illegal lending is not the loan shark with a baseball bat of popular imagination, but online and at scale.
- Demand does not go away when supply is restricted, it just goes elsewhere – to, among others, unlicensed, unregulated lenders, potentially off-shore.
- Once the illegal lending market becomes established, it is very difficult to tackle.
- Illegal lenders tend to look just like licensed lenders, and unsophisticated consumers
- find it hard to differentiate between them
- If regulators measure impact and realised consumer benefits in the authorised sector alone, they may miss the larger detriment arising from illegal activity.

The CFA's 2015 report, *"Credit 2.0 – a commentary on borrowing and spending in the 21st century"*, raised similar concerns about the unintended consequences of regulation. Its conclusion was that many customers will fail to check the legitimacy of a lender's licence and so will not know whom they are dealing with.
So, monitoring the activity of illegal lenders is a challenge – one that will largely fall on the government, the regulators and the judicial sector.

Loan sharks of the traditional sort are still active in the UK. To tackle them, the government's National Trading Standards office has set up "illegal money lending teams'", hosted by Birmingham City Council and Cardiff Council. According to the Birmingham team, around 300,000 households in England currently borrow from illegal lenders. There is no typical borrower profile, but they are generally located in low-income neighbourhoods, and have a high level of debt. Even though 95% are said to have some sort of bank account, they have few alternative sources of credit when money is needed for everyday expenses such as food and clothing or to pay off existing arrears.

Hence, recourse to the unregulated sector. Loan sharks are generally known to family and friends, and are regarded as part of the community. Notwithstanding that, involvement with a loan shark can go well beyond financial extortion to physical and mental distress – at its most acute, leading to suicide. Immigrant populations are particularly vulnerable as many have yet to meet the requirements necessary to interact with the formal credit sector.

Box 5: Payday lending and regulation

"The introduction of FCA regulation has transformed the high-cost credit sector. The single-payment loan, which used to characterise payday lending, has generally been replaced by longer-term loans. The most common is a small sum loan repayable in instalments over three to 12 months. These loans are still subject to the cap on the cost of credit, which includes an interest rate of 0.8% per day, or £24 per month for each £100 borrowed. This cap means the loan cannot exceed 100% of the amount borrowed, and that penalty fees are limited to £15. There are no rollovers and no penalty fees for most short-term products.

"The reason for the change in the structure of the industry is two-fold. First, the FCA price cap has funnelled the lending market into a narrow channel of loan options. Second, instalment loans are proving popular with consumers. Many people are taking longer instalment loans, which they often pay off before the full term. As the market diversifies and as the FCA becomes more informed, we are likely to see more innovative credit products challenging traditional loan offers.

"According to CFA members, the number of loans approved against loan applications made has declined by 68% from the market peak in 2013. On average, CFA members now approve only 8% of loan applications. This trend is echoed by debt advisers. A Coventry Citizens Advice Bureau manager commented recently: "Only 17 per cent of people questioned said they had taken out, or were thinking about taking out, a payday loan. Two years ago when we carried out that survey, the figure was 75 per cent."

"Despite the new lending landscape, the media continues to be fixated on a debate that fails to recognise a fundamental truth. For many reasons, the banks have a poor appetite for risk, which has restricted access to credit for a wide segment of the population. As a result, a credit void was created. Entrepreneurial short-term lenders stepped into this space and sought to provide credit to those who were excluded by mainstream lenders. More recently, High Street lending has declined – with the largest store-based firms closing down outlets in order to meet the requirements for authorisation or to reduce overheads. Only around 20% of lending is now through High Street stores. However, the demand for short-term credit still remains strong and consumers continue to seek credit from non-mainstream sources.

"The growth of online financial services reflects this, responding to an increasing consumer appetite for speed and convenience. Short-term lenders were the pioneers of web-based financial services and led the way for what is now an acknowledged "fintech" sector. With advanced use of powerful analytics, lenders have developed sophisticated data models to assess affordability and underwrite credit. The technology is more advanced than in mainstream financial services, and short-term lenders have a deeper understanding of their customers' profiles and behaviour. This point often gets lost in the moral debate about high-cost credit, which means that innovation could be held back.

"There is no doubt that the FCA's new regulatory regime has had an impact. The CFA has estimated that, by the summer of 2016, 51 firms had received full FCA authorisation to offer high-cost, short-term credit, compared with around 240 firms two years ago. However, many of these permissions are for franchised businesses, micro-businesses or firms not lending. The majority of high-cost, short-term loans are provided by about a dozen firms. (However, there are also a number operating on interim permissions, which have mixed portfolios and a different application deadline.)

"As the market settles into the new regulatory framework, we will inevitably see consolidation and a reduction in the number of lenders, coupled with a widening of the range of customers attracted to alternative finance. Having been forged in the furnace of political and media fires, short-term lenders are emerging as modern, high-tech businesses for the digital age."

Russell Hamblin-Boone,
Chief Executive, Consumer Finance Association

Rent-to-Own

The 'never-never' is back...

Payday lending and recourse to loan sharks are not the only problem area. Another is what is now known as rent-to-own (RTO) – what we used to know as Hire Purchase (or the never-never).

Like most forms of high-cost borrowing in the UK, rent-to-own experienced rapid growth in the era of "austerity", establishing itself on the High Streets of less affluent towns, cities and communities. RTO businesses now provide credit to more than 400,000 households, typically with low incomes and reliant to some degree on

benefits, enabling them to spread the cost of purchasing large household items, such as furniture, kitchen appliances, TVs and computers.

The sector has more than doubled in size over the last five years, and is now dominated by just three providers – with BrightHouse the best-known and largest. The business model relies upon costly hire-purchase arrangements, whereby the customer has a credit agreement, but does not actually own the goods outright until the last payment. Falling behind with RTO repayments means customers face losing the goods they bought, which can put undue pressure on them to prioritise such payments. A number of other practices have been highlighted as unfair by organisations concerned about personal financial stress. The combined effect is to compound the debt trap for many low-income families. The main issues are:

- Price: RTO agreements are expensive and price transparency is poor, with interest rates reaching 99.9% APR. Taking in charges for additional cover, the cost of goods can almost triple.

- Delinquency: Many customers experience high levels of financial difficulty, with roughly half paying late or failing to repay.

- Repossession: Over 10% of customers have their goods repossessed.

- Add-ons: Poor value (and often unnecessary) service cover, warranties and insurance tend to be bolted on, with at least 85% of BrightHouse customers estimated to purchase such services.

Basically, the structure of the RTO market exposes customers to over-charging and poor practices, and the lack of choice makes consumers vulnerable to exploitation. As a result, RTO is simply inappropriate for many customers. Unfortunately, the typical RTO customer is extremely vulnerable – from a low-income household, wholly or partly reliant on welfare benefits, often a young and female lone parent living in rented accommodation.

The industry is now firmly under the spotlight of the FCA, which has regulated it since 2014. As a result, the authorisation process now pays particular attention to affordability assessments, arrears handling, forbearance and price transparency. In addition, there is a new requirement: the appointment by RTO firms of an independent “skilled person”, effectively a self-policing provision.

Compared with the treatment of the payday lending industry, this is still extraordinarily mild. However, the FCA did impose a redress scheme in March 2016 against Buy As You View, requiring close to £1 million to be paid to 59,000 customers through either a balance write-down or cash to those customers who had been overcharged.

A fairer RTO industry?

To offer an alternative that addresses some of the consumer detriment issue (while meeting the legitimate demand for RTO), a number of social businesses (such as Fair for You, and Smarterbuys) have been launched.

Box 6: Rent-to-Own – New Initiatives

The lack of mainstream alternatives offering affordable credit to low-income households for essential items is recognised as a key issue. The link to the growth of the high-cost RTO market was highlighted by the All Party Parliamentary Group on Debt and Personal Finance, which identified the need for more ethical RTO options from the social enterprise and not-for-profit sectors.

In recent years, there have been a number of attempts to deliver an RTO alternative that combines the purchase of household goods with access to affordable credit. Fair For You is one such initiative:

Fair for You is a not-for-profit lender, providing small loans to lower income households to purchase essential household items. It has been under development for the past two years, and has built its business model on extensive research about the circumstances and preferences of people currently using high-cost RTO. As such, it offers a different approach to other new RTOs, which typically are BrightHouse lookalikes. Primarily aimed at low/medium income workers who typically have experience with online short-term credit, it provides flexible, affordable loans to buy household items. Early partnerships are with Hotpoint, Indesit and Whirlpool, with further product and retail arrangements under discussion.

Customers browse online for products, add items to the basket, check the cost of purchase (all charges are transparent) and apply for a loan. Fair For You staff call potential customers to check affordability. Finance is provided directly from Fair For You Enterprise CIC using capital sourced from a variety of funders. Typically loans offer weekly repayments, with some degree of flexibility. Interest is set at 3% per month, 42.6% APR, which is following the credit union ceiling rate. Repayment is via Continuous Payment Authority taken from a customer's bank card.

Once approved, items are delivered within 72 hours. The scheme will be open to customers throughout the country. If a council or housing association wishes to promote the scheme, Far For You will provide support and advice.

Fair For You has developed direct arrangements with various large manufacturers to supply High Street-branded white goods. It has recently added beds, cots and sofa beds, and a furniture range to the product line. Goods will be sold with no additional fees, just the standard warranty and insurance bolt-ons, as requested by the customer.

Fair For You will receive a commission from the retailer as part of its business model.

These bring together local stakeholders and suppliers of household goods and affordable credit to offer elements of the RTO model that appeal to consumers, while avoiding the more harmful ones. These providers are able to generate significant savings for low-income customers, helping them to avoid paying a "poverty premium" for essential goods. However, it is still early days for these firms, and they face a number of big challenges before they reach scale and make a significant impact. These issues include:

- Credit provision: Who will deliver the lending facility?
- Lending capital: Who provides the capital for lending and who shoulders the lending risk?
- Delivery outlet: How will household goods and lending be promoted and accessed by customers?
- Viability: If the cost of credit is "affordable", can the business model support the cost of physical stores and warehouses?
- Customer base: Are there sufficient creditworthy customers attracted to these alternative providers? And should less creditworthy customers be subsidised eg by local councils?

A common theme is the role of public-private partnerships, involving local authorities, social housing providers and other third-sector organisations working with the alternative credit providers.

Other new short-term credit initiatives

An obvious way to mitigate the impact of high-cost, commercial financial services on vulnerable consumers is to improve the offering from legal, ethical and affordable providers. As discussed in Chapter 4, credit unions have significant potential, but one has to accept that it will take time to develop them as a serious alternative for short-term credit provision. Indeed, many would say that it will take at least ten years given the challenges facing the sector – namely leadership, fragmentation, capital, technology, product and service innovation, capacity and skills.

So, what of other alternatives that can provide the right sort of products and services to low and volatile income people in the here and now?

Responsible finance providers

One possibility is what are now known as responsible finance providers – hitherto (and more commonly) known as Community Development Finance Institutions (or CDFIs).

These typically offer small consumer loans (less than £500) over terms of up to a year. There are currently ten RFPs in operation around the country (down from 12 in 2015). The better-known names include Fair Finance (London), Five Lamps (North East and Yorkshire), Scotcash (Glasgow), Street UK (the Midlands) and Moneyline (national).

In 2015, RFPs lent £22 million to 45,185 individuals, an increase of 14% over the previous year. Consumers accessing this segment of the market are characterised by the familiar, inter-related social and financial challenges of low-income households with no, or poor, credit history. They are predominantly women living in social housing, often single parents, and heavily dependent on benefit payments as their main source of income. Unlike the commercially motivated short-term credit providers, RFPs offer a more inclusive approach, with products and terms that take account of a customer's ability to repay, and they try to build financial capability through face-to-face advice and signposting to debt and money advice services.

RFPs sit alongside home credit and pawn shops in terms of their customers' credit scores (poor/none), but charge a lower interest rate on loans (on average, 78% APR), though higher than credit unions where interest is capped at 42.6%. Debt write-off for responsible finance loans is around 14%, middling for this segment of the unsecured personal finance market.

Unlike credit unions, RFPs do not take deposits. Capital for on-lending comes in various forms, from grants to commercial funding and a variety of other sources, including central and local government, the EU, housing associations, trusts and foundations, social investors and banks. In recent years, there has been an increase

in commercial capital, in part to compensate for the shrinking pot of grant funding. However, the latter remains crucial to the business model of providing unsecured loans to high-risk/high-cost customers.

According to *"Responsible Finance: The Industry in 2015"*, the industry body's latest annual report: "For responsible finance providers, specialising in lending to market segments that are traditionally underserved and excluded by the mainstream, there is a tension to continue to operate in this market but to do so more commercially. The sector's model, once grant reliant for both funding and revenue, is now much more diverse, generating the majority of its income through activities and using both new grant and recycled funds in order to leverage in more commercial investment for on-lending… Whilst the majority of providers are able to cover their operating costs with income generated from their lending and support activities, fewer are able to cover their financial costs. The gap in financial self-sufficiency underscores the need for a first loss mechanism that enables the overall model, and the social and economic impact produced by its activity, to continue in the long-term."

Box 7: Affordable Lending Portal

The Affordable Lending Portal is a new partnership between seven responsible finance providers and credit unions, Asda, Experian, StepChange and Barclays. The concept, developed by the Government's Cabinet Office, aims to direct financially excluded and vulnerable customers who are seeking credit towards a responsible finance provider via initial contact with a high street supermarket and/or utility company. Using an online portal, the customer will be directed to a credit provider that will review their situation and take appropriate action. The idea is to make applying for credit seamless and efficient, using responsible local providers yet building on the footprint of national supermarkets and utility companies. The scheme is being piloted in 2016, with plans to expand in 2017.

Credit scoring and price comparison...

Other areas seeing exciting developments are credit scoring and price comparison sites.

On the former, Pariti provides online tools, guidance and access to low-cost loans, and offers a different approach to credit assessment, building on positive debt reduction steps. Price comparison websites, purpose-built for users of short-term credit with poor credit scores, are also beginning to emerge in response to the CMA's recommendation (e.g. FairMoney.com), and the FCA is in the process of establishing standards for these sites. A particularly interesting development is the use of metrics other than APRs to compare the cost of borrowing short term.

But that is not to suggest that all is well. New market entrants are finding that it is not uncommon for credit rating companies to misrepresent credit histories of people, notably those with complex records. Inconsistent reporting, mislabelling defaults where debts have been settled, and duplication of debt from the same source are all too common. For this reason, some new lenders are still carrying out manual assessments in order to reach a decision. This is both costly and time consuming.

Box 8: Sheffield Money

"In August 2015, the City of Sheffield launched a pioneering venture aiming to address the problem of unaffordable credit and growing indebtedness. A not-for-profit organisation, based in the city centre, was set up to tackle restricted and unfair access to finance.

"Sheffield Money offers loans, savings accounts, current accounts, and lower-cost white goods and appliances, as well as money and debt advice, all under the Sheffield Money brand. The organisation operates as a broker for existing suppliers with shared objectives (e.g. credit unions, responsible finance providers and the advice services). An essential objective is to encourage financial inclusion and awareness.

"By offering alternatives to non-standard credit, it hopes to improve and reduce debt crisis cycles, as well as help customers start saving regularly to create a financial buffer. A money adviser is available in the branch to help people with 'all things finance' - such as budgeting, savings, benefit eligibility, or improving credit scores to ease access to credit. It is written into our mission statement that we will never recommend a loan to someone who cannot afford it. But we will always try to offer an alternative if possible, for example, signposting using our strong links with local advice services.

"With 10,000 hits on our website and almost 2,000 applications for quotes and loans, it's clear that there is demand for the service. These inquiries and applications have come from all over the Sheffield City region and we hope to be able to expand the model to other cities."

Rob Shearing,
CEO Finance for Sheffield – Sheffield Money

At the local level, there are a number of promising initiatives. These include Sheffield Money (see Box 8), the city's new one-stop shop. This provides joined-up money and debt advice – together with access to loans (from credit unions and responsible finance providers), credit for white goods, and savings and bank accounts

from the "better" banks. Birmingham's Fair Money works along similar lines as an online multi-agency service. The London Capital Credit Union, the Leeds Credit Union and the Pollok Credit Union all now offer payday-like, short-term loans to residents of four London boroughs, Leeds and Glasgow, while Street UK and Northern Money provide sizeable lending services in the Midlands and the North respectively. Lendlocal is a peer-to-peer platform connecting people with spare cash to those seeking a loan, brokering the money through credit unions and responsible finance providers.

Neyber is another new entrant, offering loans of between £1,000 and £25,000 over a five-year period. Interestingly, Neyber works with employers – currently police forces, NHS trusts, universities and some large private sector companies – and accesses customers through those employers. As a result, loan repayments are collected via payroll deductions. In its early phase, a significant proportion of borrowers have used Neyber for debt consolidation since its rates substantially undercut credit cards.

Chapter Three: The other side of the coin: savings and financial advice

Savings

Not enough saving is a big problem...

There is a lot of evidence showing that too many people in the UK have few or no savings. Indeed, it is estimated that:

- 24% of working age people rarely save;
- four in ten – 21 million people – have less than £500 in savings and cannot meet unexpected bills; and
- the problem is most acute among low- and middle-income households.

A lack of savings exposes families to income shocks. These are all too often covered by expensive short-term debt and increase the risk of problem debt. In a recent report, StepChange estimated that half a million households could be prevented from falling into problem debt if only they had £1,000 in precautionary savings. In recognition of this problem, in his January 2016 Life Chances speech, the then Prime Minister, David Cameron, pledged: "We'll also do more to help people save – and help build families' financial resilience. Those with no savings at all have no buffer – no shock absorber – for when unexpected events hit."

In March 2016, the government announced a new "Help to Save" scheme to kick-start savings for up to 3.5 million low-income people, with a £1,200 bonus. Anyone in work and in receipt of universal credit or working tax credits will be able to save up to £50 a month and receive a 50% bonus after two years, worth up to £600; the arrangement can be repeated for a further two years.

This follows two previous government-backed schemes to encourage savings: Child Trust Funds and the Savings Gateway – both of which were abolished in 2010. The biggest challenge with the new scheme will be to find a way to help very low-income families save; this is where previous schemes failed. Save-as-you earn and auto-enrolment (as used with pensions) are among the suggestions on the table.

Another important goal would be to encourage savings at a young age to help establish a savings culture. Here, the Archbishop's Task Group has made an important contribution. Earlier this year, it launched the Life Savers programme,

promoting saving in primary schools – starting in Church of England schools but extending to other schools. The savings generated by this programme are held at credit unions, which have a history of promoting savings (indeed, many require a savings record before credit can be provided)
.
In the commercial world, Squirrel, which works with employers to help promote saving, is one of the early innovators. Other new ethical lenders, such as Neyber and Uberima, are also considering adding a savings product to their loans business. When it comes to the (bewildering array of) savings schemes offered by banks and the Post Office, reform is needed to provide ones that are easy to access and understand, that have straightforward arrangements for deposits and withdrawals, and that have a transparent and stable interest rate.

Financial advice

Need for (free) advice

A great deal needs to be done before there is provision of a full suite of financial services to meet the lifetime financial needs of 21st century households. In an ideal world, consumers would have the financial capability, skills and motivation to make informed choices. In reality, they need help. To recall one of the Financial Inclusion Commission's 2020 objectives:

> Every adult (should have) access to objective and understandable advice on credit, debt, savings and pensions, delivered via the channel most suited to that individual.

From 2010, the Money Advice Service (MAS) has been the main public sector organisation offering advice on a wide variety of financial topics, including debt and borrowing, saving and investing, budgeting and money management, insurance, and benefits. In the 2016 budget, however, the government announced that the MAS – which is funded by a statutory levy on the banks – is to be replaced by a smaller advice body. The rationale is that few people apparently know of the services offered by the MAS, and it is not considered cost-effective. Details on the replacement service had yet to be announced at the time of writing.

As a general observation, financial advice is rarely sought before a problem arises. The most common problem for the financially stressed is, therefore, debt. StepChange is the most frequently used source of free advice on debt. Since it was established in the early 1990s, StepChange has grown to provide coverage throughout the UK, with online, telephone and face-to-face services covering a variety of debt issues. Debt advice is also offered by The Citizens Advice Bureau, which has a nationwide network.

Chapter Four: Are credit unions the answer?

Credit Unions are not-for-profit organisations built abound a "common bond". They promote savings and offer affordable credit, and are viewed as one of the most effective ways to provide basic financial services to unbanked and under-served populations. Reflecting this, the Archbishop of Canterbury's Task Group chose to focus on credit unions as the best way to offer more ethical and suitable financial services. That included supporting the establishment of a new credit union for the Church itself.

Box 9: The Task Group and credit unions

"In response (to the problems of financial exclusion), the Church acted in the one arena where it could materially affect change – strengthening the credit union sector. Never conceived as a total solution, there were synergies to exploit here. Churches have a culture of volunteering, some skills and people to lead them. But the Archbishop's Task Group never viewed credit unions as the solution, and certainly not as equipped to compete directly with the payday lenders. The focus has been, rather, on the potential of the model to build more robust and diverse credit unions, able to offer a decent range of products. Where we underestimated the challenge was in failing to see that credit unions wedded to a "small and local is beautiful" ideal can be a restraint to growth – and thus to achieving the sector's potential. But payroll-based, rather than neighbourhood, credit unions are often much more open to expansion and development.

"The foundation of the Churches' Mutual Credit Union has been a major milestone – and not an uncontroversial one. Some local credit unions looked askance at the churches setting up a body that they saw as competing with their own work. But competition was precisely the point – not just between credit unions, banks and payday lenders, but within each sector."

Red Dr Malcolm Brown,
Director of Mission and Public Affairs for the Archbishops' Council of the Church of England.

Credit unions have not expanded in Britain as elsewhere

Credit unions have existed in Britain since the mid-nineteenth century. But, unlike in many other countries (e.g., Ireland, where more than 70% of the population belongs to a credit union), they did not expand in the mainland UK into full-service, modern financial institutions. Instead, they largely remain small local cooperatives, offering limited savings and loan services. Few had a High Street presence and, even now, they rarely offer electronic or mobile banking facilities. Founding principles of community, mutual support and self-government have often taken precedence over expansion, modernisation, professional management and sound governance.

Despite that, political support for credit unions has been growing – with funding from government initially being channelled through the Growth Fund (2006-11) and most recently the Credit Union Expansion Project (2012-17). The latter is particularly significant since it has moved support away from subsidy into investment, offering credit unions the opportunity to use a variety of automated platforms facilitating faster lending decisions, a banking app for online banking and payroll deductions for savings and loan payments. With parallel support from Barclays and Lloyds, important links are also being created with the conventional banking sector.

Box 10: The future for British credit unions and financial inclusion

"The past two years have seen credit unions in the UK reach a number of milestones. More than a million Britons now use their services, and more than £1bn is entrusted to the management of the 350 credit unions in England, Scotland and Wales. The sector has doubled its membership and tripled its asset base in the last decade.

"Much of this growth has been driven by unprecedented engagement by the sector with low-income communities. Under schemes like the DWP's Growth Fund, credit unions have seen hundreds of thousands of low-income households make use of their services to replace high-cost credit with affordable loans and to begin to save – in many cases for the first time. This role in supporting low-income communities and enhancing life chances is firmly embedded in the credit union growth story, and its lending has saved low-income families many millions in interest.

"So far, so positive. But the sector is not without its challenges. Since the peak of the financial crisis in 2009, credit unions' lending growth has lagged behind that of deposits, expanding at roughly half the rate. The continued use of extraordinary monetary measures by the Bank of England has also put investment income under pressure.

"Credit unions' cost-income ratios are pressed even further in the wrong direction by high operating costs, driven by outdated manual

processes. Similarly, as the pace of digital adoption – particularly among the young – reaches higher levels, their ability to invest in new technology and to compete is in doubt.

"These trends are exacerbated by a skewed membership base – an over-representation of low-income families and an ageing cohort of long-standing members who tend to be savers. Without a compelling, modern offering and a differentiation in the marketplace, these trends are set to continue. In the context of limited public and philanthropic support, they are placing pressure on credit unions' long-run sustainability.

"But it's not all doom and gloom. The government is investing £38 million in the Credit Union Expansion Project, again under the auspices of the DWP. This will see 35 credit unions adopt a common operating model driven by agency access to payments infrastructure, allowing a compelling digital offering with the ability to self-serve and access services online and on mobile devices – as is taken for granted by today's consumer.

"Elsewhere, a growing band of credit unions is utilising the proven mechanism of partnership with employers and payroll deduction to provide a differentiated and attractive service to those in work (often low-paid) – both supporting their financial resilience and diversifying credit union membership. Government support in accessing the armed forces via the Ministry of Defence and the staff of the DWP is a key development – as is the imminent launch of a credit union for the retail sector.

"The next stage of development will be to diversify the services the sector offers and to innovate in order to build new sources of revenue. Credit unions around the world already engage in the full range of retail financial services – competitive mortgage lending, credit cards, car finance and insurance mediation. British credit unions need to do the same.

"For this to succeed, however, the sector needs regulators to recognise the importance of a diversified business model to ensure its long-term stability and growth, and to enhance consumer choice through competition. Much progress has been made in creating a proportionate and flexible regulatory regime; we hope that this can be built upon to allow British credit unions to flourish as they have elsewhere."

Matt Bland,
Head of Policy and Communications, Association of British Credit Unions (Abcul)

Box 11: Large credit unions lead the way

"How do you run a successful business when your primary statutory objective is to encourage your customers to save, and yet the only way you can make money is to deliver a return on those savings by lending to those very customers? That is the credit union conundrum, and it has been exacerbated during this prolonged period of near-zero base rates.

"In dealing with this problem, being one of the dozen or so large credit unions (out of 350) in Britain is both a blessing and a curse. Large is, of course, a relative term. In the wider world of UK financial services, no credit union would be described as large – even the largest is barely the size of the smallest building societies. Yet in the credit union marketplace, the biggest ones dwarf the rest. For example, the National Credit Union Forum represents six credit unions that collectively account for over 15% of British membership and over 30% of the sector's assets and loans.

"Large credit unions need the infrastructure in place:

- to serve tens of thousands of members (and manage tens of millions of pounds of their savings);
- to meet enhanced regulatory compliance requirements; and
- to provide the online banking and mobile apps required to attract "mainstream" customers.

"On the one hand, that infrastructure does not come cheap and the option open to some of the smaller credit unions of simply hunkering down until the storm blows over cannot apply. On the other, it provides a solid foundation for tackling the market conditions head on.

"What are the larger credit unions doing? That depends on where they are in respect of their business life cycle. Those organisations that have just become large are under pressure to be innovative simply to ensure they can secure an income stream that can sustain their developing infrastructure investment. Those with a mature model, with a history of profitability, are tending to focus on efficiency and being better at doing what they already do. That does not mean there is a lack of innovation in the sector; on the contrary, the large credit unions are leading the way in offering highly competitive loan products, collaborative partnerships, online services and innovative marketing strategies.

"All of this, however, just addresses the symptoms of life under the Credit Union Act, which dictates that:

- we only have one primary income stream – loan interest; and
- this income stream can only be derived from a closed group of customers – the same ones we are meant to encourage to save.

Increasingly, therefore, the larger credit unions are turning their attention to the root of the problem: the Act itself.

"Credit unions, large and small, are trusted by their members, valued by their partners and lauded by politicians and financial inclusion activists. Yet they are legally prevented from delivering a wider range of services. This needs to change. If we want financially empowered consumers in Britain, we need to provide them with a wider set of options – not only in terms of the range of services available, but also in the ownership and accountability structure of the organisations providing those services. To achieve that, we need legislatively enabled credit unions, which are permitted to deliver a wider range of complementary financial services – and which can do so in sufficient volumes to attract customers because it makes economic as well as ethical sense. Delivering that change is where the challenge to the larger credit unions lies."

Kenny MacLeod,
Chief Executive Officer, Scotwest Credit Union.

Credit union membership in the UK now exceeds one million. The amount of money being saved with these institutions also continues to grow apace, with total member deposits now surpassing £1bn – an increase of 25% in three years. However, that is still trivial by the standards of mainstream banks.

As the above two contributions – written by leading UK practitioners – suggest, there is now considerable innovation in the sector, and some are firmly on a trajectory to become full-service, modern financial institutions.

As discussed by Mr Kenny MacLeod, one of the major concerns for credit unions is that their main source of income – loans – is not growing at a sufficient pace, and that loan book growth has been unable to keep pace with deposits. This is creating a headache for most credit unions. An "excess" of savings, totalling more than £435m in summer 2016, sits languishing in credit unions' accounts. These funds are not only earning next to no return but, more critically, they make it difficult for some credit

"Excess" savings are a problem...

unions to meet increasingly stringent regulatory capital requirements. This is one of the greatest threats facing the sector.

Many credit unions want to diversify, as a way of building a sustainable business. At the moment, regulation is probably overly restrictive. As a very small part of the overall financial services landscape, the sector has long been subject to extremely tight regulation. Although sector-specific regulation (designed to ease the regulatory burden) was introduced in 1979, it was only the 2011 Legislative Reform Order that gave credit unions any scope to widen their activities – allowing them to liberalise the common bond (eg, occupation or locality), to enrol community groups and businesses as members, to pay interest on savings (as well as a dividend) and to charge for a limited range of additional services. However, while the cap on interest rates charged to borrowers was raised to 3% per month, it remains in place – and makes it hard for credit unions to achieve financial sustainability.

In 2014, regulation of credit unions moved to the FCA and the PRA. This has not been entirely positive. Indeed, the FCA's guidance on loan affordability and customer vulnerability is proving challenging for some new market entrants/potential innovators, who complain about the considerable costs imposed on their businesses. More fundamentally, as Mr MacLeod argues, the Credit Union Act needs reforming to loosen restrictions on the services the sector can offer.

A final question about the future of the sector relates to its role in addressing financial exclusion. Specifically: which set of customers will benefit from credit union expansion, modernisation and a broader provision of products and services?

Can credit unions ever help the truly excluded?

It is unclear whether credit unions will ever be able to service the truly excluded. More likely, they will tend to rely on those in employment and with a relatively stable financial profile, who prefer credit unions over mainstream banks for ethical reasons. They certainly need this cohort to be financially sustainable, but it does suggest that they will not significantly reduce the problems of the neediest. Individual credit unions will determine their own risk appetite – so, there will be no uniform policy on lending priorities. But it seems inevitable that they can be no more than a relatively small part of a solution.

Government support, in the form of the CUEP, has prioritised the link between modernising the sector and its ability to help more people on low incomes. Without doubt, credit unions are more sensitive to the situation of low-income people – they typically operate on a more personal level and employ flexibility in the way they work with customers under financial stress. But to look to credit unions to "solve" financial exclusion is asking them to do the impossible. As Malcolm Brown put it: "The Archbishop's Task Group never viewed credit unions as the solution, and they are certainly not equipped to compete directly with the payday lenders. The focus has been, rather, on the potential of the model to build more robust and diverse credit unions, able to offer a decent range of products."

Box 12: Innovative lending solutions within the credit union sector

"How do credit unions meet the challenge of falling lending levels as a proportion of assets?

"The key to finding a sustainable solution is to understand the reasons for the fall in lending. First, there has been a failure to attract sufficient numbers of younger members, while older members are net savers. Moreover, credit unions can often be their own worst enemies when it comes to lending – creating unnecessary barriers through restrictive loan criteria (particularly for new members), burdensome loan processes and prolonged decision-making, and by limiting access to often inconvenient office opening hours and overly narrow loan product offers. Finally, there has been increasing competition from other lenders that better meet borrowers' requirements.

"The solution adopted by some credit unions is a more innovative approach to lending through the use of new technology and service functionality to provide automated loan delivery, both online and via mobile devices. One such example is the London Mutual Credit Union, which, back in February 2012, launched an online automated lending system (www.cuok.co.uk). This was in response to the growing success of online payday lending. It aimed to stimulate demand for its loans by acting as a gateway to attract new borrowers into the credit union and to address the use of high-cost payday lending by some of its own members (since its own credit offer was not meeting their needs). The platform offers convenient access 24/7 to short-term credit with a simple and quick application process. It has a comprehensive infrastructure that is integrated with both the credit union's own internal data (for applications from existing members), as well as instant identification and credit assessment checks with credit reference agencies to enable immediate decisions. Faster payment facilities for instant dispersal of funds and the automated collection of future monthly loan repayments mean that individuals can apply, get a decision and have the money in their account quickly and without any manual intervention.

"As of June 2016, the London Mutual had approved 23,261 loans, totalling £6.3 million, through its online short-term lending platform. Levels of delinquency were low, totalling just £109,546 at that time (equivalent to 1.7% of total lending). Not only is this facility benefiting the credit union, but an evaluation of the scheme undertaken by

the Financial Inclusion Centre showed it to have a positive impact on the borrowers by diverting them from expensive payday lenders, saving them at least £1.3 million in interest alone (without factoring in late payment fees and interest) and helping foster saving and better financial habits.

“Both the Leeds Credit Union and, more recently, the Pollok Credit Unions (Glasgow) have partnered with London Mutual to utilise the same technology. It allows each credit union to deliver its own tailored automated loan offer, but to enjoy the collective benefits of economies of scale such as the sharing of development and other costs. It is hoped that other credit unions will join the partnership, to develop a single online portal that enables prospective borrowers to apply for and access responsible social lending on a national basis.

“Similarly, over 70 credit unions are now using Cornerstone Mutual Services’ Automated Lending Decision (ALD) system, which also utilises credit bureau data to make recommendations on whether a loan application should be accepted, declined or referred for manual assessment. It allows credit unions to base decision-making on their own risk appetite, and has been shown to deliver significant benefits to participating credit unions – including reductions in bad debts, lower operating costs and, importantly, loan book growth.

“Overall, the use of technology to deliver automated lending online has enabled these credit unions to meet customers’ expectations and to compete more effectively. It has streamlined procedures, not only making it far simpler for members, but also reducing the time taken for a decision to be made and the unit costs of administration. It has helped to attract new and more diverse members, who are younger and often have higher incomes, to expand lending portfolios both in terms of new loan products and lending levels, and to enable more informed decisions that reduce bad debts.”

Gareth Evans,
Co-Director, Financial Inclusion Centre

Chapter Five: Can FinTech offer a solution?

The term ”FinTech” does not just mean financial technology. After all, financial technology has been around since the days of barter. What the current buzzword tries to describe is the many new initiatives in the delivery of banking, investment and payments through an evolving mix of software, the internet, Big Data (another much-abused term), machine learning etc, through personal devices and other innovative channels.

So, what can FinTech (as defined above) do for the financially excluded?

That question, when directed towards consumers in emerging economies, has attracted substantial interest from social entrepreneurs, international development agencies, financial institutions and telecoms companies. However, the issue has so far attracted less attention here in the UK, where few FinTech entrepreneurs are developing products aimed primarily at the financially excluded. That said, there is considerable potential – in both the short and long term.

“Moonshots”: Open banking, platform banking and financial inclusion

In theory...

Given that more than one million adults in the UK still do not have a conventional bank account, it may seem premature to discuss how the “account of the future” could benefit the financially excluded. Nonetheless, “open banking” and “platform banking” could transform the way in which the financially marginalised budget, save, access credit and insurance, and seek financial advice. So, they are worth a look:

- Open Banking: This is the idea that bank customers should be able to authorise third-party access to personal data held by their bank. The hope is that this will enable those third parties to offer products and services that better meet individual needs. An obvious example is a budgeting app, which could combine behavioural nudges, notifications and alerts to prevent overspending – without requiring individuals to waste time manually inputting their expenses. Although sticking points remain, such as how to assign responsibility if and when a data breach occurs, the possibilities are no longer hypothetical. In particular, the Open Banking Working Group, convened by HM Treasury and involving the major UK banks, published a report in February 2016 outlining next steps for the industry.

The UK Competition and Markets Authority followed six months later, setting a deadline of early 2018 for open banking to become a reality. A number of digital "challenger" banks, including Monzo, Tandem and Starling, are now seeking to take open banking one step further to embrace platform, or marketplace, banking.

- Platform Banking: Platform banking potentially presents the customer with a completely new proposition. It would allow an individual to open a current account with his or her bank, to give access to account data to third party providers (of insurance, savings, credit) and, crucially, to allow the bank to use insights derived from personal data to find the financial products and services that best meet the customer's needs. This is "your" bank, as a financial assistant rather than as a cross-seller. Many questions remain, including:

    - will banks really source the best third party products, or will they fall back on cosy tie-ups with selected providers?

    - will everyone in the ecosystem play nice and share data? and

    - will customers switch to those banks that do the best job of finding the right products?

What could all this mean for the financially excluded?

As we have discussed, the financially excluded are typically caught in a vicious circle. They have the least margin for financial error – overshooting weekly or monthly budgets by even a small amount, for instance, can force them to take on expensive debt. At the same time, they do not have sufficient time, information or even competence to find the best solutions. Open and platform banking could help square that circle. At the heart of both is a bold promise: that giving second and third parties real-time access to an individual's raw data will enable them:

- to source the products/services that "best" meet the customer's needs/ preferences; and/or

- to protect him or her from bad decision-making – without requiring more time and effort to achieve these better outcomes.

That means banks and trusted third parties (including debt charities and money advice services) will have the capacity to:

- source responsible credit and insurance products based on an individual's bank data (points two and four of the FIC's Vision 2020);

- offer objective financial advice (point five of Vision 2020) based on live bank account data, in order to pre-empt problems; and

- make financial education (point six of Vision 2020) context-specific, rather than relying on people remembering lessons learned years ago.

This is not to understate the challenges in terms of business models, technology, regulation and consumer behaviour. Even if "next-generation" bank accounts do offer those on the financial margins a potentially transformative experience, they will do nothing for the digitally excluded. In that sense, FinTech may actually exacerbate inequalities for those without access to a bank account. Still, this is not a development that those with an interest in greater financial inclusion can ignore. The digital challenger banks are confident that customers will soon expect their banks to help them with their finances – just as Google already helps people catch their flights on time or find a restaurant. We have to find a way to ensure that the financially excluded do not miss out on this revolution.

"Back to Earth": FinTech and financial inclusion today

In practice...

There are several more immediate developments in credit scoring, savings and insurance that may benefit the financially excluded. Again, however, these developments only work to the benefit of those who are not digitally excluded:

- Credit Scoring: As individuals spend more time online, they leave behind data-rich digital "footprints". The CEO of Kreditech, an online lender, has described "all data as credit data". If that is true, those digital footprints may contain data that could help lenders price risk for "thin-file" borrowers. As a result, some of those who are currently financially excluded – those with minimal credit records but who are active, for example, on social media – could gain access to a wider range of credit products. London-based Aire is typically held up as the poster-child for pro-inclusion, alternative credit scoring. Founded in 2014, the company's scoring process relies on "expressed permission", whereby credit applicants decide which datasets Aire can utilise in calculating their credit score.

  Another shift – towards greater transparency in credit scoring – could also benefit the financially marginalised. As Aneesh Varma, Aire's co-founder, has put it: "Helping people understand the factors and features that impact their credit score allows them to also positively change their financial habits in the long run… The black box approach of the past has created confusion and uncertainty where people end up guessing whether their actions are actually improving their scores."

- Savings: At least two "smart" savings apps that may have relevance for the financially excluded are preparing to launch. They have three main features: easy

transfers from current to savings accounts; assistance with budgeting for multiple savings goals; and measures to reinforce good savings behaviour. Folio App offers project-by-project savings targets; the option to create automated transfers to your savings account on a daily, weekly or monthly basis; text message updates; and the option to share your progress with friends and family. Swave aims to build positive saving habits: whenever the user purchases a luxury item, he or she will be encouraged to authorise a contribution (eg 10% of the cost) to a savings account with a simple swipe of the phone. Neither app is available yet for download, nor do they appear to be targeting the financially excluded. The former's marketing materials cite examples such as saving for a skiing holiday, and the latter's use of terms such as "luxuries" might be offputting to those with little room for discretionary spending. But their example may encourage other, low-income orientated apps to enter the market.

- Insurance: The poverty premium can be difficult to calculate. On the one hand, those on low incomes could benefit from cheaper deals if they felt financially secure enough to commit to longer contracts. On the other, the flexibility offered by pay-as-you-go arrangements can avoid debt spirals and credit-score damage should the person's income dip or disappear. In insurance, that dilemma could be resolved via on-demand services that enable users to insure individual items – and, crucially, to turn the insurance off and on with the touch of a button. Tröv is a prominent example of such an on-demand, mobile-based services. It and other apps have criticised the complexity of filing insurance claims and promise a smoother user experience. The service is available in beta in the UK. Cuvva allows users to take out as little as one hour's worth of insurance when driving a friend's car. Expect more such services to enter the market. Their impact on the financially marginalised will vary depending on the type of item targeted, the extent to which their marketing appeals widely or focuses on narrower groups such as urban millennials, and whether users can easily discern the point at which traditional wall-to-wall insurance products become more cost effective than on-demand alternatives.

It is far too early to draw any firm conclusions about the implications of FinTech for financial exclusion. But the potential is clear. A financial exclusion strategy that does not factor in emerging financial technologies is at risk of becoming quickly outdated.

Box 13: The main barriers to developing and scaling up innovations

Fintech developments have the potential to improve the financial health of lower-income households, but a number of barriers remain to be addressed if this potential is to be realised. Barriers fall into three groups:

- Regulatory: With high levels of public concern about the practices of payday lenders and other firms that target low-income groups, regulators are subjecting new business models to greater scrutiny and have established tougher rules for providers in the sector. However, there is also a need to ensure regulation does not stifle innovation that could benefit the consumer. Regulators can be pro-active by providing safe harbours, or regulatory sandboxes (as the FCA has started to do), to allow innovators to experiment. There is also a need to encourage the development of a common infrastructure for the community finance sector, enabling the pooling of liquidity and providing access to the payments system.

- Financial: The UK has a sophisticated investment environment with a wide variety of possible funding sources. However, there is frustration that when it comes to developing products and services targeting the needs of lower-income households, much of the investment is short-term and subject to changing priorities. The case for blended finance can be made to help lubricate the sector, and the recently created Access Foundation for social investment is an important initiative. It aims to bridge the gap between charities and social enterprises on one side and social investors on the other.

- Organisational: While not-for-profits and community finance organisations have in-depth knowledge of low-income households, fintech firms have the technical expertise. There is a natural partnering arrangement to be sought here, although different cultures need to be overcome.

Taken from “Using Insight and Innovation to Benefit Low Income Households”, Centre for Responsible Credit, January 2016.

Chapter Six: Where do we go from here?

Financial services have changed significantly in the last couple of decades. There is now a huge array of both product offerings and the means by which one can access and transact money. Gone are the days when most depositing and borrowing took place in a High Street bank, with face-to-face interaction. Today, most transactions are either online or via a smartphone. With the exponential growth of payday lending after the financial crisis, access to short-term credit also took on a whole new look: anonymous, quick and backed by complex algorithms.

Complexity is a big problem

Thus, for the majority of the UK population, there are now more solutions to their financial needs than there are days in the year – but understanding this complexity and using the vast array of products in a responsible manner requires a particular set of skills. Indeed, one sees a good number of well educated, middle-income people getting into financial difficulties, especially over indebtedness. The low-income segment of the population faces an additional set of problems: they are either partially or wholly excluded from mainstream financial services.

Why is this? What can be done about it? And whose responsibility is it?

The financially excluded are not a homogenous sub-set of the population. Some are elderly; some live in remote rural areas where both physical and technological access is poor; some are young and yet to establish a credit track-record – or worse, already have CCJs from unpaid loans. Some are very poor, often entirely benefit dependent, and require only the most basic financial services; others have volatile incomes and need flexible services. Then there is another segment of society that is engaged with financial services, but for various reasons finds itself in a mis-fit situation, using the wrong products to address a need – often leading to over-indebtedness. Or worse.

Payday lending is an example of a product that can be useful, in so far as it offers (in a highly innovative way) small amounts of short-term credit to tide people over between pay cheques, so-called income smoothing. But when it is used to tackle a more permanent imbalance between income and expenditure, problems arise – and they can arise very quickly. Here, the answer has to be a combination of better consumer protection through regulation and financial education.

In the box below, Mick McAteer, of the Financial Inclusion Centre, offers an interesting analysis of how regulators can pursue the twin goals of protecting consumers and creating a space for alternative, more socially acceptable financial services providers. Since its inception, the FCA has taken some positive steps to balance consumer protection with market freedom, but its actions are not above criticism. Some would argue that the regulator has been too lenient on the banks

when it comes to overdrafts, the credit card industry and the rent-to-own sector, where scope for practice that is hugely detrimental to consumers still exists. On the other hand, Russell Hamblin-Boone, who represents the payday lending industry, argues that the FCA's measures have been overly restrictive. Similarly, Matt Bland, of Abcul, and Kenny MacLeod, of Scotwest Credit Union, think the current regulatory framework for credit unions is too restrictive, arguing that the sector needs regulatory recognition that allows for a more diversified business model. In MacLeod's words:

> "If we want financially empowered consumers in Britain, we need to provide them with a wider set of options – not only in terms of the range of services available, but also in the ownership and accountability structure of the organisations providing those services. To achieve that, we need legislatively enabled credit unions, which are permitted to deliver a wider range of complementary financial services – and which can do so in sufficient volumes to attract customers…"

Box 14: The role of regulation

"Regulation, done well, can protect consumers and make markets work for them. Recent changes to consumer credit regulation are a good example.

"The responsibility for regulating the consumer credit sector was transferred to the FCA in 2014. This heralded a major change from the light touch applied by the Office of Fair Trading. The FCA has a different approach and philosophy to the OFT, and is more willing to intervene in markets (for now)[1] . The FCA's authorisation process is much tougher than the OFT's licensing approach. There are now meaningful conduct-of-business rules, which determine how firms should behave and treat consumers. The FCA has much greater resources to scrutinise the business models of firms during the authorisation process, to undertake more intensive supervision and to take action against breaches of regulation.

"The introduction of a tough charge cap on payday lending was a landmark decision. The Financial Inclusion Centre had campaigned for a price cap on two grounds. First, a charge cap is the most direct form of consumer protection as it constrains the ability of unscrupulous lenders to target vulnerable consumers. Second, a cap allows not-for-profit lenders, such as credit unions, to compete fairly against

1. There are concerns that the financial services industry is lobbying hard for a less tough approach to regulation arguing disingenuously that regulation is stifling access, innovation and competition

aggressive payday lenders. Historically, not-for-profits have been crowded out of the market by payday lenders who could deploy huge marketing and advertising budgets – generated from exploitative business models[2]. Capping the charges on payday loans should constrain the ability of payday lenders to win and maintain market shares, so clearing space for alternative lenders.

"This has been borne out by recent experience. The price cap introduced in early 2015[3] has already had a major effect in cleaning up the payday lending industry. Critically, the number of payday lenders in the market and volume of payday loans sold has shrunk dramatically, creating space for credit unions.

"While we have seen real progress in the payday lending market, major problems remain in the wider consumer credit sector, harming consumers and acting as barriers to not-for-profit lenders that want to offer a fairer deal. For example, the credit card and overdraft markets are not working for financially vulnerable households. Millions of credit card borrowers face an uphill struggle to manage over-indebtedness. Consumers in the high-risk credit card market are vulnerable to unfair practices and high charges from the four dominant providers[4] . High charges for unauthorised overdrafts continue to harm consumers struggling to make ends meet. Unfortunately, the CMA recently decided not to recommend a regulated cap on overdraft charges[5], leaving consumers vulnerable.

"As our recent report on the rent-to-own (RTO) sector shows[6], the market for this form of borrowing has grown significantly since the financial crisis and is expected to grow further. There is huge consumer detriment, with people paying a high cost to own basic consumer goods.

"The FIC will press the FCA to apply tougher regulatory interventions to stamp out unfair charges and practices in the credit card and overdraft markets, and to apply the same approach adopted for the payday lending market to RTO. But we need to be realistic. The CMA's weak conclusions may hinder the ability of the FCA to take tough regulatory

2. We showed that consumer detriment in the payday lending market was not an unintended consequence or accidental by-product of the payday lending business model but an intrinsic part of it – in other words, revenues and profits in the sector were dependent on consumer detriment
3. The price cap will be reviewed in the first half of 2017
4. https://www.fca.org.uk/news/final-findings-credit-card-market-study
5. https://www.gov.uk/government/publications/retail-banking-market-investigation-overview
6. See http://inclusioncentre.co.uk/wordpress29/wp-content/uploads/2016/03/Better-and-Brighter-Responsible-RTO-Alternatives-Full-Report-150316-1.pdf

action on unfair charges in the credit card and unauthorised overdraft markets[7] .

"What does this mean for not-for-profit lenders? The clampdown on payday lending has created a real opportunity for them to offer the short-term, convenient credit consumers sometimes need and want. But there is an even bigger role for not-for-profits. We need a concerted effort to help vulnerable households build financial resilience, including a savings cushion, so they do not have to rely on expensive credit cards or unauthorised overdrafts.

"Despite some positive signs of growth, there is much more to be done if alternative providers are to step into the breach to meet the need for affordable short-term credit and to promote financial resilience. The capacity of credit unions, and other community-based providers, needs to expand to reach under-served consumers by:

- creating economies of scale;
- developing innovative products and new more efficient forms of distribution;
- improving governance and levels of professionalism; and
- promoting awareness of, and confidence in, the services they offer.

"Regulation should not be seen as a burden or barrier to expansion or innovation. The Financial Inclusion Centre cannot think of a truly socially useful financial innovation that would be prevented from coming to market by the recent tougher approach to regulation."

Mick McAteer,
Co-Director of the Financial Inclusion Centre

While this report looks in some detail at the role of credit unions in addressing financial exclusion, we cannot, and should not, look to this segment alone. As noted elsewhere, they are only part of the solution.

As to where other solutions lie, we are encouraged by some of the new market entrants – the innovators, the disruptors. These might be termed social businesses in that they are looking for sustainable business models while delivering socially

7. The banking industry will now be able to cite the CMA recommendations to argue that further interventions would be disproportionate

valuable products and services. However, these new, more ethical private sector entrants – such as FairforYou, Neyber, Uberima, Squirrel – face a number of challenges, which stand between them and major scale and impact. Issues include the need to attract consumers away from better-known brands with much larger advertising budgets, and the difficulty of assessing risk. Their problems are often aggravated by unreliable credit reference data and limited access to affordable capital. The innovators that are making progress have devised business models that navigate around these hurdles. But the upshot, in many cases, is that they focus on serving medium-risk consumers who are in regular employment and who have a transactional bank account.

No easy answer for the poor...

At the end of the day, there is no easy solution to the problem of how to offer the very poorest the financial services they need - in particular how to make credit available. Plus, however good they are, credit products are no substitute for the measures that are needed to help raise incomes, reduce the cost of essential services (such as housing and utilities) and to promote savings as a form of financial resilience.

In this context, some of the new credit models are interesting in so far as they cut costs by using technology – by being entirely online, by using automated systems wherever possible, and by assessing credit risk in a manner that more carefully reflects customer reality and ability to repay. This is where some of the new market entrants have the edge on the banks, and it is a promising development since one has to question whether conventional banks have the ability and/or the appetite to address financial exclusion. It is important to recognise that it has required government intervention, backed by law, to get incumbent banks to offer fee-free basic bank accounts to anyone who wants one. At best, one can hope that banks will partner with innovators, and use their scale and outreach to spread access to new products and delivery channels that work for more people. That said, the problems of the very poor – those who are unbanked and digitally excluded, and who are unlikely ever to be profitable customers for either traditional or state-of-the-art financial services providers – will remain with us for a very long time.

Annex: The Church Credit Champions/Just Finance Network

"The Church Credit Champions Network was set up in the belief that local churches have resources which, if unlocked, could increase the capacity of community finance providers, particularly credit unions, to provide access to saving and responsible credit. The network was piloted in London and Liverpool from 2014 to 2016. It employs a "bottom up" approach, seeking to help local churches to listen to local experiences of money and debt before exploring possible practical interventions. This has proved to be much more successful than simply making a "sales pitch" to churches on the virtues of credit unions, as it has allowed local relationships to develop that are genuine partnerships based on shared interests. It is no surprise then that these partnerships generated different kinds of activity in different places.

"In Hackney in East London, for instance, several churches have turned their buildings into credit union "access points", with church volunteers trained to help local people use the services offered, or just to have a conversation about the person's financial situation. This has worked best where the churches have committed volunteers and where pre-existing activities mean there is a natural footfall. In the City of London, churches have been at the forefront of promoting payroll savings schemes between employers and credit unions. While these schemes offer considerable benefits to all the parties, it can often be difficult to get the necessary decision-makers together to create the momentum needed to get them off the ground. In this, the "civic capital" of church leaders has been helpful and, as a result, organisations such as the law firm Linklaters, St Paul's Cathedral and the Financial Services Compensation Scheme have successfully launched payroll savings schemes.

"In Liverpool, the same application of civic capital and community connections has enabled new credit union branches to be opened in Netherton and St Helen's. The Credit Champions Network has also been influential in ensuring that local debt advice services are connected with credit union provision, ensuring that local people are able to access a complete set of services to meet their financial needs. Finally, many churches have provided skilled volunteers and board members to credit unions, increasing the quality of governance, which can provide a platform for growth.

"However effective, local churches on their own are not able to boost the capacity of community finance to meet the huge need in the UK. But what the Church Credit Champions Network has demonstrated is the key role civil society organisations can play in ensuring that community finance providers can grow and innovate, without losing their local roots and relational anchors. Without these local partners, the future will be less rosy for credit unions and other forms of ethical finance in the UK, and that is why the Church is committed to rolling out the Credit Champions Network from 2017 under the new name of the Just Finance Network."

David Barclay

CSFI Financial Inclusion Roundtables

June 7, 2016

Consumer protection in the rent-to-own sector.
With Yvonne Fovargue MP, Gareth Evans (Financial Inclusion Centre), Angela Clements (Fair For You), Vicky McCourt (Smarterbuys) and Christine Allison (CSFI Financial Inclusion Fellow).

May 3, 2016

Final report of the Archbishop's task group on responsible savings and credit.
With Sir Hector Sants (chair of the task group), The Ven Antony MacRow-Wood (The Archdeacon of Dorset), Malcolm Brown (Church of England), Tom Sefton (LifeSavers), David Barclay (CCCN), Mick McAteer (Financial Inclusion Centre) and Christine Allison (CSFI Financial Inclusion Fellow).

October 13, 2015 (*with To Your Credit*)

Encouraging small-value savings schemes.
With Joseph Surtees (StepChange), Mutaz Qubbaj (Squirrel), Alex Letts (Ffrees) and Christine Allison (CSFI).

June 10, 2015

Locked out: financial services for ex-convicts.
With Juliet Lyon and Sam O'Sullivan (Prison Reform Trust), Ian Fiddeman (BBA), Denis MacShane and Nicky Smith (Bureau Insurance Services).

February 18, 2015

Community franchise banking.
A breakfast discussion with Sam Moore & Robert Musgrove (Bendigo Bank), Sue Lewis (Financial Services Consumer Panel) and Don Kehoe (London Capital Credit Union).

January 13, 2015

The Financial Inclusion Commission.
With Sir Sherard Cowper-Coles (HSBC), Sir Brian Pomeroy (FCA) and Christine Allison (CSFI).

October 1, 2014

Regulating the debt management industry – has the FCA done enough?
A CSFI round-table discussion with Matthew Cheetham (Harrington Brooks) and Damon Gibbons (Centre for Responsible Credit).

September 23, 2014 (*with To Your Credit*)

An early harvest of the achievements of the Archbishop of Canterbury's Task Group on Responsible Credit and Savings.
With the Task Group's chairman, Sir Hector Sants, Christine Allison (CSFI) and Malcolm Brown (Church of England).

September 9, 2014

The future of the bank branch:
A round-table discussion on their recent report, with Louise Brett and Harvey Lewis (Deloitte), and with Derek French (Campaign for Community Banking) and Jeff Prestridge (Mail on Sunday).

June 25, 2014 (*with To Your Credit***)**

The potential impact of caps in the short-term credit market.
A CSFI round-table discussion with Karen Rowlingson and Jodi Gardner (University of Birmingham), Peter Tutton (StepChange) and Michelle De Cort (DWP).

April 29, 2014 (*with To Your Credit***)**

The challenges of regulating high cost short-term credit.
A CSFI round-table discussion with Nadege Genetay (FCA), Russell Hamblin-Booth (Consumer Finance Association), Jodi Gardner (University of Birmingham), Damon Gibbons (Centre for Responsible Credit) and Christine Allison (CSFI).

January 9, 2014

Credit Unions and short-term credit.
A round-table discussion with Christine Allison, Gareth Evans (Financial Inclusion Centre), Joan Driscoll (LMCU) and Angela Clements (Citysave).

December 9, 2013

South Yorkshire alpha project.
A CSFI round-table discussion with David Rennie (Cabinet Office), Ian Guest (South Yorkshire credit union),Steve Pannifer (Consult Hyperion) and Karen Wendel (IdenTrust).

October 21, 2013

Credit Union Expansion Project.
A CSFI round-table discussion with Christine Allison, Mark Lyonette (ABCUL), Fiona Brownsell (Tusmor) and Don Kehoe (London Capital Credit Union).

March 20, 2013

Credit Unions: what needs to be done?
A round-table discussion on the CSFI's interim report, with the author, Christine Allison.

March 11, 2013

The short-term credit market:
A round-table on the pros and cons of short-term credit.
With Henry Raine (Wonga), Russell Hamblin-Boone (Consumer Finance Association) and Mark Haslam (StepChange).

March 4, 2013

Older people and finance.
A round-table discussion with Prof. Andrew Monk (University of York), Rowena Crawford (IFS), Keith Gold, Mervyn Kohler (Age UK) and Dr Verina Waights (Open University.

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Christine has been working on matters related to poverty and exclusion most of her adult life. For the first twenty five years, the focus was on the developing world, working predominantly with the World Bank. Upon returning to the UK in 2008, Christine turned her attention to social business and access to finance, and in 2012 undertook a study on credit unions in the north-east for the Bishop of Durham. When Justin Welby became the Archbishop of Canterbury, Christine joined his Task Group on Responsible Credit and Savings.

With degrees in economics, Christine is a Specialist Adviser to the Treasury Committee. She also provides advisory services to three young companies providing more affordable credit and related financial services.

As a resident of Devon, Christine is a trustee of the Devon Community Foundation, and is active in a number of local initiatives.



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