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Consumers, Credit and Scaling Affordable Lending: A Literature and Evidence Review

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Executive Summary

What is Affordable Credit Lending

Access to financial goods and services is a key requisite for full and fair participation in today's economy and society. Yet many millions in the UK are unable to secure access to mainstream finance, paying more for financial goods and services, with less choice, and often exacerbating financial vulnerability and risk.

The vision of affordable credit lenders is that in the UK, wherever people live, they should have access to more affordable and appropriate forms of consumer credit, which reduce the cost of borrowing for those outside of the mainstream, are delivered in a fair, respectful and responsible manner, and support financial resilience and reduced financial exclusion.

Responsible Finance (RF) and Centre for Business in Society (CBiS), Coventry University have been funded by Oak Foundation to undertake a research programme to advance the supply of sustainable and affordable finance products to those excluded from mainstream credit and lending markets. The programme's particular focus is to investigate how to overcome barriers to affordable lenders meeting consumer demand at a national scale and in a sustainable manner.

This Review draws on a range of academic, think tank, policy, advocacy and financial industry reports to provide a broader historical and literature context to the current market assessment activity of the Financial Conduct Authority (FCA). The Review is focused on the position and implications for affordable consumer lending and forms part of a larger programme of work including: Evaluation of the Affordable Lending Portal; Case Studies of other affordable lending initiatives; and an investigation in to the emergence of 'inclusive credit scoring' approaches.

The Demand for Consumer Credit

Consumer credit is a debt advanced to consumers for the purchase of goods or services (also known as consumer debt). It may be provided by banks, shops and a range of other financial providers. Consumer credit includes purchases obtained with credit cards, lines of credit and some loans. In 2008–2009, as the global financial crisis was about to unfold, two-thirds of people in the UK had at least one form of unsecured credit. Today, for example, most UK adults hold a credit card, with around 30 million cardholders in 2015. Such cards are a core product within the financial portfolio of most UK adults with a multiple selection of card offers providing a balance of benefits and risks arrayed against a highly differentiated consumer base dependent on income, risk, historical credit profile and consumer preference.

In contrast to the 30 million 'prime' UK credit cardholders, large numbers of individuals and households are unable to borrow through these mainstream credit channels. This has seen the rise of products and lenders deliberately targeted at those on low or precarious incomes, with no or damaged credit histories and who have been further squeezed out in recent times by credit rationing within post-crisis banking regimes. The expansion of new forms of lending are generally recognised as the rise of the 'sub-prime lender'. Actively targeting and creating 'non-prime' customer markets, customers are likely to have more restrictive terms and conditions, higher interest rates and greater fees which, at best, provide much more expensive alternatives to the mainstream and, at worse, have seen regulation to bear down on excessively high charges, poor lending practices and exploitation of the most vulnerable.

Often characterised as the 'rise of the payday lenders' or the growth of high-cost short term credit (HCSTC), Carnegie UK Trust has labelled such sub-prime developments as the growth of 'non-standard' consumer credit options, in order to reflect the full diversity of product markets that have been created.

Non-standard options include high cost, short term credit firms, home credit companies, rent to own businesses, pawnbrokers, and specialist credit card and mail order catalogues (Table ES1). It is estimated that this market includes around 10 – 12 million customers.

Table ES1: 'Non-standard' credit: The UK unsecured high cost credit market

Credit Type	Annual Consumers	Borrowing (£)	Outstanding (£)
Catalogue	1,900,000	800,000,000	4,000,000,000
Store Card	400,000	200,000,000	700,000,000
HTSTC	800,000	1,100,000,000	1,100,000,000
Home Credit	700,000	1,300,000,000	1,100,000,000
Rent to Own	200,000	600,000,000	500,000
Running Account	200,000	200,000,000	1,100,000,000
Guarantor	100,000	200,000,000	300,000,000
Logbook	100,000	100,000,000	100,000,000
Total	**4,400,000**	**4,500,000,000**	**8,800,000,000**

Source: Carnegie 2017, drawn from FCA HCSTC Appendix July 2017

Variegated and Problematic Consumer Credit Markets

The provision of, and access to, consumer credit is now part of the financial DNA of the UK. So much so that the rise of consumer debt has become of policy concern, whether expressed as the rise of indebtedness, the increasing use of credit 'to get by', or the particular debt burden and financial vulnerability of certain socio-economic groups. This concern is set against the equal policy desire to achieve financial inclusion across the UK population.

The consumer credit market landscape of today is that of 'variegation' – a series of overlapping but nevertheless tiered consumer credit systems; in shorthand ranging across prime, near prime, sub-prime, and sub-sub-prime to simply illegal. Across this highly dynamic market environment, problems are evident.

Within the prime market, the FCA has recently published a Consultation Paper proposing measures to tackle persistent credit card debt and encourage earlier intervention. Meanwhile the 'sub-prime' or 'non-standard' market is witnessing a period of major structural change. In the face of poor and irresponsible lending practices and high levels of consumer detriment, a series of ('rate cap') regulatory interventions have been driven forward, with lending volumes falling by around two-thirds since 2013, market exit and a tightening of credit provision in non-standard credit markets.

The reduction in poor and inappropriate lending activity has been strongly welcomed by all, with regulators viewing substantial reduction in the supply of consumer credit as part of efficient market corrections and solutions. Yet other studies have highlighted that such

restrictions do not necessarily correspond with a drop in demand. Concern has turned to what viable alternative routes to credit now exist for these consumers, including the potential provision of affordable lending.

Beyond the mainstream and non-standard in consumer credit, a third group of providers are 'affordable lenders'. Examples are credit unions - a financial co-operative movement for members with a 'common bond' (locality, employment, etc.) - and community development finance associations (CDFI). Jointly these continue to grow, including to both meet the demand from those unable to access mainstream channels and in an attempt to provide affordable, fair and alternative provision, in contrast to many 'non-standard' consumer credit options.

It is the sheer scale up required of affordable lending providers to meet this potential demand that has triggered this research and other initiatives. The responsible finance personal lending sector remains very small, less than ten per cent share compared to the other providers in the non-standard market, and lending a combined total of around £800m in 2016.

The Provision of Consumer Credit Beyond the Mainstream: Non-Standard Consumer Credit

Given a comparatively deregulated environment, the UK consumer credit market has been the largest and fastest growing in Europe, featuring an ever greater diversity of product mix and a wide spectrum of pricing. The Review briefly overviews the scale and scope, products and industry developments across the non-standard credit options of: payday loans, logbook loans, home and catalogue credit, rent-to-own, pawnbrokers, illegal money lending and peer-to-peer.

Reflecting risk profiles, the costs of such products are higher and the terms and conditions poorer, but this non-standard sector has also been characterised by substantial poor lending practices with high levels of consumer detriment. The outcome has been recent, substantial, dynamic and on-going regulatory intervention across the segments of the market.

Nevertheless, the non-standard consumer credit sector has reflected also clear dimensions of consumer choice such as targeted consumer engagement, ease of accessibility, speed of service, simplicity, trust, non-intrusiveness, multiple delivery channels, and other non-price based factors.

Alongside the regulatory framing and reinforcement of responsible lending practices, such consumer choice dimensions will need to be taken forward also by the affordable lending sector if they are to scale up to meet the increasingly unmet needs of consumer credit triggered by regulatory tightening, and do so in a responsible and sustainable manner (see Table ES2).

Table ES2: Consumer credit provision – beyond the mainstream

	Size / Trend	Product	Typical Consumer	Advantages identified by consumers	Responsible Finance Lessons (for personal lending)
Payday Loans	2013: £2.8bn; 1.8mn customers; 2016: £1bn, 760,000 customers	Small value (< £1,000), short term (days) High cost (fees/APR)	Age 35; 62% male; lower incomes than the national average (£20,400 v £26,370); 88% earned income; 23% receiving benefits; 76% employed full time; 10% mortgage; 76% have no accessible savings.. Non-mortgage debts £4,700	Fast, highly accessible, flexible, relatively non-intrusive	Speed and simplicity, often technology-enabled, valued over price; Very substantial cohort of borrowers (0.5m plus) no longer accessing these products
Logbook Loans	2014: 52,000 2017: circa 100,000	Loan secured against a vehicle, which you are able to use	Age 38; income lower than national average (£23,000 v £26,370) Profile includes high number of products with outstanding debt; 40% in work, one third unemployed, 27% not working (caring responsibilities, ill-health). Complex financial lives: servicing other debts; debt consolidation; variable income patterns; periods of unemployment or sudden income shocks; unexpected bills or expenses; minority characterised with problematic behaviour (excessive drinking / gambling)	Large, if opaque, loan alternative where few others exist; Often less intrusive lending decision	Vehicles are key / essential household good that drives borrowing
Home Credit	2012: 900,000 with a value of £1.4 billion. 2016: circa 700,000 with a value of £1.3 billion.	Involves relatively small sums paid in cash generally repaid in under a year through weekly instalments.	Age 42; much lower average income (£15,500 vs £26,370) Predominantly used by people in low income households; for example, more likely than adult population to experience vulnerability or live in insecure situations; half in the lowest earning fifth of adults; majority of customers (90%) renting and nearly 40% reporting a long-term illness or disability.	Offers a higher level of personal service.. Offer payment options range; direct repayment through bank accounts or by post	Noticeably servicing the lower income scales. Making it as easy as possible for people on the periphery can create large loan book.

Catalogue Credit	2012: 2.8 million people. 2016,:1.9 million customers people to the value of £0.8 billion; Dramatic rise in the level of debt since the 2008 crisis	Catalogue lending (mail order / home shopping) provides the option of purchasing goods over a period of time by making weekly or monthly repayments on credit.	Age 45; Income lower than average (£17,700. V £26, 370). Large number of consumers have outstanding debt on catalogue credit (57%)	Offers an accessible, convenient and ease of repayment form of credit , Not perceived as a dangerous form of debt. Can be used to fund impulse purchases	Loyalty and trust
Rent to Own	2016: Consumers per year taking out a loan remained steady at 200,000 over the past five years. Overall, number of loans is falling consistently as is the value of outstanding debt (£0.5bn)	A form of credit which spreads the cost of purchasing consumer goods by allowing the borrower to lease the consumer good in exchange for a weekly or monthly payment, with the option to purchase at some point during the agreement.	Age 36; Close to average income (£24, 700 v £26, 370). High number of products with outstanding personal debt (8) Households taking out such credit are almost exclusively on low incomes and reliant to some degree on benefits. Rent to Own customers are less likely to have a mortgage and are relatively less likely to have credit card borrowing. However, they are more likely to hold other household bill debts and other high cost products than any other category of high cost credit user	Attractive to consumers who would not normally be able to afford a one off payment of hundreds of pounds for an item they need immediately.	Problem debt.
Pawnbrokers	2010: 1,300 pawnbrokers 2017: 1,800 with a total loan book value of around £0.5 billion.	Pawnbrokers earn their income on the interest charged on loans secured by a pledged item; and as a consequence (as the loan is secured) credit checks are not carried out.	Age 39. Women are most common among pawnbroker customers (64%); just under half of customers (46%) lived in families with dependent children; nearly half of customers (45%) reporting they rented their home from a local authority or housing association. Customers typically had low incomes (less than £300 per week), and around half (53%) lived in households where no-one worked	No credit check required it may offer better value than the other options open to someone with a low or modest income	Day to day expenses and bills are a driver of demand.
Illegal lending	2007: used by 165,000	People who lend money without a license. Loans are more likely to have	Illegal money lending is often concentrated amongst the most vulnerable members of society living in areas of significant deprivation (32% of IML borrowers face difficulty in putting	Fills a vacuum in legitimate credit	Responsible finance has a role to play in decreasing the finance

	2010: used by 310,000 individuals with some £120 million borrowed	extortionate rates of interest.	sufficient food on the table; 43% have difficulty affording fuel and heating; 52% have faced difficulties in affording shoes and clothing,	supply.	vacuum filled by illegal lending
Peer-to-Peer	2014: £547million 2015: £909 million	P2P platforms serve as 'brokers', bringing together individual borrowers and lenders, therefore bypassing traditional forms of lending.	The typical P2P borrower is a home owner with above average income. The money is typically used to fund buying a new car, home improvements or debt consolidation	Cheaper than bank loans	Efficiencies of fintech Individuals as sources of finance – but issues of risk appetite. Social investment? A very different profile compared to other consumer groups/
Affordable lenders (credit unions/ CDFIs)	2016: Credit unions, £788m; CDFIs £22.6m	Credit unions: variable and full range of amounts; secured and unsecured; to members (mostly minimum membership time required). Interest rates capped by law, considerably cheaper than payday / other non-standard lending products. CDFIs: short term, low value loans priced to recover costs of affordable and appropriate lending (average 130% APR?). No rate cap, no membership - lend against social mission	Credit union membership varies but generally further up the creditworthiness 'credit curve'. Older (45+), higher percentage of homeowners, employed, higher income brackets. Recent targeted expansion of junior savers and more financially disadvantaged by some. CDFI loan clients: Around half are unemployed, half live in social housing; half are female; half are single parents and 60% are on benefits. Around a third live in the UK's most deprived areas. Around 40% used a high cost credit provider in the previous twelve months.	Membership benefit; cheap, trustworthy, personal and responsible Substantially cheaper than (quick) alternatives; fair and trustworthy lending	

Beyond the Mainstream: Affordable Lending

Within the broader consumer credit landscape, a small but growing group of 'affordable lenders' has developed, linked with the concept of 'responsible finance' and as part of a broader 'community finance' movement. Affordable lenders comprise two major types of institution – credit unions and community development finance institutions (CDFIs) – and an emerging range of pilot partnerships and initiatives.

Credit unions are member-owned not-for-profit financial institutions that accept deposits and provide loans and bill payment facilities, as well as financial advice and education, life insurance and other financial products.

UK credit unions have grown substantially in the last decade, almost quadrupling their membership to just over 1.9 million between 2005 and 2016, and increasing assets to over £3 billion. They are legally obliged to define a group of people who share a 'common bond' from whom they can recruit their membership and to whom they can provide services. This is often the workplace and/or the local community. They are co-operatives run by and for their members.

Credit unions are by far the largest community finance sub-sector and operate with three main aims, to: provide loans at low rates (and which are capped by regulation at 3 per cent a month or 42.6 per cent a year APR in England, Scotland and Wales); encourage all members to save regularly; and help members in need of financial advice and assistance. Credit unions vary substantially in size and membership and in the services they offer; by being prepared to lend to people who are (or are likely to be) rejected by mainstream providers such as banks they can address financial disadvantage. As part of the commitment to their membership credit unions operate, a priori, on a 'responsible lending' model, which involves assessing the income and savings (or ability to save) of loan applicants.

Community Development Finance Institutions (CDFIs) are not-for-profit lenders who provide a range of loan products across the full range of access to finance markets: personal, SMEs (small and medium-sized enterprises), social ventures and home improvement lending. Personal lending is primarily aimed at people unable to access mainstream credit. Unlike credit unions, however, they do not require people to save before they can borrow (so need to raise capital for lending because they do not take deposits) and there are no restrictions on the rates of interest that they can charge or the geographical range of their lending.

The UK CDFI sector remains tiny within the consumer credit market. In 2016, ten CDFIs offered affordable credit personal lending products and six offered finance to homeowners to make urgent repairs to their homes or for energy efficiency upgrades. In 2016, total personal lending reached £19.8 million to 36,957 individuals, and £2.8 million to 389 homeowners.

Based upon provider infrastructures such as CDFIs and credit unions, a partnership-based community finance movement continues to grow and innovate, responding both to broadening issues of financial inclusion and seeking to develop community banking services alongside its traditional savings and lending activity.

An array of recent examples include: Citysave and London Mutual credit union banking services; Scotcash's partnership based expansion of its money management approach; ThinkMoney new entrant bank; Street UK moving in to on-line lending; BOOST Neighbourhood Finance; the platform-based Affordable Lending Portal for affordable consumer credit lending;

Headrow Money Line; and the entrance of responsible lender Fair For You in to the rent-to-own market.

Nevertheless, key challenges remain to expanding the affordable credit lending base to meet the growing affordable credit finance gap. These include:

- There are competing views about the future direction of credit unions within the sector itself, and given their 'common bond' membership basis;
- This relates to customers using commercial non-mainstream credit products such as payday loans and home credit being somewhat different from the traditional credit union customer base, which is generally made up of people higher up the 'credit curve';
- The credit union model limits the ability of the sector to provide the type of loans that those who use commercial high cost lenders demand: customer demand is for small, short term loans, processed quickly with minimal bureaucracy, online or on the doorstep. This is not the traditional lending model for credit unions, and a capped lending price of 3% a month is highly unlikely to directly cover the higher cost risk of default;
- Most credit unions still require new customers to save before they can borrow. This can be off-putting for many people, particularly those on the lowest incomes, as they are least likely to have any savings or be in a position to be able to save. In addition, this model does not fit with the top priority of payday loan customers, which is the speed at which they can access credit;
- In contrast, the average interest rate currently being charged by personal lending CDFIs is around 130% APR. Whilst high compared to the 42.6% maximum APR of credit unions, it is still significantly lower than rates offered by commercial providers in the high cost credit sector. Rates could be reduced further with expansion;
- The key issue for CDFI personal lenders is not that operational sustainability is constrained by capped interest rates but rather that as non-deposit taking organisations they need to source capital to on-lend.

The different challenges to both credit unions and CDFIs serving the non-standard market at scale is one of the drivers for the sector to seek innovative collaborations and partnerships. More broadly, such partnerships may also support the wider community finance and banking visions of many in the sector.

Scaling Affordable Lending

Over the past decade the responsible finance sector has helped several million people access affordable credit, mostly avoid high cost lenders and potentially evade a cycle of over-indebtedness. Nevertheless, compared to the scale of demand this has only 'scratched the surface'; with evidence of the impact of regulatory change suggesting further recent substantial and rapid growth in the demand for affordable credit finance.

Affordable lenders have responded through modernisation programmes, mergers, partnerships and new innovative forms of collaboration, products and services - but it remains the case that the sector faces substantial challenges and barriers to scaling up and increasing the supply of affordable credit at national level, and as part of a broader community finance and banking movement.

Scaling up needs to occur in credit markets where consumers have demonstrated that cost and affordability are often relegated in decision-making behaviour behind ease of accessibility, speed of service, simplicity, trust, non-intrusiveness, and other non-price based factors.

Sustainable credit lending business models can be 'spreadsheeted' at (national) scale, but the issue remains how to take a small scale and patchy sectoral infrastructure from where it is now to such (economies of) scale.

Partnership

As currently configured it remains clear that no responsible finance provider is in a position to scale on its own to the point that it could impact substantially within a national consumer credit environment – it will need to partner, whether that be to access customer volumes, access capital of scale, and/or put in place systems and procedures to manage demand and post loan requirements at scale.

The Community Banking Partnerships, Credit Union Expansion Programme and myriad other pilots within the community finance sector all tell a story that partnership is neither straightforward nor easy. Differentiated missions and rationales, organisational cultures, legal and regulatory constraints, and mismatched protocols and procedures are just some of the pitfalls that mitigate against successful partnerships and reinforce one of the key long term lessons of the CBPs, 'adequate resourcing is essential to partnership work'.

This report has provided some examples of recent partnership activity and, in 2017, Responsible Finance published Creating Local Finance Partnerships: A Toolkit to support responsible finance lenders in developing partnerships and the move to greater scale.

Deal flow (or loans at volume)

It is recognised that loans at volume are a, if not the, critical step to sustainable business models – both in terms of meeting the demand for responsible finance products and sustainable business models.

Accessing consumers

UK credit union membership remains low on international comparison. CDFIs have even less awareness amongst the general population or within consumer credit markets.

Even on their own terms **brand remains weak**, and marketing budgets and skills highly limited, and that is before setting responsible finance providers against the substantial budgets and demonstrated marketing prowess of, say, payday lenders and the finance mainstream.

One recent development is to partner with recognised consumer brands. In Scotland, Scotcash has partnered with Virgin Money to provide basic bank accounts in Scotcash branches. The national Affordable Lending Portal pilot has partnered with Asda, providing a web-link from Asda Money alongside some in-store promotional activity.

Credit unions face **regulatory restrictions** on the market they can lend to and the size they can reach. Furthermore, as 'common-bond' membership organisations, it remains the case that capital for on-lending is drawn from member savings. This implies an agreed contract between members as to the nature and risk of any such lending (and subsidy) across membership cohorts, and an undoubted tendency towards risk-averse lending.

A further barrier is **established consumer behaviour**. Once consumers have found a reliable credit source and are content with the service they receive, the evidence is that they tend to stick with that provider and are reluctant to switch, even where a cheaper alternative could save them money. This has been demonstrated also regarding the limited impact of a range of 'switching' initiatives put forward across products such as bank accounts and utilities.

When consumers have limited potential sources of credit they are especially keen to maintain a relationship with their lender, build trust and not risk jeopardizing this for a new lender who may not be available to them in future. The greatest resistance to switching lenders has been found amongst those on the lowest incomes who don't want to risk disrupting their finances.

The lending process

Consumer behaviour within non-standard credit markets is driven very strongly by non-price considerations, especially **ease of access (whether high street or on-line) and speed of decision making**. This remains a major barrier for responsible finance providers.

Given membership requirements, the typical credit union lending process remains multi-stage and relatively and generally slow. Much remains paper-based, although there are numerous and expanding examples of the introduction of the efficiencies and effectiveness of electronic processes including, for example shared automated lending tools. Within an almost upon us era of platform finance, open banking and 'fintech', peer-to-peer and payday lending has demonstrated latent demand and customer expectations regarding easy and fast decision-making. Pilots by responsible finance lenders have demonstrated further that in these markets consumers are willing to pay additional fees for speed of access.

Whilst personal lending CDFIs tend to have stronger and speedier lending processes, their **geographical coverage and loan capital is limited**. Fair for You is a recent example of a responsible provider that has adopted a national on-line lending model through their 'digital high street'.

Aside from operational systems, fundamentally, of course, 'slowness' in decision making by responsible finance providers is related to their 'relationship' finance approach and careful **calculation of 'affordability' to ensure responsible lending**. This includes the ability for further signposting to appropriate lending channels and / or financial advice and education opportunities. The challenge remains to balance information requirements against (speed of) decision making, including the layering of information requirements around different consumer segments and the depth of 'relationship' believed to be required.

Considering this, the other major information requirement in the lending process is **credit scoring**. In the main, credit unions and CDFIs adopt or replicate the credit scoring methodologies of mainstream credit providers, adding subsequent information and / or further engagement with the client. Two issues arise from this use of mainstream credit scoring approaches: first, the danger that responsible finance providers are merely replicating the issue of exclusion from mainstream finance and, second, and more common, that this does not provide the full information required to make the lending decision appropriate within responsible lending consumer credit markets.

Most recently, a number of developments around 'inclusive credit scoring' have emerged. These are framed around using a wider range of indicators, sources of information or financial transactions to assess credit scores in contrast to the highly dominant FICO models. For responsible finance providers, whilst attractive in principle, the adoption of such innovative approaches to credit scoring would likely require significant and complicated changes to underwriting and the documentation procedure.

Post loan management

Arguably, the greatest driver of company exits from payday lending markets has been the combined impact of recent regulatory change on business models and the 'contribution' of post loan management. Put another way, remaining lenders now receive the vast majority of their revenues from the contractual interest payments agreed with the (more appropriate) customer at the start of the loan, rather than revenues from late fees, late interest or rollovers – or what could be described as a distinctive form of ('irresponsible') post loan management.

Clearly, whilst responsible lenders have never held this business model, as they scale up into potentially riskier markets and consumer segments of non-standard credit the message is still highly pertinent - of how appropriate underwriting married to post loan management and loan delinquency is a critical determinant of any sustainable business model.

Accessing capital

A key concern for CDFIs is to secure capital for on-lending, given that unlike credit unions they do not take savings. This remains a key barrier as regards scaling up. Concerns have long been expressed by these responsible finance providers that investment in awareness raising and marketing will raise lending demand but without the capital to fulfil such demand; in turn, requiring the need for demand management to avoid, simply put, running out of money. The issue of 'turning the taps on and off' has long plagued the sector as attaining sufficient capital has remained a long run problematic.

Policy driven funding remains inconsistent, often localised and rule-bound, despite strong recognition of concern around financial inclusion, consumer detriment and indebtedness. Social investment has grown as a funding source but is of limited scale. Without lending responsibly at volume in higher risk lending markets, sustainable and investable business models are compromised.

In contrast, the combined asset base and loan funds of credit unions continue to grow, but given their membership profiles and maximum interest rate cap, lending in to riskier consumer credit markets is operationally constrained, notwithstanding membership desire given vision and mission.

A sustainable business model?

For credit unions, given mission and rate capping, pilots have provided evidence as to how sustainable lending activities might be developed and maintained in non-standard consumer credit markets - but such models are 'vulnerable' in the move towards riskier consumer segments. For CDFIs, and without rate capping, servicing of such markets in a sustainable manner is possible but operating infrastructures remain under invested and funds for lending sparse. Without volume, income driven models remain more ambition than reality beyond localised provision. As Alexander et al. (2015) note: "this customer base requires immediate access to small, short term loans, processed with minimal bureaucracy, online or on the doorstep. This type of lending is intrinsically expensive – particularly as there is also a high risk of default."

The on-going Affordable Lending Limited, a partnership of CDFIs and credit unions with Asda and Experian, is one such pilot attempt to create a national platform-based product offer, fulfilled by a group of responsible finance providers, and in which to test models and pricing. It combines partnership, platform and provider diversity – but currently remains some way from determining pricing and a sustainable business model.

What may be a particularly pertinent statement for responsible finance providers on market positioning and business model frameworks can be taken from combining recent conclusions from FCA and commercial industry reports:

- FCA: lenders have been incentivized to issue loans that are affordable and that consumers can pay back on time, so that the lender is more likely to successfully collect the contractual interest payments, rather than revenues from late fees, late interest or rollovers; and,
- Industry report: the view is that shorter pay day loans are now unprofitable with the most attractive loans set at over £300 for between 3 and 7 months and alongside substantially reduced default levels.

Furthermore, it is suggested that success in high cost short term credit lending is dependent on the following:

- Effectiveness of marketing and advertising in driving high volumes of traffic to operators' websites at low average costs;
- Low cost back-office processes involving a high degree of automation;
- Accurate credit assessment processes to enable loans to be offered without incurring high collections costs and write-off rates; and,
- Compliance with FCA Handbook regulations and other relevant laws to ensure that FCA authorisation is retained, penalties are avoided and agreements are legally enforceable.

1 Introduction to this Review

In February 2017, Responsible Finance (RF) and Centre for Business in Society (CBiS), Coventry University were funded by Oak Foundation to undertake a research programme to advance the supply of sustainable and affordable finance products to the millions of consumers and families excluded from mainstream credit and lending markets. Its particular focus is to investigate how to overcome a number of known barriers to affordable lenders meeting consumer demand at a national scale and in a sustainable manner.

The Oak Foundation (http://oakfnd.org/) commits its resources to address issues of global, social and environmental concern, particularly those that have a major impact on the lives of the disadvantaged.

Responsible Finance (http://responsiblefinance.org.uk/) are the voice of the responsible finance industry. They support a strong network of responsible finance providers who are increasing access to fair finance across the UK. At their heart is the idea of bringing social and economic benefits to people, places and businesses.

This Review forms part of a larger programme of work including: Evaluation of the Affordable Lending Portal; Case Studies of other affordable lending initiatives; and an investigation in to the emergence of 'inclusive credit scoring' approaches.

All these outputs are framed by seeking to support responsible finance providers to overcome the barriers to scaling affordable lending.

1.1 What is affordable credit lending?

Access to financial goods and services is a key requisite for full and fair participation in today's economy and society. Yet many millions in the UK are unable to secure access to mainstream finance, paying more for financial goods and services, with less choice, and often exacerbating financial vulnerability and risk. Such financial exclusion has been shown to have negative impacts on education, employment, health, housing and overall well-being.[1]

The vision of affordable credit lenders is that in the UK, wherever people live, they should have access to more affordable and appropriate forms of credit, which reduce the cost of borrowing for those outside of the mainstream, are delivered in a fair, respectful and responsible manner, and support financial resilience and reduced financial exclusion.[2]

1.2 This Review

In July 2017, the Financial Conduct Authority published a comprehensive market assessment and set of technical annexes that considered the high cost credit market given its recent substantial regulatory activity, including a credit price cap.[3]

This Review draws on a range of academic, think tank, policy, advocacy and financial industry reports to provide a broader historical and literature context to this market assessment activity, and which is focused on the position and implications for affordable consumer lending.

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[1] See http://www.financialinclusioncommission.org.uk/about

[2] See, for example, https://www.carnegieuktrust.org.uk/project/affordable-credit/ and http://responsiblefinance.org.uk/responsible-finance-providers/what-is-responsible-finance/.

[3] https://www.fca.org.uk/publications/feedback-statements/fs17-2-high-cost-credit

The Review begins with an overview of the demand for and provision of consumer credit. This places the affordable lending sector within the segmented and dynamic landscape of consumer credit. This frames an understanding of the strategic challenges to achieving a national range and scale of sustainable and resilient providers of affordable and suitable financial products. An appraisal of the current scale and scope of the affordable lending sector and its current initiatives then follows, before the Review ends on the barriers faced by the sector to meet the continued and substantial demand for affordable and fair consumer credit lending.

2 The Demand for Consumer Credit

2.1 What is consumer credit?

Consumer credit is a debt advanced to consumers for the purchase of goods or services (also known as consumer debt). It may be provided by shops, banks and a range of other financial providers. Consumer credit includes purchases obtained with credit cards, lines of credit and some loans. There are many ways to classify consumer credit, including use, method of generation (running account and fixed sum, restricted and unrestricted use, debtor-creditor, credit token and consumer agreements), and the kind of financial institution generating the loan (banks, finance companies, credit unions, others) (Consumer Credit Act, 1974).

2.2 The rise of consumer credit – as a mainstream financial product

It is generally recognised that the liberalization of financial markets and rise of non-bank lending in the 1980s enabled the growth of consumer credit (Fernandez-Corugedo and Muellbauer, 2006; Langley, 2008a; Leyshon and Thrift, 1997). This facilitated access to personal credit from mainstream sources such as credit cards, overdrafts and loans for those on middle and higher incomes with good credit scores. Such access supported the ability to consume goods and services to maintain or enhance lifestyle, particularly if incomes were squeezed (Crouch, 2009). By 2008 – 2009, as the global financial crisis was about to unfold, two-thirds of people in the UK had at least one form of unsecured credit (Rowlingson and McKay, 2014).

Today, most UK adults hold a credit card, with around 30 million cardholders in 2015 (FCA, 2017). Consumer credit has come to be viewed as one financial tool 'among a wider set that enables consumers to maintain, promote and enhance their own welfare' (Marron 2012). Recently, Bank of England figures in the year to November 2015 reported that credit card debt, personal loans and other forms of borrowing rose by 8.3%, the highest rise for nearly a decade (BoE 2015:7). The amount borrowed by British households had risen to £178.6 billion; with credit card borrowing rising by more than £2 billion to £63.3 billion; and debt on personal loans and overdrafts rising by £4 billion to £115.3 billion (BoE 2016:7).

Credit users rarely rely on a single product for credit, tending to use different credit products for different types of borrowing; though many borrowers have a dominant credit product within their overall credit portfolio. Typically this is a matter of personal preference but also reflects the credit options made available to any individual. Nevertheless, revolving credit (primarily in the form of credit cards) has become the dominant mainstream credit model (FCA, 2016; POLICIS, 2015; Shargall, 2016).

Credit cards allow consumers to make purchases or cash withdrawals on credit, up to an agreed limit. A consumer borrows from the credit card issuer when they use their credit card to make a payment, withdraw cash (to buy goods and services) or make a balance transfer (for example to reduce the cost of debt when 0% balance transfers are used) or to earn rewards or cashback (paid by the retailer when the cardholder makes a payment) (FCA, 2017). Each month a minimum balance has to be paid off. Interest will be charged on any outstanding balance. Average APR for credit cards is 17.9% (UK Credit Cards Association, 2016). If the balance has been transferred from another card with an introductory offer of 0% APR, then no interest is charged on the outstanding balance. Interest generates the most revenue for credit card issuers; and there is strong competition for certain consumer groups, particularly those seeking 0% balance transfers (FCA, 2017; Shargall, 2016).

Amongst the around 30 million cardholders studies have shown that credit card ownership is heavily biased towards the more affluent (Payments Council Consumer

Payments Survey 2012; POLICIS 2015). Similarly, multiple card holding and the value of credit card balances is heavily influenced by socio-economic profile and income, with those on higher incomes more likely to have multiple cards and have much higher balances and card limits (POLICIS, 2015). By contrast, if a customer's credit score is low (with credit cards applied for and issued based on credit checks) they may be refused a credit card or receive a poorer deal (such as a lower spending limit or higher interest rate) (Shargall, 2016). Given the dominance of affluent credit card holders, analysis of developments for all cards tends to obscure the dynamics of card use among low income card holders, who represent a relatively small share of cards in circulation and a smaller share of card balances (POLICIS, 2011).[4]

There are a range of providers, typically banks, but also mono-lines (firms that only provide credit cards) and subprime-focused issuers (that primarily target cards to those with a weak credit history). Most cards have a complex combination of features, for example: a standard credit card has no extra perks or benefits (but may offer a low interest rate to attract customers); a balance transfer credit card offers an introductory interest rate and sometimes a low fee on balance transfers; a rewards credit card pays rewards on the purchases you make; a premium credit card has lots of perks and benefits (like concierge services) sometimes for a higher annual fee; a retail credit card can only be used at the store associated with the credit card; and a secured credit card requires you to make a deposit against the balance (and is a good option for rebuilding bad credit).

Research by POLICIS in 2011 and 2015 has identified an overall growing trend of credit card debt repayment, with an increasing proportion repaying their balance in full. However, the evidence suggests that this is primarily a feature of the better off; and although many customers value the flexibility available from credit cards, for many low income groups increased flexibility is leading to increased consumer debt. Recent estimates by the FCA identify around 6.9% (2 million) of cardholders are either in arrears or had defaulted; with a further 2 million identified with persistent levels of debt and 1.6 million people consistently only paying off the minimum amount each month. The scale of indebtedness reflected in total outstanding balances is rising, from around £16 billion in December 2014 to around £63 billion in December 2015 (FCA, 2017).

Those on low incomes are identified as much more likely to revolve credit card debt, to make minimum payments, and to do so for an extended period (FCA, 2016; POLICIS, 2015). This partly reflects the broader phenomenon of credit card debt that is difficult to pay down being primarily a feature of the finances of the "squeezed middle" and, in part, differences between credit card models targeting the more or less affluent. For example, it has been noted that the lowest income borrowers using sub-prime cards characteristically have lower balances, and a higher proportion of revolvers, but with minimum payments set high to repay debt more quickly than with mainstream card models (FCA, 2016; POLICIS, 2015).

Today, credit cards are a core product within the financial portfolio of most UK adults with a multiple selection of card offers providing a balance of benefits and risks arrayed against a highly differentiated consumer base dependent on income, risk, historical credit profile and consumer preference.

2.3 Consumer credit – beyond 'the mainstream'

Historically, the most widely used form of consumer credit has been bank overdrafts and credit cards (POLICIS, 2015). In contrast to the 30 million UK credit cardholders,

[4] Policis estimated in a 2011 report that card holders aged 18-65 in the lowest 50% of household income represented 15% of cards in circulation but just 10% of card balances.

large numbers of individuals and households have been unable to borrow through these mainstream credit channels leading to what Carnegie UK Trust has labelled as the growth and diversity of 'non-standard' consumer credit options**.**

Non-standard options include high cost, short term credit (HCSTC) firms, home credit companies, rent to own businesses, pawnbrokers, specialist credit card and mail order catalogues, and a suggested 10 – 12 million customers (see Table 2.1 below, Carnegie UK Trust, 2017).

Table 2.1 'Non-standard' credit: The UK unsecured high cost credit market

Credit Type	Annual Consumers	Borrowing (£)	Outstanding (£)
Catalogue	1,900,000	800,000,000	4,000,000,000
Store Card	400,000	200,000,000	700,000,000
HTSTC	800,000	1,100,000,000	1,100,000,000
Home Credit	700,000	1,300,000,000	1,100,000,000
Rent to Own	200,000	600,000,000	500,000
Running Account	200,000	200,000,000	1,100,000,000
Guarantor	100,000	200,000,000	300,000,000
Logbook	100,000	100,000,000	100,000,000
Total	**4,400,000**	**4,500,000,000**	**8,800,000,000**

Source: Carnegie 2017, drawn from FCA HCSTC Appendix July 2017

Table 2.1 reflects an array of products and lenders, both historical (Kempson and Whyley, 1999; Collard and Kempson, 2005a) and which have grown up deliberately targeted at those on low or precarious incomes, with no or damaged credit histories and who have been further squeezed out in recent times by credit rationing within post-crisis banking regimes. The expansion of new forms of lending are generally recognised as the rise of the 'sub-prime lender' (French, 2014) – actively targeting and creating 'non-prime' customer markets – but which, at best, provide much more expensive alternatives to the mainstream and, at worse, have seen regulation to bear down on excessively high charges, poor lending practices and exploitation of the most vulnerable (FCA, 2014a; Carnegie UK Trust, 2015; Step Change, 2016).[5]

A third group of consumer credit providers are 'affordable lenders' such as credit unions - a financial co-operative movement for members with a common 'bond' (locality, employment, etc.) - and community development finance associations (CDFI). Jointly these continue to grow, including to both meet the demand from those unable to access mainstream channels and in an attempt to provide affordable, fair and alternative provision, in contrast to many 'non-standard' consumer credit options. Nevertheless, they remain very small compared to the other providers in the market, lending a combined total of around £800m in 2016.[6]

[5] Indeed such has been the growth of these lender types that terms such as 'predatory inclusion' and 'adverse incorporation' have been coined to describe a situation where 'fringe finance has become mainstream' (French, 2014; Kear 2013; Aitken, 2015).

[6] See http://www.abcul.org/media-and-research/news/view/776 and Responsible Finance (2017) The Industry in 2016

2.4 The problems of consumer credit

Today, the use of credit is now widespread in society and, for many, for most of the time, it is a convenient and flexible way of managing budgets and spreading the cost of larger payments. Critical to this use, however, is the reasons for doing so, the diversity of the customer base, and their ability to access the range of credit products on offer. Reflecting what academics have described as the on-going and increasingly pervasive 'financialisation of everyday life' (Martin 2002; Langley 2008), in particular, three especially major concerns have been raised concerning the everyday emergence of consumer credit, namely: the general nature and distribution of growing 'indebtedness' across the UK population; the increasing reliance on credit 'to get by'; and the costs and risks of differential access to credit borne by a spectrum of financially excluded consumers.

2.4.1 High levels of indebtedness

At the end of 2016, an estimated 27.4 million people had outstanding personal debt. This represents just over half of the UK adult population.[7] However, a relatively small number of people hold a very large share of outstanding debt; for example, 8 million people – 16% of UK adults - hold 82% of outstanding debts but just 1.3 million people or 2.6% of UK adults hold over 30% of outstanding debt.[8] In the 12 month period 2015-2016, there was particularly strong growth of 14% in consumer credit debt (Gibbons 2017). There is, however, caution about the concept of 'problem debt', especially given differences both in definitions and methods of data collection over time.[9]

Data from the Bank of England's NMG Consulting survey ('the NMG survey') indicates that whilst just under half of all households (48.5%) have consumer credit debts outstanding, the debt to income ratios of low to middle income households are much higher than for those further up the income distribution. Those on the lowest incomes are identified as holding a debt to income ratio almost four times as high as those at the top (46.5% compared to 12.9%). Households in the lowest two income quintiles are paying around one fifth of gross (pre-tax) incomes to consumer credit lenders (at an estimate of around 4.8 million households, containing 11.4 million people) (Gibbons 2017).

Alongside growth in consumer credit, and the debt servicing associated with it, a sharp decline in national savings has also been noted. The UK savings ratio moved down from 3.3% (from the previous quarter) to 1.7% for January to March 2017 – and down from a high of 11.5% in 2010 (Office for National Statistics, 2017). Around 40% of the working age population is estimated to have less than £100 in savings (UK Parliamentary Select Committee on Financial Exclusion, 2017), leaving them vulnerable to sudden income shocks such as unemployment, relationship breakdown or illness (Step Change, 2016).

2.4.2 Using consumer credit 'to get by'

A term that has come to prominence in public policy discourse, and refers to an increasing section of the population, is people who are 'just about managing' (Citizens Advice Bureau: n.d.). While, practically, it is difficult to clearly distinguish this growing group from those who are 'not managing', it speaks to financial struggles in everyday

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[7] FCA, 2017 High-Cost Credit Review Technical Annex 1: Credit reference agency (CRA) data analysis of UK personal debt, Table 3, July

[8] Ibid, Figure 3

[9] Although in October 2017 the head of the Financial Conduct Authority publicly noted concerns around the 'pronounced build up of indebtedness amongst the younger age group', http://www.bbc.co.uk/news/business-41627238

life. Studies identify a growing number of people who now rely on credit to pay for day-to-day essentials (Personal Finance Centre, 2014; Carnegie UK Trust, 2015). Estimates in 2016 revealed over 7 million people (15% of the population) in Britain turned to credit to pay for their everyday essentials; with over 13 million (27% of the population) reporting they would need to borrow money to cover an emergency cost (Step Change Debt Charity, 2016); and around 2.7 million people estimated to be using (in some cases unauthorized) overdraft facilities to meet everyday expenses (Community Investment Coalition, 2017).

Furthermore, research published in 2016 by the debt charity StepChange estimated 4 million people were regularly using credit as a 'safety net' and for basic money management. These were characterised as working families on lower and middle incomes; in more insecure, 'casual' employment; with 36% struggling financially (including falling behind on household bills and credit payments) – compared with just 7% of the overall population in financial difficulties as a whole.

It is this use of credit, as a 'safety net', that has raised questions about the consumer credit market, and in particular about consumer debt and financial ex/inclusion. This is because this use of credit, over a prolonged period, can quickly lead to further financial difficulties as credit repayments become an additional essential cost that have to be met, potentially leading to consumers falling back on commitments and building up problem debt. Problematic features of commonly used credit products, such as irresponsible lending, costly and complex default fees and charges, the fact that individuals often have multiple products, and the structure of minimum payments are thought to contribute to problem debt (Step Change, 2016). Moreover, there is the gradation to 'debt spirals' which typically include a progression from the missing of debt repayment through escalating penalty charges and pressure from creditors to legal proceedings, enforcement orders and eviction (Griffiths Commission, 2005; POLICIS, 2015; Rowlingson and McKay, 2016).

In its most recent update on the 'non-standard' consumer credit market the FCA (2017) noted that the credit scores of those using high cost credit products worsened significantly between 2015 and 2017. Despite recent evidence that the market is functioning more appropriately and providing much greater levels of affordable loans the FCA concluded that users of high cost credit are experiencing 'difficult and deteriorating financial situations'.[10]

2.4.3 Financial inclusion / exclusion

The term 'financial exclusion' emerged in the early 1990s in the UK, reflecting concern among geographers especially towards bank closures and their impact on access to financial services (Leyshon and Thrift, 1994; 1995).[11] The phenomenon is multi-faceted and can include problems of physically getting to services, issues with passing risk assessment for financial products, exclusion caused by an unaffordable price of credit, an unawareness of credit products and instances where people 'exclude themselves voluntarily' (Leyshon et al., 2006).

The term 'financial inclusion' has in many respects replaced 'financial exclusion' in much of the policy and literature on this topic (HM Treasury, 2004; Marshall, 2004; Mitton, 2008). It has been suggested that financial inclusion occurs when individuals are able to: manage day-to-day financial transactions (such as through appropriate bank accounts); meet one-off expenses (both predictable expenses through savings, and unpredictable expenses also through savings and/or appropriate credit and insurance products); manage a loss of earned income (such as through savings,

[10] FCA (2017) High-cost credit including review of the high-cost short-term credit price cap 17/02, July; Figure 3.1 and 3.2

[11] More recently, see the Move Your Money campaign; https://twitter.com/moveyourmoneyuk?lang=en

including pension savings); and avoid/reduce problem debt (Rowlingson and McKay, 2016).

These multiple criteria are useful in reflecting the sense of differential levels of financial inclusion across the population but, at its most stark for example, in 2015 it was estimated that there were two million people in the UK without a bank account. As a consequence, it was estimated that these individuals were incurring around £1,300 per year in additional costs as a result (Financial Inclusion Commission, 2015), and providing just one example of the 'poverty premium' incurred by those experiencing differential access to financial products and services (Strelitz and Korber, 2007).

2.5 Variegated and problematic consumer credit markets?

The provision of, and access to, consumer credit is now part of the financial DNA of the UK, such that fair and affordable access has come to be seen as a requisite for full and fair participation in today's economy and society. Why this has become so has, and continues to be, connected to a variety of causes including financial liberalisation and financialisation of the everyday, consumerism, restructuring and retrenchment of the welfare state, the growth of sole trader and SME business demographies and precarious labour markets, and, ultimately, polarised, low and insecure incomes.

The market landscape of today is that of 'variegation' (Appleyard et al., 2016) – a series of overlapping but nevertheless tiered consumer credit systems; in shorthand ranging across prime, near prime, sub-prime, and sub-sub-prime to simply illegal. Across this highly dynamic market, problems are evident.

Within the prime market, the FCA has recently published a Consultation Paper (April 2017) proposing measures to tackle persistent credit card debt and encourage earlier intervention. Meanwhile the 'sub-prime' or 'non-standard' market is witnessing a period of structural change as part of an earlier 'rate cap' intervention by the FCA, with lending volumes falling by around two-thirds since 2013, market exit and a tightening of credit provision in non-standard credit markets (FCA, 2017).[12]

Whilst such a reduction in poor and inappropriate lending activity has been welcomed, and regulators have tended to view restrictions in supply as part of market solutions, many studies have highlighted that such restrictions do not necessarily correspond with a drop in demand (Bryan et al., 2010; Langley, 2008b; Rowlingson et al, 2016). Thus concern has turned to what viable alternative routes to credit now exist for these consumers, including affordable lending. In turn, the sheer scale up required of affordable lending providers becomes clear, especially in the face of the continued limitations and barriers reflected in current scale-up initiatives. The even greater concern is that these customers may turn to 'sub-sub prime' and or illegal lenders.

[12] FCA (2017) High-cost credit including review of the high-cost short-term credit price cap 17/02, July

3 Consumer Credit Provision: 'beyond the mainstream'

This Review continues by outlining the market landscape of variegation across 'non-standard' provider segments before turning to the affordable lending sector and the challenges it faces.

3.1 'Non-standard and HCSTC provision'

When credit is unavailable from mainstream financial providers, low and precarious income consumers and the credit impaired turn to an array of alternative 'sub-prime', non-standard providers, notwithstanding that costs will be higher and terms and conditions poorer. However, whilst this diverse customer base includes many of the poorest and most vulnerable people in society, this is certainly not true of all customers in this market; with differences in the demographic profile of users of different financial products.

Using what is an increasingly crude distinction of 'sub-prime' (see Section 2), this market offers secured and unsecured loans to people with a history of bad debts, poor credit records, over-stretched mortgages, defaulted loans, low and volatile incomes, etc.. These companies have tended to largely resemble lenders in the prime credit market except that their charges are significantly higher to reflect the higher-risk borrowers they serve (Corr, 2007). A distinguishing feature is their use of credit-rating practices which allows them to ensure that they make a profit regardless of the risk, and a hierarchy of price banding allows that a client will be charged automatically in accordance with the stability of their repayment history (Burton et al., 2004).

As noted earlier, the UK sub-prime credit market is, however, finely segmented and features a diverse product mix and a wide spectrum of pricing. It represents a large sector, which has rapidly expanded, including the rise to prominence of the 'high-cost short term credit' (HCSTC) segment serving the highest risk borrowers. A broad definition adopted by the regulator (FCA) and outlined in the Consumer Credit sourcebook (CONC), HCSTC captures a range of different loan products that are regulated credit agreements:

- *which are borrower–lender or P2P agreements; and*
- *in relation to which the annual percentage rate (APR) is equal to or exceeds 100%, either:*
    - i. *in relation to which a financial promotion indicates that the credit is to be provided for any period up to a maximum of 12 months or otherwise indicates that the credit is to be provided in the short term; or*
    - ii. *under which the credit is due to be repaid or substantially repaid within a maximum of 12 months of the date on which the credit is advanced;*
- *which is not secured by a mortgage charge or pledge.*

Types of product captured within these definitions vary in terms of for how long money can be borrowed (ranging from a day up to a year), and how much can be borrowed (from small, fixed amounts to larger amounts repaid in instalments). The most common of these are 'payday' loans, notwithstanding the fact that they are often not paid back on 'payday' (nor only cover a day or two shortfall, see Section 2.4).

Other products covered in this section include logbook loans, home credit, catalogue and rent-to-own. One of the oldest forms of consumer credit in existence, pawnbroking, continues to not only survive but thrive, whilst unlicensed and illegal moneylenders continue to exist. Peer-to-peer is a recent form of credit provision.

3.2 Payday loans

In 2013, at what is viewed as the peak of the industry, there were around 90 payday lenders issuing £2.8 billion worth of payday loans to 1.8 million UK customers (Competition & Markets Authority, 2014).[13] The 11 major lenders comprised Ariste, CashEuroNet, CFO Lending, Cheque Centres, Dollar, Global Analytics, H&T, MYJAR, SRC, The Cash Store and Wonga. By 2016, the market was estimated to have reduced substantially to £1bn lent to around 760,000 consumers.

3.2.1 The Product

In the UK, the Competition and Markets Authority (building on the approach taken by the Financial Conduct Authority) defines payday loans as: *short-term, unsecured credit products which are generally taken out for 12 months or less, and where the amount borrowed is generally £1,000 or less.*

There are two lending channels for such loans: where customers visit a lender (or intermediary) website initially (online) and where customers are required to visit a high street store (retail). Online lenders operate an almost exclusively automated approach to verify customer details and assess credit risk whereas retail lenders will use a combination of automated and manual processes. Approach notwithstanding, access to finance is relatively quick with loans typically transferred to customers the same day (although online applications can be processed as quickly as 10 minutes).

Historical transaction data provided by the largest lenders identified payday loans as, typically, for relatively small amounts (usually £100 or less); and for shorter-term products the maximum amount that can be borrowed by a new customer generally lay between £100 and £500; with repeat customers and those using longer-term products often able to borrow higher amounts, although rarely more than £1,000. CMA (2015) analysis of lending data for loans issued between September 2012 and August 2013 identified the average size of a payday loan to be £260; with the single most common amount borrowed £100 (around 25%) although amounts of £50, £150, £200 (around 50%) and £300 were also relatively common. Across lenders, average values of payday loans varied substantially (from £163 up to £326). Borrowing profiles identified that high-income customers, older customers, those in full-time employment and those who own their own house all took out larger than average loans; with unemployed customers found to have the lowest average loan value (TNS BMRB, 2014).

Payday loans are typically issued for relatively short durations (often repaid in a single instalment). The lending data analysed by the CMA identified over 80% of loans had durations of 31 days or less (10% of customers borrowing for a week or less), and over 95% a duration of 90 days or less. Longer-term products accounted for around 4.5% of all loans, providing the facility for customers to repay in several instalments – the duration again often varying by lender and product but typically lasting between 2 months and 1 year. Some lenders offered flexibility to customers who wanted to borrow additional amounts. For example, some allowed customers to extend – or 'roll over' – an existing loan for an additional period if they paid off outstanding fees and interest. In addition to roll-overs, some products allowed customers to borrow further amounts – or 'top up' – during the course of a loan.

Credit from payday lenders is considerably more expensive than from mainstream lenders with payday lenders usually charging a fee instead of an interest rate. Typically, a £100 loan for a month has a fee of around £25 (so a customer would repay £125) (Moneysaving Expert, 2017). Alexander et al. (2015) demonstrate that extremely high headline rates of APR are due to the short term loan periods, but note that costs are high due to the fixed costs of lending not reducing with small loans, the high risk customer base and the use of cash. More broadly, Alexander et al. (2015)

[13] CMA (2014) Payday lending market investigation: provisional findings report. FCA have suggested similar but slightly different figures, 1.7m customers and a total of 10.3m HCSTC loans worth £2.5bn, FCA High-cost credit Including review of the high-cost short-term credit price cap 17/02 (July 2017)

provide a succinct and comprehensive summary of the parameters of the payday loan market, the attractiveness of the product to consumers – especially due to speed of provision – and evidence on the type of consumer.

There is, however, a fundamental transformation on-going in the segment.

3.2.2 Transformation through regulation

In 2014, the high cost short term credit (HCSTC) sector experienced a major transformation in FCA regulatory regime, in addition to measures brought in by a Competition and Market Authority (CMA) market investigation and HCSTC price cap introduced from November 2014 (an initial cost cap of 0.8% per day; a £15 cap on late fees; and a total cost cap of 100%; FCA, 2014b).

New regulation specifically aimed at the HCSTC sector has introduced:

- a restriction on the number of rollovers to no more than two per loan;
- a maximum of two unsuccessful Continuous Payment Authority (CPA) attempts to draw money from a customer's bank accounts to repay loans;
- requirements that HCSTC lenders (along with all consumer credit providers) apply for authorization (including the need to demonstrate they can meet threshold conditions (COND));
- a supervisory regime, whereby the FCA proactively investigates evidence of consumers suffering due to poor services and products – with powers to intervene; and,
- handbook requirements – firms are required to comply with the standards set out in the FCA's handbook including the Principles for Businesses (PRIN), rules on senior management arrangements, systems and controls (SYSC), and some general provisions including rules on setting out firms' regulatory status. Since authorization, HCSTC lenders are also subject to quarterly product sales data (PSD) reporting and annual regulatory reporting requirements.

Subsequently, the CMA, as part of reforms to improve the effectiveness of competition in the sector, has introduced a price comparison website and increased clarity on charges (effective from December 2016).

The impact on HCSTC provision has been immediate and profound. For example, data for the first nine months of 2014 reported that revenue and new lending was down year on year by 27% and 26% (respectively); with four major lenders exiting the market rapidly.[14] By 2015, the top 8 market lenders had 2015 revenues of c. £400m, down from £700m for the top 8 in 2014 (and which were a different set of lenders).[15]

The FCA expected a decline of approximately 250,000 consumers per year, whereas the actual subsequent decline has been measured at some 600,000 consumers per year. FCA data and consumer research (YouGov, 2015) suggests that the sharp reduction in HCSTC usage appears to be predominately driven by a reduction in the acceptance rates of loans (loan acceptance rates falling from around 50% to 30% between 2014 and 2015); with only 13% of declined HCSTC customers accessing another source of credit in the following 30 days.

Indeed, most recent FCA statistics suggest that by 2016 the market had shrunk from 10.3m loans in 2013 to 3.6m loans, worth around £1b against a previous £2.5bn, and distributed to 760,000 consumers as against 1.7m consumers.[16] As a recent industry report noted, whilst the FCA prediction of market consolidation to only 4 providers has

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[14] Ariste, CFO Lending, Cheque Centres and The Cash Store.

[15] https://www.apex-insight.com/product/high-cost-short-term-credit-market-insight-report-2017/

[16] FCA High-cost credit Including review of the high-cost short-term credit price cap 17/02 (July 2017)

not yet happened, the expectation is that four providers will cover 90% of the market within 5 years.[17]

This industry exodus and reduction is due to the impact of these extensive regulatory changes on the functioning of the market and, relatedly, the nature of the product now available in the market. Complying with regulation and providing customer service over longer loan durations have created additional costs for lenders. Consequently, gross profit (revenues minus loan losses) has fallen relative to the number of loans, number of customers and the size of the loan book.

In terms of product, FCA regulation – in particular the price cap – has reduced the cost of credit. The SMF found that up to April 2016, the cost of borrowing was down £36 for a 30-day loan, and that over half of borrowers say loans are more affordable (FCA, 2016). Similarly, requirements on rollovers, re-lending and affordable lending have been far-reaching. The volume of HCSTC lending has fallen sharply since 2013, with reduced loan acceptance, reduced default and late fees, longer loans and lower loan usage per customer. FCA and SMF data (SMF, 2016) shows that: loan acceptance rates[18] fell from around 50% to around 30%; the proportion of loans being charged a late payment fee has decreased from 16% to below 8%; and the proportion of loans entering arrears for seven days or more has decreased from 16% to 12%. Further, loan size has stayed broadly constant, while loan duration has increased from nearly 30 days to nearly 80 days, which has improved the affordability of loans and resulted in more clarity about the total costs upfront; and the number of loans taken out by consumers over a 6-month period has significantly fallen.

Put another way, lenders now receive the vast majority of their revenues from the contractual interest payments agreed with the customer at the start of the loan, rather than revenues from late fees, late interest or rollovers (CFA, 2017). Consequently, in the eyes of the FCA, lenders are incentivized to issue loans that are affordable and that consumers can pay back on time, so that the lender is more likely to successfully collect the contractual interest payments. In the eyes of industry market reports, the view is that shorter pay day loans are now unprofitable with the most attractive loans over £300 for between 3 and 7 months and alongside substantially reduced default levels.[19]

3.3 Logbook loans

A logbook loan (also known as 'bills of sale'[20]) is a loan secured against a vehicle. There has been a rapid increase in the use of logbook loans as reflected in the use of bills of sale rising from nearly 3,000 in 2001 to over 52,000 in 2014. Only around 350 bills of sale in 2015 were related to loans against other goods than vehicles (The Law Commission, 2016, Bills of Sale, Law Com no 369). By 2017, it was estimated that there are now 100,000 annual logbook customers.

3.3.1 The Product

The loan is analogous to a pawn-broking arrangement, whereby full ownership of the vehicle is returned after the loan has been repaid. In contrast to 'pawned' items, however, as long as the borrower keeps to the repayment schedule they can continue to use the vehicle. However lenders - unlike for hire purchase - are allowed to seize vehicles without a court order, even if almost all the logbook loan has been repaid.

Logbook loans offer the benefit of access to credit without conventional credit checks, and a larger loan amount than (many customers perceive) to be available elsewhere. Providers often:

[17] https://www.apex-insight.com/product/high-cost-short-term-credit-market-insight-report-2017/

[18] As measured by the FCA

[19] https://www.apex-insight.com/product/high-cost-short-term-credit-market-insight-report-2017/

[20] UK Law Commission.

- have high APRs (typically 400% or more) plus additional fees and charges;
- appear to rarely carry out affordability checks;
- mainly consider the value of the car when granting a loan online rather than the individual's ability to pay;
- consider employment status as more important than the value of the car when granting a loan in branch; and,
- in the UK, report that they abide by the trade-body Consumer Credit Trade Association's (CCTA) code of practice (FCA (2014) Consumer Credit Research: Payday Loans, Logbook Loans and Debt Management Services).

Consumer research (Citizens Advice Bureau (2013), Logbook Loans Campaign) has identified that the majority of those who take out a logbook loan are in work (40%), with around a third unemployed, and over a quarter (27%) not working due to factors such as caring responsibilities or ill-health. Other research has highlighted the complex customer needs of logbook borrowers: dealing with financial challenges (such as servicing other debts or attempting to consolidate debts); variable income patterns; periods of unemployment or sudden income shocks and/or unexpected bills or expenses; with a minority characterised with problematic behaviour (such as excessive drinking or gambling) (FCA, 2014).

Borrowing is typically characterised by:

- the perceived benefits of being able to access large amounts of credit without credit checks, with repayments staggered over a longer period (than for example payday loans);
- few alternative sources of large amounts of credit;
- discovery of the product and the lender at the same time, doing little or no shopping around;
- being unclear about important loan aspects (such as the total cost of the loan, additional charges, and the fact that ownership of the vehicle transfers to the lender); and,
- misleading and limited communication by some lenders: with evidence suggesting that the costs of loans is often not visible in advertising; that additional fees and charges are not always clear - masking the total amount of the loan; contracts often complicated with key terms and conditions buried within lengthy small print (The Law Commission, 2016).

This has generally translated into poor borrowing outcomes with research highlighting the scale of indebtedness of logbook consumers compared with other forms of credit. For example, the Citizens Advice Bureau, in its analysis of more than 23,000 cases of significant debt problems handled between April and September 2013, found on average:

- Logbook loan debts were worth more than double that of payday loan debts (£2,500 compared to £1,000);
- People with logbook loans had a total of 10 debts (including other forms of credit) - double the number of loans held by all debt clients;
- Over half (57%) of clients with logbook loans also had one or more other types of high cost credit;
- Just over a third (37%) of clients with logbook loans also had one or more payday loans; and,
- A sizeable total amount of debt (across all loans) for people with logbook loans – estimated at £13,500.

3.3.2 Transformation through regulation?

Given such evidence, the government has raised considerable concerns about consumer detriment in the logbook loan market. In particular this relates to the lack of protections available to consumers who take out a logbook loan, as well as innocent third party purchasers who unknowingly buy a vehicle that is subject to a logbook loan. This concern sits alongside government's wider reformation of the consumer credit market led by the FCA. A Law Commission investigation has recently reported providing a variety of recommendations for a new replacement Goods Mortgage Act that provides enhanced transparency and protection for all parties involved in bills of sale/logbook activity.[21] The Economic Secretary to the UK Treasury has recently (February, 2017) confirmed planned changes to the law[22] to protect buyers and borrowers alike, based on at least some of the recommendations.

There was a fall in logbook loans in 2015 when logbook lenders were required to obtain authorisation from the Financial Conduct Authority (FCA). Now that logbook lenders have completed the FCA authorisation process, there is evidence that the market has been expanding once more. It has been demonstrated that the cost and complexity of logbook loans will be reduced once new legislation is enacted, although impact on volume of usage has not been estimated.

3.4 Home credit

Home credit - also sometimes referred to as a 'doorstep' loans (Competition Commission, 2013; Falconer and Lane, 2017) – are provided by local lending agents based within communities. Lending involves relatively small sums paid in cash generally repaid in under a year through weekly instalments.

The Consumer Credit Association states that there are over 420 home credit businesses in operation in the UK (Consumer Credit Association, 2017)[23] with FCA (2017) suggesting that, in 2016, just under 700,000 people took out a home-collected credit loan to the total value of £1.3 billion.[24]

3.4.1 The product

Given the 'doorstep' nature of loans, home credit loans are argued to offer a higher level of personal service than other forms of credit that are delivered remotely (Consumer Credit Association[25]). Lenders offer a range of payment options from direct monthly repayment through bank accounts or by post; although the most common form of repayment is direct weekly collection from customer homes by lending agents. Studies report that lenders believe this to be the best way of managing the risk of non-payment and retaining some control over repayment collection for those on low incomes (Collard and Kempson, 2005b).

Historically, loans typically range from £100 to £1,000, although at least one major lender offers repeat customers loans of up to £2,000; and Financial Conduct Authority (FCA) analysis of the Wealth and Assets Survey 2012-14 placed the median loan size at £500. The interest rate on loans is variable and is generally higher for smaller loans or loans taken out over a shorter time period (see Table 3.1).

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[21] http://www.lawcom.gov.uk/app/uploads/2016/09/lc369_bills_of_sale.pdf

[22] See the Government response to the Law Commission recommendations on Bills of Sale (February 2017) available at: http://www.parliament.uk/business/publications/written-questions-answers-statements/written-statement/Commons/2017-02-07/HCWS462/

[23] http://www.ccauk.org/about-us/membership-statistics/

[24] FCA High-cost credit Including review of the high-cost short-term credit price cap 17/02 (July 2017), Table 3.5

[25] See: http://www.ccauk.org/information-for-consumers/home-credit-what-you-need-to-know/

Table 3.1 Example of Loan Costs with the Largest Providers, June 2017

Loan Amount	Provider	Weekly Payment	Duration (weeks)	APR	Interest Charged	Total Repaid
£200	Mutual	£10.00	26	188.0%	£60	£260
	Morses Club	£15.00	20	756.5%	£100	£300
	Provident	£12.00	26	535.3%	£112	£312
	Loans at Home	£10.00	33	433.4%	£130	£330
£500	Mutual	£13.73	51	104.0%	£200	£700
	Morses Club	£17.50	52	272.5%	£410	£910
	Provident	£18.0	52	299.3%	£436	£936
	Loans at Home	£20.00	45	340.0%	£400	£900
£1000*	Mutual	£27.45	51	104.0%	£400	£1,400
	Morses Club	£35.00	52	272.5%	£820	£1,820
	Provident	£36.00	52	299.3%	£872	£1,872

Source: Centre for Business in Society Analysis of Lender Websites. Figures correct as of 30 June 2017.

* Loans at Home provide maximum loan amount of £750

Home credit is predominantly used by people in low income households; for example, the Citizens Advice analysis of the Wealth and Assets Survey 2012-14 identified home credit customers in the survey were more likely than the adult population to experience vulnerability or live in insecure situations; half were in the lowest earning fifth of adults; with the majority of customers (90%) renting and nearly 40% reporting a long-term illness or disability. Further research has shown that part of this customer profile seems to be the result of deliberate targeting, for example, one major lender stating that its target customer is often a middle-aged female in part-time/casual employment, having a low income of £10-£15,000 per annum, limited indebtedness and typically living in rented or social housing (Falconer and Lane, 2017).

Other studies have shown that 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. For example, Kempson et al. (2009) report that 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; with constancy of demand highest among customers with payment problems.

Most recently, FCA (2017) analysis of home-collected credit consumers has suggested that they are ‘a particularly vulnerable group’, with the median amount of outstanding debt more than doubling from £1,200 to £2,800 between November 2014 and November 2016.[26]

Studies critical of home credit have highlighted the benefit to lenders of keeping customers in a refinancing cycle, and problems associated with pressure sales (including repeat loans and unsolicited visits from a doorstep lending agent), poor affordability checks, and intimidating collection practices (Office of Fair Trading, 2004; Falconer and Lane, 2017).

Despite 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 - many use home credit as part of a portfolio of credit options (Kempson et al., 2009). 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 (Rowlingson and Kempson, 1994; Jones, 2002; Brooker and Whyley, 2005; Collard and Kempson, 2005). Other research has shown that, for people on low incomes, a key driver of demand is access to a 'trusted lender', with affordability more important than cost when it comes to repayments along with the desire for flexible repayments. Lender business models recognize this with common definitions of a 'quality' customer being those who make 60% of their repayments on time (Kempson et al., 2009). In terms of the home credit business model this means a single price, underpinned by cross-subsidy, is also vital with cross-subsidy occurring both between customers and over an individual customer's life cycle.

3.4.2 Industry developments and alternatives

At its peak in 2012 the industry saw 900,000 consumers borrowing to a value of £1.4 billion. Several years of small but steady decline followed but 2015-2016 saw strong year-on-year growth – over 12% and 21% growth in the number and value of lending respectively. The value of the average loan value also increased from £710 to £770.[27]

Recent estimates based on major companies' reported customer numbers puts the market size at over 1.3 million customers (Falconer and Lane, 2017). The largest providers account for the bulk of this figure: Provident had 860,000 customers, Morses Club had 200,000, Loans at Home had 95,000 and Mutual had 40,000.[28] Whilst Provident has reported a steady decline of customers over the past 5 years from 1.8 million customers in 2012 to just under half of that at the end of 2016, Morses Club has just reported an increase of customer numbers to 233,000 and a substantial increase in credit lent, although it is believed this may have been at the expense of Provident.[29]

Collard and Kempson (2005b) and Kempson et al.(2009) have examined the costs of home lending with a view to exploring the potential for reducing charges and of creating a sustainable not-for-profit sector. They have, however, highlighted a number of challenges:

- the level of need to borrow is high among people on low incomes and supply is constrained, so any new home credit service is likely to be met with high demand;
- new market entrants face real dangers of adverse selection due to demand likely to be highest among people who have the highest risk of default, with the importance of 'round density' to profitability (requiring high levels of recruitment in a small geographical area) with the potential to exacerbate problems of adverse selection;

[26] FCA High-cost credit Including review of the high-cost short-term credit price cap 17/02 (July 2017), p.39

[27] FCA High-cost credit Including review of the high-cost short-term credit price cap 17/02 (July 2017), Table 3.5

[28] These figures come from respective companies' Annual Reports or websites.

[29] https://www.creditstrategy.co.uk/news/doorstep-lender-issues-82m-of-credit-in-2017-3739

- the importance of attracting good agents with the skills and personality to deliver lending quality and collection performance (and ultimately financial results) is also important - with home collection channels remaining attractive to home credit borrowers there may be reluctance to move to cheaper, remote repayment channels;
- A high degree of cross-subsidy is also likely to be required with cross-selling potentially an important element in viability - reducing price sufficiently to motivate consumers is likely to require significant investment; and
- perhaps fundamentally, as third sector lenders look to achieve scale, developing a home credit model is often viewed as a poor use of funds, in recognition of the limitations of a not-for-profit home credit service.

3.5 Catalogue credit

Credit can also be tied to the purchase of goods. Catalogue lending (mail order / home shopping) provides the option of purchasing goods over a period of time by making weekly or monthly repayments on credit.

In 2016, 1.9 million people took out catalogue credit to the value of £0.8 billion; in 2012 it was 2.8 million people. Nevertheless, customer numbers have stabilised in recent years but outstanding debt has increased to a high of £4 billion. This means that those consumers that do exist are increasing their use of existing catalogue credit facilities.[30]

3.5.1 The product

Mail order catalogue lending offers an accessible, convenient and ease of repayment form of credit , whether through agents or increasingly on-line (Jones, 2002). In the current low interest rate environment, UK customers can even buy goods through catalogues which are technically interest-free. Typically though, high interest rates are used and, if payments are extended, interest charged can be as high as 30% APR (Money Advice Service, 2017). Furthermore, the revolving nature of catalogue credit means the outstanding debt will be higher because, unlike loans, the balance will not necessarily reduce if the consumer keeps spending on it. This makes catalogue credit a potentially expensive way to borrow, despite Step Change (2013) reporting that ‘many people don’t consider debts built up on catalogues to be as important as other forms of credit such as credit cards and loans.’ [31] Moreover, mail order catalogues allow ‘quick access to funds at or close to a point of purchase and so can be used to facilitate impulsive spending’ (Gathergood, 2012).

In 2013, StepChange (2013) reported that it had seen a dramatic rise in the level of catalogue debt since the 2008 financial crisis; a rise of 43% on average since 2006 to £1,808 in 2012. This trend is seemingly continuing; FCA (2017) reported that the median amount of debt per consumer in the market has increased substantially from £300 in November 2014 to £1,300 in November 2016, with arrears and default rates now amongst the highest across the HCSTC market.[32]

The FCA has announced that there will be a consultation on new regulatory measures to be proposed in Spring 2018.

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[30] FCA High-cost credit Including review of the high-cost short-term credit price cap 17/02 (July 2017), Table 3.6

[31] See also https://www.theguardian.com/money/2016/feb/26/buy-now-pay-later-catalogue-debt-high-interest-rates

[32] FCA High-cost credit Including review of the high-cost short-term credit price cap 17/02 (July 2017), p.43

3.6 Rent to Own

Rent to own is a form of credit which spreads the cost of purchasing consumer goods by allowing the borrower to lease the consumer good in exchange for a weekly or monthly payment, with the option to purchase at some point during the agreement. Mean average loan value is around £1000.

The number of consumers per year taking out a loan has remained steady at 200,000 over the past five years but, overall, the number of loans is falling consistently as is the value of outstanding debt (£0.5 billion across 400,000 loans in 2016).[33]

3.6.1 The product

Rent to Own agreements are attractive to consumers who would not normally be able to afford a one off payment of hundreds of pounds for an item they need immediately. As major provider BrightHouse argues it “plays a critical role helping people with low incomes and damaged credit histories to get everyday items they otherwise couldn’t have” (Jones, 2016).

Contracts can be extremely profitable for the lender because such items can end up costing several times the retail price for a one off purchase on the high street. For example, a Samsung 9kg AddWash washing machine, which costs around £600 as a one off purchase at a retailer, costs £730.01, plus £55 for delivery and installation at BrightHouse. The total fee demanded by BrightHouse is £1,560, which is broken down into weekly payments of £10. This assumes a representative interest rate of 69.9% APR (Jones, 2016).

Households taking out such credit are almost exclusively on low incomes and reliant to some degree on benefits. Rent to Own customers are less likely to have a mortgage and are relatively less likely to have credit card borrowing. However, they are more likely to hold other household bill debts and other high cost products than any other category of high cost credit user (FCA, 2017). The FCA views consumers in this market as a ‘particularly vulnerable group’ with debts increasing despite overall decline in the market.

3.6.2 On-going regulatory intervention and a new affordable alternative

Rent to own has come under considerable scrutiny from regulators because the agreements are expensive and price transparency is poor. Moreover, rent to own is inappropriate for a proportion of customers and customers who often experience high levels of financial difficulties. The FCA has also been working closely with the three dominant market providers - BrightHouse, PerfectHome, and Buy As You View account for 90 per cent of the market - to address a number of immediate and pressing concerns in relation to: affordability assessments, arrears handling and forbearance, and price transparency (FCA, 2016).

In 2016 the regulator took disciplinary action: requiring Buy as You View to pay £939,000 back to 59,000 customers in respect of fees charged to customers in arrears; and, in October 2017, it agreed with BrightHouse to make redress of £14.8m to almost 250,000 customers in respect of poor assessment of some customers' ability to repay and unfair collected payments.

In contrast, in November 2015 Fair For You (https://www.fairforyou.co.uk/about-us/) was granted FCA authorisation as a credit provider. It provides small loans to households to buy essential items such as white goods via its website, where it has

[33] FCA High-cost credit Including review of the high-cost short-term credit price cap 17/02 (July 2017), Table 3.4

linked up with major brands (Jones, 2016). The main mission statement for this lender is that lending is appropriate and affordable for the customer. Loans are then paid back in weekly, fortnightly or monthly instalments to suit customer income patterns.

Backed by a number of social investors, in its first year this social enterprise delivered over 3.500 loans across the UK, totalling £1 million of lending to low income families. A customer taking a £750 loan from Fair for You over 52 weeks would pay a total of £895 (52 lots of £17.22), working out at a 42.6% APR (Jones, 2016). Compared to the cost of obtaining equivalent items through mainstream rent-to-own stores it has been calculated that customer savings in Fair for You's first year amounted to over £1million.[34]

3.7 Pawnbrokers

Pawnbrokers earn their income on the interest charged on loans secured by a pledged item; and as a consequence (as the loan is secured) credit checks are not carried out. Goods are accepted into pawn generally following an on-the-spot valuation of goods.

Pawnbrokers are one of the oldest sub-prime consumer credit markets in existence and yet very little is known about the sector. The National Pawnbrokers Association estimates that there are around 1,800 pawnbrokers in the UK, up from around 1,300 in 2010 and 800 in 2003, with a total loan book value of around £500 million.[35]

3.7.1 The product

Like banks, pawnbrokers earn their income on the interest charged on loans secured by a pledged item. The customer and pawnbroker will agree a sum to be advanced against a good and the pawnbroker presents a completed document known as pre-contract information, which allows customers to confirm that they are happy to accept the terms of the loan and provides details of customer rights and protection (under the Consumer Credit Act 1974 in the UK). Such agreements are generally for a minimum period of 6 months with customers able to exercise the right to withdraw from the agreement within 14 days, as well as making partial or full early repayments. When the loan and the interest are paid, the goods are returned to the customer. If the customer has not repaid the loan during this time, and the loan was over £100, they will receive notice that the property is due to be sold providing a further statutory period of 14 days in which to redeem. Crucially, pawnbrokers must obtain the true market value on the date of sale ensuring a fair price is obtained, with any amount over that due to the pawnbroker going back to the customer; only where the loan is for less than £75 does the pawnbroker gain title to the goods.

Pawnbrokers offer a rate of interest that is more than a high street bank loan, but normally a lot less than a payday lender, although pawnbrokers had been diversifying into other sub-prime financial services including payday loans. For example, there are an increasing number of online 'Wonga-style' pawnbrokers that offer next day loans against any assets that are likely to be re-saleable at auction, ranging from musical instruments to designer handbags, at rates of between 18.8% to 63.1% with the market suggesting high demand from asset-rich people who have short-term liquidity issues (Bachelor, 2015). The Community Investment Coalition has suggested that pawnbrokers in the UK and Ireland may charge APRs that can range from 70 to 200% on a £100 loan over six months.

The diversification of UK pawnbrokers can also be observed in the turnover of National Pawnbroker Association (NPA) members - with an average of around 43% of turnover derived from pawnbroking (Collard and Hayes, 2010). Similarly, it is fairly

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[34] https://www.fairforyou.co.uk/2016/11/30/first-charity-owned-national-challenge-high-cost-credit-exceeds-expectations-first-year-trading/; https://www.responsible-credit.org.uk/fair-for-you-real-difference-peoples-lives/

[35] http://www.thenpa.com/About-Pawnbroking/The-History-Of-Pawnbroking.aspx

common for companies specialising in cheque cashing, payday lending and rental purchase to also offer pawn-broking. Nevertheless, it is expected that the recent regulatory changes across the consumer credit market may have dampened this diversification trend.

Despite being a well-established market, pawnbroking has been the focus of little social research. Results of work by Collard and Kempson (2003) and Collard and Hayes (2010) have reflected the largely anecdotal evidence about the types of people who use pawnbrokers and their views and experiences of doing so. A national survey of pawnbroker customers undertaken by Collard and Hayes in 2010 identified: women are most common among pawnbroker customers (64%); just under half of customers (46%) lived in families with dependent children; and levels of home-ownership were low - nearly half of customers (45%) reporting they rented their home from a local authority or housing association. Customers typically had low incomes (less than £300 per week), and around half (53%) lived in households where no-one worked. Reflecting these circumstances, the most commonly cited reasons for using a pawnbroker were to pay for day-to-day living expenses or household bills (51% reported they had used their loan for food and groceries and 27% for bills other than rent or mortgage).

For low-income consumers who have items of value (typically jewellery) to pledge, pawnbroking offers a quick and easy way of obtaining cash loans without the need for a lengthy application form or credit checks (Collard and Kempson, 2005). While the cost of borrowing from a pawnbroker is relatively high, it may nonetheless offer better value than the other options open to someone with a low or modest income (Collard and Kempson, 2003; Collard and Hayes, 2010). It is the case, however, that 88% of respondents did not know the APR being charged on their most recent loan.

3.7.2 No change

Recently, the FCA noted 'very little evidence of harm from pawnbroking' with comparatively low credit charges given this is secured against goods.[36] The suggestion was of no immediate drivers of change, regulatory or otherwise.

3.8 Illegal money lending

Illegal money lenders (often known as 'loan sharks') are people who lend money without a license[37]. They operate outside the law and can often be linked to other illegal activities (POLICIS, 2006).

The illegal lending market in the UK was estimated in 2010 to be used by 310,000 individuals (up from 165,000 in 2007) with some £120 million borrowed by individuals. This resulted in circa £450 million paid to illegal lenders, at an average cost of three and a half times that of the highest cost legal credit in the market (POLICIS, 2010). Nevertheless, the illegal credit market in the UK is small by international standards[38], in large part it is argued due to a regulatory environment that permits high cost credit

[36] https://www.fca.org.uk/publication/feedback/fs17-02.pdf

[37] In the UK, the legislative framework controlling the provision of most consumer credit (in the forms of loans or goods and services bought on credit) is set out in the Consumer Credit Act 1974. The Act requires lenders to be licensed by the Office of Fair Trading and trading without a consumer credit licence is a criminal offence, which can result in a fine and/or a prison sentence. The Act also sets out requirements for the form and content of individual consumer credit agreements, in particular the information that consumers should receive about costs and charges. Following an extensive review of consumer credit law, a further Consumer Credit Act was introduced in 2006 to provide even greater consumer protection.

[38] Research undertaken for DTI "The effect of interest rate ceilings in other countries" (2005) and based on consumer research with low income households in France, Germany and the UK suggested that the incidence of IML among the credit impaired and those refused credit was 2 and 3 times higher in France and Germany respectively than in the UK.

and does not prevent those with adverse credit histories from borrowing in the legitimate market.

3.8.1 The product

Illegal lending arises where a vacuum of legitimate supply exists (Ellison et al., 2006), with illegal lenders unequivocally the lenders of last resort for consumers. Research undertaken by Policis into illegal money lending in the UK has also indicated that those who have been refused credit by a legitimate lender are 20% more likely to use an illegal lender than other credit users - with those who have been turned down by a high-cost lender more than five times more likely than other credit users to turn to an illegal lender (Policis, 2006 and 2010).

Studies have shown that illegal money lenders are often well known in the community and source their customers through word of mouth (Corr, 2007). While it is true that illegal lending has a spectrum in which some firms operate in ways that mimic legal organizations and just lack a license, it is also the case that illegal lenders typically are very high cost relative to the legitimate market. Illegal lenders are more likely to offer loans with extortionate rates of interest; for example, assuming that illegal lenders charge three times as much as legal home credit lenders (which themselves can range from 188% to 535%) the APR they charge will be between 564% and 1,605%. Illegal money lenders tend to sustain collections by a modus operandi that often involves, at best, continual pressure and, more typically, outright intimidation. Occasional violence is a feature of many illegal lending operations.

Studies have highlighted concerns about market expansion in tough economic contexts (Ellison et al., 2006; POLICIS 2010); a concern reiterated by the then Financial Inclusion Taskforce[39] which highlighted the increased risk of vulnerable people turning to illegal lenders in the wake of the financial crisis in 2008. This precipitated policy concerns which resulted in the establishment of a national Illegal Money Lending Team in 2007[40] as part of government priorities to tackle over-indebtedness, financial exclusion, and investigation and prosecution of unlicensed lenders. The POLICIS national interim evaluation of the illegal money lending industry in 2010 reported some 870 investigations had commenced; resulting in 289 arrests and 96 prosecutions; 28 custodial sentences totalling 56 years; with borrowers having saved (in net terms) an estimated £11.7m in income that would otherwise have gone to loan sharks

There are few studies into the dimensions and nature of illegal money lending in the UK. There is a body of work around credit use among low income households that makes reference to illegal lending, which indicates that illegal money lending is often concentrated amongst the most vulnerable members of society living in areas of significant deprivation (Kempson and Whyley, 1999, Speak and Graham, 2000; Whyley et al, 2000; Jones, 2002; Whyley 2002). Furthermore, research into illegal (unlicensed) credit in the UK identified 32% of IML borrowers face difficulty in putting sufficient food on the table; 43% have difficulty affording fuel and heating; 52% have faced difficulties in affording shoes and clothing, whilst almost one in three are struggling to make rent and mortgage payments, with such payments being made primarily to social landlords (POLICIS, 2010).

When the research compared the profile of borrowers of illegal loans with home credit users (the nearest equivalent legal product) they found the illegal money cohort to be suffering greater stress than home credit users across a series of financial

[39] Now the Financial Inclusion Commission – established in 2015 as a non-partisan, cross-party commission. See: http://www.financialinclusioncommission.org.uk

[40] A pilot Illegal Money Lending Team (IMLT) was set up in 2004 in England. Following its success National IML Teams were set up in 2007, funded by £10.8m funding from the Department for Business Innovation and Skills, augmented by a contribution of £2.8m from the Financial Inclusion Fund. As of 2017, the national IMLTs investigates and prosecutes illegal money lenders while supporting those who have borrowed money from a loan shark. http://www.stoploansharks.co.uk

dimensions, with concomitant impact on social isolation, the welfare of children and child poverty, and on the standards of living and quality of life of individuals and their families.

3.8.2 Concerns over the future

Concerns have been raised that the regulatory clamp down on HCSTC and the subsequent reduction in lending has increased demand for illegal money lending. Research published by Policis in January 2015 raised these concerns of a rise to serve unmet demand in the new UK regulatory regime and suggested that illegal lending may be increasingly online and in large part offshore. Most recently, the FCA's (2017) review of the impact of its regulatory activity suggested no current evidence of those rejected from payday lending turning to illegal lending sources.

3.9 Peer-to-Peer lending

Peer-to-Peer (P2P) lending is included briefly given its labelling as a 'disruptor' and 'challenger' to traditional mainstream lending providers.

P2P platforms don't make loans, they serve as 'matchmakers' or 'brokers', bringing together individual borrowers and lenders, therefore bypassing traditional forms of lending. The idea is that each gets a better rate than offered by mainstream providers: lenders receive more interest than they would get from a bank savings account; while borrowers pay less than on a bank loan (Henry et al., 2014). In such a way, P2P is thought to offer a 'socially useful' financial service by linking savings with borrowers and productive investments according to a model of traditional financial intermediation (Rogers and Clarke 2016).

One of the biggest differentiators for P2P platforms has been the online interface and customer experience the platform enables – the P2P lending process is generally simplified and streamlined; checking interest rates can be done online in a matter of minutes by providing basic information; and, because most (if not all) of the process is done online, borrowers can log on to get real-time updates (24/7) through the approval and funding processes. Research has also highlighted that underpinning market growth in P2P lending is innovation in credit modelling and underwriting, with the majority of platforms incorporating a wide range of data beyond (traditional) credit scores; risk-based pricing, and return-seeking investors keen to diversify investment portfolios driving acceptance in lower credit tiers (PWC, 2015).

There has been explosive growth across the P2P market of consumers, small businesses, property developers, or professional landlords but the reality in personal lending is that P2P lending is accessed by those with good credit ratings or with access to security (Henry *et al*., 2014; Evans, 2016). The typical P2P borrower is a home owner with above average income. The money is typically used to fund buying a new car, home improvements or debt consolidation (The Telegraph, 18th July 2016). Most recently, one of the leading firms Ratesetter has launched a consumer hire purchase product for cars[41], including a much greater range of APR offers dependent on creditworthiness and an expectation of higher default rates.

Nevertheless, given the lending profile of this emergent sector, it sits as an alternative out of reach of virtually all of those unable to access traditional mainstream lenders; although Roberts and Clarke (2016) argue that the P2P sector has played at least some role in sustaining demand in tight credit conditions, and as new and innovative financial providers they offer some lessons for the development of new provision.

[41] http://www.p2pfinancenews.co.uk/2017/09/15/ratesetter-consumer-hire-purchase/

3.10 Beyond the mainstream in consumer credit: summary

Given a comparatively deregulated environment, the UK consumer credit market has been the largest and fastest growing in Europe, featuring an ever greater diversity of product mix and a wide spectrum of pricing. This has included the substantial growth of an array of 'non-standard' providers offering a variety of lending products to 'sub-prime and beyond' consumers, including those recognised as the most financially vulnerable in society.

Reflecting risk profiles, the costs of such products are higher and the terms and conditions poorer, but this non-standard sector has also been characterised by substantial poor lending practices with high levels of consumer detriment. The outcome has been recent, substantial, dynamic and on-going regulatory intervention across the 'non-standard' consumer credit market.

Nevertheless, the rapid growth of the non-standard consumer credit sector has reflected also clear dimensions of consumer choice such as targeted consumer engagement, ease of accessibility, speed of service, simplicity, trust, non-intrusiveness, multiple delivery channels, etc.

Alongside the regulatory framing and reinforcement of responsible lending practices, such consumer choice dimensions will need to be taken forward also by the affordable lending sector if they are to scale up to meet the increasingly unmet needs of consumer credit triggered by regulatory tightening, and do so in a responsible and sustainable manner (see Table 3.2).

Table 3.2 Consumer credit provision – beyond the mainstream

	Size / Trend	Product	Typical Consumer	Advantages identified by consumers	Responsible Finance Lessons (for personal lending)
Payday Loans	2013: £2.8bn; 1.8mn customers; 2016: £1bn, 760,000 customers	Small value (< £1,000), short term (days) High cost (fees/APR)	Age 35; 62% male; lower incomes than the national average (£20,400 v £26,370); 88% earned income; 23% receiving benefits; 76% employed full time; 10% mortgage; 76% have no accessible savings.. Non-mortgage debts £4,700	Fast, highly accessible, flexible, relatively non-intrusive	Speed and simplicity, often technology-enabled, valued over price; Very substantial borrower cohort (0.5m plus) no longer accessing these products

Logbook Loans	2014: 52,000 2017: circa 100,000	Loan secured against a vehicle, which you are able to use	Age 38; income lower than national average (£23,000 v £26,370) Profile includes high number of products with outstanding debt (7). 40% in work, one third unemployed, 27% not working (caring responsibilities, ill-health). Complex financial lives: servicing other debts; debt consolidation; variable income patterns; periods of unemployment or sudden income shocks; unexpected bills or expenses; minority characterised with problematic behaviour (excessive drinking / gambling)	Large, if opaque, loan alternative where few others exist; Often less intrusive lending decision	Vehicles are key / essential household good that drives borrowing
Home Credit	2012: 900,000 with a value of £1.4 billion. 2016: circa 700,000 with a value of £1.3 billion.	Involves relatively small sums paid in cash generally repaid in under a year through weekly instalments.	Age 42; much lower income than average (£15,500 vs £26,370) Predominantly used by people in low income households; for example, more likely than the adult population to experience vulnerability or live in insecure situations; half were in the lowest earning fifth of adults; with the majority of customers (90%) renting and nearly 40% reporting a long-term illness or disability.	Offers a higher level of personal service. Lenders offer a range of payment options from direct monthly repayment through bank accounts or by post	Quite noticeably servicing the lower end of the income scale. Making it as easy as possible for people on the periphery to borrow can create a large loan book.
Catalogue Credit	2012. 2.8 million people. 2016,:1.9 million customers people to the value of £0.8 billion;	Catalogue lending (mail order / home shopping) provides the option of purchasing goods over a period of time by making weekly or monthly repayments on credit.	Age 45; Income lower than average (£17,700. V £26, 370). Large number of consumers have outstanding debt on catalogue credit (57%)	Offers an accessible, convenient and ease of repayment form of credit , Not perceived as a dangerous form	Loyalty and trust

	Dramatic rise in the level of debt since the 2008 financial crisis;			of debt. Can be used to fund impulse purchases	
Rent to Own	2016: The number of consumers per year taking out a loan has remained steady at 200,000 over the past five years but, overall, the number of loans is falling consistently as is the value of outstanding debt (£0.5bn)	A form of credit which spreads the cost of purchasing consumer goods by allowing the borrower to lease the consumer good in exchange for a weekly or monthly payment, with the option to purchase at some point during the agreement.	Age 36; Close to average income (£24, 700 v £26, 370). High number of products with outstanding personal debt (8) Households taking out such credit are almost exclusively on low incomes and reliant to some degree on benefits. Rent to Own customers are less likely to have a mortgage and are relatively less likely to have credit card borrowing. However, they are more likely to hold other household bill debts and other high cost products than any other category of high cost credit user	Attractive to consumers who would not normally be able to afford a one off payment of hundreds of pounds for an item they need immediately.	Problem debt.
Pawnbrokers	2010: 1,300 pawnbrokers 2017: 1,800 with a total loan book value of around £0.5 billion.	Pawnbrokers earn their income on the interest charged on loans secured by a pledged item; and as a consequence (as the loan is secured) credit checks are not carried out.	Age 39. Women are most common among pawnbroker customers (64%); just under half of customers (46%) lived in families with dependent children; nearly half of customers (45%) reporting they rented their home from a local authority or housing association. Customers typically had low incomes (less than £300 per week), and around half (53%) lived in households where no-one worked	No credit check required it may offer better value than the other options open to someone with a low or modest income	Day to day expenses and bills are a driver of demand.
Illegal lending	2007: used by 165,000 2010: used by 310,000 individuals with some £120	People who lend money without a license. Loans are more likely to have extortionate rates of	Illegal money lending is often concentrated amongst the most vulnerable members of society living in areas of significant deprivation (32% of IML borrowers face difficulty in putting sufficient food on the table; 43%	Fills a vacuum in legitimate credit supply.	Responsible finance has a role to play in decreasing the

	million borrowed	interest.	have difficulty affording fuel and heating; 52% have faced difficulties in affording shoes and clothing,		finance vacuum filled by illegal lending
Peer-to-Peer	2014: £547million 2015: £909 million	P2P platforms serve as ‘brokers’, bringing together individual borrowers and lenders, therefore bypassing traditional forms of lending.	The typical P2P borrower is a home owner with above average income. The money is typically used to fund buying a new car, home improvements or debt consolidation	Cheaper than bank loans	Efficiencies of fintech Individuals as sources of finance – but issues of risk appetite. Social investment? A very different profile compared to other consumer groups

4 Beyond the Mainstream: 'affordable lending'

4.1 Affordable lending

The widespread use of consumer credit in the UK is, for many, most of the time, a convenient and flexible way of managing budgets and spreading the cost of larger payments. Over recent decades a complex and 'variegated' (Appleyard et al., 2016) landscape of supply has developed serving ever greater numbers of increasingly differentiated consumers. These developments have, however, been accompanied by increasing levels of debt, credit dependence and poor lending practices. Millions of consumers in the UK are unable to secure access to mainstream finance, paying more for financial goods and services, with less choice, and often exacerbating financial vulnerability, and recent years have seen substantial and far reaching regulation to reduce irresponsible and exploitative lending and to inform and protect consumers.

It is within this landscape of provision that a small but growing group of 'affordable lenders' has developed, linked with the concept of 'responsible finance' and part of a broader 'community finance' movement.[42]

The vision of affordable credit lenders is that in the UK, wherever people live, they should have access to more affordable and appropriate forms of credit, delivered in a fair, respectful and responsible manner, and which support financial resilience and reduced financial exclusion.[43]

Historically also part of the policy solution by government[44], affordable lenders comprise two major types of institution – credit unions and community development finance institutions (CDFIs) – and an emerging range of pilot partnerships and initiatives. Nevertheless, whilst growing, they remain very small compared to the other providers in the market, lending a combined total of around £800m in 2016.[45]

4.2 Credit unions

Credit unions are member-owned not-for-profit financial institutions that accept deposits and provide loans and bill payment facilities, as well as financial advice and education, life insurance and other financial products. They are legally obliged to define a group of people who share a 'common bond' from whom they can recruit their membership and to whom they can provide services. This is often the workplace and/or the local community. They are co-operatives run by and for their members.[46]

Credit unions are by far the largest community finance sub-sector and operate with three main aims, to: provide loans at low rates; encourage all members to save regularly; and help members in need of financial advice and assistance. Credit unions

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[42] See, for example, https://www.carnegieuktrust.org.uk/project/affordable-credit/; http://responsiblefinance.org.uk/; http://www.abcul.org/media-and-research/parliament; https://mycommunity.org.uk/wp-content/uploads/2016/09/Guide-to-Community-Finance.pdf; https://issuu.com/citizensuk3/docs/community_finance_foundation_v4; http://responsiblefinance.org.uk/cic/; https://mycommunity.org.uk/take-action/community-economic-development/; http://www.respublica.org.uk/disraeli-room-post/2015/04/16/community-finance-expanding-credit-unions-sustainably/; https://justfinancefoundation.org.uk/#home-intro.

[43] See, for example, https://www.carnegieuktrust.org.uk/project/affordable-credit/ and http://responsiblefinance.org.uk/responsible-finance-providers/what-is-responsible-finance/.

[44] Notable national examples include the Phoenix Fund, Financial Inclusion Growth Fund and Credit Union Modernisation and Expansion Fund

[45] See http://www.abcul.org/media-and-research/news/view/776 and Responsible Finance (2017) The Industry in 2016

[46] Credit union members elect a board of directors from their membership. Members each have one vote in board elections, regardless of their amount of savings or shares in the credit union.

vary substantially in size and membership and in the services they offer; by being prepared to lend to people who are (or are likely to be) rejected by mainstream providers such as banks they can address financial disadvantage.

As part of the commitment to their membership credit unions operate, a priori, on a 'responsible lending' model, which involves assessing the income and savings (or ability to save) of loan applicants. There are several key features of a credit union:

- People who save or borrow through one must have a 'common bond' (i.e. associational, community, industrial or geographical proximity);
- They are run on a 'not for profit' basis. Net income is applied first to adequacy requirements. A "member owned" capital structure (compared to stockholder capital) allows a credit union to manage a surplus to lower interest rates on loans, raise interest rates on savings or develop new products and services;
- Many of the people who run credit unions are volunteers; the sector employs around 1,500 staff (mainly involved in credit assessment and loan management);
- They can be large or small – with membership ranges from just a few hundred up to the UK's largest with over 30,000; and,
- In the UK, they are regulated by the Prudential Regulatory Authority (PRA) and the Financial Conduct Authority (FCA); with the Financial Services Compensation Scheme (FSCS) protecting consumer savings up to £85,000.

UK credit unions have grown substantially in the last decade, almost quadrupling their membership to just over 1.9 million between 2005 and 2016 (see Table 4.1), and increasing assets to over £3 billion.

Table 4.1 The growth of UK credit unions

	2005	2008	2012*	2014*	2016*
No of credit unions	568	520	595	523	462
Adult members at year end (000s)	530	659	1,406	1,564	1,919
Total assets (000s)	466,728	595,142	2,178,246	2,619,628	3,006,060

* Figures include Northern Ireland

Source: Bank of England – Credit Union Statistics[47]

4.2.2 Products offered

In the main, credit unions offer three types of financial product: current accounts, savings accounts and loans.

Some credit unions provide basis bank accounts. Usually these accounts provide debit cards, direct debits and standing orders but will not provide overdrafts or chequebooks to avoid the ability to go in to debt..

Savings accounts are the lifeblood of credit unions, providing deposited money that can be lent to other members. Deposits are made through direct debits (including from wages) or physical sites including branches and collection points. It is only since 2012 that savings interest may be offered, previously dividends were paid to members. Credit unions are seeing growth in a broader array of savings products such as Christmas savings accounts; junior savers' accounts (often collected in partnership with schools); and Cash ISAs (Association of British Credit Unions, 2017). Links are

[47] Available from: http://www.bankofengland.co.uk/pra/Pages/regulatorydata/cu/creditunionsstatistics/default.aspx

also made to loan facilities through 'Save As You Borrow' arrangements whereby the borrower makes a small contribution to a savings account alongside their monthly or weekly loan repayment to encourage savings habits.[48]

Lending activity is based on fair and affordable principles – to members only and generally who have completed a minimum period of membership. Credit unions will lend small or large amounts, secured and unsecured. Whilst interest rates vary they are capped by law making them considerably cheaper than payday and other non-standard lending products.

Credit unions in the UK are subject to a cap in maximum interest rate that they can charge of 3 per cent a month or 42.6 per cent a year APR (England, Scotland and Wales)[49] and 1 per cent a month in Northern Ireland[50] (FCA, 2017b). In many cases credit unions charge less than the statutory cap.[51] In comparison:

- A £300 loan over 52 weeks from Provident Financial home-collected credit at 272% APR costs £246 in interest while the same loan from a credit union at the maximum 42.6% APR costs £58 in interest;
- A £300 payday loan from Wonga at 1,509% Representative APR over one month costs £72 in interest, the same loan from a credit union at 42.6% APR costs £9 in interest;
- A £1,000 loan from longer-term lender, Pounds to Pocket, at 277% APR over 12 months costs £907 in interest, the same loan from a credit union at 42.6% APR costs £205.55; and,
- A Hotpoint Tumble Dryer from Brighthouse would cost £780 over three years with interest, compulsory insurance and service cover. The same model bought from Curry's with a credit union loan at 42.6% APR costs £229 cash and £148.69 in interest – totalling £377.69, less than half of the Brighthouse cost.

Whilst payday lenders question the use of APR comparisons as a measure of affordability - on the basis that their loans are designed for 30-days[52] - such comparisons highlight the affordable lending credentials and potential of credit unions, alongside their fair and transparent lending practices.

Credit unions are beginning to expand the range of lending products they offer, including rolling lines of credit, car loans and, in a few instances, mortgages. Other financial products and services include, for example, life assurance and a range of specialist financial management services.

Given the range of scale and scope of credit unions it is argued that there is no such thing as a "typical" credit union member. The level of diversity within each credit union's field of membership is a function of its community, region and marketing strategy pursued. However, looking at membership demographics at the national level can provide a reference point. Carnegie UK (2015) pulls together a range of evidence: more than 70 per cent of credit union customers are aged over 40 - compared with around 50 per cent of payday loan customers and 40 per cent of home credit customers (CarnegieUK, 2015); nearly half of credit union customers in the UK own their own home, compared to around a fifth of those who take payday loans or home credit (ABCUL, 2006; Competition Commission, 2014; Provident Financial Group, 2010); and 6 per cent of households in Scotland with an income over £30,000

[48] See http://fairbanking.org.uk/wp-content/uploads/2017/02/Save-While-You-Borrow-web-1540217.pdf

[49] As of 1 April 2014.

[50] The Northern Ireland Department of Enterprise, Trade and Investment has consulted on whether to increase this

[51] See https://www.findyourcreditunion.co.uk/

[52] See https://www.pdlenders.com/money-management/why-using-apr-to-compare-payday-loan-terms-can-be-misleading

use a credit union whilst only 3 per cent of households in lower income brackets have a credit union account (Scottish Household Survey, 2012).

4.2.3 A scalable affordable lending solution

It was in 2006, in ‘Building better credit unions’, that Goth et al. (2006) raised a question mark over the long term survival of half of Great Britain’s credit unions. Looking across business models they juxtaposed an ‘ethical/traditional’ model of credit unions inspired by the community for the community, with a new fast track growth model seeking scale to achieve efficiency but in danger of losing the common bond basis of joint enterprise and membership held by credit unions.

In 2015, PERC (2015) returned to this analysis to make sense of the intervening period of credit union development in the UK; and to consider growing arguments that a scaled up credit union movement could provide the solution to a rapidly expanding credit finance gap as ‘non-standard’ lenders such as payday lenders exit the sub-prime market.

On the face of it an almost quadrupling of membership to just over 1.9 million between 2005 and 2016 and increasing assets to over £3 billion are highly promising for proponents of credit unions and affordable lending (see Table 4.1).[53] Aggregated data for UK credit unions suggest that this growth has been broadly achieved in a sustainable way, with sector wide year on year profits declining slightly to £6 million at the end of 2016. Total capital held by credit unions has substantially increased from below 10% of total assets in 2005 to around 12% in 2016 (Bank of England Credit Union Statistics, 2016).

Indeed, such growth is in line with delivery of the UK Government’s Credit Union Expansion Project (CUEP)[54], which has set a goal to achieve 2 million credit union members by 2019[55], and reflects new co-operative and innovative developments across the sector such as Cornerstone Mutual Services (the Association of British Credit Union’s trading subsidiary) established to support the growth of credit unions further through co-operation and innovation.[56]

Yet, looking behind such figures (Table 4.2), PERC (2015) identify the development dichotomy (and polarisation) presaged by Goth et al. (2006) for the sector - and a sharpening divide between those who see credit unions as community based savings and loans associations focused on poverty alleviation and those whose sole aim of scaling up and professionalising the credit union sector is that the sector can provide alternative services to the public in an effort to increase competition in the landscape of UK retail banking. Arguably, somewhere between the two, is PERC’s (2015) warning of the increased expectancy that credit unions will fill the gap in ethical provision for consumer credit, namely replacing and filling the widening finance gap within payday/HCSTC/non-standard credit markets. Ultimately, PERC (2015, p.4) conclude that ‘the recent growth in the credit union sector intensifies the split occurring among credit unions and puts financial strain on the sector’.

Examination of credit union growth figures more closely (Table 4.2), and in context, identifies that recent growth has introduced a number of developments that provide a potentially mixed outlook for the credit union sector.

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[53] http://www.respublica.org.uk/disraeli-room-post/2015/04/16/community-finance-expanding-credit-unions-sustainably/

[54] Launched in 2013 by the Department for Work and Pensions this has entailed a £38 million investment with the purpose of modernising and growing the credit union industry to help those on low incomes.

[55] More recently, the European Parliament’s Credit Union Interest Group has met to explore growing the sector across Europe (*ABCUL news, May 2017: http://www.abcul.org/media-and-research/news/view/856*).

[56] http://cornerstone.coop/

Table 4.2 The growth of UK credit unions in greater detail

	2005	2008	2012*	2014*	2016*
No of credit unions	568	520	595	523	462
Adult members at year end (000s)	530	659	1,406	1,564	1,919
Total assets (000s)	466,728	595,142	2,178,246	2,619,628	3,006,060
Gross loans (000s)	341,152	441,694	1,103,907	1,198,039	1,250,749
Total capital (000s)	45,779	69,718	270,154	323,470	350,423
Loan as a % of total assets	73%	74%	51%	46%	42%

* Figures include Northern Ireland

Source: Bank of England – Credit Union Statistics[57]

First, the number of credit unions was 462 in 2016, down from a total number of 835 in 2001 (Table 4.2; ABCUL 2015). Consolidation may partly explain this, driven by modernisation and the desire to create ‘challenger’ credit unions with the ability to compete with high street banks and building societies. It is also the case, however, that credit unions are continuing to close due to lack of sustainability and greater competition. Moreover, very few credit unions have been established in the post-crisis era (Bank of England Credit Union Statistics, 2016) with suggestions that the historically polarised position between the few largest and the rest is, if anything, increasing.

Second, international comparisons reveal that the UK credit union sector is small – both in terms of assets as a proportion of bank assets and market penetration rates (see Table 4.3).

Table 4.3 Credit union market penetration rates in selected countries

	Penetration
Ireland	77%
United States	49%
Canada	44%
Australia	27%
Total for Europe	3.4%
United Kingdom	3.1%

Source: WOCCU Statistical Report, 2015

In fact the figures for United Kingdom are in themselves misleading. In Northern Ireland, for example, almost 30 per cent of the population are members of a credit

[57] Available from: http://www.bankofengland.co.uk/pra/Pages/regulatorydata/cu/creditunionsstatistics/default.aspx

union, compared to almost 6 per cent of the Scottish population, more than three times the penetration achieved in England (1.3 per cent) and Wales (2.0 per cent). Although, alternatively, this suggests the potential market that exists still for credit union expansion.

Third, the ability of credit unions to generate income from loans has seemingly worsened since 2005 with loans as a percentage of assets declining from 73% to 42% in 2016 (see Table 4.2). For PERC (2015) this questions the ability of the sector as a whole to grow assets further. Clearly there is likely substantial variation across credit unions but given the fact that income covers dividends paid on savings products, a lack of income would also have serious repercussions for attracting savings, thus potentially threatening the survival of a credit union.

Fourth, on the lending that is being undertaken, loans in arrears are rising, by £2.5 million to £54.9 million at the end of 2016 (*Bank of England Credit Union Statistics, 2016*). There are concerns that expansion and the need for income generation are seeing a worsening loan book (PERC, 2015).

In summary, on the one hand the welcomed modernisation and expansion of credit unions as affordable lenders is well underway. Membership and assets have never been higher, their profile is growing and the breadth of financial goods and services offered by the sector growing and widening. Indeed, given this success alongside other community finance initiatives, visions of 'community banking' in the UK are being put forward once again in the face of years of sustained withdrawal of access to financial goods and services across communities and localities.[58]

On the other hand, what PERC (2015) suggest is that there may be structural limitations – or at least some clear dangers - to this trend continuing. Regulatory change and government policy has provided strong impetus to the growth of large, multi-product, platform-enabled credit unions but limits remain within membership organisations that, fundamentally, are based on those who save and a model of internal cross-subsidy. Credit unions have aimed to provide loans at low rates to generally low risk members. Moreover, their ability to do so is based on encouraging saving behaviour amongst their members; this is their source of lending capital. Yet research continues to show that the need for affordable credit is amongst those who are of greater risk and least able to save regularly. Both through identity and market position there remains substantial disagreement with the identification and marketing of credit unions as an alternative to payday and high cost loan companies (Ryder, 2002; McKillop and Wilson, 2011).

One suggestion has been to seek partnerships with other affordable lenders as mission and operational limitations become clearer (see Section 4.4 below), but a number of credit unions have also been involved in piloting payday type lending. PERC (2015) reviews detailed profit and loss assessments of recent pilot and 'payday lending type' activity by credit unions[59], and which shows both the possibilities and pitfalls. Similarly, Alexander et al. (2015) has detailed the extent to which past credit union lending activity may – or may not - match the type of borrower and loan within the existing market. Reflecting a complex answer related directly to the particular context of any credit union there are examples of credit unions who have now moved in to this market with badged products (see Box 1).[60]

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[58] See file:///C:/Users/ab5841/Downloads/00518_4pp-A4-Charter_web.pdf; http://www.respublica.org.uk/wp-content/uploads/2014/07/ueq_Virtuous-Banking-Final-new.pdf

[59] See, for example, Evans and McAteer (2013) Can payday loan alternatives be affordable and viable? An evaluation of London Mutual Credit Union's pilot scheme

[60] See http://www.creditunion.co.uk/loan-calculator/pay-day-loans/

Box 1: Credit Unions: Entering the Payday Lending Finance Gap

"This customer base requires immediate access to small, short term loans, processed with minimal bureaucracy, online or on the doorstep. This type of lending is intrinsically expensive – particularly as there is also a high risk of default."

Alexander, N., White, D. and Murphy, T. (2015), p.20

Credit unions have been put forward as one solution to the growing payday lending 'gap'. Reports by PERC (2015) and Alexander et al. (2015) discuss both the possibilities and pitfalls of credit union involvement.

In one payday lending pilot run by London Mutual Credit Union, customers were offered credit at a rate of £2 per £100 for 30 days. In the year-long pilot, almost £700,000 was disbursed through almost 3,000 loans. On evaluation, and notwithstanding the 'loss leader' nature of the product, high levels of customer satisfaction with the product were reported with the pilot accessing a valuable segment of potential new customers to the credit union (Evans and McAteer, 2013). Evans and McAteer made the case that LMCU scheme's 'loss leader' model can actually work in practice. By drawing new members into the credit union a significant proportion quickly move on to use other profitable services and thus support a payday loan product to be financially viable. In contrast, PERC (2015) argues that the low level of loans in arrears in the LMCU pilot was unrepresentative and masks the reality that it would it would require more than five performing repayments to pay for the losses of one default half way through the loan period.

Alexander et al. (2015) argue that the fact that customers using payday loans and home credit are different from the traditional credit union customer base is a considerable challenge for a credit union approach to the payday financing gap This is based on the demand for immediate simple access to small, short term loans from riskier clients. Reflecting a complex answer related directly to the particular context of any credit union there are examples of credit unions, such as LMCU, who have now moved actively in to the market with badged short term lending products (http://www.creditunion.co.uk/loan-calculator/pay-day-loans/).

Several pilots have reinforced that a key determinant of customer choice and behaviour in this credit market is ease of access and speed of loan provision. In the LMCU pilot, for an additional £11, the borrower could receive their loan funds on the same day – 86% of customers took up this option. Similarly, East Lancs Moneyline, a Community Development Finance Institution (CDFI), introduced a 'same day' transfer option in 2014 for a cost of £7 – with 75% of borrowers opting for this service.

Sources:

Alexander, N., White, D. and Murphy, T. (2015), Meeting the need for Affordable Credit. Discussion Paper. Carnegie UK Trust. (2015). Available at: https://www.carnegieuktrust.org.uk/wp/wp-content/uploads/sites/64/2016/02/pub14550114201.pdf;

Evans, G and McAteer, M. (2013). Can payday loan alternatives be affordable and viable? An Evaluation of London Mutual Credit Union's Pilot Scheme: Final Report. Financial Inclusion Centre. Available at: http://www.friendsprovidentfoundation.org/wp-content/uploads/2013/09/Can-payday-loan-alternatives-be-affordable-and-viable-Final-Report.pdf;

PERC (2015) Gaining Interest: A New Deal for Sustained Credit Union Expansion in the UK. Goldsmiths, University of London. Available at: http://www.perc.org.uk/perc/wp-content/uploads/2015/06/Gaining-Interest-Report.pdf

4.3 Community development finance institutions

Community Development Finance Institutions (CDFIs) are not-for-profit lenders who provide a range of loan products across the full range of access to finance markets: personal, SMEs, social ventures and home improvement lending.

Personal lending is primarily aimed at people unable to access mainstream credit. Unlike credit unions, however, they do not require people to save before they can borrow (so need to raise capital for lending because they do not take deposits) and there are no restrictions on the rates of interest that they can charge or the geographical range of their lending (Responsible Finance, 2017, Hadjimichael et al. 2014; Henry and Craig, 2013).

CDFIs aim to:

- *Increase access to finance:* serving customers not supported by mainstream lenders.
- *Treat customers fairly:* by being clear and transparent about the costs of borrowing, lending only to those who can afford to repay. This ensures that customers get the best deal and outcome.
- *Offer a personalised service:* through lending, but also through providing support such as advice, training and mentoring alongside loans.
- *Mission driven*: social enterprises re-investing profits to deliver economic and social benefits.

The UK CDFI sector remains tiny within the consumer credit market.[61] In 2016, 10 CDFIs offered affordable credit personal lending products and 6 offered finance to homeowners to make urgent repairs to their homes or for energy efficiency upgrades. In 2016, total personal lending reached £19.8 million to 36,957 individuals, and £2.8 million to 389 homeowners.[62]

4.3.1 The product

Personal lending generally takes the form of short-term, low-value loans; whilst loan products for home repairs are typically higher in value and have longer terms (see Table 4.4).

Table 4.4 Individuals: CDFIs – Loan size, interest rate, and term

	Average loan size	Average term	Average interest rate (APR)	Secured loans (x/£)[63]
Personal	£530	9 months	129%	0% / 0%
Home owner	£7,300	7.5 years	4.5%	69% / 84%

Source: Responsible Finance Statistics, 2016

Demand for personal lending is most associated with special or seasonal/unexpected events (56%) such as birthdays, Christmas, school supplies and car repairs; and paying for emergencies and existing debt (19%); with individuals in 2016 helped to deposit £3 million in savings accounts (an average of £158 per customer).

Homeowner loans often relate to urgent repairs to homes or energy efficiency upgrades enabling customers to stay in their homes (61%) and bring their homes up

[61] Carnegie (2017) suggests 0.01% of the unsecured credit market

[62] http://responsiblefinance.org.uk/policy-research/annual-industry-report/#CL

[63] Secured against property or assets, or using a loan guarantee sheme such as Enterprise Finance Guarantee (EFG) or European Investment Fund (EIF).

to a decent standard (57%) (Responsible Finance Annual Industry Report, 2016). For home improvement loans, CDFIs typically work with local authorities (subsidies bringing down the cost of the loan) who distribute funds to local residents to complete improvement work.

CDFIs support some of the most vulnerable and financially excluded people within society (see Table 4.5) – individual customers typically are unemployed; come from households with annual incomes of less than £15,000; live in social housing; with around one third located in the UK's most deprived areas. Around 40% of those who received a CDFI personal loan had used a high cost credit provider such as a payday lender or a loan shark in the previous twelve months (CDFA, 2014).

Table 4.5 CDFI Individual Customer Demographics

Individuals	
Unemployed	51%
Social housing occupant	46%
Woman	55%
Living in a household with dependents under the age of 18	45%
Single parent	54%
BAME (Black, Asian or Minority Ethnic)	6%
Under 30 years old	40%
Located in the UK's 35% most disadvantaged areas	36%
On household incomes of less than £15,000	57%

Source: Responsible Finance Statistics, 2016

4.3.2 Scaling up?

Industry research by Responsible Finance has identified that between 2007 and 2016 CDFIs lent £156 million to 253,000 people and homeowners, helping consumers save £23 million in repayments to high cost lenders.

While the number of personal lending CDFIs is very small, they face significantly fewer restrictions on their operations compared with credit unions. Fundamentally, they do not have interest rate caps, aside from the standard Financial Conduct Authority regulations. This means loans can be priced to recover the costs of lending, even for small-value loans – a key constraint for credit unions.

CDFIs also do not require a common bond – they are not membership organisations - and lend against their social missions which generally include an explicit focus on serving financially excluded groups. Like credit unions, CDFIs have an interest in promoting financial inclusion in a wider sense, rather than focusing only on providing access to more affordable credit, by offering linked saving products, money advice and bank accounts (through partnerships) (see Section 4.4).

Given they do not take deposits a critical issue for CDFIs is to secure capital for lending and create sustainable business models based on the income generated from such lending, and to cover loan defaults given their lending profiles in to higher risk markets.[64] Personal lending default rates ranged from 7.7 per cent to 13.6 per cent in 2015; with levels reducing to around 8.5 per cent in 2016 (Responsible Finance Annual Report, 2016).

Currently, capital for lending is secured from a variety of sources, including loans from commercial and social lenders, grants from the government, trusts and foundations, equity from shareholders, and funds they manage on behalf of third parties (Table 4.6). CDFIs also receive income from interest and fees through lending and portfolio management charges (Responsible Finance 2017, Hadjimichael, Anderson et al. 2014).

Table 4.6 CDFI sources of funding, 2012 – 2016

Source	2012	2013	2014	2015	2016
Central government	7%	26%	44%	48%	41%
Banks	10%	10%	20%	26%	27%
Individual investors	16%	20%	14%	2%	6%
European Union	38%	11%	13%	11%	10%
Local government	24%	14%	7%	8%	4%
Trusts / foundations	6%	1%	1%	<1%	3%
Social investors	0%	11%	1%	4%	9%
Housing associations	0%	7%	0%	<1%	<1%
Total	**£15.8m**	**£42.3m**	**£59.4m**	**£83.8m**	**£71.0m**

Source: Responsible Finance Statistics, 2016

In summary, CDFIs have a track record of affordable lending in to consumer credit markets and have the pricing flexibility to allow them to, in principle, cover lending costs. They remain, however, tiny in the market lacking capital to lend and scale.

Launching a research project to investigate the sector and organisational change required to increase CDFI personal lending to £200m by 2027 in an operationally sustainable manner, Carnegie (2017, p. 3) note: “Over the past 15 years those CDFIs that specialise in personal lending have developed and delivered through a number of different iterations and models, across issues such as funding, delivery channels, expansion, pricing, partnership working and regulation. Some of these changes have been planned for and actively pursued, others have been responses to unfolding events or circumstances that necessitated changes.”

4.4 Community finance

As fair and affordable access to financial goods and services has become a recognised key requisite for full and fair participation in today’s economy and society, so a community finance movement has continued to grow and innovate. Based upon existing historical provider infrastructures such as CDFIs and credit unions, and in response to broadening issues of financial inclusion[65], this movement has most especially sought to develop broader community banking services alongside its traditional savings and borrowing activity.

Some of the first substantial initiatives were the Community Banking Partnerships (CBPs) 2005-2008 (National Association of Credit Union Workers, 2004; National Federation of Community Development Credit Unions, 2005).[66] Seven CBP pilots were launched across England and Wales with over 150 local stakeholders involved; and which emulated ‘one-stop-shop’ models in the USA and Ireland. Despite

[64] See Henry. N. and Craig. P. (2013) mind the Finance Gap https://www.rbs.com/content/dam/rbs_com/rbs/PDFs/Sustainability/Downloads/cdfasummaryreport_2013.pdf; PWC (2015) The Sustainability of Community Development Finance Institutions http://www.pwc.co.uk/assets/pdf/the-sustainability-of-community-development.pdf

[65] See http://www.financialinclusioncommission.org.uk/about

[66] https://www.microfinancegateway.org/sites/default/files/mfg-en-paper-community-banking-partnership-a-joined-up-solution-for-financial-inclusion-2004.pdf

achievements, a consistent challenge for CBPs was operational sustainability, and nearly ten years on only a few still exist, such as the Robert Owen Community Banking Fund.

Nevertheless, a series of lessons were identified from the pilots, including:[67]

- Debt prevention services are needed to complement specialist debt and money advice services;
- Suitable legal models will take time to develop because it takes time to build trust among the partners and because of the challenge of establishing, managing and governing company affiliates;
- Clarity about the appropriate social business development strategy and delivery for different aspects of the partnership service can be best structured operationally and for accountability to funders by having a clear legal separation of credit provision from advice services;
- Social landlords found that supporting CBPs through service level agreements was less expensive than a sole reliance on litigation;
- Community bank accounts are essential for those who cannot get, or cannot manage, basic bank accounts;
- Adequate resourcing is essential to partnership work and can achieve a good value investment;
- Appropriate training and learning networks are central both to ensuring that the partners understand each other's needs and capacities and to facilitate co-operation between partners; and,
- Business planning and the availability of appropriate capital resources are a pre-requisite for success. Securing affordable premises in the right location is essential.

More recently, and as the retreat from the high street as accelerated amongst banks, other examples of the expansion of provision of financial goods and services by responsible finance providers have included:

- Citysave (a credit union): offering a range of banking services with packages that include access to a transactional bank account, a Visa Card with cashback rewards, budgeting support and bill payment services;
- Scotcash (a CDFI based in Glasgow) have created a partnership with a high street bank for basic bank account facilities, money and welfare benefits advice providers, housing associations who refer tenants and Glasgow City Council. Scotcash can now support customers to move from a crisis management intervention to a longer-term money management approach;
- Street UK and its 2016 launch of an on-line ('payday') lending facility alongside the lending facility it has offered in its branches for a number of years. Providing a different product to that offered 'in branch', Track Loans undercuts other high cost lenders alongside an underwriting and delivery model designed to deliver sustainability and signposting to financial management and advice services where appropriate. Work is ongoing to develop and expand the lending facility based upon early learning and close and continuous assessment of market dynamics;
- ThinkMoney, a new entrant bank, ensures customers' bills are paid on time, provides a pre-paid card with available spending money and financial advice to support customers to stay out of debt; and,

[67] http://www.nacuw.org.uk/sites/www.nacuw.org.uk/files2/pdf/Community_Banking_Partnership.pdf

- BOOST Neighbourhood Finance, a new partnership in Bristol, is building local financial resilience and boosting economic growth. It is a partnership between Bristol City Council, Bristol Enterprise Development Fund, Co-op and Community Finance, South West Investment Group (SWIG) and local communities to boost local investment.

Ultimately, however, such initiatives have remained patchy and fragmented and amidst growing pressure for a UK-wide approach the Community Investment Coalition (CIC) Community Banking Charter was published in 2014.[68] The Charter called on politicians and regulators to:

- Create a framework for UK-wide coverage of community finance providers;
- Encourage local community finance providers to collaborate in networks to pool central services and achieve economies of scale without losing local autonomy, proximity and customer focus;
- Increase investment into credit unions and CDFIs to extend reach to new customers, and to modernise and innovate;
- Support innovation in new payment systems and digital currencies;
- Encourage financial literacy and awareness of community finance; and,
- Encourage partnership models that bring together financial service providers and advice agencies to create a 'one stop shop' that combines access to affordable financial services and products with money management and debt advice.

4.4.1 The potential for partnerships

In 2017, building both on the Charter's call to encourage partnership models and a new round of Local Authority strategic priorities focused on financial and social exclusion, Responsible Finance published research on collaboration models within community finance.[69] The research outlined three broad types of collaboration:

1. **Referral** – whereby existing independent organisations cross refer consumers when there is demand they cannot individually serve. Some referral models are more embedded (i.e. placing staff in partner offices to offer seamless client handover and and/or 'triage' a client with multiple products and services) than others.
2. **Consortium** – where one organisation coordinates a group of existing independent organisations. These organisations operate as they did before entering the partnership, but receive consumer referrals through the coordinating body.
3. **Integrated** - where multiple entities exist within the same company group; for example, a credit union with a responsible loan fund sister company.

The research identified that partnerships offer a pathway for small scale organisations to find synergies and efficiencies that will improve their value-for-money proposition; and for larger scale organisations an opportunity to gain access to new markets. The findings also point to how systematic partnership between local finance organisations has the potential to be replicated across localities – for a national approach.

Some emerging examples of partnership models of community finance in the UK, are presented in Table 4.7 below.

[68] file:///C:/Users/ab5841/Downloads/00518_4pp-A4-Charter_web%20(1).pdf

[69] file:///C:/Users/ab5841/Downloads/Tackling-Financial-Exclusion-Through-Local-Finance-Partnerships%20(1).pdf

Table 4.7 Responsible Finance partnership models, 2017

Partnership Model	Examples in the UK	Strengths	Weaknesses
Referral	Scotcash - a Glasgow-based responsible loan fund, launched in 2007 by Glasgow City Council to address high cost credit identified as reducing social wellbeing through pushing consumers into overindebtedness.	Mobilises the supply side. This model is generally flexible in terms of adding or removing partners to meet demand. Access to new markets through referral partners. Reduced overhead costs. Improved product choice - spectrum of products more likely to keep more consumers 'in house'.	Structuring (perceived and actual) incentives to benefit all partners involved – particularly where there are cultural differences between partners; and a failure to clearly overlap the missions of partners.
Consortium	Sheffield Money - formed in 2015 to provide an alternative to a variety of high cost products, both through a telephone and online presence. It was launched by Sheffield City Council following its Fairness Strategy to combat the extensive use of high cost credit in the city. Affordable Lending Portal (ALP) – an online portal launched in 2016 in partnership between private and social sector bodies[70] to make it easier for people with poor or no credit rating to access affordable loans from responsible lenders.	Broker model for existing suppliers with shared objectives. Increased opportunities to scale based on existing coverage of partners. Improved reach and a streamlined message – unlocking markets and communciation channels/ 'branding' and joint marketing increasing demand and opportunities to access new funding. Product innovation - sharing resources, expertise and unlocking new markets which better meet and drive demand. Improved efficiency with digital services - enabling individual organisations to overcome the risk aversion linked to investing in digitizing/automating	May be required to comply with partnership rules and expectations. Challenges around the set up and sustainability of the coordinating company, marketing the brand and managing performance amongst consortium members. For example, Sheffield Money takes a fee on successful loans; so the partnership must generate sufficient volume of loans to sustain its role. Maintaining sustainability of the coordinating organisation is a challenge that led to some consortia partnerships, such as the Community Banking Partnerships in the 2000s to dissolve after the initial funding for the project ended.

[70] The Affordable Loans partnership is made up of Scotcash, Scotwest Credit Union, Manchester Credit Union, Leeds Credit Union and Five Lamps, and has the backing of the Cabinet Office, credit score experts Experian and Responsible Finance (formerly the CDFA), among others. Asda, one of the private partners in the project, is hosting the portal and customers can go directly to the Affordable Loans website to get a quote or via Asda Money.

		some services; automated services can reduce operational costs through economies of scale; an online presence can help reach more people (and improve standardisation of customer experience). Credit migration – an advantage for credit unions in particular: partnering with responsible loan funds could improve their ability to serve marginalised and otherwise financially excluded consumers whose credit scores are built up through a good lending relationship with the responsible loan fund.	
Integrated	Leeds Credit Union and Headrow Money Line - is a community based provider. As a Credit Union it is subject to regulation caps of loan interest at 3% per month; the union identifying it was unable to serve higher risk borrowers (declining 30% of its members' loan applications because they were higher risk), and, as part of a solution to this launched (in 2011) a responsible loan fund called Headrow Money Line (responsible loans having more flexible loan pricing). The sister loan fund was supported by Leeds City Council's financial inclusion programme, which was launched at the same time to reduce the £90 million high cost credit market in Leeds.	All entities are located under the same roof – providing efficiencies around overheads and back office/administrative services; and a simpler/direct customer journey.	This model requires greater set-up costs and more regulatory barriers given that separate companies must be established and managed at arm's length. For example, credit unions are subject to prudential regulation so starting a new lending arm is considered high risk; as both entities are regulated, broking licenses are needed to refer consumers back and forth – which can be a double regulatory burden for small scale organisations. Because of this there is also less flexibility in terms of adding new products and services.

Most recently it has been noted that as 'place-based' economic and social development models have begun to be discussed and find favour once more so new partnership opportunities for credit unions and CDFIs may be opening up once more with anchor institutions such as housing associations, universities, the NHS and the faith sector.

4.5 Affordable lending: a summary

Affordable credit lending is an invaluable offer within the consumer credit market, especially for those individuals who struggle to achieve mainstream credit access and as a result are likely to use high cost lenders. Suppliers of affordable credit such as credit unions and CDFIs are also typified by offering or signposting financial education and guidance alongside lending as they see themselves as not just delivering finance, but with a social mission to support individual and household financial resilience.

There are, however, key challenges related to expanding the affordable credit lending base to meet what many perceive as a growing credit finance gap. These include:

- There are competing views about the future direction of credit unions within the sector itself, and given their 'common bond' membership basis. Generally, the largest credit unions, which have the loan capital (through member deposits) and efficiency in systems, might be described as "able but not necessarily willing" to deliver small sum, short term credit to high risk customers, whilst the smallest are not in a position to do so;

- This relates to customers using commercial non-mainstream credit products such as payday loans and home credit being somewhat different from the traditional credit union customer base, which is generally made up of people higher up the 'credit curve';

- The credit union model limits the ability of the sector to provide the type of loans that those who use commercial high cost lenders demand: customer demand is for small, short term loans, processed quickly with minimal bureaucracy, online or on the doorstep. This is not the traditional lending model for credit unions and particularly as there is also a higher risk of default more expensive. Credit unions' capped lending price of 3% a month means that, at present, they are not positioned to sustain this type of loan book;

- Most credit unions still require new customers to save before they can borrow. This can be off-putting for many people, particularly those on the lowest incomes, as they are least likely to have any savings or be in a position to be able to save. In addition, this model does not fit with the top priority of payday loan customers, which is the speed at which they can access credit;

- In contrast, the average interest rate currently being charged by personal lending CDFIs is around129% APR. Whilst this may appear high, particularly when compared to the 42.6% maximum APR of credit unions, it is still significantly lower than rates offered by commercial providers in the high cost credit sector. If the sector could be grown, then these rates could potentially reduce in future due to increased economies of scale and a wider spreading of risk. This supports the findings from the DWP Growth Fund Evaluation, which suggested a break-even APR of 70% for not-for-profit lenders;

- In contrast to credit unions, the issue for CDFI personal lenders is that as non-deposit taking organisations their key issue is sourcing capital to on-lend, not constrained operational sustainability due to capped interest rates;

- The different challenges to both credit unions and CDFIs scaling up in the affordable credit sector is one of the drivers for the sector to seek collaborations and partnerships. More broadly, such partnerships may also support the wider community finance and banking visions of many in the sector;

- As it stands, the combined sector loan book is barely 10% of the size of the commercial high cost credit market, to scale up the sector remains a huge challenge, and a starting point remains that credit unions and CDFIs have a market awareness and image problem (and limited resources available to support branding and marketing);

- Notwithstanding the above, there exists a growing diversity of innovative developments and collaborations in the sector seeking to meet the financial needs of citizens in a fair, respectful and responsible manner.

5 Scaling Affordable Lending

5.1 An expanded affordable credit sector

Over the past decade the responsible finance sector has helped several million people access affordable credit, mostly avoid high cost lenders and potentially evade a cycle of over-indebtedness. Nevertheless, compared to the scale of demand this has only 'scratched the surface'[71]; with evidence of the impact of regulatory change suggesting further recent substantial and rapid growth in the demand for affordable credit finance.

Affordable lenders have responded through modernisation programmes, mergers, partnerships and new innovative forms of collaboration, products and services - but it remains the case that the sector faces substantial challenges and barriers to scaling up and increasing the supply of affordable credit at national level, and as part of a broader community finance and banking movement.

Moreover, as noted in Section 3, scaling up needs to occur in credit markets where consumers have demonstrated that cost and affordability are often relegated in decision-making behaviour behind ease of accessibility, speed of service, simplicity, trust, non-intrusiveness, and other non-price based factors.

5.2 Achieving scale: partnership, deal flow, fulfilment, sustainability

What is known is that sustainable credit lending business models can be 'spreadsheeted' at (national) scale, but the issue remains how to take a small scale and patchy sectoral infrastructure from where it is now to such (economies of) scale.

A journey through the barriers to scale can be usefully understood through the eyes of the client journey: engaging with a provider, making a loan application which is fulfilled and repaying the loan such that the provider remains in business for future use if required.

5.3 Partnership

As currently configured it remains clear that no responsible finance provider is in a position to scale on its own to the point that it could impact substantially within a national consumer credit environment – it will need to partner, whether that be to access customer volumes, access capital of scale, and/or put in place systems and procedures to manage demand and post loan requirements at scale.

The Community Banking Partnerships, Credit Union Expansion Programme and myriad other pilots within the community finance sector all tell a story that partnership is neither straightforward nor easy. Differentiated missions and rationales, organisational cultures, legal and regulatory constraints, and mismatched protocols and procedures are just some of the pitfalls that mitigate against successful partnerships and reinforce one of the key long term lessons of the CBPs, 'adequate resourcing is essential to partnership work'.

This report has provided some examples of recent partnership activity and, in 2017, Responsible Finance published *Creating Local Finance Partnerships: A Toolkit* to support responsible finance lenders in developing partnerships and the move to greater scale.

5.4 Deal flow (or loans at volume)

It is recognised that loans at volume are a, if not the, critical step to sustainable business models – both in terms of meeting the demand for responsible finance products and sustainable business models.

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[71] See Henry and Craig, 2013

Nevertheless, to achieve this position, entails at least three key inter-related developments:

- Access to demand (and demand management);
- Operational infrastructure; and,
- Access to loan capital to fulfil loan volumes.

5.4.1 Accessing consumers

Whilst there has been recent improvement in awareness, it remains the case that UK credit union membership remains low on international comparison. CDFIs have even less awareness amongst the general population or within consumer credit markets.

Even on their own terms **brand** remains weak, and marketing budgets and skills highly limited, and that is before setting responsible finance providers against the substantial budgets and demonstrated marketing prowess of, say, payday lenders and the finance mainstream. In 2013, Wonga's spending on TV advertising was estimated at £16m; in the same year the total volume of personal loans made by CDFIs reached just over £19m.

One recent development is to partner with recognised consumer brands. In Scotland, Scotcash has partnered with Virgin Money to provide basic bank accounts in Scotcash branches. The national Affordable Lending Portal pilot has partnered with Asda, providing a web-link from Asda Money alongside some in-store promotional activity.

Credit unions face **regulatory restrictions** on the market they can lend to and the size they can reach. Under current legislation membership of a credit union is based on the concept that "a common bond exists between members of the society". Recent reforms have provided some greater flexibility to the common bond stipulation but, for example, those with an inscribed geographical area are limited to a maximum of 2 million members.

Furthermore, as membership organisations, it remains the case that capital for on-lending is drawn from member savings. This implies an agreed contract between members as to the nature and risk of any such lending (and subsidy) across membership cohorts, and an undoubted tendency towards risk-averse lending.

A further barrier is **established consumer behaviour**. Once consumers have found a reliable credit source and are content with the service they receive, the evidence is that they tend to stick with that provider and are reluctant to switch, even where a cheaper alternative could save them money. This has been demonstrated also regarding the limited impact of a range of 'switching' initiatives put forward across products such as bank accounts and utilities.

When consumers have limited potential sources of credit they are especially keen to maintain a relationship with their lender, build trust and not risk jeopardizing this for a new lender who may not be available to them in future. The greatest resistance to switching lenders has been found amongst those on the lowest incomes who don't want to risk disrupting their finances.

5.4.2 The lending process

Consumer behaviour within non-standard credit markets is driven very strongly by non-price considerations, especially **ease of access (whether high street or on-line) and speed of decision making**. This remains a major barrier for responsible finance providers.

Given membership requirements, the typical credit union lending process remains multi-stage and relatively and generally slow. Much remains paper-based, although there are numerous and expanding examples of the introduction of the efficiencies and effectiveness of electronic processes including, for example, shared automated lending tools. Within an almost upon us era of platform finance, open banking and ‘fintech’, peer-to-peer and payday lending has demonstrated latent demand and customer expectations regarding easy and fast decision-making. Pilots by responsible finance lenders have demonstrated further that in these markets consumers are willing to pay additional fees for speed of access.

Whilst personal lending CDFIs tend to have stronger and speedier lending processes, their geographical coverage and loan capital (see later) is limited. Fair for You is a recent example of a responsible provider that has adopted a national on-line lending model through their ‘digital high street’.

Aside from operational systems, fundamentally, of course, ‘slowness’ in decision making by responsible finance providers is related to their ‘relationship’ finance approach and careful **calculation of ‘affordability’** to ensure responsible lending. This includes the ability for further signposting to appropriate lending channels and / or financial advice and education opportunities. The challenge remains to balance information requirements against (speed of) decision making, including the layering of information requirements around different consumer segments and the depth of ‘relationship’ believed to be required.

Considering this, the other major information requirement in the lending process is **credit scoring**. In the main, credit unions and CDFIs adopt or replicate the credit scoring methodologies of mainstream credit providers, adding subsequent information and / or further engagement with the client. Two issues arise from this use of mainstream credit scoring approaches: first, the danger that responsible finance providers are merely replicating the issue of exclusion from mainstream finance and, second, and more common, that this does not provide the full information required to make the lending decision appropriate within responsible lending consumer credit markets.

Most recently, a number of developments around ‘inclusive credit scoring’ have emerged. These are framed around using a wider range of indicators or sources of information to assess credit scores in contrast to the highly dominant FICO models. VantageScore has been developed in recent years and, in 2016, a new credit reference start-up, Aire, was authorised and which is focused on those such as young adults, the self-employed and migrants who may have issues with ‘thin’ credit histories. Other developments are based on, for example, social media scraping and enhanced psychometric calculations of ability and willingness to repay. Nevertheless, for responsible finance providers, whilst attractive in principle, the adoption of such innovative approaches to credit scoring would require also significant and complicated changes to underwriting and the documentation procedure.

5.4.3 Post loan management

Arguably, the greatest driver of company exits from payday lending markets has been the combined impact of recent regulatory change on business models and the ‘contribution’ of post loan management.

In this market, loan acceptance rates have fallen from around 50% to around 30%; the proportion of loans being charged a late payment fee has decreased from 16% to below 8%; and the proportion of loans entering arrears for seven days or more has decreased from 16% to 12% (FCA, 2017). Put another way, remaining lenders now receive the vast majority of their revenues from the contractual interest payments agreed with the customer at the start of the loan, rather than revenues from late fees, late interest or rollovers – or what could be described as a distinctive form of (‘irresponsible’) post loan management.

Clearly, whilst responsible lenders have never held this business model, as they scale up into potentially riskier markets and consumer segments of non-standard credit the message is still highly pertinent - of how post loan management and loan delinquency is a critical determinant of any sustainable business model. In this regard, for example, early signs of the worsening of credit union loan books has been noted alongside credit union expansion.

5.5 Accessing capital

A key concern for CDFIs is to secure capital for on-lending, given that unlike credit unions they do not take savings. This remains a key barrier as regards scaling up. Concerns have long been expressed by these responsible finance providers that investment in awareness raising and marketing will raise lending demand but without the capital to fulfil such demand; in turn, requiring the need for demand management to avoid, simply put, running out of money. The issue of 'turning the taps on and off' has long plagued the sector as attaining sufficient capital has remained a long run problematic.

Policy driven funding remains inconsistent, often localised and rule-bound, despite strong recognition of concern around financial inclusion, consumer detriment and indebtedness. Social investment has grown as a funding source but is of limited scale. Without lending responsibly at volume in higher risk lending markets, sustainable and investable business models are compromised.

In contrast, the combined asset base and loan funds of credit unions continue to grow, but given their membership profiles and maximum interest rate cap, lending in to riskier consumer credit markets is operationally constrained, notwithstanding membership vision and mission.

5.6 A sustainable business model?

In the face of new (market) opportunities and demands, responsible finance providers are seeking to scale up to achieve fair and sustainable lending models within non-standard consumer credit markets.

For credit unions, given mission and rate capping, pilots have provided evidence as to how sustainable lending activities might be developed and maintained in such markets - but such models look 'vulnerable' in the move towards riskier consumer segments. For CDFIs, and without rate capping, servicing of such markets in a sustainable manner is possible but operating infrastructures remain under invested and funds for lending sparse. Without volume, income driven models remain more ambition than reality beyond localised provision. As Alexander et al. (2015) note: "this customer base requires immediate access to small, short term loans, processed with minimal bureaucracy, online or on the doorstep. This type of lending is intrinsically expensive – particularly as there is also a high risk of default."

The on-going Affordable Lending Limited, a partnership of CDFIs and credit unions with Asda and Experian, is one such pilot attempt to create a national platform-based product offer, fulfilled by a group of responsible finance providers, and in which to test models and pricing. It combines partnership, platform and provider diversity – but currently remains some way from determining pricing and a sustainable business model.

In combination, what may be highly pertinent recent statements for responsible finance providers on market positioning and business model frameworks can be taken from combining recent FCA and commercial industry reports:

- in the eyes of the FCA, lenders have been incentivized to issue loans that are affordable and that consumers can pay back on time, so that the lender is more likely to successfully collect the contractual interest payments, rather than revenues from late fees, late interest or rollovers; and,
- in the eyes of industry, the view is that shorter pay day loans are now unprofitable with the most attractive loans set at over £300 for between 3 and 7 months and alongside substantially reduced default levels.[72]

[72] https://www.apex-insight.com/product/high-cost-short-term-credit-market-insight-report-2017/

Furthermore, success in high cost short term credit lending it is suggested is dependent on the following:

- Effectiveness of marketing and advertising in driving high volumes of traffic to operators' websites at low average costs;
- Low cost back-office processes involving a high degree of automation;
- Accurate credit assessment processes to enable loans to be offered without incurring high collections costs and write-off rates; and,
- Compliance with FCA Handbook regulations and other relevant laws to ensure that FCA authorisation is retained, penalties are avoided and agreements are legally enforceable.

5.7 Next steps

This Review forms part of a study programme to investigate how to overcome a number of known barriers to affordable finance lenders scaling up to meet consumer credit demand at a national scale and in a sustainable manner.

The Review has drawn on a range of academic, think tank, policy, advocacy and financial industry reports to provide a broad historical and literature context to recent FCA market assessment activity. It has set out the segmented and dynamic landscape of consumer credit, the current scale and scope of the affordable lending sector, and noted current sector initiatives aimed at overcoming a series of identified scale up barriers faced by the sector.

Alongside sector dissemination and capacity building activities by Responsible Finance, further study activities include: Evaluation of the Affordable Lending Portal; Case Studies of other affordable lending initiatives; and an investigation in to the emergence of 'inclusive credit scoring' approaches.

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