Promoting financial inclusion

December 2004

HM TREASURY

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Foreword: Financial Inclusion in the UK

Many people, particularly those living on low incomes, cannot access mainstream financial products such as bank accounts and low cost loans.

This financial exclusion imposes real costs on individuals and their families – often the most vulnerable people in our society. It also has costs for the communities in which they live.

Despite the UK having one of the most diverse financial services sectors in the world, financial exclusion remains a reality for many people.

One in twelve households in the UK lacks access to a bank account of any kind. For them the costs of transactions as simple as cashing cheques or paying bills are high, and services such as hiring videos and contract mobile telephones are unavailable.

Whilst lacking a bank account has costs in itself, the implications of financial exclusion can be much broader. Families can be locked in a cycle of poverty and exclusion, or turn to high cost credit or even illegal lenders, resulting in greater financial strain and unmanageable debt.

They may also suffer from a lack of quality advice on how to improve their finances. These can all, in turn, contribute to over-indebtedness and further social exclusion.

Tackling financial exclusion is the responsibility of financial services providers, working in partnership with the Government and the voluntary and community sector. Working together we can empower individuals to take control of their own finances, access basic financial services and break free of unmanageable debt.

Stephen Timms

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INTRODUCTION

FINANCIAL EXCLUSION

1.1 In the Spending Review 2004,[1] the Government set out its commitment to tackle financial exclusion and undertook to publish specific proposals in three priority areas:

- access to banking;
- access to affordable credit; and
- access to free face-to-face money advice.

1.2 The Spending Review also set out the intention to establish a Financial Inclusion Fund to support initiatives to tackle financial exclusion, and a Financial Inclusion Taskforce to monitor progress. This document sets out the details of these initiatives.

Financial services in the UK

1.3 The UK has a large and sophisticated financial services market, and the most competitive and diverse consumer credit market in Europe. In 2002, the financial services sector accounted for 5.3 per cent of national income and the UK's surplus in financial services trade was £17.8 billion, the largest in the world – more than twice that of Switzerland, the next biggest. Assisted by the deregulation of the UK financial system in the 1980s, highly competitive generic financial institutions have emerged, together with an influx of new entrants such as supermarkets and major high street retailers.[2] These developments have made financial products, especially credit and mortgages, more widely available than ever before.

Increasing participation in financial services

Drivers of change

1.4 In addition to the liberalisation of financial markets, other key trends have promoted participation in financial services markets:[3]

- a general increase in living standards for the great majority of the population in the UK compared to 20 or 30 years ago, leading to greater disposable wealth;
- the move from payment of wages in cash to more cost-efficient and secure electronic money transfer mechanisms;
- new ways of accessing financial services such as telephone and internet banking; and
- increased participation of women in the labour market.

1.5 However, not all sections of society have experienced this expansion of access. Indeed, some trends, such as increasingly sophisticated customer segmentation technology – allowing, for example, more accurate targeting of sections of the market – have led to restricted access to financial services for some groups. There is a growing divide between the majority, with an increased range of personal finance options, and a significant minority who lack access to even the most basic banking services. This is termed 'financial exclusion'.

[1] *2004 Spending Review,* HM Treasury, July 2004

[2] Often joint ventures with banks

[3] *In or Out? Financial Exclusion: a literature and research review*, Financial Services Authority, July 2000.

THE NATURE OF FINANCIAL EXCLUSION

Defining financial exclusion

I.6 The term 'financial exclusion' is used in different ways. It can be a broad concept related to a lack of access to a range of financial services or a narrow concept reflecting particular circumstances such as: geographical exclusion; exclusion on the grounds that charges and prices are prohibitively high; or exclusion from marketing efforts.[4] Self exclusion is also important – where an individual believes there is little point in applying for a financial product because they expect to be refused, sometimes because of a previous experience of refusal, because they know someone else who has been refused, or because of a belief that 'they don't accept people who live round here, or who are like me'.

I.7 These aspects of exclusion are not mutually exclusive. They will overlap and reinforce each other, resulting in individuals, households and communities having little or no connection to mainstream banking and financial services.

The costs of financial exclusion

I.8 Financial exclusion imposes significant costs on individuals, their wider neighbourhood, and on society as a whole.

Costs to the individual

I.9 For the individual, some of the most important costs associated with financial exclusion include:

- **higher charges for basic financial transactions and credit** – lack of access to a bank account means that certain financial transactions such as money transfer and cheque cashing may be more expensive;
- **no access to certain products or services** – a range of services, such as contract mobile telephones, require a bank account for regular Direct Debits;
- **lack of security in holding and storing money** – operating solely on a cash budget leaves people more vulnerable to loss or theft;
- **barriers to employment** – a bank account for receipt of wages is a basic requirement for most employers; and
- **entrenching exclusion** – having *no* formal banking or credit history at all can be as much of a disadvantage as an impaired credit history in accessing certain financial services.

Costs to society

I.10 For the wider community, there are further additional costs:

- **contributor to child poverty.** The Child Poverty Review[5], published in July 2004, highlighted the links between financial exclusion and child poverty. Paying more for certain financial services and the impact of debt on family life can exacerbate the harm caused by child poverty;

[4] For example, in 2003 the National Consumer Council defined basic financial needs – which, if left unmet, risk financial exclusion – as the need for income, fair rates of borrowing, savings and insurance as well as money management skills and sufficient advice and information to make use of these services. *Basic Financial Needs: What are they and how can they be met?* Seminar Report, National Consumer Council, 2003.

[5] *Child Poverty Review*, HM Treasury, July 2004.

- **costs to the benefit system.** The benefit system aims to provide a minimum standard of living for claimants. If benefit claimants are forced to use high cost credit, less benefit is available for other essentials; and

- **link to social exclusion.** The 1998 report of the Social Exclusion Unit noted interactions between social and financial exclusion,[6] and put particular emphasis on access to banking services, insurance 'red-lining' (where financial institutions refuse to provide a product or service in a particular area) and the problems of expensive credit.

TACKLING FINANCIAL EXCLUSION

The case for Government intervention

Market failures

1.11 There is a case for Government intervention in financial services markets on the grounds of market failure and equity. 'Market failure' is a term used when the market, left to itself, would lead to an inefficient outcome – and public action may be appropriate to correct this. To a certain extent, the exclusion of a significant minority from financial services can be attributed to market failures:

- **information asymmetry** – both on the part of providers (who cannot accurately assess potential profitability) and of the financially excluded (who may assume they will be refused access to mainstream financial services without applying – in some cases this assumption may be correct but not for all);

- **externalities** – occur when the wider social costs or benefits of particular actions are different to the private costs and benefits. In the context of financial exclusion, examples are the negative impact of exclusion on employment prospects or the detrimental effect on regeneration initiatives; and

- **distributional concerns** – intervention may be justified by the delivery of social and equity objectives. It may be considered unacceptable for a significant and increasingly marginalised minority to have unmet financial needs or pay more than is necessary because they are excluded from mainstream financial services.

Action to date

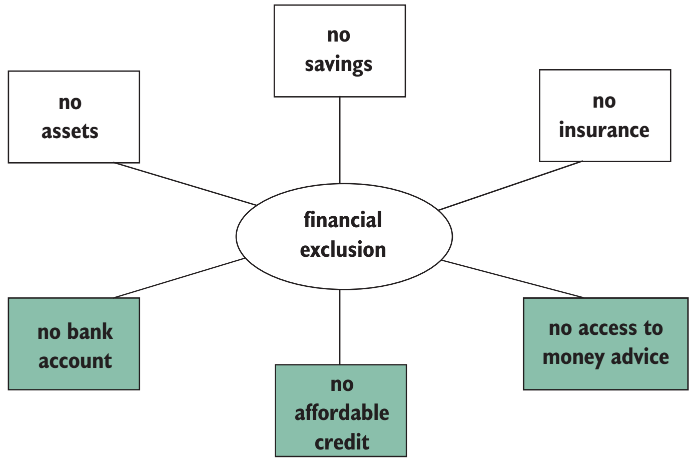
1.12 Policy Action Team 14 (PAT 14) was set up by the Social Exclusion Unit to focus on access to financial services and included a range of experts from the voluntary and community sectors, academia, representatives of financial services providers and government departments. PAT 14's 1999 report, *Access to Financial Services*,[7] recommended a number of policy changes which are outlined in box 1.1.

[6] *Bringing Britain together: A Strategy for Neighbourhood Renewal*, Social Exclusion Unit, September 1998

[7] *Access to Financial Services*, HM Treasury, 1999.

1.13 Chart 1.1 outlines the key components of financial exclusion. Progress has been made over recent years to address all six of these elements.

Chart 1.1: Financial exclusion



Assets and Savings **1.14** The Government has put innovative plans in place to build assets through the Child Trust Fund, and through the Saving Gateway, the Government has piloted and evaluated a way of encouraging those on a very low income to begin saving. The Government has also designed the stakeholder suite of simple, risk-controlled, low-cost savings and investment products for consumers' short, medium and long term savings needs. These will be available in the marketplace from April 2005.

The Child Trust Fund **1.15** April 2005 will see the launch of the new Child Trust Fund. Announced in Budget 2003, this initiative will improve financial education, promote positive attitudes to saving and ensure assets for all children, regardless of their family background. To help children start saving, all those born since September 2002 will receive at least £250 to invest in a long-term savings or investment account. Children from families on lower incomes will receive more and the Government will make an additional payment when children reach age seven. To encourage the saving habit, children, parents, family and friends will between them be able to contribute up to £1,200 a year to each account.

The Saving Gateway **1.16** The Saving Gateway is designed to be an ideal starting point for many low-income individuals who would otherwise have difficulty starting on the savings ladder. The aim of the Saving Gateway is to encourage saving by means of a Government-funded match of all money saved, up to a limit. Tailored financial information and education is provided alongside Saving Gateway accounts to help individuals make informed saving choices. The indications from the interim evaluation are positive and the Government looks forward to the full evaluation.

Insurance **1.17** PAT 14 recommendations on insurance with rent schemes have led to a promising start to extending home contents insurance to the financially excluded. In 2001, the Association of British Insurers (ABI) and the Housing Corporation launched a best practice guide on establishing insurance with rent schemes. The ABI continues to engage with stakeholders in Government and the private and public sectors to explore these schemes further.

1.18 The ABI is in the process of commissioning research in order to identify the reasons for the relatively static uptake of home contents insurance over recent years. It will examine the types of insurance products that low-income households need and study the reasons why these households do not take out existing products. The research will steer the ABI's future work on social exclusion, particularly in addressing issues of take-up and access.

Box 1.1 PAT14 Measures to address financial exclusion

Insurance with rent

PAT 14 noted the difficulties facing households in deprived communities in accessing various forms of insurance. The Housing Corporation and the Association of British Insurers (ABI) have now provided guidance on combining insurance with rent payments. Currently around half of local authorities operate such schemes.

Credit unions

As a result of PAT 14, and the Government's 1999 Credit Union Taskforce, several reforms were implemented, including:

- **deregulatory measures to help increase the competitiveness and flexibility of credit unions; and**
- **bringing credit unions under the regulation of the Financial Services Authority to increase member protection.**

Basic bank accounts

As recommended by PAT 14, all major high street banks now offer a basic bank account designed to meet the banking requirements of people for whom a standard current account would otherwise be unavailable or unsuitable. Basic bank accounts are an important means of dealing with financial exclusion and are a gateway to wider mainstream services. Basic bank accounts provide essential financial services such as enabling people to pay their bills by direct debit, pay in cheques and cash, make cash withdrawals 24 hours a day and receive income and benefit payments. They are also specifically designed to minimise the risk of an unauthorised overdraft and should not, therefore, require unnecessary credit check restrictions before they can be opened.

1.19 The Spending Review White Paper set out in the Government's commitment to take action in the three remaining key areas highlighted in Chart 1.1: access to banking; access to affordable credit; and access to money advice. This document outlines the rationale for this focus and a strategy for tackling financial exclusion in these areas.

Banking

1.20 Following the PAT 14 report the banking industry has worked with the Government to introduce the basic bank account which is specifically designed to address the needs of the financially excluded. The banking industry has also undertaken a range of other initiatives to tackle financial exclusion, some of these are highlighted in box 1.2, others are described in other boxes through this document.

1.21 In April 2003, the Government began the process of transforming the payment of benefits, moving to a modern, efficient and secure system of direct electronic payment. A significant proportion of benefit recipients were without a bank account and basic bank accounts were expected to meet much of this need. For those not able or not ready to use a basic bank account, the Post Office®Card Account (POCA) was introduced with a financial contribution from the banks of £182m over five years. Many banks also make their basic bank accounts accessible at the Post Office. Latest figures show that over 75 per cent of benefit recipients are now paid electronically into a bank account, a basic bank account or a POCA.

1.22 The Payment Modernisation Programme is nearing completion of the roll-out of electronic payment of benefits. However, a clear challenge remains: in 2002-03, 8 per cent of UK households – 1.9 million households or around 2.8 million adults – lacked a bank account of any kind. Chapter 3 sets out how a reduction in this number might be achieved.

Box 1.2 Bank and Building Society initiatives

Barclays provides funding for seven former members of staff on community placement with community finance organisations undertaking work to tackle personal financial exclusion. In addition, they have a large staff-volunteering programme and are increasingly encouraging staff to volunteer their time in community finance organisations.

HSBC, like the **National Australia Group** (which owns **Northern Bank**, **Clydesdale Bank** and **Yorkshire Bank**) participate in various educational programmes, all of which work towards promoting financial capability. Examples include support for the Personal Finance Education Group, which supports teachers to teach financial education in schools, and various numeracy support programmes.

The **HBoS** Foundation is involved in various schemes including the National Children's Home's 'Money Matters' scheme which provides financial awareness and money advice for young people leaving care.

Royal Bank of Scotland Group have set up a Financial Inclusion Innovation Fund which provides grants to organisations to test out new approaches and activities in the area of financial inclusion.

Lloyds TSB supports the Financial Inclusion Newcastle (FIN) project. As part of this, credit unions are working in partnership with a central body to provide money advice – through funding for a dedicated Citizens Advice adviser – and access to loan schemes.

Building Societies, as member-based mutual institutions, often have a strong base in local communities. Research suggests that, at a local level, many building societies provide considerable advice and support to individuals in financial difficulty as well as simple accessible financial products. In addition, many individual building societies have engaged in partnerships with alternative financial institutions, including housing associations and community development finance institutions.[a]

[a] *Improving financial inclusion – the hidden story of how building societies serve the financially excluded*, Dr Karl Dayson, University of Salford, November 2004.

Affordable credit

1.23 The financially excluded typically lack the range of choice of credit options available to most people. Instead, they may be forced to resort to the alternative credit market, paying interest rates often over 100 per cent. For example, a £200 loan from a home collected credit company might attract a charge of £94, while a pawnbroker might charge £54, over 30 weeks and 6 months respectively, the equivalent Annual Percentage Rates are 309 per cent and 110 per cent.[8]

1.24 Government action on provision of affordable credit so far has involved deregulatory measures to help credit unions grow and recent reforms to the Social Fund designed to provide greater consistency and transparency in accessing loans. In addition, the Government has recognised the need for effective and equitable regulation of the market for credit and is in the process of legislating to improve the functioning of the consumer credit market.

[8] Typical loan examples taken from *Access to credit on a low income; a study into how people on low incomes in Liverpool access and use consumer credit*, Paul A Jones, Co-operative Bank, 2001. *Pawnbrokers and their customers*, Sharon Collard and Elaine Kempson, The Personal Finance Research Centre, University of Bristol, October 2003.

1.25 In December 2003, the Government published the Consumer Credit White Paper[9], outlining plans to improve the fairness, transparency and efficiency of the consumer credit market. Since then, the Government has laid four Statutory Instruments designed to increase transparency in the market – by, for example, reforming advertising regulations – and will bring forward a Consumer Credit (Amendment) Bill to transform the framework of consumer credit regulation. This Bill will replace the current test for extortionate credit with one based on unfairness, lowering the threshold for challenging credit agreements, and will introduce an Alternative Dispute Resolution system, assisting consumers to seek redress. Chapter 4 discusses the alternative credit market in more detail and sets out Government action to increase the availability of affordable credit.

Money advice

1.26 The Consumer Credit White Paper recognised that the majority of households manage their borrowing effectively, paying off their debts as they fall due. However, there are a minority of consumers for whom over-indebtedness can be a problem. The White Paper established a cross-departmental Ministerial Group on Over-indebtedness to oversee and coordinate action to tackle this problem. In July 2004, the Government published an action plan on over-indebtedness outlining action to tackle the problems associated with over-indebtedness, working with partners in the credit industry, voluntary and community sector and consumer groups.[10]

1.27 The supply of free face-to-face money advice falls far short of demand and vulnerable consumers facing debt problems are often unable to access free advice when they need it. Advice is crucial to minimising the consequences of debt to the individual, as well as the creditor, and for building a foundation for future financial capability. Chapter 5 discusses what forms of advice are needed to meet the needs of the financially excluded and looks at increasing the supply of money advice.

NEXT STEPS: TOWARDS INCLUSION

1.28 Despite the progress that has been made since PAT 14, the problem of financial exclusion remains significant in the three areas set out above: banking, affordable credit and money advice. The costs of this exclusion are wide-ranging and solutions require coordinated effort across the public, private, voluntary and community sectors.

1.29 Much impressive work is already underway. Many voluntary and community sector organisations have been active in this area for some time, establishing projects to address financial exclusion problems in their local areas. Many banks, credit providers and utility companies also contribute charitable support to these groups or run their own projects. The Government wants to provide support and focus so that momentum is maintained, available resources are used effectively and progress is achieved. A range of initiatives are also underway in the Devolved Administrations. Box 1.3 describes measures undertaken by the Scottish Executive. In Northern Ireland, the Department of Enterprise, Trade and Industry recently consulted on a major review of Northern Ireland credit union law. In 2001, the Welsh Assembly initiated a credit union national project which delivered a trebling of credit union membership over three years. The Wales Co-operative Centre, Coalfields Regeneration Trust and local credit unions have also engaged in a Debt Redemption and Money Advice (DRAMA) scheme to tackle over-indebtedness in disadvantaged areas.

[9] *Fair, Clear and Competitive. The Consumer Credit Market in the 21st Century,* DTI, 2003.

[10] *Tackling Over-indebtedness Action Plan* 2004, DTI and DWP, July 2004.

Box 1.3 – Tackling financial exclusion in Scotland

Increasing levels of financial inclusion is a key part of the Scottish Executive's 'Closing the Opportunity Gap' approach to overcoming poverty in Scotland. Financial inclusion is one of the six high-level objectives of this approach.

In 'A Partnership for a Better Scotland', published in May 2003, the Executive set out its commitments for the next four years which included specific financial inclusion deliverables. The Executive is already doing a number of things to achieve these commitments, which include:

- **putting £5 million per annum into frontline money advice services via local authorities;**
- **funding money advice for people who may have difficulty using mainstream services, for example people with mental health problems or learning disabilities, minority ethnic communities, lone parents, young people and those who are making the transition to employment;**
- **funding credit unions to develop their services through a £0.5 million per annum credit union capacity fund, to support the target to increase membership to 5 per cent of the population by 2005;**
- **running projects through Citizens Advice Bureaux to find innovative ways to deliver financial education to people with particular needs, such as homeless people and young people leaving care; and**
- **setting up a national Debt Arrangement Scheme, to give people in multiple debt protection from court enforcement and bankruptcy while they sort out their money problems.**

The Executive continues to investigate new and innovative ways in which Government and other organisations, such as local authorities, financial institutions, advice agencies, Registered Social Landlords and others can work in partnership to contribute to and benefit from increased levels of financial inclusion.

1.30 The dramatic reduction in financial exclusion which the Government seeks has so far not been achieved. The Government is looking for a new commitment from all involved to achieve a step-change in the three priority areas of access to banking, access to affordable credit and access to money advice.

The Financial Inclusion Taskforce and Fund

1.31 **As set out in Spending Review 2004, the Government will establish a Financial Inclusion Taskforce to monitor progress against the objectives the Government has set, and to report to Government on what more can be done.**

1.32 **The Government will establish a 'Financial Inclusion Fund' of £120 million over three years to support initiatives to tackle financial exclusion. In particular, the Fund will support the Government's aims to increase access to affordable forms of credit and to see a significant increase in capacity of free face-to-face money advice.**

2 WHO, WHERE AND HOW MANY?

Summary

- **Common characteristics of those who lack access to banking facilities and affordable credit and are likely to require face-to-face money advice include: living on a low income; being in receipt of benefits; living in socially rented accommodation; and lone parenthood.**
- **In addition, analysis suggests that financial exclusion is a localised problem, with certain areas of the country particularly affected.**
- **Policy to tackle financial exclusion must therefore be targeted in terms of who and where.**

Who are the financially excluded?

2.1 There is extensive research into the characteristics of those regarded as financially excluded under different definitions.[1] This ranges from qualitative research looking in detail at the experiences, views and attitudes of the financially excluded to quantitative surveys and statistical analysis mapping the take-up of various financial products among different socio-economic groups and geographical areas. Using these sources, it is possible to build up a detailed picture of the attributes and likely location of the financially excluded. This chapter sets out the characteristics of those lacking access to banking, affordable credit and money advice.

ACCESS TO BANKING SERVICES

How many people?

2.2 The most recent Family Resources Survey (FRS) in 2002-03 shows that there were around 8 per cent or 1.9 million households in Great Britain without access to any kind of bank account, equating to one in twelve households or around 2.8 million adults.[2] A further 1.1 million households manage with some sort of savings account, taking the total population without a current account to 12 per cent or 3 million households. Compared to international experience these figures are high. For example, Chapter 3 highlights that only 3 per cent of adults in Australia lack an 'everyday' bank account.

2.3 The analysis below concentrates on the most excluded: the 1.9 million households without an account of any kind – referred to here as 'the unbanked'.

[1] For a comprehensive survey of the literature, see *In or Out? Financial exclusion: a literature and research review*, Kempson, Whyley, Caskey and Collard for Financial Services Authority, 2000.

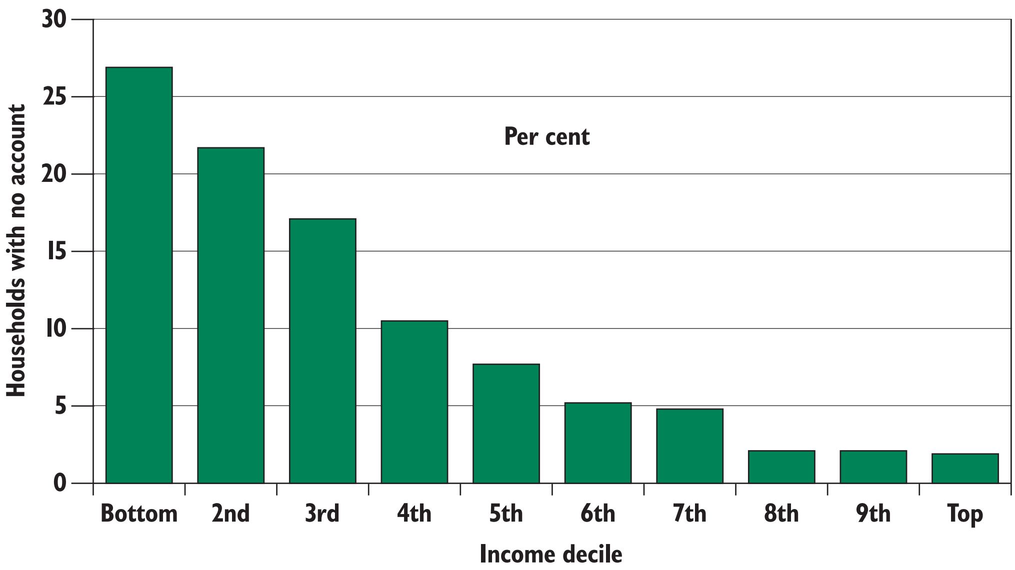
[2] The Family Resources Survey looks at family composition, income, tenure, patterns of benefit receipt, economic status and the characteristics of the 'household reference person' – the person who would be considered the head of the household – such as their age, gender and ethnicity. One set of questions covers the assets, savings and financial products held by households. Secondary analysis of the underlying data can be used to provide a detailed picture of unbanked households.

Characteristics of those without a bank account

Household income

2.4 Analysis of the FRS allows conclusions to be drawn about the nature and characteristics of the unbanked. Unbanked households are concentrated at the lower end of the income distribution, with over 65 per cent of households with no account in the bottom three income deciles, meaning an annual household income of just under £14,500.[3]

Chart 2.1: Unbanked by income decile



Source: Family Resources Survey (FRS), 2002-2003.

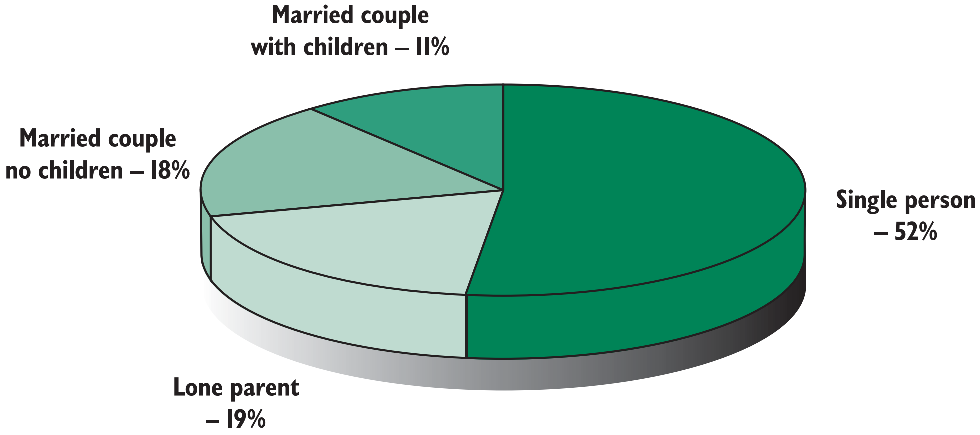
Family characteristics

2.5 About half of unbanked households are single people living alone compared with 30 per cent in the population as a whole. In addition, a further fifth are lone parents, roughly double the proportion in the population as a whole.[4] Therefore lone parents are over-represented in the population of the unbanked relative to the proportion of lone parents in the population as a whole.

[3] This figure is before housing costs and calculated on an equivalised household income basis. Equivalisation is a standard methodology that takes into account the size and composition of households and adjusts their incomes to recognise differing demands on resources. This reflects the common sense notion that, in order to enjoy a comparable standard of living, a couple with three children will need a higher income than a single person living alone. Equivalence scales conventionally take a couple as the reference point, with an equivalence value of one. The process then increases relatively the income of single person households (since their incomes are divided by a value of less than one) and reduces relatively the incomes of households with three or more persons, which have an equivalence value of greater than one.

[4] www.statistics.gov.uk/census2001.

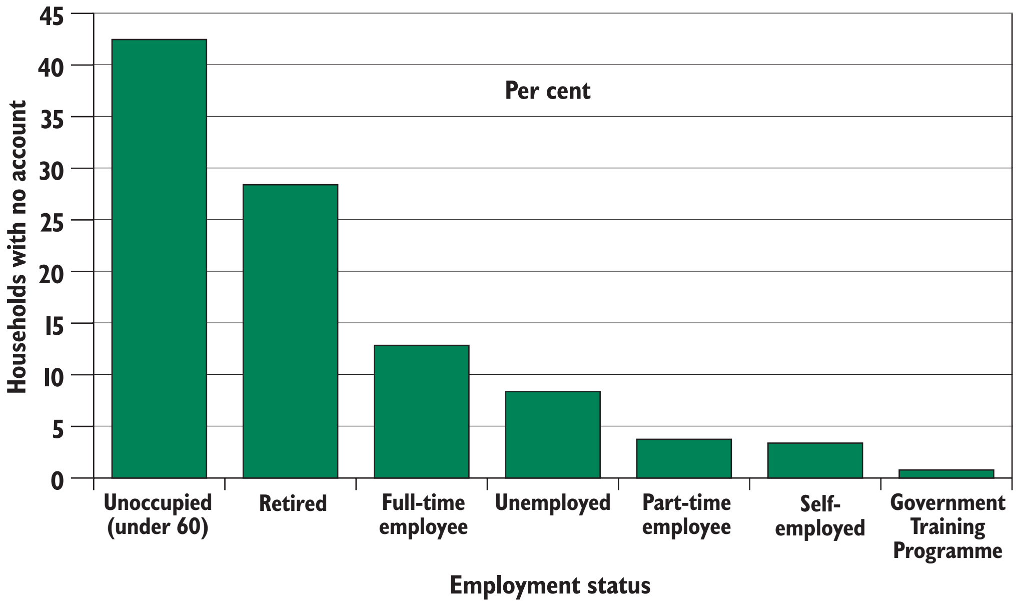
Chart 2.2: Unbanked by household type



Source: Family Resources Survey (FRS), 2002-2003.

Economic status **2.6** Looking at the economic status of the heads of these households,[5] over 40 per cent are of working age but not available for work, mostly because of childcare responsibilities. Almost 30 per cent are retired.

Chart 2.3: Unbanked by economic status of household reference person



Source: Family Resources Survey (FRS), 2002-2003.

[5] The Household Reference Person is defined as the member of the household who owns the household accommodation, or is legally responsible for the rent of the accommodation, or has the household accommodation as an emolument or perquisite, or has the household accommodation by virtue of some relationship to the owner who is not a member of the household. If two people fit the above characteristics, the HRP is the one with the highest income.

2.7 The majority of households with no bank account are in receipt of some form of state support or benefit payment:

- 64 per cent receive council tax benefit;
- 62 per cent receive housing benefit;
- 48 per cent receive Income Support or the Minimum Income Guarantee; and
- 8 per cent receive Jobseeker's Allowance.

2.8 In addition, around 44 per cent of unbanked households rent accommodation from a local authority. A further 15 per cent rent from a housing association. This means that almost 60 per cent of people in households without a bank account live in socially-rented accommodation. This indicates that working through the bodies that provide this housing, as well as through organisations such as Jobcentre Plus may be an effective means to reach the financially excluded.

LACK OF AFFORDABLE CREDIT

How many people?

The alternative credit market

2.9 People on low incomes frequently use small, short-term cash loans as a way of managing day-to-day expenditure. Since mainstream lenders do not provide credit on this basis, many people on low incomes turn to alternative lenders for their credit needs. Rates of interest in the alternative credit market are far higher than mainstream credit. Forms of alternative credit include:

- home credit;
- pawnbrokers;
- sale and buyback shops; and
- mail order.

2.10 Compared to access to banking, there is less systematic large-scale data on users of the alternative credit market.[6] Smaller quantitative and qualitative data sources suggest that there may be about 3 million regular users of the alternative credit market – though this estimate varies widely depending on the type of credit. For example, estimates of the size of the doorstep lending market vary from 0.5 to 3 million people, while around 600,000 people are thought to use pawnbrokers.

[6] There are even less data on the users of newer forms of alternative credit, such as payday loan companies or sale and buyback shops. However, what is clear is that the number of these outlets has grown rapidly since the early 1990s, implying that an increasing number of people are making use of these forms of credit.

Characteristics of users of alternative credit

2.11 For the most part, users of the alternative credit market have similar characteristics to the unbanked population. A recent survey of pawnbrokers' customers found that they were predominantly women with children, either in low paid work or not working and receiving state benefits.[7] Evidence from Citizens Advice Bureaux into the nature of debt amongst their clients found that debts to home credit companies were more prevalent among:

- women;
- local authority and housing association tenants;
- the unemployed; and
- those on low incomes.[8]

2.12 Similarly, although mail order catalogues are used by a large cross-section of the UK population, those who rely heavily on them are more likely to be in socio-economic groups D and E and are thus relatively poor.[9] The clear majority of mail order catalogue users are women, most have children, and are likely to be living in council accommodation.[10]

ACCESS TO MONEY ADVICE

How many people?

2.13 Looking at the current levels of over-indebtedness in the UK gives a picture of the potential demand for free debt and money advice. Department of Trade and Industry research into household debt indicates that around 7 per cent of households have levels of credit use associated with over-indebtedness.[11] Chapter 5 provides a more detailed discussion as to how these figures translate into demand for free debt and money advice and compares these figures to current supply in the advice sector.

2.14 A snapshot of current demand and supply of debt advice has been provided by the Money Advice Trust – a charity funded by financial institutions that aims to increase the supply and quality of debt advice. It estimates current face-to-face and telephone supply at around 600,000 places, but diagnoses total demand to be at least 850,000 places, split between different delivery mechanisms.

Characteristics of people seeking money advice

2.15 The Government's Over-Indebtedness Action Plan notes the link between a low income and the likelihood of experiencing over-indebtedness.[12] The action plan also highlights that families with children, and particularly lone parents are more likely to be in arrears, along with those who are unemployed.

[7] *Pawnbrokers and their customers*, Sharon Collard and Elaine Kempson, October 2003.

[8] *In Too Deep*, CAB clients' experience of debt, Sue Edwards Citizens Advice Bureau, May 2003.

[9] Those in semiskilled manual occupations or the unskilled.

[10] *March UK Ltd and the home shopping and home delivery businesses of GUS plc: A report on the merger situation*, Competition Commission, January 2004.

[11] *Tackling Over-Indebtedness Action Plan*, Department of Trade and Industry and Department for Work and Pensions, 2004.

[12] *Ibid*.

2.16 Citizens Advice is the largest single provider of face-to-face debt advice. Its 2002 survey *In Too Deep* questioned 900 adults seeking debt advice services and the results indicate the characteristics of those under financial stress and seeking their help. Respondents seeking debt advice services were typically:[13]

- poor, with average net incomes typically below half the national average;
- in receipt of state benefits;
- single, with a significant number of single parents;
- renting socially; and
- usually working, and likely to be of working age.

WHERE: THE GEOGRAPHICAL DISTRIBUTION OF FINANCIAL EXCLUSION

2.17 It is difficult to gain precise information about the geographical distribution of financial exclusion. However, analysis of a broad group of people, either unemployed or on very low annual household incomes, who use cash rather than bank accounts for their financial transactions and who are unlikely to have a mortgage or a savings account of any kind, suggests that financial exclusion is particularly concentrated in certain areas of the country. Map 2.1 demonstrates the extent of the concentration of this "financially disengaged" group.[14]

2.18 Looking in particular at families with low levels of financial activity further suggests the geographical concentration of financially excluded groups:

- 68 per cent live in the ten per cent most financially excluded postcode districts;
- 25 per cent live in the three per cent of postcodes with the highest concentrations of financial exclusion. These postcodes are concentrated in areas including parts of East and South-East London, Middlesbrough, Manchester, Bradford, Birmingham, Glasgow and Liverpool.

2.19 This suggests that the existence of local financial service providers, such as credit unions, in areas of high financial exclusion, can make a real difference. Policy proposals should, therefore, be focused in these areas, at least initially.

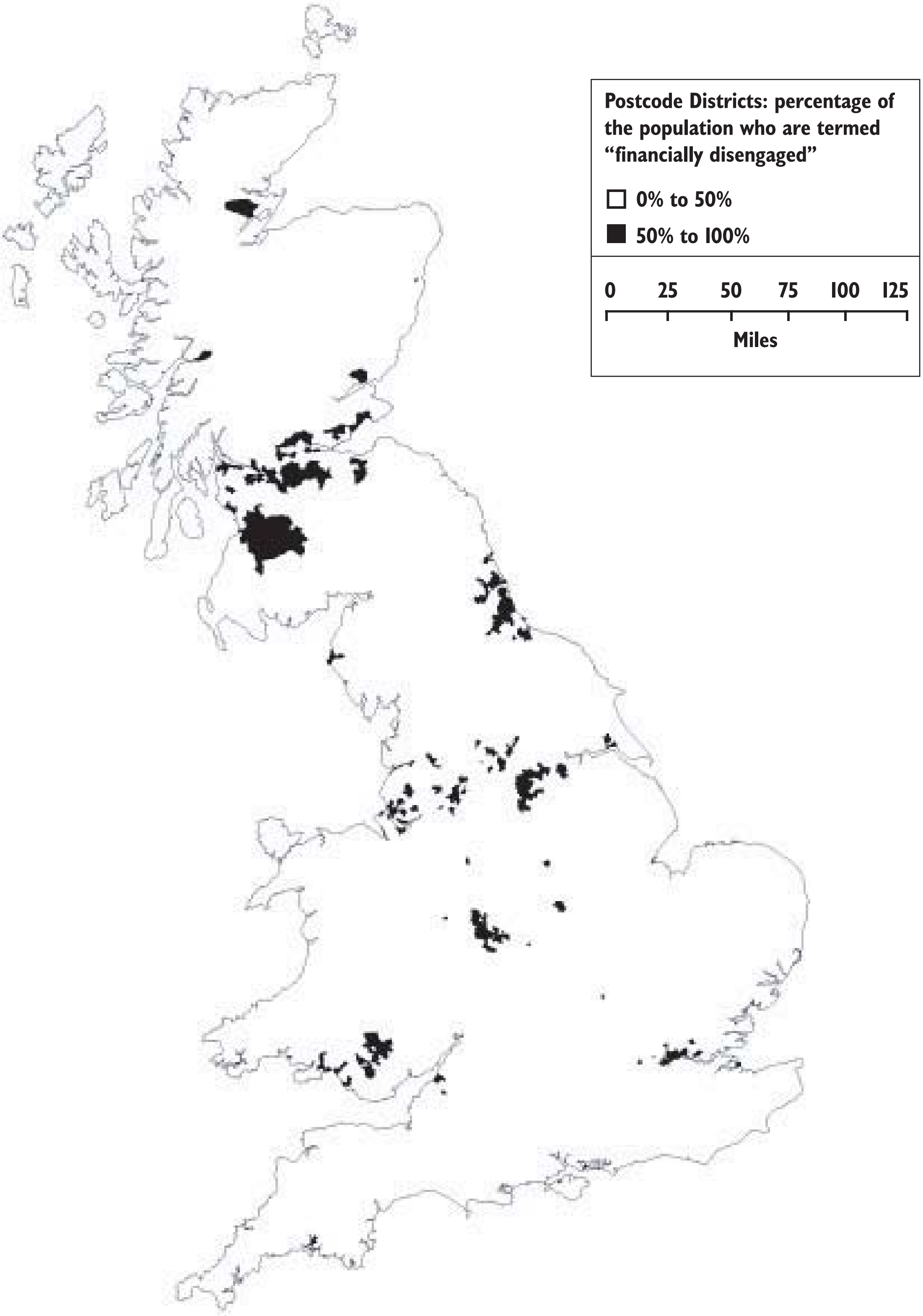
Linking exclusion and physical access to financial services

2.20 A simple analysis of the relationship between concentrations of financial exclusion and access to financial services such as banks, building societies, Post Offices and ATMs shows no overall correlation between levels of financial exclusion and a lack of service provision. This suggests that in absolute terms banks are not under-represented in areas of high financial exclusion.[15]

[13] *In Too Deep, CAB clients' experience of debt*, Sue Edwards, Citizens Advice Bureau, May 2003. Note that the above characteristics are trends within the population seeking CAB advice, not absolute numbers.

[14] In the financial services sector, customers are typically classified into marketing groups based on a combination of socio-economic factors and consumption patterns. The map relates to those people are either unemployed or on very low annual household incomes. This means that their financial activity generally is negligible: they use cash rather than a bank account for their financial transactions and are unlikely to have a mortgage or savings account of any kind.

Map 2.1: Geographical location of financial exclusion



SUMMARY OF POLICY CONCLUSIONS

2.21 The analysis of the numbers, characteristics and location of the financially excluded suggests that policy interventions should be:

- **focused on the core financially excluded people** who are most likely to suffer the negative consequences of a vicious circle of exclusion. Access to banking could be the key to unlocking access to other financial services;
- **delivered through trusted intermediaries and public bodies** with whom the financially excluded are already in contact, such as Jobcentre Plus, Sure Start or housing associations. Building on these relationships to work in partnership could be an effective way to achieve results; and
- **focused in financial exclusion hotspots.**

2.22 Chapters 3, 4 and 5 explain how these conclusions will be used in the design of the Government's strategy to promote financial inclusion.

[15] It should be noted that this analysis does not examine whether there are more withdrawals from deprived areas, or whether they started from a higher base.

3 ACCESS TO BANKING SERVICES

Summary

- **Most people take a bank account for granted as an essential tool in managing day-to-day finances. However, 1.9 million households in the UK operate without a bank account of any kind.**
- **Action over recent years has made some progress towards tackling exclusion from banking services but more remains to be done.**
- **The Government will work in partnership with the banking industry and others to achieve real progress in reducing the number of unbanked.**

LIVING WITHOUT A BANK ACCOUNT

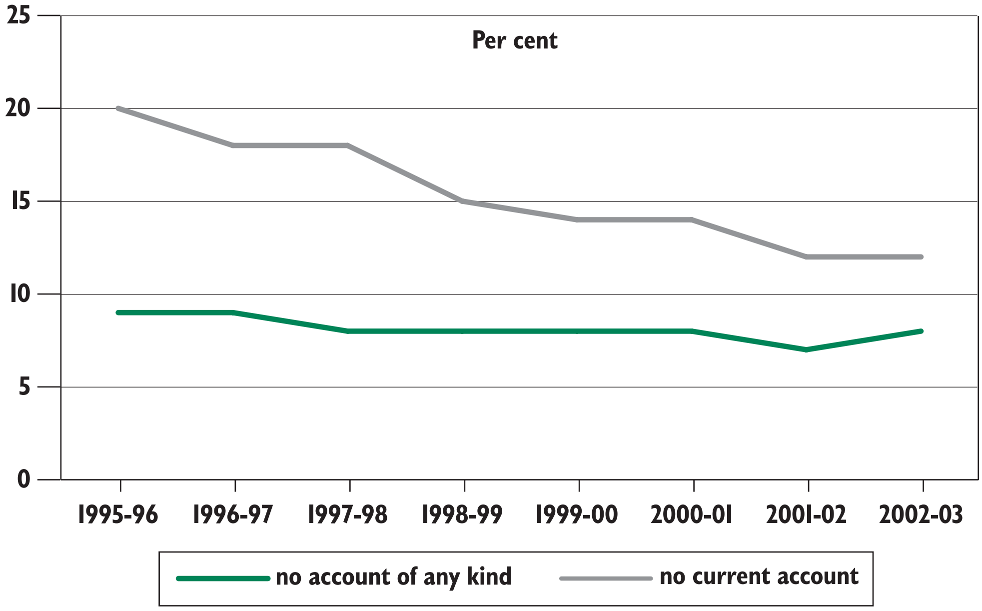
How many people live without a bank account?

Accounts are the norm for most people

3.1 The Family Resources Survey (FRS) for 2002-03 indicates that 1.9 million households, or 2.8 million adults, operate without a bank account of any kind.[1] Around 3 million households (12 per cent of households in the UK) had no current account. A current account is an account with a chequebook and/or bankcard, and access to electronic funds transfer, that is used to manage the household budget day-to-day. The balance between these two populations is likely to be made up of households, typically older people, who have a savings account but operate day-to-day in cash.

3.2 Whilst the percentage of households without a current account has fallen over time, the number of households without an account of any kind has remained fairly constant.

Chart 3.1: Households without accounts



Source: Family Resources Survey (FRS), 2002-2003.

[1] The Family Resources Survey (FRS) for 2002-03 indicates that 8 per cent of households (1.9 million) in the UK operate without an account of any kind.

International comparisons

3.3 International data demonstrate that the UK has a relatively high number of households and individuals without bank accounts. A 2002-03 survey in Australia found that just three per cent of adults lacked an 'everyday' banking account, while the most recent figures from Canada show that between three and four per cent of adults do not have a bank account.[2] The comparable figure for the UK is the 12 per cent of households lacking a current account.

3.4 Other countries have taken regulatory or legislative action to improve access to banking services. Measures taken in Germany, Canada, the USA and France are described in box 3.1.

Box 3.1 Banking regulation for financial inclusion – international approaches

These experiences offer important lessons for how progress could be achieved in the UK.

Germany – in June 1995, the banking industry endorsed a joint recommendation entitled "Current Accounts for Everyone", undertaking to provide current accounts on demand. There have been a further two reports (1996 and 2000) on the effects of this voluntary undertaking. The results have so far been positive and so the Federal Government has chosen not to legislate in this area at this time.

Canada – in 2003, legislation entitled "Access to Basic Banking Services Regulations" was introduced to ensure that all Canadians could obtain personal bank accounts without difficulty. Financial institutions are required to open personal bank accounts as well as cash most government cheques at no charge (even to non-customers) for any individual that meets basic requirements. The Federal Government also introduced legislation requiring banks to offer a standard low cost bank account with a basket of services. Memoranda of Understanding were signed between the Federal Government and eight financial institutions to ensure that all Canadians have access to affordable banking services.

United States – between 9.5 and 20 per cent of US households lack a bank account. 22 per cent of low-income families (over 8.4 million families earning under $25,000 per year) do not have either a current or savings account, although some states place an obligation on banks to provide accounts to all citizens, (for example, New York).

The Community Re-investment Act and Home Mortgage Disclosure Act require banks to disclose details of people and groups to whom they are currently offering services. Originally introduced as a response to banks 'redlining' areas (refusing to do business with residents of certain neighbourhoods) the Acts ensure that deposit services and credit services serve the convenience and needs of the communities in which financial institutions are chartered to do business.

This is a key part of ensuring that banks meet their social objectives and serves to encourage access by the community to banking services. In addition, the legislation had the effect of changing other aspects of commercial behaviour. For example, banks often give money to community development funds in order to ensure positive scoring when lending is disclosed under these two legislative instruments.

France – The 1984 Banking Act made access to a bank account a legal right in France: people refused one can apply to the Bank of France, which will nominate an institution to provide the bank account. In addition, in 1992, French banks signed a charter committing themselves to opening a bank account at an affordable cost with related payment facilities.

[2] Precise international comparisons are difficult given questions over comparability of data and even definition of accounts across countries. However, the data available indicate that financial exclusion is a particular problem in the UK. These figures are quoted in a report commissioned by the Department for International Development - *Policy level response to financial exclusion in developed economies: lessons for developing countries*, Elaine Kempson, Adele Atkinson and Odile Piley, The Personal Finance Research Centre, University of Bristol, September 2004.

REASONS FOR REMAINING OUTSIDE BANKING

3.5 Most people take a bank account for granted as an essential tool in managing day-to-day finances. The specific features of different types of accounts, and the degree to which these features are used, will differ according to the lifestyle and financial needs of each individual, but the costs of lacking access to banking can be significant.

3.6 Despite these costs, there remain many people outside mainstream banking. The reasons for this are complex and interrelated, but in broad terms:

- people without an account see no advantage to opening one; and
- banks have concerns about profitability and risk.

3.7 These two pressures are mutually reinforcing, and together can serve as powerful barriers to inclusion. Increasing bank account take-up and reducing exclusion will require changes both on the part of the currently unbanked, and of the banking industry.

The perceptions and attitudes of the financially excluded

3.8 Several pieces of research have investigated common reasons for not having a bank account and suggest why many people continue to manage a solely cash budget.

Reasons for staying outside banking

3.9 The majority of people currently operating outside mainstream banking are people who could both operate a bank account capably and stand to benefit. However, there are clear concerns about bank accounts, ranging from the practical to the emotional.

3.10 Typical concerns include:

- **control** – fear of going overdrawn and incurring charges and perceived lack of control over finances in comparison to weekly budgeting in cash;[3]
- **confusion and complexity** – basic bank accounts are not heavily marketed by banks, their access arrangements and extra features can vary, and there is no unifying name or brand to aid recognition;
- **the attraction of alternatives** – benefits can be paid directly into a Post Office Card Account (POCA) which can be set up with fewer identity hurdles. This reduces the perceived need for a bank account, particularly for those whose main need for electronic money transmission is to receive benefits;
- **cultural** – research indicates that many people simply think that bank accounts are 'not for them' and are instead intended for wealthier people with jobs. An innovative study concluded that non-users of financial services have a very similar profile to existing users drawn from the same social groups.[4] The main difference between the two groups was the extent to which their friends and family members are users of financial services. This implies that one of the main deterrents to opening a bank account is the social norms of an existing cash-only culture. It also suggests that since similar populations can be both banked and unbanked, there is no reason to assume that a bank account is not a viable option for many people currently excluded from the financial mainstream; and

[3] Basic bank accounts have no overdraft facility and charges can only occur if there are insufficient funds to cover a direct debit (and even then some banks do not levy a penalty for this). However, charges for some failed transactions can reach £40, a significant proportion of a low-income household's weekly income.

[4] *Social networks: their role in access to financial services in Britain,* Pamela Meadows, National Institute of Economic and Social Research, Paul Omerod and William Cook, Voltera Consulting Ltd, National Institute Economic Review no. 189., July 2004.

- **mistrust of banks** – qualitative research commissioned by HM Treasury, and supported by research sources elsewhere, indicates that many people without accounts believed that banks frequently 'lose' money, and/or levy high and irreversible charges on banking errors the banks themselves cause, such as late payment of a standing order.

3.11 These factors are clearly interrelated – some are based on objective fact and experience, while others may reflect misunderstandings. To reduce the number of unbanked, these perceptions will need to be changed. The banks, the Government and others will need to work in partnership to achieve this.

Costs of change outweigh the benefits

3.12 For some excluded groups, many of the immediate benefits of bank accounts are not perceived to be sufficiently compelling to motivate change or are outweighed by other considerations. For example, older people may feel less comfortable with the process of electronic transmission and withdrawal of money through cash cards, and may prefer to use more familiar methods of money management. For these people, the barriers to change may simply be too high.

Box 3.2 SAFE and partnership with banks

Services Against Financial Exclusion (SAFE) is a project run by Toynbee Hall, a community volunteering organisation in East London. SAFE aims to provide a range of information, education and generic advice for the financially excluded. This includes information and advice on access to banking services.

SAFE works with the Community Banking sections of banks to address access issues at a local level, as well as providing one-to-one preparatory guidance for clients seeking to open accounts. This can involve helping clients complete the necessary forms and gather the correct identification documents, as well as offering training and awareness raising for bank branch staff around financial inclusion issues. These activities both help the excluded access banking services, and ensure that banks and their staff are able to process such applications with the minimum of difficulty.

This is an example of how partnership between banks and the voluntary and community sector can help increase access to banking services for the excluded while reducing the potential costs banks may face in extending account facilities.

The incentives for the banking industry

3.13 The banking industry itself may also face disincentives to attract the excluded into banking.

Current account profitability

3.14 Banks have often argued that current accounts are not in themselves a profitable product unless the idle balance is very high. This is particularly sharply defined in the UK because of the way the market has developed with no standing charges for most current accounts.[5] Thus, the profitable activity is cross-selling products with high margins such as insurance, savings and investments, mortgages and large loans to current account holders.[6]

3.15 As competition between providers of financial services has intensified, and information and marketing technology has become more powerful at segmenting the market, such long-standing cross-subsidies are being eliminated and providers are increasingly chasing the same profitable customers.

[5] In most other countries, current accounts attract a standing charge and/or limits on the number of free transactions – such as counter withdrawals and deposits – that can be made in a month.

[6] *Competition in UK banking: A report to the Chancellor of the Exchequer*, Don Cruickshank, March 2000.

3.16 In addition, the basic transaction costs for low-income customers are often higher because they are heavier users of branches, making them even less likely to generate profits for the bank. Therefore, most banks do not yet see basic bank accounts as a commercial opportunity.

Money laundering regulations

3.17 Some consumer advocates and banks also point to money laundering regulations – which require banks to satisfy themselves of the identity of customers – as a major block to opening bank accounts for the excluded who may lack standard documents such as passports, driving licences and utility bills in their name.

The customer experience

3.18 These supply side barriers can lead to difficulties for those trying to open a basic bank account. The Banking Code Standards Board undertakes mystery shopping exercises to determine the extent to which customers are able to access basic bank accounts. The most recent results indicate some positive reactions from consumers. For example, the number prepared to recommend a bank for the overall account enquiry and opening experience rose from 41 per cent in 2003 to 57 per cent in 2004. However, from the overall sample of 396 mystery shopping exercises, only 54 per cent of assessors were able to achieve their objective of opening an account without difficulty. A total of 7 per cent of applicants were turned down as they did not have identification readily available, but 33 per cent were unable to open a basic bank account for other reasons, such as inability to obtain information about the account and staff insistence that an alternative account would be better.[7]

Moving forward – money laundering

3.19 The 2003 Money Laundering Regulations set high-level objectives for the regulated sector to meet. It is for individual firms to decide how to interpret the Regulations. They are assisted in making such policies by the availability of industry-produced guidance notes. For the banks, this is the Joint Money Laundering Steering Group (JMLSG) Guidance Notes.

3.20 The Financial Services Authority ID Working Group, consisting of a wide variety of stakeholders, recently published a progress report.[8] The Government welcomes the work of the group, in particular the progress that its members are making on the benefits of electronic verification of customer identification and the scope firms have to accept the results of ID checks undertaken by others (subject to legal requirements). The report also notes that the JMLSG is exploring the scope for firms to place greater reliance on a single document including letters from Jobcentre Plus or other government agencies to confirm the identity of their customers. The Government encourages financial institutions to adopt a risk-based approach to customer identification requirements and to follow the JMLSG Guidance Notes, which give flexibility to determine identity in different situations. The guidance recognises that, if the 'socially/financially disadvantaged' do not possess any proof of identification in circumstances in which they cannot reasonably be expected to, they should still have access to financial services. JMLSG is currently updating this guidance.

The Banking Code

3.21 The Banking Code is a voluntary code, followed by banks and building societies in their relations with personal customers in the UK. The Code has just been independently reviewed. The most recent review of the code should also improve the customer experience of opening basic bank accounts. A new commitment to make basic bank accounts more available for those who want them will be included from March 2005. The Code will be amended to ensure that where a bank offers a basic bank account, staff assess whether it is suited to the needs of a customer wanting to open a current account and, if so, offer them one. The Government welcomes this change.

[7] *Survey of Subscribers providing basic bank accounts*, Banking Code Standards Board, November 2004.

[8] *ID – defusing the issue: A progress report,* Financial Crime Sector Report, Financial Services Authority, October 2004.

Box 3.3 Banking services, housing associations and financial exclusion

As a sector, social housing providers (housing associations and local authorities) have combined assets in the order of £40 billion and are highly profitable corporate customers of banks. This is both in terms of normal banking services and in provision of loan facilities for capital expenditure on increasing housing stock.

Some innovative housing associations have extended the range of services available to their tenants to include provision of financial services.

In partnership with Bank of Scotland Community Banking, and as part of their negotiated banking facilities, Prospect Housing Association in Edinburgh set up a savings and loan scheme as part of the wider Wester Hailes Community Banking Agreement. Tenants also have access to basic bank accounts and financial advice. Account opening and loan assessments are undertaken by Prospect's money advice worker who provides a personalised approach to financial services.

Changing industry perceptions

3.22 Despite the discussion above, there are reasons to believe that banks can indeed find a real commercial interest in the financially excluded. Most obviously, a proportion of low-income customers will, in time, prosper and need additional (more profitable) financial services.

3.23 There are also wider commercial benefits for a bank that can flow from efforts to attract the financially excluded. For example, a clear majority of the unbanked rent local authority or housing association properties. Such organisations have significant banking requirements, particularly with regard to debt financing. Efforts to improve the situation of the financially excluded who are connected to such organisations could form part of a banking services package that could retain and attract such profitable business.

ACTION TAKEN ALREADY TO INCREASE ACCESS TO BANKING

Long-standing recognition of the problem

3.24 The problem of lack of access to banking services has been recognised for many years. The Government, working with others, has instituted a number of policies and regulatory changes in an effort to increase access to banking services for the most excluded – notably through the conclusions of Policy Action Team 14 (PAT 14) and the universal banking programme. In addition, policies underway in other areas will have a beneficial secondary impact on access to banking services.

Box 3.4 Government action which will impact on the uptake of financial services

As well as moves towards universal banking and benefit modernisation, a number of other Government policies, with different objectives, are likely to affect banking behaviour. These include:

- **introduction of Child Trust Funds in 2005: this initiative will strengthen financial education, promote positive attitudes to saving and ensure assets for all children, regardless of family background. All children born on or after 1st September 2002 will receive £250, children from poorer families receive £500, and a further payment will be made by the Government when children reach age 7. At the age of 18 the fund will be available to the child, and must be transferred into a bank account in order to be accessed;**
- **Education Maintenance Allowances: in order to increase incentives for the most deprived students to move to Further Education the Government will now pay up to £30 a week directly into students' bank accounts if they stay on in education at school or college after GCSEs;**
- **Saving Gateway: in pilot areas the Government has been matching savings of low-income families up to a limit of £375. These are being run in conjunction with the private sector, and community organisations. Pilots will end in February 2005 and will be used to inform future developments; and**
- **Housing Benefit: flat rate Local Housing Allowances (LHAs) were introduced in nine Pathfinder areas for private sector tenants between November 2003 and February 2004. Tenants taking part in these pilots know their Housing Benefit entitlement before signing a tenancy agreement so that they get the opportunity of choosing where they live, keeping the difference if the rent is below the LHA or finding the extra money if it is above. The new system empowers tenants to make choices about accommodation and employment. Claimants in these areas will receive a standard allowance based on the area in which they live and the number of occupiers. The allowance will normally be paid directly to the tenant, not the landlord. But there will be safeguards to enable local authorities to pay the landlord where necessary. Subject to positive evaluation evidence, the Government intends to roll out the flat rate system nationally. Nine more Pathfinders will commence from April 2005 to help develop best practice before national roll out.**

Move to electronic payment of benefits

3.25 At the time of the PAT 14 report in 1999, it was expected that the move to electronic payment of DWP benefits to claimants' accounts through the Payment Modernisation Plan would drive uptake of basic bank accounts. The Payment Modernisation Plan aims to make the benefit system more efficient by using the increased security and accuracy offered by direct electronic transmission of benefit payments.

3.26 Recognising that a bank account would not suit all those in receipt of DWP benefits, the Post Office Card Account (POCA) was also introduced. The POCA is a useful stepping-stone to financial inclusion as it enables individuals to become familiar with electronic management of their money. The banking industry made a contribution of £182 million towards development of the POCA, making an important contribution to modernising the benefit system as well as to financial inclusion. In recognition of the fact that the Post Office is an important point of access to cash for many individuals, many basic bank accounts are accessible over the counter at the Post Office.

3.27 However, while POCAs are a useful step towards mainstream banking they do not amount to full financial inclusion, for example they cannot be used to deposit cash or cheques, or to make payments either electronically or with a card and cannot be accessed through Automated Teller Machines (ATMs).

Lower than expected take up of basic bank accounts

3.28 Since the beginning of the universal banking programme over 1 million basic bank accounts have been opened. Despite these numbers, evidence from the universal banking programme so far suggests that fewer than anticipated benefit recipients are choosing to open basic bank accounts. Many DWP customers have chosen instead to use a POCA to receive their benefits. Comparing expectations of bank account take up with the remaining number of excluded individuals and households suggests that while some progress has been achieved, there remains much to do.

Box 3.5 Access to bank accounts

Banks are central to the objective of increasing access to bank accounts.

All the major high street banks and building societies offer the basic bank account; and 16 of these basic bank accounts are accessible at the Post Office.

Examples of specific work undertaken by the banks to increase access to banking include:

Barclays has undertaken research to ensure that the basic bank account is reaching the appropriate target market and to determine whether the account is meeting customer needs and requirements. Barclays are the only bank to disclose personal account data in deprived areas. Barclays also open basic bank accounts in partnership with organisations such as The Passage, a homeless charity in London.

HBoS are piloting work with the prisoners' charity Unlock to provide bank accounts to prisoners before release.

Royal Bank of Scotland Group have developed partnerships to allow vulnerable groups to open basic bank accounts, including working with Services Against Financial Exclusion in Tower Hamlets and Working Links, through which unemployed New Deal participants in Employment Zones can open a basic bank account through a call centre with the New Deal Advisor verifying the customer's identification.

Alliance and Leicester run training sessions for their staff to remind them of the obligations to assist in the opening of basic bank accounts and refreshing their product knowledge.

ACHIEVING PROGRESS

3.29 The experience of PAT 14 and the universal bank has shown that partnership working between the Government and the banks can be an effective way of achieving progress. This approach has allowed the Government to make clear its eventual desired outcome, and then leave it up to the banking industry, drawing on their day-to-day knowledge of the banking market, to decide how and by what means this outcome can be best achieved.

3.30 **The Government wants to continue to take this partnership approach to working with the banking industry and others to achieve real progress in reducing the number of unbanked.** The Government has been working with the banking industry to identify together the numbers and characteristics of people in households without a bank account, including analysis of the Family Resources Survey and the banking industry's own data on the take up of basic bank accounts. This information will form the basis of assessment of progress towards a significant reduction in the number of unbanked.

A framework for delivery

3.31 The Financial Inclusion Taskforce will provide a focus within Government and the banking sector for efforts to increase access to banking. The Taskforce will report annually to Government on progress.

4 Access to affordable credit

Summary

- **Those excluded from mainstream credit are faced with a lack of low-cost options, a lack of transparency in the credit products they can access, pressure to take on more debt and possibly having to resort to illegal lenders.**
- **The Government wants to ensure that those excluded from mainstream credit are able to access affordable loans and is undertaking a reform of the consumer credit market to ensure transparency and fairness.**
- **The Government announced in the 2004 Spending Review its intention to abolish the 'double debt' rule for Budgeting Loans eligibility, and lower the highest loan repayment rate to a maximum of 12 per cent of a claimant's benefits. The Pre-Budget Report announces that these reforms will be implemented in April 2006. These measures amount to an increase in funding for the Social Fund loans scheme of £210 million over the three years to 2008-09.**
- **The Government is therefore considering arrangements whereby, in certain circumstances, private and third sector lenders could apply for repayment to be made by deduction from benefit, where normal repayment arrangements have broken down.**
- **The Government will map the location of credit unions and community development finance institutions (CDFIs) to ensure that support provided to these organisations is appropriately targeted.**
- **Subject to any necessary state aids clearance from the European Commission, the Government will set up a growth fund for third sector lenders, from within the Financial Inclusion Fund, to boost the coverage, capacity and sustainability of the sector in providing an affordable source of credit for the financially excluded.**
- **The Government will consult on the costs and benefits of raising the cap on interest that credit unions can charge on loans, in particular to ascertain the likely impact on existing credit union members and the communities they serve.**
- **The Government will invite the Financial Inclusion Taskforce to consider ways in which the capacity and skills of volunteers and staff within third sector lenders can be enhanced.**
- **The Government will consult stakeholders within the community finance sector and the investment community on the case for, and practicalities of, extending the Community Investment Tax Relief scheme to investments in CDFIs' personal lending activities. Any action in this area would be subject to state aids clearance from the European Commission.**
- **The Government will consult stakeholders, seeking views on ways to improve the transparency of the process whereby home credit companies gain the written permission needed to offer a cash loan on the doorstep through the credit agreement on another product.**

CREDIT AND THOSE ON LOW INCOMES

4.1 In addition to the costs of operating without a bank account, highlighted in chapter 3, households without access to banking services find it very difficult to access sources of mainstream credit, given that a bank account is a standard requirement for many credit providers. Mainstream lenders also do not offer the sorts of loans which people on low incomes want.

Preferences of low-income groups

4.2 Forthcoming research on affordable credit from the Personal Finance Research Centre indicates that the financially excluded value credit agreements that offer:[1]

- small cash loans, typically under £500, repayable over short periods;
- easy access to credit, without having to engage in lengthy application procedures or interrogative processes;
- affordable weekly repayments;
- a method of repaying that fits with a household's method of financial management;
- a flexible approach to repayments and rescheduling; and
- credit from a reputable and trusted provider.

The need for credit

4.3 In contrast to the use of credit among people with higher incomes, who often use credit to spread the cost of expensive discretionary purchases, academic work suggests that there are three reasons why people on low incomes may need to borrow:[2]

- to buy essentials such as household appliances, furniture or clothing;
- to pay bills; and
- to meet the cost of smaller discretionary items, such as Christmas gifts or to finance family events.

EXCLUSION FROM THE MAINSTREAM CREDIT SECTOR

4.4 In recent decades, the majority of households have seen a dramatic rise in the availability, flexibility and affordability of credit. However, while the majority borrow using mainstream credit cards, bank loans and overdrafts at relatively low rates of interest, those on the lowest incomes often have to borrow to make ends meet, at interest rates many times that of a standard overdraft.[3]

The alternative and non-status credit markets

4.5 The non-mainstream credit market can be divided into the 'alternative' and the 'non-status' markets. The non-status market provides credit products similar to those in the mainstream sector, such as personal loans and credit cards, to people who would normally be unable to access the mainstream market, often because of a poor credit history. Due to the nature of these products, it is very likely that customers in this market have access to a bank account.

[1] There is considerable research on these preferences, for example *In or out? Financial Exclusion: a literature review*, Financial Services Authority, July 2000.

[2] *Life on a low income: An overview of research on budgeting, credit and debt among the 'financially excluded'*, Elaine Kempson, 1996 in *How People on Low Incomes Manage Their Finances*, Economic and Social Research Council, 2002.

[3] *Life on a low income*, Elaine Kempson,1996.

4.6 The alternative credit market, on the other hand, exists to meet the needs of low-income households requiring access to small, short-term loans, catering for people whose needs are not adequately met by mainstream credit providers.[4] Research data suggests that clients of the alternative market are likely to be on low-incomes, single (with a large number of single parent families), not in work and living in accommodation provided by a local authority or housing association. There are therefore clear overlaps with the population lacking bank accounts. Low income households also use credit tied to the purchase of goods.

Box 4.1 Credit sources available to low income households

Home credit companies – also referred to as doorstep lenders, provide small, short-term, unsecured cash loans, with weekly repayments traditionally collected from customers' homes by a network of agents.

Pawnbrokers – also cater for the need for small cash loans over short periods of time, offering credit secured against goods such as jewellery.

Sale and buyback shops – buy second hand goods and give the seller the option to buy them back after 28 days at a higher price.

Payday loans – a relatively new form of short-term credit, whereby customers write a cheque to a lender and will receive that amount in cash, less an agreed fee. The lender then waits for up to 30 days before presenting the cheque to the bank, although the customer can settle the debt before that date or extend the credit agreement. Payday loans however require borrowers to have a bank account

Mail order catalogues – provide a wide range of goods on credit and often operate through a network of credit-assessed agents, on commission, who either buy for themselves or for a number of customers. Customers can make small weekly or monthly payments over a set period.

Rental purchase outlets – the high street shop version of mail order selling goods to people who can either pay outright in cash, spread the cost with weekly repayments or pay monthly by direct debit.

Illegal moneylending – lenders operating without a credit licence – provide small cash loans to those excluded from even the alternative credit market.

CURRENT STATE OF THE ALTERNATIVE CREDIT SECTOR

High cost

4.7 Reliance on the alternative credit market means that the most vulnerable consumers typically end up paying much more for credit. Typical alternative credit products have Annual Percentage Rates (APRs) over 100 per cent – many times the APRs of standard mainstream personal loans, overdrafts and credit cards. For example:

- a typical loan from a home collected credit company for £200 might attract a charge of £94, which is repaid over 30 weeks (309 per cent APR) at £10 a week;[5]
- pawnbrokers charge interest each month for the length of the loan. A loan from a pawnbroker would have a monthly interest rate of around 7-12 per cent. A loan of £200 over 4 months, at 7 per cent interest a month would equate to a charge of £56 and an APR of 110 per cent;[6] and

[4] *Extortionate Credit in the UK – A report to the Department of Trade and Industry*, Elaine Kempson and Claire Whyley, June 1999.

[5] *Access to credit on a low income: a study into how peole on low incomes in Liverpool access and use consumer credit*, Paul A. Jones, Co-operative Bank, 2001.

[6] *Pawnbrokers and their customers*, Sharon Collard and Elaine Kempson, The Personal Finance Research Centre, University of Bristol, October 2003.

- an example from a Citizens Advice Bureau in Merseyside highlights the costs of sale and buyback. One client received £45 from selling a television/video recorder that he had bought for £500, 12 months previously. The item was recoverable by him paying £56.25 within 28 days, equivalent to an APR of 1355 per cent. Due to confusion over the date on the contract, the item was sold before the client could recover it, with the resale price being £120.[7]

4.8 There are several reasons why costs in this market may be higher, and some of these costs reflect the preferences of low-income groups:

- loans tend to be small and therefore the fixed costs of provision are proportionately higher;
- loans are usually repaid on a weekly basis, in cash, and are therefore expensive to collect; and
- there is a higher risk of default among low-income groups and providers are often more flexible in their approach to defaulting and rescheduling.

4.9 Therefore, while it is clear that lending to financially excluded groups will generally be more costly for providers, it is also true that it is often those on the lowest incomes – and thus those least able to pay – who face these higher charges. Some questions have been raised over whether prices in this market are too high, due to a lack of competition. For example, in the home collected credit market, concerns raised include the market dominance of a small number of major companies, the high barriers to entry into the market and the high costs of the loan product.

The NCC super-complaint

4.10 In June 2004, the National Consumer Council lodged a super-complaint with the Office of Fair Trading (OFT) on the home credit industry, highlighting these concerns.[8] The OFT response to the super-complaint identifies several market features that suggest that there may be limited incentive for lenders to compete on price.[9] The OFT conclude that this is likely to lead to significant harm to the interests of consumers and are therefore currently consulting on a market investigation reference to the Competition Commission. The OFT Board will decide whether or not to make a reference, following this consultation, before the end of the year.

Lending practices

4.11 As well as being high cost, the specific lending practices of some of the key providers in this market are often criticised as intentionally leading clients into taking out more credit and then creating and perpetuating a cycle of borrowing and indebtedness. In the home credit market, customers can become reliant on the easy access to credit and the weekly contact with their agent. Once they have built up their credit worthiness with one agent, customers are reluctant to change to a new provider, whatever their experience of their existing company. Further borrowing, paying interest on top of interest, may ultimately propel those on low incomes into unmanageable debts. These quotations from focus groups commissioned by HM Treasury highlights the spiral of debt that people can get into:

> *'they come to your door with £50 … and you think oh go on and you pay that off easy and then it is like oh do you want £100 cash and you pay that off and when it gets to £400 or £500 you think oh God I cannot afford to pay it.'*
>
> *'They just get you more into debt and you don't want it. Then you can never get out of it. The interest is just ridiculous.'* [10]

[7] *Daylight Robbery:* The CAB case for effective regulation of extortionate credit, NACAB, 2000.

[8] *Home Credit – an investigation into the UK home credit market*, National Consumer Council, June 2004.

[9] *Response to the super-complaint on home credit made by the National Consumer Council*, September 2004. OFT 747a.

A lack of transparency

4.12 Commentators have also expressed concern over the lack of transparency in this market. For example, mail order catalogues providing goods on credit offer zero per cent APR – a seemingly good deal. A 1997 Competition Commission report into the mail order industry found that, catalogue prices were on average 15 to 20 per cent above those on the high street.[11] However, a 2004 Competition Commission report into the industry found that given the agents' commission, the credit offer and free delivery of goods, prices in the market are not excessive.[12]

4.13 At rental purchase outlets, the typical credit offer may be around 30 per cent APR. However, independent research suggests that not only are prices initially inflated, but also consumers are encouraged to enter into expensive agreements for ancillary services such as, for example, a service package and the ability to return products and restart agreements without penalty. Evidence suggests that around 90 per cent of customers take up the service cover, which pushes up the overall cost significantly.[13]

Illegal lending

4.14 Some consumers excluded from alternative sources of credit, may be forced to resort to illegal moneylenders – those lending without a credit licence.[14] Illegal moneylenders lend almost exclusively to people who need money to make ends meet, typically lone parents, the long-term unemployed, hostel dwellers and people living in high crime areas. They usually make weekly or fortnightly loans at very high rates of interest.[15] Intimidation and violence in debt recovery practices are also a feature of the illegal moneylending market. Some lenders engage in other forms of illegal practice to encourage payment, such as taking benefit books or passports as security.[16]

Identifying the problems

4.15 In summary, those excluded from mainstream credit can be faced with:

- a lack of low-cost options;
- a lack of transparency;
- pressure to take on more debt; and
- possibly having to resort to illegal lending.

[10] Focus group commissioned by HM Treasury into the effects of financial exclusion, 2004.

[11] *The Littlewoods Organisation and Freemans plc (a subsidiary of Sears plc): a report on the proposed merger*, Monopolies and Mergers Commission, 1997.

[12] *March UK Ltd and the home shopping and home delivery businesses of GUS plc: A report on the merger situation*, Competition Commission, January 2004.

[13] *Profiting from Poverty – Why debt is big business in Britain*, Henry Palmer and Pat Conaty, New Economics Foundation, 2002.

[14] *Fair, Clear and Competitive. The Consumer Credit Market in the 21st Century*, DTI, December 2003.

[15] *Extortionate Credit in the UK – a report to the Department of Trade and Industry*, Elaine Kempson and Claire Whyley, June 1999.

[16] *Kept out or opted out? Understanding and combating financial exclusion*, Elaine Kempson and Claire Whyley, 1999.

4.16 The Government intends to tackle these problems by:

- increasing the availability of low cost options; and
- regulation to improve transparency and address specific practices in the consumer credit market.

ADDRESSING THE LACK OF LOW COST OPTIONS

4.17 The Government wants to ensure that those on low incomes, excluded from mainstream sources of credit and reliant on high cost options, are able to access affordable loans. However, increasing the provision of credit for those on low incomes – even if specifically designed to be more affordable – must ensure that is does not simply lead vulnerable consumers into patterns of unsustainable debt. The Government has considered a number of options.

Interest rate ceilings

4.18 Some commentators have argued for an interest rate cap to curb high interest charges in the credit market. A cap would prevent lenders from legally offering loans bearing an APR higher than the ceiling set.

4.19 The Department of Trade and Industry commissioned research into the effect of interest rate ceilings in France, Germany and the United States. This showed the possible harm that a ceiling might cause to the supply of credit.[17] The research found that:

- mainstream lenders do not provide credit for small loans repayable over a short period, excluding some low income consumers from the market or leading others to take out larger loans than they need;
- some low income customers will take out credit products that have extra charges, not included in the interest rate; and
- the percentage of consumers who admitted having borrowed from illegal lenders was twice as high in France and Germany as in the UK.

4.20 This research has informed the decision that an interest rate ceiling will not be introduced as part of the current reform of consumer credit law. However, the Government will keep the question of an interest rate ceiling under review.

Affordable credit

4.21 The Government will instead take forward measures to increase access to affordable credit by:

- reforms to the Social Fund;
- exploring new models to reduce the cost of credit; and
- providing support to not-for-profit lenders providing loan products designed to meet the needs of low-income groups.

[17] *The effect of interest rate controls in other countries*. Policis, August 2004.

The Social Fund

4.22 The Social Fund provides a safety net of grants and interest-free loans (with repayments deducted direct from benefits) for the most vulnerable in times of crisis. The Social Fund is successfully targeting those families who are most in need and is likely to be a valuable source of credit for financially excluded groups. Recent research found that Social Fund customers were more likely to be lone parents, younger people, tenants, more likely to have a young child, a longstanding illness, health problem or disability, as well as caring responsibilities.[18] They were also more likely than others to have debts and less likely to have a bank account. In addition, for Social Fund applicants, the only other options for borrowing tend to be from high cost lenders.[19]

4.23 The Government has introduced several changes to the Social Fund since 1997, including a simpler and more transparent applications process for interest-free 'Budgeting Loans'. The Government announced in the 2002 Pre-Budget Report that £90 million would be added to the Discretionary Social Fund over the three years to 2005-06.

Abolishing the double debt rule

4.24 As the next step in the reform of the Social Fund, the Government announced in the 2004 Spending Review its intention to abolish the 'double debt' rule for Budgeting Loans eligibility, which takes an applicant's outstanding Budgeting Loan debt into account twice in calculating the maximum amount he or she can borrow. It also announced the intention to lower the highest loan repayment rates, this means that the current 15 per cent repayment rate will be lowered to 12 per cent of a claimants benefits. These measures will give greater consistency and transparency in access to Budgeting Loans, and will enable the Social Fund to play a more effective role in helping those people most likely to access high cost credit.

4.25 **The Pre-Budget Report announces that these reforms will be implemented in April 2006. These measures amount to an increase in funding for the Social Fund loans scheme of £210m over the three years to 2008-09.** The Government is continuing to consider further reform of the social fund in the wider context of its vision for greater financial inclusion.

New models of affordable credit provision

4.26 The Government also intends to explore commercial mechanisms that allow loans to be made to those on low incomes, at lower rates of interest than found in the alternative credit market, on a national scale. The aim would be to reduce some of the increased costs and risks of lending to vulnerable groups. **The Government is therefore considering arrangements whereby, in certain circumstances, private and third sector lenders could apply for repayment to be made by deduction from benefit where normal repayment arrangements have broken down.** There are similar arrangements for managing arrears of, for example, fuel bills. This facility would be subject to criteria designed to ensure that it is only available where loan products are appropriate and provided in a responsible manner. The Government will seek responses from private and third sector lenders, possibly working together, by January 31st 2005. The costs and benefits of this scheme for lenders and borrowers would be evaluated.

[18] *The Use of the Social Fund by Families with Children*, N. Finch and P. Kemp, University of York, July 2004.

[19] *Saving and borrowing*, C. Whyley, S. Collard and E. Kempson, DWP Research Report No125 Leeds: Corporate Document Services, 2000.

Third sector lenders

4.27 The not-for-profit, or 'third', sector has a key role to play in the provision of affordable credit. Community-based organisations such as credit unions and community development finance institutions (CDFIs) are already active in providing affordable credit and money advice to those on the lowest incomes. Due to the geographical concentration of financial exclusion, these third sector lenders can make a difference to affordable credit provision in financial exclusion hotspots, increasing the supply of more affordable credit, and developing more innovative and suitable methods of loan delivery. **The Government will map the location of credit unions and CDFIs to ensure that support provided to these organisations is appropriately targeted.**

4.28 Rates of interest offered by third sector lenders are well below those in the alternative credit market (between around 12 and 30 per cent). In areas where these organisations exist they can offer substantial savings for customers compared to the costs of borrowing from high-cost lenders. For example, a customer taking out a £400 loan over 53 weeks with a CDFI (at an APR of 22.5 per cent – a rough average for the sector) could make a total saving of around £190 over the repayment period, compared to a typical loan of a similar size and loan period taken out with a home credit company.[20]

Credit unions

4.29 Credit unions are mutual financial organisations offering savings and loans facilities to their members. In 2003, there were 665 credit unions in Britain serving over 410,000 members, up from around 365,000 members in 2001. Credit unions are legally obliged to define a group of people who share a 'common bond' from whom they can recruit their membership and to whom they can provide services. This is often the workplace and/or the local community.

4.30 Loans offered are typically at low rates of interest: credit unions are restricted by law to providing loans at an interest rate of 1 per cent a month or less (around 12.7 per cent APR). Where credit unions serve members in particularly deprived areas, they can be vital in targeting the poorest communities and connecting people to more mainstream financial opportunity, but may find it difficult to become sustainable.

Box 4.2 Dalmuir credit union

Established in April 1977, Dalmuir credit union in Strathclyde is an example of a credit union that has managed to create a sustainable personal lending business. In 2002, Dalmuir lent over £3 million to its clients and, since moving into a new central location, has seen growth of around 15 per cent in its business.

As well as providing loans to members who have established saving records, Dalmuir also provides:

- **instant credit to those in real need;**
- **welfare rights surgeries; and**
- **a debt management service.**

[20] The interest payment on a loan of £400, repaid over 12 months at an APR of 22.5%, would be £45.68. APRs offered by doorstep lenders are typically around 170% (though this can vary hugely depending on the size of the loan and the agreed repayment period). The 'Access to credit on a low income' report for the Co-operative Bank by Liverpool John Moores University (November 2001) gives an example of a doorstep loan of £400 over 53 weeks with Provident Financial, which generated an interest payment of £236 (an APR of 164.08%).

Community development finance institutions

4.31 Community development finance institutions (CDFIs) are not-for-profit organisations which provide lending and investment facilities at competitive rates in disadvantaged communities. The majority of CDFI activity is focused on lending to small businesses, including social enterprises. However, in recent years there has been a rise in the levels of personal and micro-finance lending (the lending of small sums to individuals in order to spur business creation).

4.32 CDFIs offering personal loans typically offer interest rates of between 15 and 30 per cent, although many operate a risk-based lending approach, charging higher rates for riskier clients. Evidence suggests that this flexibility allows CDFIs to reach those at the very end of the spectrum of financial exclusion.[21] In addition, CDFIs can help clients to obtain money advice in the course of providing a loan – a service which can be vital for those managing on low incomes with little experience of mainstream financial products.

Box 4.3 CDFIs in practice

East Lancs Moneyline

East Lancs Moneyline (ELM) opened in Blackburn in January 2002. ELM provides an alternative source of finance for individuals and businesses unable to obtain help from high street banks and building societies. By November 2004, over 2000 loans had been completed and over £1.5 million lent out. ELM has established partnership working arrangements with two major banks to enable its customers to open bank accounts, and engages with other local agencies and organisations to provide specialist advice, information, training and support when needed. ELM plans to expand geographically throughout East Lancashire and to build on its core aim of providing an integrated service of loans, savings, specialist advice and financial education for its customers.

South Coast Moneyline

South Coast Moneyline (formerly Portsmouth Area Regeneration Trust) offers personal loans and micro-finance loans to people in Portsmouth and the surrounding area who are unable to access mainstream credit. The organisation targets the unemployed, women, people from minority ethnic groups, young people, people with disabilities and older people. Personal and micro-enterprise loans are offered up to £5,000 at a typical APR of around 22 per cent. South Coast Moneyline also operates a low cost cheque cashing service.

Barriers to growth

4.33 The Government recognises the valuable role already played by third sector lenders in providing low-cost lending services to financially excluded customers. However, coverage is at present limited and a number of barriers to further growth remain.

4.34 Credit unions already operate in some areas of high financial exclusion, but the sector needs a larger capital base in order to grow and become sustainable. As set out above, the personal lending CDFI sector is well placed to reach those at the very end of the spectrum of financial exclusion – yet at present these organisations are not well distributed around the country. In addition, since the CDFI business model relies on external investment, the long-term sustainability of the sector depends on CDFIs' ability to attract external investors.

[21] Research produced by Community Finance Solutions at the University of Salford suggests that customers of personal lending CDFIs tend to be younger, less well-off and in less stable relationships than credit unions' customers.

4.35 In view of this, the Government will take action to:

- boost the geographical coverage of the third sector in areas of high financial exclusion;
- increase the capacity of the sector to take on additional lending; and
- promote long-term sustainability within the sector.

Boosting coverage

4.36 **Subject to any necessary state aids clearance from the European Commission, the Government will set up a growth fund for third sector lenders, within the Financial Inclusion Fund, to boost the coverage, capacity and sustainability of the sector in providing a source of affordable credit for the financially excluded.**

4.37 The Government will invite bids to the Fund from third sector lenders. Support for credit unions will be granted on the basis of credit unions' business strategies for further growth and sustainability. Support for CDFIs will be made up of a mixture of revenue and capital support, focused on establishing brand new personal lending CDFIs, supporting enterprise-lending CDFIs expanding into the personal lending market and providing ongoing support for existing organisations. Further guidance on the bidding process for this will be issued in due course.

4.38 Credit unions are currently subject to a statutory limit of 1 per cent a month on the interest rate they can charge on loans to members. The Government is aware that some in the sector consider that this restricts credit unions' ability to make loans available to those who may currently be dependent on higher cost alternatives, and disadvantages credit unions in comparison with other not-for-profit lenders. It may also make it harder for credit unions to become more financially self sufficient, and so increase the range and reach of the services they provide. Some in the sector would therefore like to see an increase in the statutory limit which would allow, but not require, credit unions to charge higher rates of interest where they felt it appropriate to do so.

4.39 On the other hand, others are concerned that legislative reform to increase the limit could have the effect of making loans more expensive for existing credit union members or undermine credit unions' social role.

4.40 **The Government therefore intends to consult on the costs and benefits of raising the interest rate limit, in particular to ascertain the likely impact on existing credit union members and the communities they serve.** The Government will also seek views on possible safeguards to limit any negative impact on existing borrowers, such as restricting the application of higher rates to new loans or requiring member approval before any increased limit is applied by an individual credit union.

Increasing capacity

4.41 The Government recognises the crucial role of volunteers and staff in delivering an increase to the capacity of the sector. The 2004 Spending Review announced that the Government would seek to promote greater corporate community involvement as part of a Corporate Challenge National Campaign to run in 2005. This National Campaign will provide an opportunity for highlighting and promoting the way in which corporates can play a role in providing assistance to third sector lenders. **The Government will invite the Financial Inclusion Taskforce to consider other ways in which the capacity and skills of volunteers and staff within third sector lenders can be enhanced.**

Promoting sustainability

4.42 The Government recognises the work currently being done by the credit union movement, in collaboration with private sector partners, to increase the sustainability of the credit union sector. The Association of British Credit Unions (ABCUL), in partnership with Barclays and the Office of the Deputy Prime Minister, recently piloted PEARLS, a financial monitoring and business planning tool developed by the World Council of Credit Unions (WOCCU), with a number of credit unions in the sector. The results of this pilot project were encouraging and the Government looks forward to hearing of further progress.

4.43 Personal lending CDFIs also need to attract inward investment from external investors in order to ensure the long-term sustainability of the sector. The Community Investment Tax Relief (CITR) has played a valuable role in incentivising investment into CDFIs' enterprise lending activities since being set up in 2002. The Government is interested in the views of stakeholders on the viability of extending this scheme to cover investments into the personal lending services offered by CDFIs.

4.44 **The Government will consult stakeholders within the CDFI sector and the investment community on the case for, and practicalities of, extending the CITR scheme to investments in CDFIs' personal lending activities. Any action in this area would be subject to state aids clearance from the European Commission.**

4.45 A further important element in encouraging investment into CDFIs' personal lending activities is establishing and maintaining an appropriate regulatory environment for the CDFI sector. The Financial Services Authority has been in discussions with representatives of the sector on this issue, and is considering the case for a proportionate regulatory framework for CDFIs which invite retail investment.

Box 4.4 Access to affordable credit

Lloyds TSB has supported South Coast Moneyline (formerly PART) which is a not for profit community based finance initiative and has made 1,200 loans since July 2000 totalling £1 million.

Barclays is a major private sector supporter of credit unions. Since 2000, Barclays has contributed over £0.5 million and supported the introduction of the PEARLS financial monitoring and business planning tool to the UK. Early results show that credit unions using PEARLS have increased membership, increased volume of savings, reduced delinquency on loans and decreased reliance on grant funding.

Abbey helped Tower Hamlets Community Credit Union to negotiate the purchase of a former branch premises from the freeholder on preferential terms.

Bank of Scotland is working in partnership with Mercian Housing Association in Birmingham and Prospect Community Housing in Edinburgh to deliver savings and loans schemes enabling tenants to save and access affordable loans.

The Co-operative Bank is soon to launch its second major piece of research into credit for low-income households. In 2001 *'Access to Credit on a Low Income'* revealed a world of low-income families in Liverpool struggling to make ends meet by borrowing from high cost alternative lenders. Now, *'Would You Credit It?'* widens the research to involve low-income families throughout England, Scotland and Wales.

INCREASING TRANSPARENCY AND FAIRNESS IN THE MARKET

Updating the regulatory framework

The Consumer Credit White Paper

4.46 As well as addressing a lack of low-cost credit options for the financially excluded, the Government is taking action to improve the working of the consumer credit market. The Consumer Credit White Paper, published in December 2003, outlines an enhanced regulatory framework for the whole market.[22] The White Paper sets out the Government's proposals to increase transparency and fairness in the market and will improve consumers' access to redress mechanisms when lenders do not meet the standards set. The measures will increase the capacity of consumers to make informed credit choices appropriate for them and ensure that they have access to the relevant information to make those decisions. The effect will be to improve the operation of the licensed consumer credit market for all consumers.

Box 4.5 The Consumer Credit White Paper

Published in December 2003, the Consumer Credit White Paper sets out the Government's vision to create an efficient, fair and free consumer credit market where consumers are empowered to make fully informed decisions and lenders are able to compete on a fair basis. The White Paper reforms cover the following areas:

Licensing – The reforms will make it easier for the regulator to identify rogue traders and tackle unfair practices, through new powers to obtain information from licensees. A strengthened fitness test for licence applications will also be introduced to ensure that licences are granted to those that are and continue to be fit to hold them.

Extortionate credit – The Government will replace the current test for extortionate credit with one based on unfairness, lowering the threshold for challenging credit agreements and widening the factors that the courts may take into account.

Consumer redress – The Government will assist consumers to seek redress by enabling them to take their disputes to an independent body – through an Alternative Dispute Resolution system – that is simple, informal and affordable.

Transparency – Following the White Paper, the Government laid four Statutory Instruments in June 2004 reforming the current advertising regulations, requiring pre-contract information to be given before an agreement is concluded, reforming the way early settlement fees are calculated and setting out the form, content and structure of credit agreements. All these regulations are designed to make the current credit framework more transparent for consumers.

Over-indebtedness – The Government wants to minimise the number of consumers who become over-indebted and to improve support for those who have fallen into debt. The White Paper stated that the Government would establish a cross-departmental Ministerial Group to oversee development, coordination and implementation of a strategy to tackle over-indebtedness, including delivery of a single gateway to free telephone debt advice. An Action Plan on progress was published in July 2004.

[22] *Fair, Clear and Competitive. The consumer credit market in the 21st Century*, DTI, 2003.

Addressing specific practices in the alternative credit market

4.47 As well as reforming and updating the regulatory environment for the entire credit market, the Government wants to take action to address some specific concerns about transparency in the alternative credit market.

Home credit – the use of vouchers to open up credit relationships

4.48 Home credit lending often begins with agents canvassing people's homes for new customers with vouchers. Home credit companies canvass with vouchers rather than cash, as they are not permitted to canvass with cash loans under the Consumer Credit Act 1974.[23] These vouchers can be redeemed in particular high street shops and are repaid weekly in the same way as cash loans. Some lenders then use the voucher credit agreement as the means to gain the written permission needed under the Act to subsequently offer a cash loan. Concerns have been raised about the transparency of this process. **The Government will consult stakeholders seeking views on ways to improve the transparency of the process whereby home credit companies gain the written permission needed to offer a cash loan on the doorstep through the credit agreement on another product.**

Pawnbrokers and sale and buyback shops

4.49 Although similar in structure and effect, sale and buyback is unlike a pawnbroking pledge in that there is no actual credit agreement. The item is bought by the shop, which then agrees to retain it for sale back to the customer. There are no set interest rate charges and the amount paid for the item and the resale price are determined by the individual shop.[24]

4.50 People using the sale and buyback service tend to equate the transaction with a pawnbroking pledge and additional confusion can often arise due to the fact that many companies offer both types of transaction. However, unlike pawnbroking, sale and buyback does not fall under the Consumer Credit Act 1974 and therefore customers are not offered the same protection as they are under a pawnbroking agreement.

4.51 However, as many sale and buyback traders are also pawnbrokers, they are licensed under the Consumer Credit Act. Where the trader is licensed for consumer credit, her/his behaviour elsewhere may call her/his general fitness to hold a licence into question. Traders should not deliberately mislead consumers about the services they offer. If the OFT has evidence that a trader is unfit to hold a licence, it can start action to revoke that licence.

Tackling illegal moneylending

'Loan shark' pilots

4.52 The Government has sent a clear message that it will no longer tolerate illegal moneylending and the effects this has on some of the poorest and most vulnerable members of society. As announced in the DTI Consumer Credit White Paper, the Government has set up two pilot programmes to tackle illegal lending to be run by Trading Standards departments in Birmingham and Glasgow.

[23] The Consumer Credit Act 1974 bans the canvassing of cash loans – following on from the 1971 Crowther committee statement: on second charge mortgages; 'We take the view that the doorstep peddling of non-purchase money credit is extremely undesirable' due to the potential for 'whetting the appetite of prospective borrowers by pointing out the range of expensive goods which they would be able to purchase … schemes of this kind obviously provide a strong motivation for deception and sharp practice by agents.'

[24] *Access to credit on a low income. A study into how people on low incomes in Liverpool access and use consumer credit*, Paul A Jones,Co-operative Bank, 2001.

4.53 The Government is committed to ensuring that those on the lowest incomes do not have to rely on illegal lenders nor the other high cost options prevalent in the most deprived areas of the country. The pilots to tackle illegal lending therefore form an integral part of the wider strategy laid out in this chapter to increase the supply of affordable credit and to ensure that the consumer credit market is transparent and fair for all.

5 ACCESS TO MONEY ADVICE

Summary

- **Building financial capability and providing access to money advice are of key importance in promoting financial inclusion. Much is already being done in this area – however, further action is needed to address shortfalls in money advice provision.**
- **The Government will use its representatives on the working groups of the National Strategy for Financial Capability to ensure that the capability needs of the financially excluded are adequately addressed and that the recommendations reflect the needs of the financially excluded.**
- **The Government will work with potential providers to develop proposals for delivering a significant increase in the capacity of free face-to-face money advice, targeted in areas of high financial exclusion.**
- **As part of the two-year review of the Financial Services and Markets Act 2000 (FSMA), advice centres such as Citizens Advice Bureaux will be provided with an exemption from the FSMA financial promotion regime.**
- **The Government will pilot models of money advice outreach aimed at reaching those who do not normally present themselves to debt advisers.**

5.1 Good budgeting skills are essential to managing day-to-day on a low income. However, the knowledge, education and advice necessary to make optimal financial decisions are not necessarily available. Many consumers are far from confident in the decisions they make about their financial future and raising levels of financial capability is a key element of the Government's wider commitment to tackle the causes and effects of social and financial exclusion.

FINANCIAL CAPABILITY

5.2 Building financial capability means providing people with the education, information and advice needed to make financial decisions with confidence and providing opportunities for individuals to take greater control of the financial decisions that affect their lives, recognising that different consumers have different financial needs.

5.3 Numerous studies show that many people find personal finance difficult. It is often complicated and relies on seemingly complex mathematical concepts. It also involves considering difficult questions of future income, expenditure and borrowing needs. Many people find this an unappealing procedure and are inclined to carry on as before.

5.4 However, the potential benefits are substantial. For example, consumers who are aware of the implications of their personal financial choices will be better able to learn about the advantages of financial products that will be of benefit to them. They will also be less likely to use unsuitable financial products and services and be less likely to end up in financial difficulty.

Financial information, education and advice

5.5 Building financial capability can take several forms, including the provision of information, education and advice. Together these information channels can help increase financial capability overall:

- **financial information** provides individuals with facts, data and opinion on the financial decisions with which they are faced. Sources of financial information include literature from banks and financial institutions, information packs from financial regulatory bodies and the media;

- **financial education** provides individuals with the skills and knowledge necessary to identify and address their own financial needs and know where to go for help. Financial education can be delivered by a range of different people and institutions, including schools, employers, financial institutions, and government agencies; and

- **financial advice** typically relates to the specific choices faced by individuals and households, rather than the general understanding of financial products achieved through financial information and education. The provision of product-specific financial advice is regulated by the Financial Services Authority.

Building financial capability

5.6 Increasing financial capability and ensuring that people have the skills necessary to make effective financial decisions is in the interests of everyone. The Financial Services Authority has a duty to promote public understanding of the financial system and is currently working with the public, private, voluntary and community sectors to develop a National Strategy for Financial Capability,[1] focused on increasing capability across the population at key life stages. The Strategy is a crucial platform to ensure that financial capability, particularly for the excluded, is built effectively.

5.7 **The Government will use its representatives on the working groups of the National Strategy for Financial Capability to ensure that the capability needs of the financially excluded are adequately addressed and that the recommendations reflect the needs of the financially excluded.**

THE PROBLEM OF OVER-INDEBTEDNESS

5.8 Department of Trade and Industry research into household debt indicates that around 7 per cent of households can be considered over-indebted according to the definitions used.[2] Furthermore, people with the highest ratios of debt to income are concentrated at the lower end of the income distribution.[3] It appears, therefore, that those most likely to be financially excluded – the poorer households – are also more likely to be experiencing over-indebtedness and be in need of money advice.

[1] *Building Financial Capability in the UK*, Financial Services Authority, May 2004. This strategy has identified seven key areas where increases in financial capability are particularly important, such as becoming a parent and retiring. In addition, the Strategy Steering Group has resolved to ensure that the needs and position of the financially excluded are particularly emphasised in the deliberations of the working groups.

[2] According to the DTI's 2004 *Action Plan on tackling over-indebtedness*, 7% of households have four or more credit commitments, one of the definitions of over-indebtedness used.

[3] Ibid

5.9 This connection between the banking and credit aspects of exclusion and an increased need for money advice is supported by the results of a 2003 Citizens Advice survey of debt clients.[4] This indicated that Citizens Advice Bureaux saw a relatively high number of people with debt problems who also displayed other characteristics associated with financial exclusion as regards lack of access to banking services and affordable credit, such as:

- relative poverty;
- households being headed by a single person; and
- households renting socially.

5.10 Box 5.1 below sets out some of the costs associated with over-indebtedness.

Box 5.1 Negative effects of over-indebtedness

The costs of over-indebtedness fall on both creditors and debtors, the individual and wider society. The 2003 Consumer Credit White Paper *'Fair, clear and competitive. The Consumer Credit Market in the 21st Century'* outlined some of the costs associated with over-indebtedness:

- **increased recovery costs for financial institutions;**
- **public expenditure implications for the courts system in handling debt cases, and costs for the health service in dealing with the stress, anxiety and depression that over-indebtedness can cause; and**
- **costs to the economy as a whole as worker productivity is reduced by debt anxiety.**

Benefits of money advice

5.11 Timely, well-delivered money advice can reduce the costs of over-indebtedness, to the benefit of both the individual and society. Data from providers of money advice points to its beneficial effects. For example, an evaluation of the National Debtline pilot found that a large majority of callers were extremely satisfied with the money advice service they received and did not need to seek further advice elsewhere. Qualitative information provided by Citizens Advice suggests that the financial gains for money advice clients, in terms of saved income, are around four times the average case cost.

5.12 The Department for Constitutional Affairs, in collaboration with other Government departments, is currently taking forward a detailed research study into the impact of debt advice interventions on a number of outcomes, including health (both physical and mental) and recurrence of debt problems. Results are expected by late 2005.

Channels for delivery

5.13 Timely and helpful money advice may prevent people losing control of their finances and being at greater risk of voluntarily excluding themselves from mainstream financial products,[5] or getting bad credit ratings that force them into the alternative credit market in the future. Money advice can also help to build financial capability more generally, with the associated benefits for inclusion.

[4] *In too deep – CAB clients' experiences of debt*, Citizens Advice, May 2003.

[5] Information from HM Treasury focus groups indicates that once people have been in financial difficulty with mainstream banks before, they are less trusting of banks and other financial institutions again in the future.

5.14 Money advice is currently delivered through a range of channels:

- **telephone advice**, as provided by National Debtline or the Consumer Credit Counselling Service;
- **face-to-face advice**, as provided by Citizens Advice Bureaux, local authorities or other independent community advice groups;
- **'self-help' methods**, for example generic money advice materials provided by advice agencies;
- **fee-charging debt management companies**; and
- **other financial professionals**, such as bank managers or independent financial advisers.

5.15 The financially excluded are unlikely to have much contact with financial professionals given their lack of connection to mainstream financial services. In addition, self-help materials are likely to be difficult to use for some, given the documented link between financial exclusion and a lack of basic skills.[6]

Delivering money advice to the financially excluded

5.16 Evidence suggests that face-to-face money advice is likely to be more effective than other forms of advice for the financially excluded. Research into the impact and operation of the National Debtline pilot suggests that, although the relatively less well off DE social groups[7] are more likely to be in need of money advice given their borrowing and income patterns – and so most likely to benefit from National Debtline services – this group was disproportionately less likely than other socio-economic groups to use the telephone money advice available.[8]

5.17 Reasons put forward in the research suggest that such people may:

- be less likely to have a telephone;
- be less willing to receive advice;
- be less persistent in getting through to advisers; and
- be less aware of telephone services.

5.18 The Citizens Advice debt survey also reported that large numbers of their face-to-face money advice clients were living on relatively low incomes, with an average household income for their clients of less than half the UK average. Given the links between low income and financial exclusion, this suggests that those most likely to be excluded are particularly likely to use face-to-face advice. This conclusion is supported by evidence from qualitative focus group research commissioned by HM Treasury.

5.19 These results suggest that face-to-face money advice is a popular medium of delivery for those on low incomes, who are most likely to be experiencing financial exclusion. Therefore, when looking to tackle problems of lack of access to money advice for the financially excluded, face-to-face delivery channels appear to be an effective way to reach the target group.

[6] *Basic Skills and Financial Exclusion*, Basic Skills Agency, March 2003.

[7] Those in semi-skilled manual occupations or the unskilled.

[8] *Evaluation of Money Advice Debtline pilot and business case for development of "National Debtline"*', Deloitte and Touche.

Current supply of money advice

5.20 The Money Advice Trust – a charity funded by financial institutions that aims to increase the supply and quality of money advice – estimates the overall current supply of money advice at around 600,000 places, with approximately 350,000 of these being delivered through face-to-face channels. Citizens Advice is the largest provider of face-to-face money advice through its nationwide network of Bureaux, dealing with 250,000 – 300,000 clients each year on debt matters. There is some evidence that demand is increasing: Citizens Advice reports an 18 per cent increase in new debt enquiries over the five years to 2003. Many Bureaux are unable to deal with all the debt clients who present themselves as in need of advice and long waits to see a debt adviser are commonplace.

5.21 The Government is working closely with representatives of the money advice sector and the credit industry to increase the capacity and effectiveness of telephone money advice, and a number of steps have already been taken:

- a new telephone gateway, to better publicise and coordinate calls to debt services;
- formal referral agreements between telephone and face-to-face service providers; and
- better signposting of services by government agencies (which may raise awareness of telephone advice).

5.22 In addition, leading free telephone money advice providers, such as National Debtline, the Consumer Credit Counselling Service and Payplan are building adviser capacity in order to increase the number of clients helped, by over 100,000 places over the next twelve months. This may help to reduce the pressure on existing face-to-face providers, as some of the clients for these services are migrated across to the increased telephone provision. However, even taking into account these changes, it is likely that demand for face-to-face advice will continue to exceed supply for the financially excluded.

Box 5.2 Access to money advice

The credit industry makes contributions to money advice through the Consumer Credit Counselling Service (CCCS) and Payplan. These schemes offer a free and professional debt counselling service.

Many banks also support access to money advice through contributions to the Money Advice Trust (MAT). These include **Barclays, The Royal Bank of Scotland Group, HSBC** and **Lloyds TSB** who also seconded a senior manager to the Trust. The Money Advice Trust provides education and second-tier support to improve the quality of face to face money advice, delivered through organisations such as local advice centres and Citizens Advice Bureaux.

Lloyds TSB is working on a joined-up initiative with various charitable bodies which will see money advice, amongst other services, offered through a new combined credit union/CDFI model, working in partnership with local banks and money advice agencies.

Barclays is also fully engaged with organisations in the development of new strategies for delivering money advice. In addition, a number of Barclays debt management staff are training as volunteers with the Citizens Advice Bureau.

Demand for money advice

5.23 Estimates vary as to the exact size of the current shortfall in money advice, and how this can best be met. The Money Advice Trust estimates a current shortage in the provision of money advice of at least 250,000 places a year (through both telephone and face-to-face channels). As set out earlier, research carried out for the Department of Trade and Industry suggests that 7 per cent of households could be considered over-indebted – this equates to 1.5 million households. Research undertaken by MORI for Citizens Advice found that 34% of respondents would go to a Citizens Advice Bureau for advice about financial difficulties.[9] Applying this to the DTI figure, this suggests that around 515,000 of those households most at risk of over-indebtedness may potentially go to a Citizens' Advice Bureau for advice about financial difficulties. Given that current provision is between 250,000 and 300,000 face-to-face places, estimated un-met need for face-to-face advice may be in the range of between 215,000 and 265,000 of those households most at risk.

5.24 Increasing the supply of money advice will have a powerful and positive immediate effect on the situation of the financially excluded, by reducing the cost and hardship of over-indebtedness and increasing financial capability through the money advice process.

5.25 **The Government wishes to see a significant increase in the capacity of free face-to-face money advice over the Spending Review period. It will work with potential providers to develop proposals for delivering this increase, targeted in areas of high financial exclusion.**

5.26 The Government will work with existing providers of funding for face-to-face money advice (including the Legal Services Commission and local authorities) to share best practice and to ensure this additional funding complements the support already being provided.

FSMA two-year review

5.27 **As part of the two-year review of the Financial Services and Markets Act 2000 (FSMA), advice centres such as Citizens Advice Bureaux will be provided with an exemption from the FSMA financial promotion regime.** This will enable these advice centres to provide advice and other debt-related support, such as assistance with applications, without them having to worry that they might be subject to the financial promotion restriction.

Piloting models of money advice outreach

5.28 Evidence suggests that, even if capacity of money advice services is increased to meet current estimates of unmet need, there would still remain a potentially significant number of 'unrepresented' people who could benefit from money advice, who do not currently seek it. **The Government will pilot models of money advice outreach aimed at reaching those who do not normally present themselves to debt advisers.** This will involve providing money advice in new locations, by new methods and with new partners.

[9] 'Financial over-commitment survey' MORI for Citizens Advice, July 2003.

6 Promoting financial inclusion: summary of policy action

6.1 As set out in the introduction, some action is already being taken to tackle financial exclusion (eg Saving Gateway, Child Trust Fund, Over-indebtedness Strategy, Consumer Credit White Paper, insurance with rent etc). But more remains to be done to tackle this problem. The Government believes action in the following areas is key to tackling financial exclusion:

- **increasing access to banking;**
- **increasing the availability of affordable credit;** and
- **extending the provision of face-to-face money advice.**

6.2 The preceding chapters set out the Government's analysis of the problems and commits to a number of interventions to address these. To summarise:

- The Government will establish a Financial Inclusion Taskforce to monitor progress against the objectives the Government has set, and to report to Government on what more can be done.
- The Government will establish a Financial Inclusion Fund of £120 million over three years to support initiatives to tackle financial exclusion. In particular, the Fund will support the Government's aims to increase access to forms of affordable credit and to see a significant increase in the capacity of free face-to-face money advice.
- The Government will work in partnership with the banking industry and others to achieve real progress in reducing the number of unbanked.
- The Government announced in the 2004 Spending Review its intention to abolish the 'double debt' rule for Budgeting Loans eligibility, and lower the highest loan repayment rate to a maximum of 12 per cent of a claimants benefits. The Pre-Budget Report announces that these reforms will be implemented in April 2006. These measures amount to an increase in funding for the Social Fund loans scheme of £210 million over the three years to 2008-09.
- The Government is therefore considering arrangements whereby, in certain circumstances, private and third sector lenders could apply for repayment to be made by deduction from benefit, where normal repayment arrangements have broken down.
- The Government will map the location of credit unions and community development finance institutions (CDFIs) to ensure that support provided to those organisations is appropriately targeted.
- Subject to any necessary state aids clearance from the European Commission, the Government will set up a growth fund for third sector lenders, from within the Financial Inclusion Fund, to boost the coverage, capacity and sustainability of the sector in providing an affordable source of credit for the financially excluded.
- The Government will consult on the costs and benefits of raising the cap on interest that credit unions can charge on loans, in particular to ascertain the likely impact on existing credit union members and the communities they serve.

- The Government will invite the Financial Inclusion Taskforce to consider ways in which the capacity and skills of volunteers and staff within third sector lenders can be enhanced.
- The Government will consult stakeholders within the community development finance sector and the investment community on the case for, and practicalities of, extending the Community Investment Tax Relief scheme to investments in CDFIs' personal lending activities. Any action in this area would be subject to state aids clearance from the European Commission.
- The Government will consult stakeholders, seeking views on ways to improve the transparency of the process whereby home credit companies gain the written permission needed to offer a cash loan on the doorstep, through the credit agreement on another product.
- The Government will use its representatives on the working groups of the National Strategy for Financial Capability to ensure that the capability needs of the financially excluded are adequately addressed and that the recommendations reflect the needs of the financially excluded.
- The Government will work with potential providers to develop proposals for delivering a significant increase in the capacity of free face-to-face money advice, targeted in areas of high financial exclusion.
- As part of the two-year review of the Financial Services and Markets Act 2000 (FSMA), advice centres such as Citizens Advice Bureaux will be provided with an exemption from the FSMA financial promotion regime.
- The Government will pilot models of money advice outreach aimed at reaching those who do not normally present themselves to debt advisers.

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