DEMOS

GOOD CREDIT INDEX 2023

POLICY BRIEFING PAPER

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AN INCLUSIVE ECONOMY

This project is part of Demos' ***"inclusive economy"*** strategic pillar.

This pillar investigates how we can build an economy where everyone participates and contributes to shared goals and where, as a consequence of that contribution and participation, there is an equitable distribution of the benefits.

Financial inclusion is an important part of an inclusive economy by enabling everyone to get fair access to the credit. Affordable, appropriate credit is a way that households can maintain their financial resilience and get access to goods and services that otherwise would be beyond their reach.

INTRODUCTION

In August 2023, Demos published its 5th Good Credit Index – a UK-wide analysis of three metrics to understand the level of credit need across the country, and the level of access to "good" (legal, regulated, affordable, sustainable and transparent) sources of credit. Each year, the Index has identified a number of pockets of high credit need, combined with low credit affordability. These so-called "credit deserts" have, in the 2023 Index, become more acute in the light of the cost-of-living crisis.

This year, for the first time, Demos carried out a series of interviews with households living in credit deserts to capture the lived experience of this crisis and the role good credit can play. It is clear the need for affordable, reliable credit has grown as even those on modest incomes find their budgets stretched – yet the supply of good credit has not expanded consistently in response.

Demos has therefore decided to publish an additional policy paper to explore this issue. Using evidence from the 2023 Good Credit Index, combined with further research into the regulatory and policy frameworks and consultation with experts from the industry, civil society and policymakers, this paper seeks to present a series of potential solutions to improve the access to affordable, transparent credit across the UK, but particularly in "credit deserts".

We are aware that improving access to good credit is tackling a symptom of the problem, not the cause. However, tackling the root causes of the cost-of-living crisis, including food and fuel inflation and wage stagnation, welfare and housing reform, is beyond the remit of this paper. We should also bear in mind that good credit has an important role to play in a healthy, growing economy, as a means for households to smooth lumpy one-off purchases. Well managed and affordable credit underpins consumer confidence.

We are therefore considering both short term measures to ease the current pressure on households struggling to access good credit at a time of economic uncertainty; and how to develop a longer-term vision of a fair, affordable and inclusive UK credit market.

This paper will:

1. Consider whether more can be done to tackle high cost, unregulated and illegal sources of credit through regulation; and
2. Explore how the supply of and access to good credit can be expanded country wide, but with a particular focus on credit deserts.

PART 1
TACKLING BAD CREDIT

In the Good Credit Index, we define "bad credit" as illegal and unregulated sources of credit, and High Cost Short Term Credit (HCSTC). Fortunately, in recent years, the Government has improved the regulation of some of these credit industries. For example, from 2014 Payday Lending came under FCA regulation, which meant the introduction of new consumer protections, including:

- A price cap
- Limits on how many times a loan could roll over
- Stronger affordability checks and financial health warnings for loan applicants

Within three years, customer complaints about payday lenders had dropped by 86%.[1] However, the Consumer Finance Association, which represented the industry until 2022, warned in 2015 that the regulation had squeezed profit margins and led to large compensation pay outs, meaning payday lenders were leaving the market in droves. The number of payday lenders fell from 240 in 2013 to around 30 to 40 lenders by 2015, while 80% of payday loan applications were rejected. As a result, the CFA claimed, 4% of those whose loans were rejected had turned to illegal lenders.[2]

These early concerns seem to have been justified. The most recent survey from Ipsos suggested more than 3 million people had borrowed from an unlicensed or unauthorised money lender between 2020-23, while only 1% of customers reported their situation to illegal moneylending teams around the UK. Fair4AllFinance, which commissioned the research, commented:

> *'Our research suggests illegal lenders are flourishing in the credit vacuum left by the departure of high cost yet regulated lenders. The unintended consequence is that millions of people who can well afford to repay a fair loan are left with fewer safe options.*
>
> *'There is a growing consensus that structural change is needed to create a credit market that serves everyone.*[3]

Responsible Finance also reported this year that the number of people unable to access credit from a mainstream lender had increased by 50% since 2017, and concluded:

> *Regulatory action to address poor lending practices… has driven many of the worst lenders out of the market, but this may also be contributing to an increase in illegal lending.*

1 https://www.theguardian.com/money/2016/sep/20/archbishops-criticism-payday-loans-causes-reform-industry
2 https://www.independent.co.uk/news/business/news/payday-lending-borrowers-turn-to-illegal-loan-sharks-after-crackdown-wipes-out-hundreds-of-legal-lenders-10403588.html
3 https://fair4allfinance.org.uk/as-one-door-closes-illegal-money-lending/

Given half of the victims that the organisation Stop Loan Sharks helped in 2021 had borrowed money from a loan shark to pay for food and fuel, we can fairly assume these figures, and the consequent human cost, will only increase in the current economic context.[4]

In short, the drop in the *supply* of sources of credit has not eradicated the demand for it. Evidence suggests this may provide new opportunities for illegal lenders, as well as other lines of high-cost credit that cater to the same market. This includes doorstep lending and BNPL schemes.

DOORSTEP LENDING

Doorstep lending – where a local agent brings cash to a customer's home and then collects repayments on that amount in the same way – is a popular form of credit among households who need small sums of money, but who have poor credit ratings. Indeed, customers do not even need a bank account to secure this form of loan, meaning financially excluded and otherwise vulnerable groups are more likely to be doorstep lender customers.[5] Citizen's Advice found 48% of their clients using doorstep lending had a disability or health condition, for example. 43% were behind on their water bill, 49% had unsecured debt amounting to more than half their annual income and only 32% were employed. Moreover, 34% were paying back more than two doorstep loans[6], suggesting lenders were "doubling up" – allowing customers to take out a new doorstep loan to pay back another – a clear sign of bad credit.

In spite of all this, the doorstep lending industry is not subject to the same consumer protections as payday lenders, and Citizen's Advice has been campaigning for several years to rectify this.[7] Their report *Doorway to Debt* claims 1.6 millions people are using doorstep loans, and regulating this market in the same way as payday lending could save up to £123m in interest payments on up to 540,000 loans each year.[8]

There are currently no plans to apply the consumer protections that payday lenders abide by to doorstep lenders, but following an FCA investigation into mis-selling and a large amount of compensation claims lodged with the Financial Ombudsman Service, the UK's biggest doorstep lender, Provident Financial, closed its doorstep lending division in 2021 after 140 years. It had over 300,000 customers. Morses Club, the UK's second largest doorstep lender, went into administration in November 2023, leaving another 140,000 customers without access to this credit.[9] Supporters have warned the contraction of the doorstep lending market is likely to increase the numbers of people seeking credit from unregulated or illegal lenders.[10]

BNPL

While the payday and doorstep loan markets have declined in the UK, the Buy Now Pay Later (BNPL) market has boomed – £10bn has been lent to consumers by BNPL companies since 2020.[11] Survey data suggests the number of people using BNPL is steadily growing: the Financial Conduct Authority reported that 27% of UK adults – about 14 million people – had used BNPL at least once in the six months to January 2023, compared to 17% who had used it in the 12 months up to May 2022[12] and 20% had used it in the 12 months up to November according to Demos' own survey.[13]

BNPL was designed to allow people to make large one-off purchases (such as white goods) in instalments at zero interest, though missed payments incur interest and fees (around 14% of customers currently face these late fees). However, recent research suggests that consumers are now turning to BNPL for household essentials (11% of BNPL customers surveyed said they were using it to buy groceries, 8% toiletries and 5% household bills).[14]

BNPL products are currently unregulated, in spite of worrying evidence of consumer harm: Citizen's Advice found that two fifths of BNPL customers have had to borrow (credit card, overdraft, payday lending and so on) to pay off their BNPL debt,[15] while the FCA found 14% of BNPL customers had used it more than ten times in a year, and were more than 4 times as likely to have missed bill or debt payments in 3 of the last 6 months and almost twice as likely to have doubled the amount of debt they have in the last year.[16]

4 https://responsiblefinance.org.uk/download/fair-banking-act-policy-paper-march-2023/?tmstv=1679908282
5 https://www.stepchange.org/debt-info/doorstep-loan-debt.aspx
6 https://www.cashfloat.co.uk/blog/personal-finance/doorstep-lenders-new-bad-guys/
7 https://www.theguardian.com/money/2018/mar/19/high-interest-doorstep-loans-need-to-be-regulated-says-charity
8 Ibid
9 https://www.pccu.co.uk/doorstep-lender-morses-club-stops-lending-money/
10 https://www.bbc.co.uk/news/business-57012254
11 https://news.sky.com/story/treasury-xpoised-to-shelve-crackdown-on-buy-now-pay-later-sector-12921319
12 https://debtcamel.co.uk/big-jump-bnpl-usage-regulation-needed/
13 Demos, Good Credit Index 2023
14 https://thefintechtimes.com/consumers-are-turning-to-bnpl-to-pay-for-essentials/
15 https://www.citizensadvice.org.uk/about-us/about-us1/media/press-releases/two-fifths-borrowed-to-pay-off-buy-now-pay-later/
16 https://debtcamel.co.uk/big-jump-bnpl-usage-regulation-needed/

Following concerns expressed by consumer and debt advice charities, the government has for the past two years been holding a consultation process to regulate the BNPL market, going as far as to produce draft legislation.[17] However, these plans have recently been shelved – the government stating it was reluctant to limit the lending capacity of the industry during a cost-of-living crisis. A coalition of organisations including the Citizens Advice Bureau, MoneySavingExpert, Which?, StepChange, the Money Advice Trust, and Christians Against Poverty wrote to the Chancellor in an open letter asking the government to rethink this move, saying:

> *We are particularly concerned that those already struggling to make ends meet are most likely to use BNPL because there are currently no safeguards in place to prevent people already grappling with debt to sign up.*[18]

The Labour Party also urged a rethink, with Tulip Siddiq, Shadow City Minister, writing to Andrew Griffith MP, Economic Secretary to the Treasury, in August 2023. In the letter, she stated regulatory delay "has left millions of consumers unprotected and the BNPL sector in a state of uncertainty" and pointed out that BNPL providers themselves (including Klarna, the biggest BNPL provider in Britain) and Innovate Finance, the trade association for the BNPL industry, supported FCA regulation. She declared that a Labour government would work with the BNPL industry to develop consumer protection regulation, and in September 2023, Labour's final policy platform paper (which will inform the 2024 Manifesto) pledged that a Labour Government would "bring forward long overdue consumer protection regulation in areas like BNPL."[19]

Given the evidence of unaffordable interest rates, households taking multiple loans to pay off debts, and a concentration of low income and vulnerable households among the customer base, it is clear that payday lending, doorstep lending and BNPL markets need to be regulated in the same way under FCA Rules. This is also a matter of consistency – having payday lenders operating under stringent safety measures (e.g. capped APR), doorstep lenders having fewer safeguards, and BNPL customers having no form of recourse whatsoever, increases the risk of consumer confusion between short term loan products which may look similar but operate in entirely different ways. This approach has the support of consumer groups and charities, the Labour Party *and* the BNPL sector itself – suggesting the current Government is significantly out of step with wider expert opinion.

17 https://www.pinsentmasons.com/out-law/news/fca-set-regulate-buy-now-pay-later
18 https://www.citizensadvice.org.uk/Global/CitizensAdvice/Debt%20and%20Money%20Publications/BNPL%20open%20letter.pdf
19 https://www.policyforum.labour.org.uk/npf-consultation-2023

PART 2
IMPROVING ACCESS TO GOOD CREDIT

While improving the regulation of high-cost credit will protect consumers from unaffordable debt and the financial, mental and physical toll this can have, we need to bear in mind the knock-on effect of cutting off access to this credit for sub-prime customers. Without a commensurate improvement in the supply of, and access to, good credit alternatives, reducing the overall supply of credit may well drive households further into financial crisis or into the world of illegal lending.

The primary focus of this paper therefore is to consider what more ought to be done to improve the supply of and access to good credit, at a time when more and more households are using credit to make ends meet.

As we also point out in the introduction, there will always be demand for credit. Rather than a necessary evil, well managed credit use is a sign of a growing economy: consumers smoothing the costs of large purchases using good credit that they can afford and readily pay back, is an indicator of consumer confidence and improving living standards.

While policy makers do need to tackle the *drivers* of the UK's currently problematic credit use, therefore, they must also ensure that the UK credit market is healthy and fit for purpose. This is important not just at a time of economic uncertainty when many more people are relying on credit to make ends meet, but also in the future, when the UK economy recovers.

We now consider how this might be achieved.

TACKLING CREDIT NEED

Evidence suggests that the UK's need for good credit is outstripping supply. As explained above, this allows illegal, unregulated and unaffordable credit options to flourish in the gap. One obvious solution is to reduce demand – in other words, tackle the growing reliance on household credit during this cost-of-living crisis. Welfare and the housing market, food and energy price inflation are just some of the areas in need of urgent policy reform to support UK households to make ends meet without relying on loans. As pointed out in the introduction, however, it is beyond the remit of this paper.

UNIVERSAL SOLUTIONS

The Demos Good Credit Index uses a range of metrics to establish where in the UK people struggle the most in accessing good credit. However, the findings also show that particular groups of people, regardless of where they live, face the same struggle. Those with poor (or no) credit scores, deemed 'sub-prime', for example, will find it hard to access affordable credit even in areas where these options are plentiful. For this reason, we need to consider universal solutions – so that consumers country-wide have better access to good credit.

Reform of the credit information market

Most banks and other lenders use a credit score when evaluating credit applications. This three-digit number is an indicator of consumers' credit-worthiness – how reliable they are at borrowing and repaying money. As such, the accuracy of this score, and how fairly and transparently it is calculated, is an important feature in ensuring access to good credit.

However, for many years financial providers, consumer groups, poverty charities and others have suggested the current information upon which scores are based is too narrow in scope and does not adequately or accurately reflect people's ability to repay a loan. For example, Responsible Finance, the membership body representing responsible finance providers such as CDFIs and credit unions, is particularly concerned by the way in which credit scores penalise those with no or limited credit information. There are said to be around 5.8 million people described as "credit invisible" in the UK. This group will be awarded an estimated, often low credit score simply because they may not have used credit in the past. Those with limited information cannot, therefore, access good credit, thereby creating a catch 22 – credit invisible consumers are forced to take out high-cost credit and pay that back, in order to then generate a credit score which will enable them to access more affordable credit options in future. This approach also reinforces geographical inequality, as estimated credit scores are often based on information such as a person's postcode.[20] Without doubt this exacerbates the "credit desert" phenomenon we noted in our Good Credit Index.

The UK public are also dissatisfied with the credit score system. The Motley Fool published a survey in 2022 which also found 46% of British adults think the current system is ineffective; 38% believe that their credit scores do not accurately reflect their current lifestyle or livelihood, and 36% think a limited credit history should not result in a poorer credit score.[21] Responsible Finance's April 2023 survey found only 4% of those polled thought a loan applicant's location was an important factor that should be considered by lenders when assessing loan applications, while 55% thought have it was unfair that having no credit history had a negative impact on credit scores. The organisation is calling for a "social credit score" to replace the current score system. This would mean all applicants have their financial situation assessed and ability to repay a loan calculated, so no one is rejected outright for having no credit history.[22]

Public awareness and understanding of the credit information market is also poor, with many myths regarding what information is used, and how certain behaviours may or may not affect credit scores. Credit Strategy and Experian launched Credit Awareness Week[23] in 2017 to improve people's understanding about how credit information works and dispel common misconceptions around credit scores and reports. However, the impact of this has been limited and awareness remains poor. In 2021, polling to coincide with the CAW found 69% of the public did not know their credit score. 75% wrongly believed a credit blacklist exists that affects their ability to access finance, and 30% believe credit reference agencies like Experian decide the outcome of credit card applications. [24]

In response to the growing discontent with the current UK credit scoring system, the FCA launched a Credit Information Market Study in 2019, the Final Report of which was published in December 2023.[25] Their 'remedies' to some of the problems outlined above include improving the quality and coverage of credit information through mandatory data sharing, as well as ways to make consumer access easier and proposals for a new independent industry body.[26]

Demos consulted a range of experts on this particular issue. A representative body in the lending industry told us how its members felt affordability assessments were too blunt a tool, and that a customer's attitude towards and experience of credit was often more important. Others felt that AI and open banking technology opened a range of further opportunities to improve the credit information market by expanding the range of information being used to calculate the score. This is already happening in limited ways - Experian Boost, for example,[27] is a new scheme run by the credit information agency Experian which uses open banking to gain access to a customer's accounts, and adds a wider range of payments to the credit history file by scanning account transactions from the previous 12 months to calculate a "Boost" to their credit score. A representative from the regulation industry reflected that there was a growing divergence in the lending industry, between those adopting open banking methods and those still

20 https://responsiblefinance.org.uk/2023/04/uk-public-think-credit-scores-unfair-as-organisations-call-for-reform-of-credit-information-market/
21 https://www.fool.co.uk/2022/03/31/heres-why-half-of-brits-believe-the-current-credit-score-system-is-flawed/
22 https://responsiblefinance.org.uk/2023/04/uk-public-think-credit-scores-unfair-as-organisations-call-for-reform-of-credit-information-market/
23 https://www.experianplc.com/newsroom/press-releases/2023/experian-and-credit-strategy-launch-credit-awareness-week-2023
24 https://www.creditstrategy.co.uk/latest-news/latest-news/nearly-70-of-uk-adults-donrsquot-know-their-credit-score-ndash-credit-awareness-week-survey
25 https://www.fca.org.uk/publication/market-studies/ms-19-1-3.pdf
26 https://www.fca.org.uk/news/press-releases/improvements-needed-credit-information-market-deliver-better-lending-decisions-borrowers
27 https://www.fs-cp.org.uk/sites/default/files/202307_for_publication_data_use_research_report.pdf

using "traditional" data collection, which was often three months old.

The Financial Services Consumer Panel has begun to grapple with the ethical implications of these developments, and in particular the risks of using AI to scan big data sources to assess credit, noting that there are risks of bias towards protected characteristics (disability, gender and so on) due to "algorithmic feedback loops" – for example, where low income households without insurance and using high-cost credit are flagged as "high risk", excluding them further from mainstream financial products.[28]

Some of the experts we spoke to also raised concerns about the ethical implications of what information ought to be used, and what discounted. For example, if a review of all payment data shows a consumer buys a lottery ticket each week, would this count as a gambling habit? Should this information be used to lower a person's credit rating? If spending information suggests a customer is having a baby, or separating from their partner, should these insights be used to calculate creditworthiness?

Whether technological advances such as AI could create a transparent, standardised, replicable assessment to capture this wider concept of "credit readiness", while also avoiding some obvious gender and ethnicity biases and ethical questions that might arise, remains to be seen. Nonetheless, it could have significant implications for financial inclusion – one of the regulatory experts Demos consulted for this paper was confident that by using open banking, more consumers would be found eligible for credit without lenders having to relax their risk profile. In other words, more comprehensive data would mean more consumers meeting traditional lending criteria – adding no further risk to lenders: a win-win situation.

Moreover, AI and open banking can be used in less ethically complex ways to improve the credit scoring system. For example, a credit builder start-up launched in October 2023 is using open banking to link a Mastercard to customer's bank account. This is then used by customers like a normal debit card to pay for items, but the startup holds the money and "pays back" the card two working days later, demonstrating reliable repayment behaviour and building a positive credit rating for the customer.[29] AI can also be used to automatically scan multiple accounts and lending products and identify a risk of defaulting on payments *before* this happens. Some of the experts we spoke to commented that there had been a "sea change" in public opinion regarding what was deemed intrusive, and customers were now far more likely to appreciate their bank or credit provider reaching out to help them before problems arose and preserve their credit rating. Banks in particular were becoming more adept in fulfilling their consumer duty by spotting problems early on, learning from techniques adopted by the gambling sector in identifying and supporting customers with problem gambling habits.

Overall, evidence suggests that the UK's current credit scoring system is not fit for purpose, and much more work needs to be done to develop a new credit assessment process that could adequately take its place. The credit scoring system's transparency, simplicity and useability will also be improved as part of its reform, and a public awareness campaign ought to coincide with the launch of a new scoring system.

Tackling regulatory uncertainty and compliance costs

Regulatory uncertainty is another factor which limits consumer access to credit UK-wide. As we explained in the previous section, the Financial Ombudsman Service (FOS) became very active in upholding complaints among payday lending customers who felt they were mis-sold loans, and as a result many payday lenders went into administration, unable to bear the costs of the compensation awarded to customers by the FOS. A similar phenomenon has occurred in the doorstep lending industry – while these lenders are not subject to the same guidelines as their payday counterparts, many have been affected by compensation claims following the FOS applying a stricter interpretation of mis-selling rules to boost consumer protection, and some of the largest doorstep lenders have now left the market.

The policy experts, lenders and representative groups that Demos consulted during the development of this paper maintained that the stringency of consumer protection rules were not problematic *in and of themselves.* Rather, the main problem was the variability with which they were applied and the room for interpretation of these rules by the FOS.

This has created an environment of regularity uncertainty, where lenders cannot *always* be sure that approving a credit application will not fall foul of mis-selling rules. As one representative body put it: their members sometimes struggled to know which sided of the regulatory line they were on, when the line kept moving. The claims management industry – whose business model encourages consumers to make complaints regarding potential mis-selling of

28 https://www.fs-cp.org.uk/sites/default/files/202307_for_publication_data_use_research_report.pdf
29 https://www.finextra.com/newsarticle/43085/uk-startup-taps-open-banking-technology-to-help-people-build-their-credit-score

(among other things) credit products – has increased the number of cases of lenders owing significant amounts of compensation following a FOS ruling.

This has had two adverse impacts.

The first is that regulatory uncertainty could undermine the confidence of investors that underpin the sub-prime lending industry. This is because investors and the financing banks, who finance credit providers, may be less willing to invest if there is an unknown risk of large compensation pay outs.

This, in turn, makes lenders less willing to lend to 'risky' customers – the second adverse effect. To ensure their business stability and assuage investor concerns, lenders are becoming more risk averse – erring on the side of caution when consumer protection rules are subject to interpretation. This has led to fewer customers being approved for credit, particularly in 'marginal' cases, and increased prices for those who are being approved. One of the regulatory representatives Demos consulted for this paper described a "waterfall effect" caused by the pandemic and the cost-of-living crisis, whereby some prime credit consumers had been pushed into the fringes of mid-prime, and mid-prime had moved closer to sub-prime. With more consumers on these margins of credit suitability, risk aversion and higher (risk based) prices among lenders is a more significant issue for more people.

Reflecting on this issue, which has significant implications for financial inclusion, representatives of the regulation industry Demos consulted were keen to point out that the FOS was not trying to stop lending per se – but that anxiety among lenders regarding what the FOS might do was having that effect. They agreed greater clarity and consistency could help to bring reassurance to the sector.

However, this issue is not just a problem for the payday, doorstep or other high cost loan markets. Fair4AllFinance reports that there has been a 50% drop in the number of people being able to access credit from mainstream banks since 2017[30], and that there a lower risk appetite even among responsible lenders, with 44% of community finance lenders tightening their criteria, and despite high application rates, loan approvals have fallen.[31]

The Financial Services and Markets Act 2023[32] will overhaul financial services regulation, in part to replace a range of EU rules with UK-specific ones in a post-Brexit regime. Importantly, the Act will increase the number of rules in the FCA Handbook, PRA Rulebook and Bank of England rules, rather than imposing requirements on financial services through legislation. This will give the FCA more power over financial service providers. The Consumer Credit Act is also being reformed next year, and will be fully subsumed within FSA regulation. The government's consultation response[33] took a range of views on, and discusses at length, the pros and cons of a self-policing regime versus enforcement and prescriptive versus outcomes-based regulation – with many responses to the consultation favouring the former for the sake of improved clarity.

Both of these important legislative developments could provide a wider opportunity for a debate regarding the extent to which FSA rules are consistently applied, and how to balance this with room for adaptability to different circumstances.

The role mainstream banking

Fair4All Finance, an organisation of financial inclusion experts that works to promote improved access to credit and other financial products, estimates there will be a £3bn gap between demand for and supply of affordable credit by 2025.[34] This suggests that even if access is improved (through reform of the credit score system, or greater regulatory certainty to ensure lenders are not unnecessarily restricting access to their credit products), there are simply too few good credit products available.

In the following section, we look at ways the supply of good credit might be increased at local level. However, here we consider the how supply of good credit might be boosted UK-wide, through the mainstream banking sector.

The Fair Banking For All Campaign came about in response to the fact that mainstream banks and building societies were not meeting the needs of low income and/or high risk customers. This Campaign – a coalition of responsible lenders, charities, civil society organisations and academics – are calling for a Fair Banking Act, which would require mainstream banks to report on what they are doing to tackle financial exclusion, and create a new rating system against which banks would be compared.[35]

30 https://responsiblefinance.org.uk/download/fair-banking-act-policy-paper-march-2023/?tmstv=1679908282
31 Fair 4 All Finance. Community Finance Sector Reporting - Q4 2022. Fair4AllFinance, March 2023. Available at: fair4allfinance.org.uk/community-finance-sector-reporting-q4-2022
32 https://www.legislation.gov.uk/ukpga/2023/29/enacted
33 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1168986/CCA_consultation_response_-_v7__new_format_.pdf
34 https://fair4allfinance.org.uk/deliver-scaled-affordable-credit-market-for-those-who-need-it-most/
35 https://responsiblefinance.org.uk/2023/03/coalition-calls-for-fair-banking-act-which-public-would-back/#:~:text=The%20Fair%20Banking%20for%20All%20Campaign%20is%20a%20coalition%20of,on%20financial%20exclusion%2C%20and%20academics

This was inspired by the Community Reinvestment Act in the US, which was enacted in 1977 and led to a significant increase in the banking sector funding credit unions and CDFIs in order to improve their ratings.[36]

Campaign members suggests that mainstream banks and building societies in the UK could either a) adopt the same strategy as US firms to improve their Fair Banking rating – i.e. by providing capital to responsible credit providers (which would boost local availability of good credit); or, b) provide financial products to excluded customers themselves (which would improve the national picture). We consider the latter here.

Offering credit to excluded households

Since 2016, the nine largest personal current account (PCA) providers in the UK (including Barclays, Lloyds, Santander, HSBC) have been legally obliged to offer a fee-free bank account that can be used to save, make payments and access cash to those who might not be eligible for a standard current account. BBAs do not have as many services as a current account – importantly, there is no overdraft facility, so those who have bad credit or who been declared bankrupt are still entitled to one. Although BBAs do not help people access affordable credit, they are clearly an important tool for financial inclusion and give banks a readymade 'target market' of customers who may well need help accessing affordable credit.

Banks could, for example, offer a credit equivalent of a BBA – a credit product specifically for their BBA customers, tailored to their circumstances.

One option might be to fund a No Interest Loan Scheme (NILS) as part of a CSR endeavour. A NILS provides an alternative to a grant for people who have been refused an interest-paying loan, usually worth around £500 (but up to £2000) that can be paid back within 18 months without incurring any interest. The NILS Manchester Credit Union ran the first proof of concept of the scheme, and found 87% of applicants had poor or very poor credit scores, but achieved a 94% successful repayment rate.[37] With financial backing from the Treasury, JP Morgan and Fair4All Finance, the NILS pilot has been rolled out to 20,000 people UK-wide since September 2022 and will be evaluated in 2025.[38] Fair4All finance is seeking to expand the scheme by securing more money from the Dormant Accounts fund, and so there is a clear opportunity for Banks to partner with the government to co-fund further schemes, and help administer it to their vulnerable (BBA) customers.

Alternatively, banks could move into the small loans market themselves, offering them to their low income/higher-risk customers as a direct alternative to payday or doorstep lenders. However, in addition to the regulatory uncertainty in the credit market, the shift to stronger consumer credit protections has also increased the overall cost of regulatory compliance. This means lending small amounts (usually below £1000) is not economically viable without significantly increasing APRs. The policy experts we consulted pointed out that mainstream lenders in particular are reluctant to enter the small-loan market, as they risked reputational damage if they were seen to be offering "high cost" credit (perhaps three or four times higher than the rates they apply to their larger loans) and so tended to avoid serving this customer base altogether.

This is, of course, an unhelpful misconception. Credit unions offer small loans at around 12.7% APR (1% a month), up to a maximum capped rate of 42.6% APR (3% a month)[39], and maintain positive public perception and status as responsible lenders. Moreover, when compared to the HCSTC market, where APRs average at 1500%,[40] a bank loaning small sums at 40-50% APR would clearly be a far superior product.

The experts we consulted felt that, if banks were to be convinced of moving into the small-loan market for higher risk customers, a fresh public conversation would be needed about what an "affordable" APR actually meant and a real effort on the part of government, regulators and financial service providers to destigmatise higher APR short term credit. If this were achieved, banks might be less reluctant to move into this market, and could look first to their BBA customers – this group already have a savings and payment history with their bank of choice, and are most likely to struggle to secure affordable credit. They may well be using HCSTC lenders to fulfil that need already, and in such cases, their bank offering an alternative line of credit at a fraction of HCSTC APR (even if it is much higher than average bank loan products) would certainly be a welcome development.

36 https://financeinnovationlab.org/our-work/grow/fba/
37 https://fair4allfinance.org.uk/learning-from-our-no-interest-loan-scheme-proof-of-concept/
38 https://www.moneysavingexpert.com/news/2022/06/no-interest-loan-scheme-to-be-rolled-out-in-the-uk-from-septembe/
39 https://www.moneysavingexpert.com/loans/credit-unions/
40 https://www.fca.org.uk/data/consumer-credit-high-cost-short-term-credit-lending-data-jan-2019

LOCAL SOLUTIONS

In the previous section, we considered how to improve the supply of and access to good credit for consumers UK-wide. However, the Demos GCI has demonstrated, over successive years, that geographical inequality plays an important role in accessing good credit. We know, for example, that clusters of financial exclusion and high credit need exist in the most deprived neighbourhoods in the UK, and these (often urban) credit environments lack ATMs, bank branches and credit unions, but have plenty of pawn shops, loan shops and local "money men" (doorstep lending agents) to facilitate access to high-cost credit. We also need to consider the digitally excluded, older, vulnerable, disabled and ethnic minority groups, who are also more likely to be financially excluded and living in credit deserts. These groups are a sizeable minority: we know, for example, 1 million people in the UK cannot afford to access the internet, 9 million lack the digital skills to do so, and 23% of the public say they do not feel comfortable with online banking. A further 1.9 million people do not have a bank account.[41]

These vulnerable groups tend to benefit from more locally accessible 'in person' support services – be that children's centres, drop in mental health and advice clinics, food banks and so on. The same is true for services to support financial inclusion – an affordable lender presence on high streets and housing estates could do much to counter the cash and loan-shop presence which has become ubiquitous in low-income neighbourhoods. We consider now how this might be achieved.

Expansion of the CU and CDFI sectors

The affordable credit sector, which includes credit unions, Community Development Financial Institutions (CDFI) and community banks[42], provides often small loans to low-income households or those with poor or no credit scores. They have a local presence, with branches usually situated within the communities they serve enabling people to visit in person to arrange loans. They also have innovative products and add-on services designed to promote financial inclusion – for example, loan repayments can be made in the form of wage deductions, to avoid missing a payment. Others can be linked to savings, so that a 'repayment' is actually a contribution to a savings pot, which can then be partially or wholly used to pay off the debt. Others include a benefits check as part of the application process, to ensure that those applying for credit have explored other options first and maximised their benefits income, while others run savings schemes to purchase white goods or school uniforms, and offer food bank referrals.

However, the UK's affordable credit sector is relatively small, and at present unable to meet even a fraction of the demand for affordable credit among UK households. Only 3% of the UK population are credit union members, compared to the Europe average of 10%, 61% in the US and 31% in Australia.[43] Fair4All Finance's Affordable Credit Scale Up Programme aims to triple the availability of affordable credit to over £900m by 2025, but estimates there will still be a £3bn gap between demand for and supply of credit by that time.[44]

Some steps could be taken to expand the sector. For example, credit unions' common bond rules[45] could be relaxed, allowing credit unions to expand and serve a wider population that may not share a "common bond." This could pave the way for city-wide, or regional credit unions, for example, which would benefit from larger brands and marketing outreach, economies of scale to improve their IT and on. Previous attempts to strengthen the infrastructure of the sector, for example with centralised underwriting and automation, did not have as significant an impact as hoped.[46] However, this may now be more feasible and affordable in the light of technological advances.

Increasing capital investment in the CDFI sector, to expand its lending capacity and serve more individual customers and SMEs, is another option. As mentioned above, supporters of the introduction of a Fair Banking Act believe banks would provide investment to the sector, if they were expected to demonstrate their commitment to tackling financial exclusion. This certainly happened in the US after similar legislation was introduced there.

These measures may well boost the reach of affordable lenders, whose strong local presence would be particularly useful in credit deserts. Nonetheless, as the sector is so small, with limited infrastructure and public reach, it is unlikely it could expand enough to meet the expected £3bn gap in affordable credit by 2025. The experts Demos

41 https://responsiblefinance.org.uk/download/fair-banking-act-policy-paper-march-2023/?tmstv=1679908282
42 https://cles.org.uk/what-is-community-wealth-building/the-principles-of-community-wealth-building/making-financial-power-work-for-local-places/mutuals-and-community-banks/
43 https://www.woccu.org/documents/2021_Statistical_Report
44 https://fair4allfinance.org.uk/deliver-scaled-affordable-credit-market-for-those-who-need-it-most/
45 Credit Unions can only accept members that have a 'common bond' with each other - this might be living or working in a particular area, borough or postcode, or those who work for a particular employer or in a certain industry.
46 https://www.gov.uk/government/news/further-investment-to-secure-future-of-credit-unions

consulted for this paper felt that the sector's natural limit would be when it reached around £1bn in loans. While some minority voices have claimed the sector could grow to £3bn, reservations were expressed regarding the types of actors that would need to enter the market to achieve such a significant expansion.

Bank visibility

Given the limited potential growth of the responsible lending sector, the need for mainstream lenders (such as banks) to enter the affordable credit market and serve excluded and low-income households is all the greater. As we discuss in the previous section, regulatory uncertainty, high costs and reputational risk all discourage mainstream banks and building societies from taking this step.

However, if these financial institutions *could* be convinced to provide credit services to low income, high risk customers, they would also need to consider the strength of their local presence to ensure they reached excluded and marginalised groups. Just as the financially excluded living in credit deserts would benefit from local credit unions on their high streets, the same can be said for local bank branches and ATMs.

Banks and building societies have in fact been closing branches for more than a decade, as part of a wider move towards digital banking. 34% of bank branches closed between 2012 and 2021.[47] This is problematic not only as it limits access to cash/deposits and services where face to face interactions may be preferable, but it also reduces the local visibility and public awareness of banking brands. This may be particularly important for young adults making their first financial decisions, as well as minority ethnic groups vulnerable to exploitation.

A promising counter-trend has been the appearance of shared banking "hubs", which have been opening since 2022. These hubs cost the same as a bank branch to run, but are shared between a number of banks. They enable customers of the banks who share the hub to access their accounts, deposit and withdraw cash, and make face to face appointments on a rota system (i.e. staff from each participating bank will be present on one day a week),[48] however, only a handful have opened thus far. Many more would be needed to cover the credit deserts across the UK.

Banks could also look to tech solutions to improve reach – for example, face to face services could be provided in areas without branches by using remote contact points in libraries, community and children's centres for example, in much the same way as unmanned cash and deposit machines are being installed. A booth with a screen for video calls to banks could be installed, where appointments for discussing loans, mortgages, savings and other matters could be booked and take place. Again, these could be shared on a rotation system between multiple banks in order to share costs.

Expanding a low cost 'local network', either through Hubs or tech-enabled access points, focusing on areas of high deprivation and credit deserts, could be part of banks' efforts to tackle financial exclusion and contribute towards their 'fair banking score', should a Fair Banking Act be introduced. Such a network could be used to promote Basic Bank Accounts as well as small loans for those struggling to access credit, should banks be convinced to enter this credit market.

Local referral – destigmatising credit

In addition to improving the local visibility of affordable credit providers and mainstream bank presence, areas with high credit need and limited credit availability would also benefit from a coherent place-based strategy to promote good credit options. Our research clearly shows that, in the midst of a cost-of-living crisis, using credit to make ends meet is necessary for more households, including those further up the income scale.

To suggest low-income households should attempt to avoid all debt at such a time is an outdated, possibly harmful notion, and local support services (community and children's centres, food banks, charities and others) need to become more open about the use of credit, embracing the reality that it is no longer a question of "if" their clients use credit, but "what type". Local support services should therefore assume their low-income, vulnerable clients are probably already using high-cost credit, possibly juggling multiple forms of BNPL, and perhaps even illegal loans. Knowledge of the local credit environment (becoming familiar with both good and bad credit options being used locally) would be an important tool for many support services. Moreover, general fluency about using credit needs to be encouraged, so that credit is not stigmatised, and households can be steered towards affordable credit sources, benefits maximisation, debt forbearance and consolidation as alternatives to bad credit options.

47 https://financeinnovationlab.org/wp-content/uploads/2023/03/Fair-Banking-Act-policy-paper-March-2023.-Final-1.pdf
48 https://www.bbc.co.uk/news/business-62794680

PART 3
SUMMARY OF RECOMMENDATIONS

TACKLE BAD CREDIT:

1. Apply the same consumer protections – a cap on APRs, a limit on "roll over" lending and stricter application checks – that apply to the payday lending industry to the doorstep lending industry, so there is alignment between these two HCSTC lending markets.
2. Bring BNPL into FCA regulation, enacting the draft legislation that has already been prepared.

TACKLE THE OBSTACLES TO ACCESSING GOOD CREDIT:

3. Overhaul the UK credit scoring system to create a system that is fairer for credit invisible and credit poor households.
4. Tackle regulatory uncertainty which makes lenders risk averse, by clarifying and standardising mis-selling and consumer protection regulation related to credit products.

INCREASE THE OVERALL SUPPLY OF GOOD CREDIT:

5. Bring in a Fair Banking Act to encourage banks to:
   - **a.** invest in the affordable credit sector
   - **b.** provide their own affordable credit products
6. Expand the local supply of credit unions, CDFI and community banks, shared bank hubs and face to face outreach.
7. Develop a local referral strategy to destigmatise and steer people towards good credit.

CONCLUSION
TIME FOR A NEW FINANCIAL INCLUSION STRATEGY?

This paper presents a variety of policy options to help improve access to, and supply of, good credit at both national and local level. It is clear, however, that each of these are likely to have limited impact. There is no single solution to fix the UK's credit market but rather a need to implement each of these policy steps in a coordinated way.

For example, regulating high-cost credit *without simultaneously* improving access to and supply of good credit could actually harm consumers rather than help them, by pushing the most vulnerable into unregulated or illegal credit markets. Similarly, introducing a Fair Banking Act *without also* looking at compliance costs and reputational risk in the banking industry may fundamentally limit its impact in helping financial excluded customers.

We therefore recommend the government consider creating a new Financial Inclusion Strategy, to include the various measures outlined in this paper so they can be planned and implemented in a coordinated and coherent way. A new FIS would also include wider issues of financial resilience, debt prevention, education and so on, and would be a good place to start a national conversation about good and bad credit, destigmatising the use of credit, improving awareness of APRs and affordability, and credit scoring.

Many of the experts we consulted when writing this paper commented that the UK lacked a 'holistic vision' for building financial resilience and a healthy relationship with a well-regulated credit market. Many felt leadership was needed to scale up the credit market, and a new FIS was long overdue – the economy and the financial services market is unrecognisable when compared to 2004, when the Government launched its first financial inclusion strategy, *Promoting financial inclusion.*[49]

The *Promoting Financial Inclusion* strategy included a £120 million budget over three years to boost access to banking, affordable credit and free face-to-face money advice. It led to a considerable reduction in the numbers of unbanked, a rapid expansion of the affordable credit sector, and a new free money advice service.[50] The Financial Inclusion Taskforce was launched in 2005 to help monitor the progress of the Strategy, and was very active in identifying best practice, gathering evidence and developing pilots in a range of important areas, including a large exploration on the costs of exclusion from credit services and the advantages of access to affordable credit.[51] The FIT was wound down in 2011 and the Strategy was not renewed, but what was achieved to improve financial inclusion in a relatively short period suggests a new Financial Inclusion Strategy could provide invaluable momentum in driving through the sorts of reforms to the UK credit landscape we outline here.

49 https://publications.parliament.uk/pa/cm200607/cmselect/cmtreasy/53/5304.htm#:~:text=In%20the%202004%20Spending%20Review,Inclusion%20Taskforce%20to%20monitor%20progress.
50 A new national Money Advice Service was launched in 2011, and is now the Money and Pensions Advice Service
51 https://researchbriefings.files.parliament.uk/documents/CBP-9533/CBP-9533.pdf

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