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Response to the Financial Inclusion Commission

EVIDENCE QUESTIONS

What policy change would most support increased financial inclusion for the client group you represent?

1. Regulators should allow lenders to assess customer affordability and take risks with lending without being second guessed by regulators who have little concept of lending models that work successfully, even if some customers do not repay in full and on time.

What do you see as the role of the regulator, government, and financial services in promoting inclusion?

2. Regulatory restrictions should not protect consumers right out of the market. It should be acknowledged that there is a significant need for access to consumer credit, particularly by those who have uneven income streams and often uneven credit repayment histories. Lenders should be allowed to assess lending risk and lend on an unsecured basis to those who may be risky or who have impaired credit records. Regulators should impose restrictions on post-contract costs and charges. In this way lenders would be allowed to take risks, and price for risk, and borrowers would be protected from spiralling charges if they failed to repay, were late with repayments or had uneven repayment histories. Lenders who provided loans to those who patently could not afford to repay, would be penalized by losing their money.

Do you have any practical examples of financial inclusion initiatives that have been successful?

3. If there had been initiatives that had been successful on anything other than a small local scale, they would have been replicated and rolled out by now. It is important, however, to look at initiatives that have ***not*** been successful in order to avoid making similar mistakes in future.

4. The 2003 Loan Guarantee Scheme set up for credit unions was a disaster. The idea was that a loan guarantee scheme is a fund which is used as a reserve to cover any losses arising from high risk loans. With such a scheme, a credit union could make instant or debt redemption loans to low income people without putting its own members' savings at risk. However, fewer than half loan guarantee schemes were a success and only 17.6% of original funders were willing to replenish the fund. Here are some comments of those who administered the fund:

"*We would probably never do it again, it wore us out. It was hard work and high risk. You really have to ask yourself do you want to live with it again. It was a lot of hassle*".

"*There were a lot of dishonest people about*",

"*it was like money being given away to them*",

"*people missed the point about managing their money*"

"*we got very few new members out of it, people came to us because there was free money*".

"Making large numbers of high risk loans is expensive. We are not covering our costs. We should be able to charge higher amounts"

"I'd say to any credit union thinking about doing something similar, don't do it. It's time consuming and stressful and, when people get to know money is available, you are harassed, followed around and stopped in the street".

5. In Acton the scheme was discontinued after two years of operation even though two thirds of borrowers still had loans outstanding.

6. The last Labour Government set up a £120 million DWP "Growth Fund" that ran from July 2006 to October 2010 (when it was scrapped by the Coalition Government). HM Treasury enabled loan funding which was channelled through Credit Unions, primarily for those on low incomes who did not, or could not, use Credit Unions. Part of the aim was to revitalise Credit Union usage. 329,888 Growth Fund loans were made in deprived communities from July 2006 up to the end of October 2010, with a total value of over £137 million. Operating costs were between £60 and £75 per loan. The cost of administering the scheme totalled £40.8 million, with the additional social cost of lending estimated at £14.3 million. The scheme also displaced the profits of commercial lenders (including higher-cost lenders and other credit providers) to total a maximum of between £21.3 million to £30.5 million.

7. So note, the Government spent £40.8 million just to administer the loan process and displaced profits from existing lenders by a maximum of £30.5 million, so not exactly value for money. Low cost loans to the financially excluded can be made available, but Government (or *someone*) has to subsidise them significantly.

What impact, positive or negative, does the increasingly digital delivery of financial services (e.g. prepaid cards, online banking) have on financial inclusion?

8. Those who may be defined as financially excluded are not automatically as excluded from the digital environment, indeed they may use digital devices as much as anyone else. The potential for using digital delivery and social networking to engage with the financially excluded to provide advice and education, is significant. Digital delivery of financial services impacts far more on those who are technologically excluded than those who are financially excluded.

What opportunities are there to use technology to facilitate financial inclusion?

9. Some people self-exclude from financial services, either because of a lack of trust or because they consider that they would be declined access if they applied. Social media are already considering introducing payment systems through their platforms which could attract many who currently do not engage in financial services. Social media could also be used to inform, generically advise and encourage use of financial services by those who might otherwise not engage.

How has the financial downturn changed the nature of financial exclusion?

10. If anything, the financial downturn and austerity measures have focussed minds far more onto financial issues generally. A lack of confidence in financial services may have led to increased self-exclusion. Lack of returns for savers has undoubtedly reduced what was already a poor appetite for saving, despite virtually all consumer organisations saying that people should save more – much more an idealistic aspiration than practical reality. Regulatory restraints on innovation mean fewer choices and less competition for

consumers. The only significant lending innovation since the introduction of the credit card in 1968 has been the payday loan. And look what has happened to that despite significant customer enthusiasm.

What is the impact of welfare reform on financial inclusion and what support should be available to people as a result?

11. Universal Credit forces many who operated on weekly budgets now to manage on a monthly basis. It is very unclear how successful this will be. Evidence from the home credit sector (weekly collected credit) indicates that those who can manage weekly loan repayments often founder if they are moved to monthly repayment products. The idea that everything should be settled monthly is a middle class premise which refuses to accept that others operate differently, and manage well doing so. Particularly those who have varied and uneven incomes may find monthly arrangements simply too complex to manage and may become more financially excluded, incur late payment charges for taxes, utilities and loans, and fall into unmanageable debt more easily, than before.

What transactional services do households on low or unpredictable incomes, or who have experienced a life shock, need and want?

12. Speaking just from the perspective of consumer credit, households on low or (particularly) unpredictable incomes (the two are not synonymous) require access to credit products that do not significantly penalise uneven repayment patterns. Running account credit (such as credit cards) is often dangerous since there is a very limited capital repayment requirement, usually just 1% or 2%. Fixed sum loans that require regular repayment of both capital and interest mean the debts get paid off. But for those on uneven incomes, a greater repayment latitude than is currently available is required. The FCA is compounding this problem with its affordability requirements which are designed to foster regular repayment in full and on time, when in fact many consumers need a lot more flexibility than this. It would be interesting to see if the FCA would authorise a lender whose business model operated on the basis that overall his customers repaid 8 of every 10 contracted repayments. Such models have worked well in the past, both for lenders and customers. There needs to be much greater flexibility than is currently allowed.

What improvements are needed to make basic banking fit for purpose?

13. Anti Money Laundering requirements are the main factor preventing many applicants obtaining even a basic bank account. I personally know a UK born person of white English heritage, who had to apply for a passport and attend a face-to-face interview to get it, although she had no need of one, in order to access a bank account. She did not drive and had no driving licence so had no method of proving her identity in a manner acceptable to the bank. We have regulatory and social views of normality that seriously disenfranchise those who do not quite fit. More flexibility is required.

14. There is also something very wrong with a situation where a basic bank account offers no overdraft facility, but will levy returned item fees if there is no money in the account and a payment is attempted. In some circumstances basic bank account holders may have to pay a returned item fee to the bank *and* a late payment charge for a failed payment to a third party.

Can technology help deliver better transactional banking services for people on low or unpredictable incomes?

15. We are starting to see warning text facilities when funds are low and/or when a payment is due that would not be covered. The ability for the bank to communicate with its customer (rather than the customer having to check) – by whatever means the customer

chooses and has access to, must be a good thing in such circumstances. Ideally there should be no such thing as an unexpected charge when technology could be used to alert customers to avoidable charges that are looming.

Is there scope to bring people into mainstream credit who are currently excluded, while also ensuring that this does not risk financial difficulty?

16. It does not have to be mainstream credit, it could well be credit from specialist providers. This works well since the specialist lender understands the need for flexibility for those on variable incomes. Mainstream providers have a very poor track record with this. And, frankly, what would encourage those currently excluded to trust the banks? See paragraph 12 above for fuller details.

For people who are unlikely to qualify for mainstream credit, what might affordable alternatives be? Should banks, building societies and others play a role in provision?

17. *Affordable* is a term that is usually used as a synonym for *cheap*. There is no such thing as cheap credit. If the customer pays a lower than market rate for the credit provided, someone else has to make up the difference. See paragraphs 6 and 7 above. The reality is that if cheap credit is to be provided at below market rates, then *someone* will have to subsidise it. And then there will be eligibility criteria to consider – if subsidised loans are available, will we not all want one?

18. But of course affordable does not mean cheap. It means that the repayment process allows one to have access to the funds needed but repay in a manageable manner. A mortgage is not cheap (you repay more than 100% of the sum borrowed in most cases) but the mortgage system allows significant capital purchases of property by a method that is affordable for most who participate. At the other end of the scale, Home Credit - small weekly repayments, whilst not cheap in a total cost of credit analysis, works very well for its target customers because they can manage small weekly repayments and there are no financial penalties if a payment is missed occasionally.

19. Affordability is all about what one can usually manage. The FCA approach though is that is it about what one can *always* manage, which is not the same thing at all. Commercial loans that allow a flexible repayment structure with minimal post contract charges will enfranchise more people than any other system yet devised. Even highly subsidised Credit Union loans have never managed to meet the demand.

How does credit scoring contribute to financial exclusion, and are there viable alternatives to traditional credit scoring?

20. Credit scoring is one of those facets of financial services that all believe in but which serve primarily to exclude people from access to consumer credit. The Credit Reference Agencies have long lobbied for access to more and more data – unpaid civil fines, HMRC income data, unpaid TV licences etc. Their mantra is that the more financial data that can be accumulated about an individual, the better the lending decision will be. In reality though, it simply means that middle aged, middle class, middle income people who never failed to pay a bill, a parking fine nor even return their library books late, get credit, but others may not. Society has shunned the idea of a national DNA database, even though the Police assert that to have one would clear up the majority of crimes. Yet the CRAs, and indeed many Politicians, regard the idea of a national "financial DNA" database as the ultimate solution to prevent lending to those who may not be able to repay. And so it is! The cost though, is far greater financial exclusion since fewer and fewer people will be able to access credit because of a glitch on their file.

21. What is required is a far greater breadth of lending decision making. The primary data required are simply those which suggest that *any* lending would be unsafe. Otherwise if there are potentially safe ways of offering suitable products, even to those with impaired credit files, lenders should be allowed to do so. They take the hit if repayments are not made if the regulator ensures that post contract fees and charges are limited. The *never pay back more than 100% of the sum borrowed* now applied to the payday market would be a good marker for all consumer credit. The benefits would be particularly helpful for those with a maxed out credit cards. Once they had repaid in charges a sum equivalent to their borrowing, the debt would freeze.

What reforms could be considered to ensure consumers getting into financial difficulty are protected including those who become insolvent?

22. Having observed, and been involved with to some extent, the development of debt advice and regulatory reform since 1995 I have to say that the situation has never been better for those who get into financial difficulty and insolvency. They are very well protected and served. The only areas of concern are with some fee charging debt management companies – but these will soon be sorted out as they seek full authorisation from the FCA; and the political activist stance being taken by some debt charities which is alienating many in the lender community who end up funding such activity. There is no justifiable place for playing politics by organisations that are set up and funded to provide high quality debt advice to consumers in financial straights.

What role should the state and the insurance sector play in providing a financial safety net in the event of an unexpected life event? e.g. bereavement, family breakdown, unemployment and illness

23. I have no suggestions. I am not sure that it is really possible to mitigate against life events. They are so varied and affect people in so many different ways.

Is the insurance market functioning appropriately and competitively?

24. I have no expertise in this field. However, when the then Financial Services Authority took over the regulation of General Insurance in 2005 we moved from a situation where there were numerous small insurance companies and brokers, to the situation today where there are simply just a few large players. It seems very likely that the consumer credit industry will go the same way. This means less choice, less competition and fewer products available for consumers.

How can we ensure that people on low incomes, especially private tenants, have access to appropriate and attractive insurance products for their possessions and property?

25. I have no expertise in this field.

Will pension reforms enable inclusion, and what further improvements could be made?

26. In theory the automatic enrolment of employees into pensions will help. But with a lot of part time and shift work, people having two or three employers, and indeed significant numbers being self employed (4.6 million people working for themselves, with the proportion of the total workforce self-employed at 15% compared with 13% in 2008, and 8.7% in 1975) it really does seem unlikely that inclusion will be improved by this measure.

27. Those who subscribe to behavioural economics theories should be able to come up with ideas that will "nudge" people into making good pension provision – indeed the Thaler & Sunstein book *Nudge* makes much of this. It does not actually seem to have worked out well in practice though.

Should policymakers enable and encourage people on low incomes to save, particularly in the economic downturn?

28. All commentators say that people need to be saving – yes, and they need to eat less, drink less, exercise more and not have unprotected sex – but strangely, generally they don't. Where is there any incentive (or ability) to save? Returns are abysmal and the cost of living is outstripping wage rises. Previous incentives such as ISA's have been artfully manipulated by the providers in recent years to both give paltry returns and lock up money for long periods. I strongly suspect that many on low incomes would rather buy a lottery ticket in hope than save £2. Some research into such an attitude might be enlightening.

29. As with low cost loans, any real incentives to save would have to be subsidised or funded by someone, and I cannot see the Government proposing to commit itself to that.

To what extent can savings act as a preventative measure, helping people to avoid debt? What incentives to save work best for people on low incomes, and how might the costs of these incentives be met?

30. Interestingly, many people who do have savings also have debt. They pay more to service their debt than they gain in returns on their savings. Yet they cling to their savings rather than pay down their debt. Again, the behavioural economists may have something to say on this, but it seems that if we do have savings, we are very loathe to part with them even if it makes rational economic sense to do so.

31. In truth there is no incentive for someone on a low income to save, unless a third party were to inject additional funds. Governments will be loathe to do this, so perhaps the debt (and perhaps other) charities could use some of their substantial reserves to promote savings for their clients, perhaps contributing 50p for every £1 of client saving.

What practical steps could be taken to foster a savings culture in the UK?

32. The question fails to recognise some realities. If saving were such a beneficial activity we would not have a vibrant consumer credit market. The simple fact is that someone who can generally repay £50 a month for a loan would be incapable of saving £50 a month instead. Logically, if you want to buy an item for £500 and can afford £50 a month, save for 10 months and the product is yours. In practice though, some other priority will come along that will grab your savings, or the product will have been superseded by a newer model, or you simply cannot do without the item (a washing machine, say) for the next ten months. Since you can afford £50 a month, it seems sensible to you to buy the product on credit, have it now, even though you will pay perhaps £750 for it in the long term.

33. If this were not exactly how life is, there would be no credit market. It is not feckless consumer behaviour, it is not widespread irresponsible lending, it is simply that the vast majority of people see little or no benefit in saving, but significant advantages in borrowing. If we do not recognise this fact we will simply be propounding a nice sounding savings theory which bears no relation to consumer reality.