the state of the nation report

indebtedness

December 2006

The Indebtedness Working Group

In April 2004 the Rt. Hon Oliver Letwin established a Commission on Personal Debt to examine the way in which families get into debt-spirals and to make recommendations how they may be helped to avoid them. The Members of the Commission were:

Lord Griffiths of Fforestfach (Chairman)
Manish Chande, CEO, Mountgrange Capital plc
Professor Iwan Davies, University of Wales
Tom Jackson (Secretary), Fellow, Centre for Social Justice
Rt Rev James Jones, Bishop of Liverpool
Heather Keates, Director, Community Money Advice
Prue Leith OBE Founder of Leiths Ltd, writer & journalist
Keith Tondeur, Credit Action

The Commission published its Report What Price Credit? in March 2005 which made 30 policy recommendations covering the responsibility of prime lenders, doorstep lending, community finance initiatives, data sharing, money advice and money education.

Following the policy initiative of the Rt Hon David Cameron and the subsequent establishment of the Social Justice Policy Group, the Rt. Hon Ian Duncan Smith invited the Commission to be part of his initiative and analyse the impact of personal debt on Britain's most vulnerable communities. We have started taking new evidence and reviewing our findings of last year, as well as taking account of the developments which have occurred since then.

This is our first report and covers five areas:

- the background to the debate
- the scale of the debt problem (Part A)
- debt and low income families (Part B)
- the debt spiral (Part C)
- auses of increasing indebtedness (Part D)

Contents

Foreword by Iain Duncan Smith

This Report shows the staggering levels of personal debt in the UK. The problem may be even worse that people think and our own polling exercise has shown that 9 million people may be experiencing debt problems. The current debt crisis could get even worse and significant changes in the economic climate could plunge millions into desperate problems of debt repayment.

Debt problems are triggered by a number of different factors and are strongly correlated with family breakdown, alcohol and drug addictions and educational failure. Debt particularly affects low- income families, many of whose lives are characterized by a constant struggle to meet repayment obligations. Exorbitant interest rates, loan sharks and pawnbrokers need to be replaced with a more responsible approach to lending.

My thanks to Brian Griffiths and his committee, all of whom have worked incredibly hard to collect as wide a range of evidence as possible.

Rt Hon Iain Duncan Smith MP

Executive Summary

The conclusion of a recent YouGov poll was that "personal debt is the most serious social problem facing the UK". For many people in the UK being in debt has become a way of life. Consumer debt is now at record levels;

- Personal lending has now reached £1.25 trillion, the equivalent to an average debt per household of £50,000
- The ratio of debt to income has risen from under 50% in the '70's to over 140% today
- British consumers are on average twice as indebted as those in Continental Europe

The consumer credit industry has been remarkably resourceful in devising new products to meet changing consumer needs. The enormous growth of consumer credit in the UK has clearly benefited most consumers. Personal loans have allowed some people to access cash at times when it is needed. Credit cards have proved a great convenience by reducing the use of cheques and cash. They are a secure, convenient method of payment accepted all around the world. Store cards are attractive because they provide extra services and personalized accounts. Most important still, access to mortgages and loans enables individuals and families to even out expenditure over the course of their lifetime.

However, the number of adults who are finding unsecured debt a serious problem is rising. While it is difficult to measure the scale of the consumer debt problem precisely, the available evidence suggests that the problem may be far worse than most people imagine:

- A recent Bank of England survey estimated that nearly 6 million people felt they are currently struggling with their finances
- Our own polling exercise suggested that the actual figure may be higher; the number of adults who claim to have had a serious debt problem is between 7 and 9 million. If we include the children of these adults then these numbers rise to between 9 and 12 million
- The Consumer Credit Counselling Service reported that the number of people calling them for help increased by 21% in 2005 over 2004 and by 48% increase in the number taking up Debt Management Plans
- Bankruptcies and IVA's have increased exponentially since the change in legislation, with the number of IVA's increasing by 118% from 2005 to 2006
- The number of missed payments of bills, tax, credit cards and mortgages, and the demand for the services of debt agencies have both increased dramatically

The number of people who admit to having debt problems, the many indicators which provide evidence on the scale of the problem and the contrast of UK indebtedness with that of Europe confirm the conclusion of our polling exercise that "personal debt is the most serious social problem facing the UK today".

THE DEBT TIME BOMB

Debt is a serious current problem for millions of the population. However there are a significant number of people for whom it could easily become one. The potential for the debt crisis to worsen is a serious concern;

- **Lack of Savings for unexpected expenditure**; many people have inadequate savings for unexpected expenditure and less than 50% of the population has made provisions for a drop in income or a deterioration of financial circumstances
- **Rising Interest Rates**; interest rates have risen from 3.5% since July 2003 to 5.0% now, and show no signs of falling in the medium term
- **Rising unemployment**; unemployment stands at its highest level for 6 years and has risen from 4.8% a year ago to 5.5% today

An energy crisis, a recession in the US, a global terrorist incident or a substantial fall in house prices, could change the economic climate, plunging many more people into a severe debt crisis.

THE IMPACT OF DEBT ON LOW INCOME FAMILIES

Many low income families are excluded from the mainstream financial sector: Around one in 12 households, or 2.8 million adults, in Great Britain have no bank account. Even though such families are excluded from mainstream credit markets, many still need access to credit from sources such as;

- Doorstep lending
- Pawnbrokers (cash converters)
- Sale-and-buyback shops
- Mail order catalogues

The Treasury has estimated that there may be three million regular users of these types of credit and that the size of the doorstep lending market may vary from two to three million people. One problem with these markets is that lenders tend to charge interest rates of between 100%-400%. or even greater.

The Bank of England has estimated that around half of people who describe debt as a "serious burden" are from a low income group. This was confirmed by our polling analysis which showed that people living in housing provided by local authorities or housing associations were more than twice as likely to have been in debt as the average person. The survey also found that 37% of respondents living in such accommodation had experienced serious personal debt problems compared to an average of 20% for all respondents.

Our conclusion therefore is that debt is a particular problem for low income families; with little savings to fall back on and little or no access still to mainstream banking facilities, they are more vulnerable than other income groups to unexpected changes.

DEBT AND SOCIAL PROBLEMS

The recent YouGov survey has shown the correlation between unemployment, alcohol and drug addiction, criminality, educational failure and family breakdown. Social problems are a cause of personal indebtedness but at the same time debt is a cause of social problems

- Respondents who were out of work were more likely to have experienced serious personal debt problems
- Respondents with a history of drug or alcohol addiction or a criminal record were more than twice as likely to have experienced serious personal debt problems as the average respondent
- Respondents who left school early, or came from single parent families, or said that their parents were unemployed were more likely to have been in debt

Other studies point to symptoms of stress caused by debt.

- according to a survey of 1400 people across the UK undertaken for the Financial Services Authority, 74% of British couples find money the hardest subject to talk about, 27% regularly argue when they try to discuss finances, 32% lie to their partners about how much they spend on credit cards and 35% are kept awake at night worrying about their finances
- AXA, the global insurance company, commissioned research which concluded, on the basis of independent research, that 3.8 million people admit to money worries causing them to take time off work, that more than 10.7 million people suffer relationship problems because of money worries and that 43% of people have suffered from symptoms of stress arising from anxiety generated because of poor understanding of their finances or poor controls over their personal financial situation

THE DEBT SPIRAL

People with debt problems typically experience a debt spiral involving ten steps:

1. Initial Trigger

Unexpected changes are the most common trigger of debt spirals as well as delays in entitlements to benefit payments, changes in family circumstances, family breakdown and over-borrowing and over-lending.

2. Missed payments

The first symptom of a debt spiral is usually a missed payment thereby incurring interest charges.

3. Escalating Penalty Charge

Once a payment is late or missed, penalty charges are often imposed, thus causing debt to escalate.

4. Juggling of finances

Following late payments, a common strategy for debtors is to prioritise the payment of one debt over another and the juggling act becomes compounded when the debtor takes out new loans in order to pay off old ones.

5. Pressure from Creditors

The methods used by various creditors and debt collection agencies can add tremendous pressure to a person caught in a debt spiral.

6. Personal and Financial Chaos

Many people become so overwhelmed by the pressure that they lose the ability to take control of the situation.

7. Unrealistic Promises

Contact with repayment agencies generally results in the setting up of a repayment schedule but often, the level of repayment is set at too high a rate to be sustainable.

8. Legal Proceedings

If repayments are not forthcoming on a regular basis, creditors will ultimately make a claim against the debtor in court in order to obtain a judgement against them.

9. Enforcement Orders, Bankruptcy and Eviction

If a debtor defaults on a Court judgment, then Enforcement Orders such as the attachment of Earning Orders, Charging Orders and Bankruptcy Orders can be sought.

10. Total Loss

CAUSES OF THE GROWTH OF INDEBTEDNESS

Our recent YouGov survey asked people what they considered to be the principal causes of the debt crisis in the UK. The four most important findings were:

(1) "It's too easy to get into debt."

Respondents in the YouGov polling believed the prime reason given for people getting into debt was that credit was too easily available. This is true. For the last five years interest rates have been at low levels and credit therefore has been cheap. For the past ten years inflation has been low, the stop-go cycle has given way to continued economic growth and there has been full employment. Against this background the demand for credit has been high.

At the same time the retail financial industry has been extremely innovative and competitive with new products being brought to the market at historically low rates of interest. Before liberalisation of credit markets in the early 1970's credit was rationed. Today over 400 mainstream financial institutions compete fiercely to satisfy consumer demand. Since the 1980s, credit card and mortgage markets have also grown rapidly and the increase in unsecured lending has been accompanied by risk-based credit pricing in which interest charged to customers depends on the perceived risk of default.

(2) "Lenders target vulnerable people"

Banks may not explicitly target vulnerable people but their lending practices have been attacked for:

- aggressive marketing such as misleading marketing in supermarkets, unsolicited increases in credit limits, inappropriate selling of payment protection insurance and the introduction of credit card cheques
- lack of transparency with the banks needing to develop a consistent, single method of calculating interest. The current method of comparing interest using APRs means that there is no easy way to compare the cost of borrowing. Recent measures to improve the transparency of credit card penalty charges should be welcomed
- undue care in lending; the liberalisation of financial markets and the changes in technology and credit scoring have made banking more impersonal. Responsible lending requires adequate credit rating systems and high standards from lenders in assessing credit applications
- lack of data sharing which has significantly contributed to debt problems and hampered responsible lending. Over 20% of people now hold four or more credit cards and there is insufficient communication between lenders on default data such as arrears, missed payments and bankruptcies

It is going too far to say that banks set out to target vulnerable people. However, vulnerable people are often caught up in the process with disastrous consequences because there is a strong correlation between serious indebtedness and drug and alcohol addictions and family breakdown. Vulnerable people are far more likely to get into serious debt problems.

(3) Doorstep lending or home credit

The liberalisation of credit has meant that credit facilities have been available to a wider range of customers than ever before. Estimates suggest that 7.9 million people are affected by financial exclusion, but borrowers excluded from mainstream lending institutions are nevertheless able to borrow from a number of alternative sources. Low income households can access home credit companies, pawnbrokers, sale and buyback shops, cheque cashers, mail order catalogues, weekly repayment shops, rental purchase outlets and illegal money lenders.

10% of consumers in Great Britain have used some home credit at some time in their lives and about 5% do so each year. In certain neighbourhoods this number can be very high. Typical borrowers tend to have low incomes and low socioeconomic status.

- easily accessible cash loans of small amounts, polling results of home credit suggests it has clear benefits: usually short term
- personalised service
- repayment compatible with weekly budgeting
- flexible repayments with no hidden charges
- credit is offered regardless of credit history

Such services are particularly valuable and important to low income communities and represent a viable business model.

The four principal criticisms of Home Credit are:

The high cost of its credit: the APR of sub-prime credit is high-rates in excess of 150% are typical and sometimes higher. The industry claims this is necessary due to the high risk of default in lending to very low income families and the high cost of providing a weekly home collection service.

Lack of Competition in the market; one of the main reasons why doorstep lending is so expensive is that there is so little competition in the market. The Competition Commission has estimated that this means consumers need to spend an extra £100 million per year in interest, which equates to over £9 per £100 loaned. There is concern over such an increase in market concentration as research reveals that six large lenders account for around 90% of the market, and that of these, Provident Financial accounted for around 60% on most measures. There is a prima facie case that competition is limited.

Perverse lending practices and a lack of transparency; another charge is the failure of disclosure and a lack of transparency on the part of home credit companies. This means customers fail to understand the meaning and relevance of high APRs, and are often more concerned with weekly repayment costs rather than with the actual cost of the product. Apart from Home Credit, other sub-prime lenders have been accused of benefiting from the low financial literacy skills of their customers, creating expensive offers that are not sufficiently transparent.

Undue pressure on the doorstep in selling loans; sub-prime lenders are frequently criticised for the undue pressure they exert on the doorstep for pressure selling and repayments. Nearly all targeted customers are on very low incomes and are short of money, making the offer of ready cash or vouchers very tempting.

4) Modern society is too materialistic

Society's attitude to borrowing has changed radically over the past 60 years and evidence reveals that many believe a significant contributor to debt is that society is too materialistic. Credit moved from being perceived as dangerous, to morally neutral, to beneficial. Professor Holman underlined three social changes that have made low income families more vulnerable to problems of debt: the decline in working class collective organisations with hardship funds, the fragmentation of families and the advent of the drug culture. Alongside this shift in social attitudes, there has also been a major structural change in the financial system, making consumer credit available to all social groups in society.

Many world religions have traditionally been very critical of charging interest due to the power relationship created between borrower and lender that is often unequal and constraining. One Bishop consulted stated that, "the people who need to be addressed about debt are the creditors, not principally the debtors" and was clear that the fundamental issue that needs addressing is one of justice. Personal debt cannot be addressed as an isolated issue, without first addressing what triggers people to get caught up in a debt spiral.

CONCLUSIONS

Debt is a serious problem for millions of families in the UK. Debt problems are triggered by a number of different factors and are strongly linked with family breakdown, alcohol and drug addiction and educational failure. The current debt crisis could get even worse and significant changes in the economic climate might plunge millions into desperate problems repaying debt. Debt particularly affects low-income families, many of whose lives are characterised by a constant struggle to meet repayments.

The committee is keen to explore a range of solutions to the current debt crisis including improving financial literacy, more information and greater accessibility to savings for low income families, strengthening the role of credit unions and increasing competition in the Home Credit market. This must be matched by more transparency of interest and charges, better regulation of advertising of credit, data sharing among lenders, and greater care in lending practices, particularly for low income families.

Background to the Debate

For many people in the UK, being in debt has become a way of life. Access to mainstream credit through mortgages, credit cards and personal loans has become an integral part of today's economy. For low income households, credit is readily available through home credit companies, mail order catalogues, pawnbrokers, lease purchase outlets, credit cards and illegal money lenders.

Over the past 30 years the consumer credit industry has been remarkably resourceful in devising new products to meet changing consumer needs. Competitive credit markets have grown rapidly responding to consumer needs.

The enormous growth of consumer credit in the UK has clearly benefited most consumers. Personal loans allow people to access cash at times when it is needed. Credit and debit cards have proved a great convenience by reducing the need for cheques and cash. Store cards are attractive because they provide extra services and personalised accounts.

More important still, access to mortgages and loans enables individuals and families to even out expenditure over the course of their lifetime. Younger people who expect their income to rise over their working life will borrow (i.e. dissave) when they are young, and repay the mortgage or loans as they get older (i.e. save). Typically this means consumption will be greater than income for people in their 20s and 30s and less than their income in the 50s and 60s. Finally, if higher education is thought of as an investment whose return is higher future stream of income, then student loans are a way of financing it.

At the same time the growth of consumer credit has provided benefits; public concern has been expressed in the media and in Parliament about what has been termed the "debt problem" or the "debt crisis":-

- The media regularly features headlines suggesting that the country is on the verge of bankruptcy and that property prices could collapse
- All of the debt advice agencies consulted[1], as well as other bodies who offer debt advice such as numerous Credit Unions and Moneylines, spoke of 'a rapid growth' in the demand for their services. The Consumer Credit Counselling Service answered 200,000 new calls in 2005 and National Debt Line 46,000 new calls in 2004. Both showed a substantial increase on the previous year. Citizens Advice also recorded a large increase in people asking for debt advice, though their number should be treated with caution as they record the number of visits, not the number of people advised
- In his evidence to the Commission, Ed Mayo, the Chief Executive of the National Consumer Council spoke of a worsening addiction to credit and claimed that 'pushing credit was like pushing drugs.' He observed that we live in a society in which 'houses earn more than nurses….in which there are more credit cards than people', so that 'it's no surprise that people are spending nearly £3,000 every second on their credit cards'. He went on to say that consumer debt was at record levels (both absolutely and relative to income); and that savings as a proportion of income had nearly halved from 10% in 1993 to 5% in 2003
- Other organizations such as Church Action on Poverty and Christians Against Poverty spoke of debt being 'a huge problem in the UK'. The Bishop of Worcester, the Rt Revd Peter Selby in his book, Grace and Mortgage,[2] when asked about the scale and availability of credit in the UK today, responded by saying that 'degree does become kind at a certain point. So actually think that the explosion of credit is an evil, although the fact that people lend is not'

The concept of a debt crisis is considered unduly pessimistic by others. For example, Lord Skidelsky drew the Commission's attention to his contribution in a debate in the House of Lords, in which he emphasized the changes which had resulted from the Bank of England being granted greater independence, namely lower inflation and lower and less volatile interest rate levels. In his judgment, these would affect both the amount of borrowing and saving.

The Commission also noted carefully the various papers written by Prof. Stephen Nickell of the London School of Economics and the Bank of England's Monetary Policy Committee, whose conclusion was that "the overall picture remains benign despite the rapid accumulation of debt"[3].

1 by the Commission, including Citizens Advice, Speakeasy, Community Money Advice, AdviceUK, and CHAS (formerly the Catholic Housing Aids Society)
2 P Selby, Grace and Mortgage: The Language of Faith and the Debt of the World, Dartman Longman Todd, 1997
3 S Nickell. 'Two Current Policy Issues', Speech given at Market News International Seminar, 16th September 2003

The leading economics consultancy, Oxera, has conducted research commissioned by the Association for Payment Clearing Services (APACS), British Bankers Association (BBA), Consumer Credit Association (CCA), and the Finance and Leasing Association.[4] Dr Helen Jenkins, a Director and Senior Economist at Oxera, drew the Commission's attention to the three major conclusions of the Are UK Households Over Indebted? report:

- only a minority of households could be considered over-indebted
- over-indebtedness was often a temporary problem
- the proportion of households facing financial problems has remained broadly stable over the last nine years

She concluded by stating that "we are not at the edge of a cliff". In response to the report, Paul Rodford, the Head of Policy at APACS, stated that "over the past five years, many reports have suggested over-indebtedness is a growing problem in the UK and that society stands on this precipice of a debt disaster. Yet the data we collect within our industries suggest this is not the case".

Halifax Bank of Scotland (HBOS), while recognizing the individual challenges posed by the expansion of credit, agreed that it "should be seen in the context of the enormous benefits that its democratisation has brought to society".

Nick Pearson of adviceUK, which is a membership organization of about 1, 000 independent, not for profit advice centres from around the UK, was frank in stating that:

> *"Clearly there has been a huge growth in personal borrowing in the UK over the last 10 years, but there is no overwhelming evidence to suggest that there is any significant consumer detriment or over-indebtedness. It is certainly true to say that the number of people seeking debt advice from adviceUK members has increased in real terms over the last three years, but this can largely be explained by the fact that the media have given almost daily publicity to the existence of free independent debt advice, rather than there being an increase in the percentage of borrowers with financial difficulties."*

He went on to argue that there will always be "a small percentage of borrowers who get into difficulties" and concluded:

> *"To put it brutally, there is a small but growing percentage of borrowers who use easy access to credit as a justification for what is little more than theft. Their decision to over-borrow is then rationalized by shifting the blame to lenders, and their moral justification for their actions is some spurious notion of being a victim or someone with an addiction".*

4 Oxera, Are UK Households Over-Indebted?, July 2004.

Part A: The Scale of Personal Indebtedness

Consumer debt, and in particular personal unsecured debt has become a major problem in the UK. The evidence is as follows:

a. the sheer scale of personal borrowing

- lending on both a secured and unsecured basis to individuals has grown rapidly over recent years: in July 2004 it passed the £1 trillion (i.e. £1,000,000,000,000) mark, the equivalent to an average debt per household of £40,000: by September 2006 it is £1.25 trillion
- more important than absolute numbers is the ratio of debt to income which indicates ability to repay: in the 1970's this was less than 50%: by 2005 it had risen to 140%

b. the sharp increase in unsecured borrowing

- total unsecured lending is now over £200m
- in recent decades there has been an explosion in the growth of certain kinds of unsecured debt, such as credit cards. In 1971, there was only one UK credit card – the Barclaycard – while today there are 1,300 cards on offer: the total number of credit cards in the UK is 72m against an adult population of 46m
- in 1971 credit card debt was only £32m; by 2005 it was at a record level of £49 billion (the equivalent to an average household credit card debt of £1,950)
- the UK has a third of all unsecured debt in Europe and the average British consumer owes twice as much as the average Western European

c. the growth in personal bankruptcies

	Bankruptcies	IVA's	Scottish insolvencies
2001	23,477	6,298	6,827
2002	24,292	6,295	8,389
2003	28,021	7,583	8,780
2004	35,898	10,752	9,321
2005	47,287	20,292	11,846
2006(Q1-Q2)	45,749	31, 294	11,256

Bankruptcies, IVA's and Scottish insolvencies have all increased dramatically. IVA's grew between 2005 Q3 and 2006 Q3 by 118%. Between 2000-2004 Scottish sequestrations showed little growth but in 2005 there was a 51% increase in insolvencies and the growth in 2006 looks to be just as large. Unlike in England there was no recent equivalent change in the law in Scotland.

d. missed payments of bills, tax, credit cards and mortgages

- Using statistical analyses and interviews with people who received a summons for **non-payment of council tax**, Michael Orton from Warwick University explored how many households are struggling to pay council tax. The principal finding was that more than two million households struggle to pay council tax each year in England; these households predominantly have low incomes and are in low-value properties not high-value ones
- In October 2006 OFWAT, the water industry's regulatory body, reported that 8.3 million letters were sent last year to **household water customers** warning they could face legal action because of the non-payment of bills – a 43% increase compared to the previous year. Unpaid water bills now stand at £936 million
- By the end of Q1 2006 the number of **mortgages one month or more in arrears** had increased by 4% over the previous year and the number of properties taken into possession in Q1 2006 rose for the seventh consecutive quarter, to the highest since Q3 2001 – 32% more than the previous quarter (Q4 2005)
- **Credit card arrears** increased by 14% in 2005 over 2004

e. the record demand for the services of debt advice agencies

- calls to National Debtline increased in 2005 over 2004 by 43%
- Citizens Advice view the debt problem as getting worse, with an increase of 47% in enquiries over the last five years. Last year they dealt with 1.1 million enquiries
- the Consumer Credit Counselling Service reported a 21% in 2005 increase over 2004 in the number of people calling them for help and a 48% increase in their Debt Management Plans
- newly established debt advice centres to which we talked have been overwhelmed with the demand for their services

f. record bad debts at retail banks

- High street banks are writing-off record levels of bad consumer debts
- Barclays recorded a 50% rise in bad-debt charges in the first six months of 2006
- Lloyds Bank put aside £800m as charges bad debt: a 20% rise in the first six months of 2006
- HSBC put aside £4 billion to cover bad debts in the first half of 2006

- HBOS lost £753 million covering bad debts in the first six months of 2006

g. increasing stress from money worries

- according to a survey of 1400 people across the UK undertaken for the Financial Services Authority, 74% of British couples find money the hardest subject to talk about, 27% regularly argue when they try to discuss finances, 32% lie to their partners how much they spend on credit cards and 35% are kept awake at night worrying about their finances
- AXA, the global insurance company, commissioned research from Dr Roger Henderson, a GP and leading mental health expert, who concluded on the basis of independent research that 3.8 million people admit to money worries causing them to take time off work, that more that 10.7 million people suffered relationship problems because of money worries and that 43% of people have suffered what he terms a "money sickness syndrome", namely symptoms of stress arising from anxiety generated because of poor understanding of their finances or poor controls over their personal financial situation

MEASURING THE SCALE OF THE PROBLEM

The scale of the consumer debt problem in the UK is more difficult to measure than individual problems such as rent arrears, personal insolvencies or the bad debts of banks, for which we have reasonably accurate measures. The source of information on the scale of personal debt and peoples' ability to cope with it comes primarily from surveys asking questions regarding the amount of their debt, whether it is secured or unsecured, whether they view debt as a heavy burden, whether they have ever experienced a serious personal debt problem themselves, whether they are managing reasonably well and so on. We examine three pieces of research. (As background the total population of the UK is 60 million, adult population 46 million and number of households 26 million.

a. Bank of England

The most recent evidence on which the Bank of England has reported is a survey conducted in September 2005 by NMG in which 1923 people were interviewed (Bank of England Quarterly Bulletin Spring 2006). Their findings were that:

- 60% of the adult population are in debt (28 million people) and 41% hold unsecured debt (19 million people)
- 10% of people holding unsecured debts found it to be "a heavy burden"
- 20% of people holding unsecured debts found them "somewhat of a burden"

This means that 4% of the adult population or nearly 2 million people found debts a heavy burden and 8% - or 3.7 million – found them somewhat of a burden. In total therefore between 5.5 - 6 million adults found unsecured debt either a heavy burden or somewhat of a burden. If we add in the children of the adult population who have difficulties repaying debt, which measures the total number of the population affected by problems with debt, the figures are 2.5 million having a heavy debt problem and nearly 5 million finding debt somewhat of a problem, making a total of 7.5 million people in all suffering from the consequences of excessive debt.

The conclusion was that "the majority of households appeared to be comfortable with their finances. But there were a small number of households who appeared to be in distress: typically they had below-average incomes and none or not many assets to draw on…..very few people viewed bankruptcy as a solution to debt problems".

b. University of Bristol Personal Finance Research Centre

Professor Elaine Kempson is the director of the University of Bristol Centre in Personal Finance Research and one of the leading authorities on personal debt in the UK. With colleagues she conducted a survey between June and September 2005 for the Financial Services Authority which aimed to measure levels of financial capability in the UK. In all 5328 people were interviewed (FSA Levels of Financial Capability in the UK: Results of a baseline survey by Adele Atkinson, Stephen McKay, Elaine Kempson and Shara Collard). The report was in March 2006 and further analysis published in November 2006.

The results of the study were that:

- 58% of people were financially sound which meant being hardly ever overdrawn and keeping up with their commitments
- 25% were managing reasonably well: most kept up with their commitments but a minority said it was a struggle and a quarter said they sometimes ran out of money
- 9% showed signs of financial stress: they were invariably overdrawn and one in eight said it was a constant struggle to make ends meet and that they were on the brink of financial difficulties
- 6% were struggling and on a low income while four in ten admitted to missed payments and more than a half said it was a constant struggle
- 2% were struggling and over-indebted and regularly running out of money

Kempson et al claim that their findings are consistent with other research on this theme (Kempson 2002, Kempson, Mckay and Willits 2004, Elliot 2005)

The conclusion of this research therefore is that 8% of the adult population or, 3.7 million adults, have serious financial problems and another 9% or just over 4 million show signs of financial stress. This is a total of nearly 8 million people with financial problems.

c. YouGov Poll on Personal Debt

In the summer of 2006 the Centre for Social Justice commissioned a YouGov poll using a sample of 2165 respondents was polled made up of people who were representative of the UK adult population. The findings of the survey were;

- over 40% said that "people getting into serious personal debt" was the biggest social issue facing the UK – significantly ahead of welfare dependency, alcoholism and binge drinking, failing schools, drug addiction, family breakdown and long term unemployment
- 63% said they knew of someone (either themselves, immediate family members, other family members or friends) who had experienced "serious personal debt problems"
- 20% said they experienced a "serious debt problem" themselves

YouGov also has a panel of 43, 693 respondents who tend to be younger and more affluent than the general adult population. They were also questioned regarding debt and:

- 15% of respondents in this survey said they had experienced "serious debt problems"

There are two reasons why this larger panel gives lower results than the smaller one –

a there is a sample bias as younger more affluent people have had less time to experience debt and less chance of doing so

b and the smaller sample was made up of people who were conditioned by asking them a number of questions about the subject, which meant they were more likely to recognize themselves as having had this problem

It would not be unreasonable however to take the 15% of the general adult population as the lower bound of those who have experienced a serious debt problem. As there are 46 million adults in the UK the results of this survey suggest that between 7 and 9 million people have faced a serious problem with excessive debt.

HOW SERIOUS IS THE DEBT CRISIS?

1 The Numerical Scale of the Problem

a The number of adults in the UK who are finding unsecured debt a serious problem / heavy burden is between 2 and 4 million. With children this means between 2.2 and 5 million of the total population.

b Those in the adult population who have debts and who are currently struggling with their finances or on the brink of a serious debt problem are roughly another 4 to 5 million. If we add in children this means between 5 and 6.5 million of the total population.

c The number of adults who claim to have had a serious debt problem is between 7 and 9 million. If we include children these numbers rise to between 9 and 12 million.

2 Getting at the Complete Picture

The numbers of those who respond to surveys on this subject must be taken alongside a variety of other evidence:

- the increasing numbers of missed payments of utility bills and council tax
- arrears in rent and mortgage repayments
- the record demand for the services of debt advice agencies and the growth of new agencies
- the scale of the bad debts banks are having to write off
- the growth in personal bankruptcies and IVA's
- the evidence of stress caused by personal finance problems

3 The UK and Europe

The UK has the most competitive retail financial services sector in the whole of Europe. It also has a third of all unsecured debt in Europe. In addition the average UK consumer owes over twice as much as the average Western European consumer.

Conclusion

The number of people who admit to having debt problems, the many indicators which provide evidence on the scale of the problem and the contrast of UK indebtedness with that of Europe all confirm the conclusion of the YouGov survey that:

"personal debt is the most serious social problem facing the UK".

THE POTENTIAL FOR THE DEBT CRISIS WORSENING

1 Debt as a Heavy Burden

Earlier we showed on the basis of survey research that between 2-4 million adults are currently experiencing a serious debt problem.

2 The At-risk population

We also showed that those who are struggling with debt from time to time are a far greater number, somewhere between 4-6 million: these are people who are exposed and at risk. An unexpected decline in income or an unexpected increase in costs could push them into crisis.

3 Inadequate protection for a rainy day

Often people have inadequate savings to meet a rainy day. Elaine Kempson in her survey of financial capacity in the UK says:

> *"On the whole, the UK population is not particularly good at planning ahead. Fewer than half of the people interviewed had any provision in case they experienced a drop in income, and only three in ten had made this provision personally. Similarly, fewer than half had enough money to meet an unexpected expense of a month's income or more, or had made adequate provision for an expense they anticipated in the near future. Provision for retirement was similarly poor."*

4 Rising Interest Rates and Rising Unemployment

At the same time as large numbers of people are at risk because of the amount of consumer debt, the two major factors which would trigger the time bomb of personal debt exploding are both moving in the wrong direction. Interest rates have been rising since July '03 from 3.5% to 5.00% and show no signs of falling. Meanwhile unemployment stands at its highest level for 6 years, having risen from 4.8% a year ago to 5.5% today.

5 A 40% Crash in House Prices

The Financial Services Authority in October 2006 asked retail banks to assess how they would cope with a fall in house prices of 40% and a situation in which 35% of mortgages in default ended with houses being repossessed. It pointed out that this was not a forecast but a "severe but plausible scenario".

Conclusions

1 There is a significant number of people for whom debt while not at present a great problem could easily become one
2 The UK population is not good at planning ahead financially and more than 50% of the population has very little savings to cope with a rainy day
3 The risk of debt becoming a more serious issue has increased because interest rates and unemployment are both rising
4 Even if house prices were to stop rising or fall a little the present situation would not pose a threat to the overall stability of the banking system, by for example a bank failure: what is disturbing however is the FSA's view that a 40% fall in house prices is a "plausible scenario"
5 If there was a shock to the economy both from fiscal mismanagement and external factors, such as dramatic oil price rises, acts of terrorism and wars, it would create serious economic and social problems for those struggling with personal indebtedness

Part B: Impact on Low Income Families

Many low income families are excluded from the mainstream financial sector. In the Family Resources Survey of 2002-03 around 8%, or 1.9 million households in Great Britain did not have a bank account: that is, roughly one in 12 households, covering 2.8 million adults[5] Around three million households do not have a current account.[6] Those without access to mainstream banking facilities are typically in receipts of welfare benefits, live in socially rented accommodation and are lone parents. Of the unbanked, 64% receive council tax benefit, 62% receive housing benefit, 48% receive income support or the minimum income guarantee and 60% live in socially rented accommodation.

Even though low income families are often excluded from mainstream credit markets, many still need access to credit. They typically borrow for a variety of reasons: to buy essentials such as household appliances, furniture or clothing; to pay bills and to meet the cost of Christmas gifts or birthday presents. Access to small, short-term cash loans through doorstep lending, pawnbrokers, sales-and-buyback shops and mail order catalogues help families manage day-to-day problems. In its Financial Exclusion Report, the Treasury estimates that there may be three million regular users of this type of credit, despite the absence of systematic data with estimates of the size of the doorstep lending market varying from two to three million people, while about 600,000 people use pawnbrokers.

One problem with these markets however is that borrowers tend to be charged very high interest rates. Rates ranging from 100% to 400% are not uncommon.

The percentage of debtors saying that debt was a heavy burden rose to 10% in 2005 and around one in five found them something of a burden. In its survey of household debt for 2004,[7] the Bank of England found that of the 8% of debtors who say their debt burden is a heavy burden, around half are in social class DE, few have other assets and a disproportionate number are between 25 and 35 years of age. "….households on very tight budgets are among those most likely to need to borrow, being less likely to have savings safety net for cash emergency, or to be in a position to save towards essential purchases."

A further characteristic of low income families is the higher proportion which are likely to be in arrears in both consumer credit and household utility bills. A household with an income of less that £15,000 per annum is three times more likely to be in arrears than a household with an income of £35,000 or more per annum.

One interesting contrast among low income families is between those who rent and those who own their own accommodation. For the population as a whole, the proportion of households who had unsecured debt outstanding in September 2004 was roughly 45%, something which was unchanged since 1995. Within the total however, the proportion of those with unsecured debt and renting accommodation increased from 39% in 1995 to 46% in 2004 while the proportion of homeowners with unsecured debt fell from 47% to 45%. There seems to be a difference in the behaviour of low income houseowners and low income tenants with the latter tending to rely disproportionately on loans from family, friends and from finance companies, while low income houseowners tend to rely on credit cards, bank loans and overdrafts. Home-owning single households were five times more likely to use credit cards than single tenants.

A study by Alliance & Leicester has shown that 14% of tenants are expected to rack up increased credit card debt in the next six months. This compared with 7% of people who owned their own home. This increasing debt among social housing tenants has raised concerns that the gap between homeowners and social renters is growing wider. According to Alliance & Leicester figures unsecured borrowing by homeowners made up around 19% of their income while average debts for non-homeowners, including social tenants, made up nearly a third of their income.

YOUGOV SURVEY ON DEBT AND LOW INCOME FAMILIES

A second YouGov survey in November 2006 further illuminates the relationship between debt and low income families. A panel of 40,000 people were approached, of whom 2111 were willing to discuss their social problems, and of whom 886 said they had experienced a serious

5 Department for Work and Pensions, Family Resources Survey of 2002-03, 2004

6 HM Treasury, Promoting Financial Inclusion, 2004.

7 O May et al, op. cit

problem with debt. Analysis of this group compared with another representative sample of 2747 people representing the general adult population showed that:

- Although debt can affect all people regardless of social background, respondents from socio-economic groups C2, D and E were more likely to have experienced serious personal debt
- People living in housing association or local authority accommodation were nearly twice as likely to have been in debt as the average person. The survey found that 37% of respondents living in such accommodation have experienced serious personal debt, compared to an average likelihood of 20% for all respondents

In addition, the survey found that respondents who had suffered being out of work, substance abuse, criminality, educational failure and family breakdown - all associated with poverty - were more likely to have experienced serious personal debt than other respondents:

- Those respondents who were out of work were more likely to have experienced serious personal debt than those who were in employment, were retired or were students
- Respondents with a history of alcohol or drug addiction, depression or a record of trouble with the police were more than twice as likely to have experienced serious personal debt as the average respondent
- Respondents who left school early, or came from single parent families, or said their parents were poor or unemployed were also more likely to have been in debt

The survey also identified different segments of respondents according to whether they had experienced mild forms of debt, household liability debt, debt related to shopping (e.g. storecards) or debt used to assist with outgoings (e.g. a bank overdraft). The analysis found that:

- Respondents with household liability debts were the most likely to have experienced a poor education and debt in childhood, and the least likely to have had a stable upbringing
- The greatest levels of serious household liability debt problems related to debts that are associated with low income families, such as unpaid utility bills, rent or mortgage arrears, hire purchase agreements and doorstep lending. Respondents who said they had experienced these kinds of debts were between 30% and 50% more likely to have experienced serious personal debt than the average person
- Respondents with household liability debts were also the most likely to have had their serious debt problem triggered by a loss of income rather than by overspending
- The same respondents were also the most likely to have experienced the severest consequences of the debt spiral, such as increased pressure from creditors, legal proceedings, enforcement orders, bankruptcy and eviction
- Finally, the same group of respondents identified themselves as those who would have most greatly valued help in dealing with their debt problem in comparison with other segments

Part C: The Debt Spiral

During the course of its investigations, the Commission held in-depth interviews with more than 50 people who had either experienced a debt problem themselves or who regularly advised people with such problems. Meetings took place in Blackburn, Blackpool, Milton Keynes, Cardiff, Glasgow, Liverpool, London, Manchester, Salford, Sheffield, Sussex and Swansea. Individual members of the Commission also interviewed many other people with first hand knowledge of the problems.

People with debt problems typically experience a debt spiral involving ten steps as the problem worsens These ten steps are adapted from a model that has been used by hundreds of debt advisers, working with a variety of different clients in widely differing organisations. Their experience is entirely consistent with the evidence we received.

TEN STEPS OF THE DEBT SPIRAL

1. **Initial Trigger**
2. **Missed Payments**
3. **Escalating Penalty Charges**
4. **Juggling of Finances**
5. **Pressure from Creditors**
6. **Personal and Financial Chaos**
7. **Unrealistic Promises**
8. **Legal Proceedings**
9. **Enforcement Orders, Bankruptcy and Eviction**
10. **Total Loss**

1 INITIAL TRIGGER

Unexpected changes in circumstance are the most common trigger of debt spirals. This finding was corroborated by Professor Kempson's 2002 Department of Trade and Industry survey where changes in circumstances were cited by 66% of households as the cause of their debt problems.[8] These typically included unexpected reductions in income, (e.g. Unemployment), delays in benefit payments and relationship breakdown or a break-up of a relationship.

Delays in entitlements to benefit payments are a common cause of debt spirals. A number of witnesses stated how the complexity of benefit applications had either delayed or caused mistakes in their applications. One debt adviser said 'Benefit applications can require information such as payslip history which clients may not have. This delays resolution of the case and can cause additional hardship.

> A woman claimed Working Tax Credit on the basis she thought she was in receipt of High Care Disability Living Allowance. Months later, it transpired it was actually Low Care Disability Allowance she was paid. When this mistake was discovered, she had to repay a substantial proportion of the tax credits she had previously received. This dramatically reduced her income and it was not long before she found herself in debt.

One cause of benefit delays is the inefficiency of benefit agencies. The average time to process new Housing Benefit claims in 2003/2004 was 41 working days. Widespread variations exist between individual councils. In 2004 one application took 152 days to process.[9] In such circumstances, an applicant is highly likely to develop substantial rent arrears and become a debtor. One ex-chief executive of a large city local housing department stated that in his opinion, most low income families with whom he had dealt did not want to get into debt but found themselves being in debt because of the delay in their payment of benefit.

Citizens Advice research found that 9% of their clients attributed their debt problems to problems with the benefits system.[10] The problems are particularly acute in some areas. The manager of one of the debt advice centres we visited in London said 'we manage approximately a thousand debt cases a year and estimate 92% have a benefits payment problem. In my view, the housing benefit system in this borough has broken down.'

Another contributory factor of debt spirals is a change in family circumstances. This may occur with the birth of a new child, the breakdown in a relationship, or because of family bereavement.

"The husband of a woman in her seventies had recently died. As a result of the bereavement and her age, she struggled to manage the funeral and other affairs needing to be put in place. During this time, she also failed to notify the Housing Benefit

8 E. Kempson, Over-Indebtedness in Britain - A Report to the Department of Trade and Industry, 2002 p.32

9 Housing Benefit Admininstration Quarterly Performance Statistics (Data for Second Quarter 2004/05)

10 In Too Deep, page 56, section 5.25,

Department about the death of her husband. When they were eventually informed, substantial repayments were deducted from her benefit so that the income she had to live on was dramatically reduced and she soon became over-indebted".

Family breakdown often causes debt spirals. In her DTI survey, Elaine Kempson found that 'The level of arrears is especially high for lone parents; nearly half of them had been in arrears in the past 12 months and a similar proportion were facing financial difficulties at the time of the survey.'[11]

Another trigger of debt spirals is over-borrowing and over-lending. In these cases, it was either unrealistic or at least reckless of one or both parties to expect repayments to be sustainable in the future. In the DTI survey over-borrowing was cited by 10% of households as the primary reason for their over indebtedness.[12] This figure rose to 30% in the case of Citizens Advice clients.[13]

As one debt adviser said to us, 'Day after day, people come to us who should not have been given so much credit. A tenant on income support should not be allowed to run up debts of £25,000. The problem is that if you have credit and are servicing it, you tend to feel you can service more without doing the proper calculations.'

Debt spirals can be triggered by debts other than consumer credit commitments. An important distinction must be drawn between over-borrowing and over-commitment. The former refers to consumer credit, while the latter includes arrears on utility bills. For people on the lowest incomes, over-commitment is at least as important as over-borrowing.[14]

2/3 MISSED PAYMENTS AND ESCALATING PENALTY CHARGES

The first symptom of a debt spiral is usually a missed payment, which is an indication that things are starting to go wrong with their budgeting and control of their finances. A missed payment on credit commitments may well result in the imposition of penalty charges, which can increase rapidly the amount owed. For late or non payment of credit card debts there are additional heavy penalties. With interest causing the debt to mount and further penalty charges being added it is not difficult to see how quickly debts can grow and get out of control. Debts can also escalate. Debt collection firms buy the debt and then charge extra fees to the debtor.

4 JUGGLING OF FINANCES

Following late payments a common strategy for debtors is to prioritise the payment of one debt over another. This ensures that the most threatening creditor is paid off at the expense of other creditors, who have less leverage over them. Payments which are collected at the doorstep are more likely to be paid than those received by correspondence. Similarly, debts which carry more severe financial penalties are more likely to be serviced than those which have less serious consequences.

Typically credit commitments tend to get paid at the expense of household bills such as rent, council tax and utilities. Not only that, but Claire Whyley of the National Consumer Council told us, 'There are people who may be keeping up with all their credit commitments but are cutting down elsewhere on things like food or heating and are paying other priority bills late.'

This juggling act becomes compounded when the debtor starts to take out new loans in order to pay off old ones. As one adviser told us, 'Clients often present us with multiple credit card, store card and bank loan debts. They often take out a new credit card or loan because they are having difficulty paying off their existing debt, and say that they have been robbing Peter to pay Paul.'

5 PRESSURE FROM CREDITORS

By this stage, unpaid creditors will be attempting to contact the debtor through numerous phone calls and letters. The methods used by various creditors and debt collection agencies can add tremendous pressure to a person who is caught in a debt spiral, and who is in the category 'can't pay' rather than 'won't pay.'

The British Bankers Association voluntary code states that creditors should be sympathetic and make all reasonable efforts to help those experiencing financial difficulties by agreeing suitable arrangements for repayments. Our evidence suggested this was not typical practice. Citizens Advice found that 'although half the debt clients had tried to negotiate reduced payments with their creditors themselves before seeking advice from the CAB, most had not received sympathetic responses from their creditors.'[15] Other advisers told us that 'creditors frequently take their own perspective when dealing with a client and make demands which are clearly unrealistic.'

Witnesses described to us the psychological pressure that occurs when creditors repeatedly knock on the door

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11 Kempson, 2002, p.25

12 Kempson, 2002, p.32

13 In Too Deep

14 Kempson, 2002, p.27 & 29 Kempson found that 'overall more households were in arrears with household bills (including mortgages) than had got into difficulty with consumer credit commitments… The four main household bills - gas, electricity, water charges and council tax - were the ones were the highest proportions of households had fallen into arrears.' Those with incomes below £15,000 pa had particularly high arrears on household bills (up to 24%)

15 In Too Deep, page 67, section 6.9

or telephone from early in the morning to late evening. “It wears you down” was a common response.

6 PERSONAL AND FINANCIAL CHAOS

The pressure of the escalating debt problems combined with being pursued by debt collectors regularly results in great emotional stress. Many people became so overwhelmed with pressure that they lost the ability to take control of the situation. Denial is a common reaction and it appears not unusual for debt advisers to have to sort through carrier bags or refuse sacks filled with unopened bills.

> F is a single mother in her late thirties with three children aged between seven and fifteen. They live together in a two bedroom flat. She had built up seventeen debts ranging from car insurance to credit card debts and bank loans.
>
> She tried moving off benefits in order to start work and repay her debts but gained no significant increase in income as her benefits were reduced. She found the process of adapting to a work environment very stressful. At the same time, her ex-husband was harassing her because he wanted to move back in to the home and her fifteen year old daughter was threatening to move out. It was at this stage that bailiffs started chasing her and she was too frightened to answer the telephone or door
>
> When she eventually sought debt advice, she told her adviser ‘my head feels like a washing machine.’ She had no idea of her monthly income or expenditure or the level of her debts. The advisers visited her house where they found four black bin liners full of old correspondence that she had not dared open – including numerous letters from her creditors.

There appears to be a strong link between debt and depression. Teresa Perchard, the Director of Policy at Citizens Advice, told us ‘25% of people told us that they were suffering from depression and stress and were seeing their GP.’ Another adviser said about her locality, ‘I’d say 80% of our clients suffer from depression.

7 UNREALISTIC PROMISES

Creditors often try a variety of methods to contact the borrower – telephone calls at different times of the day, letters and even home visits. Once they have established contact it is in the interest of both parties to set up an affordable repayment schedule. All too often however, the level of the repayment is set at too high a rate to be sustainable.

8/9 LEGAL PROCEEDINGS, ENFORCEMENT ORDERS, BANKRUPTCY AND EVICTION

If repayments are not forthcoming on a regular basis, creditors will ultimately make a claim against the debtor in court, in order to obtain a judgment against them. Typically the judgment will stipulate the amount of debt to be repaid and also set a rate of repayment. Once a judgment has been entered by the court, it has long term implications for the borrower as it is then registered with credit reference agencies for a period of six years. If a debtor defaults on a County Court judgment, then enforcement orders such as sending in the bailiffs, attachment of earnings orders, charging orders and bankruptcy orders can be sought.

They typically result in loss of goods, utilities, possessions and property. Debtors may find that amounts are taken from their wages or benefits to repay their debts through an Attachment of Earnings order, leaving them even less money to make ends meet.

It is not unusual for bailiffs to call several times to ‘collect a debt.’ Often the bailiff will fail to recover anything, either through being denied access to the property, or through there being nothing of any value to take. The debtor however is likely to be charged for each visit, increasing the total indebtedness.

Disconnection of services, especially gas and electricity, has become more unusual as utility companies have changed their approach from debt enforcement to debt management and prevention. However, it is still used as the ultimate sanction for non-payment.

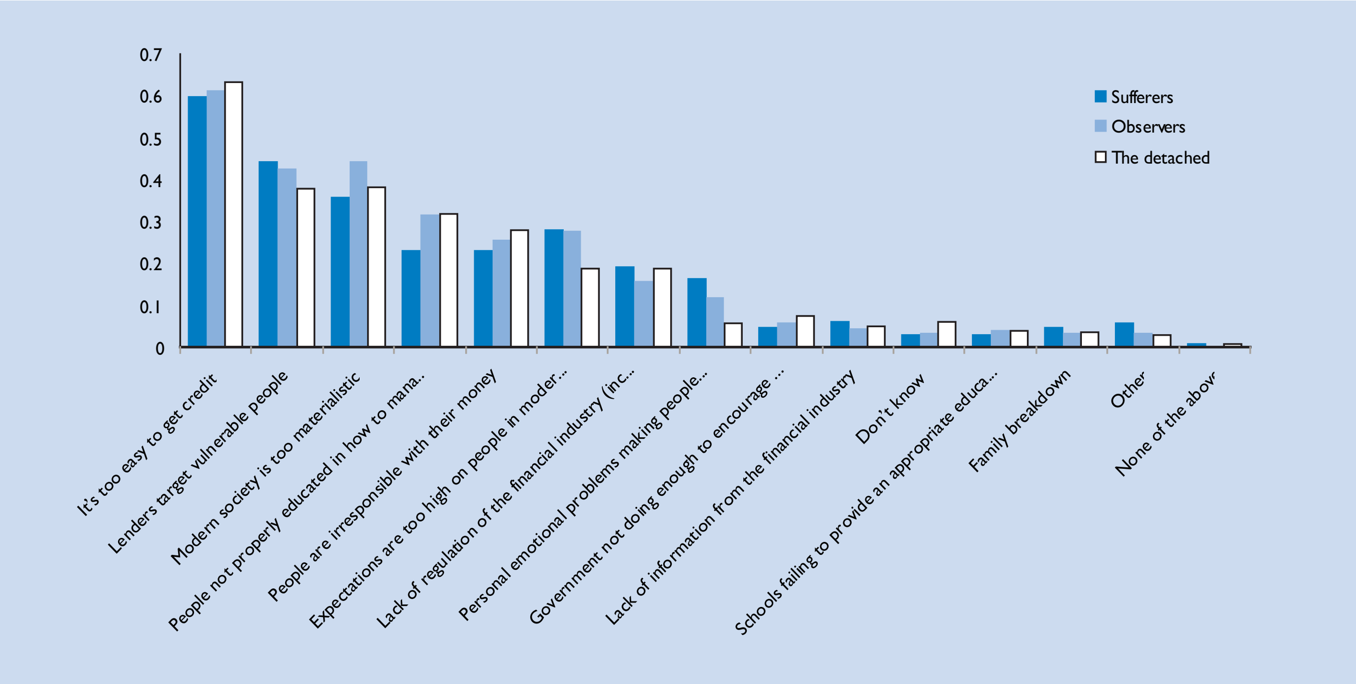
Creditors may push for bankruptcy if they feel it will yield benefit to themselves.

10 TOTAL LOSS

Even these enforcement sanctions may not conclude the matter. Following eviction any outstanding rent arrears can still be pursued. Tragically, in some well publicised cases, debtors have taken the ultimate sanction to escape their spiraling situation and committed suicide.

Our conclusion therefore is that debt is a particular problem for low income families: with little savings to fall back on they are more vulnerable than other income groups to unexpected changes in their circumstances and have less choice of where they can borrow and on what terms.

Part D: Causes of the Debt Problem



The causes of increasing indebtedness which emerge from the YouGov survey confirm what we set out in our Report of last year.

1 "IT'S TOO EASY TO GET DEBT"

The YouGov poll showed that the prime reason given for people getting into debt was that credit was too easily available.

Most consumer credit in the UK is provided by mainstream financial institutions. The Indebtedness Group received oral evidence from a number of financial institutions and industry bodies, including Barclays Bank, HBOS, GE Consumer Finance, the British Banking Association, the Council of Mortgage Lenders, the Banking Code Standards Board and Martin Taylor, the ex-CEO of Barclays Bank. It also met informally with executives from over 30 other financial institutions, received written statements from further institutions and were referred to existing evidence given to other inquiries in recent years.

Until credit markets began to be liberalised in the UK in the early 1970s, competition for consumer credit was limited. Different kinds of institutions such as clearing banks, building societies, finance houses, leasing companies and foreign banks operated in well-defined product areas. Overdrafts and personal loans were provided by the clearing banks; mortgages by building societies, many of whom had a mutual form of ownership; and hire-purchase finance by finance houses and leasing companies. There were well accepted conventions. In each area competition on the basis of price was strictly limited, as key lending rates were all tied to the level of the bank rate. The result of these cartels was that competition was on the basis of quality rather than price, with the allocation of credit being rationed such as 'mortgage queues.'

Today the situation is very different. The ten largest of the 400 or so mainstream financial institutions within the UK (Abbey, Alliance & Leicester, Barclays, Bradford & Bingley, HBOS, HSBC, Lloyds TSB, Northern Rock, RBS & Standard Chartered) handle most of the banking and credit needs of prime household borrowers operating in a very competitive environment. In the early 1980s, five of these would have been classified as building societies. In addition, HBOS is the result of the merger of the Halifax building society and the Bank of Scotland as the process of demutualization which began in the late 1980s has meant that many large building societies have changed their status to that of banks.

Since the 1980s the credit card and mortgage markets have grown rapidly offering a large range of new products. Barclaycard, the UK's first credit card, was set up in 1966 and today has over 11.2 million customers in the UK. According to APACS, spending on credit cards last year amounted to £292.1 billion, over four times the amount spent a decade ago. At present there are over 60 card issuers and 1,600 different products in the UK; credit cards outnumber the British population – at the end of 2005, there were 74.6 million credit and charge cards, compared to a population of 60 million. Competition in this sector is fierce with limited barriers to entry. The result has been that the share of credit accounts held by the big four banks has declined from 73% in 1995 to 65% in 2000. Non financial card issuers today include football clubs, energy and utility companies and supermarkets.

The increase in unsecured lending has been accompanied by risk-based credit pricing (see below), in which interest charged customers depends on the perceived risk of default. The Bank of England Financial Stability Review states that it is not clear whether credit pricing has taken due account of the upward drift in the banks' write-off rates on unsecured lending.[16] The spread between the effective interest rate charged and the banks' funding costs has narrowed recently, which points towards increased competition. The Bank has pointed out that although mainstream banks have continued to improve credit-scoring models and stress tests, these techniques have yet to be tested by a period of pronounced economic strain. If in such a period, lenders attempt to lower their risk by making it more difficult or expensive for borrowers to rollover their unsecured lending, wider repayment problems might be precipitated. Although unsecured lending makes up only 20% of large UK owned bank's lending to UK residents and individuals, it has been responsible for 93% of write-offs on such lending in the past 17 years.

One other factor explaining the growth of credit over the past ten years is the relatively low level of interest rates. If credit is cheap more will be demanded. Over this period inflation has been low by post-war standards and the last decade has seen uninterrupted growth which has created confidence among borrowers that in a full employment economy they have the capacity to repay loans. This confidence was further increased by the government giving the Bank of England independence over interest rate, exchange rate and monetary policy. The past ten years are in marked contrast to the 'top-go' cycle of previous decades in which interest rates rose and fell sharply over the cycle and which bedeviled economic policy in the UK. This can be seen clearly from Chart 1.

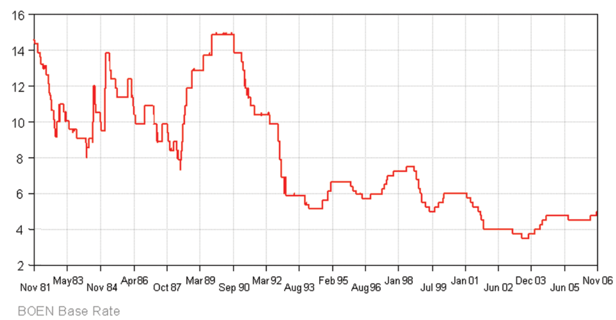
2 "LENDERS TARGET VULNERABLE PEOPLE"

Banks have come in for strong criticism for lending practices. The charge is that their marketing is too aggressive, the terms on which credit is given are not fully known, bank branches have become money shops concerned with selling credit rather than offering impartial advice and because of technology the process of lending has become impersonal. Some of these criticisms have been set out in detail in the two excellent reports issued by the House of Commons Treasury Select Committee.[18]

Aggressive Marketing

This charge applies especially to the credit card business through:

- Unsolicited Increases in Credit Limits
- Misleading marketing in supermarkets, shopping malls and motorway service stations, including targeting customers in supermarkets, shopping malls and motorway service stations, initially with promises of a general nature pertaining to shopping habits and then moving on to financial habits. The interview finally ends with an encouragement to apply for a credit card which could be seen as misleading and damaging to the interests of the consumer
- Direct Mail Marketing: Direct mail is the dominant media for the promotion of credit cards accounting for three quarters of the total spent on credit card promotion. Around half a billion items of marketing material are sent each year and in 2002, credit card issuers spent around £250 million on direct mail. The banks indiscriminately send advertising material to customers even though they may have serious debts and multiple credit cards. This can lead those with existing debt problems to increase their commitments. The Indebtedness Group also noted the increasing use of direct telephone marketing with calls being made by sales agents to potential consumer's homes, invading their privacy, especially in the evening



- Payment Protection Insurance: This is a form of insurance often sold by lenders at the time of credit cards applications. This insurance meets some of the

17 The Bank of England, Financial Stability Review, No.17, December 2004.

18 Treasury Select Committee, Transparency of Credit Card Charges: First Report of Session 2003-04, volumes I and II, 2003; and Credit Card Charges and Marketing. Second Report of the Session 2004-05, 2005.

costs of repayment should the customer be unable to work due to illness, redundancy or accident and in addition, the balance would be cleared in the event of the cardholder's death. This can be valuable but should only be sold to customers who would meet the terms and conditions

- Credit Card Cheques: Some credit card firms issue chequebooks which can be used to draw on credit card accounts. The DTI Task Force on Over-Indebtedness identified the unsolicited issuing of such cheques to households at risk of being over-indebted as one of the lending practices which has the potential to make a bad situation worse. Although the Association for Payment Clearing Systems (APACS) has said the industry has developed a set of best practice guidelines for inclusion in the Banking Code, there has been a mixed take-up. Some prime lenders have sought to justify this by stating that credit card cheques are a way of helping customers to pay for goods/services where credit cards are not accepted. For example, just over 50% of the good/services sold in the Yellow Pages do not take credit cards, so issuing cheque books enables customers to function without a credit card
- Certain other practices have also been criticised, such as:

- the speed and ease of credit applications
- the emphasis in promotional material on very high credit limits and
- important information appearing in small print

Lack of Transparency

Owing to a concern about the lack of transparency of credit card charges, the Treasury Select Committee's report of December 2003 recommended the introduction of summary boxes on lenders marketing and monthly statements.[18] These boxes would include all relevant Annual Percentage Rates (APRs), administration charges, interest free periods, minimum repayment requirements and the order in which payments are allocated to different parts of the balance. A number of members of the lending community have adopted the summary box, they still need to continue to move towards using simple language and standardised wording.

It was also recommended that there should be a single method of calculating the APR for credit cards. The APR figure is most commonly used by consumers to compare the cost of credit cards. Over a period of two months, the Committee estimated the costs and interest of a series of transactions, finding that customers with two cards with the same APR could be charged up to 76% more by one card than another, depending upon the interest rate calculation method used. There are a number of different technical and opaque methods to calculate the total interest charged. Many consumers are unaware that such differences exist and cannot compare the real cost of using different credit cards. A number of industry leaders conceded in their evidence to the Treasury Select Committee that the variety of interest rate calculations presently in use can be unfair for the consumer.

Another criticism relates to a lack of transparency over penalty charges. Credit card companies often levy account charges following a borrower's breach of the terms and conditions. These penalty charges are typically for:

- Late payments
- Exceeding a credit limit
- A refused payment

Consumer groups have expressed concern about the level of some of these charges within the whole credit industry with some banks admitting that over 40%of the credit card profits come from fees and other charges. These penalty fees can vary substantially. The Treasury Select Committee has advocated that the industry, working with consumer bodies, should standardise charging methods. They call for prime lenders to publish the information necessary to create confidence that penalty charges are reasonable. The OFT's reduction of default charges on credit cards is a welcome initiative, as is their extending the work into account default charges, which is currently ongoing.[19]

Undue Care in Lending

The liberalisation of financial markets and the changes in technology and credit scoring has made banking more impersonal in recent years. Shane O'Riordain, Head of Corporate Communications at HBOS, gave evidence to the Working Group:

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18 Treasury Select Committee, Transparency of Credit Card Charges: First Report of Session 2003-04, Volumes I and II, 2003.

19 OFT Press release 7 September, 2006

"One of the consequences of extending the availability of credit is that the banking model has changed. That personal model was not available 20 years ago to everybody because essentially the customer franchise was a restricted one; it was for a particular group in society, now it isn't. From the viewpoint of lenders, all personal banking decisions – the decision to give somebody a credit card, the decision to give them an overdraft or to extend an overdraft – is done by computer now. And from our point of view, it works a lot better, because computers generally make a lot less mistakes than individuals. I hazard a guess that if we had had the computerisation of credit scoring in the late eighties and early nineties, we wouldn't have had the repossessions and arrears record that subsequently took place, to the same extent."

As a result of this change, the banks freely admitted to us that their branches today are effectively money shops. The role of the bank manager and branch employees has changed immeasurably: they are there to give advice to consumers buying products or simply to sell products. The case below is one in point:

The Vicar in Debt

A debt counselling agency was helping a vicar who had run up unsecured debts in excess of £100,000 with 19 different creditors. He had no assets. A friend had offered to pay £30,000 on a pro-rata basis if the remaining amounts were written off. Eventually all but one – a major clearing bank – agreed. On the same day that the vicar received a letter saying the bank would only accept 70%, he received another letter from the same bank offering him an increase of £5,000 on his credit limit. When this information was fed back to the bank they immediately accepted the original offer.

The Working Group found strong evidence to support the conclusions of a report published by Liverpool John Moores University in 2001, which recognised that although credit-scoring techniques help to reduce the risk of debt default, the lack of a personal relationship has increased distrust of lenders by borrowers in low-income and financially excluded communities.[20]

Most prime lenders aim to set high standards in their lending. When conducting credit checks on potential applicants for loans or credit cards, we believe there should be a 'traffic light system' put in place in partnership with the Credit Rating Agencies. While satisfactory and unsatisfactory credit ratings should be given 'green' and 'red' lights respectively; marginal decisions should be given an 'amber light' to indicate the likely presence of financial stress. An amber light would then require the lender to conduct a more personal and thorough discussion with the applicant in order to assess whether the credit should be granted or not.

The replacement of the extortionate credit test with an unfair relationships test that has come in the Consumer Credit Act 2006,is a welcome implementation. The test is based on a lower hurdle than that of extortionate credit and is designed to move the focus of the courts away from scrutiny of the credit agreement alone to the overall way in which the lender has dealt with the borrower (see Appendix 2). We believe this is a helpful development to encouraging responsible lending.

Data sharing and debt collection

In recent years, data sharing has become an important issue in the debate over personal debt because of two developments.

a borrowers increasingly deal with more than one financial institution and use many different credit products. Over 20% of people now hold four or more credit cards. For banks to make responsible lending decisions in these circumstances they need access to overall information on the credit commitments of their customers, and this means they need access to data from other lenders.

b Following advances in technology, banks rely increasingly on a credit scoring mechanism to make decisions about whether to issue loans. In evidence received form Experian, these scorecards differ from bank to bank, but all require a wide variety of data including credit reference agenda data that, for example, predicts the potential value of each individual customer and their risk profile. These Customer Value Management models are collections of analytical scores, segmentation systems and characteristics that lenders can combine to analyse credit risk and so make an informed lending decision. One advantage of credit scoring is that it is a way of making the lending decision more objective.

The credit scoring approach differs from the situation existing before the liberalisation of credit markets when customers met with their bank manager who was able to develop a clear understanding of the customer's circumstances. Customers valued the personal nature of the relationship and trusted the manager not only to provide

20 P A Jones, Access to Credit on a Low Income, The Cooperative Bank, 2002.

credit but also to offer objective advice. This loss of a personal relationship has deprived bank customers of a potential, valuable and experienced source of debt and money advice and the banks themselves of key information.

The case for data sharing is that it allows lending institutions to make better decisions about the amount and the terms on which they will lend: and that it allows borrowers to access the most appropriate size and kinds of credit. Access to shared data also helps with account management and the ongoing relationship between customer and lender. By highlighting the need for an individual consumer to manage their commitment at an early stage, it lessens the likelihood of consumers over-reaching themselves. This in turn increases the chance of successfully managing agreements through to settlement. In summary, the sharing of financial data will improve the risk calibration in the lending decision, as well as the calculation of the individual's ability to pay.

Lenders currently share information on credit agreements with other lenders through credit reference agencies. In evidence received from HBOS and also from the credit reference agencies, Experian, Equifax and Callcredit, it appears that the best financial decisions are made when there is access to the widest possible information on an individual's financial status. Lenders making decisions remotely are reliant upon information collected and verified by others to confirm the identity of applicant and access the future risk to their organisation. Many lenders do ask applicants to schedule their commitments but most consumers do not present an accurate record of their position and without requiring large amounts of paper confirmation, it is difficult to check this with any confidence. As a result, lenders are becoming even more reliant on data provided by credit reference agencies. Sharing information prevents fraud, as the identity of the applicant can be confirmed, as well as other information provided by the applicant.

Data sharing involves two kinds of data.

- Default data which includes information such as arrears, missed payments, IVA's and bankruptcies:
- Positive data which included the credit limit, the size of the outstanding balance, the maximum balance, the size of payment and a full record of the amount and time of any late payment made over the last two years

The sharing of positive information is important to promoting a competitive lending market. As the House of Commons Treasury Select Committee recently pointed out:

> *"With the increased prevalence of risk-based pricing (determining the customers' interest rate according to their credit record), non sharing of positive information may preclude consumers from being eligible to lower rates elsewhere"*[21].

The Commission strongly supports the Treasury Select Committee's conclusions that:

> *"The lack of full data sharing in the credit card industry has significantly contributed to problems of over-commitment by hampering responsible lending. As industry representatives themselves acknowledge there is significant scope for the system of data sharing to be improved and the industry must make progress in this direction"*[22].

3 DOORSTEP LENDING OR HOME CREDIT

In recent years, the liberalisation of credit has meant that credit facilities have been available to a wider range of customers in the UK than ever before. In early 2003, Datamonitor estimated that 7.9 million people were still affected by financial exclusion.[24] Borrowers who are excluded from access to mainstream lending institutions are nevertheless able to borrow from a number of alternative sources.

Among these different types of product, home credit is unique. It provides short-term, unsecured cash loans of small amounts. Repayments are collected weekly, by agents, from customers at their home where the transactions are quick, informal and face-to-face. Potential borrowers do not have to provide references or disclose their previous credit record. Home credit has between 2 million and 3 million customers and employs roughly 27,000 agents. The four leading companies are Provident Financial, Cattles (Shopacheck), London Scottish and S & U.

Credit Sources Available to Low-Income Households

Home Credit Companies

Also referred to as doorstep lenders, provide small, short term, unsecured cash loans, with weekly repayments traditionally collected from customer's homes by a network of agents. Examples include Provident Financial & Shopacheck.

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21 Treasury Select Committee, Credit Card Charges and Marketing, Second Report of Session 2004-05, pp 23-24

22 Ibid., p.24

23 Datamonitor, Non-Standard and Sub-Prime Lending, January 2003, cited by P A Jones & T Barnes, Would You Credit It? p. 25.

Pawnbrokers
Also cater for the need for small cash loans over short periods of time, offering credit secured against goods such as jewellery.

Sale and Buyback Shops
Buy second hand goods and give the seller the option to buy them back after 28 days at a higher price. An example is Cash Converters.

Cheque Cashers/Payday Loans
A relatively new form of short-term credit, whereby customers write a cheque to a lender and will receive that amount in cash, less an agreed fee. The lender then waits for up to 30 days before presenting the cheque to the bank, although the customer can settle the debt before that date or extend the credit agreement. Payday loans however require borrowers to have a bank account. Examples include The Money Shop & Cash Generator.

Mail Order Catalogues
Provide a wide range of goods on credit and often operate through a network of credit-assessed agents, on commission, who either buy for themselves or for a number of customers. Customers can makes small weekly or monthly payments over a set period. Examples include Littlewoods and Kays.

Weekly Repayment Shops
The high street shop version of mail order selling goods to people who can either pay outright in cash, spread the cost with weekly repayments or pay monthly by direct debit. An example is Brighthouse.

Rental Purchase Outlets
The high street shop version of mail order selling goods to people who can either pay outright in cash, with weekly repayments or monthly direct debits.

Illegal Money Lending
Lenders operating without a credit licence – provide small cash loans to those excluded from even the alternative credit market.

Adapted from HMT, Promoting Financial Inclusion, p.29

Home Credit
About 10% of consumers in Great Britain have used home credit at some time in their lives and 5% do so each year. On certain estates and in certain neighbourhoods the level of use can be very high. In one part of Liverpool, the debt advisers giving evidence estimated that 98% of the total population used home credit. Professor Paul Jones of Liverpool John Moores University told us that 'it is not stigmatising because everyone does it.'

The typical customers of home credit tend to have low incomes and low socioeconomic status (social class D, E): roughly 60% are without paid employment; 70% tend to be between 21 and 44 years of age; most rent from local authorities or housing associations. Home credit is more prevalent among women than men, among cohabiting couples and those who have experienced marital breakdown. They tend to have low levels of financial literacy, come from homes with a tradition of doorstep borrowing, live on tight budgets and may have a history of bad debt or a damaged credit rating. Recent research commissioned by the DTI found that three-quarters of low-income households said they would find it difficult or impossible to save £500 for a special purchase, and of those receiving state benefits, 90% said they would be unable to raise £200 to 300 in an emergency without borrowing. The National Consumer Council's quantitative research also indicated that there was a high incidence of long-term illness or disability among home credit customers.

Sub-prime lenders have been the subject of intense, vigorous and repeated criticism. These criticisms have come from campaigning bodies such as 'Debt on our Doorstep' and have been widely reported. The campaign against them reached its climax in the summer of 2004 when the National Consumer Council (NCC) launched a super-complaint to the OFT regarding home credit. The OFT then referred the matter to the Competition Commission in December. Firstly, however, it is important to highlight the key benefits of the home credit industry, beginning with the National Consumer Council's own recognition that home credit has positive benefits:

> *'Home credit offers a unique service in terms of both its characteristics and delivery mechanism. This means that it is well placed and, therefore, highly successful in meeting the key requirements of its customer base. While many commentators and money advisers, in particular, are critical of the way that these features facilitate the use of this expensive form of credit by people on very low income, they are, in fact, the features that make home credit so popular among its target customers.'*[24]

From existing survey and interview evidence and from home credit customers met by the Working Group, it is clear that the major benefits of home credit are:

24 C Whyley and S Brooker, Home Credit: an investigation into the UK home credit market, NCC, July 2004.

- **Easily accessible cash loans of small amounts**: According to the Competition Commission, the average home credit loan is around £300, and 70% of home credit loans are for less that £500. [25] The fact that it is a cash-based system is very important. It does not require customers to have a bank account. Weekly repayment instalments are modest – between £5 and £20 and in cash - and it is very important for customers that loans can be repaid in cash. Mainstream credit is not available on such terms.
- **They are short-term loans**, usually from 23 weeks to a year in duration, according to Provident Financial.
- **Personal Service**: The success of the home credit industry is built on a personal and intimate service. The evidence received by the Working Group was that personal and face-to-face service is highly valued by customers and contrasted sharply to the increasingly impersonal provision of services by mainstream lending institutions. Respondents emphasised that a relationship of mutual trust between customer and lender has often been built up over generations. Most home credit customers know of others who have borrowed from local agents and a significant number (over a third) of customers were introduced to the agent by a friend, relative or neighbour. Provident Financial claim that most of their agents are women, and that many have been customers themselves and live in the same communities as their customers.[26]
- **Repayment Compatible with Weekly Budgeting**: The fact that home credit agents make collection visits on a weekly basis matches the preference of many people on low incomes to budget on a weekly basis, rather than a monthly one on which bank statements and direct debits are made
- **Flexible Repayments with No Hidden Charges**: Elaine Kempson told the Working Group that 'households on low incomes want loans with the certainty of flexible repayments.' The home credit industry does not charge penalties for late payments; the arrears are simply passed on for collection the following week, and extra interest does not accrue. This gives customers the reassurance they can miss the occasional payment if they need to. Provident maintain that home collection 'builds in flexibility, the agent can easily reschedule payments on the spot if that is what the customer requires.'[27] Home credit lenders are reluctant to take court action to recover longstanding arrears
- **Confidence of Success and a Continuous Line of Credit**: Home credit provides credit facilities to people irrespective of their credit history. This means that potential borrowers are fairly confident they will not be refused. A number of witnesses commented that this line of credit is so valued by many households that, even though they do not presently need credit, they keep taking out small loans in order to ensure the ongoing use of this facility in the future

For these reasons, Dr Karl Dayson of Community Finance Solutions at Salford University told us there is a legitimate need for home credit and that 'the decision to pay more for such credit is not an irrational one.' Elaine Kempson's plea was: 'Don't knock them too much.' A survey undertaken by PM Management Consultants for Provident Financial found a high level of customer satisfaction. Around 90% were either satisfied or very satisfied with the discretion shown by the agent and the speed and responsiveness in the way the transaction was done. When asked about whether they were satisfied that the service represented good value for money, the satisfaction level fell to 75%, and when asked if they were satisfied with the cost of borrowing, it fell further to around 60%.[28]

The benefit of home credit to strengthening the community was emphasised by Professor Paul Jones in his most recent study. He found that 'in Cumnock, where many of the traditional alternative lenders are absent, unauthorised money lending was much more prevalent.'[29] The view that home credit is an important bulwark against illegal money lending was expressed by a number of witnesses. The Consumer Credit Association believes home credit agents provide valuable support through their agents:

> *'Because of their position in society, our customers are more prone to, and affected by, unexpected events and personal crises which adversely affect their income. For example, death in the family, an accident, marriage breakdown, redundancy or loss of overtime can all have a serious effect. Support at such times of crisis is essential.'*[30]

It is clear that home credit provides a valuable and important service to low-income communities. Even the National Consumer Council stated in their analysis that:

25 Competition Commission, Home Credit Market Inquiry, Provisional findings report (28 April 2006)
26 Provident Financial Submission to Social Justice Policy Group
27 Ibid.
28 Research conducted by Swift Research, January 2005.
29 P A Jones & T Barnes, Would You Credit It?, 2005, p.10.
30 Consumer Credit Association, Mirage or Reality, p.15.

'It is important to reaffirm that the home credit industry provides a valuable source of credit to consumers on low incomes. Our findings are that the characteristics of the home credit market meet the needs of the customer base well… It follows that to remove home credit from the market or to drive it underground could be to the detriment of low-income consumers.'[31]

Other Forms of Sub-Prime Credit

Other forms of sub-prime credit such as mail order, pawnbroking and sub-prime credit cards are important, but none quite rival home credit in what they offer. Mail order credit has some success since it provides face-to-face service in the customer's home, with repayments being made in cash through weekly collection by the agent. It is used widely by people with low incomes, but is restricted by its exclusive provision for the purchase of goods rather than that of cash. Customers would not be granted the same flexibility over missed payments. Pawnbroking has a long history and its procedures can be quick, simple and flexible. Again, however, it is a limited industry, since its major commodity is jewellery, and loans are repaid in lump sum rather than by instalment.

Research commissioned by the DTI and published in 2004 indicated there is a clear trend for sub-prime credit cards to be introduced following trends in the US.[32] In recent years home credit companies have been losing market share to sub-prime credit cards. Last year a subsidiary of Provident Financial piloted a credit card; and in mid-February 2005 Provident Financial announced that it was launching it more widely later in the year. However this facility will require bank accounts. In addition the DTI has already criticised the practice of 'behavioural pricing' by home credit companies, so that penalties and charges are added to the cost of credit.

One characteristic of all of the major lenders in the sub-prime markets, the home credit business, catalogue companies, and pawnbrokers needs to be emphasised. Each of them have viable business models. They are all private sector companies, able to cover the full cost of doing business, including the cost of equity, by charging fees and prices in the marketplace.

Criticisms of the Sub-Prime Lenders

There are three basic criticisms of home credit:

- the high cost of its credit and the lack of competition
- perverse lending practices and a lack of transparency
- undue pressure on the doorstep in selling loans

The High Cost of Credit and the Lack of Competition

The APR of sub-prime credit is high. This has led to charges of exploitation and abuse. For example, in the home credit industry, rates in excess of 150% p.a. are typical and sometimes higher. 'Debt on the Doorstep' suggests rates on average are above 177%. A study by Paul Jones in 2000/01 of clients of one of the bureaux of Community Advice in Liverpool revealed typical rates of 164% rising to 903%.[33] In comparison, it is claimed that APR rates in the mainstream lending industry rarely exceed 30%. This is misleading, however, as the APR calculation excludes penalty charges and APRs for overdrafts are never published.

The accusations that the prices charged in these markets are high is not limited to home credit. For example, in the case of weekly repayment shops:

'BrightHouse's own promotional leaflet called "Buying made easy" provides a typical example of a washing machine at a cash price of £351.10. In making 156 weekly repayments of £3.24, a total amount of £505.44 is paid for the washing machine. Optional service cover is available at £1.75 per week, which means that the total cost of the washing machine, including service cover is £778.44. The cost of buying this washing machine on credit is £427.34 more expensive than the original cash price of £351.10: more than double the original cost.'[34]

In response, the industry points to a number of factors which help to explain the high cost of their products:

- If the APR is used as a measure of the cost of borrowing over short periods of time, then it introduces a great distortion. For example, £100 borrowed at a flat rate of 10% and repaid by weekly instalments over two years would have an APR of 10%: if it were paid over 52 weeks it would rise to around 22%, over 26 weeks to 45% and over 13 weeks to 105%. This is without any charges being made for the cost of collection. Even the NCC acknowledges 'that short term loans do distort the APR upwards.'[35] After having recognised the severe weakness of the APR, it is ironic that it still concludes the APR is the best way for comparing credit products
- The industry claims that they face a high risk of default in lending to very low-income families with little saving. There are no credit references, there is a lack of any form of security, and because they are prepared to allow flexible repayments, this means that

31 C Whyley and S Brooker op. cit.
32 DTI, The Effect of Interest Rate Controls in Other Countries, August 2004.
33 P A Jones, Access to Credit on a Low Income, p.16.
34 P A Jones & T Barnes, Would You Credit It?, 2005, p.46.
35 C Whyley and S Brooker op. cit., p.64.

the APR effectively includes a charge for missed payments. This was challenged by the NCC who argued that market risks for short-term loans were less: the collector-customer relationship made the paying off the loan a priority for the customer and the circumstances of the borrowers were known in a way in which they were not known to mainstream financial institutions

- Another factor is the high cost of a weekly home collection service. If agents expect to take home-pay just a little above the minimum wage, this has a huge impact on the APR. The Competition Commission considered 'whether the levels of profitability being earned in the industry suggested that prices might be higher than necessary to cover those costs (including the cost of capital) and hence above competitive levels.' They have provisionally concluded that 'Provident has, in the period from 1999 to 2004, been earning returns substantially and persistently in excess of the cost of capital.'[36]

High APRs, however, are just one of the concerns raised about the lack of competitive practices in the industry; other concerns are that there is little evidence of customers switching between home credit companies, that there are significant switching costs which are strengthened through 'step-up' loans and 'rollover' loans, and that financial literacy among consumers is low. This, it is alleged, gives rise to an unfair relationship between the parties.

The NCC supported by the Competition Commission also claims that the home credit market is characterised by significant barriers to entry which prevent the prospect of large new entrants entering on a sufficient scale to challenge the present market concentration. Its evidence includes the following criticisms:

- The current market is either stagnant or contracting
- There is no evidence of a recent major entry into the market
- The current risk to reputation of being associated with sub-prime lending
- The high start-up costs required to generate sufficient representation
- Difficulties in winning new customers in an industry premised upon historic relationships and personal recommendation
- High switching costs for customers due to step-up loans and the absence of data sharing
- The increasing regulatory burden

Finally, there is concern over the high degree of market concentration in the home credit industry. The Table, below, based on research published by Datamonitor shows the market share of the home credit industry between 1999 and 2003.

This research estimates that the home credit industry currently lends £2 billion a year. Of this, the largest company, Provident Financial represents 49% of the market and the largest four companies together have nearly 70% of the market share. The other players in the market consist of around 50 to 60 medium-sized companies with a regional base, and the rest comprising several hundred sole traders.[37] Based on these figures, and using the Herfindahl-Hirschman Index (HHI), the NCC claims that the home credit market is highly concentrated and that therefore customer choice and intra-market competition are restricted. The market is dominated by a small number of major suppliers, which have gained market share at the expense of the smaller operators. The impact

Home credit providers market share and balances outstanding 1999-2003

	1999		2000		2001		2002		2003 (est)	
	£million	%	£million	%	£million	%	£million	%	£million	%
Provident	637	43.1	699	43.9	806	45.3	972	48.7	985	49.2
Cattles	146	9.9	193	12.1	219	13.3	295	13.4	266	12.2
London Scottish	56	3.8	73	4.6	76	4.3	82	4.1	84	4.2
S & U	50	3.4	56	3.5	61	3.4	64	3.2	63	3.2
Others	578	39.8	519	35.9	587	33.7	677	30.6	691	31.2
Market Total	1468	100	1540	100	1749	100	2041	100	2089	100

Source: Datamonitor, UK non-standard and sub-prime lending, April 2004 cited by NCC, Home Credit, p.55.

36 Competition Commission, Home Credit Market Inquiry, Provisional findings report (28 Apr 2006)

37 Information provided in evidence by the Consumer Credit Association.

of these small operators on competitors is difficult to quantify, but the available evidence suggests they are not able to act as a competitive constraint on the larger firms.[38]

In their provisional 2004 report, the Competition Commission stated that home credit lenders lent about £1.5 billion to around 2.3 million customers, and collected around £1.9 billion in repayments. They found that six large lenders (five of which are quoted companies) accounted for around 90% of the market, and that, of these, Provident Financial accounted for around 60% on most measures.

The industry has argued that the evidence based on market concentration is arbitrary because it depends on the definition of the market. David Rees, the legal adviser to Provident Financial stated to the Working Group that 'it depends how you define the market. We would say the market includes mail order, rent to own, pawnbroking – the whole range of businesses that are offering small loans to people on lower incomes.'

The conclusion of the OFT and the reason for its reference of the industry to the Competition Commission was very clear:

'Taken as a whole, the evidence presented and representations made during the consultation do not lead us to alter the suspicion… that competition among home credit lenders is restricted. Lenders seem to have limited incentive to compete on price or to attempt to win business by taking over other lenders' loans.'[39]

The following factors were said to be restricting competition:

- Many home credit customers are in a poor bargaining position and their financial need may mean that they are not price-sensitive
- Customers may have difficulty comparing loans and do not appear actively to shop around
- Step-up and 'roll-over' loans may, to the extent that they occur, tend to tie customers in to existing lenders
- Collectors' relationships with customers contribute to making them unlikely to switch lenders
- Aspects of the structure of the market may deter entry on a large scale, although entry on a small scale is feasible

The Competition Commission has provisionally concluded that:

'…the detriment to customers from high prices is substantial, and may be in excess of £500 million over the period 2000 to 2004, or over £100 million a year over that period. This implies that the price of an average loan was approximately £26 higher than could have been expected in a competitive market. This equates to £9 per £100 loaned.'[40]

The Working Group reached three conclusions on these issues.

- That the APR is not a good measure of the cost of borrowing for short term loans
- That there is no easy way to compare the cost of borrowing as it is impossible to compare 'apples with pears.'
- On the basis of one company having 60% market share there is prima facie case that competition is limited

Perverse Lending Practices and the Lack of Transparency

Another charge is a failure of disclosure and lack of transparency on the part of home credit companies. Paul Jones found that 'the lack of understanding of the cost of borrowing in low-income communities is of particular concern.'[41] This lack of financial literacy puts customers in a weak bargaining position. Two areas of financial illiteracy are highlighted:

- A failure of customers to understand the meaning and relevance of high APRs: The NCC found that 'most home credit customers are not aware of what APR means or how to use it to compare across products.'[42] Similarly, the OFT in its analysis concluded that:

'Home credit customers may not see the APR until they have the credit agreement and are on the point of signing. Customers may in any case not understand APRs and may be largely unaware of current APRs for other types of loan.'[43]

- The customer's prime concern was with the weekly repayment costs, rather than with the actual total cost of the product. Jones found in his research in Liverpool that:

38 C Whyley and S Brooker op. cit., p.57.
39 OFT, Home credit: The OFT's Reasons for Making a Reference to the Competition Commission, January 2005, p.5.
40 Competition Commission, Provisional finding
41 P A Jones & T Barnes, Would You Credit It? p.6.
42 C Whyley and S Brooker op. cit., p.53.
43 OFT, op. cit., p.13.

'People tended to think more about affordability rather than the total cost of the credit. The two were not necessarily linked in people's minds. Affordability was judged, not by the overall cost of the credit, but much more by the level of the weekly payment. Of course, it is precisely this that enables alternative lenders to charge high interest rates which are then lost or hidden in a relatively affordable weekly sum.'[44]

Apart from home credit, other sub-prime lenders have also been accused of benefiting from the low financial literacy skills of their customers, by creating expensive offers that are not sufficiently transparent and so fail to disclose the real costs to customers. For example, the Monopolies and Mergers Commission found evidence in 1997 that sub-prime mail order catalogues were selling:

'Interest-free' products at up to 20% higher prices compared to the same product sold exclusive of interest in another catalogue owned by the same company. Finding that the difference in price represented an implicit credit charge, they concluded 'we found a lack of transparency in the agency mail order credit offer, and a generally poor understanding on the part of agency mail order users of the nature of the credit terms offered.'[45]

Nevertheless, Provident claim that 'home credit is almost uniquely transparent', since there are no penalty charges for missed or late repayments, which means that 'unlike some other types of credit, the customer's costs remain fixed.'[46]

Undue Pressure on the Doorstep in Selling Loans

A third charge against sub-prime lenders, especially doorstep lenders is the undue influence exerted on the doorstep from pressure selling. Agents are under pressure to build up their loan portfolio and they use the strength of the relationship with the customer to sell additional or top up loans. From the customer's point of view, nearly all of whom are on low incomes and short of money, the offer of ready cash or vouchers is very tempting. Stories of agents putting large amounts of cash in front of customers just before Christmas or before children's birthdays were common.[47]

Dr Karl Dayson of Salford University, who acknowledged the legitimate need for home credit products, accused the industry of 'some shabby practices and a relationship that is inherently exploitative.' In explaining this comment, he referred to the 'intimacy' resulting from knocking at someone's door and the consequent vulnerability of the customer. This intimacy can easily lead to an excessive influence and intimidation of the lender. During our meetings with customers of home credit, there was never any suggestion that physical intimidation was applied – indeed such suggestions were specifically rejected. Nonetheless, we heard numerous reports of 'moral' intimidation, created primarily through the personal nature of the relationship with the agent and the 'desire not to let them down.' A number of people told of how they had been encouraged by agents to take out loans to buy products they did not really need and that these products were often marketed by the agent themselves.

On the other hand, John Lamidey of the Consumer Credit Association told us 'there is no evidence of over-selling or pushing loans. If you pressurise the customer, they will simply go elsewhere.' Provident Financial said the pressure for larger loans came from the customers; the Working Group was told that the first most frequent question asked of an agent is 'how much can I get?', which was rejected, in turn, by the home credit customers with whom we spoke. The CCA also pointed us to evidence of their view that:

'Agents build up long-term relationships with their customers. They often become friends of the family. They get to know the customers financial circumstances intimately. This detailed knowledge helps when customers hit bad patches. The agent can judge whether this difficulty is genuine. If it is repayment can be adjusted temporarily to levels which the customer can manage… Over the years the agent will see this family through its crises. Our members keep their customers because they and their agents look after them.'[48]

Home credit agents are encouraged through training programmes to recognise the importance of responsible lending. However, the evidence received by the Working

44 P Jones, Access to Affordable Credit on a Low Income, p.38.

45 Monopolies and Mergers Commission, The Littlewoods Organisation PLC and Freemans plc (a subsidiary of Sears plc): A Report on the Proposed Merger, November 1997, p.9.

46 Provident Financial Submission to the Social Justice Policy Group

47 P A Jones, Access to Credit on a Low Income, p.20.

48 CCA, Mirage or Reality, p.11.

Group suggests there is a difference between the aspirations of home credit head offices and the activity of some of their agents on the ground.

(4) Modern society is too materialistic

The YouGov poll carried out for the Social Justice Policy Group revealed that the third highest reason for people getting into substantial personal debt was that modern society was too materialistic.

This backs up the evidence from a number of witnesses including the Rt Revd Peter Selby, the Bishop of Worcester, Rob Parsons, National Director of Care for the Family, Ruth Lea, Director of the Centre for Policy Studies, and Bob Holman, a Former Professor of Social Administration at the University of Bath and founder of Family Action in Rogerfield and Easterhouse (estates on the outskirts of Glasgow) drawing our attention to the ways in which society's attitude to borrowing has changed radically over the past 60 years. In the immediate post-war years, it was common for parents to encourage their children to 'save for a rainy day.' It was considered not just imprudent, but morally wrong to spend without having first saved. Many did borrow, but the amounts borrowed were small and the lender was likely to be local: family or friends, possibly the corner storekeeper who ran a 'slate' for regular customers, or the high street pawnbroker. There was a stigma attached to being in debt and buying through the 'never-never' was looked down on. When people did borrow it was considered right to repay the loan as soon as possible. Professor Holman said, 'I think the important thing is that there was no media pressure to take out loans, particularly high interest loans and no pressure to keep buying things. There were no mail shots then.'

The advance of hire-purchase and television in the 1950s, and the 'let it all hang out' zeitgeist of the 1960s gradually changed attitudes to borrowing. It became more acceptable to borrow in order to invest in a house or flat, a new kitchen, children's school uniform, a suit to wear when applying for a job, but borrowing purely for consumption was still frowned upon. Professor Holman argued that the social liberalism of the late 1960s and early 1970s had encouraged individuals to throw off restraints, while the economic liberalism which followed in the 1980s had encouraged economic selfishness. He said that:

> *'Mammon had become a god in our society. The result is that the poor were under great pressure to conform to the norms of a consumerist society, not least by television advertising to children, and that loan companies had become skilled at exploiting their limited means.'*

He defined our consumerist society using the Access card advert: 'It takes the waiting out of wanting', and the slogan of a Barclaycard from a few years ago: 'Don't put it off, put it on'.

In a technical sense, debt and credit are of course two sides of the same coin; debt is a liability and credit the corresponding asset. Whilst taking evidence, however, certain individuals stressed the difference between the symbolism of the words debt and credit. We 'accept' credit but we 'incur' debt. Credit has moved from being dangerous, to morally neutral, to being beneficial. The words themselves however have become symbols of something far more important, namely the changed values of a consumerist society. Holman quoted Roy McCloughry:

> *'In contemporary society we have allowed our moral values to become so distorted that what was formerly bad is now considered good. The term 'credit' is applied to what our grandparents called 'debt.''*

Professor Holman underlined three social changes which have taken place since the 1960s and which made low-income families more vulnerable to problems of debt: the decline in working class collective organisations, such as working men's clubs and trade union branches, which used to have hardship funds; the fragmentation of families which meant that parents and grandparents were not available for regular support, so that people were less likely to borrow from family members; and the advent of the drug culture, which meant that people were taking out loans to buy drugs, an observation he made whilst living and working in housing estates. Some of these issues are starting to be addressed by credit unions and community finance initiatives.

The Democratisation of Debt

Alongside this shift in social attitudes to debt, there has also been a major structural change in the financial system. It is easy to forget how recently consumer credit has been available to all social groups in society. It dates from the time of the Crowther Report on Consumer Credit (1971), the precursor to the Consumer Credit Act (1974), and the abolition of quantitative credit controls in the early 1970s.

Shane O'Riordain from HBOS referred to it as the 'democratisation of credit':

> *'Credit has become widely available for the first time. Twenty years ago it was really only the middle classes, as it were, that had access to credit. The old-style bank manager model where one went in and had a chat with one's bank manager was really confined to the so-called salaried classes. And that model has really*

gone and we have a much more open banking system where the vast majority of people can get credit - be it in the form of a conventional overdraft, or in the form of credit through credit cards.'

This process has taken place alongside the changing culture and today fits comfortably with the norms of a post-modern society.

Since the Second World War, the ability of financial institutions to make consumer loans was severely limited. People with bank accounts, which formed a small percentage of the population, could be granted overdrafts and take out personal loans, but there were strict quantitative limits imposed on the banks by government. Building societies supplied mortgages for house purchases, but again these were rationed on the basis of rigid and conservative debt to income ratios. For people to be assured of a mortgage, it was preferable that they held building society deposit accounts. People were free to buy consumer goods by hire-purchase and instalment credit, and the mid-1960s saw the growth of finance companies which supplied consumer credit more generally. Some of these were subsidiaries of the large clearing banks. In all these markets, competition on the basis of price was limited (as interest rates were tied to bank rate), the main form of competition being on the quality of the service offered. Mail order catalogue buying flourished and in low-income neighbourhoods, people always resorted to doorstep borrowing.

The 1970s saw the abandonment of this approach following the White Paper, Competition and Credit Control. Quantitative restrictions on lending by the banking system were scrapped and interest rates were determined by free-market forces. Instead of banks being directed to lend in certain areas, they were now free to lend to whom they wished. And they did. At the same time advances in information technology revolutionised banking: machines replaced people; branches which had been the source of local advice were closed; technology made it possible for banks to target their customers more accurately; and the introduction and widespread use of credit cards led to a reduction in paper transactions. The result has been a huge increase in consumer credit markets.

CONCLUSIONS

Debt is a serious problem for millions of families in the UK. Debt problems are triggered by a number of different factors and are strongly linked with family breakdown, alcohol and drug addiction and educational failure. The current debt crisis could get even worse and significant changes in the economic climate might plunge millions into desperate problems repaying debt. Debt particularly affects low- income families, many of whose lives are characterised by a constant struggle to meet repayments.

The committee is keen to explore a range of solutions to the current debt crisis including improving financial literacy, more information and greater accessibility to savings for low income families, strengthening the role of credit unions and increasing competition in the Home Credit market. This must be matched by more transparency of interest and charges, better regulation of advertising of credit, data sharing among lenders and greater care in lending practices, particularly for low income families.

Consumer Indebtedness Working Group

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Tom Jackson
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The Right Reverend James Jones
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