Is a not-for-profit home credit business feasible?

Elaine Kempson,
Anna Ellison, Claire Whyley
and Paul A. Jones

March 2009

This study tests the commercial feasibility of a not-for-profit home credit service.

The seizing up of wholesale markets, combined with tightened lending criteria, has created a credit supply crisis among vulnerable borrowers, many of whom rely on home credit. Commercial home credit is long-established, with large numbers of low-income customers. It has many features that are valued by its customers, but the cost is high.

This report addresses:

- The essential elements of a not-for-profit service as identified by customers and lenders. These are home collection, a single price under-pinned by cross-subsidy, flexibility with regard to payment and debt recovery for people who genuinely cannot pay.

- Development of a business model that adopts the operating experience of commercial home credit providers, covering running costs in year five. Even on a not-for-profit basis, the cost will be high if the service is to be financially sustainable.

- Identification of a stand-alone provider as the best option for delivery.

JOSEPH ROWNTREE
FOUNDATION

www.jrf.org.uk

Contents

List of figures and tables 3

Executive summary 4

1 Introduction 7

2 The customer perspective 11

3 Market research with commercial home credit lenders 23

4 The business models 29

5 Market research with not-for-profit lenders 38

6 Conclusions 45

Notes 51

References 52

Appendix: List of participating credit unions and community development finance institutions 53

Acknowledgements 54

About the authors 56

List of figures and tables

Figures

1 Home credit customers who usually renew/take on new loan by extent of home credit payment problems 12

2 Preference for weekly home collection by channel and frequency of payment preferences 13

3 Preference for agent collection of repayments by length of time as home credit users 13

4 Use of mainstream and sub-prime credit products in last two years by people on low incomes 15

5 Other types of credit being used when last home credit loan taken out 15

6 Home credit customers' perceptions of their ability to get credit elsewhere 16

7 Whether considered more than one lender for last home credit loan by home credit repayment history 16

8 Home credit customers who usually renew/take on a new loan as soon as one finishes by whether considered other lenders for their loan 17

9 Whether considered more than one lender for last home credit loan by borrower preferences 17

10 Reasons given for using more than one home credit company 18

11 Customers who regard their agent as a personal friend by length of time they have been a customer 19

12 Overall satisfaction with home credit by length of time they have been a customer 19

13 Overall satisfaction with home credit by payment record 20

14 Payment problems within last six months by frequency of home credit use 21

15 Payment problems within last six months by source of new business 21

Tables

1 Categories of home credit customers 22

2 The risk-based segmentation underpinning the business model 30

3 Financial results of the model based on the central scenario 34

4 Social benefit outcomes of the model based on the central scenario 35

5 The impact of different levels of APR on funding requirement, financial results, cost of credit to the consumer and savings relative to commercial lenders 35

6 The impact of encountering greater or lesser adverse selection than for the current market profile 36

7 The impact of differing levels of agent retention 37

Executive summary

Commercial home credit is long established, with large numbers of customers on low incomes. Despite criticism of the high cost of the loans, it has many features that are highly valued by its customers. The aim of this study was, therefore, to test the commercial feasibility of a not-for-profit home credit service.

The consumer perspective

Demand for a not-for-profit service is likely to be high and relatively stable, especially among those already using commercial home credit. It is, however, likely to be highest for those with existing payment problems. The demand is for a product that closely resembles the existing commercial model, including weekly collected repayments and a flexible approach to missed or late payments in particular.

There is mixed evidence on the ease with which a not-for-profit new entrant might attract existing users of commercial home credit companies. Potential users have a strong desire to deal with a known and trusted lender, which could pose a challenge to a new entrant unless they already have an established reputation. Existing users are also not as credit-constrained as might be expected. Although there is little evidence of shopping around, four in ten commercial home credit customers use more than one home credit company at a time. Two important barriers will, however, make it harder for a new lender to attract customers from commercial lenders: first, the close relationship between home credit customers and their agent; second, high levels of satisfaction with existing lenders.

The types of customers who are most likely to be attracted to a new lender are those who also have a high risk of payment problems. There is, therefore, a real risk of disproportionately attracting potential bad payers and the success of a new entrant rests on an ability to manage this, especially in the early days.

Commercial home credit lenders

Lenders were united in their view that it is not possible to unpack and separate the key elements and still have a viable business. The essential elements from their perspective are: home collection; a single price underpinned by cross subsidy (both between customers and over an individual customer's life cycle) and flexibility with regard to payment and debt recovery for people who can't rather than won't pay.

Missed and partial payments are endemic to home credit customers and around a third of all payments are missed each week. A common definition of a 'quality' customer is someone who makes six in ten of their repayments on time.

New business acquisition is a major challenge for commercial home credit providers, as levels of customer turnover are high and increasing – reflecting the competition for 'quality' customers. Retention of good payers is essential, as is recruiting new customers with a similar propensity to pay. Lack of demand is not a problem, but finding good customers is becoming more difficult. Traditionally, agent referrals and recommendations from existing customers have been the key source of new business, but both are shrinking. Consequently, other recruitment methods (canvassing and/or use of remote channels) have to be used. These are more costly and run a greater risk of adverse selection. This has significant implications for a new entrant and alternatives, such as referrals from social organisations, would need to be maximised.

Good agents are critical to a successful home credit business. They are the best method of recruiting new customers and a key source of repeat business. Their detailed knowledge of their customers is an important input to lending decisions. They build a rapport with, and personal commitment from, customers that is reflected in a commitment to pay. And without their persistent visits to people in default a significant proportion of the money lent would not be collectable. Agents do, however, represent a major cost to home credit companies.

Most agents are women and work part time, usually on a self-employed basis with most (85 per cent) of their commission based on collection. On average they have 130 customers in their round; and to provide an adequate income they typically aim to serve between six and ten customers an hour. Round density is, therefore, a critical factor in determining both an agent's effectiveness and her remuneration.

A good agent fits into the community they serve, is self-motivated, professional with a maturity of outlook and numerate. Recruiting agents with the right qualities is, consequently, challenging but essential. So, too, is retention of good agents as new agents and new rounds require subsidy. New agents are more dependent on systems and controls, particularly for bad debt management.

On the whole, agent safety and fraud are not major problems but only because commercial companies have learnt how to mitigate them. A new entrant would need to learn from their experience.

Building the business model

Return-on-investment, cost-of-delivery and pricing models were developed drawing on the evidence above. It was decided that it would be inappropriate for a social provider to incentivise sales of new loans to existing customers but that they could draw on various social agencies to recruit new customers. Both these elements were included in the model.

Two major generations of the business model were developed. The first assumed the service would be run by existing third sector lenders – who wanted to include the transitioning of users to their mainstream loans. This was, therefore, included as a core assumption in this model. The second generation model was based on a stand-alone service and did not include this assumption.

Business model outputs

Even on a not-for-profit basis, the cost of home credit would be high if the service were to be financially sustainable. Based on the assumptions above, the first generation model (based on existing third sector lenders) has a break-even annual percentage rate (APR) of 129 per cent on an average 56 week loan of £288 – compared with a current advertised APR of 183 per cent for one major commercial lender. The second generation model (based on a stand-alone lender and no transitioning of customers) has a slightly lower break-even APR of 123 per cent for a similar loan. Both models become cash positive by year five and assume an investment of £18 million to achieve this. It has been assumed that a public subsidy or social business investment would cover this investment and the cost of lending capital. If this were not the case the APR would be significantly higher.

On the second generation model, an APR of 123 per cent would imply a customer saving of £50 on an average loan of £288 over 56 weeks, compared with commercial home credit.

In a social lending context, an APR of 123 per cent might be unacceptably high. The models show that if it were reduced to 100 per cent, the investment required over ten years would rise sharply to close to £90m. The customer saving on the average loan of £288 over 56 weeks would be £72, compared with using a commercial home credit provider. With an average loan frequency of 2.34 loans a year, this would translate to a saving of a little under £170 a year.

Such modest savings may not be sufficient to attract 'quality' borrowers from an existing provider. It would, therefore, be important to explore ways of achieving cross subsidy through offering other products, such as insurance, savings and cheque cashing. Cross sales of such products have not been successful when offered by the commercial home credit lenders, but a social business may have advantages in this respect through links to other financial inclusion initiatives. There also may be opportunities to cross-sell a range of advice and financial capability services, which would be separately funded and effectively part-subsidise credit provision.

Delivering a not-for-profit home credit service

The original assumption was to operate the new service through existing third sector lenders: credit unions and community development finance institutions (CDFIs). Discussions of the business model with these providers indicated that they were broadly supportive of the initiative and agreed with the assumptions that underpinned it, but there was limited appetite for becoming involved in its delivery.

The high APR was a major concern, especially when seen alongside the relatively small cash saving to customers. Credit unions are, in any case, restricted by legislation form charging an APR in excess of 26.82 per cent. They were also concerned about the potentially high levels of default, and the experience of serving financially excluded borrowers under the Financial Inclusion Growth Fund has created a new appreciation of the challenges involved in serving high-risk borrowers.

After many years of subsidy, some third sector lenders are moving towards financial sustainability and there were fears that becoming involved in a high-risk home credit service could jeopardise this. With many competing demands for new services for people who are financially excluded, third sector lenders saw developing a home credit service as a diversion and likely to work against the efforts to scale-up the sector.

In view of these reservations, a stand-alone not-for-profit provider would seem to offer the best way forward. More work would be required to investigate the feasibility of this and the type of body that might be set up to deliver the service. One possibility is a stand-alone CDFI, either owned by a group of third sector lenders or by one of the two main the trade bodies – ABCUL (Association of British Credit Unions Limited) and CDFA (Community Development Finance Association). Another option would be the establishment of a new Friendly Society.

1 Introduction

Commercial doorstep lending, or home credit, is long established, with large numbers of customers on low incomes. Despite widespread criticism of the cost of loans offered in this way, successive studies have shown that home credit has many features that are liked by its users. Indeed, for many users it is far from the last resort. People on low incomes welcome its ready access, the flexibility over repayments, the certainty of the cost (there are no separate default charges), as well as the fact that payments are collected on the doorstep (see, for example, Rowlingson and Kempson, 1994; Jones, 2002; Brooker and Whyley, 2005; and Collard and Kempson, 2005).

At the same time, it is clear that commercial lenders believe that a large section of people on low incomes can only be offered credit if the risk of non-payment is managed by the lender retaining some control over repayment collection. Most commonly this means home collection (Collard and Kempson, 2005).

Home credit is, however, under pressure with the prospect of shrinking supply. First, many former users of home credit have migrated to other companies in the growing sub-prime market, leaving home credit companies with a larger proportion of high-risk, low-profit customers. Indeed, the largest home credit companies have themselves been moving towards the more affluent consumers within this sub-prime market. One provider (Cattles) has greatly scaled back its provision of home-collected credit, and has retreated from lower-value loans and providing credit to the highest-risk borrowers. Another (London and Scottish Bank) was under administration at the time of writing. There has been only one recent new entrant to the home credit market – Park Group – which struggled to establish market share and profitability and did not become a major lender with a national spread of customers. Following a strategic review of the business the company announced in its 2006 annual report that it had taken the decision to close its home credit operation 'in the light of the recent disappointing performance of Park Direct credit and changes in the [home collected credit] market' (Park Group, 2006, p 6). In August 2006, Park Group shareholders approved the sale of its home credit loan book to CL Finance Limited.

Second, a Competition Commission inquiry into the home credit industry has concluded that there *is* evidence of lack of competition in the home credit market and has estimated that, on average, customers are paying approximately £7 more per £100 borrowed 'than could have been expected in a market in which competition ensured that prices reflected only the costs of provision' (Competition Commission, 2006, p 9). The final report setting out the remedies was published in November 2006 (Competition Commission, 2006). These remedies include requirements on lenders to: share data on customers' payment records through credit reference bureaux (this applies only to lenders with over 60 agents or £2 million in annual turnover), publish specified information on the price and other terms of their cash loans on an independent website, provide at least one free statement per quarter or one per loan (whichever allows for more requests) and ensure that customers who repay loans early get a fair rebate. The report also recommended that the Department of Trade and Industry should ensure that the annual statements lenders are required to provide under the Consumer Credit Act 2006 contain information that is relevant to home credit customers. The Competition Commission decided against intervening directly to control prices because of fears that to do so would lead to the financial exclusion of some home credit customers.

It remains to be seen what impact these remedies will have. Lenders' and others' fear that they may accelerate the present decline in home credit with lenders deciding to increase minimum amounts (small loans are used by newer and poorer customers) or even to leave the home credit market altogether (Competition Commission, 2006).

Certainly, the draft remedies, and the impact of the Competition Commission inquiry, were important factors in the Park Group's decision to leave the home credit market (Park Group, 2006).

Research that the Personal Finance Research Centre and Policis recently completed into illegal (unlicensed) credit in the UK shows that it is widespread but relatively small-scale at present. People resort to these lenders when they cannot gain access to loans from licensed home credit companies (Ellison et al., 2006). We have concluded from this research that an alternative to home credit needs to be found. Without it, people who are unable to borrow from commercial home credit companies because of a contraction of the market will have little alternative but to turn to illegal lenders in greater numbers.

The numbers of people on low incomes borrowing from credit unions or other community development finance institutions (CDFIs) has increased in recent years. The Association of British Credit Unions Limited (ABCUL) has been encouraging the development of credit union services that are better targeted to people on low or unstable incomes and is supporting the introduction of the system of financial management to promote financial sustainability (PEARLS). As a consequence, a growing number of credit unions now offer loans without the need for borrowers to demonstrate a pattern of regular saving and there are signs that they are reaching more people on low incomes than other credit unions (Collard and Smith, 2006).

These developments were given a boost by the setting up of the Financial Inclusion Growth Fund to support the development of third sector lenders in areas of financial exclusion. Around 100 organisations have received finance from this fund and between July 2006 and December 2007 they issued 46,500 loans, totalling £20.4 million. Over 80 per cent of these loans were to low-income customers in areas of high financial exclusion (Financial Inclusion Taskforce, 2008). This has shown that third sector lenders have the potential to meet the needs of people who currently use home credit companies – indeed there is already some crossover in customers. The Financial Inclusion Taskforce Credit Working Group has, however, identified 81 local authority areas with high levels of financial exclusion but no third sector lender. The group estimates, conservatively, that the nationwide demand for affordable credit by financially excluded people is around three million loans a year. Assuming that an average loan is £288 (the average for commercial home credit), the total size of the market would be around £860 million.

While many of these people's needs could be met from existing products, home collection could increase substantially third sector lenders' capacity to serve some of the most vulnerable credit users. The Competition Commission remedies could make entry into this market easier for them.

Aims

The aim of this project was to test the commercial feasibility of using the doorstep model in the not-for-profit sector. This included an assessment of:

- the overall potential scale of demand for such a service and its attractiveness to potential customers;
- the segments of the low-income market that could be served;
- the core operational requirements and critical success factors for establishing a not-for-profit service;
- the costs of serving different segments of the low income-market and the factors (including scale, target market definition and pricing structures) that would influence that cost;
- whether a not-for-profit model could offer loans at a price that is substantially lower than those in the commercial sector and, if so, under what conditions.

Overall, the research team has approached the development of a home credit service as a business proposition within the not-for-profit sector, not as a social service.

Research design, methods and analysis

The study involved three linked stages: market research of both demand and supply, product development and market testing with third sector lenders.

Market research of demand and supply

Demand

The primary aim of the demand-side market research was to identify the potential scale of the demand for a not-for-profit home credit service and the types of borrower it would serve. It was primarily based on secondary analysis of data from five sources:

- four separate nationally representative surveys with low-income credit users, one of which covers collection-related issues in some depth while another covers the critical issue of payment delinquency and default on home credit in considerable detail; and

- the home credit use section of the Financial Resources Survey, which includes supplier relationships, switching between providers, and price sensitivity.

This was informed by existing published research, including research commissioned by the Competition Commission (for example, Rowlingson and Kempson, 1994; Opinion Leader Research, 2000; Jones, 2002; Collard and Kempson, 2005; Ellison and Whyley, 2005; Brooker and Whyley, 2005; Ellison et al, 2006).

This is described in Chapter 2.

Supply

The second strand of the market research developed a detailed understanding of the current model of home credit, its method of working, its cost structure and barriers to entry. This was based on in-depth interviews with a range of senior executives working in commercial home credit companies in the areas of marketing, finance, strategy and corporate affairs. These were supplemented by desk research, including publicly available data and information collected by the Competition Commission home credit inquiry team, and our own detailed knowledge of the home credit industry.

This is described in Chapter 3.

Product development

Having completed this market research, we undertook an assessment of the business case for doorstep lending run on a not-for-profit basis. This involved the development of return on investment, cost of delivery and pricing models, drawing on the considerable body of work and model development undertaken by Policis around credit pricing, segmentation, product and channel design and development, and customer profitability.

The development of these models is described in Chapter 4.

Market testing with third sector lenders

This phase of the study was conducted as a participative research inquiry with a range of third sector lenders, selected on the basis of their track record of working with home credit consumers in low-income communities, their organisational and financial capacity to innovate products and services and their stated interest in piloting a home credit service.

It began with a series of detailed consultations and planning sessions with the staff, directors and volunteers of two credit unions (Manchester and South Tyneside Credit Unions) and one CDFI (Money Answers South Tyneside [MAST]). The aim was to explore the rationale and the business case for a not-for-profit home credit service in the light of the prior market research with customers and commercial home credit lenders. All three lenders had a track record of reaching out to financially excluded people; both credit unions were delivering the Financial Inclusion Growth Fund and MAST specialised in serving people already over-indebted to home credit companies.

These informed the content of three workshops, a telephone conference and individual interviews to market test the home credit business model with a wider group of credit unions and CDFIs.[1] All of these agencies had direct experience of serving financially excluded people and all were delivering the Growth Fund.

This is reported in Chapter 5.

2 The customer perspective

The feasibility of a not-for-profit model of doorstep lending – however well designed and delivered – is, inevitably, dependent on whether there is sufficient demand for it, and on the nature of that demand. Success requires a volume of potential customers that is high enough to enable cost recovery and provide some economies of scale. There also needs to be the type of demand that will generate sufficient profit to achieve sustainability. In other words, success requires attracting enough of the right kind of demand, without taking on too many of the high-risk customers who are likely to be most attracted to a new provider. An assessment of whether these conditions are likely to be met requires answers to the following questions:

- What level of demand could we expect for a not-for-profit model of doorstep lending?
- What are the key components of that demand?
- How likely are people to use a new provider of doorstep loans?
- What are the risks of 'adverse selection'?
- What are the implications for customer selection?

The answers to these questions provide a key context for the feasibility of a new model of doorstep lending, and highlight some important demand-side risks.

What level of demand can we expect?

The evidence indicates that the likely level of demand for not-for-profit home credit will be high, especially among existing home credit customers, and relatively stable.

Low-income households have, by necessity, a strong appetite for credit use. Six in ten households in the lowest income quintile, and almost all current users of home credit, feel the need to borrow in any twelve-month period. They have few options to raise money other than borrowing. Finding £200 to £300 in an emergency would be difficult or impossible for four in ten low-income households, and eight in ten existing home credit customers. A similar proportion would find it difficult or impossible to save £500 for a special purpose.

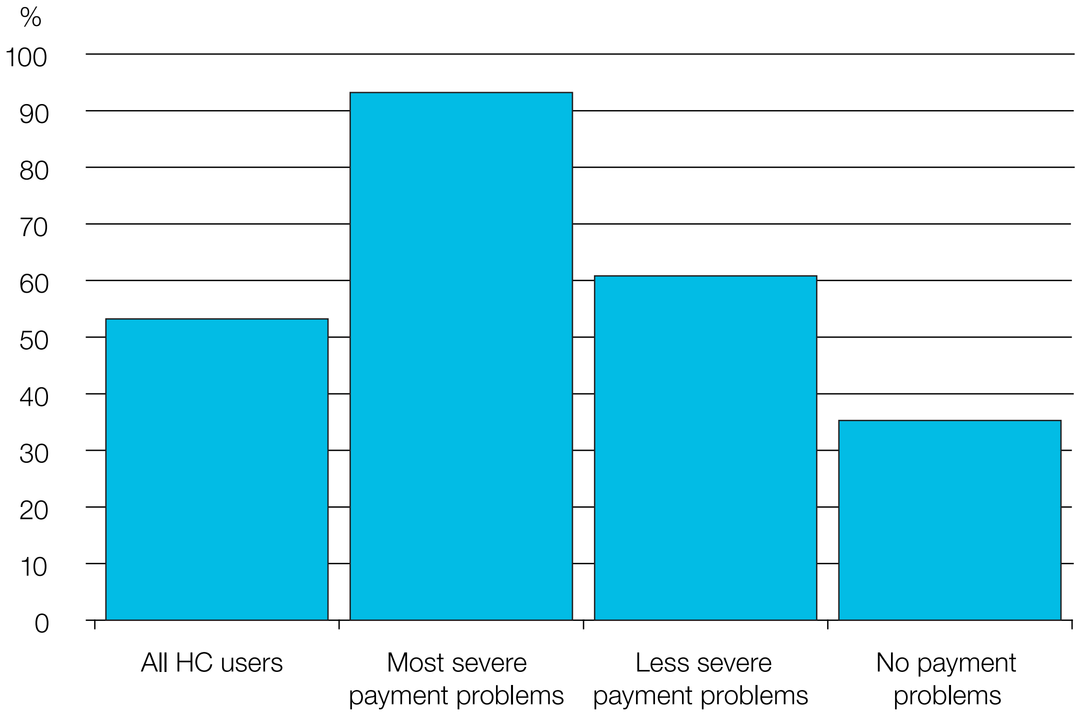
Borrowing from mainstream lenders – such as high street banks or building societies – is not seen as a realistic option. Six in ten low-income households, and more than seven in ten home credit users, believe they would find it difficult or impossible to borrow from a mainstream lender.

The level of demand is also likely to be fairly constant. This is particularly likely to be the case among established users of home credit, who are almost continually in the market.

More than half of home credit customers borrow again as soon as they finish repaying their existing loan, and the likelihood of this happening increases with the length of time they have been a customer. So, while four in ten of those who have been using home credit for up to a year immediately renew their loans, the proportion rises to nearly seven in ten among customers of five years or more.

On a more cautionary note, however, it is important to note that constancy of demand is highest among customers with payment problems, who would present a high risk for a new lender. Just over one in three of those without any payment problems are continually in the market, compared with nine in ten of those with the most severe payment problems (see Figure 1).

Figure 1: Home credit customers who usually renew/take on new loan by extent of home credit payment problems



Base: 150 home credit users (UK nationally representative sample).

Demand is slightly more likely to be constant among customers recruited via more costly recruitment channels. Six in ten customers recruited by agents are continually in the market, compared with just over half of those recruited by other means.

What are the key components of demand?

As the evidence below illustrates, this level of demand is, largely, for a product that closely resembles the existing home credit model, suggesting little room for flexibility regarding design and delivery and raising some issues around trust and familiarity that are likely to impact on demand for a new lender.

Weekly collected repayments

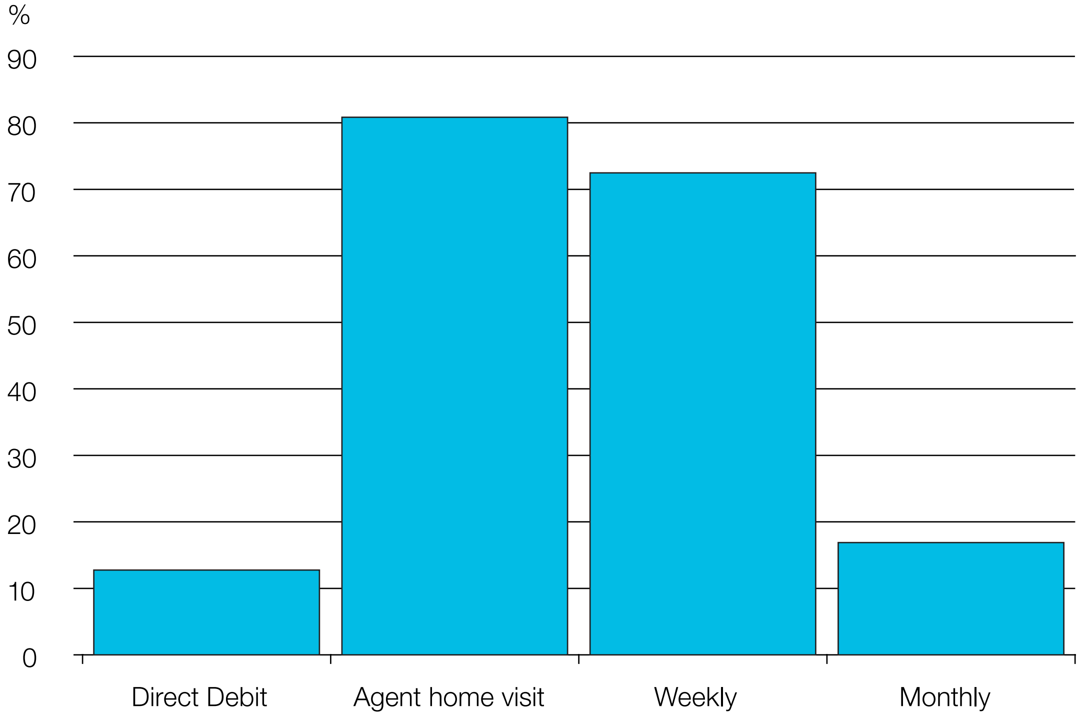
As other research (Rowlingson and Kempson, 1994; Collard and Kempson, 2005; Brooker and Whyley, 2005) has shown, for people on low incomes affordability is more important than cost when it comes to repayments. Affordability, in this context, is delivered by an expensive and, from the perspective of a new lender, potentially risky combination of weekly repayments, home collection and flexibility regarding payment problems.

Eight in ten home credit customers prefer their repayments to be collected by an agent calling at their home, and seven in ten want to make weekly repayments (see Figure 2). Fewer than two in ten would rather pay monthly and fewer still would prefer to pay by direct debit.

Seven in ten customers agree that, while home credit costs more than other types of borrowing, they would struggle to manage without the weekly collection of their repayments. This preference for home collection of repayments is largely unaffected by the length of time they have been a customer or whether they have experienced repayment problems, indicating that home collection attracts people to home credit, rather than being something they grow to appreciate (see Figure 3).

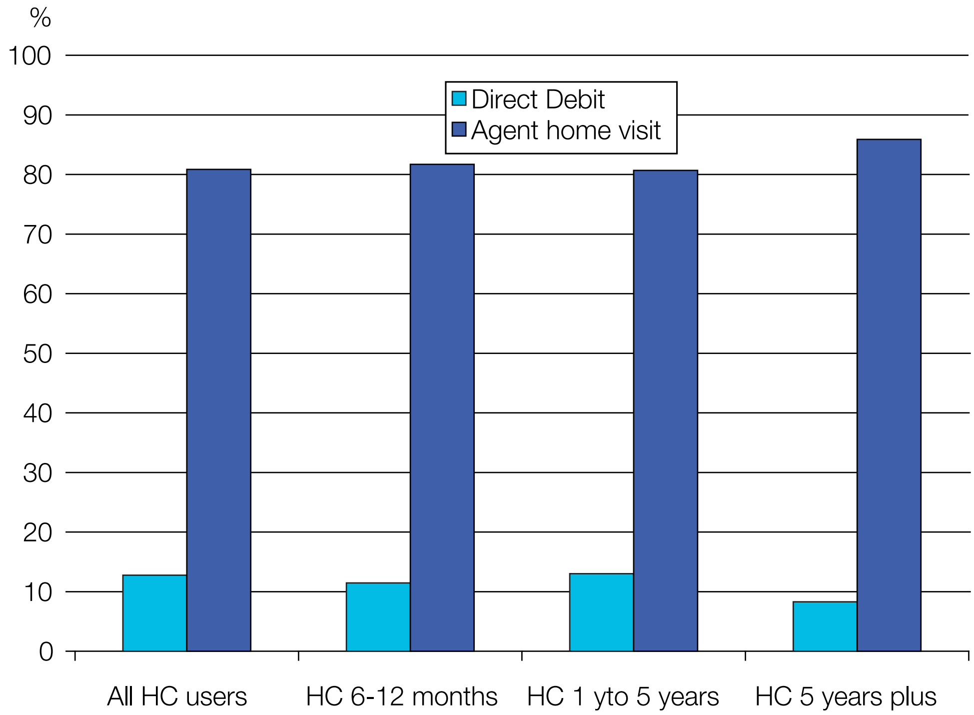
A small segment of home credit customers show a preference for other, less costly, payment channels. These tend to be people looking for higher-value loans, prepared to repay them on a monthly basis and less wedded to the agent-collection model. These customers are likely to be more financially included, using home credit as

Figure 2: Preference for weekly home collection by channel and frequency of payment preferences



Base: 1,107 home credit users (UK nationally representative sample).

Figure 3: Preference for agent collection of repayments by length of time as home credit users



Base: 1,107 home credit users (UK nationally representative sample).

part of a range of credit options and borrowing for discretionary purposes rather than for necessities. This would be a potentially desirable customer segment for a new lender to gain but, by definition, could be harder to attract.

Flexible approach to missed/late payments
A flexible approach to payment difficulties is also crucial in making repayments affordable for people on low incomes with missed or late payments not incurring a default charge or interest penalty, which would further disrupt already very tight budgets. A

high proportion of home credit customers rely on this flexibility to help them make ends meet and manage the peaks and troughs in their income.

Two thirds of home credit customers say they use the product because of the understanding approach shown to payment problems. Six in ten customers have missed or made late payments on loans, primarily because their income is insufficient to cover outgoings, or because of an unexpected bill or expense. In this context, any additional charge would disrupt already very precarious budgets and could seriously jeopardise the likelihood of a loan being recovered.

Trusted, reputable lender

Another key component of the demand for credit among people on low incomes and home credit customers, in particular, is for a reputable lender. Secondary analysis of in-depth interviews with people on low incomes, and other research on the topic (Rowlingson and Kempson, 1994; Collard and Kempson, 2005; Brooker and Whyley, 2005), show that this requires lenders to be familiar and deemed to be trustworthy. It is also important that they are perceived to understand the needs of people on low incomes and be able to understand their circumstances without judging them. This combination is necessary for customers to feel comfortable asking for loans and being honest about their ability to repay. It also enables them to assess, with a reasonable degree of confidence, their likelihood of getting a loan.

In this context, it could be difficult for a new – and unknown - lender to attract customers, even if its product is well designed and delivered. Branding and marketing will be crucial in building familiarity and establishing a new lender as trustworthy. The agent network, as representatives of the lender, will also be vital in establishing trust and familiarity.

How likely are people to use a new provider of doorstep loans?

As the evidence above indicates, demand for a new doorstep lending product is likely to be highest and most consistent among existing home credit customers, looking for a home credit-type product. How likely is it that these customers will use a new provider instead of, or in addition to, their existing lender(s)?

Use of multiple credit sources

Many people on low incomes already use multiple sources of credit – formal and informal, commercial and non-commercial. For most, home credit is used as part of a portfolio of credit options, rather than a last resort. People on low incomes who had used home credit in the previous two years had also used a range of mainstream and sub-prime credit products, including mail order, shopping vouchers, credit cards, Social Fund loans, hire purchase and pawnbrokers (see Figure 4).

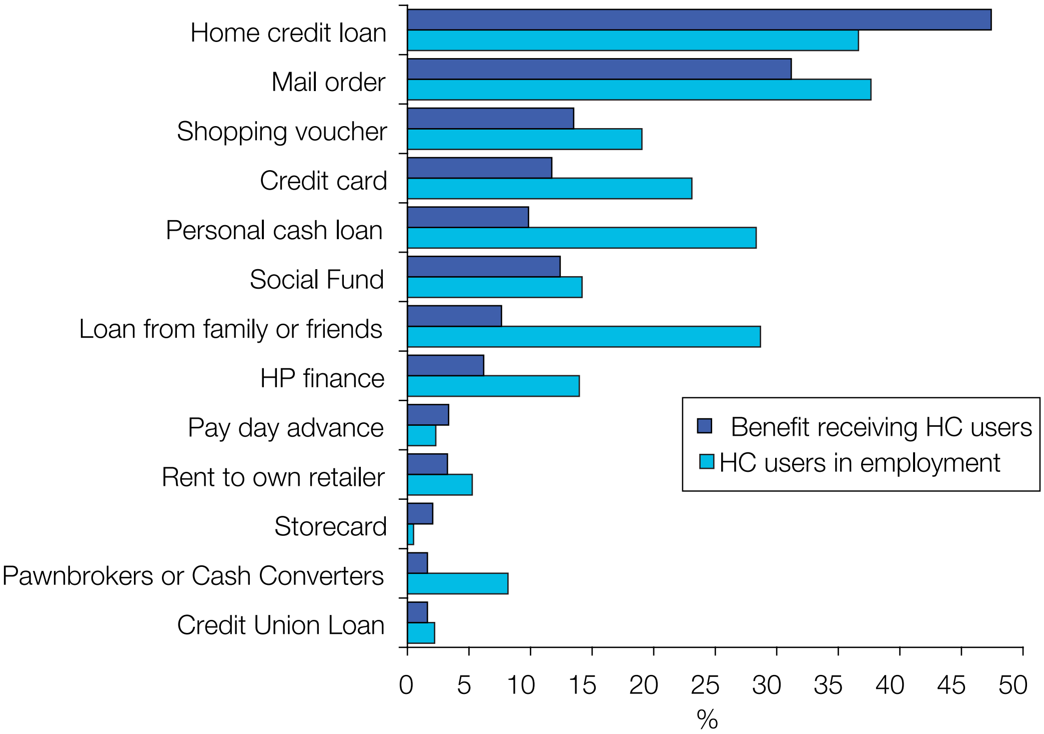
Some of those taking out home credit loans were also still using other types of credit, including loans from other home credit companies, at the same time (see Figure 5). Mail order was, by far, the most common form of credit to be used alongside home credit, used by around one in eight people at the time they took out their last home credit loan. Just over one in twenty people already had a loan with another home credit company at the time they took out their last loan.

In addition, most home credit customers felt that their access to credit was relatively unconstrained (see Figure 6). More than half believed they would be able to get credit elsewhere, and simply used home credit because they liked it. Nearly seven in ten believed they could easily borrow from another home credit company.

Shopping around for credit

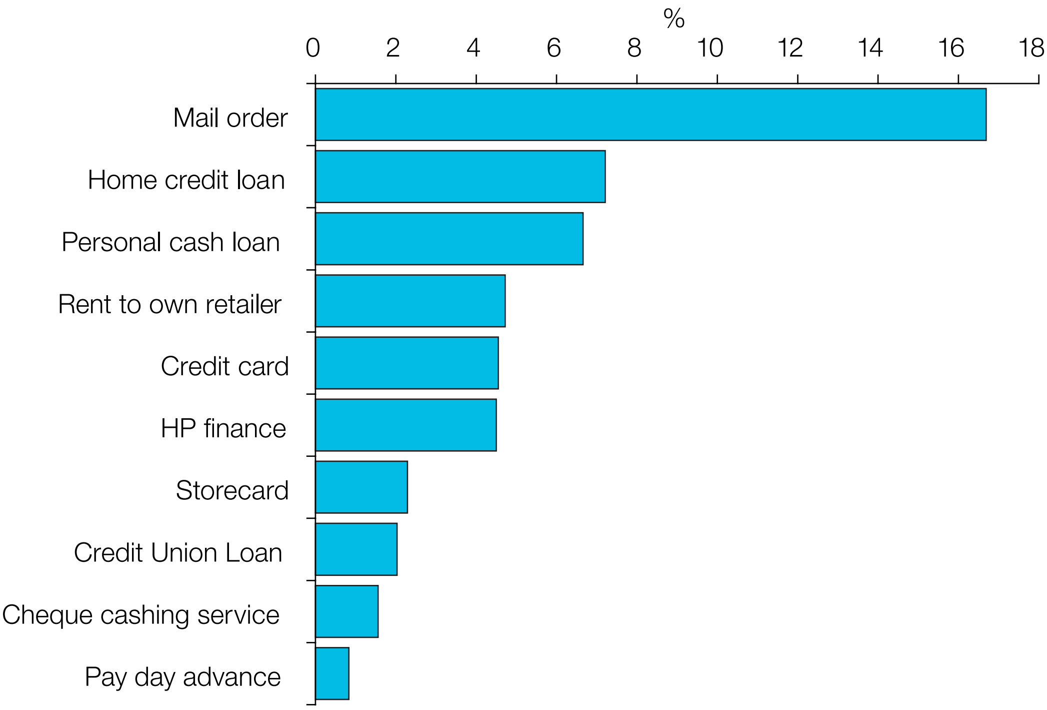
Despite this, it seems that few people actively shop around between lenders at the time they are taking out a home credit loan. Just one in ten customers considered other lenders at the time they took out their last loan (see Figure 7). Where shopping around does occur it may be driven by negative rather than positive factors. Customers who shopped around were more likely to have payment problems than those who did not. In addition, they also tended to be more 'credit hungry'. More than eight in ten customers who considered other lenders at the time of their last loan were those who took out a new loan as soon as they had repaid one (see Figure 8).

Figure 4: Use of mainstream and sub-prime credit products in last two years by people on low incomes



Base: 1,107 home credit users (UK nationally representative sample)

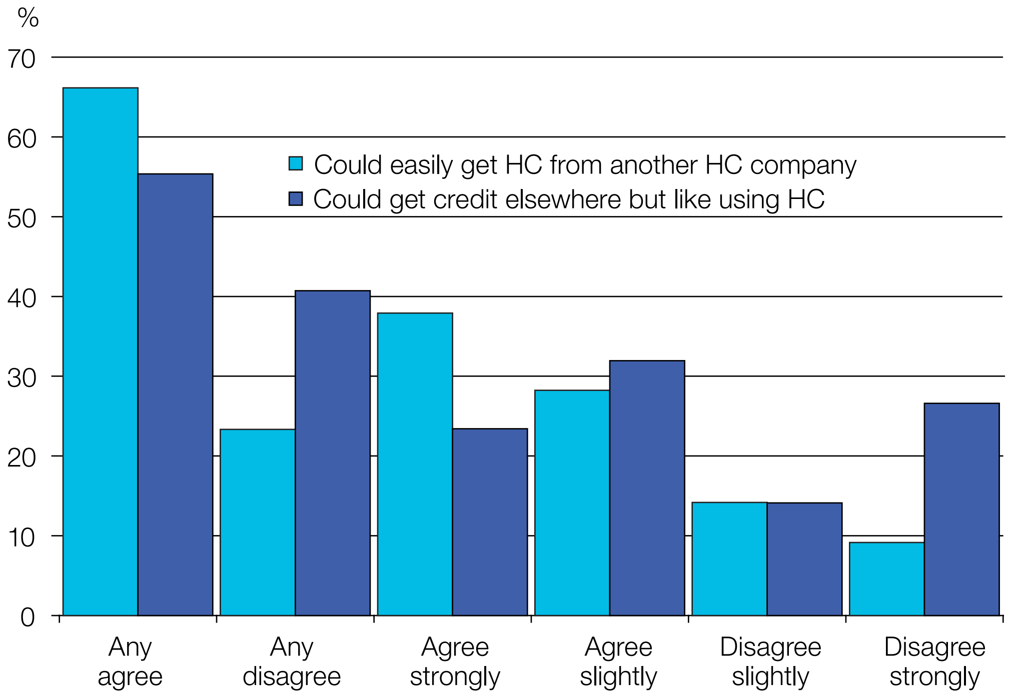
Figure 5: Other types of credit being used when last home credit loan taken out



Base: 150 home credit users (UK nationally representative sample).

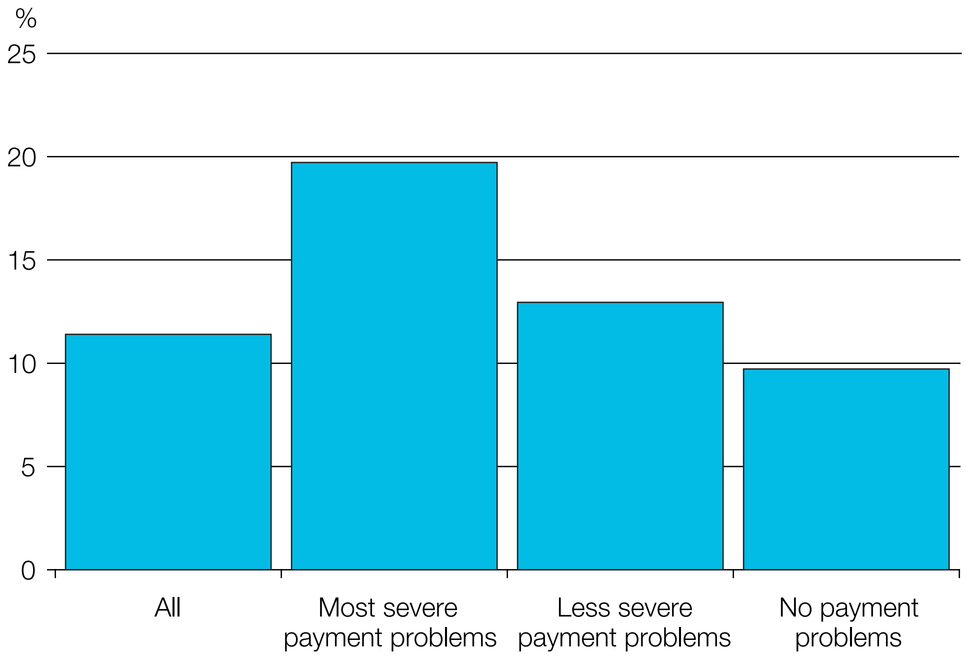
Shopping around is also associated with a small group of customers who are less wedded to the traditional home credit product, looking for higher-value loans and express a preference for less frequent, remote repayment methods (see Figure 9). Nearly a quarter of customers whose preferred payment method was direct debit had considered other lenders when they took out their last loan,

Figure 6: Home credit customers' perceptions of their ability to get credit elsewhere



Base: 150 home credit users (UK nationally representative sample).

Figure 7: Whether considered more than one lender for last home credit loan by home credit repayment history

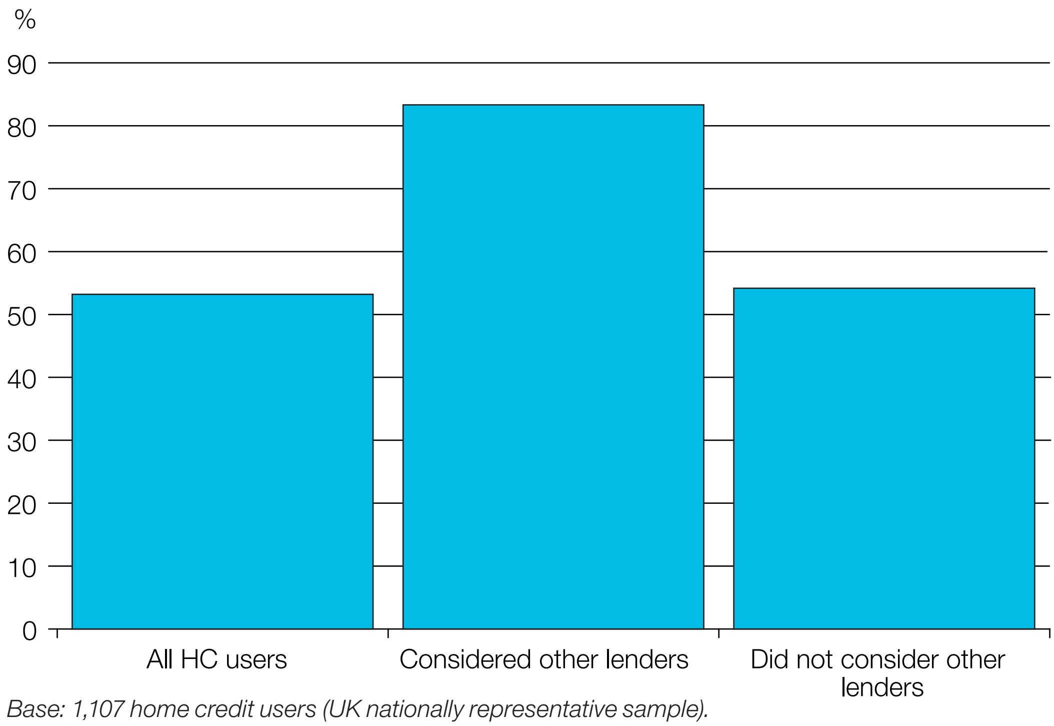


Base: 1,107 home credit users (UK nationally representative sample).

as had one in five people looking to borrow £500 or more, and a similar proportion of those who preferred monthly repayments.

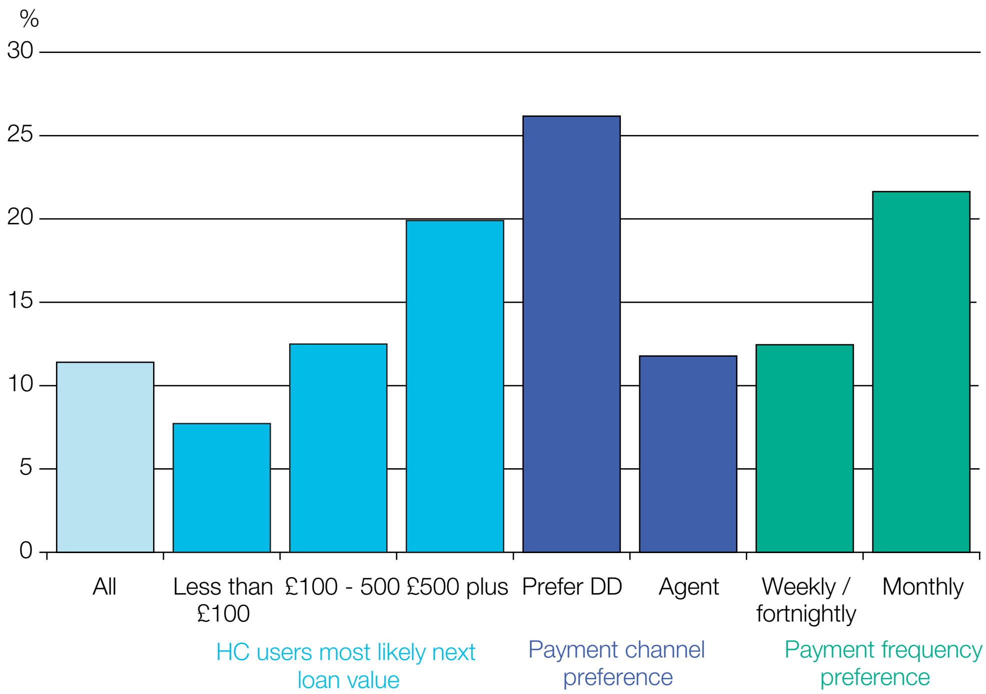
Multiple use of home credit companies
Around four in ten customers used more than one home credit company at the same time. Again, however, this is more often driven by a need to maximise their access to credit, than by a desire to get the best deal.

Figure 8: Home credit customers who usually renew/take on a new loan as soon as one finishes by whether considered other lenders for their loan



Base: 1,107 home credit users (UK nationally representative sample).

Figure 9: Whether considered more than one lender for last home credit loan by borrower preferences

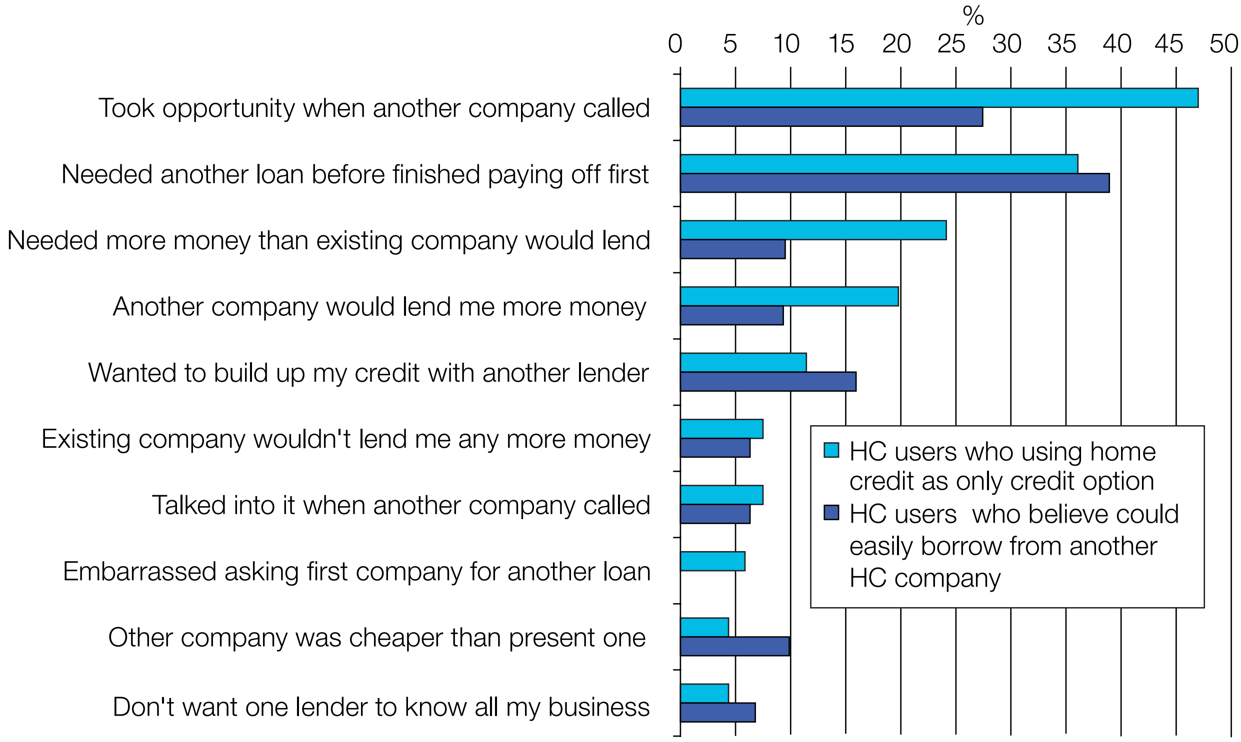


Base: 1,107 home credit users (UK nationally representative sample).

Many of the reasons given for multiple home credit use related to the need for further borrowing before an existing loan is repaid; needing to borrow more than a single lender was prepared to advance; being refused further credit by an existing lender; and reluctance to ask for a further loan with the same lender (see Figure 10). While these customers may be fairly easy to attract to a new lender, they represent a relatively high-risk customer base.

There are, however, some grounds for optimism regarding the likelihood of a new lender picking up business among existing home credit customers.

Figure 10: Reasons given for using more than one home credit company



Base: 150 home credit users (from a UK nationally representative sample of 1,441 people on low incomes).

Some multiple home credit use appears to be motivated by more positive factors. One in ten had used more than one company because they wanted to build up their credit history with other lenders; around one in twelve did so because another company was cheaper; and a similar proportion did not want any one company to know all their business. Although they are a minority, these customers may be attracted to a new lender by lower prices, or to increase their access to credit in the future.

In addition, one in three people who had used more than one home credit company at the same time had done so opportunistically, because a new lender had called round. A very small proportion, around one in twenty-five, had been talked into taking out a loan with a new lender. This suggests that a new lender could pick up business from an extensive and proactive campaign of doorstep canvassing, especially if they adopted very persuasive sales tactics. This may not, however, be consistent with the ethos of a not-for-profit doorstep lender.

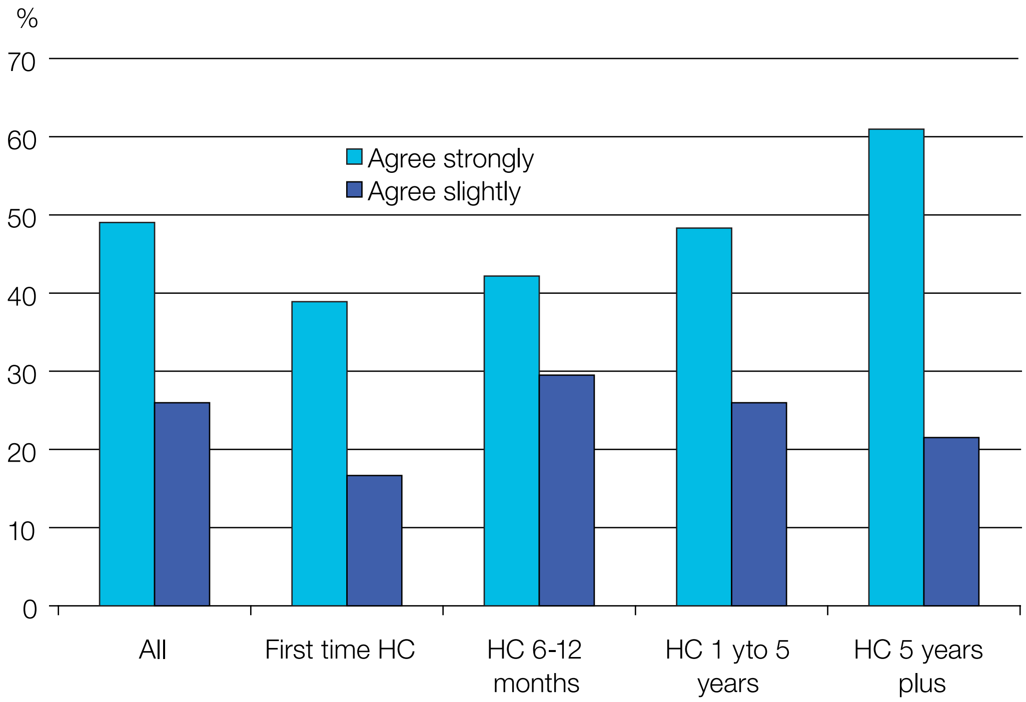
Barriers to using a new lender

Two important barriers will make it harder for a new doorstep lender to attract customers away from existing lenders: first, the close relationship between home credit customers and their agent; second, high levels of satisfaction with existing lenders.

Nearly half of home credit customers strongly agreed that they regarded their agent as a personal friend (see Figure 11). This increased with the length of time the customer had been with the company, rising to six in ten customers of five years or more. It seems reasonable to assume that this sense of friendship might reduce the likelihood of customers leaving their existing home credit company altogether. It may not, however, be a significant barrier to them using a new lender in addition to their existing company. More than four in ten customers who considered other lenders at the time of their last loan agreed strongly that they saw their agent as a personal friend.

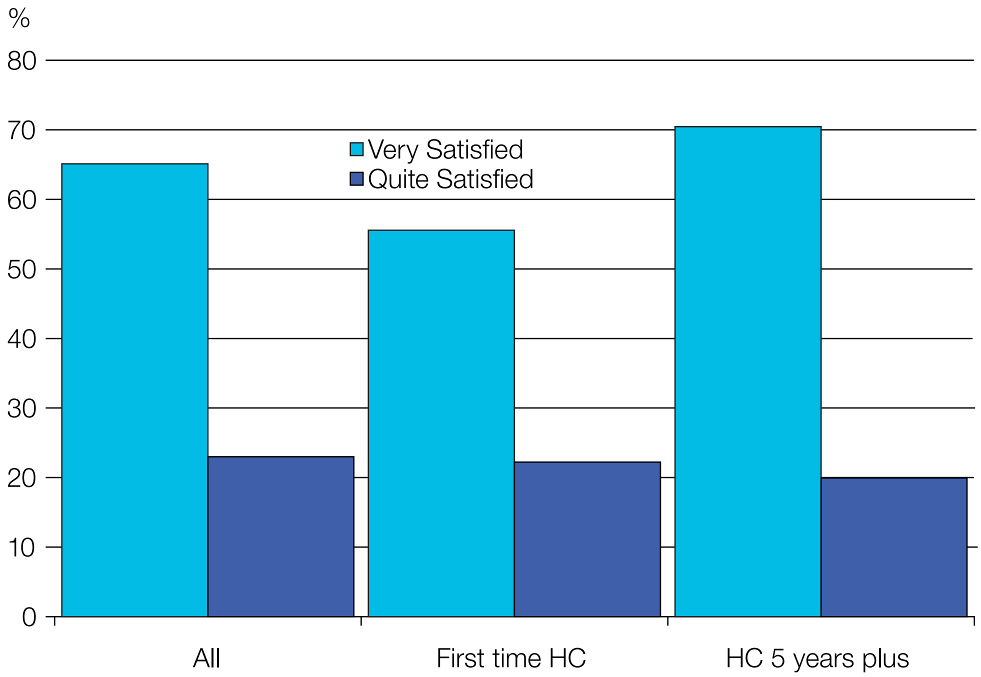
Customers of home credit companies also show high levels of satisfaction with the service they receive. Two thirds of customers were very satisfied with the overall service, increasing to seven in ten customers of five years or more (see Figure 12). Levels of satisfaction varied little between those who had experienced payment problems and those who had not (see Figure 13).

Figure 11: Customers who regard their agent as a personal friend by length of time they have been a customer



Base: 1,107 home credit users (UK nationally representative sample).

Figure 12: Overall satisfaction with home credit by length of time they have been a customer



Base: 1,107 home credit users (UK nationally representative sample).

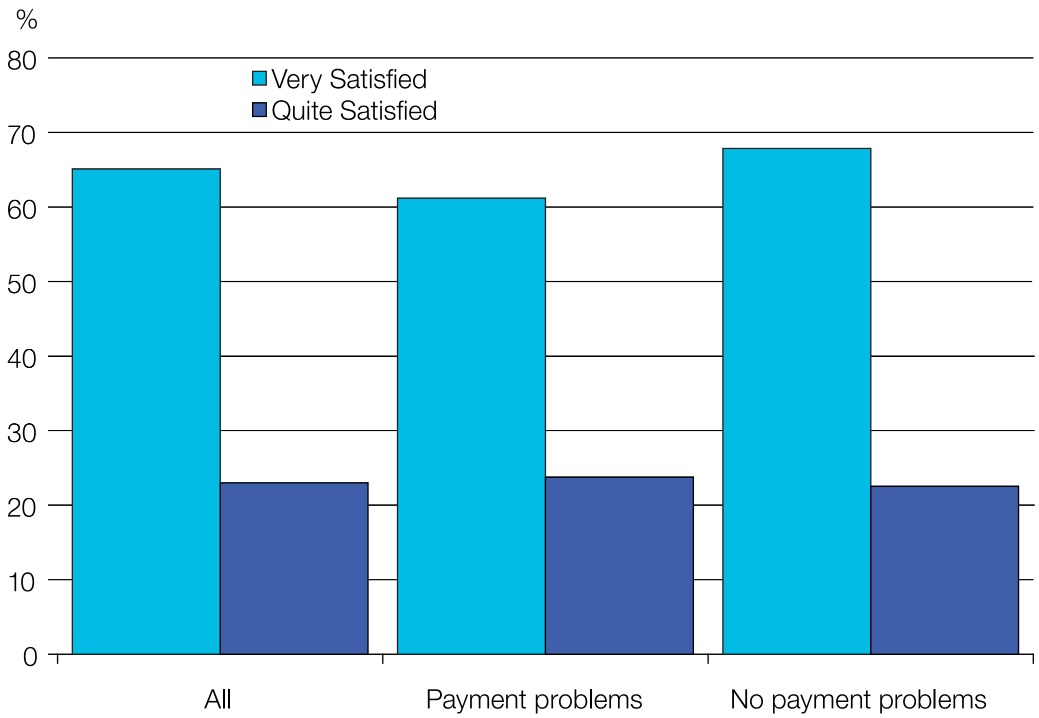
What are the risks of adverse selection?

The success of a new doorstep lender will rely heavily on its ability to manage the risks of adverse selection among its customer base, especially in the early days. The evidence suggests that there is a real danger of adverse selection in this market.

The type of customers most likely to be attracted to a new lender will be those who are:

- newer to home credit, who have not yet built up a strong relationship with their current lender;
- ‘credit hungry’ and continually in the market for new loans, regardless of the lender;

Figure 13: Overall satisfaction with home credit by payment record



Base: 1,107 home credit users (UK nationally representative sample).

- not recruited by an agent and, therefore, have not built up high levels of loyalty to their agent.

These customers are, however, the ones who are most likely to have payment problems (see Figures 14 and 15). Almost eight in ten first-time home credit customers had payment problems, compared with an overall average of four in ten. Three quarters of customers who were more or less continually in the market had problems with repayments.

What does this mean for customer recruitment?

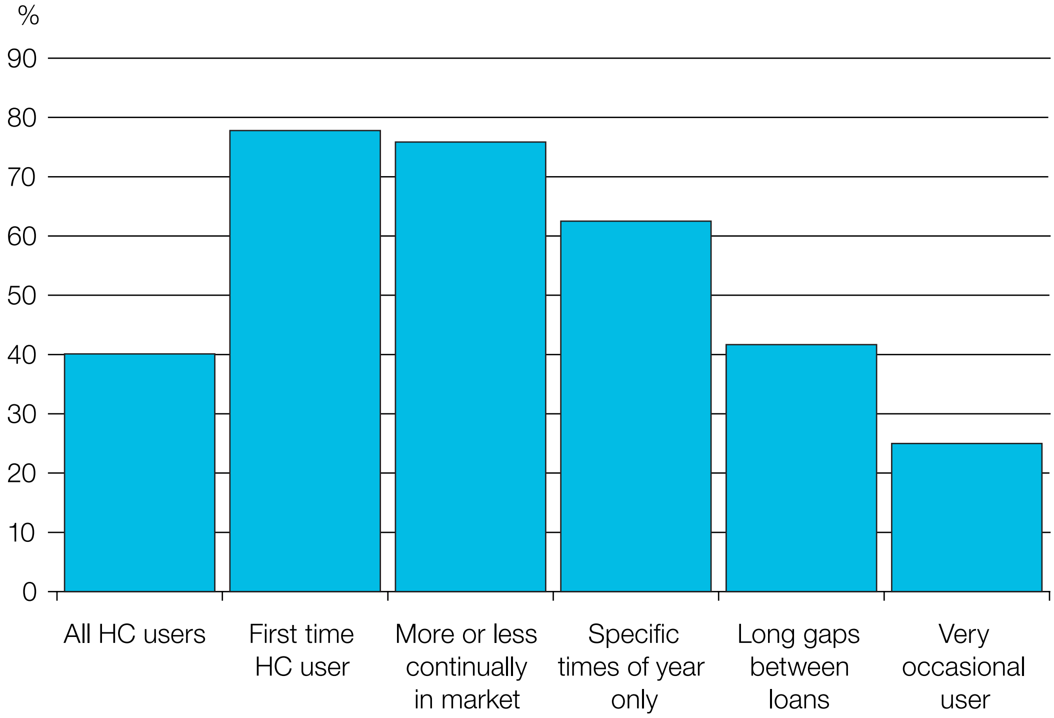
The risks of adverse selection make a new lender's ability to segment demand and select its customers accordingly an essential component of success.

Cluster analysis of existing home credit customers, using variables such as loan values; extent to which they are continually in the market; availability and use of alternative credit options; affinity with the traditional home credit model; payment history; and likelihood of using a new supplier, indicates the existence of five broad customer categories (see Table 1).

From a customer perspective, then, a realistic, commercial-style business model for not-for-profit home credit would need to take into account the following factors:

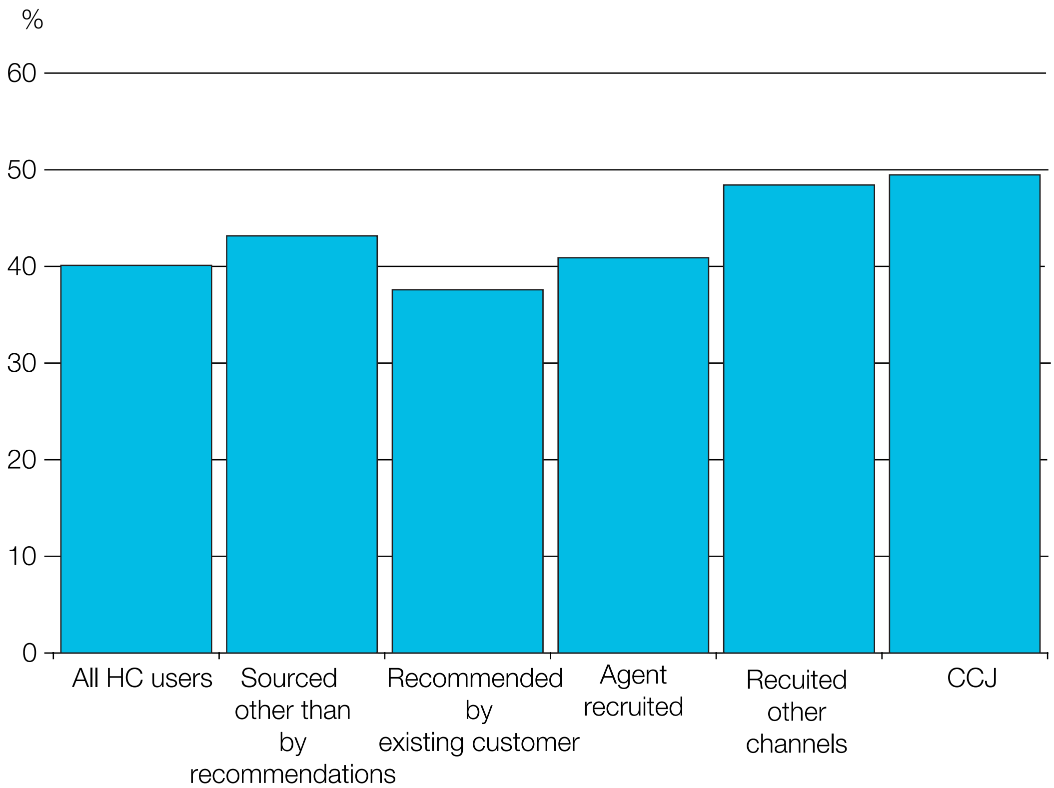
- the relative risk profiles of its potential customers;
- the extent to which different types of customer would need to be managed to minimise the risk of payment problems;
- the potential for transitioning some customer groups to cheaper, remote payment channels;
- the price that would need to be charged to accommodate the different degrees of customer management; and
- the degree of subsidy that different customer groups would require.

Figure 14: Payment problems within last six months by frequency of home credit use



Base: 1,107 home credit users (UK nationally representative sample).

Figure 15: Payment problems within last six months by source of new business



Base: 1,107 home credit users (UK nationally representative sample). [what does CCJ stand for?]

Table 1: Categories of home credit customers

	% of market	Characteristics
Residual in-work product migrators	6	• part of home credit traditional customer base but most have now left the market • more affluent and secure than other home credit users • use other forms of credit, home credit no longer first choice • strong affinity with remote channels of recruitment and monthly direct debit • low incidence of payment problems
In-work credit impaired sector entrants	19	• more affluent than other home credit users but not as stable as migrators (above) • access to other types of credit, relatively heavy credit users • likely to have recent credit refusals due to impaired credit history • strong preference for remote recruitment channels and direct debit • significant minority experience payment problems
Traditional home credit payment strugglers	17	• largely benefit receiving women with families • more disadvantaged than other home credit users • payment problems endemic • heavily dependent on home collection • more frequent and continuous users • less likely to have other credit options
Traditional home credit quality payers	43	• mainly long-term benefit receiving women with families • more capable money managers than strugglers (above) • regular payers • prefer weekly collection of repayments • few other credit options
Male cross-sector credit strugglers	10	• more likely to be in work and home-owners • have used a variety of credit products and had payment problems • significant minority have ongoing payment problems • strong preference for weekly home collection despite being in work

3 Market research with commercial home credit lenders

Despite the large increase in consumer borrowing generally, the home credit market is 'ultra-mature' and facing fierce competition from new forms of sub-prime credit. Traditional home credit companies are, themselves, strategically diversifying, with some withdrawing from the supply of home credit *per se.* Smaller lenders are shifting to longer-term, lower-cost, higher-value loans, while the larger ones are developing risk management systems, diversifying into products (remote loans, secured lending, sub-prime credit cards, sub-prime mortgages) that involve electronic payments. Some have also expanded internationally.

Consequently, recent years have seen only limited growth in the overall sums of money lent in the form of home credit and customer numbers have been in gradual decline. In the wake of the credit crunch and tighter lending conditions in the mainstream market, however, customer numbers have begun to increase, primarily because of the entry or re-entry to the market of customer types now facing refusals by mainstream and sub-prime lenders The customer profile has also changed in recent years with the effect that the core demand for home credit has increasingly been concentrated in groups who are most difficult and resource-intensive to serve, as the 'top end' of the customer base (better payers who are generally also better off) has migrated to other credit products in the sub-prime market. This effect is to some extent being moderated under current conditions by the influx of credit-impaired borrowers now unable to borrow in the mainstream market.

> *"It's becoming more hard core, more concentrated … We've got full employment, all these things the government have been doing are working … so those who are left are more difficult to serve than they have ever been."*

All those we interviewed said that that the traditional home credit model is getting more difficult to sustain as the potential for cross-subsidy becomes eroded. Not only is the market shrinking, as a consequence of external market forces, but the business environment has become significantly tougher, and is likely to become more so.

> *"It's much tougher to do business and you need a set of skills and an experience of lending in this environment that is just completely different to lending in any other part of the market."*

Interviewees believed that pressure on margins arising from remedies imposed following the Competition Commission home credit inquiry would accelerate existing trends, particularly withdrawal from high-risk borrowers. They are finding it more difficult to find good home credit customers and more critical to make good lending decisions. They are, therefore, developing systems that enable them to segment the potential customer base and focus on the most profitable customers, while declining applications from marginal or loss-making ones. Even so, cross-subsidy, which is central to the home credit model, is becoming seriously undermined; leading some of those we interviewed to believe that it is no longer sustainable.

Since the interviews were held, the so-called 'credit crunch' has begun to have an effect. This has resulted in a tightening of lending by prime lenders, which appears to be creating increased demand in the home credit market.[2] These 'new' customers will almost certainly be at the lower end of the risk profile of home credit companies and it remains to be seen whether they will accelerate the decline in lending to high-risk customers just described or reverse the trend by providing a wider risk pool for cross-subsidy. So far, however, home credit lenders have responded to the new conditions by tightening lending criteria for existing customers, resulting in higher refusal rates within the existing customer base. This suggests that, overall, the lenders are seeking to move upmarket as they gain greater access to new customer types now facing rejections by other lenders. If so, this would seem to imply that the highest-risk home credit customers will find it more difficult to source the credit they need, and may start to use illegal lenders.

The key elements of the home credit model

Lenders were united in their view that, as home credit is based on extensive experience of customer need and behaviour, it is not possible to unpack and separate the key elements and still have a viable business.

Home collection is an essential element. Customers who want, and are able to sustain, other methods of payment have largely migrated to other products. Consequently, surveys have shown that seven in ten home credit customers say they use this form of credit because they find it easier to manage when their payments are collected. Lenders estimated that no more than five to ten per cent of the core of existing customers could be served by remote channels. In this context, the agent force is crucial – a point that is elaborated below.

A single price, underpinned by cross-subsidy is also vital, with cross-subsidy occurring both between customers:

> *"This is about charging sufficient so that the bad customers are paid for by the good. That is the basis of home collected credit. If you take that away, the people who want – who need – your product most are disenfranchised. You've got to have cross-subsidy for it to work."*

and over an individual customer's life cycle.

> *"Customers come in and out of being subsidised. A customer who has been cross-subsidised at one stage of the cycle will be cross-subsidising someone else at another stage of the cycle."*

They also believe that flexibility with regard to payment and debt recovery in cases of 'can't pays' is an essential ingredient and key to the appeal of home credit to its users. Missed and partial payments are endemic to home credit customers. Customer surveys show that six in ten customers admitted to having missed or made late payments on loans (primarily because of low incomes and unexpected demands). Information from the three largest lenders, however, indicates a rather higher level of default. Around one third of all payments are missed each week, and across the full term of all loans, these three lenders reported a range of:

- between 2 and 10 per cent of loans repaid on time and to contract terms;
- between 8 and 20 per cent of loans that involve one in ten missed payments;
- between 34 and 48 per cent that have up to half of payments missed;
- between 29 and 44 per cent that have more than half of payments missed; and
- between 1 and 6 per cent that have no payments made at all.

A common definition of a 'quality' customer, who lenders are happy to re-serve, is someone who makes 60 per cent of their repayments on time. In this context, flexibility and forbearance is very important.

> *"If it wasn't flexible you wouldn't be able to collect that debt because the fact is that even though half of the people don't make half of their payments as they are contracted to do, very few people don't actually pay off their debt in the end."*

New business acquisition is a major challenge

Given the competition for 'quality' customers, it is not altogether surprising that levels of customer churn are high and increasing. The level varies between companies but averages between 25 and 35 per cent of the customer base per year for larger lenders. Half of this customer loss is effectively written off, but the other half lenders would like to have retained. There is, therefore, a constant need to acquire new customers. Agent referrals and recommendations from existing customers are the key source of quality new business but both are shrinking.

> *"An agent is always going to be the best. They are not going to recommend someone who they are not going to be able to collect from because you don't want to lend what you can't collect."*

Traditionally, almost all new business has come through these routes, but they now account for between 50 and 70 per cent of new business, depending on the lender. Consequently, other recruitment methods (canvassing and/or use of remote channels) have to be used, at an average cost of £100 to £200 per customer. Canvassing has been the traditional way of recruitment when building up new rounds. Third-party canvassers either sell low-priced items on credit in the customer's home or, more commonly, offer low-value shopping vouchers (typically £50) and sell on the loan to the home credit company. These methods are, however, used less now than they were in the past. The focus is increasingly on using in direct and remote recruitment channels. For one large lender, such channels now account for more than a third of all new business.

All the lenders we interviewed stressed that lack of demand is not a problem, but finding customers who can and will repay the money owed is an important consideration.

> *"There's no problem lending money. We've never faced a shortage of demand for our services. The challenge is not overlending to the customers you've got and not taking on too many new ones who are not going to pay you back."*

Consequently, most of the larger companies have invested in some form of credit scoring and rates of refusals vary between 50 and 80 per cent, but can be as high as 90 per cent for smaller lenders and sole traders and for new business acquired through remote channels. Even so, customers recruited through remote channels and canvassing exhibit a higher incidence of collection problems and bad debt than those acquired on agent or customer recommendation.

> *"Of all new business we get in, only about half would we be happy to reserve … That's much lower on direct response, even given the higher refusal rates and credit checking."*

> *"[Referring to canvassing] you will only get a third of these people who you put on will be good customers, a third will pay you but won't turn out to be very good customers and a third won't pay at all."*

Agents feel they have less 'ownership' of customers acquired in these ways and, in turn, customers feel less commitment to the agent. They are, therefore, less likely to develop long-term relationships with the lender. Only 30 to 40 per cent of customers recruited through canvassing take out a subsequent loan and bad debt is high as canvassers are concerned only to make a sale and, unlike agents, not with the need to collect the money owed. Customers recruited remotely also often have a poor geographic fit and, consequently, dilute round density and agent efficiency (the importance of round density is discussed below).

This has major implications for a new entrant to the home credit business.

> *"Bad debt is huge on new rounds. New rounds unfortunately don't come packaged with a load of good customers. That's where trial and error comes in. That's where all the cost is … Each good new customer you put on you'll be serving for some years, has probably cost you somewhere between £100 and £200 to acquire."*

> *"If you look at the people in this business who have got into trouble, it was because they expanded too quickly."*

Retention of 'quality' customers

Against this backdrop, retention of 'quality' customers is essential. Retained customers can remain with a company for many years, with a significant minority of them borrowing continually over that time. The average length of customer relationships is seven years and about four in ten take out a new loan either before they have repaid their existing one or as soon as all the repayments have been made. On average, customers take out 2.3 loans per year.

Lenders are circumspect about the amounts they will lend, and a new customer can usually only expect a small sum initially.

> *"The whole business is to give people a tiny little transaction … you have a little nibble to see if they are any good and if they are, you step it up…"*

Loan values therefore reflect both the customer's circumstances and their repayment record. The average loan to a new customer is about £50; established customers are lent about £280; while 'quality' customers can expect to borrow £325 on average. Loans to customers who are receiving means-tested benefits average £220; those to people in employment are somewhat higher at £350. When set against the costs of recruitment, it is clear why customer retention and repeat loans are so important to the home credit model and why lenders take a long-term view on the profitability of customers.

But even here there are pitfalls as repeat customers tend to be those who are less well off. As we noted above, flexibility over repayments is, therefore, essential to their retention.

> *"You keep your customers a long time in this business … People are poor a long time too, and when you're skint, you're bound to have crises. These people aren't feckless. Their problem is just that they haven't got any money and no prospect of getting any any time soon. So in those cases you bend with the customer."*

> *"… a customer who is wanting to pay you but their circumstances are causing difficulty … you want to retain because this business has longevity. That customer may be with you for five, ten, fifteen or even twenty five years. So if you help them through today's problem, they may become a very worthwhile customer in quite a short period of time."*

Home credit agents

All but the smallest firms rely on agents, who are usually self-employed and remunerated primarily on collections; approximately 15 per cent of their income is commission on sales; the bulk (85 per cent) is based on collection. Rates of commission vary between lenders but average about 8 per cent of the sums collected. The commission structure includes incentives to collect part payments (rather than none) and to collect arrears. Lenders stressed that this performance-related remuneration is key to the control of bad debt.

> *"… they know that if they collect in full from this house it is going to be worth 75p to them. That's what they're thinking about. So any discussion that goes on about paying or not paying, or paying less – whatever – impinges on that 75p. It is not so much of their income that they can't afford to say 'OK, I understand that you can't afford to pay this week and I'll go away'. But they wouldn't want to do that on ten consecutive calls … If you take that away, you will have very significant credit control problems."*

Agents are overwhelmingly female, most have young children and their circumstances are similar to those of their customers. The great majority work part time, juggling employment with childcare and school hours; only 5 to 10 per cent work full time.

On average they have 130 customers in their round; a round of 200 to 300 customers would be considered large. To provide an adequate income they typically aim to serve between six and ten customers an hour. Round density is, therefore, a critical factor in determining both an agent's effectiveness and their income, as it minimises the distances walked (or driven) between customers and their ability to service higher-risk borrowers, who may require several repeat visits before any payment is collected.

Agent behaviour is conservative and notoriously difficult to influence and this increases the more experienced the agent is. They are reluctant to take on or collect from customers they have not recruited themselves. They are also conservative in the amounts of money they are prepared to lend.

Efforts to encourage new customer acquisition and develop larger rounds have failed historically, as this compromises agents' work/life balance. They have also been largely resistant to efforts to promote cross-sales.

> *"They work to the level of income they want and no more … they'd rather have 100 customers paying them £10 than 200 customers paying them £5 and they like them to live close together. They work hard for their money but they don't want to work harder than it takes."*

Good agents are critical to the home credit model

As we noted at several points above, good agents are critical to a successful home credit business in a number of important ways. They are the best method of recruiting new customers and a key source of repeat business. The detailed knowledge they have of their customers is an important input to lending decisions, including whether to lend at all and, if so, how much to lend. They build a rapport and personal commitment with customers that is reflected in a commitment to pay. And the discipline of their weekly collection visits makes borrowing manageable for many borrowers and, without persistent visits from agents to people in default, a significant proportion of the money lent would not be collectable.

It is not surprising, therefore, that agents also represent a major cost to home credit companies. Their commission alone accounts for 30 per cent of the total cost of a loan.

But what makes a good agent – what skills do companies look for when they are recruiting? A good agent fits into the community they serve; they have the ability to mix easily with people in a wide range of circumstances, are non-judgemental and 'street-wise', but have the ability to maintain a distance from their customers.

> *"You have to be a certain type of person; the sort of person who is comfortable in communities in which we lend. Agents are quite tough. You have to be credible. They have to believe you and a lot of that is based on trust. Agents are people you meet in the supermarket."*

They are self-motivated, have strong people and communication skills and good observational abilities. They have a consistency of approach that is firm but fair and are persistent when customers are late with payments or trying to avoid payment altogether.

> *"It's not necessarily 'Come on in and have a cup of tea'. It's being told 'I'm not going to pay you this week'. You've got to have a certain type of mentality to be prepared to do that week-in week-out and not many people would have the stomach for it."*

They are professional, unflappable and have a maturity of outlook. And added to all this they need to be numerate.

Recruiting agents with the right qualities is, therefore, challenging but key to running a successful business.

So, too, is retention of good agents. Agent turnover is high, at 20 to 50 per cent annually. Many leave within the first six months but those who stay, do so for a long period of time; on average, agents of the larger companies have seven years' experience. And, with experience, comes better lending decisions and higher levels of collection.

Agents rarely leave good rounds, so in an established business, new agents are usually faced with either new or underperforming rounds. Lenders indicated that the business transacted by an agent with more than five years' experience can be three times more profitable than that of a new recruit. Indeed, new agents' business is usually loss-making for the first two to three years, although this can be longer.

Consequently, new agents and new rounds require subsidy. Even when a new agent takes over an established round, collections and sales fall, and lending quality suffers.

> *"There's always going to be a period of testing the water with a new agent, see what you can get away with, pushing the limits and your collections will suffer and bad debt can go through the roof."*

> *"The big problem for the inexperienced agent is less about collecting and more about lending, because the inexperienced agent is going to be pestered by the customer for more money. They have to develop techniques for saying 'no' without turning the relationship sour. That's a big challenge."*

New agents are, therefore, more dependent on systems and controls, particularly for bad debt management; while longstanding agents are more autonomous. Even so, only some of the risks can be moderated by the development of systems to support lending decisions and payment collection.

Where agent turnover on a round is high, companies have found that it is often cheaper to close it down altogether than to pass it to a new agent.

> *"You cannot get a seasoned agent to take on a new round or a round where there has been a lot of grief and maybe a succession of agents in there … we've had better success … just closing it down and taking the hit."*

Safety and fraud

The lenders interviewed saw agent safety as an important concern, but it was not considered to be a major problem as they had learnt how to mitigate it. They recruit agents who are both streetwise and at home in the communities they serve. Safety is a significant component of the induction and training received by new agents and they are left to make their own decisions about safety and are never required to work in areas where they have safety concerns. Most agents will, therefore, avoid areas they consider unsafe and customers who exhibit antisocial behaviour.

> *"It's [safety] not a huge problem – not as much as people might think. The [agents], they know the areas, they're savvy. They know the yobbos and to stay clear. They wouldn't walk down a dark alley. They stay clear of the problem families in cul-de-sacs with speed bumps and a way in for the police and social services."*

There are procedures to minimise the amount of cash carried at any one time; round density also reduces this risk. Agents may be accompanied if they do, for some reason, need to collect in an area that is potentially dangerous, although this clearly affects profitability.

Likewise, fraud was not regarded as a major problem. It occurs only rarely and when it does, the lenders interviewed indicated that it is small-scale. This is in contrast to other credit providers who face a significant fraud problem and is entirely attributable to the way that home credit companies transact their business. Where it occurs, it generally involves agents creating phantom customers, although this also requires the collusion of the branch office if agents are supervised in this way. It is generally comparatively easy to identify. Recent changes in the industry have reduced fraud still further. These include the greater use of direct marketing and central communications with prospective customers and of credit reference agency checking.

4 The business models

The business model created for this project was intended to facilitate understanding of the likely costs, risks, funding requirements and potential consumer benefits associated with a not-for-profit home credit model. It was designed to illustrate the price that would have to be charged to make a not-for-profit home credit service viable and the way that various factors would interact. Finally, it was intended to demonstrate how all of the above would vary given different scenarios, different approaches and differing levels of efficiency and success.

It sought to pull together the key elements of the demand- and supply-side dynamics revealed by the research (reported in Chapters 2 and 3) and the considerations and dimensions specific to a not-for-profit business. This required the project team to make a number of assumptions about this business – such as the way it would operate, the likely target market, the proposition that would be put to customers, distribution channels, and service model. This chapter describes the assumptions underpinning the model and the outputs from it, given different scenarios and variations on these assumptions. It also discusses the implications of these outputs and the various issues they raise for a not-for-profit home credit business.

There were two major generations of the model developed. The first was created on the assumption that part of the rationale for developing a not-for-profit home credit model must be to transition as many borrowers as possible to cheaper channels. This envisaged that borrowers would be transferred to third sector lenders such as credit unions or CDFIs, and remote collection channels, having due regard for both user preference and payment track record. The second generation of the model was based rather on a stand-alone not-for-profit home credit business, with no effort made to transition better payers to an alternative credit model or other collection channels. This chapter describes these models, the thinking behind them and the key outputs. Against the background of the lack of appetite among credit unions and CDFIs for the concept, however, the emphasis within the chapter is on the stand-alone model. Comments from a variety of parties, including members of the Project Advisory Group, third sector lenders, commercial home credit lenders and others were taken on board in constructing the second generation model. To enable meaningful comparison of the two models (i.e. with and without transition of customers to a third sector lender), some of the changes made as a result of this feedback were also incorporated into the original model, so that in setting the outputs of the two models side by side, like is being compared with like.

The assumptions driving the models

The project team, supported by the Project Advisory Group, reached the view that a not-for-profit home credit service would need to share many of the core features of the commercial home credit model. On the one hand, this was because these features had significant appeal for customers. On the other, various elements of the commercial model appeared to be fundamental to the financial dynamics of the business. Perhaps the most important of these are the cross-subsidy between customer types implied by a fixed price and the inherent incentive for the agent to lend responsibly, by remunerating them in the form of commission, linked to effective repayment collection.

On this basis, the core assumptions underlying the business model were as follows:

- low-value loans over short terms (of a value similar to those offered by commercial lenders);
- single fixed price with no penalties for late or missed payments or an extended term;
- in-home collection on a weekly basis with a degree of flexibility around payment irregularity;

- agent force, paid solely by commission on collections made;
- limited debt recovery.

We also made a number of assumptions that were different from those of the commercial lenders in a number of important respects, reflecting the nature of a not-for-profit operation as a social business. Our original thinking was that a social home credit model would seek to transition customers to the third sector mainstream. The first set of models that we developed, and which we shared with the third sector lender participants in the study (see Chapter 5), were based on this premise. There was, however, a broad feeling among these lenders that setting up a not-for-profit home credit model would be a diversion at a critical time in the sector's development. Consequently, subsequent iterations of the model were developed, which did not rest on their participation. The second consideration was a view that it would be inappropriate to incentivise sales of new loans to existing customers. This remained a feature of both the first and second generations of the model. It was also hoped that a social model might have a competitive advantage in being able to draw on various social agencies and partnerships as introducers of new customers. This also was retained in the second generation model.

A risk-based approach to segmentation

It was decided to assume that the target market for the putative not-for-profit home credit model would be broadly equivalent to the customer base of the major commercial home credit lenders. As was discussed in Chapters 2 and 3, commercial home credit lenders face a degree of payment irregularity – late and missed payments – that is significantly higher than the third sector encounters currently.

The degree of risk being taken on by any lender is clearly a critical factor in the financial dynamics of the business. A risk-based segmentation was therefore constructed, which was broadly aligned with the risk profile of commercial home credit customers. This was based on some 16 different segments, eight of which were people not in work and eight of which were people in low-waged employment. A different degree of risk, expressed as the proportion of payments missed or not paid in full, was ascribed to each segment. The core segmentation is shown in Table 2.

This segmentation was one of the key drivers of the model, so that varying the mix of segments, for example to take in either more or fewer high-risk borrowers or a greater or smaller proportion of borrowers not in employment, would feed through into the model outputs and financial results. The segmentation and the central scenario did not, therefore, allow for lending to borrowers who would currently be unable to borrow even from existing commercial home credit lenders. A mechanism was, however, included to allow for varying degrees of adverse selection so that it was possible to take a view of how increasing the proportion of very high-risk borrowers would be likely to impact on the model outputs.

Average loan values and frequencies were ascribed to each segment, which were broadly in line with commercial market practice and experience, but adjusted downward to reflect the lack of sales incentives for agents. The terms over which monies due were collected, together with the degree of write-off, were calculated separately for each segment. These patterns of segment-level loan values, frequencies and repayment patterns

Table 2: The risk-based segmentation underpinning the business model

		Not in employment (%)	**In low-waged employment (%)**
	To contract terms	5	10
Quality payers	Miss 1 in 10 payments	20	10
	Miss/part pay 1 in 5 payments	15	25
Non-quality but acceptable	Miss/part pay 1 in 3 payments	10	15
Payers	Miss/part pay 1 in 2 payments	10	10
	Miss/part pay 2 in 3 payments	15	15
No re-serve and write-off	Miss 4 in 5 payments	15	10
	Don't pay	10	5
Total		100	100

applied only to established customers. For new business assumptions, see the following section.

New business, customer attrition and retention

New business is a major cost for the commercial home credit lenders, with new customers being given much smaller loans and being less likely to pay satisfactorily or, indeed, to repay at all. Customer churn is also high. Our core assumptions on new business and for customer churn and retention are intended to be in line with the commercial lenders' experience in the market as a whole, as follows.

- New business loans are assumed to average £50.
- It is assumed that:
  - a third of new business loans are paid satisfactorily and these customers continue to pay in a satisfactory way;
  - a third of new business loans are paid less than satisfactorily and these customers are not re-served;
  - a third of new business loans are written off.
- Customer churn each year is assumed to be 40 per cent.
- Average retained customer lifespan is assumed to be eight years.

The agent force

The quality and performance of the agent force is clearly not only one of the most critical factors in the likely success of any new home credit business, but also one of the major components of costs. Experienced agents, able to make effective judgements about customers' ability to repay their loans and with an established book of relationship business, deliver very significantly more profitable business than new recruits. Indeed, new recruits are likely to be unprofitable for a considerable period. Agent retention is therefore key to business performance.

Our assumptions in relation to the agent force were intended broadly to reflect the practice of the commercial market; agents were assumed to be paid on a commission basis on sums of money collected in repayments and commercial lenders' experience on the relative profitability of different agent types.

The initial iteration of the first generation model had taken insufficient account of the impact on agent effectiveness of two factors. First, we had taken insufficient account of the negative impact on agent retention of transitioning the better-risk customers to the third sector. Adjusting the original model to allow for a negative impact on agent motivation and retention resulted in an increase in the break-even annual percentage rate (APR) than had earlier been estimated. Second, we took the view that we had underestimated the relative inefficiency of a newly formed agent force compared to one that was long established. We therefore adjusted the collection performance downwards in the early years. We calculated improvements on a year-by-year basis, with the mix of new recruits and established agents calculated for each year and the relative experience of the agent force determining collection performance and business cash flow and profitability. Differences in the effectiveness of agent retention and in the quality of agents initially recruited feeds through to all of the model outputs in both generations of the model.

Our key assumptions in relation to the agent force were:

- Recruitment and training costs per agent would be, on average, £3,500 per head, in line with current commercial sector costs.
- There would be 40 per cent agent turnover.
- Agents with five years' experience are three times more profitable than new recruits.
- Average agent retention would be seven years.
- There would be 40 per cent attrition within the first year for new agents.

- Round density, round sizes and quality mix would be broadly in line with the commercial market:
  - average 130 (55 per cent of total);
  - small 80 (40 per cent of total);
  - large 500 (5 per cent of total).
- Eight customers would be served per hour.
- Remuneration would be commission-based, with commission on collections calibrated to provide agents with minimum target earnings of £10 per hour.

In the first generation model, agents were assumed to be run out of third sector lender branches, with agents run out of stand-alone branches in the second generation model.

Customer recruitment and payment channels
It was assumed that customer recruitment would rest on a mix of channels, including agent personal approach (30 per cent), direct response (20 per cent), customer referral (20 per cent) and competitor agent acquisition (10 per cent) plus local authority sponsorship, housing association referrals, partnership and community referrals, with none of the latter representing more than 5 per cent of new business.

Each channel was assumed to have both a direct cost (ranging from £30 to £150 per customer acquired, and averaging about £75) and also an impact on round density, which is itself a key factor in collection performance. So that customer and agent referrals were assumed to have a positive impact on round density, for direct response it would be negative. Different channels were also assumed to have different acceptance ratios, for example with refusals for direct response applicants assumed to be higher than for agent-recruited customers.

Payment collection in the first generation of the model was assumed to be a mix of home collection, direct debit, PayPoint and benefit deductions, with all customers assumed to be home collection in the first instance before being transitioned to other payment methods (see below). In the second generation of the model, all customers were assumed to be making payments via home collection, regardless of the channel through which they were recruited.

Transitioning borrowers to cheaper channels
The initial iteration of the first generation of the model saw some 40 per cent of customers, primarily the more reliable payers, being transitioned to credit unions and remote collection. The third sector lenders had concerns about serving even these more reliable customers, among whom patterns of late and missed payments were significantly worse than those of their customers currently. Mindful of their Financial Inclusion Growth Fund targets on bad debt and of the challenges they are already facing in expanding their services to take in higher-risk and financially excluded borrowers, third sector lenders were concerned about the potential for these new borrowers to destabilise their finances through an increase in bad debt. There were also fears that, even though borrowing from a not-for-profit lender should be more affordable, the payment quality of these customers could even decline further if not reinforced by home collection. This would restrict the potential for transitioning to cheaper payment methods. This was felt also to limit the potential for any subsidy of the higher-risk borrowers through savings made through serving the reliable borrowers more cheaply.

Other comments on the initial iteration of the first generation model led us to the view that insufficient allowance had, in any case, been made within it for the negative impact of the heightened risk profile of the residual customers either unwilling to move away from home collection or judged not suitable for transition to the credit union mainstream because of an uneven or poor payment record. Transitioning the best customers out of the home credit model was felt likely to have an effect beyond that simply associated with the increased risk profile of the residual customer base. Removal of some four in ten customers was thought likely to undermine the density and thus the financial viability of rounds, demotivating agents in the process. A greater reliance on new business as part of the mix within each round, combined with a higher proportion of less reliable payers among the established customer base, was also thought likely to move the payment profile of relatively established and stable rounds closer to that of new and more troubled rounds (both of which have lower collection performance and are less profitable). Taking these factors together, therefore, we concluded that the first generation of the model had underestimated the risk and performance impacts of transitioning the better-paying customers to credit unions. In revising the model, adjustments were thus made to it to take better account of these impacts. Unsurprisingly, these adjustments, which we judge to be more realistic, impact on both bad debt and the APR required to break even over ten years (see Table 3 later in this chapter). Transitioning was not, however, a feature of the second generation model.

Collection performance and bad debt
Collection performance and bad debt are a function of three factors: the segment profile of the customer base (and the pattern of missed and late payments associated with each), the balance of new to established business and the effectiveness of the agents both in making judgements on lending and in collecting repayments (both of which are a function of experience). The adjustments to the first generation model and those incorporated into the second generation model have greatest impact on the bad debt position in both cases. In both models the bad debt position is worsened by the more negative assumptions about the collection and lending effectiveness of a newly established agent force.

In the first generation model, which envisages transitioning the best payers into the mainstream lending of the third sector lender, this effect is further exacerbated by an increase in the balance of new to established home credit customers (caused by the need to replace the transitioned customers), by the heightened risk profile of the residual customers and by the effect of a decrease in the retention of agents arising from demotivation in the face of declining round density and the loss of their best customers.

In the second generation model, which does not seek to transition customers out of the model, these latter effects do not occur. However, while there is some cross-subsidy from the better home credit payers to the less reliable ones, there is none available from savings made by transfer of these borrowers to cheaper channels.

Assumptions on scale and structure
It was assumed that the home credit operation would require a degree of critical mass if it was to be viable. The first generation model assumed that it would be run from credit union/DFI premises and that only the largest lenders would be involved initially, with smaller ones developing the service in subsequent years as the concept was proven. Clearly, if the concept were to be adopted by the not-for-profit sector, it would be piloted.

As we wanted to understand the potential dynamics of a model that might be scaled, the service was assumed to be running in ten branches in year one, growing to 50 branches after five years and remaining at that level for the rest of the model's ten-year span. It was assumed that home credit customers would never be more than 20 per cent of the overall customer base of an individual provider, with a scaling factor also assumed for the sector over time. On the central scenario and associated assumptions, this resulted in a little under 20,000 home credit customers across all branches in year one, rising to around 300,000 by the end of the ten-year period.

The second generation model also assumed that scale would be critical to effective delivery. In this instance, however, we assumed that dedicated branches would not have the same constraints on the proportion of home credit customers relative to people paying in other ways and so could be larger while operating out of fewer centres. Overall, however, customer numbers and the scale of growth were assumed to be similar for both generations of model, with the second generation stand-alone operation also incurring substantial set-up costs, which did not arise in the same way, or to the same extent for the first generation model, which was assumed to run from existing third sector lender offices.

Model outputs

Break-even pricing and pricing relative to commercial home credit
The not-for-profit home credit model is assumed to be targeting a customer base that is broadly in line with that of the commercial lenders in the market. It also assumes a similar degree of efficiency, which might be challenging for a newly established provider. On the basis of the assumptions described above, including the adjustments to the initial model, a break-even APR of 129 per cent is suggested for the first generation model, which rested on transitioning some of the lower-risk borrowers to mainstream third sector lending. In the second generation of the model, where there is no such transition, the break-even APR falls to 123 per cent.

This would imply a total cost of credit per £100 lent of £50 for the second generation model, compared with £68 for the largest commercial provider in the market. For the average loan size within the model (£288) over a 56-week term, this would imply a total cost of credit of £145.14 compared with a cost with the same commercial lender of £195.80, with weekly payments being £7.73 and £8.65 respectively. This implies a saving to the consumer of a little over £50 on the total cost of the average loan – or a little under £1 per week – compared with borrowing from a commercial home credit lender (based on the current advertised APR of 183 per cent).

It should be noted that the assumption of 123 per cent APR being needed for overall break-even over a ten-year period does not allow for the cost of any funding required to reach a cash positive position nor of the cost of lending capital over that period. We have made the assumption that such an operation would be funded by some form of public subsidy or social business investment. If these costs were included, clearly the APR would need to be significantly higher. In the current climate, assumptions on the cost of capital are difficult to make. Even under more normal market conditions, however, such costs would significantly increase the APR quoted above.

Summary of the second generation model outputs central scenario
Table 3 shows the key financial outputs of the second generation model over ten years, based on the central scenario and assumptions. The model reaches overall break-even (i.e. covering all costs from its inception) after ten years, is cash positive (i.e. reaches annual break-even) by year five and requires funding of £18.5 million to achieve.

If costs were to be covered on a yearly basis from the outset, it would require an APR of 414 per cent to cover costs in the first year as it would include a major initial outlay for setting up a stand-alone operation. The APR would then fall gradually over time as the operation scales to the point where it would require an APR of 142 per cent by year five and 123 per cent by year ten. Bad debt is consistently high, being some 27 per cent even by year ten, and is considerably higher than the rate of 10 per cent that is the current target for third sector lending within the Financial Inclusion Growth Fund scheme.

The cost savings to the consumer switching from commercial to not-for-profit home credit total £52 million per annum by year ten. Individuals are presumed to be able to divert some of this to a modest cash savings pot, enabling average cash savings of around £92 per annum (see Table 4).

Table 3: Financial results of the model based on the central scenario

Central scenario at 123% APR					
Financials	Year 1	Year 2	Year 3	Year 5	Year 10
Total value loans advanced (£ million)	£8.6	£20.4	£35.2	£63.6	£158.2
Numbers of individual borrowers (000s)	20	40	67	114	285
Annual cash shortfall/surplus (£ million)	–£13.1	–£2.4	–£2.0	£0.6	£6.0
Rate needed to break even	414%	225%	175%	142%	123%
Value of uncollected receivables as % of advances	77%	77%	76%	74%	72%
Bad debt written off as % of advances	29%	29%	29%	28%	27%
Years to annual breakeven	4	3	2	0	0
Cumulative cash investment required	–£13.1	–£15.5	–£17.5	–£18.0	£0.0

Table 4: Social benefit outcomes of the model based on the central scenario

Central scenario at 123% APR					
Social policy outcomes	Year 1	Year 2	Year 3	Year 5	Year 10
Savings to consumer					
Savings made by borrowers on high-cost home credit (£ million)	£2.7	£6.5	£11.2	£20.6	£52.2
Potential cash savings built up (average £ per customer per annum)	£68	£80	£83	£90	£92
Savings to consumer per £ of investment	£0.21	£2.69	£5.49	–	–

Note no investment from year five.

It should be noted that the ten-year period to break-even was chosen as likely to be acceptable from a funder's perspective. This, in turn, determined the APR for the central scenario. As can be seen in Table 5, pricing at different levels will influence the period over which the model will break even. Conversely, a more or less demanding approach to the period over which the model must break even will require higher or lower APRs.

Alternative scenario outputs

The central scenario assumes not only a target customer base that is similar to those that are already in the market but also a similar degree of operating efficiency. As discussed in previous sections, there is a high risk of adverse selection for new entrants and it may be highly challenging also to achieve similar operating efficiencies. The central scenario has also been constructed on the basis of a break-even price. In a social lending context it might be considered desirable to offer credit at a lower cost to the consumer. The various tables that follow are intended to illustrate the likely financial and other impacts of offering credit at a lower price, varying the target market, experiencing different degrees of adverse selection and better or worse new business or collection performance. As the results show, relatively small changes would have significant implications for funding requirements.

It is difficult to anticipate the likely impact of a significant reduction in the cost of credit on borrower behaviour, not least because of the lack of price sensitivity of home credit customers and their focus on the amount of the weekly payment rather than the overall cost of credit in

Table 5: The impact of different levels of APR on funding requirement, financial results, cost of credit to the consumer and savings relative to commercial lenders

APR	**Funding requirement/ net income required after ten years (£ million)**	**Years to annual breakeven**	**Cost per £100 borrowed**	**Weekly payment on 56-week average £288 loan**	**Total customer saving on average £288 loan compared with commercial home credit product**
50%	–£286	10+	£23.90	£6.37	£127.01
60%	–£247	10+	£28.04	£6.59	£115.08
70%	–£207	10+	£31.97	£6.79	£103.78
80%	–£168	10+	£35.74	£6.98	£92.92
90%	–£129	10+	£39.37	£7.17	£82.46
100%	–£89	10+	£42.87	£7.35	£72.36
110%	–£50	10+	£46.25	£7.52	£62.63
120%	–£11	6	£49.52	£7.69	£53.21
123%	£0	5	£50.39	£7.73	£50.73
130%	£29	4	£52.71	£7.85	£44.05
140%	£68	3	£55.75	£8.01	£35.29
150%	£107	2	£58.72	£8.16	£26.73
160%	£147	2	£61.60	£8.31	£18.43
170%	£186	2	£64.41	£8.46	£10.35
180%	£225	2	£67.13	£8.60	£2.50
190%	£265	2	£69.79	£8.73	–£5.14
200%	£304	2	£72.40	£8.87	–£12.66

assessing the affordability of a loan (Competition Commission, 2007). As discussed in earlier chapters, agent–customer relationships for better-paying customers also tend to be unusually close and 'sticky'. A 70 per cent APR would represent a weekly payment of £6.79 on the average loan and thus a saving to the customer of £1.89 per week (and a total saving of £104 on the cost of the loan). It may be that a significant reduction in price of this order would attract better-paying customers in sufficient numbers to create a virtuous circle of better collection, enhanced agent remuneration and retention and lower delinquency and default rates. This in turn would putatively lower the cost of delivery and result in lower funding requirements, although they are likely to remain significant. Equally, however, given that the customers most likely to be attracted to a new lender are those with less reliable payment records, there is the potential for the opposite effect to occur. In the absence of robust data we have not attempted to model these dynamics.

Were the APR to be reduced to 100 per cent, the funding requirement over ten years would rise sharply to close to £90 million. The benefit to the consumer of a 100 per cent APR on the average loan of £288 would be a saving of £72. On the basis of an average loan frequency of 2.34 loans per year, this would translate to a saving of a little under £170 per year on current commercial home credit borrowing costs. The weekly payments of £7.35 would represent a saving of £1.29 per week on the average payments (£8.64) on a commercial home credit loan.

Achieving a lower-risk customer profile, perhaps by having access to recruitment channels that are unavailable to commercial lenders (such as referrals from other social organisations), will result in a significant improvement in the cash requirement, with a 20 per cent improvement enabling a ten-year (overall) break-even APR of around 118 per cent (see Table 6).

Conversely, encountering adverse selection, as was the case with the last major new entrant to this market, will cause the cash requirement to rise significantly. A 20 per cent adverse selection factor gives rise to a cumulative funding need of some £20 million and requiring a break-even APR of around 128 per cent. It should be noted that this APR calculation again does not include the cost of lending capital or interest on start-up costs.

Agent retention and collection performance are critical factors in the business model and are among the most difficult to control. The last major new commercial entrant to the home credit market expanded too rapidly and, in doing so, reportedly sacrificed agent quality and thus collection performance.

If agent attrition could be reduced by even a few percentage points, both break-even APRs and the funding requirement would be reduced. Conversely, deterioration in retention levels has the opposite effect. An agent churn rate that is 20 per cent higher than that of current providers implies a break-even APR of 125 per cent and a cumulative funding requirement of about £8 million (see Table 7).

Table 6: The impact of encountering greater or lesser adverse selection than for the current market profile

Adverse selection (measure of risk)	Cumulative subsidy/net income required after ten years (£ million)	Years to annual breakeven	Ten-year breakeven
–20%	–£20	8	128%
–16%	–£16	7	127%
–12%	–£12	6	126%
–8%	–£8	6	125%
–4%	–£4	5	124%
0%	£0	5	123%
4%	£4	5	122%
8%	£8	5	121%
12%	£12	5	120%
16%	£16	5	119%
20%	£20	4	118%

Table 7: The impact of differing levels of agent retention

Agent retention performance relative to central scenario	Cumulative subsidy/net income required after 10 years (£ million)	Years to annual breakeven	Ten-year overall breakeven APR	% of fresh recruits in workforce after ten years
50%	–£29	10+	130%	12%
60%	–£21	8	128%	17%
70%	–£14	6	126%	19%
80%	–£8	5	125%	20%
90%	–£4	5	124%	20%
100%	£0	5	123%	20%
110%	£3	5	122%	20%
120%	£6	5	121%	20%
130%	£8	5	121%	19%
140%	£10	5	120%	19%
150%	£12	5	120%	19%

If a home credit model could be devised that was less dependent on agent collection performance or which could derive cross-subsidies from other activities, this might potentially have a major impact on both the cost dynamics and the price that would need to be charged to borrowers in the context of a social business.

Business model overview

Even on a not-for-profit basis, it would seem likely that home credit from a social lender would still need to be high cost if the model were to be sustainable without significant ongoing funding. It would also require a relatively substantial initial investment if it were to be established on any scale. There are significant risks and costs attached to the potential for adverse selection and any shortfalls in operating efficiencies, particularly with regard to the quality of the agent force.

Seen from the perspective of the consumer, the modest savings compared with using commercial home credit may not be sufficiently compelling to attract quality borrowers from an existing provider, especially if they have had a long-term relationship with them. This could still be the case even if loans were offered at less than the rate required to break even – a development that would have significant funding implications.

The central scenario for the business model rested on the assumption that a not-for-profit home credit model would serve customers with a similar risk profile to those of the current home credit lenders. If, for social policy reasons, an alternative approach were to be taken, this could have significant implications for the risk profile of the customer base and thus for funding requirements. A case might be made, for example, that a not-for-profit home credit model might represent a desirable alternative to illegal money lending. Given that the customers of illegal lenders tend to be higher risk than those of the home credit lenders, such a move would almost certainly result in a higher risk profile than assumed in the business model's central scenario and thus in higher overall costs. Whether it is desirable to adopt such a course is, of course, a policy decision. Our purpose in creating the business model was to illuminate the cost and funding implications of a not-for-profit home credit model, however the target market for such a model might be defined.

5 Market research with not-for-profit lenders

The experience of delivering the Growth Fund had heightened credit union and CDFI participants' awareness of the depth and persistence of financial exclusion in low-income communities. Consequently, they understood the value of home credit to the people who use it.

> *"It is a form of credit that people want and value and, as such, it merits close consideration."*

The attraction of a not-for-profit home credit service was, therefore, the possibility it offered of deepening their reach in the low-income market.

> *"I recognise the potential out there – credit unions are only touching 1 per cent and not meeting the needs of 99 per cent of the target market – we need to answer the question how to make credit union services more accessible. We are not still meeting our social and economic objectives and if this helps us do this, I will be going for it."*

A few participants were strongly attracted to the idea of home credit, but the majority were more circumspect and cautious. The fact that home credit took the needs of the customer seriously certainly appealed. But this was tempered by a belief that its attractiveness lay not in the nature of the service itself, but as a conduit to greater financial inclusion.

In all discussions, the driver to consider a not-for-profit home credit service was the opportunity it offered of opening up a pathway to financial inclusion and to the use of affordable credit as currently offered by third sector lenders. Somewhat paradoxically, the prime attraction of not-for-profit home credit lay in the possibility it afforded of moving people away from commercial home credit in the longer term. So, for the majority of participants, it was "an intervention for change".

On this basis, credit unions and CDFIs were open to exploring the possibility of a not-for-profit option in greater depth. They considered that, in many ways, they were ideally placed to consider such an intervention as they already had grassroots experience of serving the financially excluded, including some in transition from commercial home credit. But their scepticism grew as they learnt more about the supply- and demand-side dynamics of the home credit industry and of the financial and credit pricing dimensions of the business model. They were realistic in their assessment of the challenges a not-for-profit home credit service would present. The complexities and risks of entering a market, which even the commercial sector has found to be increasingly difficult, were not underestimated by participants. These tended to focus around a number of key issues:

- the investment needed and cost of credit;
- problems associated with customer recruitment and the avoidance of adverse selection;
- agent recruitment and remuneration;
- the threat to achieving sustainable development; and
- a mismatch with their mission and values.

Overall reactions to the business model

Participants acknowledged that a not-for-profit home credit service, if it were to make a lasting impact in the market, would need to be established on a significant scale. They felt, however, that the business model was overoptimistic in its assumptions about the numbers of customers that could be recruited. The annual migration of 40 per cent of customers into more affordable credit options was seen as a key positive feature of the business model. However, this depended on 60 per cent of customers being retained each year as longer-term users. To retain these, given the rate of customer churn, and also to replace the 40 per cent who migrate, the number of new customers that would have to be recruited each year is inevitably high. We explore the issue of customer recruitment more fully below. Most had significant doubts about the desirability of the sector serving those who, for whatever reason, could only be served on a home collection basis.

Concerns were also expressed on the level of default and bad debt and the efficiency, control and costing of the service over a ten-year period. This arose particularly from participants' recent experience of managing the Financial Inclusion Growth Fund where the challenges and the costs of serving a very low-income market were keenly felt and understood. In some credit unions, for example, default on Growth Fund loans had already exceeded the rates envisaged in the home credit central scenario. This does not, however, take account of the fact that the purpose of home collection is to reduce levels of risk associated with loans where payment control lies with the customer. We also explore the issue of adverse selection in more detail below.

It was accepted, albeit with caution, that the proposed business model was achievable theoretically but, in practice, most thought it would be very difficult for third sector organisations to realise, given the variables involved.

It was stressed by respondents that a not-for-profit home credit or outreach service would need to offer added value to borrowers and support them in ways that led to greater financial and social inclusion. People wanted to go beyond a service that just offered credit on the doorstep. It was suggested that partnerships with other agencies could be built on and expanded in order to offer a more holistic home service including access to debt or money advice or advice on welfare benefits, employment, health, housing, social services or education and training. The overall aim would be to reach people, often excluded from multiple services, through an integrated home outreach service.

Cost of credit

A major concern for all participants was the APR that would have to be charged on home credit loans. Discussions focused on the central scenario of an APR of 125 per cent needed to break even in ten years and all struggled to come to terms with a charge this high. An interest rate below 100 per cent APR was marginally more acceptable to some, but others felt that the service could not realistically be provided at a charge they would find acceptable. This inevitably influenced their overall approach to the desirability of third sector home credit.

The dilemmas for participants deepened when they considered what the reduced cost to the customer of a not-for-profit home credit service may mean in practice. To the customer, the saving per week on a third sector home credit loan, in comparison to a loan from a leading commercial company, would be small. Given that loan decisions are made by customers on the basis of affordability, rather than cost, participants felt that the price differential was just not big enough to motivate people to move from commercial to not-for-profit home credit.

A particular problem for credit unions (but not CDFIs) entering the home credit market is that they are restricted by law from charging an interest rate in excess of 26.82 per cent APR. This means that a credit union home credit service would have to develop a charging system based on elements of both interest and a service fee for collection. This is technically possible but not without problems. Importantly, credit unions could not make the service fee obligatory, without having to include it in the APR. And the business model would be seriously undermined by having a voluntary charge. Moreover, it would leave credit unions open to the charge of a lack of cost transparency. The credit union focus group discussed the possibility of credit unions, collectively, establishing and owning a subsidiary loans company through which a home credit service could be administered. This would not be subject to the credit union interest rate cap. There was, however, little immediate appetite for this idea, and participants stressed that a home credit service would need to be delivered by credit unions themselves and not by an intermediary agency. This position arose out of a concern that a home credit service, if implemented, would need to be fully under credit union control. It was felt that the introduction of an intermediary may not only create confusion in the minds of borrowers but also lead, under market pressure, to the intermediary becoming a credit union competitor. This concern was, however, not replicated in South Tyneside where MAST worked collaboratively rather competitively with the credit union to provide additional services.

Customer recruitment and the dangers of adverse selection

The lenders also struggled with the idea of serving customers on a scale similar to that of a commercial home credit branch operation. There was considerable scepticism as to whether a not-for-profit service could generate this size of customer base.

It was recognised that recruiting people to take out a home credit loan is not, in itself, difficult. The problem is to recruit people who have the capacity and the willingness to repay. All of those consulted were clear that the risk of adverse selection and bad debt was very high. It had been high in the delivery of loans using the Growth Fund and had been difficult to manage. Participants were sure that it would be much higher in any form of home credit.

Reflection on the danger of adverse selection led participants to consider their target market carefully. The majority did not see the role of a not-for-profit lender in terms of recruiting people who had not previously used home credit. There were some in the CDFI sector who contested this and felt that, in theory, a home credit service could only succeed if it was prepared to target the low-income population as a whole and to seek to recruit customers who were new to home credit. They were not necessarily arguing that this is what should happen in practice.

For the most part, participants saw not-for-profit home credit targeting existing home credit customers, with the overall aim being to facilitate their transition, over time, to standard third sector or mainstream financial services. Participants were conscious that these potential customers were a high-risk group but stressed that the only purpose to becoming involved in home credit from their perspective was to offer people a pathway to financial inclusion. The feasibility of achieving this through the provision of a not-for-profit home credit service was increasingly contested, as where they had succeeded in the past, it was usually on the basis of no further contact with the home credit industry.

Moreover, with the desired emphasis on transition, building repeat business with good customers could not be a central feature of a third sector model. Quality customers in the third sector model would be those that had built the capacity to migrate to standard credit union, CDFI or mainstream financial services. In the commercial model, they are those stable borrowers who bring long-term profits to the company.

The paradox of developing a home credit service in order to move people away from home credit surfaced regularly in the discussions.

> *"As the motivation for the venture is to get people out of the home credit market, it seems contradictory not to mention unsustainable to want to do this by joining that market."*

Yet, for most participants a commitment to home credit service could not be based on the long-term provision of a service at a reduced cost to the customer alone. What mattered was transition. But it was clear from the model that without commitment to long-term delivery to people who are wedded to home credit, a not-for-profit home credit service is unsustainable.

There were also concerns that the level of cost saving would be too small to persuade people to switch from an existing commercial provider.

> *"With minimal financial savings, loyalty to existing agents would militate against migration. I am struggling to understand how and why people would migrate. I am struggling to understand where the customers would come from."*

It was recognised that people would be reluctant to leave a tried-and-trusted commercial home credit company, particularly given the strong relationship that exists with agents.

The likelihood of significant migration to mainstream services was also questioned in the light of the suggestion from the commercial lenders that their own estimate was that only 5 to 10 per cent of the core of their existing customers could be served by remote channels.

Methods of recruitment

There was some discussion of recruiting new customers through word of mouth and referrals from community organisations, housing associations and money and debt advice agencies. At first, a community referral approach appeared attractive and was even seen as a distinctive element of a not-for-profit home credit approach. However, building a business plan on the actions of others seemed precarious to the CDFI participants. This was confirmed by a housing association representative who argued that a referral for a Growth Fund loan is different from one for a relatively high-cost home credit loan, which he did not think housing officers would find acceptable.

Some participants suggested that a way forward could be the purchase of a small home credit company as this would readily increase the customer base. The financial future of that company, however, could be in doubt if its management ruled out recruiting customers new to home credit or the long-term development of quality customers.

Agent recruitment and remuneration

Both credit unions and CDFIs felt that not-for-profit lenders would face the same kinds of challenges as the commercial sector in identifying and retaining skilled and competent agents. It was accepted that finding good agents would not be easy and participants were not convinced that they could be recruited in sufficient numbers or with the required experience.

It is unlikely that they could be found from existing staff. Surveys in three agencies[3] revealed that no existing credit union or CDFI personnel would be prepared to take on the role of an agent. In one credit union, the presence of staff with prior experience as home credit agents strengthened the view that the role was just too stressful, dangerous and difficult.

The challenge would, therefore, be to recruit new people as agents. Various suggestions were made, including identifying people in the community who would make suitable agents, recruiting from credit union members and 'poaching' staff from commercial lenders. The last of these was felt likely to be unsuccessful unless the remuneration package offered was sufficiently attractive, particularly as the approach to selling loans would be different in a not-for-profit model.

Participants acknowledged the core agent skills that had been identified by commercial lenders, and ensuring the development of skilled agents was seen as a major challenge. But they did not want agents to replicate what they saw as the stereotypical agent behaviour of persuading people to increase their borrowing.

Agent remuneration

Those consulted had no principled objection to home credit agents being self-employed and paid commission on collections. In fact, Manchester Credit Union had already employed people on a commission-only basis to collect, but not make, loans in the home. Home collection was here a form as debt collection as it was only offered to people with poor repayment records. However, improvements in debt recovery did confirm the value of the home collection model for certain borrowers.

However, two practical issues surfaced in the discussions. Traditionally, agents have maximised their income through commission on repayments of loans and collection quality. In a not-for-profit model, where some of the focus is on transition and the model includes incentives to move people onto cheaper credit products or repayment methods, it would be important that incentives were adequate to motivate agents to actively promote transition. There were also concerns about good employment practice within third sector organisations. When agents are self-employed, and remunerated entirely through commission, commercial companies take no responsibility for sickness or injury. There was wide agreement that home agents should be employed and paid a wage that had elements of basic pay (including holiday and sick pay) as well as commission.

Agent safety

In contrast to the views of commercial lenders that safety must be taken seriously but with adequate safeguards is not an issue in practice, third sector participants were particularly exercised by the potential dangers involved of cash collection by agents.

A focus on sustainable development

The majority of participants stressed that developing a home credit service could divert attention and resources away from the actions that their organisations need to undertake to develop as sustainable financial institutions.

They were equally clear that credit unions and CDFIs currently lack the capacity, skill and experience to enter the very complex and high-risk home credit market. However, committed as they were to tackling financial exclusion, it did not make business sense for them to make a major shift in the direction of their development.

> *"Why would we invest into something that will divert us away from what we are better equipped to do?"*

Many questioned the business sense of taking on the risks associated with entering a declining market and developing cash-based models of repayment when people were increasingly migrating to electronic payment methods.

Credit union participants, in particular, thought that a focus on home credit could endanger the retention of their core, more financially included, members, who are essential to their development and sustainability.

> *"Our core members are crucial to survival. Once they perceive we are not for them but for the financially excluded, we will lose them – quietly they will disappear – then we will find out that all membership is from lower income."*

Without middle-income customers they would be unable to serve the poor and financially excluded. Whether middle-income members would, in practice, desert credit unions that offered home credit is, of course, an untested assertion.

There was also a concern among some participants that not-for-profit home credit could just be another passing innovation that diverted attention away from the real issue of sustainable development.

Mission and values

Discussions disclosed a strong divergence in culture and values between third sector lenders and those perceived to be associated with the commercial home credit industry. Understanding this divergence helps to explain the strong feelings that surfaced from time to time that home credit is fundamentally against the ethos of the credit union and of CDFI movements.

The cultural divergence turns on a belief in customer responsibility. In commercial home credit, the customer was seen as handing over responsibility for decision making about the loan and also for the collection of repayments to the company. In the third sector, there is an emphasis on self-help and an expectation of more from users than being mere recipients of a service. Credit union values, in particular, have traditionally focused on enabling customers to want to improve their own financial circumstances for themselves.

This explains, for example, why the concept of a fixed-price loan, fundamental to home credit, was not accepted by all credit union participants. In their view, a fixed price and no penalty for default encouraged repayment irresponsibility. Unlike home credit, default on standard credit union and CDFI loans results in an increase in interest payable due the extended period of the loan. Linked to this approach to personal responsibility was the stress on financial independence as a route to financial inclusion. In contrast, home credit was seen by many as fostering dependence, although some contested this and stressed that contact through a not-for-profit home credit service could be a first step on the ladder to inclusion.

These values also underpinned third sector sensitivities about charging a high rate of interest on loans. This was considered to be an ethical and reputational issue for credit unions and CDFIs, who felt deeply uncomfortable charging interest at levels associated with the sub-prime sector. Some people, but fewer in number, were more sanguine about this and were ready to argue the case for an APR rate in excess of 100 per cent if it meant a real saving to the customer. The problem was that the weekly repayment saving to any individual customer at that rate was minimal.

In search of solutions

The initial appeal to participants of home credit was based on the desire of credit unions and CDFIs to extend their reach into the low-income market. They wanted to explore the possibility of a home credit intervention that would enable third sector services to be more accessible to people who they see as having little choice but to use commercial home credit.

However, as discussions progressed, it became clear that participants were struggling with the feasibility of using home credit as a vehicle to tackle financial exclusion. There were too many dilemmas and practical difficulties as well as a real danger that investment in such a major project would divert attention from the existing priority of strengthening the third sector.

In short, participants thought that there must be more cost-effective ways of using the funds required than developing a ten-year home credit programme. It was felt that with similar investment much could be done by other means to migrate home credit users to more affordable forms of credit and into greater financial inclusion. A good deal could be done, for example, to prioritise financial literacy programmes, to assist people to open current accounts in credit unions or to use a CDFI.

> *"The problem is us trying to enter that market to provide an expensive service, what we need probably more is to get people included by educational ways, tying the credit union service up with debt advice, making sure people get the right benefits. An army of people going around doing that would have more of an impact than home credit and would be a better long-term investment."*

There was an overall fear that a new home credit intervention would make it harder for people to move towards financial inclusion.

At the same time, there was a keenness to preserve elements of the model in a reworked form of third sector home credit or, rather, of a doorstep outreach service. A strong role was seen for agents in building and sustaining relationships with consumers excluded from affordable financial services and in following up on slow payers, defaulters or people in difficulties.

The CDFI participants suggested a model of home credit that was based on an outreach service connected to what was termed a "capability channel". The idea was that this would be a low-key form of home credit, which would target a particular estate and through a variety of outreach interventions, including access to credit,

endeavour to develop the financial capability of consumers.

> *"It would include leverage to try and change behaviour so it has to include training in behaviour management that will enable consumers to shift to more affordable providers."*

Rather than the large-scale approach developed in the business model, this home credit intervention would be a first step in a "kind of phased learning process". Disbursements and repayments could be based on new technology and customers would use PayPoint or other electronic payment methods. This approach was supported by several credit unions, all of which placed a strong emphasis on the repayment of loans directly from benefits deposited in a credit union account.

Of course, these modifications would dilute the integrity of home credit as understood in the business model. While some were inclined to disaggregate the package and adopt those elements of the model that fitted with third sector business aspirations, others, especially in the CDFI sector, argued that any tinkering with the model undermined it absolutely.

Taken together, therefore, while the various third sector lenders emphasised their commitment to tackling financial inclusion, there was little appetite for developing a home credit service of any scale, which was seen as an inappropriate direction for credit unions and CDFIs and one which might both damage the sustainability of the movement and divert energy and resources from the wider mission to scale.

6 Conclusions

The overall aim of this study was to test the commercial feasibility of developing a not-for-profit home credit service. As previous chapters have shown, this will not be easy and there are many pitfalls to be negotiated. It was, however, possible to build a viable business model that, with substantial investment, could provide credit at rates that are lower than those in the commercial sector. Exactly how much lower would depend on the level of subsidy available and the timescale over which it could be provided.

What is less certain is how the service could be delivered. In many ways it would be sensible to build on the existing network of third sector lenders, but there is limited appetite for developing a not-for-profit home credit service given competing priorities for service development and the pressure to achieve financial sustainability. The other option would be a stand-alone service. Business models were built for both of these options.

In this final chapter, we bring together the key lessons from earlier chapters and set out our conclusions and potential next steps.

Demand will be high but need 'quality' as well as high-risk customers

The level of need to borrow is high among people on low incomes and supply is constrained, so the potential level of demand for a new home credit service is likely to be high.

Moreover, the drying up of existing mainstream credit, due to the current unprecedented financial crisis, is likely to increase potential demand, including from those who have previously migrated from home credit. Indeed, demand is likely to be swelled by the less reliable payers among current home credit customers who are also finding new loans more difficult to come by.

Such a service could aim to recruit its customers either from existing home credit customers or from people who are not current users. The advantage of the former is that it should be possible to identify their past payment record, although this would also be possible for former home credit users too.

There are, however, several potential barriers to persuading existing 'quality' home credit users to switch to a new provider. These include the closeness of the relationship with their existing agent, levels of satisfaction with existing providers and the need to establish a new credit record before being able to borrow as much as they can from their existing lender. There is a strong possibility that people attracted to a new service will be at the end of an existing credit line or seeking an additional credit supplier.

There is a real danger of adverse selection

A new entrant faces a real danger of adverse selection for a number of reasons. Demand is likely to be highest among people who have the highest risk of default. People who are attracted to home credit a have higher risk of default than those who want and are able to pay by direct debit, or even cash at an office. The recruitment methods (largely direct advertising) open to a new entrant are associated with higher levels of both refusals and default. The importance of round density to profitability – requiring high levels of recruitment in a small geographical area – could exacerbate the problems of adverse selection.

The costs of customer recruitment will, almost inevitably, be high relative to the amounts of money being lent and will need to be recouped over a number of loans. So retention as well as recruitment of good customers will be essential. In the commercial sector this means actively 'selling' new loans as existing agreements draw to a close, although both evidence from the Competition Commission inquiry and the research that informed this project indicates that demand for follow-on loans is likely to be high.

It will call for cross-subsidy – both between customers and, almost certainly, between different products and service lines. This is discussed more fully below.

Attracting good agents will be a challenge

The recruitment and retention of good agents will be among the greatest challenges faced by a new entrant, with lending quality, collection performance and, ultimately, financial results critically dependent on it. The skills and personality required in a good agent outlined in Chapter 3 will make them hard to find. One option would be to try to attract experienced agents from commercial home credit companies, either by offering better pay and conditions, which will have cost implications, or by offering a superior product that will attract demand and thus create opportunity. This might include incentivising the facilitation of financial or social inclusion goals, such as the move into savings or banking or the use of money advice.

The home collection channel remains attractive to home credit borrowers

Originally, part of the rationale for the project and for existing third sector lenders entering the home credit market was to help customers to move to cheaper, remote repayment channels. As others have observed (Competition Commission, 2007), and the data underlying the analysis for this project confirms, the home collection channel is itself valued by consumers and, for some, is a critical component of the ability to manage credit repayments. It would seem likely, therefore, that some home credit customers at least will opt for home collected channels even where other channels are available.

There are limits to the number of people who can be migrated to cheaper, remote channels

From the agents' point of view, diluting round density and earnings potential by transferring good customers to a cheaper collection method is likely to be demotivating and would therefore compromise collection performance and agent retention, both of which are critical to the financial viability of the home credit model. From a home credit lender's perspective, the home collection channel is an important component of risk management. Home collection is also a major part of the appeal of the model for consumers, many of whom value the agent service, albeit that it comes at a high cost.

Taking all of these factors together, there will be limits to the numbers who can be transferred to cheaper channels, either because they are unwilling to make the change or because the risk of non-payment is too high. The model developed indicated that the majority of those who might be served would be difficult to move out of home collection. Commercial competitors are in any case likely to continue to offer home collection so that home collection is likely to remain a feature of this part of the market for some considerable time.

The core elements of the home credit model cannot be unpicked

It is clear from our market research both with potential customers and with commercial home credit companies that it is not possible to unpick the core elements of the traditional home credit model and expect to set up a viable service. These elements include:

- a single price to all customers, with a high degree of cross-subsidy being required;
- collection of repayments by agents in the home, who also play a key role in lending decisions;
- flexibility over payments in genuine cases of 'can't pay'; and

- small initial loans to new customers, with the size of loans gradually increasing as customers demonstrate their credit worthiness.

A high degree of cross-subsidy is likely to be required with cross-selling also potentially an important element in viability

A viable home credit model depends on cross-subsidy between customers. This will be difficult in the not-for-profit model envisaged and steps will need to be taken to ensure that the new service attracts some lower-risk customers. Recruitment methods will be key to this, as will procedures for credit screening. Other methods of cross-subsidy will also need to be explored. These include offering other products, such as insurance, savings and cheque cashing. Cross-sales of such products have not been successful when offered by the commercial home credit lenders, but a social business may have advantages in this respect through links to other social policy initiatives such as the Saving Gateway, the Child Trust Fund and efforts to widen access to affordable insurance and to transaction banking. There also may be opportunities to cross-sell a range of advice and financial capability services, which would be separately funded. Such services may prove more attractive to those most in need if linked to the provision of affordable credit, which they are likely to be motivated to obtain.

It is feasible to build a viable business model but the cost of credit will be high

The business model suggests that the cost of credit is likely to be high, even on a not-for-profit basis. The model suggests an APR of 123 per cent, on the basis of assumptions on operating efficiencies and a target customer base in line with the home credit lenders already in the market. These may, however, be challenging to achieve. An APR of 123 per cent would take ten years for the operation to achieve overall break-even, even without allowing for interest on initial capital or the cost of loan capital. Pricing at this level implies an initial funding requirement of some £18.6 million, with the project not turning cash-positive (annual break-even) until year five. On the average loan of £288 repaid over 56 weeks, this would imply a total saving to the customer of about £50 over commercial credit. On the key measure of weekly affordability, the saving is a little under £1 a week, with the total weekly payment likely to be slightly less than £8. The annual saving for a customer with the average of 2.34 loans per year would be £117. From the consumer perspective, this may not be sufficient saving to act as an incentive to switch while, from the perspective of other stakeholders, it may not be sufficient social benefit to justify a high-risk investment.

Reducing price sufficiently to motivate consumers is likely to require significant investment

The cost of credit to the consumer and level of initial funding required are clearly linked. The Project Advisory Group discussed a preliminary run of the model. The initial response was that the saving against commercial credit was potentially insufficient to attract customers who are not price sensitive. The view was taken that pricing would need to be significantly lower to attract the attention of potential customers and policy makers. Alternatively, the new lending model would need to break the mould in terms of differentiation from incumbents. However, the model indicates that in order to achieve the below-100 per cent APR rate, which the group felt was needed to galvanise the market, the funding requirement would rise sharply to £90 million. The benefit to the consumer would be a saving of £72 on the average loan, equivalent to a reduction of £1.29 on weekly loan repayments. The annual saving for someone with the average 2.34 loans per year would be £170, as compared with commercial home credit lenders.

There are low levels of interest among third sector lenders, who have competing demands for the development of their services

There are a number of possible models for a not-for-profit service, ranging from a stand-alone service to one that is run by and through third sector lenders. In many ways, it would be sensible to build on the existing network of third sector lenders, who have a detailed knowledge of and are trusted by the communities within which they operate, which was how our first generation of the business model was originally envisaged. Costs and funding aside, however, the critical issue for the feasibility of the original model is the lack of engagement by third sector lenders, who have competing demands for the development of their services. Despite being at the leading edge of the movement in terms of growth prospects and focus on financial exclusion, the majority of third sectors lenders consulted for the study were only willing to consider the development of a home credit service if it was clearly focused on transitioning borrowers to their mainstream services. Most felt a strong cultural antipathy to the home credit concept, which was seen as both backward looking and inherently exploitative. The majority also felt it inappropriate for the third sector to offer loans at APRs of 100 per cent and higher, even on a not-for-profit basis.

As the third sector lenders focus on achieving scale, developing a home credit model was seen as both a distraction and a poor use of funds

After many years of subsidy, ABCUL reports that some third sector lenders are moving towards financial sustainability. The experience of serving financially excluded borrowers under the Financial Inclusion Growth Fund has created a new appreciation of the challenges involved in serving high-risk borrowers. There were fears that becoming involved in a high-risk home credit service could jeopardise their sustainability. For the most part, the third sector lenders saw developing a home credit service as a diversion, likely to work against the effort to scale the sector. There were concerns that it would reinforce their image as 'the poor man's bank', a move thought likely to alienate better-off users who are vital to their financial sustainability. While there were clearly issues around both capacity and motivation, most participants in the study simply felt that there were better ways both to address financial inclusion and to use the funds required to establish a not-for-profit home credit service. There are also legal constraints in that there the ceilings that apply to the rates that a credit union is legally able to charge for credit, which would not allow credit unions to offer a high-cost product. Any third sector solution involving credit unions would need, therefore, to be set up as a separate legal entity, potentially as a CDFI.

It does not, therefore, seem feasible to develop a not-for-profit home credit service on any scale through existing third sector lenders

Taking the research findings together, therefore, it would seem unlikely that a not-for-profit home credit service could be developed on any scale if it were run by existing third sector lenders. There was some interest in the concept, however, both from some who were most clearly focused on financially excluded borrowers and from lenders who thought in terms of home collection as an outreach channel. In this respect, third sector lenders recognised that offering small-scale credit on a demand-led, outreach basis could open the door to a wider relationship and potentially offer a channel for delivery of financial capability, financial education and inclusion initiatives. Others saw home collection as a channel for management of customers in payment difficulties, hoping not only to moderate bad debt but also to support high-risk borrowers struggling with their Growth Fund loans.

A stand-alone service might prove the best way forward

In view of these reservations, a stand-alone not-for-profit provider would seem to offer the best way forward. More work would be required to investigate the feasibility of this and the type of body that might be set up to deliver the service. One possibility is a stand-alone CDFI, owned either by a group of third sector lenders or by one of the two main trade bodies – ABCUL and CDFA (the Community Development Finance Association). Another option would be the establishment of a new Friendly Society. The second generation of the business model suggests that a stand-alone not-for-profit home credit model would, in fact, be able to offer slightly cheaper credit to home credit customers than would be the case if the business was seeking to transition some payers to mainstream third sector lending.

There is a potential role for a not-for-profit home credit service as part of wider financial inclusion initiatives aimed at higher-risk borrowers

It would appear that there is potential for developing a not-for-profit home credit service as part of a wider financial inclusion and financial capability initiative. Indeed, linking it to affordable home credit might increase the attractiveness and success of a financial capability initiative. This might be conceived, in part, as an outreach channel designed to extend services to those who have a need to borrow but would be unlikely to approach third sector lenders. As importantly, such a service could support those whom existing third sector lenders cannot serve within the context of a low APR model. It might even be developed in the context of the government's illegal lending imitative, where it is hoped to transition victims to a source of affordable credit from a third sector lender. A further option is to consider a not-for-profit home credit initiative as part of the planned reform of the Social Fund.

As commercial home credit lenders withdraw from the highest-risk borrowers, there will be a growing pool of people unable to obtain credit at any price

There is growing evidence that the geographical areas not being served by commercial home credit companies are getting larger. The 'credit crunch' is widening the group of people turning to home credit, many of whom are at the low end of the risk spectrum for such companies. This could well hasten their withdrawal from high-risk areas, fuelling the use of illegal lenders. Part of the original rationale for this study was to find an affordable alternative for the highest-risk and hardest-to-serve borrowers, who have few other options for borrowing when commercial home credit providers leave their neighbourhood. It is clear that some of these borrowers cannot and should not be served by third sector lenders in the context of a low APR model because it would undermine the financial sustainability of these lenders. A not-for-profit home credit service may have the potential to fill the gap between the credit unions and the Social Fund, and to moderate the risk that borrowers rejected by the home credit lenders turn to illegal money lenders. In the absence of such an initiative there is a real danger that the use of illegal lenders will increase.

There are limits to a not-for-profit home credit service

The response of the third sector lenders to the patterns of payment irregularity typical of some of the highest-risk home credit users suggests that there are limits to a not-for-profit service, just as there are with loans to financially excluded people through the Financial Inclusion Growth Fund. If the new service is to be viable, even on a not-for-profit basis, customers with a high risk of default will need to be screened out. This raises two important questions. Where will these people, who have a high need and desire to borrow, get the credit they need? Previous research has shown that people with limited access to licensed lenders have only one of two options, if they cannot call on help from family or friends: the government's Social Fund (if they are eligible) or unlicensed lenders (Ellison *et al.*, 2006).

This research, along with the growing evidence from the Growth Fund, demonstrates the limits of not-for-profit lenders in the third sector meeting the credit needs of the poorest and most vulnerable consumers while still aiming for financial sustainability. In doing so, it highlights the importance of the Social Fund having adequate resources to meet these needs and being operated in a way that makes it possible to do so.

Next steps

This study demonstrates that it is feasible to develop a not-for-profit home credit service. There are two options, based on the evidence collected in the study to date.

The first is to conclude that although it is possible, in theory, to develop a not-for-profit home credit service, there are too many practical obstacles to take it forward. The social implications of this 'do nothing approach' are, however, likely to be severe, particularly in a constrained credit market. It is also clear that there are unlikely to be new commercial entrants to the home credit market, so choice is likely to continue to be limited and costs will remain unacceptably high.

The other option is to accept that there *are* obstacles and to produce a business plan exploring whether and how a freestanding not-for-profit home credit lender might address the various barriers and difficulties. This would need to cover the following points:

- whether the set-up and development costs could be covered by a subsidy (bearing in mind European Union state aid rules) or whether a long-term loan would be required (making allowance in the business model for interest payments);
- whether there other business opportunities that could generate an income to cross-subsidise loans (current accounts, cheque cashing, savings products, home contents insurance);
- whether there is potential to obtain cross-subsidy by linking a not-for-profit home credit lender to wider initiatives tackling financial inclusion and/or financial capability, including the government's illegal lending initiative;
- the scale and speed of service development that is feasible and which would minimise the problems faced by previous new entrants;
- a strategy for attracting (experienced) agents from commercial lenders, including offering employment (rather than self-employment), with consideration given to better rates of pay (while retaining commission as the basis for most of their remuneration), sickness and holiday pay, and employees' contributions to a pension scheme;
- defining who can and cannot be served, including identifying the groups of people currently using home credit who third sector lenders would be unable to serve;
- a marketing strategy for attracting high-quality customers – including setting the right charges for loans;
- the systems that would need to be developed to assess risk and support the lending decisions of agents;
- whether the use of home credit by customers should be time-limited, with the goal of migration to other forms of delivery – and the implications of this for the viability of the service;
- whether new technological developments offer possibilities for making loan repayments that contain the risk of default.

In addition, more attention needs to be given to the implications, should a not-for-profit service be established, for the people who cannot be served by it and how their needs should be met.

This is the approach that we would recommend, subject to finding political and financial support.

Notes

1 See the Appendix for a list of participating credit unions and CDFIs.

2 See, for example, http://business.timesonline.co.uk/tol/business/markets/article2980615.ece

3 Manchester and South Tyneside credit unions, and Money Answers South Tyneside (MAST)

References

Brooker, S. and Whyley, C. (2005) *Locked In, Kept Out: The Extent of Competition within the UK Home Credit Industry.* London: National Consumer Council

Collard, S. and Kempson, E. (2005) *Affordable Credit: The Way Forward.* Bristol: The Policy Press

Collard, S. and Smith, N. (2006) *Membership Counts: Who Uses Credit Unions?* Manchester: Association of British Credit Unions Ltd

Competition Commission (2006) *Home Credit Market Investigation: Final Report.* London: Competition Commission

Ellison, A. and Whyley, C. (2005) *Affordable Credit*. London: National Consumer Council

Ellison, A., Collard, S. and Forster, R. (2006) *Illegal Lending in the UK*. London: Department of Trade and Industry

Financial Inclusion Taskforce (2008) *Towards a Step Change in Third Sector Lending Coverage and Capacity: Report of the Third Sector Credit Working Group of the Financial Inclusion Taskforce.* London: Financial Inclusion Taskforce (www.financialinclusion-taskforce.org.uk/PDFs/working_group_presentation.pdf)

Jones, P. (2002) *Access to Credit on a Low Income*. Manchester: The Co-operative Bank

Opinion Leader Research (2000) *Home Credit: Bridging the Gap in Understanding*. Commissioned by Provident Financial. London: Opinion Leader

Park Group plc (2006) *Annual Report and Accounts for the Year Ended 31 March 2006.* Birkenhead: Park Group plc

Rowlingson, K. and Kempson, E. (1994) *Moneylenders and their Customers.* London: Policy Studies Institute

Appendix
List of participating credit unions and community development finance institutions

Credit unions

Castle and Minster Credit Union Ltd
Leeds City Credit Union Ltd
Lewisham Credit Union Ltd
Manchester Credit Union Ltd
Nottingham Credit Union Ltd
Sheffield Credit Union Ltd
South Tyneside Credit Union Ltd
Southwark Credit Union Ltd
Tower Hamlets Credit Union Ltd
Watling and Grahame Park Credit Union Ltd

Community development finance institutions

Community Development Finance Association Ltd
Derbyloans (IPS) Ltd
East Lancs Moneyline
Money Answers South Tyneside Ltd
South Coast Moneyline

Acknowledgements

As with most reports of this complexity, the authors have a long list of people to whom they are indebted. Mark Lyonette played an important role in the project team, contributing both to the development of the business model and to the market testing with third sector lenders. Rob Forster played a vital part in developing the business model.

The project advisory group provided valuable input and feedback throughout the project and brought a wealth of experience to the study. They were Roger Harding, Chris Issac, Peter Lane, James McCormick, Robin Newnham, Karen Rowlingson, Danielle Walker Palmour and Richard Walton. Chris Goulden, from the Joseph Rowntree Foundation, also provided invaluable support to the project throughout.

We are very grateful to the representatives from the commercial home credit companies who very generously shared their detailed experiences of working in this market. We would also like to thank the representatives of third sector lenders who took part in the discussion groups and contributed their thoughts and ideas to the research. Finally, we would like to acknowledge the help we received from David Collings, who proofread and edited the final draft of the manuscript with his usual diligence and competence.

The Joseph Rowntree Foundation has supported this project as part of its programme of research and innovative development projects, which it hopes will be of value to policy makers, practitioners and service users. The facts presented and views expressed in this report are, however, those of the authors and not necessarily those of the Foundation.

Joseph Rowntree Foundation
The Homestead
40 Water End
York YO30 6WP
www.jrf.org.uk

Further copies of this report, or any other JRF publication, can be obtained from the JRF website (www.jrf.org.uk/bookshop).

A CIP catalogue record for this report is available from the British Library.

First published 2009 by the Joseph Rowntree Foundation

ISBN 978 1 85935 692 0 (pdf)

Available in other formats

Working Towards
Investors in Diversity
www.iiduk.com

About the authors

Elaine Kempson is Director of the Personal Finance Research Centre and Professor of Personal Finance and Social Policy Research at the University of Bristol in the UK.

She is an internationally known and respected authority on consumer financial issues, and has over 20 years' experience in conducting research into various aspects of personal financial services, including over-indebtedness, financial inclusion and the need for financial education

Elaine is a member of the Social Security Advisory Committee, HM Treasury's Financial Inclusion Taskforce and the Department for Business, Enterprise and Regulatory Reform's advisory group on over-indebtedness. She is also non-executive director of the UK Financial Ombudsman Services. In 2007 Elaine was awarded a CBE for services to the financial services industry.

Full details of Elaine's work can be found on the website, www.pfrc.bris.ac.uk

Anna Ellison is Director of Policis. She has more than 20 years' experience in researching low-income households and their financial and credit needs, both in the UK and internationally. She has long experience of researching low-cost credit models and has also worked on projects exploring illegal lending in a number of markets.

Claire Whyley is a research and policy specialist with almost 15 years' experience of issues relating to poverty, debt and financial exclusion. With Elaine Kempson at the Policy Studies Institute and the Personal Finance Research Centre, Claire was involved in a series of studies of financial exclusion, examining access to products such as home contents insurance, credit, savings and bank accounts.

As head of research at the Welsh Consumer Council she led the first ever comprehensive assessment of over-indebtedness in Wales. As deputy director of Policy and then head of Consumer Futures, Claire developed and led the National Consumer Council's wide-ranging programme of work on consumer disadvantage. She is a member of the Financial Inclusion Task Force, and chair of the Affordable Credit sub-group.

Claire is now a freelance consultant, working with a range of organisations to develop and implement effective approaches to social and financial inclusion.

Paul A. Jones is a senior researcher in the Research Unit for Financial Inclusion at Liverpool John Moores University. His research interests are mainly in the fields of social enterprise, financial services for people on low incomes, money and debt advice, and credit union development.

He has published a range of works and papers including credit union development, access to affordable financial services and tackling financial exclusion. He is currently engaged in research exploring the future strategic development of the British credit union movement.

Full details of Paul's work can be found on the website, www.ljmu.ac.uk/HEA/financialinclusion