FEBRUARY 2005

findings

INFORMING CHANGE

Affordable credit for low-income households

Poor people pay more for many things, but arguably the extra they pay for credit puts the greatest strain on their budgets. Access to credit is still severely constrained for people on low and insecure incomes, and they often have to borrow at APRs typically ranging from 100 to 400 per cent. This study, by Sharon Collard and Elaine Kempson, examined the scope for widening access to more affordable credit. It also assessed the most appropriate and viable ways of developing sustainable provision. The study found that:

- People on low incomes have a higher risk of default than those who are better off because their circumstances are more likely to change. They also tend to want to make weekly cash repayments. Both these factors increase the cost of lending.
- Low-income credit users also want to borrow relatively small amounts for short periods. The costs of lending are largely fixed, so they tend to be high in relation to the amounts borrowed. This is why the charges of commercial lenders that serve the low-income market are high, mainstream lenders (banks and building societies) are reluctant to enter this market, and not-for-profit lenders with lower charges require subsidies.
- Left to its own devices, the commercial market will continue to move away from lending to the poorest people. Many of the proposals to tackle high-cost lending are likely to accelerate this trend and leave poor people with even less choice and higher costs.
- The researchers conclude that:
  - automated loan repayments – through direct deductions from income or direct debits – have the greatest potential to reduce the costs of both commercial lenders and not-for-profit credit providers. An improved direct debit system would have wider benefits and be more inclusive;
  - the most appropriate solution for the poorest people lies in further increases to the Social Fund budget, either from taxation or by using capital provided by the banks. Not-for-profit lenders also have the potential to meet borrowing needs. Moves towards larger, more professionally run credit unions and regional, community-based loan schemes, run in partnership with banks, seem particularly promising.

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Background

Provision of more affordable credit for low-income households has moved up the policy agenda, and the Government has pledged to widen access to affordable credit for low-income borrowers. Legislative changes have also been announced to tackle unfair lending practices as well as extortionate interest rates. An interest rate ceiling has, however, been ruled out for now. Finally, in December 2004, the home credit industry was referred to the Competition Commission for investigation following a super-complaint by the National Consumer Council. The study used a range of qualitative and quantitative methods, including data analysis, interviews and focus groups, to examine the credit sources available to people on low incomes.

Borrowing on a low income

In the UK's expanded credit market, more people than ever have the capacity and opportunity to borrow. For poorer people, however, little has changed. People who are out of work or have low/unstable earned incomes still have few choices when they need credit. Their borrowing needs continue to be largely met by specialist commercial lenders operating at the lower, more costly end of the credit market. Consequently, they have a real need for more affordable credit.

A survey by Policis indicated that the commercial credit sources most often used by households with no full-time wage earner were home credit and mail order catalogues. But their most common source of borrowing was interest-free Social Fund Budgeting Loans. Most people in these circumstances could not raise £200-£300 in a crisis without borrowing, or save £500 for a special purpose. They were also more likely to have an impaired credit history than households with a full-time wage earner.

Low-income borrowers' credit needs

High-cost credit has obvious disadvantages, but also has attractive features for those on low incomes. Likewise, there may be drawbacks to low-cost credit sources.

Focus groups with low-income borrowers identified the various key features they considered when using credit. They wanted to access credit quickly and easily, without lengthy or intrusive application procedures. They also wanted to be fairly sure before applying that they would obtain the money they needed. They generally saw affordable repayments as more important than the total cost of credit. In addition, suitable repayment methods were seen as helping to minimise the risk of default. They also valued lenders who recognised the difficulty of maintaining regular payments on a low income and made no additional charges for late or missed payments. Charges for settling loans early were not a key consideration. Nor was the company providing the credit. Nonetheless, the importance of personal recommendation and familiarity in people's use of commercial lenders should not be under-estimated.

Lending to low-income borrowers

Lending to people on low incomes differs from mainstream lending in several key respects. The risk of default is higher as customers' circumstances are much more likely to change, and people on low incomes prefer to make weekly cash repayments. Both these factors increase the costs of lending.

The amounts borrowed tend to be relatively small and for short periods. As the costs of lending are largely fixed, this means that they are high relative to the amounts borrowed. This is why charges by commercial lenders serving the low-income market are high, mainstream lenders (banks and building societies) are reluctant to enter this market, and not-for-profit lenders with lower charges require subsidies. The key to lending to low-income borrowers is assessing and managing the risk of default. This means careful recruitment, collecting repayments in ways that minimise the risk of non-payment, and repeat loans to defray set-up costs.

Risk assessment

Lenders serving the low-income credit market have found that word-of-mouth recommendation brings the most reliable customers. Instead of the automated risk-assessment techniques (notably credit scoring) used by mainstream lenders, they rely on face-to-face assessment of potential customers and small 'trial-run' loans. They also closely monitor new customers' ability to maintain payments, recording numbers of missed payments and how many times an agent had to call before successfully collecting the repayment. Lenders find this the best way of assessing risk. However, face-to-face screening and monitoring of repayments add to lending costs.

Some lenders in this market have been exploring the use of automated credit-scoring systems. And, as the information that credit reference agencies hold on people on low incomes improves, it is likely to become more widely used to predict borrowers' behaviour. The danger is that increased use of credit scoring and credit reference agency data in this market will exacerbate credit exclusion among the poorest households. As companies become better able to ascertain relative customer profitability, they will increasingly move away from lending to less profitable customers – i.e. the poorest, highest risk and most vulnerable.

Risk management

Unlike mainstream lenders, credit providers specialising in loans to people on low incomes distinguish between those who are unlikely to repay in full and those who may, for genuine reasons, struggle sometimes to meet a repayment. The latter is a fact of life for people on low incomes, and these lenders have processes to accommodate it.

Lenders aim to set repayments that their customers can afford. This amount is assessed at the same time as the decision about whether to lend. Most lenders would argue that this can only be done face to face. As mentioned above, many lenders closely monitor new customers' repayments for the first 10-15 weeks. They also tend to offer very small loans initially, increasing the amount once customers have a track record of reliable repayment. Similarly, credit unions and savings and loans schemes require members to establish a regular pattern of saving before they can take out a loan.

Many lenders in this market 'manage' their customers' repayments, rather than relying on customers to pay on time. Traditionally, this means agents collecting the money from customers' homes. But home service is more than a means of payment collection. It is central to how these companies operate, as it provides a way to assess potential and repeat customers, sell products and chase arrears. Maintaining a network of agents is the largest single cost incurred by home credit companies.

Many of these lenders are prepared to reschedule loans for those facing genuine difficulties. Unlike mainstream lenders, they do not view this as default and do not usually levy additional charges for late payment. But the cost has to be covered, either as higher charges or, in the case of many low-cost, not-for-profit lenders, as subsidies.

Some lenders minimise the default risk by requiring collateral in the form of savings (credit unions and other savings and loans schemes) or valuables (pawnbrokers). This limits access to credit for many poor people, although it enables others to benefit from the lower charges usually associated with secured loans.

Extent of need for affordable credit

Data analysis indicated that up to 6.2 million low-income people aged 16-64 in the UK could not meet fairly modest expenditure without borrowing. In the course of a year, 1.8 million of them had borrowed money commercially. A million of these borrowers had very constrained access to credit, such that 750,000 had needed to use a high-cost lender.

These estimates are, however, likely to understate the potential demand for more affordable credit, as:

- they do not include people who need to borrow but who, because of changes in the market, find it increasingly difficult to access credit, even from high-cost lenders;
- more people may be attracted to use credit if it were more affordable, including people who currently only borrow from friends or family;
- they do not include pensioners, though levels of borrowing among older people tend to be much lower than among the working-age population.

Type of credit needed

The main credit need is for small, unsecured, fixed-term cash loans. People on low incomes want affordable weekly payments with no hidden or extra charges. They like automatic payments, but are wary of direct debits as these can incur high bank charges should they fail. The certainty of direct deduction from benefit is preferred. For the same reason, many users of home credit like collection of repayments from their home. They also welcome the facility to reschedule loans should they encounter temporary financial problems.

In other words, potential borrowers want to reduce the likelihood of defaulting. But their requirements inevitably add to the costs of borrowing, whether these are passed on to them or met by subsidies.

No existing sources of credit fully meet these needs. Home credit comes close, but the charges are high and some people are deterred by home collection. The Social Fund meets many of the needs, but repayment levels tend to be high. The possibility of rescheduling Social Fund loans is not well known and is not straightforward. Community-based loan schemes could meet credit needs, but access is restricted and repayment methods do not always meet the desire for methods that reduce the likelihood of default.

Conclusion

Whatever shape it takes, some intervention is required to ensure that poor people have access to affordable credit. Left to its own devices, the commercial market will continue to move away from lending to the poorest people. Many of the proposals to tackle high-cost lending, while well-intentioned, could accelerate this and leave poor people with even less choice and higher costs. The study concluded that the greatest potential for widening access to more affordable credit lies in:

- reducing the cost of commercial credit;

- increasing the availability and sustainability of not-for-profit lenders;
- extending access to the Social Fund.

The biggest, most immediate impact would come from a system of guaranteed automated payments and further expansion of the discretionary Social Fund. This would require substantial investment, which could be met through public-private partnership.

A system of automated loan repayments would reduce the costs of both commercial lenders and not-for-profit credit providers. Some commercial lenders indicated that they would pass these reduced costs on to customers, as cheaper credit. For not-for-profit providers, reduced costs would make sustainability easier to achieve. Safeguards would be needed, however, to minimise the risk of default.

The study considered two types of automated payments:

- direct deduction of loan repayments from social security benefits, which is popular among those who borrow from the Social Fund;
- an improved direct debit system which would trigger payments on receipt of wages or benefits into a bank or building society account, mimicking direct deduction at source.

Considerable obstacles would have to be overcome to implement either option, but further investigation is warranted. An improved direct debit system would have wider benefits and be more inclusive.

For the poorest people, the most appropriate solution lies in further increases to the Social Fund budget, either from taxation or using capital provided by banks. Previous research has shown considerable unmet need for Social Fund Budgeting Loans and Community Care Grants. The discretionary Social Fund budget is being increased by £90 million over the three years to 2005/06. Analysis for this study suggested that this amount would have to be more than doubled to fully meet the non-discretionary borrowing needs of people in the poorest households.

Not-for-profit lenders also have real potential to deliver affordable credit. They need to reach a size where they can achieve economies of scale, including centralised back office and accounting facilities. Moves towards larger, more professionally run credit unions and regional community-based loan schemes run in partnership with banks seem particularly promising.

About the project

Researchers Sharon Collard and Elaine Kempson, from Bristol University, conducted a literature review and re-analysed in-depth interviews from five earlier qualitative studies on credit sources for low-income households.

Five focus groups with low-income credit users explored further the perceived positive and negative attributes of the credit sources they used, and participants assessed the relative importance of the essential features of a credit source. Telephone interviews were also held with a range of credit providers and other interested parties, including trade associations and the Department for Work and Pensions.

These interviews and focus groups informed a round table meeting with representatives from key government departments and trade associations representing commercial and non-commercial credit providers. This meeting examined the scope for reducing the costs of commercial lending to people on low incomes, and the potential for public-private partnerships to offer lower-cost products.

The qualitative work was supplemented by quantitative data analysis by Policis of its recent consumer survey of credit access and usage among people on low incomes, based on over 1,000 interviews.

For further information

The full report, **Affordable credit: The way forward** by Sharon Collard and Elaine Kempson, is published for the Foundation by The Policy Press (ISBN 1 86134 687 5, price £11.95).

Available from Marston Book Services, PO Box 269, Abingdon, Oxon OX14 4YN, Tel: 01235 465500, Fax: 01235 465556, email: direct.orders@marston.co.uk. (Please add £2.75 p&p for first book and 50p per book thereafter.) You can also download this report free from www.jrf.org.uk (ISBN 1 86134 748 0).

Published by the Joseph Rowntree Foundation, The Homestead, 40 Water End, York YO30 6WP. This project is part of the JRF's research and development programme. These findings, however, are those of the authors and not necessarily those of the Foundation. **ISSN 0958-3084**

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