The Griffiths
Commision on
Personal Debt

What price credit?

March 2005

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Foreword

I would like to thank the members of the Commission for the time and energy which they have devoted to our work over the past nine months. They agreed to join the Commission on the explicit assurance that it was independent of any political party, which it has been. They have been utterly frank and objective in looking at the evidence and it is fair to say that as a result of our deliberations, all of us have changed our minds with respect to certain aspects of the debt problem. The result is that we have a unanimous report.

We owe a special debt of gratitude to Tom Jackson and also to the Centre for Social Justice of which he is a Fellow, for seconding him to act as our secretary and convenor. He has been responsible for identifying a wide-ranging and impressive selection of witnesses, for organising a series of successful visits around the country and for contributing in a major way to writing the report. He has given unstintingly of his time and because of his agreeable disposition he ensured that the very hard work we have put in has been much less burdensome for all concerned.

I am also personally indebted to my assistant Miriam McCue for all the hard work she has done and for the generous spirit she has shown under considerable pressure.

We are also grateful to Jenny Stoker, Tim Knox and Tim Keates for their contributions in transcribing the evidence we received, proof-reading and typesetting respectively.

Finally, we would like to thank all the witnesses we met and spoke with who gave generously of their time.

Lord Griffiths of Fforestfach

Executive Summary

Background to Commission

1 For many, if not most people in the UK, being in debt has become a way of life. Over the past 30 years, the consumer credit industry has been remarkably resourceful in devising new products to meet changing consumer needs. At the same time, personal household debt having reached a record of £1 trillion, it has become a major issue of public concern.

2 The rapid growth in consumer debt has created financial pressure on individuals and families; led to a greater use of enforcement procedures; and a record demand for debt advice.

3 Against this background, the Commission on Personal Debt was established by the Rt Hon Oliver Letwin MP in April last year as an independent body. He asked the Commission to gather first-hand evidence about the way in which families get into debt-spirals and to identify means by which these families can best be helped. He drew our attention particularly to the indebtedness of low income families.

Key Findings

4 Unsecured personal debt is a serious problem in the U.K (chapter 2):

- It is a heavy burden for a small proportion of our society – roughly 3 million people. It is spread throughout the population as a whole, but disproportionately affects low income families, lone parents and people in their twenties and early thirties

- Although debt is a serious problem for only a small proportion of our society, the evidence suggests that up to 12 million more people struggle to repay their credit commitments from time to time

- The sheer scale of consumer debt has made millions of households extremely vulnerable to shocks to the economy, both from fiscal mismanagement and external factors such as oil price rises, acts of terrorism and wars. A downturn in the economy would create serious economic and social problems for the fifteen million people who struggle with debt repayments

- The Bank of England may be too sanguine in its judgment. Because the debt income ratio has increased from just under 100% to 140% over recent years, debt is a time-bomb which could be triggered by any number of shocks to the economy at any time.

5 Debt spirals follow a typical pattern starting with a trigger, and becoming increasingly serious following missed payments, penalty charges, pressure from creditors and legal proceedings (chapter 4):

- The major factors which signal the beginnings of a debt spiral are loss of income and changes in family circumstances

- Almost invariably when people have a debt problem it has a knock-on effect on their relationships, their health and their work, which is a cost both to society and the public purse

- Typically people do not seek debt advice until legal proceedings have been initiated.

6 Credit is far too easily available in the UK. Lending institutions market credit too aggressively (chapter 5):

- Face-to-face banking has been replaced by technology, with computerised models to assess credit risk rather than face-to-face meetings between borrowers and bank manager. The impersonal nature of modern lending has encouraged distrust between the banks and their customers

- In the area of credit cards, mainstream banks are vulnerable to charges of a lack of transparency, over aggressive marketing techniques and unacceptable debt collection methods

7 The Banking Code lacks the teeth necessary to enforce standards in highly innovative and competitive markets where lenders and borrowers conduct business on an unlevel playing field (chapter 5):

- The first Banking Code was only introduced in 1991, 20 years after the process of liberalisation started and it took a further eight years before the Banking Code Standards Board was set up

- Retail banking is the only area of self-regulation still surviving in the financial sector

- Despite the Banking Code, lending institutions face strong criticism of many of their practices including the lack of transparency of interest rates and penalty charges of credit cards; the automatic raising of credit limits; the inappropriate consolidation of loans; the irresponsible issuing of credit card cheques; the 'bundling' of payment protection insurance; and the lack of competition in the provision of store cards.

8 The home credit industry rates highly in terms of customer satisfaction; at the same time it is criticised for over-aggressive marketing, high APRs and a lack of transparency (chapter 6):

- Because of the short term nature of the loans, the fact they are for small amounts, the risks of lending and the cost of weekly servicing, the APR is not a good measure of the true cost of home credit and should not be required to be published on sub-prime loans of less than six months

- Interest rate ceilings in sub-prime markets would reduce the volume of credit available to low income families, encourage illegal moneylending and cause lenders to devise ways to circumvent the ceilings. It would hurt the most vulnerable in our society, the very people it is intended to help

- The four major companies in the home credit industry could show leadership, by improving transparency and creating greater public confidence in their marketing practices.

A Five Point Plan

9 The voluntary Banking Code should be replaced by a statutory *Bank Customers Charter* which sets standards for best practice and should be readily available to all borrowers. Among other things it would (chapter 5):

- outlaw aggressive marketing practices

- demand transparency for all interest rates and charges

- ensure compulsory data sharing

It should be supervised by the Office of Fair Trading, not the Financial Services Authority.

10 For people identified as 'at risk' from debt, the trend from personal to impersonal lending decisions must be reversed (chapter 5):

- Lending institutions should introduce a 'traffic light system' in partnership with the credit rating agencies. 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

- In marginal cases, the lender should be required to conduct a more personal and thorough discussion with the applicant in order to assess whether or not the credit should be granted.

11 Commuity finance initiatives such as Credit Unions, Moneylines and Community Banking Partnerships are an important development in offering choice for credit for low income families (Chapter 7):

- For community finance initiatives to become self-sustainable, continued support from prime lenders is critical. Those banks such as Barclays which give 1% of their profits as part of their social responsibility should be applauded. All financial institutions in this market should be encouraged to follow their example and a Community Finance Trust should be established to develop community finance initiatives. One possible model for this is the formation of Investors in Industry which was established in the 1930s to fill a perceived gap in the provision of finance.

- HM Treasury should finance a series of pilots to determine whether community finance initiatives have the potential to be viable financially and to reach sufficient scale to compete with existing providers. But it is not appropriate that community finance initiatives should be funded permanently by tax payers money.

12 Data sharing of borrowers' profiles and history should be compulsory between banks, credit card companies and the Student Loans Company. The decision of how much to lend to an individual is best made with access to the widest possible information on the individual's financial status. At present data sharing between lending institutions and other bodies such as local councils, housing associations and utility companies is inadequate (chapter 8):

- The Data Protection Act should be reviewed with a view to lifting the legal barriers to sharing financial data among credit providers, and obliging them to supply data to the credit scoring agencies

- A condition to the granting of consumer credit licences to financial institutions should be the requirement to make full disclosure of all relevant financial data to other lending institutions

- Student loan data should be disclosed to the credit reference agencies

- The Data Protection Act 1998 should be reviewed to remove the legal barriers to the sharing of financial data from non-credit providers.

13 Debt advice organisations provide an important source of help to meet the growing needs of borrowers. Local debt advice organisations should be funded from a variety of sources and in addition the government must ensure that in its funding, small enterprising initiatives are not crowded out by larger players (chapter 9):

- Funding from central and local government should be distributed pro rata between separate advice organisations according to the contribution they make in their locality. A clear and simple mechanism should be formulated and put in place to ensure fairness between different agencies

- Lenders should take account of the savings in collection costs, litigation and written-off debt which debt advisers create for them by contributing a percentage of the recovered repayments to the advice service

- Money education should be developed in schools as part of the post-14 core curriculum. For adults experiencing important life events (such as job loss, having a baby, relationship breakdown and illness) better use could be made of information distributed in places such as Job Centres, doctors surgeries, supermarkets, and mother and toddler groups. A Money Advice Directory should be developed and promoted in a similar fashion to the Joined Up Money Advice (JUMA) pilot in West Yorkshire.

1 Introduction

1 For many, if not for most 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, rental purchase outlets, credit cards and illegal money lenders.

2 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 to their present size because the service they have provided have responded to consumer demands. The result has been that consumers have been able to enjoy a higher standard of living than would have been the case if these markets had not existed.

3 At the same time personal household debt has become a major issue of public concern.

There is the sheer scale of the amount of money borrowed:

- lending to individuals has grown rapidly over recent years and now stands at over £1 trillion (i.e. £1,000,000,000,000, the equivalent to an average debt per household of £40,000)
- debt to income ratios have risen sharply over recent years and to record levels
- many view this as a problem in its own right.

Within this total there has been a sharp increase in unsecured borrowing in contrast to borrowing secured against property:

- there has been an explosion in the growth of certain kinds of 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
- in 1971 credit card debt was only £32m; today it is at a record level of £49 billion (the equivalent to an average household credit card debt of £1,950).

The rapid growth in consumer debt has created financial pressure on individuals and families:

- 13% of households have fallen behind with payments on either borrowing or household bills
- 8% of debtors reported experiencing debt as 'a heavy burden' and an additional 30% reported finding it 'somewhat of a burden'
- credit card debt written off has tripled since 1996
- lenders' books of hardship cases are growing sharply.

Financial pressure has led to greater use of enforcement procedures:

- personal insolvencies rose by 35% in the final three months of 2004 and are now at record levels, with the evidence from Scotland showing that 60% of those taking this route are under 30 years of age
- debt being chased by bailiffs has risen and is again at record levels.

Debt advice agencies report a record demand for their services:

- Citizens Advice view the problem as getting worse, with an increase of 47% in enquiries over the last five years
- newly established debt advice centres have been overwhelmed with the demand.

Low income families suffer the most from the burden of debt:

- more than half of over-indebted households have an income of less than £7,500 per year
- they face less choice, are excluded from mainstream credit, pay higher interest rates, and are subject to great pressure to keep on borrowing.

Terms of Reference

4 It was against this background that the Commission on Personal Debt was established by the Rt Hon Oliver Letwin MP on 20 April 2004. In his speech launching the Commission, he set out the following remit:

'I am today announcing the formation of a Conservative Commission on indebtedness – in particular the indebtedness of the poor.

I have asked the Commission to gather first-hand evidence about the way in which families get into debt-spirals. I have asked it to identify means by which – without distorting markets, and without introducing burdensome new regulation – these families can best be helped to avoid debt-spirals.'

He made it clear that the Commission was to be independent of any political party:

'Though the Griffiths Commission has been formed at the request of the Conservative Party and will recommend policy to the Conservative Party, it will be free to act and speak independently of any Party.

Let me say here that I recognise the Government's efforts on this issue of indebtedness and I welcome many of the proposals that have emerged from these efforts.'

While the focus of the Commission's work has been on indebtedness among low income families, it became clear soon that many of the issues facing low income families with debt problems were similar to those faced by families in other income categories. As a result, this report is not concerned only with problems facing the poor.

A Shared Political Concern

5 The concerns which led to the Commission being set up are shared by all the major political parties. In a debate on personal indebtedness and savings in the House of Commons on 5 July 2004[1] introduced by Oliver Letwin, the Chief Secretary to the Treasury (Mr Paul Boateng) stated that the Shadow Chancellor:

> '...is right to draw attention to the particular dangers of debt for those on low incomes... We all know from constituency experience of the ravages of loan sharks on some of our more deprived housing estates.'

In the same debate, Dr Vincent Cable for the Liberal Democrats started his speech by saying:

> 'I broadly agree with the motion moved by the Rt Hon Member for West Dorset [Mr. Letwin] and am happy to support it. I am pleased that there has been recognition of the scale and seriousness of personal debt.'

In introducing the Consumer Credit Bill into the House of Commons on 13 January 2005,[2] Gerry Sutcliffe MP, the Minister, mentioned the fact that there had been 'so much support from Hon Members of all parties and their welcome for the Bill and the White Paper that preceded it,' and in responding to the debate stated that, 'it has been one of those rare occasions in the House when a Bill gets the general support of all parties.'

Both the Scottish National Party and Plaid Cymru also broadly welcomed the Bill and pledged their support for it as a way of dealing with excessive charges. One reason for such a consensus, and it came out very clearly in the debate, is that all MPs have had to deal with constituency cases in which the personal suffering resulting from excessive debt has been all too apparent.

Most recently the Liberal Democrats have produced a ten point Action Plan on Personal Debt calling for a greater role for the Financial Services Authority, greater flexibility in the administration of the Social Fund and tougher controls on loan sharks.

Government Initiatives

6 The Consumer Credit Bill is only the most recent of a number of initiatives which the Government has taken over the last few years to deal with the problem of over-indebtedness.

In October 2000, the Minister for Consumer Affairs at the Department of Trade and Industry (DTI) set up a Task Force to examine the extent and causes of over-indebtedness, and in particular, to look into the transparency of information provided to consumers taking out loans, the core principles of lending by financial institutions and ways of improved data sharing. It reported in July 2001.[3]

1 Hansard Vol 423: No. 113. 2 Hansard Vol 429 No 21. 3 DTI, *Report by the Task Force on Tackling Overindebtedness,* 2001

A number of recommendations of the Report called for further research. The DTI commissioned MORI to carry out research based on a national household survey of indebtedness and also set up a number of working groups to take forward the recommendations. The Task Force then considered the results of the research in a second report published in 2003.[4]

In December 2003 the Government published a White Paper, *Fair Clear and Competitive; the Consumer Credit Market in the 21st Century* and set up a consultative process, following which it introduced the Consumer Credit Bill in the House of Commons in January 2005.

To oversee the development and implementation of government policy in this area, the Government has set up a Ministerial group, an Advisory group and an Officials group, which have representatives from most departments of government.

Soon after the County Court judgment in London North Securities v Meadows in October 2004 (see below), the Government introduced the Consumer Credit (Advertisement) Regulations 2004 to limit the practice of burying important details in the small print of information regarding personal loans and credit cards.

Finally, in the 2004 Spending Review, the Treasury set out its intention to establish a Financial Inclusion Fund to support initiatives to tackle financial exclusion, and to set up a Financial Inclusion Task Force to monitor progress. Details of these were set out in *Promoting Financial Inclusion*, published by the Treasury in December 2004.

Other Initiatives

7 While the Government has clearly responded to public concern, so has Parliament, the financial services industry, the academic world, the courts and the European Commission:

- In December 2003, the House of Commons Treasury Select Committee published a report calling for greater transparency in credit card and store card charges. [5]
- The banks have redrafted the Banking Code.
- The European Commission, which has responsibility for the area of consumer credit, has issued a draft directive dealing with consumer credit.
- In June 2004, the National Consumer Council submitted a super-complaint to the Office of Fair Trading (OFT) against the home credit industry which the OFT has referred to the Competition Commission.
- In October 2004, a County Court judge created widespread publicity by wiping out the debts of a Merseyside couple who borrowed £5,750 from a finance company in 1989 and were left owing almost £400,000 (London North Securities v Meadows).

4 DTI, *Task Force on Tackling Overindebtedness, Second Report* 2003.
5 Treasury Select Committee, *Transparency of Credit Card Charges: First Report of Session 2003-04,* volumes I and II, 2003.

- In January 2005, the House of Commons Treasury Select Committee published a second report on credit card charges and bankruptcy.[6]

- More recently Elaine Kempson and Sharon Collard of Bristol University have published a report, *Affordable Credit: The Way Forward*, which examines the availability of credit for low income families.[7]

- Professor Paul Jones and Tina Barnes of Liverpool John Moore's University have published research, *Would You Credit It?,* which is concerned with protecting vulnerable low income consumers, encouraging financial literacy and supporting the growth of credit unions.[8]

Work of the Commission and Report

8 The Commission started its work by writing to a large number of financial institutions, debt advices agencies and pressure groups inviting them to submit evidence. It met 25 times and held formal hearings between September 2004 and February 2005. The list of those invited to attend hearings is given in Appendix 3. In order to meet people who had experienced debt problems and hear first hand their stories we visited locations around the United Kingdom and met with representatives from Blackburn, Blackpool, Buckinghamshire, Cardiff, Glasgow, Liverpool, London, Manchester, Salford, Sheffield, Sussex and Swansea. We should emphasise that we have deliberately not undertaken any empirical research of our own but used the large body of existing evidence and data sets.

The members of the Commission with biographical details are listed in Appendix 1.

9 Chapters 2, 3 and 4 of the Report outline the nature and scale of the debt problem and the way in which people get into a debt-spiral. Chapters 5 and 6 look at encouraging more responsible lending by mainstream banks and sub-prime sources of credit. Chapter 7 details community finance initiatives which provide alternative sources of credit for low income borrowers. Chapter 8 explains the way in which improved data sharing can be used to increase lenders' understanding of a borrower's financial circumstances, while Chapter 9 considers ways in which people get out of debt. Chapter 10 discusses how money education can be used to improve financial literacy in order to develop a more responsible approach to borrowing. Chapter 11 lists the Conclusions of the Commission's work, and Chapter 12, its Recommendations.

6 Treasury Select Committee, *Credit Card Charges and Marketing. Second Report of the Session 2004-05*, 2005.
7 S Collard and E Kempson, *Affordable Credit: The Way Forward,* Polity Press, 2005.
8. PA Jones and T Barnes, *Would You Credit It? People Telling Stories About Credit,* Liverpool John Moores University, 2005.

2 Is there a debt crisis?

1 Total outstanding consumer debt has now reached £1 trillion. The media regularly features headlines suggesting that the country is on the verge of bankruptcy and that property prices could collapse. In his evidence to the Commission, Ed Mayo, the Chief Executive of the National Consumer Council, 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. He concluded by saying that, 'pushing credit was like pushing drugs, and the addiction was getting worse.'

2 All of the debt advice agencies consulted, including Citizens Advice, Speakeasy, Community Money Advice, adviceUK, and CHAS (formerely the Catholic Housing Aids Society) 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 175,000 new calls 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.

3 Other organisations 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 and author of the book, *Grace and Mortgage*,[9] 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 I actually think that the explosion of credit is an evil, although the fact that people lend is not.'

4 At the other end of the spectrum Nick Pearson of adviceUK, which is a membership organization of about 1,000 independent, not for profit advice centres from around the UK, was equally 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.'

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

9 P Selby, *Grace and Mortgage: The Language of Faith and the Debt of the World,* Dartman Longman Todd, 1997.

> 'To put it bluntly, 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 the lenders, and their moral justification for their actions is some spurious notion of being a victim or someone with an addiction.'

6 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. This was published as *Are UK Households Over-Indebted?*[10] Dr Helen Jenkins, a Director and Senior Economist at Oxera, drew attention to the three major conclusions of the 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.

7 She concluded by stating that 'we are not at the edge of a cliff.' In a 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.'

8 Halifax Bank of Scotland (HBOS), while recognising the individual challenges posed by the expansion of credit, agreed that it 'should be seen in the context of the enormous benefits that its democratization has brought to society.' Lord Skidelsky drew attention to his contribution in a debate in the House of Lords in which he emphasised 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.'[11]

9 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 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. 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

10 Oxera, *Are UK Households Over-Indebted?*, July 2004. 11 S. Nickell, 'Two Current Monetary Policy Issues', Speech given at Market News International seminar, 16th September 2003.

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 a higher future stream of income, then student loans are a way of financing it.

10 At the same time as 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 crisis" or the "debt problem". Both are loose expressions and cover at least four different issues:

The Trillion Pound Problem
First, there is the scale of the increase in debt – the Trillion Pound Problem, and the fear that it may have adverse implications for the country as a whole

Financial Pressure from Over-indebtedness
Second, there is the financial pressure which people who have taken out loans find themselves under and the feeling that financial institutions could do more to help

Low Income Families
Third, there are the problems facing low income families, many of whom are on benefits, who rent rather than own their own homes and who are excluded from borrowing from high street banks.

Student Loans
Finally, there are the particular problems facing students who have borrowed to finance higher education

The Trillion Pound Problem

11 In July 2004, the Bank of England announced that household borrowing in the UK had reached a total of over one trillion pounds. This is now equivalent to 140% of the nation's entire national income after tax. The concern is that the economy is on the brink of bust as households have embarked on a 'spend now, pay later frenzy'.

12 Data regarding the growth in personal and household debt in the UK are shown in the box on the next page

Personal Debt in the UK

Total lending to individuals has grown rapidly from just under £200 billion in 1987 to over £1000 billion in 2005.

Since the early 1990s, *unsecured lending* has grown more rapidly than secured lending, even though it still makes up only 18% of the total lending. In the past nine years, it has been responsible for 93% of write-offs on total personal lending by the large UK owned banks. Unsecured debt as a proportion of post tax income has risen from just over 7% in the late 1970s to over 20% at present.

Because growth in lending has been faster than the growth in income, the *ratio of household sector debt to income* has risen from around 40% in 1975, to just over 100% in 1995, to 140% in 2005,. This is higher than in the US and most other large European countries.

Debt servicing costs remain low despite record levels of debt. The proportion of households reporting mortgage payment problems has fallen by about two thirds since the early 1990s. Mortgage arrears and write-offs remain at historical lows.

The *household balance sheet* however is healthy because household financial assets exceed financial liabilities. At the end of 2003 household assets were worth 3.2 times the value of household debt – five years ago it was only 2.7 times.

13 It is interesting that when consumer debt reached the trillion pound mark in the summer of 2004 the alarm bells did not start ringing. One reason for this has been the benign economic conditions. Since the mid-90s, the UK economy has performed well. Inflation has been low, interest rates have been at their lowest level since the 1950s, employment has been growing and is at a record high and unemployment has fallen and has been at its lowest level since the 1970s. These conditions contrast sharply with the early 1990s, when interest rates were high, the economy was in recession and unemployment was rising. At that time, many people encountered great difficulties meeting repayments. Since the mid-90s, the economy has grown annually by 2% and 3% and has been accompanied by a rapid increase in house prices which has raised the value of housing equity. Overall fiscal policy has been conservative and successive Governments have not breached the guidelines they have set for themselves on public sector debt borrowing and public sector debt to income levels.

14 One cause for concern has been the sharp increase in mortgage equity withdrawals. A commonly held view is that as house prices have risen, people have increased the mortgage on their property and used the funds to spend on increased consumption. Alternatively, they may have moved from a larger to a smaller house, kept the mortgage at a similar level and spent the difference. Statistically, there is a good relationship between mortgage equity withdrawal and the house price-to-earnings

ratio. Following the work of Professor Nickell and others at the Bank of England, however, a number of points need to be made about this commonly held view:

- First, two different kinds of 'consumer' spending need to be understood: 'pure' consumption spending such as on fashion items, holidays and luxury goods; and investment spending by consumers, such as installing a new kitchen or improving a property. This distinction is not made in the official statistics.

- Second, the proportion of nominal GDP spent in household consumption was roughly the same in 1996 Q4 (62.7%) as in 2003 Q4 (63.2%): the reason consumption increased in real terms greater than income during these years was that the prices of goods imported for consumption were falling relative to the price of exports.

- Third, the increase in borrowing through mortgage equity withdrawal has corresponded to a build up of financial assets by the personal sector, mainly in cash, deposits, pension funds and life insurance.

- As a result of the last point, Nickells concludes that

> 'over recent years, the rapid increase in loans has been almost exactly balanced by a rapid increase in the purchase of assets, a fact which is rarely mentioned when household debt is discussed.'

- Finally, undrawn housing equity as a percentage of total housing wealth was around 77% at the end of 2003, and has not have fallen much since then.

15 The Commission believes that the Bank of England is right in its judgment that mortgage equity withdrawal has not proved to be a major source of financing increased consumption: most goes in building up holdings of financial assets or in improving the housing stock, which is investment expenditure.

16 The more concerning statistic is the growth in the ratio of debt to income, which raises questions about the ability of people to repay loans and mortgages, in particular if there were to be an unexpected change in circumstances. Part of the explanation for the rise in the debt-income ratio from less than 50% in the 1970s to 140% in 2005 is the removal of quantitative controls over consumer credit lending. The ability of financial institutions to lend freely has meant that it is now possible for consumers to borrow on the basis of their expected life-time income. While this would explain the growth in the debt-income ratio over the 1980s, the process would not explain the sharp growth from the late 1990s until now.

17 Part of the explanation for the more recent increase is the result of the Bank of England being given independence over the conduct of monetary policy in 1997. The economic climate since that time has been more stable, inflation has been low, interest rates have been low and less volatile. Between 1993 and 2005, the ratio of unsecured debt to post-tax household income has risen from 13% to 20%. It is doubtful if all of this rise could be explained as a rational response to a more stable

economic climate. Economic cycles are exaggerated by boom and bust. Markets generate bubbles and it is probable that the UK has been living through such a time.

Two Views on the Trillion Pound Problem

18 At the end of the day there are two sharply differing views of the likely consequences of the present scale of consumer borrowing. One is that the trillion pounds of consumer debt is a time-bomb ticking away. At some date an explosion will occur – a collapse in house prices, higher interest rates, recession in the economy, growing unemployment, debtors unable to pay off their loan, repossessions and increasing insolvencies.

19 The other view is more sanguine and represented by the Bank of England and the Government. In its latest publication on household borrowing, housing wealth and attitudes to debt, the Bank concludes that 'the vast majority of debt is owned by houseowners with mortgages who appear to have few difficulties at present in servicing it.' It recognises that the problem of those renting is different, though the proportion having problems with accumulating debt has not increased. 'The overall conclusion to be derived from survey evidence is that household debt remains affordable. While circumstances can change suddenly, the survey suggests that, by the standards of the past decade, relatively few households are currently close to a stressed position.'

20 In its Financial Stability Review, the Bank does warn of the increased vulnerabilities which extra consumer debt presents:

> 'The continuing rapid growth in debt means that the UK household sector has become increasingly sensitive to any adverse shocks to employment income
>
> If the macro-economic outlook were to become significantly weaker, credit risks might increase, particularly on unsecured debt.
>
> There remains the possibility that lenders and borrowers may be underestimating the longer-term vulnerabilities highlighted above, at a time when the immediate operating environment appears benign.'[12]

21 Because of the benign character of the economy over the past decade, the Government and the Bank of England are justified in claiming that there is no immediate threat to the time-bomb of personal debt exploding. But that should not disguise the fact that it is still ticking away.

- For as long as data has been collected in the UK, there have been economic cycles – periods of prosperity followed by periods of recession and possible depression. Wars, international terrorism, commodity price hikes, inflation, fiscal mismanagement are all factors which could trigger economic recession.

12 Bank of England, *Financial Stability Review,* December 2004, p. 6.

- At present, the Bank of England has control over interest rates. It did not in the late 1980s when the Government shadowed the Deutschemark. Neither did it in the early 1990s when the UK was in the ERM. Those were periods which led to considerable instability. If this freedom is lost then this is another reason to be concerned.

- The Commission believes that, because of these reasons, the Bank of England is too sanguine in its outlook.

Financial Pressure from Over-indebtedness

22 Another aspect of the debt crisis is the significant number of borrowers who are over-indebted and who are unable, or struggling very hard, to make existing repayments.

> In the past four years various studies have attempted to measure indebtedness, most notably those undertaken by the Bank of England, Citizens Advice, academics from the Universities of Leeds and Bristol, the Financial Services Authority (FSA), commercial banks and accounting firms. Dr Helen Jenkins, a director and senior economist at Oxera, has analysed the existing research up until early 2004 and gave evidence to the Commission.[13]

23 Dr Jenkins emphasised that not everyone who has difficulties making a repayment should be considered over-indebted: those who have temporary difficulties or are unwilling to pay should clearly be excluded. While there is no generally accepted definition of over-indebtedness, her report proposed it is best understood as 'those households or individuals who are in arrears on a structural basis, or are at a significant risk of getting into arrears on structural basis.' The key words are 'structural' and 'significant.' Those who are over-indebted structurally are likely to be unable to meet financial obligations from credit commitments in the short- to medium-term. Similarly, while any borrower is at risk of not being able to repay, only those at significant risk of getting into arrears should be termed over-indebted.

24 This measurement of over-indebtedness requires data at a household level. Regrettably there is no UK database which has data on payment arrears, income, debt, debt-service and household characteristics. The result is that in published studies, two types of indicator are used: subjective indicators, which are based on consumers' assessment of their own position; and debt-ratio indicators which are objective and quantitative. These include debt-income ratios, late payments, interest payments and minimum repayment as a proportion of income.

25 The most recent and comprehensive survey on household indebtedness and financial stress was commissioned by the Bank of England.[14] The evidence from this survey is summarised in the following box.

13 Cf. Oxera, *Are UK Households Over-Indebted?,* 2004.
14 O May, M Tudala & G Young, 'British Household Indebtedness and Financial Stress: A Household-Level Picture,' Bank of England, *Quarterly Bulletin*, Winter 2004

Household Debt and Financial Stress

40% to 50% of households, and 30% to 40% of individuals (adults), have some form of *unsecured debt* (note that credit-card debt that is paid off at the end of the month is excluded. (In 2002 there were 25 million households and 47 million individuals over 16 in the UK).

These *participation rates* (that is the percentage of households or individuals borrowing) have remained stable over the past seven years.

The *average amount of unsecured debt* in 2002-3 was £3,500: average debt increased in line with income, the exception being the lowest income group, less than £4,500, which is distorted because of student loans.

The large increase in consumer borrowing is not due to a *larger proportion of the population* owing money but to greater borrowing by existing borrowers.

Nearly a half of debtors owe less than £1,000 while 26% owe more than £5,000 and 4.3% of the adult population have unsecured debts of more than £10,000.

For the past decade roughly 60% of debtors say their debt is not a problem, 30% say it is somewhat of a burden.

7% of all unsecured debt is interest free, mainly the result of zero interest rate deals on credit cards.

26 Other evidence from Elaine Kempson's research on over-indebtedness suggests that:

- 4% of households have borrowed too much and 3.4% of individuals find interest payments and repayments a heavy burden: something which has been broadly stable over the past nine years
- Over-indebtedness is often a temporary problem for a household
- 13% of households have fallen behind with payments in either borrowing or household bills
- 5% of the population spend 25% or more of their gross income on consumer credit repayments
- 6% spend 50% or more of their gross income repaying their mortgage and other credit commitments.

27 Our conclusion is that there is a serious debt problem for a small proportion of the UK, affecting roughly 3 million peopleand that up to 12 million more people struggle to repay their credit commitments from time to time.

28 In addition, it is clear that the problems facing low income families are more severe than for any other income category.

Problems of Low Income Families

29 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.[15] Around three million households do not have a current account.[16] Those without access to mainstream banking facilities are typically in receipt 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.

30 Even though low income families are 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-buy-back 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. Estimates of the size of the doorstep lending market vary from two to three million people, while about 600,000 people use pawnbrokers.

31 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.

32 Another characteristic of low income households is that they include a disproportionate share of those who consider their debt to be a heavy burden. In its survey of household debt,[17] the Bank of England found that of the 10% of debtors who say their debt 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 a cash emergency, or to be in a position to save towards essential purchases.'

33 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. One conclusion is that a household with an income of less than £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.

34 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

15 Department for Work and Pensions, *Family Resources Survey of 2002-03,* 2004.
16 HM Treasury, *Promoting Financial Inclusion* , 2004. 17 O May *et al*, op. cit.

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. While catalogue and mail order purchases are common to both, low income tenants tend to rely disproportionally 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.

35 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.

Student Loans

36 At first sight it might seem that student loans are a separate issue from the subject of personal debt and its impact on low income families. The income expectations of students are normally different from others in their income group, their loans may carry very low interest rates, or be free of interest, and the time period over which they have to be repaid might be much longer. A large amount of unsecured debt would not be comparable therefore in its impact on living standards to that for non-students. However, they cannot easily be ring-fenced for two reasons: they are included in survey data but frequently are not separated out, and when it comes to data-sharing, it is important for lenders to know the total of unsecured debt for students and ex-students.

37 The following Box summarises the evidence on student loans:[18]

Student Loans

- More than 90% of students have some form of unsecured debt.
- The average student loan is around £6,300 and the average unsecured debt of a student is around £6,500.
- Five years ago, student debt on leaving college was on average £4,000. Today it is £12,000. Barclays Bank estimates that by 2010 it will be £33,000.
- Student loans account for more than 80% of student borrowings.
- 65% of students use overdrafts compared to 7% in the population as a whole.
- 25% of students have unsecured credit in the form of bank loans, credit and store cards and hire-purchase.
- 400,000 students graduate each year.

18 Cf. Department for Education and Skills, *Student Loans and the Question of Debt*, 2005

38 This form of credit can in many ways be separated from others. As a result, the Commission has not examined it in detail. However the likely increase in tuition fees will create serious problems in the future. This is not a question of whether students should be charged fees or encouraged to take out loans. But it is a reflection of the rapid transition from a system in which fees were low to one in which they will be market-based. This has happened over a relatively short period of time, so that there are not nearly enough scholarships and charitable funds in place to help students during the transition.

Summary of Chapter 2

1 There is a serious 'debt problem' for a small proportion of our society – roughly 3 million people. It is spread throughout the population as a whole, but disproportionately affects low income families, lone parents and people in their twenties and early thirties.

2 Although debt is a serious problem for only a small proportion of society, the evidence suggests that up to 12 million more people struggle to repay their credit commitments from time to time.

3 Even though total consumer borrowing has reached over one trillion pounds it does not present a risk of higher inflation or a threat to jobs. While at present there is no foreseeable threat, this should not lead to complacency.

4 The sheer scale of consumer debt has made millions of households extremely vulnerable to shocks to the economy, both from fiscal mismanagement and from external factors such as oil price rises, acts of terrorism and wars. A downturn in the economy, accompanied by rising unemployment and falling house prices, would create serious economic and social problems for the 15 million people who struggle with debt repayments.

5 We believe the Bank of England may be too sanguine in its judgment. Because the debt income ratio has increased from just under 100% to 140% over recent years, debt is a time-bomb which could be triggered by any number of shocks to the economy, at any time.

6 Student loans are a growing problem which look set to get considerably worse over the next decade as a result of the increasing cost of tuition fees and living expenses.

3 Debt and the Consumerist Society

1 The notion that there is a 'debt crisis' in our society has a further meaning. The relationship between the rapid increase in debt, and the values of the consumerist society was not part of the Commission's remit. However a number of witnesses, among them 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), raised these concerns with us. We believe it would be wrong not to address them.

From Debt to Credit

2 In their evidence, these witnesses drew our attention to the way in which society's attitude to borrowing has changed radically over the past 60 years. They pointed out that 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 to being in debt and buying through the 'never-never' was looked down on. In his evidence to us, 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.' When people did borrow it was considered right to repay the loan as soon as possible.

3 The advance of hire-purchase and television in the 1950s, and the 'let it all hang out' attitude of the 1960s gradually changed attitudes to borrowing. It became more acceptable to borrow 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 for consumption was still frowned upon. In evidence to us, 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 said that the clearest announcement that the consumerist society had arrived was the advert for the Access card: 'It takes the waiting out of wanting' and that judging by the Barclaycard slogan of a few years ago, 'Don't put it off, put it on,' very little seemed to have changed.

4 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. In evidence to us, however, it was stressed that there was a great difference between the meaning 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. In fact the words have become symbols of something far more important, namely the changed values of a consumerist society. Holman quoted with approval 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."

5 Among the social changes which have taken place since the 1960s and which made low income families more vulnerable to problems of debt, Professor Holman stressed three: 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, something which he said was a massive problem on the housing estates on which he had worked and lived. Certain of these issues are being addressed by credit unions and community finance initiatives, which is a subject considered in Chapter 7.

The Democratisation of Debt

6 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 pre-cursor to the Consumer Credit Act (1974), and the abolition of quantitative credit controls in the early 1970s.

7 In welcoming this, 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.'

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

8 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. But again this growth was limited. 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 there was always doorstep borrowing to fall back on.

9 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 allowed to be 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 then widespread use of credit cards led to a decline in paper transactions. The result of these changes has been the huge increase in consumer credit markets since that time.

Ancient Wisdom and the Faith Communities

10 In the debate over changing attitudes to debt and credit, the Rt Revd Peter Selby, the Bishop of Worcester and author of *Grace and Mortgage,*[19] reminded us that many religions, important among them the monotheistic religions of Christianity, Judaism and Islam, had traditionally been very critical of charging interest on lending money – usually labelled usury. He pointed out that under Jewish law, the payment of interest on loans between Jews was forbidden. Debt was a form of slavery: 'The borrower is the slave of the lender' (Proverbs 22 v 7). Debt creates a power relationship between the borrower and lender that is often unequal and constraining.

11 In Jewish history debt was associated with slavery. The background to Jewish oppression in Egypt which preceded the Exodus was not the result of invasion or colonisation, but increasing personal debt based on famine. The Bishop summed it up as:

> 'The power of money and in particular the right of those who have money to use it to make more money, and with less and less restraint, makes the observation that the institutions of usury 'harm' life a dramatic understatement: we now know, and see evidence all around us, that they *destroy* life.'

19 P Selby, op. cit.

12 He spoke of 'the huge weight of the Christian tradition ranged against the practice' and observed that throughout the first four centuries of the Christian church, almost every writer condemned usury. This was a view which was also held by Greek thinkers, notably Aristotle, for whom usury was hated because it was unnatural. The Councils of the Christian Church until the thirteenth century (Arles 314AD, Nicea 325, Carthage 348, Aix 789, Third Lutheran Council 1179 and Lyone 1274) all condemned this practice, as did reformers such as Luther and Zwingli. Even Calvin, who argued that usury was not intrinsically wrong, admitted it only under strictly limited conditions; both Calvin and Luther believed there should be a 5% ceiling on loans. Even though there are differing interpretations within Islam, the Koran speaks out strongly against usury.

13 The case against the lending of money at interest, according to the Bishop, is that first it is a transfer from those who least need it to those who most need it; next that, as it is lent primarily not for production or investment but because of personal need, it is a form of exploitation; and third that it is a binding of the future which limits what borrowers can do and so has implications for society as a whole:

> A rising level of personal indebtedness in effect mortgages the future of the whole society… it is itself the creator of social needs and the producers of great shifts in social attitudes… all of us who contract debts for whatever purpose limit our future freedom of action… this pattern of our future life becomes largely determined. On the other hand since we borrow against the hope of a rising standard of living and against the steady increase in the price of property, those expectations *must* be met and those results *have* to be produced (Italics original).

14 At first sight introducing religion into a discussion of debt may seem somewhat arcane. Yet the Bishop is right to point out that this dimension should not and cannot be excluded in any discussion of this issue. It was also pointed out that the basis of the highly influential and successful Jubilee 2000 campaign for the cancellation of the debts of the poorest countries was the Jewish concept of the year of Jubilee, namely the fiftieth year in the Jewish calendar when debts were cancelled and families could reclaim the land they originally owned. A number of organisations and individuals who gave evidence, and who are actively campaigning for a much tougher approach to the regulation of consumer credit, also related their proposals for reforming consumer credit markets to a Judaeo-Christian teaching frame of reference. It was also pointed out that a vibrant banking industry based upon Islamic jurisprudence has now emerged in the City, with the express purpose of avoiding the payment of interest on debt. Recently HSBC announced that it was introducing new products to meet this demand. Further as Collard and Kempson point out, the main advantage of Social Fund Budgeting Loans is that they are interest free, which for Muslims means that they comply with the teaching of Islam.[20]

15 It is important to respect the views of differing faiths. The Commission did observe, however, that the payment of interest in the Judaeo-Christian tradition is not condemned in the same way as murder or theft. Not only that, but the Bishop recognised that the 'embedded economy' of biblical times – that is, one in which

20 S Collard and E Kempson, *Affordable Credit,* The Policy Press, 2005, p.12.

transactions we call economic are embedded in ties of kinship and community – is totally different from the market economy of modern times; and that the legislative interventions contained in the Bible would not serve the same purpose or have the same effect in a modern setting, as they would have had originally. The ancient Jewish economy was predominantly rural; and borrowing and lending were necessary to enable the poor to survive. At the same time, the poor needed protection, as did the community as a whole, and it was this which led to the ban on usury within the community. The Commission also noted that George Carey when Archbishop of Canterbury had observed 'that it is impossible to conceive of an advanced economy without a sophisticated financial sector.' Having said this, it is clear that the underlying reasons for opposition to the payment of interest in ancient economies was based on insights – such as that debt can be slavery, that justice demands fairness between borrower and lender, and that the poor need protection – which are timeless in their application.

16 On the basis of his approach, the Bishop had no doubts as to what needed to be done. First, he was outspoken in saying, 'the people who need to be addressed about debt are the creditors, not principally the debtors. I say that partly out of a kind of slightly fundamentalist biblical orientation, which always addresses the creditors.' Next, he was equally clear that the fundamental issue which needs addressing in the field of consumer credit is one of justice. In his judgment, APRs of 100% to 400% do not represent a level playing field between borrower and lender. A third point which emerged is that the problem of personal debt cannot be addressed as an isolated issue. People get into debt for a variety of reasons and, unless the factors which trigger stepping on to the dept spiral in the first place are addressed, simply addressing the financial issues will be of limited value.

Summary of Chapter 3

1 The change in values over the past few decades now means that there is little stigma attached to obtaining credit: the irony however is that a high proportion of those who consult advice centres feel guilty about being in debt.

2 The liberalisation of credit markets over recent decades is welcome: this has made access to consumer credit possible and empowered a large proportion of our society. It is not a social evil.

3 To argue in favour of the liberalisation of consumer credit is not to endorse a materialist philosophy of life.

4 Creating competitive credit markets will not in itself result in responsible borrowing and responsible lending.

5 There is not a level playing field between borrowers and lenders. Consumers need greater protection. The Consumer Credit Bill should be welcomed and needs to be strengthened (see the recommendations made in Chapters 5 and 6).

4 The Debt Spiral

1 During the course of its investigations, the Commission held in-depth interviews with more than 50 people who had either experienced a severe debt spiral themselves or who regularly advised people caught in such spirals. The meetings took place around the United Kingdom and we met with representatives from Blackburn, Blackpool, Milton Keynes, Cardiff, Glasgow, Liverpool, London, Manchester, Salford, Sheffield, Sussex and Swansea. In addition, individual members of the Commission interviewed many other people with first hand knowledge of the problems.

2 The typical features of a debt spiral are set out in the following Box. These ten steps are adapted from the work of hundreds of debt advisers, working with a variety of different clients in widely differing organisations. Their experience is entirely consistent with the evidence that we received during our visits.

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

The Initial Trigger

3 The evidence suggests that unexpected changes in circumstance are the most common trigger of debt spirals. This finding is corroborated by the results of Elaine Kempson's 2002 Department of Trade and Industry survey, where changes in circumstances were cited by 66% of households surveyed as the cause of their debt problems.[21] Changes of circumstance typically include unexpected reductions in income, delays in benefit payments and changes in family circumstances.

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

Note: all names used in case studies have been changed to protect confidentiality

CASE STUDY 1

Arthur was signed off work on long term sick leave due to stress. As his income dropped, he found it increasingly difficult to meet his basic living expenses. He therefore started to borrow on credit cards and he also borrowed from his friends.

As the level of his repayments began to increase, he started using new credit cards to pay off his old ones. Eventually that avenue closed and his bank refused to increase his overdraft or give him a personal loan. In desperation, Arthur asked his parents for help and they agreed to take out a loan secured against their property, on the understanding that Arthur paid the monthly repayments. This cleared Arthur's rent arrears and some of the debt arrears on his cards. He determined to get a job to pay off the rest.

However, given his history of illness, Arthur struggled to find employment. Before long, he started borrowing again to make ends meet. As the pressure to repay his creditors increased, his partner became too frightened to answer the door in case it was someone demanding their money back and she decided to leave him.

Arthur moved back in with his parents. One afternoon, he wrote out a list of his debts. There were 35 creditors (25 of whom were unlicensed loan sharks) and a total of more than £90,000 owed. He saw that his parents' house was on the brink of being repossessed and that they were afraid to answer the phone or the door because of the threats of creditors. Eventually, Arthur decided the only way out was to swallow an overdose of pain killers with a bottle of whisky.

Arthur was rushed to hospital to have his stomach pumped and he was discharged three days later. On the way home, he visited his local debt advice centre. They helped him by negotiating with his creditors. Arthur now has a job and is regularly making small affordable repayments to all of his creditors. His parents have been able to keep their home.

4 An unexpected reduction in income is probably the greatest cause of debt spirals. Typically, income changes occur as a result of redundancy, long term sick leave or the loss of existing overtime or bonus payments. Research by Citizens Advice found that 26% of their clients reported job loss as a major factor in their debt problems.[22] The above Case Study provides an example of a debt spiral that developed from a period of long-term sick leave.

Advisers also suggested that these changes in income are often foreseeable and that there was evidence of people being cavalier about the security of future income streams. In the DTI survey, 14% of those polled acknowledged that at the time of taking on a credit agreement, they expected to experience difficulties in their ability to make repayments. Another 6% admitted they never even thought about it:[23]

One woman we met had been working an extra 100 hours a month overtime (often working 72 hours a week in total) which made it easy for her to increase her credit limits. She failed to consider whether these payments were sustainable for the future and when her employer cut her overtime, she was immediately unable to service her debt.

22 Citizens Advice, *In Too Deep*, p.49. 23 E Kempson, op. cit.

5 Delays in entitlements to benefit payments are another common cause of debt spirals. A number of witnesses stated how the complexity of benefit applications had either delayed or caused a mistake in their application. 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,' with the result that they are forced into debt.

A woman claimed Working Tax Credit because she thought she was receiving High Care Disability Living Allowance. In fact, it transpired months later she was only entitled to Low Care Disability Allowance. 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.

6 Another cause of benefit delays is the inefficiency of certain benefit agency offices. The average time to process new Housing Benefit claims throughout the country in 2003/2004 was 41 working days. This however incorporates widespread variations across individual councils. In one instance last year an application took 152 days to process.[24] 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.

CASE STUDY 2

Mr Briggs was living in local housing association accommodation with his girlfriend and children. One night, they had an argument with their neighbours who became violent. The police were called and Mr Briggs and his girlfriend had to be admitted to hospital. Upon discharge, the police refused to let them return to their home due to concerns about their safety. The local council was asked to re-house them instead at a safe house.

The housing association advised the couple to retain both their properties because otherwise they would not be re-housed. However, the Housing Benefit Department would only pay Housing Benefit in respect of one property and consequently rent arrears began to accrue.

Two months later, the couple were finally re-housed in another property. Because the couple failed to advise the DWP of their new address, all Housing Benefit was stopped for a time and so their rent arrears increased further.

The couple visited their local debt advice centre who liaised with the DWP to ensure their Housing Benefit was reinstated. The advisers also challenged the decision of the council not to contribute towards the original property. As a result, the total rent arrears was eventually reduced by 90%.

24 DWP, *Housing Benefit Administration Quarterly Performance Statistics: Data for Second Quarter 2004/05*.

Citizens Advice research found that 9% of their clients attributed their debt problems to problems with the benefits system.[18] 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.'

7 Another contributory factor of debt spirals is a change in family circumstances. This may occur, for example, with the birth of a new child, following a breakdown in a relationship, or because of a 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. During this time, she also failed to notify the Housing Benefit 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.

8 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.'[26]

9 One 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.[27] This figure rose to 30% in the case of Citizens Advice clients.[28]

> An elderly couple aged 79 had been given the majority of their 20 credit cards when they were already in debt. By the time they sought advice, they were over £100,000 in debt.

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.'

26 E Kempson, op. cit. 27 Ibid. 28 Citizens Advice, *In Too Deep,* p.49.

> 'When I was short of money, it was easier to ask for new money than get to grips with budgeting. I was deluded in that I considered any unused part of my credit limit as spare cash. The Bank wrote saying they had automatically increased my credit limit, it was up to me to write and say no if I didn't want it. If I paid it back on time, they increased my limit. They never looked for substantiating evidence of my income or expenditure. A refusal would have been bad for my credit reference, but it would have been better than this. It would have made me seek debt advice earlier.'

Nick Pearson, the National Debt Advice Co-ordinator at adviceUK, was outspoken in acknowledging the contribution of consumers themselves to such over-indebtedness and the danger of wrongly blaming others for their own decisions. He told us '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.' He considers over-borrowing to be a more significant cause of financial difficulties than changes in circumstances.

10 It is important to note that debt spirals can be triggered by debts other than consumer credit commitments. There is an important distinction to be drawn between over-borrowing and over-commitment. The former refers to consumer credit, while the latter includes arrears on other bills such as utilities. The evidence suggests that, for people on the lowest incomes, over-commitment is at least as important as over-borrowing.

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%).[29]

Missed Payments and Escalating Penalty Charges

11 The first symptom of a debt spiral is usually a missed payment, which can either be a credit commitment or a household bill. For some, it may be an administrative mistake where they have simply forgotten to send a payment; for others it 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 heavy penalties up to a fee of £40 each time the card owner is sent a letter on top of any interest already accruing. This is applied to the account the day the payment is due and can cause further distress. 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.

29 E Kempson, op. cit., p.27 & 29

CASE STUDY 3

Mr. and Mrs. King's account was £100 overdrawn with no overdraft arrangement. Their gas, electricity and telephone bills of £27, £30 and £11.50 respectively were due to be paid by direct debit. Each one was bounced and they were charged £55 plus a letter fee of £27.50 to be notified each time resulting in an increase of their overdraft by a further £247.50 with those bills still outstanding.

12 Another practice which can cause escalating costs is passing or selling the debt on to specialist debt collection firms, which then charge extra fees to the debtor just for taking on the debt.

A credit card debt of £348 (credit card limit of £359) was passed to a specialist debt collection firm who immediately demanded £623 in settlement.

One in four people were charged at least once in the last year for paying late or going over their credit limit.[30] Some creditors wait less than 30 days before passing the debt on to specialist debt collection agencies. According to research carried out by the Credit Services Association, there are roughly 20 million cases, totaling around £5 billion a year, which are passed to these agencies.

CASE STUDY 4

Charlie is 21 years old and works full time on an income of £12,500. He is a fervent football supporter of his local team and at one match, a salesman offered him a chance to obtain a credit card. As an enticement, a free team scarf was being offered to anyone who signed up.

Although Charlie had never needed a credit card, he did fancy a new scarf and duly signed up to the agreement. Two weeks later, the card came through the post.

Within twelve months, Charlie had exceeded his limit of £2,500 and was incurring charges of almost £100 per month in interest and late payment charges. In a very short time, he had got out of his depth and his debt was spiralling out of control. His bank refused to help him and he felt he had nowhere to turn.

Juggling of Finances

13 Following late payments and in order to deal with the escalating problem, it is a common strategy for debtors to prioritise the payment of one debt over another. The

30 Malcolm Coles, 'Report on Credit Card Charges', *Which?* magazine, January 2005.

purpose of this is to ensure that the most threatening or pressing creditor is paid off at the expense of other creditors, who have less leverage over them. Payments which are collected at the doorstep are therefore more likely to be paid than those received by correspondence. Similarly, those debts which carry more severe financial penalties are more likely to be serviced than those which have less serious consequences.

This means that 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.'

14 This juggling act becomes compounded when the debtor starts to take out new loans in order to pay off old ones. All of the debt advice centres told the Commission that they regularly see clients with multiple credit card debts. 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.'

Citizens Advice reflected on the results of their survey by commenting that 'it is worrying that over half of [our] clients were trying to cope with their financial situation by either using their existing sources of credit or taking out additional borrowing.'[31]

CASE STUDY 5

Mr Dobson's income never quite met his household expenditure. In order not to worry his wife, he took out a loan, without her knowing, from which he gave her money to spend on herself and the family.

When the money had all gone, he suggested they applied for credit cards to take advantage of 0% interest rates. As Mr Dobson looked after the finances, Mrs Dobson was unaware that the balances were not being paid off but were gradually creeping up.

At this point, Mr Dobson took out a consolidation loan to pay off the cards. Unfortunately however, the spending continued as Mrs Dobson was totally unaware there was any problem. By this time Mr Dosbon was too frightened to tell her.

Things only came to a head when Mrs Dobson went shopping and found two of her cards were refused as she was over her limit. She rushed home and confronted her husband whereupon the whole story came out.

31 Citizens Advice, *In Too Deep*, p.3.

15 A growing trend in recent years has been the increase in refinancing through consolidation loans. These loans are often secured through charges upon property. At first sight, consolidation loans appear a reasonable way of simplifying the complex payment arrangements of multiple debts and reducing the cost of repayments at a lower interest rate. However, many advisers warned that if the underlying causes of the original over-indebtedness were not properly addressed, there is a real risk of falling into greater problems in the future. Commenting on the growing problem of debt, one adviser said: 'a big factor is the growth in the consolidated loan market – swapping short term debt for long term debt. But this invariably fails when the debtor finds himself back in the same position and the root issues continue not to be addressed.'

CASE STUDY 6

Eddie is a 64 year old man who owed over £110,000 to nine credit card companies and four loan companies. The cards were initially taken out to transfer existing balances to new providers and so take advantage of interest free offers.

As the level of repayments due started to grow, the offer of a consolidation loan seemed a good idea. He therefore took out a loan that was sufficient to cover the debts with a little bit extra to treat himself.

Over the course of time, E started using his old credit cards again, 'just to tide him over,' and the balances started to rise. He then took out further loans to pay off these debts.

By the time Eddie approached a debt adviser for help, each credit card was used up to its maximum credit limit, with balances in excess of £7,000 each. He had nothing in the way of assets to show for his £110,000 of debt. Most of the debt, he confessed, had been taken out to pay off previous borrowing.

Pressure from Creditors

16 By this stage, unpaid creditors will be attempting to contact the debtor through numerous phone calls and letters in order to receive payment. 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. The evidence we received suggests that this is not typical practice. Citizens Advice found in their survey 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.'[32] Other advisers told us that 'creditors

32 Ibid.

frequently take their own perspective when dealing with a client and make demands which are clearly unrealistic.'

17 Once a debt advice centre is instructed, creditors should negotiate with the centre directly rather than the debtor. However, the evidence received again suggests this does not always occur. One adviser told us 'creditors do not always appear to have good negotiating skills and often simply devise a repayment schedule without discussing the matter with ourselves.' Furthermore, the information systems of creditors appear sometimes to be insufficiently sophisticated so that standard letters are sent out irrespective of prior communication from debtors or their advisers.

A high street bank continued to send threatening letters, even after debt advisers had written to the bank explaining their client was terminally ill and requesting correspondence to be sent through the advice centre. When challenged, the bank explained the letters were computer generated.

The sense of confusion that occurs when conflicting messages are received from creditors is often increased when debts are passed over to or bought by firms specialising in debt collection, so that the chain of communication is easily broken.

A debt advice centre had written to creditors requesting that all contact with the debtor should take place through them. A few weeks later, the client received a threatening letter from a debt collection agency representing a high street bank. The debt advice agency denied knowledge of having received any letters from the advisers.

18 Witnesses described to us the psychological pressure that occurs when creditors repeatedly knock on the door or telephone from early in the morning to late evening. One said: 'it wears you down.' In some cases, the pressure was reported as continuing even after a repayment schedule had been agreed.

A husband and wife, both in their late 50s, developed health problems resulting in long-term sick leave due to stress. They approached their local debt advice centre who negotiated realistic and manageable repayments with the creditors.

Despite sticking to the agreed repayment programme, one creditor is still phoning them at least twice a day and also late at night. This is despite having been informed of their health problems and the need to liaise with the advice centre directly.

We also heard reports of some lenders (particularly but not exclusively sub-prime lenders) contacting employers, family members and neighbours in order to 'embarrass' debtors into making repayments. One witness told us how a creditor telephoned her at work and told her colleague that a debt collection agency wanted to speak with her.

Personal and Financial Chaos

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

CASE STUDY 7

Frances is a single mother in her late thirties with three children aged between seven and 15. They live together in a two bedroom flat. She had built up 17 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 15 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. There does seem to be a correlation between mental illness and indebtedness.' The Consumer Credit Counselling Service is presently undertaking research on the relationship between debt and depression in partnership with the World Health Organisation and expects to report in April.

Unrealistic Promises

20 Creditors often try a variety of methods to contact the borrower – through telephone calls at different times of the day, letters and even home visits. Once they have established contact, it is in both the creditors' and debtors' interest 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. This can either be because the creditor has not understood the situation completely and therefore refuses to accept a lower offer,

or at least sometimes because the debtor has unrealistically accepted certain levels of repayment in an attempt to deal with the pressure.

21 Debt advisers claim that many of their clients have been advised by creditors to borrow from lenders, friends or family in order to repay their debt. They suggested that the practice of promoting borrowing to get out of debt is invariably counter-productive, as the new loans will almost inevitably end up being broken. This increases the spiralling nature of the situation and makes it more likely that the creditors will take further sanctions.

A self-employed carpet fitter, married with four children, had taken out three hire purchase agreements and a personal consolidation loan. He was unable to meet the repayments and so agreed with the creditor to a three month payment break on the hire purchase agreements and promised double payments for the three months thereafter.

In reality, there was no way he could meet the original level of repayments, let alone the double payments. He defaulted and the goods were repossessed, leaving him without the tools required for his trade.

Legal Proceedings, Enforcement Orders, Bankruptcy and Eviction

22 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.

The experience of debt advisers is that many people do not seek debt advice until court action has been initiated.

23 For other debts, once a liability order has been made, there are the above enforcement options which can result in loss of goods, utilities, possessions and or property in satisfaction of the debt. 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 even push for bankruptcy if they feel it will yield benefit to themselves. The consequences of bankruptcy are explored in chapter 9.

Total Loss

24 Even these enforcement sanctions may not conclude the matter. For example, following eviction, any outstanding rent can still be pursued. The Commission met with some solicitors who collect debts and admitted to chasing housing arrears after eviction. This is despite the fact that the person or family who has been evicted, has no right to be re-housed as they are deemed to have voluntarily made themselves homeless.

25 Tragically, in some cases, debtors have taken the ultimate sanction to escape his or her spiralling situation of debt and have committed suicide.

The case of Scott Smith received much media attention in October 2004. The following extract is taken from the *Guardian*.[26]

A 21-year-old man committed suicide after running up debts of £15,000 on credit cards and personal loans, a committee of MPs was told yesterday.

Scott Smith, who was deaf and described as "vulnerable," had managed to borrow the money from a number of companies, including the Halifax.

After his death in August, his father notified the Halifax. But the bank's debt collectors continued to send 'threatening letters' and the interest has continued to build up, said the Liberal Democrat MP Norman Lamb.

Summary of Chapter 4

1 The ten steps of the debt spiral are drawn from the experience of hundreds of debt advisers, working with a variety of different clients in widely differing organisations and are entirely consistent with the evidence that the Commission received.

2 The major factors which signal the beginning of a debt spiral are loss of income and changes in family circumstances.

3 Almost invariably when people have a debt problem it has a knock-on effect on their relationships, their health and their work, which is a cost both to society and to the public purse.

4 Typically people do not seek debt advice until court action has been initiated.

5 Not all debtors go through the entire ten steps of the debt spiral because they take measures to break out of their situation.

33 *The Guardian,* 20 October 2004.

5 Challenges Facing Prime Lenders

1 The overwhelming provision of consumer credit in the UK is provided by mainstream financial institutions. The Commission 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.

Competition and Innovation

2 The key characteristics of the prime lenders, or mainstream financial institutions in the UK, are that: they are highly innovative; they operate in a highly competitive environment; they dominate the consumer credit sector; and in their interface with customers, they agree to abide by a voluntary code of conduct.

3 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 and the unwelcome effect of creating such things as 'mortgage queues.'

4 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. They operate 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. The process of demutualisation which began in the late 1980s has meant that many large building societies have changed their status to that of banks.

5 The markets in which prime lenders operate, and especially those which have grown rapidly since the 1980s such as the credit card and mortgage markets, are highly innovative. Barclaycard, the UK's first credit card, was set up in 1966 and today has

over 9 million customers in the UK. According to APACS, overall credit card penetration has increased from 38% in 1993 to 65% in 2003. At present there are over 60 card issuers and 1,600 different products in the UK, and more than 60 million credit cards outstanding. 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. Other card issuers today include football clubs, energy utility companies and supermarkets.

6 Mortgages are another highly competitive and highly innovative area. There are over 150 major providers in this market, offering literally thousands of mortgage products, including current account mortgages, flexible mortgages, offset mortgages and life-time mortgages.

7 The increase in unsecured lending has been accompanied by risk-based credit pricing (see below), in which the amount of interest customers are charged depends on the perceived risk of default. The Bank of England in its report on this issue 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.[34] 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 attempted 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 18% 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.

The FSA and the Banking Code

8 Until the Financial Services Authority was set up in 1998, the financial sector (with the exception of hire purchase, leasing companies and insurance) was regulated by the Bank of England. Since then, the FSA has been responsible for prudential supervision, but an important form of self-regulation within the banking industry is the Banking Code.

9 The first Banking Code was published in 1991. The code is voluntary and sets standards of good practice for financial institutions (banks, building societies, credit card companies) to follow when they deal with personal customers. It applies to current accounts, card products, loans and overdrafts, savings and deposit accounts and payment services. It does not cover mortgages, investments or insurances. It is an initiative by the financial institutions to show transparency and fairness in dealing with customers, to explain how financial services work and to deal quickly and sympathetically when things go wrong. It covers, among others things lending, charges, advertising and marketing and the terms and conditions of contracts.

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

10 The Banking Standards Board was set up in 1999 as it was felt that the Code lacked teeth. The Code is now reviewed every two years by someone independent of the industry. Although not its primary purpose, the Code is also an initiative to pre-empt the European Union introducing controls in this area. Following the Cruickshank report on *Competition in Banking* in 2000, DeAnne Julius was invited by the Treasury to report on the Banking Code and concluded that:

> 'There is broad consensus that service standards in banking can be effectively dealt with by self-regulation...many feel that the Banking Code while not perfect, is an exemplar of self regulation.'

Financial Exclusion

11 Despite the UK financial sector being one of the most competitive and resourceful in the world, a surprisingly large number of people are either excluded or exclude themselves from using financial services provided by the mainstream institutions.

12 The *Family Resources Survey 2002-03* showed that there were around 8% or 1.9 million households in Great Britain without access to any kind of bank account. This is roughly equivalent to 2.8 million adults, whom the Treasury have termed 'the unbanked'. In addition, a further 1.5 million households have some sort of savings account but no current account. This means that 12% of households, roughly 3 million households in total, or around 4.5 million adults have no current account. Datamonitor in January 2003 estimated that the total of the financially excluded was 7.9 million people. The Commission visited areas in which the banks had closed their branches and found that self-exclusion was as important a reason for being unbanked as exclusion. People believed there was little point in applying for a financial product because they expected to be refused – sometimes because of their previous experience, or because they knew someone who had been refused, or because they believed that their cultural and social status would prevent them form being granted credit.

13 The Treasury in its paper on Financial Exclusion described the characteristics of the unbanked as:

- at the lower end of the income scale – 65% of households without any accounts have incomes of less than £14,500.
- single people and lone parents.
- in terms of economic status, over 40% are of working age but not available for work, mainly because of childcare responsibilities.
- the majority are in receipt of state support or benefits.
- 60% live in socially-rented accommodation.

The fact that these low-income households cannot access mainstream financial services is costly. They end up paying more for basic financial transactions such as transferring money and cashing cheques; and considerably more by borrowing through doorstep lending. They cannot take advantage of receiving income or making payments by direct debit, and have no access to a range of services such as contract mobile phones.

14 Evidence presented to the Commission indicated that some major banks were genuinely engaged in developing business with low income families. Peter Kelly, Head of Financial Inclusion at Barclays, told us that nearly 7% of Barclays current accounts and 16% of cashcard accounts were held by people living in deprived areas. The Commission was unable to gain access to other banks' figures and it appears that Barclays is the only UK bank to publish this data.

15 One of the reasons given by Kelly for this was 'because we are very conscious of what's happened in America with the Community Reinvestment Act… The reason we publish this data is first of all to try and dispel the myth that we don't lend into [deprived] areas, in other words, we say we do lend to poor areas if people can demonstrate they can repay.'

16 Sarah McGeehan of the Community Development Finance Association (CDFA) in evidence to the Commission stated that, 'the best way to begin involving prime financial institutions in the areas of low income is to oblige them to give full disclosure of their current activities in such areas. This will both reveal more clearly the nature of the problem and at the same time place an implicit obligation on them to start addressing it.'

17 Most of the major prime lenders have responded positively to the problem of financial exclusion and in particular to the recommendation of the report of the Policy Action Team 14 (PAT 14), that a universal banking programme should be launched in the UK. This programme allows any individual to open a 'basic bank account,' even if they are not profitable from the bank's point of view. These accounts do not have an overdraft facility and so cannot be used to increase unsecured personal debt. They are useful however for paying in salaries, pensions, tax credits and benefits. They also enable customers to pay bills by direct debit and to withdraw money from cash machines. The success of the initiative to extend these accounts is still in question, with the Treasury reporting that take-up by the target group was smaller than expected.

18 A number of the major high street banks are working in partnership with charities in order to encourage the unbanked to open basic bank accounts. For example, Barclays has worked in partnership with a homeless charity in central London, HBOS with a prisoner's charity and Royal Bank of Scotland with young unemployed people. The following gives an example of the Bank of Scotland's involvement with a housing association. In addition, the banks spent £182 million in developing the Post Office Card Account. These accounts are a way of introducing people to using banking services but the accounts themselves are limited in that they cannot be used to deposit cash or cheques or to make direct debit payments.

Basic Bank Accounts and Social Housing

The Bank of Scotland's Community Banking team provides banking services exclusively to the UK not-for-profit sector including current accounts, deposits and lending. Working across the broad UK social economy, Community Banking manages relationships including Housing Associations, Community Development Finance Initiatives (CDFIs), Social Enterprises, Credit Unions, Charities, Community Development Trusts and other Voluntary and Community organisations.

One example of this is the Wester Hailes Community Bank Agreement, launched in March 2001. The arrangement with Prospect Housing Association is aimed at tackling the high levels of financial and social exclusion in the West of Edinburgh. Through this scheme over 1,000 basic bank accounts have been opened since April 2001.

19 These examples of prime lenders taking a responsible approach to the financially excluded should be applauded. Chapter 7 has further recommendations for developing this work.

Charges Against Mainstream Banks

20 Prime lenders have come in for strong criticism for a number of their lending practices. The fundamental charges are that it has become too easy to obtain credit; that the marketing is too aggressive; that the terms on which credit is given are not fully known; that bank branches have become money shops concerned with selling credit rather than offering impartial advice; and that because technology has replaced people, the process of lending has become an impersonal business. Certain of these criticisms have been set out in detail in the two excellent reports issued by the House of Commons Treasury Select Committee.[35]

Aggressive Marketing

21 A number of practices were identified by the Treasury Select Committee as being inconsistent with responsible lending. One charge was that bankers have been over aggressive in their marketing techniques, especially in their credit card business. This includes:

- Unsolicited Increases in Credit Limits whereby a customer's credit limit is raised as the customer becomes better known to the issuer. It would appear that it is now common practice for card issuers to raise credit limits without first consulting the customer.

- Misleading marketing in supermarkets, shopping malls and motorway service stations, including targeting customers in supermarkets, shopping malls and

35 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.

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. This 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 and now accounts 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 seem to continue to send advertising material to customers even though they may have serious debts and multiple credit cards. Approaching customers indiscriminately can easily encourage people with existing debt problems to increase their commitments. The Commission also noted the increasing use of direct marketing through telephone canvassing. This often manifests itself in telephone calls being made by sales agents to potential consumer's homes, which invades their privacy, particularly 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 costs of re-payment should the customer be unable to work due to illness, redundancy or accident. In addition, the balance would be cleared in the event of the cardholder's death. The exact terms and exclusions vary between providers. This can be a valuable form of insurance and its terms and exclusions need to be carefully explained to customers. In particular, insurance should not be sold to customers who would not benefit from it due to their age or current employment situation.

- 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 application
  – the emphasis in promotional material on very high credit limits
  – important information appearing in small print

Lack of Transparency

22 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.[36] These boxes should 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 but the Treasury Select Committee has continued to recommend that they move towards using simple language and standardised wording

23 In the same report, the Treasury Select Committee 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. In its evidence, the Committee estimated the costs and interest of a series of transactions over two months, 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.

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

- Late payment: charged when the monthly payment is not received by the due date on the statement.
- Exceeding credit limit: applied when the outstanding balance exceeds the agreed credit limit.
- Payment refused: applied when a cheque or direct debit used to pay the account is received.

25 Consumer groups have continued to express concern about the level of these charges which are not only evident in the credit card industry but also in the high street banking community. In its submission to the Competition Commission 'open day' on store cards, Brad Cooper, CEO of GE Consumer Finance, stated that 43% of 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 have called for prime lenders to publish the information necessary to create confidence that penalty charges

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

are reasonable. The OFT has launched an investigation into the level of penalty charges, which is currently on-going.

Undue Care in Lending

26 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, stated in his evidence to the Commission that:

> '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.'

27 As a result of this change, the banks freely admitted to us that their branches today are effectively shops rather than administration centres. 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:

Box 5.2 - 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.

28 The Commission 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.[37]

29 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

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

'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 decisons 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.

30 The government's proposal in the Consumer Credit Bill 2005 to replace the extortionate credit test with an unfair relationships test is welcome. 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

31 In addition to charges of over-aggressive marketing, a lack of transparency and undue care in lending, the banks have also been criticised for a failure to properly share data regarding customers borrowing and behaviour history among themselves; and for inadequate methods of debt collection. These are serious charges and are considered in Chapters 8 and 9. The recommendations made there are pertinent to prime as well as sub-prime lenders.

A Bank Customer Charter backed by Statute

32 The liberalisation of credit markets over the past 30 years has resulted in a sea-change in the way banks treat their customers. This is primarily the result of deregulation and the enormous increase in competition which has taken place in these markets. It is not fundamentally the result of the Banking Code. The Banking Code was added 20 years after the process of liberalization first started and as a response to charges that customers were being treated unfairly.

33 The Treasury has accepted DeAnne Julius's view that the Banking Code is an exemplar of self-regulation. The Commission has a different position. We believe that a number of questions need to be asked, namely:

- why is it that the first Banking Code was only introduced in 1991, 20 years after the process of liberalisation started?
- why did it take a further eight years after the Banking Code was introduced before the Banking Code Standards Board was set up?
- why is it the case that banking is the only area of self-regulation still surviving in the financial sector?
- perhaps most importantly of all, why is it that after the Banking Code has been described as exemplary, the Treasury Select Committee has issued two critical reports? These have raised questions on the following issues:
  - lack of transparency on interest rates and the penalty charges of credit cards
  - over aggressive marketing techniques

- automatic raising of credit limits
- consolidation loans
- inadequate checking of credit references
- clearer calculation of the APR
- irresponsible issue of credit card cheques
- selling of payment protection insurance
- lack of competition in the provision of store cards
- inadequate sharing of data

34 These charges contradict the claim that the Banking Code is an exemplar of self-regulation. In addition, it seems that the OFT has been far too complacent in the past and not sufficiently pro-active in promoting competition and responsible marketing in these markets. While the Banking Code has been strengthened with the setting up of the Standards Board in 1999, it is dismaying that it has been left to the House of Commons Treasury Select Committee to take the lead in exposing bad practice and calling for reform.

35 This failure means that the voluntary Banking Code should be replaced with a statutory Bank Customers' Charter. The Charter would have the full authority of the law behind it and would be overseen by the Office of Fair Trading. The Charter would among other things set standards to:

- transparency of charging
- techniques of marketing
- methods of debt collection
- data sharing

36 The Commission believes the Charter should include the following:

- The prohibition of unsolicited increases in credit limits either for loans, credit cards or other forms of finance.

- The prohibition of automatic issuing of credit card cheques. Customers who wish to avail themselves of credit card cheques should be required to opt into the system.

- The introduction of a marketing code of practice which prevents any use of misleading marketing techniques, such as enticement to enter into surveys which then lead to selling of financial products. In addition, there should be clear guidelines on face-to-face and telephone forms of marketing which should limit the ways and times in which borrowers can be approached.

- The introduction of a code of practice with regard to responsible debt collection policies. If lenders sub-contract debt collection to another agency or sell on the debt, lenders should not be able to pass on the responsibility to ensure these standards of debt collection are maintained.

- The clear identification by lending institutions of all kinds, not just credit card companies, of all charges or default penalties as part of the original granting of the loan or credit card. Summary Boxes need greater clarity and consistency, and should clearly spell out in plain English the impact of making minimum repayments for prolonged periods.
- Consistency in the calculation of APRs.
- The selling of Payment Protection Insurance needs to be properly regulated.
- Standardised, clear and transparent policies should be produced regarding penalty charges.

Summary of Chapter 5

1 Mainstream banking in the UK is highly competitive, highly innovative and provides the bulk of lending to consumers.

2 Roughly two million households in the UK are either excluded, or perceive themselves to be excluded from the financial services offered by the mainstream banks.

3 A number of steps have been taken to tackle financial exclusion including the introduction of basic bank accounts. The success of this initiative is still in question.

4 Face-to-face banking has been replaced by technology, with computerised models to assess credit risk rather than face-to-face meetings between borrowers and bank manager. The impersonal nature of modern lending has encouraged distrust between the banks and their customers.

5 In the area of credit cards, mainstream banks are vulnerable to charges of a lack of transparency, over aggressive marketing techniques and unacceptable debt collection methods.

6 The Banking Code lacks the teeth necessary to enforce standards in highly innovative and competitive markets with many players.

Recommendations

1 The mainstream banks should be encouraged to continue their initiatives to increase the number of households with basic bank accounts.

2 Banks should be required, following the example of Barclays, to publish their lending to deprived areas of the community.

3 Lending institutions should introduce a 'traffic light system' in partnership with the credit rating agencies. Satisfactory and unsatisfactory credit ratings should be

given 'green' and 'red' lights respectively; marginal decisions should be given an 'amber light' which indicates the likely presence of financial stress. An amber light should require the lender to conduct a more personal and thorough discussion with the applicant in order to assess whether or not the credit should be granted.

4 The voluntary Banking Code should be replaced by a statutory Bank Customers' Charter which sets standards for among other things:

- transparency of charging
- techniques of marketing
- methods of debt collection
- compulsory data sharing

6 Sub Prime Lenders

1 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 are still affected by financial exclusion.[38] Borrowers who are excluded from access to mainstream lending institutions are nevertheless able to borrow from a number of alternative sources. The major types of sub-prime credit products are set out in the following box.

2 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 and 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.

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 Moneylending
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

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

Home Credit

3 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 met by the Commission 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.'

4 The typical customers of home credit tend to have low incomes and low socio-economic status (social class D, E): roughly 60% were 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, cohabiting couples and people 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.

5 Even though the National Consumer Council launched a super-complaint against the home credit industry, the leading experts on the industry also recognised that it had 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.'[39]

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

- Easily accessible cash loans of small amounts. Customers have access to cash loans of small amounts, typically £150 and £400 according to David Rees of the Consumer Credit Association. 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.

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

- Personal Service. The success of the home credit industry is built on a personal and intimate service. The evidence received by the Commission 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.

- Repayment Compatible with Weekly Budgeting. The fact that home credit agents make collection visits on a weekly basis matches with 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 Commission 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. This gives customers the reassurance they can miss the occasional payment if they need to. 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.

7 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 said of the industry, '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%.[40]

8 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.'[41] 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:

40 Research conducted by Swift Research, January 2005. 41 P A Jones & T Barnes, *Would You Credit It?,* 2005, p.10.

> '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.'[42]

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

> '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.'[43]

Other Forms of Sub Prime Credit

10 Other forms of sub-prime credit such as mail order, pawn broking and sub-prime credit cards are important, but none quite rival home credit in what they offer. Mail order credit has merit in that it is sometimes provided face-to-face in the customers home, with repayments being made in cash through weekly collection by the agent. It is widely used by people with low incomes, but it is restricted in that it is only provided for the purchase of goods rather than the provision of cash. Customers would not be granted the same flexibility over missed payments. Pawn brooking has a long history and its procedures can be quick, simple and flexible. However, again it is limited in that it is often confined to jewellery and loans are repaid in lump sum rather than by instalment.

11 Research commissioned by the DTI and published last year indicated there is a clear trend for sub-prime credit cards to be introduced at the top of the sub-prime market, which follows trends in the US.[44] 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.

12 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.

42 Consumer Credit Association, *Mirage or Reality,* p.15. 43 C Whyley and S Brooker op. cit.
44 DTI, *The Effect of Interest Rate Controls in Other Countries,* August 2004.

Criticisms of the Sub-Prime Lenders

13 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 climax of the campaign against them came in the summer of 2004 when the National Consumer Council (NCC) launched a super-complaint regarding home credit to the OFT. This was followed in December by the OFT referring the matter to the Competition Commission.

14 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

15 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%.[46] In comparison, it is claimed that APR rates in the mainstream lending industry rarely exceed 30%. This however is misleading as the APR calculation excludes penalty charges and APRs for overdrafts are never published.

16 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.'[47]

17 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

46 P A Jones, *Access to Credit on a Low Income*, p.16. 47 P A Jones & T Barnes, *Would You Credit It?,* 2005, p.46.

the APR upwards.'[48] The irony is that after having recognised the severe weakness of the APR, it still concludes that it 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 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.

- A third factor is the high cost of having agents collect weekly at the borrower's home. If agents expect to take home pay just a little above the minimum wage, this has a huge impact on the APR.

18 High APRs however are just one of the concerns raised about the lack of competitive practices in the industry. Others 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.

19 The NCC 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.

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

48 C Whyley and S Brooker op. cit., p.64.

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.

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 a nearly 70% market share. The other players in the market consist of around 50 to 60 medium-sized companies with a regional base, with the tail being made up of several hundred sole traders.[49]

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 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.[50]

21 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 in his evidence to the Commission stated that, 'It depends how you define the market. We would say the market includes mail order, rent to own, pawn-broking – the whole range of businesses that are offering small loans to people on lower incomes.'

22 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.'[51]

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.

49 Information provided in evidence by the Consumer Credit Association. 50 C Whyley and S Brooker op. cit., p.57.
51 OFT, *Home credit: The OFT's Reasons for Making a Reference to the Competition Commission,* January 2005, p.5.

- Customers may have difficulty comparing loans and do not appear actively to do
- 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.

23 The Commission reached three conclusions on these issues. First, that the APR is not a good measure of the cost of borrowing for short term loans. Second, that there is no easy way to compare the cost of borrowing as it is impossible to compare 'apples with pears.' Third, on the basis of one company having 49% market share and four companies having nearly 70%, there is *prima facie* case that competition is limited.

Perverse Lending Practices and the Lack of Transparency

24 Another charge is a failure of disclosure and a 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.'[52] 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.'[53] 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.'[54]

- A concern by customers with the weekly repayment costs, while neglecting the total cost of the product. Jones found in his research in Liverpool that:

> '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.'[55]

52 P A Jones & T Barnes, *Would You Credit It?* p.6. 53 C Whyley and S Brooker op. cit., p.53. 54 OFT, op. cit., p.13.
55 P Jones, *Access to Affordable Credit on a Low Income,* p.38.

25 Apart from home credit, other sub-prime lenders have also been accused of benefiting from the poor 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.'[56]

Undue Pressure on the Doorstep in Selling Loans

26 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.[57]

27 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.

28 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 Commission was told that the first question frequently asked to an agent is 'How much can I get?', something which was rejected by the home credit customers with whom we spoke. The CCA also pointed us to evidence of their view that:

56 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. 57 P A Jones, *Access to Credit on a Low Income,* p.20.

> '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.'[58]

29 Home credit agents are encouraged through training programmes to recognise the importance of responsible lending. However, the evidence received by the Commission suggests there is a difference between the aspirations of home credit head offices and the activity of some of their agents on the ground.

Should Interest Rates be Capped?

30 As a result of the high costs of sub-prime credit, organisations such as Debt on Our Doorstep and the New Economics Foundation have called for the imposition of an interest rate ceiling to be placed on loans, so that it would be illegal for lenders to charge an APR higher than the set ceiling. Such policies are in place in other countries (e.g. Germany, France and Ireland); and in the UK, credit unions are subject to an interest rate cap of 12.68%. In arguing for a floating cap over and above the Bank's base rate, Debt on our Doorstep recognises that:

> If a cap is to be successful, it must operate at above the level of marginal costs, allow for a realistic rate given the actual risk to the lender, and fall below the levels currently being charged by companies with market power.

31 Some members of the Commission were initially sympathetic to the principle of capping because they wished to protect the most vulnerable members of our society. However, in the end, they became persuaded that in view of the evidence from other countries, capping could end up hurting the very people they were concerned to help. Its conclusion therefore is not ideological, but based on the evidence from other countries. Because of this the Commission welcomes and endorses the Government's decision not to impose caps on interest rates.

32 In coming to its decision, the Government commissioned research on the way in which interest rate ceilings have worked in France, Germany and the US and the likely effect there would be therefore in the UK. Before setting out the case against interest rate caps, it should be understood that one reason why interest rates may be higher than elsewhere is because of restricted competition. If this is a reason, then the Government has a responsibility to act, either by reducing barriers to entry, or by increasing transparency in the market, or by making certain practices illegal, and ultimately, if

58 CCA, *Mirage or Reality,* p.11.

need be, by breaking up dominant companies. In the case of home credit this process has been started through the OFT's reference to the Competition Commission.

33 The Commission is opposed to interest rate ceilings for the following reasons:

- First, the government would have to specify in great detail exactly what could and could not be included in the APR calculation. This would invite the home credit industry to develop ingenious devices to get around the official restrictions. For example in Germany, transaction costs for purchases are included in the APR, but a range of other routine costs (cash withdrawals, statement fees, correspondence fees) are not included. In the US, exemptions are typically provided for pawnbrokers and auto loans but not for others.

- Second, if the ceilings were introduced in this way and at the levels which have been suggested, it would kill the home credit industry. For decades in the UK, rent control killed the private rented sector in housing. But it did not kill off the housing demand. In fact the opposite was true: it increased it. Exactly the same would be true in this market. The research conducted for the DTI concluded that 'In markets where rate ceilings are introduced…if the business model and pricing structures cannot be adapted to fit within the new framework, lenders tend to withdraw from the market.' In 2000 the State of Florida imposed rate ceilings on Auto Title lenders, who provided high cost short-term cash credit to largely unbanked car owners. Twelve months later the number of lenders had dropped from 600 to 58.

- Third, because of an excess demand for sub-prime consumer credit, illegal lenders would step in to fill the gap. Evidence suggests there is significantly more illegal lending in both France and Germany than in the UK. In the UK, 3% of those who are on low incomes and who are credit-impaired are prepared to admit they have borrowed from an illegal lender. In France this figure is 7% and in Germany 8%.

- Fourth, the consumers most affected by interest rate caps would be the most vulnerable, unbanked, credit-impaired, low income individuals and families in the country. Those on low incomes who have been refused loans in the UK are estimated to be roughly 4%. In Germany this figure is put at 10% and in France 12%.

- Fifth, price transparency would appear to be compromised when ceilings are introduced. One of the characteristics of a significant minority of low income borrowers is that they have regular late and missed payments. Because in these instances extra charges are imposed, the interest rate frequently does not reflect the true cost of credit.

6 Treasury Select Committee, *Credit Card Charges and Marketing. Second Report of the Session 2004-05*, 2005. 7 S Collard and E Kempson, *Affordable Credit: The Way Forward,* Polity Press, 2005. 8. PA Jones and T Barnes, *Would you credit it? People telling stories about credit,* Liverpool John Moores University, 2005.

Summary of Chapter 6

1 Sub-prime markets are the only source of credit for many low income families.

2 The home credit industry rates highly in terms of customer satisfaction; at the same time it is criticised for over-aggressive marketing, high APRs and a lack of transparency.

3 Because of the short term nature of the loans, the fact they are for small amounts, the risks of lending and the cost of weekly servicing, the APR is not a good measure of the true cost of home credit.

4 The fact that one company has nearly 50% of the market and four have nearly 70% is evidence that there may be a lack of competition.

5 The Government is right not to impose ceilings on interest rates in sub-prime credit markets. Interest rate ceilings would reduce the volume of credit available to low income families, encourage illegal moneylending and cause lenders to devise ways to circumvent the ceilings. It would hurt the most vulnerable in our society, the very people it is intended to help.

Recommendations

1 Because APRs introduce great distortions when used to measure the cost of credit for short term loans and of small amounts, credit providers should not be required to publish APR's on sub-prime loans of less than 6 months. Instead the total repayment should be made more explicit in the documentation.

2 The grounds for the OFT's reference of the home credit industry to the Competition Commission are valid. This is a declining industry and it can easily be killed by inappropriate intervention.

3 Interest rates in sub-prime consumer credit markets are higher than in mainstream consumer credit markets. Nevertheless, the Government is right not to impose ceilings on interest rates.

4 The four major companies in the home credit industry have the opportunity to show greater leadership, by improving transparency and increasing public confidence in their marketing practices.

7 Strengthening Community Finance Initiatives

1 One potentially important development to meet the needs of low income borrowers is the growth of not-for-profit financial institutions or the third sector as it is sometimes called. The major third sector organisations in the UK are Credit Unions, Community Development Finance Institutions (CDFIs) such as Moneylines, and Community Banking Partnerships. Interest rates charged by Credit Unions are set at a maximum of 1% per month, making an APR of 12.68% while rates charged by other institutions in the third sector vary between 12% and 30%.

Credit Unions

2 Credit unions are a legacy of the co-operative and self-help movement that originated in Rochdale in 1844, although credit unions as we know them today originated in North America in the early twentieth century. The first British credit unions were founded in the 1960s and drew upon the experience of countries and regions such as Ireland and Australia, the Caribbean and North America. Supporters of the credit union movement pointed out to the Commission that they are an attempt to reinvent the principle of mutuality, by lending out savers' money to borrowers from the same community: 'They are mutual organisations which exist for the benefit of their members, lending to their borrowing members what their saving members invested.'

3 In 1979, Parliament passed the Credit Union Act with cross-party support to create a specific legislative framework for these growing organisations. They are financial co-operatives that are owned and run by and for their members, who are joined together through a shared 'common bond.' The common bond might be people who work in the same company or organisation or who live and work in the same community. Credit Unions have two objectives – to encourage saving and to provide access to low-cost credit for people on low incomes. An example of the services provided by credit unions is given in the following Case Study.

CASE STUDY 1

Anne is a single parent living on Income Support. Before the birth of her first daughter, she had a good job in administration which she had hoped to return to. The daughter, however, was born with severe physical disabilities so that Anne had to stay at home to provide her with full time care.

The benefit payments Anne received did not cover the considerable extra costs incurred in caring for her daughter and she therefore resorted to using doorstep credit. Over time, she became increasingly indebted to the lender and the amount of her weekly repayments escalated.

When she heard about her local credit union, Anne decided to join whereupon she started saving a couple of pounds a week. She was offered an appointment with the credit union's money advice worker who helped her to re-assess her income and to prioritise her expenditure. The credit union gave her a small loan to help with her 'spending money' and a loan to take her family on holiday. She has begun to clear her home credit obligations as well as building her savings.

4 In 2003 there were 665 credit unions in Britain serving 410,000 members. The two largest credit unions in the UK are in Scotland and serve local authorities and public sector bodies. Glasgow Council credit union has 15,000 members and assets of £25 million. It has a staff of 15 which provide a range of financial services, including money advice, debt advice and household insurance. In 2000 it paid a 7% dividend on savings. Employees of public sector bodies in the west of Scotland can join the Scotwest credit union which has 16,000 members and in 2000 paid a dividend of 5% on their savings.

5 Leeds City Council credit union which was formed in 1987 and is the largest in England, has 9,000 members and £7.5 million in assets. In addition to small loans and deposit accounts, it offers a variety of financial services such as payment of utility bills, house insurance, foreign currency exchange and energy efficiency loans. Its original common bond was employees, past and present, of Leeds City Council. Since then it as expanded to include employees of Leeds Metropolitan University, Leeds Federated Housing Association, Further Education Colleges, Leeds Co-operative Society, the University of Leeds, and Leeds Hospital Trust. Most recently its common bond is all who live or work in the Leeds Metropolitan District.

6 Despite the successes of credit unions they still suffer from a number of disadvantages:

- The majority of credit unions are small with less than 200 members and an average of only 36 loans on their books. Christine Moore, of the East Manchester Credit Union, told the Commission that 'our average loan is about £500, and we can't make enough money from these deals.' 'Our aim is to grow sustainability… with the most difficult bit to cover being the cost of advice – often a loan is the worst thing a person in debt needs.' Mark Lyonette, Chief Executive of the Association of

British Credit Unions Ltd (ABCUL), said he expected the number of credit unions 'to continue to decrease due to consolidation, with a shift from very small unions to larger better resourced ones.'

- They are required by law to cap interest rates at 12.68%. This is often too low to cover the risks attached to this market. Peter Kelly, Head of Social Banking at Barclays Bank, told us that 'in a risk-adjusted pricing world, you need to charge a rate that enables the loan fund to be sustainable… [otherwise the credit unions] are going to put their members' money at risk when they lend to the riskier end of the market. 30% interest rates might sound high, but access to finance is important.'

- Credit unions usually insist, although it is not a statutory requirement, on members saving for 11 weeks before they can take out a loan. This makes it difficult for families on low incomes already in financial difficulties to gain access to credit union loans as an alternative source of credit. However, a recent pilot scheme based upon the PEARLS initiative (see below) has shown how the requirement for prior saving can be abandoned.

- Members must repay their loans at the credit union's premises. The savings this creates helps explain why the charges for credit union loans are less than for home credit. However, there is a wealth of evidence to show both that customers of home credit consider the convenience of weekly collection highly, and that these collections substantially reduce the risk of default. For these reasons, representatives of community finance initiatives freely acknowledged that they do not compete fully with home credit providers. The Commission was referred, however, to a credit union in Llanelli which 'piloted a door-step collection service that proved to be both effective and popular with a certain section of the membership.'[59]

- The management in small credit unions is often voluntary and lacking in the necessary business skills to build the organisation. Professor Paul Jones told the Commission that one of the greatest challenges facing the credit union movement was 'the modernisation and transformation of credit unions into a more entrepreneurial movement', with a change from a traditional social welfare model, relying on volunteers, to a more professional business and market orientated organisation, with full time staff. Others told us that credit unions needed to develop business rigour by, for example, sharing back office facilities and creating economies of scale, pooling money to get better rates of return, and diversifying into different products.

- Credit unions suffer from the brand image of being 'the poor man's bank.' A number of representatives told us that many potential customers are wary of being associated with credit unions for this reason; although conversely, there is evidence that the same people value the organisations' association with the local social and community networks.

59 P A Jones and T Barnes, *Would You Credit It?* p.39.

7 In the UK, Credit Unions have developed with the active support of public sector bodies and in particular local authorities. This is true, for example, of credit unions in Liverpool, Birmingham, Telford, Leeds, Portsmouth, Rochdale, Glasgow, Scotwest, Edinburgh, Hull, Wakefield, and Cheshire amongst others. Local authorities have helped by undertaking research on the viability of proposed credit unions and by funding premises, IT and operational systems and initial staffing costs. It is difficult to assess the hidden subsidies that are involved. One local authority source commenting on Leeds City Credit Union stated that 'the continued support of the council remains a crucial factor in the credit union's development.' Mark Lyonette, Chief Executive of ABCUL, agreed that a lot of small credit unions are dependent on grant funding.

8 Evidence to us stated that in Ireland, the growth of the credit union movement was in many ways 'faith based.' It was claimed that 'the Roman Catholic Church in the 1930s was not happy with capitalism, tried a third way and encouraged the development of credit unions, so that the local priest in almost every little town made it his business to try and encourage the development of credit unions.' Credit unions have been very successful in Ireland.

9 In his evidence to the Commission, Mark Lyonotte drew attention to the PEARLS project – PEARLS being an acronym for a set of financial ratios useful to the effective management of a credit union. The ratios deal with Protection, Effective financial structure, Asset quality, Rates of return and costs, Liquidity and Signs of growth. A total of 20 credit unions took part in the first PEARLS project in the UK, which involved installing new computers and software, intensive training and dedicated support for the project. The project has shown that: credit unions need to be well capitalised, but that if they adopt PEARLS techniques, they can become financially sustainable in a reasonable time-frame; that they must be able to provide loans without requiring the condition of saving; that they must provide appropriate products for savers; and that they must adopt much stronger financial disciplines.

10 Those credit unions which took part in the PEARLS initiative have seen a significant increase in membership, increases in the volume of savings, reduced levels of delinquency and decreased reliance on grant funding.

Community Development Finance Initiatives (CDFIs)

11 The Commission received evidence regarding CDFIs and specifically 'Moneylines' from Dr Karl Dayson of the University of Salford. CDFIs emerged as a provider of financial services, business support and money advice to businesses which cannot access finance from mainstream banks. Moneylines are CDFIs that focus on providing people on low incomes with personal credit. An example is given in the following Case Study.

CASE STUDY 2

Derek is married with two children. He suffers from learning difficulties. However, he has three jobs and works extensive hours to provide for his family.

Derek's debt problems started with someone knocking on his door offering to take a family portrait at Christmas time. Derek signed up and failed to realise that the product was bundled with a loan from a home credit company or that the total charge was over £2,000 due to the high interest on weekly repayments. All he knew was that he had to pay a weekly amount that he considered manageable.

Derek told the Commission that when the collectors turned up on his doorstep, they often came with tempting goods especially around the time of his children's birthdays and at Christmas. They offered cash loans to help him purchase them. Gradually Derek borrowed more from a variety of doorstep lenders such as Shopacheck, Greenwoods and Provident Financial, each one requiring small, weekly repayments.

With more agents calling regularly, Derek borrowed from one provider to pay another. He began to be afraid of answering the door, especially after one time when, as a family, they only had £26.10 to buy food and cover bills that week. The agent took the lot.

Derek visited the money adviser at his local Moneyline where they were able to work out a finance action plan, negotiate affordable repayment agreements with his creditors and provide him with a loan to pay off the three creditors that were charging him the highest rates of interest.

12 CDFIs started up in the 1970s, when pioneers in the co-operative sector established the first viable community development loans in the UK. Their experience over 10 to 25 years inspired a second wave of initiatives in the early 1990s onwards. A third wave has appeared in the 1990s since the introduction of new policies aimed at strengthening them.

13 At present the Community Development Finance Association has 57 members, 18 of whom provide (or plan to provide) finance for individuals. Figures from the annual survey of September 2003 show that CDFIs had a total loan and investment portfolio of £106 million, comprising 4,292 loans. While loans to social enterprises represent a little over half of the portfolio by value, loans to individuals for personal use represent a little over half of the portfolio by number, and are the fastest growing area of CDFI activity. The average loan to individuals is £2,000 although those CDFIs who provide loans for individuals provide loans from as little as £50.

14 CDFIs who provide personal loans have as their main competitors licensed and unlicensed money lenders and high street goods' providers such as Brighthouse. The majority of loans are unsecured for a variety of purposes, including emergency credit for household goods, back to work loans and debt consolidation.

15 The top three challenges facing CDFIs at present are revenue funding, improving and increasing deal flow and access to capital for on-lending. A supportive funding environment remains the biggest identified need as the sector moves forward.

16 CDFIs that have been operating for more than two years are focusing more on refining their own internal controls and systems and for them and those operating over five years, staff development and retention becomes a key issue.

17 Already the CDFI sector has evolved from a loose network of financing organisations that recognised in one another broadly similar aims and operations, to a recognisable sector that shares a common mission and activities. This may prove the basis going forward for economies of scale.

18 The Commission was impressed with the people we met who ran the Salford Moneyline, the East Lancashire Moneyline and the Blackpool Moneyline. To give one example, the East Lancashire Moneyline opened in Blackburn in January 2000 and helped more than 2,000 financially excluded households in the first year of its operations, advancing around 1,800 loans. Among its customers, 95% had borrowed from sub-prime lenders, 89% had no savings and 40% had no bank account.

19 New Moneylines are being opened in rural and urban areas such as London, Preston, Wessex and Suffolk.

CASE STUDY 3

Jo is a single mother aged 20. She recently entered into an agreement to purchase a television from 'a bloke who knocked on her door'. The package included 'repair credits' such that should the television break down, she would be entitled to free repair.

Jo decided she needed a new television and could afford £11 per week. However, the repayments were due over a three year period giving rise to a total cost of £1,716. A television of equivalent make/model was available from Comet for £199 cash.

Jo turned to her local Moneyline. With their help, she cancelled the initial agreement and received a £200 loan to go to Comet. Her payments amounted to £4.30 a week and the total interest on the loan was £24.

Community Banking Partnerships

20 The third community finance initiative is Community Banking Partnerships, which have been developed through the joint efforts of the New Economics Foundation, NACUW (Credit Workers Union), National Consumer Council and Lloyds TSB. Their objective is to bring together all the leading players in a particular area to provide financially excluded households with a one-stop shop offering savings facilities, affordable loans (at about 25% APR), access to basic banking services, bill and debt repayments systems, money advice and support. These partnerships bring together credit unions and Moneylines (although each will continue to retain their separate identity).

The Social Fund Budgeting Loan Scheme

21 The Social Fund was set up in 1988 and revised in 1998 to make it more accessible and effective. Part of the payments from the Social Fund are loans which charge no interest. They are an alternative to home credit, are available to people on Income Support and Job-Seekers allowance and are meant to help with one-off, large lump sum expenses. Applications for loans are complex and lengthy. In 2002/3, there were 1,777,000 applications for loans, and 1,251,000 were made. The scheme is cash limited. Repayment terms are set by the benefits agency and typically are more inflexible than those of home credit. Many campaigning organisations claim that the Social Fund is not tackling social exclusion. The Social Fund is an important source of credit for low income households and should be the subject of a separate review to examine whether and how it can be made more effective.

Evaluation of Community Finance Initiatives

22 First, everyone associated with community finance initiatives whom we met showed enormous enthusiasm and dedication; and great commitment to ensuring that low income families were provided with access to basic financial services. At present the sector depends critically on voluntary support and the backing of private and public sector institutions.

23 Second, the home credit industry despite the criticisms made of it plays an important role in providing access to credit for low income households. It is important that in supporting the growth of community finance initiatives this sector is not killed off. The evidence from the US and continental Europe suggests this could be a real possibility.

24 Third, the Commission did not come across any viable business model in the third sector. It found no Credit Unions, no CDFIs and no Community Reinvestment Trusts which are generating sufficient revenues from their commercial activities to cover their operating costs, let alone the cost of their capital. Karl Dayson is remarkably frank on this point:

> CDFIs have proven they can reach deprived communities but at a financial cost that cannot be absorbed in their business model. Maximising their potential require genuine partnership and a public funding regime that rewards efficiency and good performance.[60]

25 It is clear that the mainstream financial institutions have a viable business model, but it is one which does not enable them to provide banking and credit facilities for all low income households. They currently lose money on new initiatives to help low income families and individuals open basic bank accounts. In its report on financial inclusion, the Treasury was also frank about basic bank accounts. Since the introduction of the universal banking programme, one million basic bank accounts have been opened. The Treasury went on to say ‘Despite these numbers, evidence from the universal banking programme so far suggests that fewer than anticipated benefit recipients are choosing to open basic

60 K Dayson, *Community Finance Initiatives – A Policy Success Story*, University of Salford.

bank accounts. Many DWP customers have chosen to use a Post Office card account to receive their benefits.'[61]

26 In some cases, prime lenders have provided support to community finance initiatives. For example, Barclays Bank sponsored the PEARLS initiative and HBOS is working with the East Lancashire Moneyline (ELM), to deliver an innovative new savings and loan scheme which was launched in January 2005. Through this scheme, ELM will open and run its own branded savings accounts for its customers using on-site access to the Bank of Scotland's systems. ELM's head office will effectively act as a branch, supported by the banks infrastructure, knowledge and experience to reach people on low incomes who would otherwise be financially excluded.

Summary of Chapter 7

1 We welcome the growth in alternative sources of credit, such as Credit Unions, Moneylines and Community Banking Partnerships. These provide low cost credit to low income borrowers, as well as offering financial advice, encouraging savings and promoting community development.

2 However, the ability of credit unions to compete and grow is hampered by their lack of freedom to charge higher interest rates on loans.

3 There is no example of a community finance initiative in the UK which currently has a track record of financial viability without either continued public sector funding, or private sector support. While credit unions have reached a critical scale in other countries, this has not occurred in the UK.

Recommendations

1 Legislation should be changed to allow credit unions to charge higher interest rates on loans. This is essential if credit unions are to achieve sufficient scale to provide competition to existing sub-prime lenders.

2 For community finance initiatives to grow, continued support from prime lenders is critical. We applaud those banks such as Barclays which give 1% of their profits as part of their social responsibility. We believe that all financial institutions in this market should be encouraged to follow their example and that a Community Finance Trust should be established to develop community finance initiatives.

3 HM Treasury should finance a series of pilots to determine whether community finance initiatives have the potential to be viable financially and to reach sufficient scale to compete with existing providers. But it is not appropriate that community finance initiatives should be funded permanently by tax payers money.

4 The Social Fund should be the subject of a separate review to examine whether and how it can be made a more effective source of affordable credit.

61 HM Treasury, *Promoting Financial Inclusion*, 2004.

8 Data Sharing

1 In recent years, data sharing has become an important issue in the debate over personal debt because of two developments. The first development is that borrowers increasingly deal with more than one financial institution and use many different credit products. Before the liberalisation of credit markets and the development of credit cards, it was typical for people to deal with just one bank and one building society. 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.

2 The second development is that, following advances in technology, banks rely increasingly on a credit scoring mechanism to make decisions about whether to issue loans. In evidence received from Experian, these scorecards differ from bank to bank, but all require a wide variety of data including credit reference agency 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.

3 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 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. In their evidence to the Commission, HBOS stated that bank branches have now been stripped of their administrative function and are effectively money shops.

4 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.

5 Lenders currently share information on credit agreements with other lenders through credit reference agencies. In evidence received by the Commission 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 the applicant and assess 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.

6 Data sharing involves two kinds of data. First, default data which includes information such as arrears, missed payments and bankruptcies; second, positive data which includes 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 past 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. [62]

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

> The lack of full data sharing in the credit card industry has significantly contributed to problem of over-commitment by hampering responsible lending. As industry representatives themselves acknowledged there is significant scope for the system of data sharing to be improved and the industry must make progress in this direction. [63]

The Data Protection Act 1998 and the Duty of Confidence

7 The Data Protection Act 1998 requires that data should be processed fairly. That is generally taken to mean that the person who is the subject of the data must have been notified of the purposes for which the data will be used and consented to the data being shared.

8 In the case of lending institutions who share default-only data, many notify their intention to share data at the outset of the relationship with their customer. They then give non-payers a further 28 days' notice of the intention to share their information with a credit reference agency. Some lenders, however, share default information in the absence of this notification on the basis that the borrower's

62 Treasury Select Committee, *Credit Card Charges and Marketing, Second Report of Session 2004-05*, pp.23-24.
63 Ibid., p.24

default has broken the terms of the agreement, and that accordingly express consent is not required. Agreement to manage such cases was made by the banking industry in 1988, confirmed with others in the early 1990s and has been endorsed by the Information Commissioner. This is clearly stated in evidence by the current Information Commissioner to the House of Commons Treasury Select Committee.

9 Some banks and credit card lenders however are not able to share data on all their accounts, because their historic 'fair processing' notices do not give them the right to do so. In the past, some lenders had not foreseen the widespread sharing of data, or had not planned to share data with the credit reference agencies. As a result they had not informed customers in their 'fair processing' notices of an intention to do so. It would be a breach of the Data Protection Act 1998 to share data relating to these customers without first obtaining their consent. Even for those lenders who have been sharing data for long periods, there are still significant numbers of accounts about which they are unable to share information with other bodies. In evidence provided to the Commission by Experian, it is estimated that data on approximately 40 million accounts is not shared for this reason and these mainly represent credit cards and current accounts, which could remain open for decades.

10 There is a view that disclosure by banks and others of positive data, without informed express consent, is a breach of the Tournier Principle which sets out the legal duty of confidentiality that financial institutions owe to their customers. This point is made forcibly by the Information Commissioner in evidence to the House of Commons Treasury Select Committee:

11 The main barrier to a wider sharing of historic data is the common law duty of confidence, rather than the Data Protection Act 1998. There is, though an interaction between the two. The 1998 Act requires that any processing of personal data is 'lawful'. A disclosure of personal information that involves a breach of the common law duty of confidence will not be lawful and will therefore also contravene data protection law. The legal advice that the Commission received is that banks, card issuers and other financial institutions owe a duty of confidence to their customers as regards the customers' financial standing and affairs. A disclosure of such information by a financial institution to a credit reference agency without the customer's consent potentially breaches this duty. There are some limited exceptions which enable disclosure of confidential information without consent. One is where there is an overriding duty to the public to disclose. Another is where, in a banking context, the interests of the bank require disclosure. The Commission's legal advice was that these exceptions could not be used to justify the sharing of positive information without consent. This legal advice also raised doubt as to whether these exceptions to the duty of confidence could be used to justify the sharing of negative information.

12 Whilst it is technically feasible for credit providers to write to their customers requesting their consent to this historic data, the number of such accounts is such that it is not considered by the Commission to be a practical option, both in terms of the timescale and the likely low response rate. The Commission considers that there is an overriding benefit to society from the disclosure of information through reduced over-indebtedness and the resulting reduction of social stress. The Commission

therefore recommends that the Data Protection Act should be reviewed to lift the legal barriers for sharing this data among credit providers.

13 There is a risk that the sharing of full data could involve predatory marketing by certain categories of lenders who provide specialist financial services to heavily indebted borrowers. However, the aggressive targeting of highly indebted borrowers – with, for example, large unsecured debts, in an attempt to persuade them to switch to secured loans – would be unlawful under the Data Protection Act 1998, as it would be a contravention of the criteria for lawful processing under Schedule 2 of that Act.

Principles of Reciprocity

14 The use of data is governed by statute and also by the Principles of Reciprocity which developed through the Steering Committee on Reciprocity made up of members of the commercial credit community, including credit reference agencies. These principles cover the supply of, and access to, credit performance data shared through the credit reference agencies. The sharing of information is based upon the governing principle that data is shared only for the prevention of over-commitment, bad debt, fraud and money laundering, and to support debt recovery and debtor tracing, with the aim of promoting responsible lending. The Commission fully supports this governing principle.

15 In the Autumn of 2004, new rules on reciprocity between the consumer and commercial databases held by the credit reference agencies were settled. Under these new rules, the following practices are permitted:

- Commercial credit providers offering small businesses services that are comparable to consumer credit products (e.g. hire purchase, credit cards and mortgages) may access consumer data on the directors/partners/sole traders.

- Consumer credit providers offering services to consumers may access commercial data to check the company/ business behaviour of a director/ partner/ sole trader.

- Credit providers offering services to both consumers and commercial organisations may access both consumer and commercial data on both consumer and commercial customers.

- Credit reference agencies offering consumer but not commercial data may partner with other providers of data. The rules are subject to the normal reciprocity requirements, so commercial lenders providing a single product to commercial and consumer customers must share data with both databases in order to access data on both databases. Further, commercial lenders providing a single product only to commercial customers may access consumer data as long as data is supplied to the commercial database. Lastly, consumer lenders providing a single product only to consumers may access commercial data as long as data is supplied to the consumer database.

16 A problem in respect of positive data sharing is that at present, under the Principles of Reciprocity, full disclosure of credit information will only be shared to a finance

institution that has itself shared full disclosure. In evidence to the Treasury Select Committee, the Information Commissioner suggested that changes in industry practice rather than legislative change should address this problem. He asked:

> 'Is part of the problem with positive information that is already shared only being available to those lenders who themselves supply positive information to credit reference agencies, rather than to all lenders? If so, then the answer lies in changes to industry practice rather than amendments to either data protection legislation or the duty of confidence.'[64]

17 The Treasury Select Committee, however, considered on the basis of the evidence it received from lenders, that the removal of legal inhibitors would enable the sharing of more data.

18 In evidence received by the Commission from the Finance and Leasing Association, it became clear that under the Principles of Reciprocity, full disclosure does not include all data. For example, information regarding debtors only making minimum payments on credit cards, is not disclosed. Further, the Debt Commission is aware that details of overdrafts below £2,000 have not been reported to credit reference agencies. There are some credit providers, such as home credit lenders and cheque cashers who see no benefit in sharing data – these are low-value borrowings and it is argued that the cost of sharing data can be disproportionate to the benefits.

19 The Commission rejects this view. The Commission considers that all finance data should be disclosed as this can make a significant contribution to preventing over-indebtedness. This means the sharing of more records but, in addition, it means the sharing of more detailed data on records that are already shared, notably, data on credit card accounts to indicate whether the customer is making only the minimum repayment each month, and whether the customer is withdrawing cash and using credit card cheques.

20 Accordingly, the Commission proposes a legislative change, notably, that a condition of consumer credit licenses for finance institutions should be full disclosure of all data.[65]

Sharing data on Student Loans

21 At present, data about student loans are not fully shared as they are not underwritten in the usual commercial sense. A student registered on a qualifying course with a recognised further and higher education institution, is eligible for a loan, unless they are already in arrears on a previous student loan.

22 There is a strong argument for student loan data to be shared on public policy grounds. The NUS estimates that the average cost of a university education is £8,584 outside London and £10,186 in the capital. With student loans currently at £3,071 and £3,714

64 Ibid., Ev 75. 65 The amended consumer credit directive published by the European Commission no longer obliges member states to set up national "consumer credit" databases enabling lenders to identify consumers who are already financially over-stretched. Instead, the proposal would require all existing databases on consumer credit to be opened up to all EU credit companies.

respectively, many students are financing all or part of the balance with commercial borrowing. Many students assume that they can service their debt post-graduation, with an average estimate of four years to repay the sum outstanding. In fact, however, in evidence presented to the Commission, it takes more than double that period for most students to repay their commercial borrowings. With tuition fees due to rise in 2006 in England and Government aspirations that 50% of young people will be educated to degree standard, there is evidently a growing debt problem looming in this area. At present, only part of the picture is available to lenders assessing or monitoring the credit portion of an undergraduate or even a graduate. Given the increasing level of indebtedness which student loans represent, £12,000 on average in 2004 and likely to rise to over £30,000 within ten years, the time is right for the matter to be reconsidered.

23 Whilst there is a proven case for commercial lenders to share and access data from credit reference agencies, the Department for Education and Science and others have previously argued that the case differs for student loans. When the matter was raised in 2000 it was rejected by the Department. The Commission is aware from evidence it received from Experian, that the matter of sharing data on student loans has been raised by commercial purchasers of student debt, and also as a result of pressure from both the credit industry and the Over-indebtedness Taskforce. The Commission considers that there is a strong case for data on student debt to be shared with lending institutions.

24 In their evidence to the Commission, Experian were at pains to point out the following points:

- Access to full data would enable any lending institution to perform basic checks, such as whether the students or graduates were up-to-date on existing loans.

- Students experiencing problems in either commercial or Student Loan Company credit would lead to creditors taking early action to help students manage the process.

- Registration of defaults is likely to provide an incentive to students to pay their debts and manage their finances at an earlier stage, thereby reducing the need for litigation.

- Reduction in costs to the Student Loan Company and increased efficiency as the number of students in arrears and at default reduce, is estimated by the student loan company to be around 10%.

- Increased data will enable the Student Loan Company to differentiate between can't pay and won't pay students, as there is evidence that there is a proportion of the population that could pay their student loans but are not doing so.

- The student loan company could use traditional credit scoring methods to identify at risk students at application and provide suitable guidance.

- The record of good performance on student loans will assist in obtaining access to commercial credit for students in the future.

25 It is the Commission's view that student loan data should be shared. In evidence presented to the Commission by Experian, it appears that there are no insuperable practical problems to sharing such data. Old style student loans can be processed on a monthly basis, in a similar way to commercial loans, if full data is shared. They do need to be kept separate from commercial loans, and for this reason it is not anticipated that the student loan company loan would be included in the scoring summary totals. Defaults, however, could be processed in exactly the same way as those of commercial loans. In the case of new style loans, collected through the tax system, then such a portfolio would have to be managed annually by way of an April update from the Inland Revenue. Defaults in respect of such loans may be treated like any others.

Sharing Other Data

26 The Commission considers that additional data sources should also be shared, and that these should include employer information about staff loan schemes, utilities companies, councils in relation to council tax and housing rents, and housing associations in relation to property rents. The evidence from Experian suggests that, while some utility companies do share data, for many barriers exist to providing data to credit reference agencies. As a result, the necessary consent to the data processing cannot therefore be given. It may be difficult for the utility companies to identify with precision the debtor. A named debtor is often not identified by water companies as they are required to provide a service even if the occupier refuses to divulge their identity. It is hard to understand why any consumer needs to be able to exercise such a degree of anonymity, unless they intend to defraud. This legislation needs to be reviewed.

27 In addition for all of the utilities, the name they hold is not necessarily complete or accurate e.g. there may be no forename or date of birth. For other companies, a significant number of people do not notify their supplier when they move address, so that the utility may not know who is actually using the service at a point in time.

28 The Commission also received evidence that some energy companies (gas and electricity) are required to supply on the same basis as to the previous occupier, irrespective of the risk associated with the new customer. This may result in a consumer being supplied with an inappropriate service and unnecessary expenses. Some utilities are specifically prevented because they have no exercisable contact in law. Energy companies which are in a monopoly situation are precluded from sharing data, as the consumer has no choice but to agree. Finally, most utilities have not included consent to share on previous supply agreements, where they have one. Many companies still operate on deemed contracts, particularly for home owners.

29 In evidence provided by Mr Martin Brassell of HPI, it became clear that providers of Hire Purchase finance have diversified into making personal loans. Where these loans are linked with the acquisition of a motor vehicle, they are sometimes registered with the asset registration agencies, HPI and Experian. This appears to the Commission to be good practice. Disposal of the vehicle by the consumer will trigger information from the asset registration agency to the original finance institution who may then be

in a position to remind the consumer that the purpose of the loan was to acquire the vehicle. Whilst disposal in itself cannot, as a matter of law, accelerate liability in this respect, nonetheless, that registration is a useful mechanism and promotes responsible lending. It can help to curb over-indebtedness which can occur if the consumer were to sell the car without settling the outstanding finance.

30 The Commission recommends that the Data Protection Act 1998 be reviewed with a view to removing the legal barriers to sharing finance data among credit providers particularly data held by utilities, employers with respect to staff loan schemes, councils in relation to council tax and housing rents and finally housing associations in relation to property rents.

Summary to Chapter 8

1 The decision of how much to lend to an individual is best made when the lending institution has access to the widest possible information on the individual's financial status.

2 At present data sharing between lending institutions and other bodies such as local councils, housing associations and utility companies is inadequate.

3 Student loan data is an important category of information not currently shared at all.

4 The scope of the 1998 Data Protection Act does not allow for the sharing of complete financial data. The sharing of default data (missed payments, arrears, bankruptcies) and positive financial data (credit limits, account history, level of repayments) will improve the assessment of risk in the individual's ability to pay.

Recommendations

1 The Data Protection Act should be reviewed with a view to lifting the legal barriers to sharing financial data among credit providers, and obliging them to supply data to the credit scoring agencies.

2 A condition to the granting of consumer credit licenses to financial institutions should be the requirement to make full disclosure of all relevant financial data to other lending institutions.

3 Student loan data should be disclosed to the credit reference agencies.

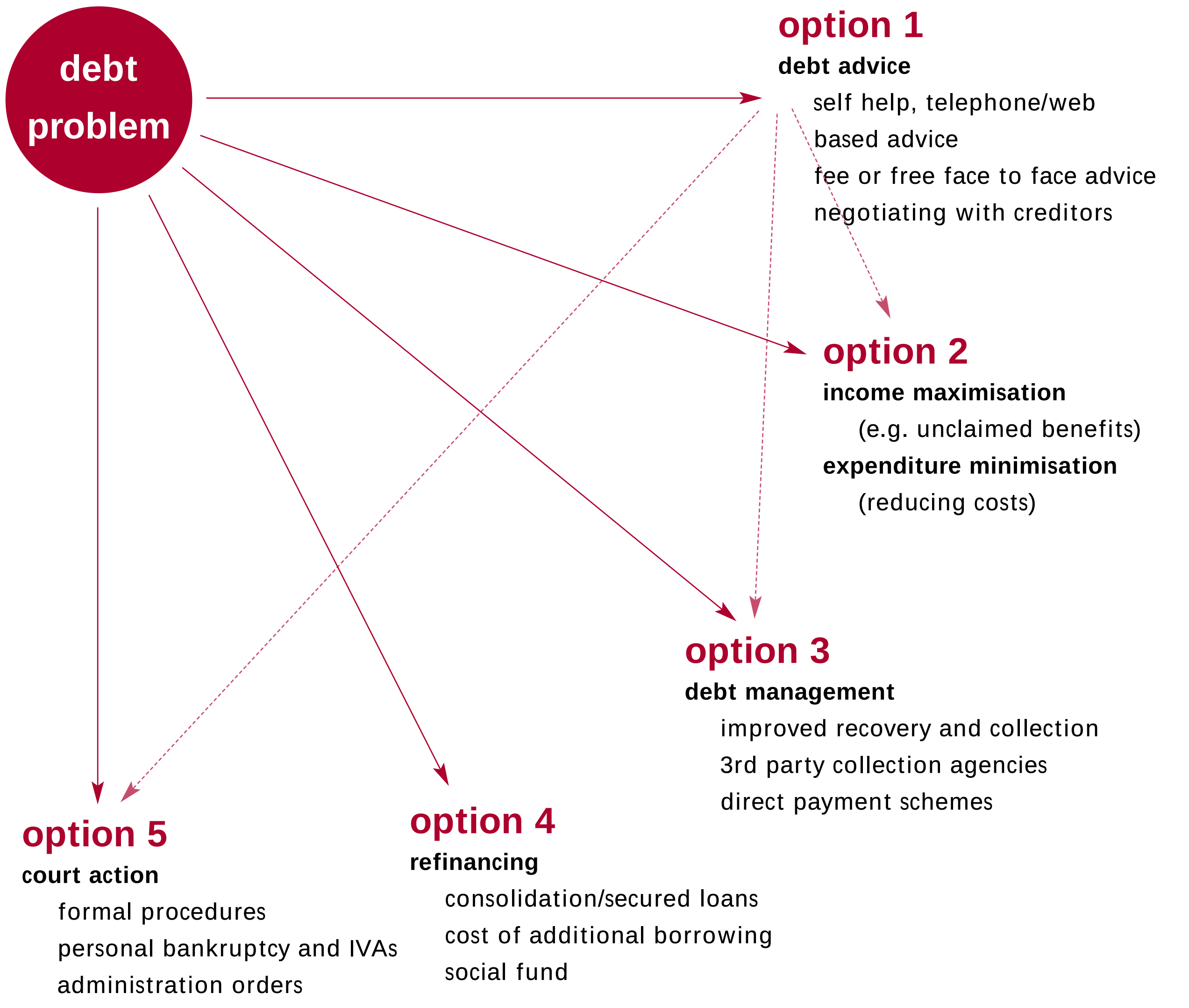
4 The Data Protection Act 1998 should be reviewed to remove the legal barriers to the sharing of financial data from non-credit providers, particularly data held by:

- utility companies
- employers in respect of staff loan schemes
- councils in relation to council tax and housing rents, and
- housing associations in relation to property rents

9 Getting People Out of Debt

1 As identified in earlier Chapters, there are numerous factors which play a role in debt spirals. These include, for example, the particular circumstances of the borrower, the debt collection practices employed by creditors, benefit entitlements and the effect of court proceedings. The approach taken to getting people out of debt will therefore vary according to the particular circumstances of each case and the following Diagram sets out the various options which may be used: namely, recourse to debt advice, increasing income and reducing outgoings, refinancing, improving debt management systems and pursuing legal remedies such as bankruptcy.

Options for Getting Out of Debt



Debt Advice

2 The obvious starting point for people who realise they have a debt problem is to seek advice. Citizens Advice statistics show they received over a million debt enquiries in 2001/02.[66] However, the figures for people actually seen appear to be smaller and in a recent letter to the Competition Commission, the Consumer Credit Association claim the figures for people advised by the biggest organisations are 200,000 by Citizens Advice Bureaux, 150,000 by adviceUK members, 45,000 by the National Debtline and 200,000 by the Consumer Credit Counselling Service.[67]

3 There are three broad options for people wanting advice on how to deal with a debt problem:

- 'self-help' using material which provides guidance on the budgeting process and on approaching creditors with realistic repayment proposals.
- seeking telephone or web based advice, where debt management plans are drawn up and sometimes administered by the advice agency.
- obtaining face to face advice, through which more complicated problems can be unravelled and a wide variety of options explored in order to find the best solution.

CASE STUDY

When Alfred retired from work, he found his household bills started mounting up. As his only source of income was his state pension, he began using credit and store cards as the easiest way to 'afford' purchases. At the same time, his bank increased his overdraft facility.

Two days after the sudden death of his wife, the bank approached Alfred and offered him a loan to provide 'a proper funeral.' A signed up to a £14,000 consolidation loan secured against his home.

Alfred also kept his credit cards 'just in case.' Over the course of time, the balances began to creep up so that Alfred found it increasingly difficult to meet the repayments.

He therefore turned to his local debt advice centre. They advised him that he was entitled to pension tax credits as well as a 25% rebate on council tax. After increasing his income through obtaining these entitlements, they helped him establish a manageable repayment plan by negotiating with his creditors. Through this intervention, he escaped having his home repossessed.

4 The first option for a debtor is to liaise with the creditors him or herself. The British Bankers' Association Banking Code states that:

66 Citizens Advice, *In Too Deep,* p.7. 67 Consumer Credit Association, letter to Competition Commission, 10 February 2005.

> 'We will consider cases of financial difficulty sympathetically and positively. You will usually spot problems first and should let us know as soon as possible… We will do all we can to help you overcome your difficulties. With your co-operation, we will develop a plan with you for dealing with your financial difficulties.'[68]

5 Self-help is a useful starting point for many people in debt. Questions have been raised, however, about the strength of the borrower's experience and bargaining position relative to the creditor. That is why self-help materials have been designed by a number of sources (e.g. National Debtline) to assist debtors map out their financial situation and re-negotiate manageable repayments with their creditors. Nonetheless, the Commission believes that the majority of people are unaware of the availability of these materials and that the quality of the resources is variable. It is important to ensure that self-help materials providing clear and impartial advice in a simple format are made widely available at no cost through places such as libraries, Town Halls, doctors' surgeries and the internet.

6 Secondly, there is a question over the extent to which creditors are prepared to negotiate with borrowers who are not represented by a debt advice centre. Notwithstanding the Banking Code, Citizens Advice research found that 'half [their] debt clients had tried to negotiate reduced payments with their creditors themselves before seeking advice, most had not received sympathetic responses from their creditors.'[69] This experience chimes with some of the evidence received from advisers around the country who said that in their experience, many lending institutions were not good at re-negotiating, until a third party adviser is involved. One witness told us that many creditors (although not all) were unhelpful, insisting on consolidating the loan as the only strategy for dealing with the debt and refusing to consider freezing the interest component.

7 Telephone and web-based advice can be an effective way to help people in debt because they provide a quick and confidential service. According to the Telephone Advice Pilot Evaluation report, 'telephone advice lines do increase access to legal advice for many people and without the lines, significant numbers of clients would not have sought help at all.'[70] The principal telephone advice services, the Consumer Credit Counselling Service (CCCS) and the National Debtline, have experienced increasing numbers of calls, with over 250,000 new calls between them last year and nearly double the number of calls in January 2005 compared to the previous year.

8 Telephone and web-based debt advice services are able to offer advice and help set up repayment plans with creditors. Their services are well funded through the Community Legal Service, central government and private funding. The model is efficient in terms of time and cost savings and it makes sense for many people in debt to be directed through this route in the first instance. However, there will always be a significant number of people who, because of the complexity of their situation, or the nature of their personal circumstances, will need face to face help and so, while the

68 S.14, British Bankers' Association, *Banking Code,* March 2005. 69 Citizens Advice, *In Too Deep,* p.3.
70 Community Legal Service, *Methods of Delivery Telephone Advice Pilot: Evaluation Report,* 2003, p.7

growth of telephone and web based debt advice should be encouraged, it should not be seen as a replacement for the provision of face to face advice.

9 Face to face debt advice is typically time consuming, complex and results in a great deal of negotiating for each case. However, it is a source of help which remains popular despite the growth of telephone and web-based advice. The opportunity to sit down with a sympathetic and non-judgmental adviser is an important means of support during a time of great emotional pressure and debt advisers will often relieve the stress of having to negotiate with creditors by undertaking this work direct. It is therefore not surprising that face to face advice is highly sought after and all the evidence received suggests that supply is far out-stretched by demand. The evidence of one advice centre in South Wales was not unusual when they told the Commission: 'whenever we open a new centre we are immediately deluged. Currently there is a six week waiting time for an appointment.' Such a delay is likely to be unacceptably long if an imminent court hearing has been fixed, or key utilities are about to be disconnected, or bailiffs are knocking constantly at the door.

10 Face to face advice may be free or chargeable. Fees can be charged by a licensed adviser either as an initial payment, or more usually as a percentage in the pound of repayments made to creditors. Providers of this type of service typically include insolvency practitioners and debt consolidation companies. They commonly advertise through publications such as Yellow Pages or national newspapers. According to an Office of Fair Trading review, fee-charging debt management services have grown rapidly since the mid-1990s for a number of reasons, including:

- increasing levels of indebtedness
- funding constraints on the free debt advice sector resulting in an unmet need for money advice
- the lack of awareness of the existence of free money advice
- the ability for fee charging debt management companies to advertise their services.

11 All debt advice agencies (whether fee-charging or free) must be licensed by the OFT and have to comply with the debt management guidance directive. This aims to ensure minimum standards across the whole debt advice regardless of whether or not the advice is paid for.

12 Debt advisers have differing views on the fee-paying advice sector. Nick Pearson told the Commission:

> 'adviceUK has maintained a view that there is a role for profit making companies as providers of debt advice; we do not see any inherent contradiction in providing debt advice for a fee as many of today's debtors are not poor and can afford to pay for advice, thus relieving the pressure on advice centres, where demand for debt advice far outweighs supply.'

13 Other advisers, however, have strong reservations about the extra burden fees add to already pressing debts and suggested that some providers took advantage of their

clients vulnerability by charging excessive amounts and deducting them before the creditors even knew about their involvement. One told us that 'unregulated intermediaries who advertise on back of tabloids charge £900 simply to refer the matter to a licensed insolvency practitioner.' A *Which?* report in 2002 concluded that the fee paying advice industry 'is showing a shocking contempt for the OFTs standards. People in serious debt are desperate and vulnerable, and it's far too easy for Debt Management Companies to take advantage of that.'[71] It is understood that the OFT will soon issue further guidelines regarding fee-charging debt advice and its recommendations will be of interest.

14 A particularly interesting model has been developed by the Consumer Counselling Credit Service (CCCS). Of the 175,000 new calls that the CCCS received last year, approximately 10% of callers were put onto a debt management plan whereby the CCCS collect and distribute monthly repayments on behalf of the debtor to the creditors. As part of this arrangement, most creditors agree to pay the CCCS approximately 10% of each monthly repayment. This contribution is sufficient not only to cover the costs of negotiating and running the debt management plans, but also to assist with pointing the other 90% of callers with less complex problems to self-help materials or other assistance. This model works in the lenders' own interest due to the savings in collection costs, litigation and written-off debt.

15 The evidence received suggests that a variety of alternative options for help and advice needs to be made available. For some people, literacy problems may make the use of telephone, web based or self help debt advice materials difficult. Particular cases maybe so complex that they require face to face support over a series of meetings. Others, however, prefer the speed and anonymity that telephone and web based advice offers. Some will want to take control early on and deal personally with their creditors. All models should be encouraged and supported – but particularly, in terms of low income families caught in debt spirals, those models which provide free advice.

16 The personal and professional service provided by small independent advice organisations responding to local needs was impressive. However, they seldom experience a level playing field when it comes to local government funding. For example, adviceUK represents nearly 1,000 members of which about 330 provide debt or money advice to the public. They estimate they advised about 150,000 people with debt problems in 2003. However, Nick Pearson described adviceUK as 'the poor relation to the CAB' and told us:

> Given that advice centres are regularly involved in a competitive tending for contracts against each other we find it totally iniquitous that Citizens Advice receives approximately £20 million every year from the DTI to support the work of Citizens Advice Bureaux, whereas adviceUK receives no public funding to support the work of our members.

71 'Debt Management Companies Not Up to the Job', *Which?* magazine, 26 January 2003, p.29

17 The contribution that dominant organisations such as Citizens Advice and the Consumer Credit Counselling Service make in their respective sectors is recognised. For example, CCCS' high telephone answer rate exceeds 85% and compares favourably with other telephone advice providers. Nonetheless, no charitable organisation should grow so dominant because of public sector funding as to make it difficult for smaller local initiatives to develop and grow. Encouraging a diverse provision of local advice centres would help to develop innovation, efficiency and best practice.

18 Although it is essential that small independent debt advice organisations should continually strive to attain best practice, there is a growing tendency towards increased regulatory requirements and the 'professionalisation' of the sector by umbrella organisations such as the Institute of Money Advisers. This will inevitably hamper the viability and effectiveness of voluntary and civil society organisations. Many of these organisations complained that such regulation 'prevents us from doing our primary role' and favours larger quasi-public sector organisations with paid administrative staff and longer opening hours. Organisations such as the Institute of Money Advisers and adviceUK avoid unnecessary regulatory demands.

19 Independent advice centres should be promoted by referral organisations on a fair and proportionate basis. The Office of Fair Trading, which licenses debt advice centres, should therefore be required to maintain a directory of all debt advice providers which is made available through the internet and locally through libraries, town halls and other public places. If the National Telephone Gateway develops, it should also be monitored by the OFT to assure its allocation of work is undertaken on a fair and competitive basis.

Increasing Income and Reducing Outgoings

20 Helping people to take advantage of opportunities for raising their income and reducing outgoings is an obvious but important tool for helping people get out of debt. In both cases, it is important to be realistic about the circumstances of the debtor and what is manageable. Income may be increased through extra work, a change of job or increased benefit payments (see below). Alternatively, budgeting skills may be used to reduce costs through, for example, better use of food provisions or changing to a cheaper energy supplier. Many advisers, however, emphasised the importance of individuals deciding what they can and cannot go without. In general, it is not for creditors to exercise judgement over a debtor's lifestyle, although in cases of default they are entitled to ask for a breakdown of the debtor's income and expenditure.

21 Advisers also emphasised the danger of people in debt cutting down on necessities. Claire Whyley of the National Consumer Council warned '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.' The Commission heard of an elderly lady who had been forgoing heating her home during winter in order to pay back her creditors.

22 A particular concern that emerged during our evidence taking is the extent of benefit entitlement that is unclaimed. British Gas, for example, told us of their programme to

help clients experiencing payment difficulties by checking their benefit entitlements. On average, they found people were entitled to £1,400 per annum more than they were claiming. Jill Harrison, the Head of Consumer Affairs at British Gas, said to us 'we have been consistently saying [to government] that the best you can do for someone in debt who is on a low income is to try and help them realise their benefits.' This area requires closer government attention.

Debt Management

23 Organisations such as the TDX Group and British Gas brought to our attention the necessity for creditors to develop more sophisticated customer management systems so as to help borrowers avoid getting into arrears and to better manage those who do. Mark Onyett, chief executive of the TDX Group, persuaded us of the long term business benefits of a more customer-oriented approach to people in debt because of the trust and relationship it creates for the future. He advocated the importance of monitoring customers and seeking early information in order to deal with any situation before it becomes a serious problem. He also argued that where arrears accrued, creditors should seek, in so far as is possible, to work in partnership with debtors towards a 'joint benefit' rather than adopting a confrontational approach.

24 The same organisations also emphasised the importance of using better data analysis to segment debtors according to their circumstances and of employing diverse strategies for different situations. British Gas spoke of 'looking to capture information from every contact with customers we have' in order to assess the nature of a customer's situation. At the most basic level, it distinguished between those who are unable to pay and those who simply choose not to pay – the so-called 'can't pay, won't pay' divide. According to a study by Dominy and Kempson, 'the majority of those taken to court are unable rather than unwilling to pay.'[72]

25 In terms of families on a low income, the use of more sophisticated approaches to debt management and debt collection also applies to local councils. Since council tax arrears, rent arrears and delays in housing benefit payments play an important part in the debt spirals of many people on low incomes, it is important that the information systems and the culture of these organisations is benchmarked against the best practice pursued in the private sector. Graham Farrant, however, the chief executive of the London Borough of Dagenham and Barking, told us that the culture and systems in local government often prevents the sharing of information between different departments when a customer is in arrears. He said 'it is ludicrous we do not see the whole picture, often until we are in court. We should be able to liaise with other departments first and put all the council information together on council tax, parking fines, rent arrears, housing benefit and so on.' Existing practice in certain local authorities is profoundly unhelpful for dealing with debt spirals. Local councils should be encouraged to develop more enlightened debt management and prevention systems.

26 Third party debt collectors are being used increasingly by creditors to pursue outstanding debt. Statistics suggest that these collectors are being instructed earlier,

72 N Dominy and E Kempson, *Can't Pay or Won't Pay*, Department for Constitutional Affairs, 2003.

with 39% of creditors waiting less than 30 days after the debt is due.[73] There is evidence that some of these third party debt collectors employ more confrontational approaches to their debt collection work. In a recent survey it was found that:

- The debt sale/ purchasing market is perhaps the fastest growing segment of the debt collection industry.
- Prior to litigation, a creditor is contacted on average eight times by letter and six times by phone.
- In 2003 more debt collection agencies were using court action to recover debts than in 2001. Debt collection agents are more likely to pursue debts in the courts.[74]

27 This evidence suggests that there is a need for third party debt collectors to develop the same customer-oriented approach to people in debt as described above and to avoid unnecessarily heavy-handed approaches to collection. This is important both in terms of being realistic about the debtor's ability to pay and in terms of the long-term reputation of the original creditor who, as Brad Cooper, the chief executive of G.E. Capital told the Commission, remains associated with the collection agencies behaviour, even after a debt has been sold on.

28 Direct payment schemes can help people to better manage their situation and get out of debt. The Government's initiative to introduce basic bank accounts is designed to help people on a low income be able to make regular standing order or direct debit payments. This can be of real help to people in debt who have to ensure regular repayments. However, according to recent statistics from the Treasury, there are still 1.9 million people in Britain who are currently without access to such accounts. In addition, there are a further 3.5 million people who only have a Post Office card account which does not cater for direct debits.[75]

29 For those on Income Support and Job Seekers Allowance (income based), a direct payment scheme operates so that the recipient can arrange for priority bills, arrears and sometimes debt repayments to be deducted directly from their benefit payments. Creditors (including local councils) are more likely to agree to lower payments because they are guaranteed to receive their money on a regular basis. The scheme has the added benefit of enabling people to rebuild their credit worthiness as they meet their regular payments over a course of time. This scheme could be extended to apply to people on long term sick benefit and those within the tax credit system.

Refinancing

30 Re-financing is another option people use to get out of debt. Elaine Kempson found that 15% of households had used loans in the previous 12 months to repay creditors or to make ends meet, suggesting that loans are being used to pay basic household bills.[76] For some, the opportunity to reduce all their credit commitments into one 'consolidated' payment at a lower interest rate can provide the lifeline they need; and the vast growth in the marketing of 'consolidation loans' is evidence of the popularity

73 CMRC, *The Debt Survey,* October 2003, p.63. 74 Ibid., p.94. 75 Royal Mail Group News Release 2004.
76 E Kempson, DTI Survey, p.35.

of this approach for people in financial difficulty. Advisers told us that it is not unusual to see clients who already have one or two consolidation loans as well as credit card debts.

31 However, a number of witnesses expressed deep concern about the use of these products where the underlying cause of the original indebtedness is not addressed. One adviser told us 'if consolidating the loan is the end of the matter then it is perhaps reasonable. However, we know that the root issues often continue, including the lack of budgeting skills and the temptation to continue taking out credit cards.' Likewise, Elaine Kempson has written that:

> 'Although refinancing can reduce the payments that households have to make on their total credit commitments, there are concerns that it is often only a short-term solution and that many of these households would do better to seek advice from a free money advice centre.'[77]

32 Advisers are particularly concerned about consolidation loans which are secured on property. As one adviser told the Commission, 'all advisers would agree that turning existing debts into a consolidated and secured loan is a bad decision. It is better to deal with the existing unsecured situation.'

33 In the face of the strong marketing of consolidated loans, many people in debt are insufficiently aware of the strengths and weaknesses of a consolidated loan which is advertised as the solution to their problem. These adverts should carry an explicit reference to a national debt telephone helpline.

Court Action

34 In order to consider the formal legal mechanisms for tackling over-indebtedness, both the debtor's ability to pay and their commitment to doing so should be taken into account. Kempson and Dominy have provided a helpful classification out of which the following distinctions emerge:

- Those who won't pay, including instances where disputes arise in respect of a debt or when debtors are seeking to avoid and/or delay payment

- Those who in time could pay, through prudent financial management to smooth over a sudden change of circumstances or financial disorganisation

- Those who cannot pay, because they have no disposable income or assets and have little prospect of getting any income or assets in the foreseeable future.[78]

35 Different policy responses will be appropriate in each scenario. In the first case, court enforcement action is likely to be necessary. In the second, temporary relief from enforcement may be most appropriate. In the third case, rehabilitation through debt relief may well be considered.

77 Ibid., p.34. 78 N Dominy and E Kempson, op. cit.

36 At present there are two legal procedures which offer some relief for debt. The first applies to personal bankruptcy and individual voluntary arrangements (IVAs). Important reforms were introduced into the law of personal insolvency under the Enterprise Act 2002 which came into force on 1 April 2004. There is evidence of a rising trend in the number of bankruptcies of consumer debtors under the new legislation, especially as they can be discharged within 12 months. Furthermore, many of the pre-existing restrictions that previously applied to undischarged bankrupts have been lifted. Personal insolvencies in the third quarter of 2004 were the highest bankruptcy figures for any quarter since the first quarter of 1993 and represented an increase of 31% on the same quarter in 2003. Taking the bankruptcy and individual voluntary arrangement figures together, this was the highest total individual insolvency number for any quarter since the Department for Trade and Industry started keeping records in 1960.

37 Bankruptcy is an appropriate mechanism for dealing with consumer over-indebtedness. However, in the light of the costs involved, it is not an appropriate mechanism for dealing with small debts. The cost of petitioning for bankruptcy can itself be prohibitive in cases of over-indebtedness since the debtor must pay a deposit of at least £310. The minimum debt requirement for a creditor's petition is £750.

38 A proposal was put forward in 2002 to make financial or management advice available to bankrupts, either on a compulsory or optional basis.[79] It is regrettable that this proposal was not taken forward in the White Paper since education can play an important part in the rehabilitation of people in debt and could be a factor to be taken into account when deciding the timing of a bankrupt's discharge.

39 The "can pay, will pay" aspect of policy is promoted through a new "fast track" post-bankruptcy voluntary arrangement procedure which is administered exclusively by the Official Receiver. This is essentially only available to people who are able to offer something to their creditors. As a fast track procedure, there is no requirement for a creditors meeting. The proposal is drawn up and sent to the creditors, who vote by post. There is no scope for modification – the proposal is put to the creditors on a "take it or leave it" basis. As the major banks and finance houses provide most of the consumer credit, they have the greatest influence upon the terms and repayment levels expected from the debtors.

40 The new style IVAs are not an easy mechanism for consumers to get out of debt because the arrangement will have significant repercussions upon future credit ratings of the consumer affecting the cost, as well as perhaps the availability, of future borrowing.

41 The second legal procedure for relief of debt is through County Court administration orders. These orders consist of a court-based debt management scheme for people whose multiple debts total no more than £5,000. Once an order is made, interest can no longer be charged and the court will manage the debts. Creditors named in the order cannot, without the leave of the court, enforce their debts or join in bankruptcy petitions against the debtor. If the debtor fails to make a payment, the court may revoke the order. Otherwise administration orders normally remain in effect for three years.

79 DTI, *Bankruptcy – A Fresh Start,* 2000.

42 A recent Department of Constitutional Affairs paper presents arguments that the administration order scheme is, as presently constituted, flawed and that only 15% of orders are fully paid. In addition, only a small proportion of the court's costs are recovered from the orders made.[80] Another problem is that because the ceiling of ?5,000 is so low, administration orders are ineffective at helping many people with multiple debts.

43 Administration orders are inappropriate for those in the 'can't pay' group, as they have no realistic hope of repaying their creditors over time. A more appropriate response for this category of debtor would be a court-based debt relief order which would release a debtor from their debts, unless a creditor could provide evidence of non-declared assets. Clearly, a debt limit would have to be set and it would seem that a figure of £10,000 is reasonable in this context. Unlike bankruptcy, a deposit would not be needed as no full investigation of the means of individual debtors or conduct would be required. Whilst a fee will be levied for the service, the normal rules governing remission of fees would apply in hardship cases or where the debtor is in receipt of benefits.

44 In the case of those who could pay, an enforcement restriction order would be the appropriate policy response, that is, temporary relief from enforcement or, alternatively, a time order. All unsecured creditors would be treated in the same way and this would stop excessive use of enforcement proceedings by creditors. It would be necessary for the debtor to show the court that his circumstances had unexpectedly changed and that there are real prospects of improvement in the short term, say within the period of six to nine months. It would be open to creditors to object to such an order on the basis of their being seriously disadvantaged or that the debtor's claims were unrealistic. The court could make it a pre-condition before making an order that negotiation had taken place between the creditor and the debtor. If, at the end of the enforcement restriction order, there is no improvement in the circumstances of the debtor, then it will be appropriate to consider alternatives, such as a court-based debt relief order or bankruptcy.

45 Enforcement restriction orders are likely to have a heavy impact on involuntary creditors, such as utilities, council tax and the Inland Revenue. Delays in recovering debts to this group of creditors is not likely to pose a real problem, providing a high proportion of debt is eventually recovered and one of the aims of the enforcement restriction order would be to facilitate this. In many respects, delayed enforcement is consistent with the best debt management practices pioneered by utility companies such as British Gas.

46 In the case of those who can pay, the £5,000 ceiling should be raised, as this has remained unchanged since 1981. Taking into account inflation and the average profile of individual indebtedness within the UK, a new ceiling of £15,000 should apply. An order of three to five years in terms of repayment would then be both feasible and affordable.

80 DCA Consultation Paper, *A Choice of Paths: Better Options to Manage Over-Indebtedness and Multiple Debt,* 2004, p.16.

47 We are aware that repayment schedules, similar to administration orders, are run by private and voluntary sectors such as CCCS or Payplan. The advantages of these schedules over a court scheme is that they are more flexible, have no court fee and facilitate more accessible payment methods. The main disadvantage is that they are unable to bind reluctant creditors and do not provide for composition (pro rata reductions in the debts) unless by consent. The Commission considers that debt management schemes run by reputable private and voluntary schemes, focused upon "could pay" debtors, should be encouraged and that an appropriate policy response would be to provide a legislative recognition of the binding nature of such schemes.

Summary of Chapter 9

1 The demand for all types of debt advice is considerably greater than the existing provision.

2 The growth in telephone and web based debt advice, although very necessary, does not replace the ongoing need for the provision of face to face advice.

3 Small independent advice organisations often provide a personal and professional service which responds to local needs. However, they seldom experience a level playing field when it comes to local government funding.

4 The growing regulatory environment and 'professionalisation' of the sector is hampering the viability and effectiveness of voluntary and civil society debt advice organisations.

5 The lack of awareness of entitlement to benefit payments is preventing many people from efficiently re-paying their debts and often increases their over-indebtedness.

6 The debt collection systems of many companies and public agencies are significantly below best practice. They fail to use customer segmentation and data analysis to develop less confrontational and more collaborative collection practices. The innovative approach to debt management and debt prevention pioneered by companies such as British Gas provides a model of best practice.

7 Re-financing through widely advertised consolidation loans often fails to get people out of debt, and frequently makes matters worse, primarily because the causes of original indebtedness have not been properly addressed.

8 Court procedures for bankruptcy and administration orders need to take account of the diverse circumstances of different debtors, who either can pay but won't pay, can pay and will pay, or can't pay.

Recommendations

1 Organisations such as the Institute for Money Advisers and adviceUK should avoid placing unnecessary regulatory demands upon small independent advice organisations in such a way as to deter voluntary effort.

2 The Office of Fair Trading, which licenses debt advice centres, should be required to maintain a directory of all debt advice providers; and to promote this through the internet and locally through libraries, town halls and other public places.

3 Funding from central and local government should be distributed pro rata between separate advice organisations according to the contribution they make in their locality. A clear and simple mechanism should be formulated and put in place to ensure fairness between different agencies.

4 Following the example of the model devised by the Consumer Credit Counselling Service, lenders should take account of the savings in collection costs, litigation and written-off debt which debt advisers create for them by contributing a percentage of the recovered repayments to the advice service.

5 The National Telephone Gateway needs to be monitored by the Office of Fair Trading to assure its allocation of work is undertaken on a fair basis.

6 Following the excellent example of organisations such as British Gas, lending institutions, utility companies and local councils should develop more sophisticated debt management systems which prioritise debt management and prevention and result in less customers falling into arrears and higher debt collection.

7 Because the evidence received from debt advisers indicated that consolidation loans and conversion loans from unsecured to secured lending had resulted in great problems for clients, primarily because of the expectations they had created, all advertisements for these loans should display prominantly information of how borrowers can access debt advice.

8 There should be a separate review of the benefit system with respect to:

- simplifying the various credits, benefits, allowances and entitlements so that they are easily understandable, cheaper and quicker to administer
- identifying the amount of any unpaid benefits
- improving the use of direct payment schemes through benefits and salary deduction.

9 Administration orders should be reformed:

- by abolishing their use for consumers who cannot pay and replacing them with a court-based debt relief order, which releases the debtor from their debts. In such cases, the debt level should not exceed £10,000.
- in the case of debtors who, given time, could pay their creditors, temporary relief from enforcement or alternatively a time order should be available as a court-based scheme.
- only applying to debtors who have a realistic prospect of making payment, the ceiling for such orders should be increased to £15,000.

10 Money Education and Responsible Borrowing

1 While there is a clear obligation on lenders to help minimise the risks of over-indebtedness, ultimate responsibility for borrowing must in a free society lie with the borrower. As Eric Leenders of the British Banking Association in his evidence to us put it, 'it is borrowers who are best placed to assess their own ability to repay.' The Commission agrees.

The Need for Money Education

2 For this to happen, it is essential that borrowers have the appropriate information to make reasoned decisions. This is particularly so given the competitive environment which has led to relentless marketing and the large number of consumer credit products. It is therefore necessary for 'information asymmetries' between borrowers and lenders to be diminished and for the financial sophistication and skills of borrowers to increase. As HBOS said in their evidence to us, 'the multiplicity of products on offer can be bewildering for many customers.'[81]

3 Statistics show a widespread discrepancy between the financial understanding of individual borrowers and the sophistication of the products available (see the following box). Gill Hind of the FSA said in her evidence that today, two thirds of people in the UK believe financial matters are too complicated for them to deal with, and that one in five people suffer from 'financial phobia.'

The Lack of Financial Understanding

According to a MORI poll:[82]

- Nearly 80% of UK adults do not know that APR refers to the interest rate.
- 40% do not understand how mortgages or ISAs work.
- 33% lack any confidence in handling money.
- 20% struggle with the concept of inflation.
- 35% do not understand how insurance works.
- Only 30% of adults could correctly calculate what the interest would be on £2000 at 4% over two years.

In addition, other research has shown:

- Almost half of people surveyed who took out new credit in shops had not planned to do so when they left home.[83]
- Consumers could collectively save £1 billion by switching to the most cost effective energy suppliers.[84]
- 55% of adults are not saving currently[85] and over 12 million adults are not contributing sufficiently for an adequate pension.[86]

81 Memorandum submitted to the Treasury Select Committee, June 2003. 82 IFS, 'Research conducted by MORI Financial Services on behalf of the Institute of Financial Services', 21 October 2004. 83 Mintel Market Report, January 2000 cited in OFT leaflet, *Think Before You Borrow – Keep Debt Under Control,* 2003. 84 Energywatch press release, 'Government Launches Drive to Help the Poorest Cut Fuel Bills', 2 November 2004. 85 Insight Investment press release, 'Nation's Financial Health Worsens as Britons Burn the Candle at Both Ends', 23 October 2003. 86 Interim Report of the Turner Commission into Britain's Pension System, cited in The Guardian, 13 October 2003.

4 This does not mean that people who struggle with the complexity of modern financial products are incapable of managing their finances. On the contrary, the financial astuteness of many of the people whom the Commission met was impressive. Howard Gannaway of the National Institute of Continuing Adult Education (NIACE) told us that 'effectively [people] have, if you like a perimeter of capability around them, depending upon what their experience has been, what they feel comfortable with, what they know their skills to be, and if they step over that line, that's where uncertainty and threat is.'

5 Financial phobia therefore is a reality when a lack of knowledge makes an informed decision impossible. At this point, many prefer to avoid the issues in the hope that the problem will go away.

6 Nearly everyone the Commission spoke to emphasised the need for better personal money education. A representative from one of the high street banks told us that 'lots of the people who come to us for a loan really just need good money advice.' Evidence from around the country suggested that many people use credit without budgeting, and therefore have no idea whether their borrowing is sensible or sustainable.

7 Research from Professor Kempson indicates that those who are most heavily over-borrowed are those who increase their borrowing the most.[87] This is a worrying indicator as it suggests that people may be trying to borrow their way out of trouble rather than tackling the real issues. There are many examples of people who had taken out consolidated loans as a short term strategy, but because the underlying issues which had created the debt had not been addressed, later found themselves in great difficulty, as their credit commitments continued to expand.

8 A major issue of concern is the lack of literacy and numeracy within significant parts of the population. Claire Whyley of the National Consumer Council told us that about one in five people are 'financially illiterate.' According to the National Audit Office, 26 million adults have some form of financial and numerical illiteracy of which approximately ten million do not have the numeracy skills of an 11 year old.[88] To give an example of what this means: if someone purchased three items which together cost £1.58, they would be unable to accurately check the change they were given from a £2 coin. Such people are severely compromised in their ability to act as responsible borrowers in the face of the complex products available to them.

9 One challenge for public policy must therefore be the ongoing development and delivery of improved financial literacy programmes for both adults and children. This means helping people to manage their money. There seems little point in running seminars on financial literacy, if people are only likely to turn up when they have specific questions about their circumstances at that particular moment. As will be argued later in this chapter, it is far better to have material readily available to

87 E Kempson, *Household Survey on the Cause, Extent and Effects of Overindebtedness,* 2002. p.44-45. 88 National Audit Office, *Skills for Life: Improving Adult Literacy and Numeracy*, 2004.

explain what actions to take when these life events occur. Another challenge for public policy, although it is not part of this report, is how to improve standards of literacy and numeracy in basic school education.

10 There is currently a continuing debate over what money education is, who it should target and how it should best be delivered. As yet, there is no commonly agreed definition of money education or financial literacy. The National Foundation for Educational Research has defined financial literacy as 'the ability to make informed judgments and to take effective decisions regarding the use and management of money.'[89] In evidence to us, Credit Action described money education as 'equipping an individual with the knowledge, skills and resources they need to make informed judgements regarding the way they manage their money.' The Commission believes that money education is best understood in relation to one or more of the following categories:

Box 10.2 – Aspects of Money Education

Increasing Income
Helping people understand how they can increase their income through sources such as employment, benefits, bursaries and tax credits.

Budgeting and Saving
Encouraging the better use of existing income through practices such as budgeting and saving.

Forward Planning
Creating awareness of the likely future costs of particular choices, such as taking out a credit card or having a child, and encouraging forward-planning.

11 A proper definition of money education must be results-oriented. This means that effective money education is more than the dissemination of facts – it requires understanding and the development of personal skills and habits in response. Howard Gannaway from the National Institute of Adult Continuing Education (NIACE) emphasised this point when he drew our attention to the important distinction between information and learning. He said

> 'There is an absolute mountain of information out there, from all levels, from the FSA through government departments and through voluntary bodies... Certainly the anecdotal evidence I've pulled together shows that information on its own doesn't achieve a great deal.'

89 The National Foundation of Educational Research 1992, cited by ABCUL, www.creditunioncommunities.org

A recent Treasury Select Committee report offers a similar conclusion when it states 'Consumers will only respond to trustworthy information if they are properly equipped to interpret it. Raising levels of financial capability is not just about educating, informing and advising consumers, but giving them the skills and confidence they need to put their finances on a sound footing.'[90]

Money Education in Britain Today

12 The importance of good money education is being increasingly recognised. The FSA in its evidence estimated that a total of £36 million is currently being spent each year on financial capability initiatives, and that five of the top seven spenders are banks. They suggested however that there is still disproportionate attention given to responding to existing debt problems rather than prevention. It does seem that the imbalance is slowly being addressed and that there has been a marked growth in money education over the last 12 months or so.

13 Money education is provided at present from the following sources:

Sources of Money Education
- Schools
- Local Services (e.g. libraries and advice centres)
- Local Councils
- Employers
- Community Groups (e.g. Mums and Toddlers)
- The Internet
- Lending Institutions

14 There are two different approaches to money education. One emphasises the need for it to be taught from an early age and especially in schools. The other focuses on education through seminars and resources, such as books and money guides which are available in shops and libraries. Increasingly, information is also available through websites run by organisations such as the FSA and Citizens Advice.

15 The evidence suggests that the availability of suitable money education is patchy and that some groups are catered for better than others. In general terms, there are good sources of money education for school children, students and the elderly (through organisations such as Age Concern and Help the Aged). The resources for single parents, prisoners and people with limited numeracy skills appear to be expanding. However, it is often harder to find good sources of money education for ethnic minorities, the homeless and people with learning disabilities or mental health problems.

90 Treasury Select Committee, *Second Special Report,* March 2004, recommendation 49, para 5:1.

16 There is an increasing recognition that money education needs to take a holistic approach which recognises the relationship between the management of money and other skills in life. This includes basic life-skills such as food preparation. As the employee of one bank stated 'There's no point in me telling a customer to go away and budget their money, if they have to spend £5 a night on ready-made meals, because they don't know how to cook". Financial problems are also involved in a breakdown in family relationship. Cheryl Turner, the Head of Public Policy at Relate told us that the 'Implications of a problem like debt are loss of trust between the couple, fear of poverty, and eventually issues around power within the relationship, and also problems with sex between the couple (often due to the loss of trust).' Good relationship support programmes should include financial education.

17 Recent research also suggests that further thought should be given to the religious, cultural and ethical contexts within which people exercise their financial decisions. For example, work undertaken by the Basic Skills Agency (2004) and Paul Jones of Liverpool John Moores University (2005), both emphasise the danger that some groups may exclude themselves from mainstream financial education because it does not take into account questions raised by their religious traditions, for example regarding loans and interest rates.[91]

Delivering Money Education

18 The most immediate and obvious point of delivery for money education is through schools. Schools offer the potential for a uniform strategy to be implemented across the whole of the country. The goal should be that pupils should leave school competent in basic money management skills such as budgeting and the sensible use of credit.

19 In this respect the current situation is far from satisfactory. At present, money education does form part of the citizenship and PSHE (personal, social and health education) curriculum in England. However, as Gill Hind of the FSA put it to us 'so does sex and drugs and rock and roll and a lot of other things.' She went on to say that '[Although] financial capability is within the national curriculum, the problem is that in the end schools don't have to do it... While they do recognise that it's important, they also have a lot of other pressures such as league tables, stats and so on and the issue is how schools fit it all together.'

20 The reality seems to be that, despite forming part of the curriculum, money education is not being made a priority and therefore is not being delivered in a consistent or strategic way in most schools. Credit Action estimate that of 6,500 secondary schools, probably no more than 300 are providing adequate money education. In the Commission's view a much more strategic and co-ordinated approach should be implemented in all schools and in this respect it supports the proposal made by the Tomlinson Report that financial education should be incorporated into the new core element of the post-fourteen school curriculum.[92]

91 C. Loftus, *Audit of Financial Literacy Resources,* The Basic Skills Agency, August 2004, p.12; and P A Jones and T Barnes, *Would You Credit It?,* 2005, p.41.
92 *14-19 Curriculum and Qualifications Reform: Final Report of the Working Group on 14-19 Reform,* 2004.

21 A national strategy for money education needs to look beyond an effective and co-ordinated schools programme. As Nick Pearson of adviceUK put it in evidence to the Commission, even if money education was properly taught in schools, it would be '20 years before we start to see any real benefit.' Given the growth of financial services this is unacceptably slow and there is therefore an urgent need to ensure the effective delivery of financial education amongst those who have already left school.

22 Young people aged 16 to 24 have statistically lower levels of financial literacy compared with the rest of the adult population. Recent research found that only a third of 21 to 24 year olds are financially literate, compared with nearly a half of adults overall; and that young people are more than four times more likely to consider themselves over-borrowed compared to other adults.[93] They also face particular financial pressures such as pursuing further education, establishing themselves in new jobs and moving into their own homes.

23 Funding the costs of higher education through student loans and top-up fees accounts for a significant part of the indebtedness of young people. A number of witnesses emphasised that the danger of this situation is not just the current levels of debt (serious as they are), but also the message that 'to get on in life you need to borrow.' The widespread concern over these debts, however, has resulted in the availability of comprehensive and well-resourced information and advice for students, which is delivered through banks and university organisations.

24 Increasingly, utility companies are playing an important role in the delivery of financial education. Utility bills are a common source of arrears, particularly amongst low income families. Since it is difficult for certain utility companies to withdraw essential services (for example, water companies who cannot cut off supplies), they have had to be more innovative and pro-active in their approach to dealing with customers. As a result they have developed programmes such as energy efficiency advice to save customers money, signposting to other sources of help for customers experiencing money difficulties, producing free literature on how to manage money better, creating alternative payment options and developing trust funds to provide financial support.

25 The financial education that British Gas provides is particularly impressive. They have moved from a culture of debt collection to one of debt management and debt prevention. In terms of financial education, they have collaborated with MENCAP to produce a *Paying your Bills* booklet which is designed to offer practical step-by-step advice about managing household finances. This was devised because, as Jill Arend, the Head of Consumer Affairs at British Gas put it, 'it isn't that [people with learning disabilities] don't want to pay their bills, it is that they often don't understand the communication.' British Gas has also developed a *Here to Help* programme which gives proactive help on a number of issues and includes a 'benefit health check' which in less than two years has uncovered £5.5 million worth of unclaimed benefit at an average of £1,400 per year per household. This example of an innovative and

93 A Atkinson and E Kempson, *Young People, Money Management, Borrowing and Saving: A Report to the Banking Code Standards Board,* 2004, p.1.

proactive strategy to develop financial education and debt prevention sets a standard of best practice which other companies should follow and build on.

26 It is encouraging to see that over the last 12 months or so, much has been done by lenders to develop 'preventative' money education strategies. Brad Cooper, CEO of GE Consumer Finance UK, recognised that: 'It is in everybody's interest to help borrowers make decisions based on the fullest possible information.' All the major banks are involved in improving the clarity of the information they supply to customers, offering basic advice to people who are struggling to manage money, signposting customers to other sources of help and funding organisations who either provide debt advice or money education.

27 Nonetheless, more can be done by the lending community. In particular it should:

- Undertake an independent "debt audit" of all standard letters and materials sent out to customers to ensure that they are accurate, fair and easy to understand. These "debt audits" could be conducted by a recognised debt advice or money education charity.

- Provide more information to customers about their credit rating. Professor Elaine Kempson stated that it was her firm belief that everyone declined credit should be told why and what, if anything, they could do to improve the situation. Many lenders are beginning to take this seriously. ASDA Financial Services for example, offers to provide customers that are declined credit, access to a free copy of their credit reference report.

- Ensure regular training of all staff dealing with customers in debt so that their problems are handled sensitively and fairly.

28 There are other ways in which money education is effectively delivered. One of the most important is through families. Parental attitudes to money are likely to have far more impact on children than anything that is taught at school. The FSA pointed to the recent Child Tax Credit as an example of the government seeking to encourage money education within families. However money is often a taboo subject in families and often not discussed between partners let alone with their children.

29 One important and until recently neglected environment in which money education can take place is through the workplace. Employees can be distracted by debt problems, may take time off as a result of them or even in desperation steal. Howard Gannaway of NIACE referred to a business in Newcastle, which offered financial education to the employees of companies, including a three hour programme on personal financial planning. It may therefore even be in the employers own interests to introduce help in this area. Having seminars, guides, cards and posters offering free money advice and debt counselling readily available could prove of real benefit to many employees and their families. The Commission would like to see this become standard practice in the workplace.

30 The Government has been involved in the delivery of a number of financial capability initiatives including, for example, the Savings Gateway pilot which offered matched saving for people on low incomes (Treasury and DFES), funding for a financial literacy project as part of the Skills for Life strategy (DFES and DWP) and a financial literacy website (DWP).

31 The Government could be more creative in its use of the benefits system by linking life-skills education to benefit payments – including training in money skills, but also in associated areas such as parenting, shopping and cooking. Courses on such subjects are already available from local colleges and national organisations.

Making Money Education More Effective

32 It was noted earlier that approaches to money education normally advocate either school-based learning or adult education. The Commission believes that both strategies are important and should be pursued together. However, it also believes that many of the existing approaches to educating adults are unlikely to succeed because they are too generic and untargeted. They are frequently premised on borrowers taking the initiative to go out and find the resources because of their desire to develop financial skills. The evidence suggests that this type of proactive behaviour is rare. Howard Gannaway of NIACE told the Commission that

> 'Adults are opportunistic in their engagement with learning and information, they tend to wait until they hit a brick wall and then cry for help... The public perception of widespread personal unmanageable debt has not resulted in a rush of learners wishing to sign up to courses on the management of borrowing. Moreover, people do not seem to 'learn ahead' in any structured sense. Instead, people seek help when they have problems. This poses challenges for any policy designed to increase widespread personal financial capability.'

33 Research recently conducted for the MoneyBasics website reinforced this conclusion. It found that people do not want to think about money until they have to, and that very few people spend time actively increasing their financial skills when they feel financially secure. Rather, they wait until a money crisis is triggered, usually by a change in their circumstances, such as losing a job. [94] Mr. Andrew Selous MP made the same point in the recent debate on the Consumer Credit Bill when he said:

94 Intrepid Consultants, *Money Basics,* 2004.

'I am sure we all agree that prevention is better than cure. Mention has been made today of proper financial education. I welcome the work done by citizens advice bureaux and schools, but I think that money education should be tied closely to significant life events that affect people's finances – losing one's job for instance, or wanting to send one's child to university... Other examples are a relationship break-up, the birth of a child or even a change of school, as was mentioned earlier. I think it would be best for financial information to be provided at the time of such major events in a clear simple form. It could be provided in a number of places: clear simple leaflets could be provided in surgeries, hospitals, jobcentres and libraries. I cannot envisage people queuing for a course on financial literacy on a wet Saturday afternoon, but I can envisage them picking up a small sensible easy to understand leaflet while they wait to see a doctor, at a jobcentre or at the local library. Such advice must be independent, so that our constituents can trust it.'

34 Following the logic of this relationship between key life events and the need for financial education, that money education resources would be more effectively marketed if they addressed the life change events themselves, rather than money management *per se*. To this extent, they would be unlikely to mention a word on the front cover about money at all. Instead of general publications on 'how to handle money' which are distributed through the financial shelves of bookshops or libraries, the production of a series of 'What if...?" leaflets may be more effective. These could be on subjects such as *What if I Lose my Job or What if my Relationship Breaks Down?* These should be made widely available in a variety of public environments including:

Distribution Centres for Money Education Literature

GP surgeries and hospitals	Media e.g. lifestyle magazines
Tenants associations	Utilities
Supermarkets	Lenders
Mums and toddlers and other community groups	Family support agencies
Job Centres	Workplaces
Local Authorities	Schools
Health centres	Trade Unions

The resources could cross-refer to other helpful guides and websites that would provide more detail should it be needed.

35 This kind of approach would cost substantially less than some of the other models presently being advocated. Simple leaflets, of at most four pages in length, are likely to be picked up and read. This would be particularly true, if a government promoted advertising campaign highlighted the availability of such material. These leaflets together with the advertising campaign should also point people towards the free

debt advice sector. To be effectively implemented, the Commission estimates that this would require less than 10% of the £120 million set aside by the Treasury to tackle money education and advice. However, it could generate significant long term benefits. As just one example, a good preventative framework for money education would create significant savings in the NHS budget if it meant that just some of the visits to GPs caused by debt-induced stress were no longer necessary. A survey from Citizens Advice indicated that as many as 25% of those seeking help from them, were also visiting their GPs because of the stress of their debt problems.

36 In recent years lenders have taken important steps develop resources which tackle financial capability and help prevent over-indebtedness. However, we are concerned that in some cases there is an unhelpful cross-over with the marketing of particular brands or products. Shaun Mundy, Head of Consumer Communication at the FSA, told us 'I think it's pretty evident that some firms provide funding, but they're doing it at least partly for commercial reasons.'

37 Although the desire to be recognised and rewarded for taking responsible approaches to money management is entirely reasonable, the evidence suggests that in this case it could well prove to be counter-productive. In research undertaken by Intrepid Consultants, every person in every focus group said they would distrust financial advice that mentioned a particular product or brand. They found that, even when lenders offered good independent advice, people were afraid that they were being sold something.[95] The evidence sugests that it would be more effective if lending institutions work in partnership with independent charities and money support groups, in such a way that avoids specific branding or marketing.

38 The FSA, as the regulator of the finance industry with responsibility for ensuring public awareness, has taken the lead in creating a national strategy for developing financial capability in the UK They have identified seven separate 'work-streams' of schools, young adults, families, borrowing, work, retirement and generic advice. Each work-stream has a separate advisory group and will develop a specific strategy. The issue of financial inclusion runs across each stream.

39 The Commisssion acknowledges the role that the FSA is playing in this respect. However, it also agrees with the concerns expressed by Howard Gannaway of NIACE who told us that:

> The main problem we have of the work of the Financial Services Authority is to do with the breadth of its approach. We're rather concerned that it may end up with a definition of financial capability which is to do with how well you can relate to the Financial Services sector… For example, 'do you know what an ISA is?', 'when did you last review your ISA,' that sort of thing. I have stressed to them that I think the agenda needs broadening to include things like cultural diversity which they really haven't got on their radar screen at all at the moment and also things like the moral approach and moral aspects of the use of money.

95 Intrepid Consultants, *Money Basics,* 2004.

40 The Commission is also concerned that some of the work being undertaken will take considerable time to come to fruition and will result in expensive programmes. For example, the suggestion of sending 'professionally paid' advisers into schools is likely to be more expensive, less effective and much slower than developing computer programmes which could be used by existing teachers. Similarly, the suggestion that individuals can obtain regular 'financial health-checks' sound excellent in theory but is likely to be prohibitively expensive in practice.

41 There is great potential in the partnerships emerging between lending institutions and money education organisations. For example, Legal and General and HBOS worked with Age Concern to provide money advice for older people, British Gas worked with MENCAP to produce resources for people with mental health and learning difficulties and GE Capital helped Credit Action and the Consumer Credit Counselling Service to create the MoneyBasics website.

42 A Money Advice Directory needs to be developed and promoted: this is because research indicates that the vast majority of people have no idea where to turn to for help when they need it.[96] This kind of project could well be developed by expanding the material on the Support4Learning, CPAG or Basic Skills Agency sites and it could be promoted through a similar gateway to the Joined Up Money Advice [JUMA] which is currently being piloted in West Yorkshire. A few basic questions would ensure that the correct leaflets were sent out, and in addition, people could be signposted to a web site for more information or to a local free debt counselling centre should they require face to face advice.

43 One way to distribute money education resources to the lowest income families is through the network created by home credit companies. The employ roughly 27,000 agents who are proud of the personal trust created between them and their clients. These agents are ideally placed to distribute material to customers to help them manage their debt. As well as offering education, the leaflets could also signpost people with debt problems to the debt advice sector.

Summary of Chapter 10

1 Ultimate responsibility for borrowing lies with the borrower, who is best placed to assess his or her ability to repay.

2 There is a widespread discrepancy between financial understanding and the sophistication of the products available.

3 The lack of literacy, numeracy, financial capability and basic English skills is an issue of major concern in tackling the problems of personal debt in low income families.

4 Money education is an area in which public money can easily be squandered.

96 Cf. C. Loftus, op. cit. p.8-9.

5 For money education to be effective, an important distinction must be drawn between information and learning. Money education is most effective when linked to life events such as the birth of children, relationship breakdown, unemployment and bereavement.

6 Utility companies are increasingly playing an important role in money education. In moving from a culture of debt collection to pro-active debt management and debt prevention, British Gas is one of the leading companies in setting a new standard of best practice.

7 The current provision of money education in schools is far from satisfactory because it is not a compulsory part of the national curriculum post-14.

Recommendations

1 Money education should be focused on life events such as job loss, having a baby, relationship breakdown and illness.

2 A series of basic leaflets produced by money education charities, such as *What if I Lost my Job? or What if we Have a Baby?* should be developed and widely distributed through places such as Job Centres, doctors surgeries, supermarkets, and mother and toddler groups.

3 All companies that lend money should, as a matter of best practice, be subject to an independent 'debt audit'. The audit would review the appropriateness of all letters and materials sent out to debtors, the training of staff who deal directly with customers in debt and the methods that they use.

4 Money education should form part of the post-14 core curriculum.

5 A Money Advice Directory should be developed and promoted in a similar fashion to the Joined Up Money Advice (JUMA) pilot in West Yorkshire.

11 Conclusions

Chapter 2 – Is There a Debt Crisis?

1 There is a serious 'debt problem' for a small proportion of our society – roughly 3 million people. It is spread throughout the population as a whole, but disproportionately affects low income families, lone parents and people in their twenties and early thirties.

2 Although debt is a serious problem for only a small proportion of our society, the evidence suggests that up to 12 million more people struggle to repay their credit commitments from time to time.

3 Even though total consumer borrowing has reached over one trillion pounds, it does not present a risk of higher inflation or a threat to jobs. While at present there is no foreseeable threat, this should not lead to complacency.

4 The sheer scale of consumer debt has made millions of households extremely vulnerable to shocks to the economy, both from fiscal mismanagement and external factors such as oil price rises, acts of terrorism and wars. A downturn in the economy, accompanied by rising unemployment and falling house prices, would create serious economic and social problems for the fifteen million people who struggle with debt repayments.

5 We believe the Bank of England may be too sanguine in its judgment. Because the debt income ratio has increased from just under 100% to 140% over recent years, debt is a time-bomb which could be triggered by any number of shocks to the economy, at any time.

6 Student loans are a growing problem which look set to get considerably worse over the next decade as a result of the increasing cost of tuition fees and living expenses.

Chapter 3 – Debt and the Consumerist Society

7 The change in values over the past few decades now means that there is very little stigma attached to obtaining credit: the irony however is that a high proportion of those who consult advice centres feel guilty about being in debt.

8 The liberalisation of credit markets over recent decades is welcome: this has made access to consumer credit possible and empowered a large proportion of our society. It is not a social evil.

9 To argue in favour of the liberalisation of consumer credit is not to endorse a materialist philosophy of life.

10 Creating competitive credit markets will not in itself result in responsible borrowing and responsible lending.

11 There is not a level playing field between borrowers and lenders. Consumers need greater protection. The Consumer Credit Bill should be welcomed and needs to be strengthened and we make recommendations in chapters 5 and 6.

Chapter 4 – The Debt Spiral

12 The ten steps of the debt spiral are drawn from the experience of hundreds of debt advisers, working with a variety of different clients in widely differing organisations and are entirely consistent with the evidence the commission have received.

13 The major factors which signal the beginning of a debt spiral are loss of income and changes in family circumstances.

14 Almost invariably, when people have a debt problem, it has a knock-on effect on their relationships, their health and their work, which is a cost both to society and to the public purse.

15 Typically people do not seek debt advice until court action has been initiated.

16 Not all debtors go through the entire ten steps of the debt spiral, because they take measures to break out of their situation.

Chapter 5 – Challenges Facing Prime Lenders

17 Mainstream banking in the UK is highly competitive, highly innovative and provides the bulk of lending to consumers.

18 Roughly two million households in the UK are either excluded, or perceive themselves to be excluded from the financial services offered by the mainstream banks.

19 A number of steps have been taken to tackle financial exclusion including the introduction of basic bank accounts. The success of this initiative is still in question.

20 Face-to-face banking has been replaced by technology, with computerised models to assess credit risk rather than face-to-face meetings between borrowers and bank manager. The impersonal nature of modern lending has encouraged distrust between the banks and their customers.

21 In the area of credit cards, mainstream banks are vulnerable to charges of a lack of transparency, over aggressive marketing techniques and unacceptable debt collection methods.

22 The Banking Code lacks the teeth necessary to enforce standards in highly innovative and competitive markets with many players.

Chapter 6 – Sub Prime Credit Markets

23 Sub-prime markets are the only source of credit for many low income families.

24 The home credit industry rates highly in terms of customer satisfaction; at the same time it is criticised for over-aggressive marketing, high APR's and a lack of transparency.

25 Because of the short term nature of the loans, the fact they are for small amounts, the risks of

lending and the cost of weekly servicing, the APR is not a good measure of the true cost of home credit.

26 The fact that one company has nearly 50% of the market and four have nearly 70% is evidence that there may be a lack of competition.

27 The government is right not to impose ceilings on interest rates in sub-prime credit markets. Interest rate ceilings would reduce the volume of credit available to low income families, encourage illegal moneylending and cause lenders to devise ways to circumvent the ceilings. It would hurt the most vulnerable in our society, the very people it is intended to help.

Chapter 7 – Strengthening Community Finance Initiatives

28 We welcome the growth in alternative sources of credit, such as Credit Unions, Moneylines and Community Banking Partnerships. These provide low cost credit to low income borrowers, as well as offering financial advice, encouraging savings and promoting community development.

29 The ability of credit unions to compete and grow is hampered by their lack of freedom to charge higher interest rates on loans.

30 There is no example of a community finance initiative in the UK which currently has a track record of financial viability without either continued public sector funding or private sector support.

Chapter 8 – Data Sharing

31 The decision of how much to lend to an individual is best made when the lending institution has access to the widest possible information on the individual's financial status.

32 At present data sharing between lending institutions and other bodies such as local councils, housing associations and utility companies is inadequate.

33 Student loan data is an important category of information not currently shared at all.

34 The scope of the 1998 Data Protection Act does not allow for the sharing of complete financial data. The sharing of default data (missed payments, arrears, bankruptcies) and positive financial data (credit limits, account history, level of repayments) will improve the assessment of risk in the individual's ability to pay.

Chapter 9 – Getting People Out of Debt

35 The demand for all types of debt advice is considerably greater than the existing provision.

36 The growth in telephone and web based debt advice, although very necessary, does not replace the ongoing need for the provision of face to face advice.

37 Small independent advice organisations often provide a personal and professional service

which responds to local needs. However, they seldom experience a level playing field when it comes to local government funding.

38 The growing regulatory environment and 'professionalisation' of the sector is hampering the viability and effectiveness of voluntary and civil society debt advice organisations.

39 The lack of awareness of entitlement to benefit payments is preventing many people from efficiently re-paying their debts and often increases their over-indebtedness.

40 The debt collection systems of many companies and public agencies are significantly below best practice. They fail to use customer segmentation and data analysis to develop less confrontational and more collaborative collection practices. The innovative approach to debt management and debt prevention pioneered by companies such as British Gas provides a model of best practice.

41 Re-financing through widely advertised consolidation loans often fails to get people out of debt, and frequently makes matters worse, primarily because the causes of original indebtedness have not been properly addressed.

42 Court procedures for bankruptcy and administration orders need to take account of the diverse circumstances of different debtors, who either can pay but won't pay, can pay and will pay, or can't pay.

Chapter 10 – Money Education and Responsible Lending

43 Ultimate responsibility for borrowing lies with the borrower who is best placed to assess his or her ability to repay.

44 There is a widespread discrepancy between financial understanding and the sophistication of the products available.

45 The lack of literacy, numeracy, financial capability and basic English skills is an issue of major concern in tackling the problems of personal debt in low income families.

46 Money education is an area in which public money can easily be squandered.

47 For money education to be effective, an important distinction must be drawn between information and learning. Money education is most effective when linked to life events such as the birth of children, relationship breakdown, unemployment and bereavement.

48 Utility companies are increasingly playing an important role in money education. In moving from a culture of debt collection to pro-active debt management and debt prevention, British Gas is one of the leading companies in setting a new standard of best practice.

49 The current provision of money education in schools is far from satisfactory because it is not a compulsory part of the national curriculum post-14.

12 Recommendations

Chapter 5 – Challenges Facing Prime Lenders

1 The mainstream banks should be encouraged to continue their initiatives to increase the number of households with basic bank accounts.

2 Banks should be required, following the example of Barclays, to publish their lending to deprived areas of the community.

3 Lending institutions should introduce a 'traffic light system' in partnership with the credit rating agencies. Satisfactory and unsatisfactory credit ratings should be given 'green' and 'red' lights respectively; marginal decisions should be given an 'amber light' which indicates the likely presence of financial stress. An amber light should require the lender to conduct a more personal and thorough discussion with the applicant in order to assess whether or not the credit should be granted.

4 The voluntary Banking Code should be replaced by a statutory Bank Customers' Charter which sets standards for among other things:

- transparency of all charging
- techniques of marketing
- methods of debt collection
- compulsory data sharing

Chapter 6 – Sub-Prime Credit Markets

5 Because APRs introduce great distortions when used to measure the cost of credit for short term loans and of small amounts, credit providers should not be required to publish APR's on sub-prime loans of less than six months. Instead the total repayment should be made more explicit in the documentation.

6 The grounds for the OFT's reference of the home credit industry to the Competition Commission are valid. This is a declining industry and it can easily be killed by inappropriate intervention.

7 Interest rates in sub-prime consumer credit markets are higher than in mainstream consumer credit markets. Nevertheless, the Government is right not to impose ceilings on interest rates.

8 The major companies in the home credit industry have the opportunity to show greater leadership by improving transparency and creating greater public confidence in their marketing practices.

Chapter 7 – Strengthening Community Finance Initiatives

9 Legislation should be changed to allow credit unions to charge higher interest rates on loans. This is essential if credit unions are to achieve sufficient scale to provide competition to existing sub-prime lenders.

10 For community finance initiatives to grow, continued support from prime lenders is critical. We applaud those banks such as Barclays which give 1% of their profits as part of their social responsibility. We believe that all financial institutions in this market should be encouraged to follow their example and that a Community Finance Trust should be established to develop community finance initiatives.

11 HM Treasury should finance a series of pilots to determine whether community finance initiatives have the potential to be viable financially and to reach sufficient scale to compete with existing providers. But it is not appropriate that community finance initiatives should be funded permanently by tax payers money.

12 The Social Fund should be the subject of a separate review to examine whether and how it can be made a more effective source of affordable credit.

Chapter 8 – Data Sharing

13 The Data Protection Act should be reviewed with a view to lifting the legal barriers to sharing financial data among credit providers, and obliging them to supply data to the credit scoring agencies.

14 A condition to the granting of consumer credit licences to financial institutions should be the requirement to make full disclosure of all relevant financial data to other lending institutions.

15 Student loan data should be disclosed to the credit reference agencies

16 The Data Protection Act 1998 should be reviewed to remove the legal barriers to the sharing of financial data from non-credit providers, particularly data held by:

- utility companies
- employers in respect of staff loan schemes
- councils in relation to council tax and housing rents, and
- housing associations in relation to property rents

Chapter 9 – Getting People Out of Debt

17 Organisations such as the Institute for Money Advisers and adviceUK should avoid placing unnecessary regulatory demands upon small independent advice organisations in such as way to deter voluntary effort.

18 The Office of Fair Trading, which licenses debt advice centres, should be required to maintain a directory of all debt advice providers; and to promote this through the internet and locally through libraries, town halls and other public places.

19 Funding from central and local government should be distributed pro rata between separate advice organisations according to the contribution they make in their locality. A clear and simple mechanism should be formulated and put in place to ensure fairness between different agencies.

20 Following the example of the model devised by the Consumer Credit Counselling Service, lenders should take account of the savings in collection costs, litigation and written-off debt which debt advisers create for them by contributing a percentage of the recovered repayments to the advice service.

21 The National Telephone Gateway needs to be monitored by the Office of Fair Trading to assure its allocation of work is undertaken on a fair basis.

22 Following the excellent example of organisations such as British Gas, all lending institutions, utility companies and local councils should develop more sophisticated debt management systems which prioritise debt management and prevention and result in less customers falling into arrears and higher debt collection.

23 Because the evidence received from debt advisers indicated that consolidation loans and conversion loans from unsecured to secured lending often resulted in great problems for clients, primarily because of the expectations they had created, all advertisements for these loans should display prominently information of how borrowers can access debt advice.

24 There should be a separate review of the benefit system with respect to:

- simplifying the various credits, benefits, allowances and entitlements so that they are easily understandable, cheaper and quicker to administer.
- identifying the amount of any unpaid benefit entitlements.
- improving the use of direct payment schemes through benefits and salary deduction.

25 Administration orders should be reformed:

- by abolishing their use for consumers who cannot pay and replacing them with a court-based debt relief order, which releases the debtor from their debts. In such cases, the debt level should not exceed £10,000.
- in the case of debtors who, given time, could pay their creditors, temporary relief from enforcement or alternatively a time order should be available as a court-based scheme.
- only applying them to debtors who have a realistic prospect of making payment, the ceiling for such orders should be increased to £15,000.

Chapter 10 – Money Education and Responsible Lending

26 Money education should be focused on life events such as job loss, having baby, relationship breakdown and illness.

27 A series of basic leaflets produced by money education charities, such as *What if I Lost my Job? or What if we Have a Baby?* should be developed and widely distributed through places such as Job Centres, doctors surgeries, supermarkets, and mother and toddler groups.

28 All companies that lend money should, as a matter of best practice, be subject to an independent 'debt audit'. The audit would review the appropriateness of all letters and materials sent out to debtors, the training of staff who deal directly with customers in debt and the methods that they use.

29 Money education should form part of the post-14 core curriculum.

30 A Money Advice Directory should be developed and promoted in a similar fashion to the Joined Up Money Advice (JUMA) pilot in West Yorkshire.

Appendix 1

Commission Members

Lord Griffiths of Fforestfach (Professor Brian Griffiths)

Vice Chairman of Goldman Sachs International, former Head of the Downing Street Policy Unit, Director, Bank of England, Dean of the City University Business School and author of numerous works on economic policy and ethics.

Manish Chande

Co-founder and chief executive of Mountgrange Capital plc and formerly chief executive of Land Securities Trillium.

Professor Iwan Davies

Professor of Law at University of Wales, Swansea, Holder of Sir Julian Hodge Chair in Asset Finance Law, Research Director of Intellectual Property in Wales and practising barrister.

Tom Jackson

Secretary to the Commission, Fellow of The Centre for Social Justice and founder of the St. Paul's Debt Advice Centre.

The Right Reverend James Jones

Bishop of Liverpool since 1998 and Bishop of Hull (1994-98), Chair of Kensington New Deal for Communities in Liverpool, Chair of the North West Constitutional Convent, Vice Chair of the Church of England's Board for Mission and Public Affairs.

Heather Keates

National Director of Community Money Advice and founder of 35 debt advice centres across the United Kingdom. Author of debt advice training programmes and literature

Prue Leith OBE

Founder of Leith's Ltd, Leith's Restaurant and Leith's School of Food & Wine, non-executive director of Woolworth's, Whitbread, Omega and formerly board member of Halifax and Safeway, Chairman of among others Ashridge Management College, writer and journalist

Keith Tondeur

National Director of the national money education charity Credit Action, author of numerous books on personal financial literacy and frequent media spokesperson.

Appendix 2

The Regulatory Environment

Background

1 The regulation of over-indebtedness must be seen within the legislative framework which has developed over 50 years to protect consumers. The principal reforming legislation can be identified as follows:

- Hire Purchase Acts 1954 and 1964
- Misrepresentation Act 1967
- Trade Descriptions Act 1968
- Unsolicited Goods and Services Act 1971
- Fair Trading Act 1973
- Supply of Goods (Implied Terms) Act 1973
- Consumer Credit Act 1974
- Unfair Contract Terms Act 1977
- Consumer Safety Act 1978
- Supply of Goods and Services Act 1982
- Consumer Protection Act 1987
- Consumer Arbitration Agreements Act 1988
- Sale and Supply of Goods Act 1994
- Sale of Goods (Amendment) Act 1995
- Unfair Terms in Consumer Contracts Regulations 1999
- Sale and Supply of Goods to Consumer Regulations 2002
- Electronic Commerce (EC Directive) Regulations 2002
- Enterprise Act 2002.

It is evident that the pace of legislative activity increased following the passage of the Consumer Credit Act 1974. At the same time, the European Union dimension is significant in terms of consumer protection legislation and, indeed, these developments highlight the massive inroads which the EU has had in domestic consumer law.

2 The civil law can assist a consumer by imposing certain obligations and rights against his immediate supplier or manufacturer and other suppliers in the distribution chain. Consideration of these matters do not fall within the scope of the Commission's terms of reference and it did not consider the fairness of exemption clauses and the impact of the Unfair Contract Terms Directive and the Regulations which incorporate the Directive into English law.

4 The criminal law too has had a significant impact on raising standards in business and protecting consumers from illegal and undesirable practices. Broadly, the Trade Descriptions Act 1968 and Part 3 of the Consumer Protection Act 1987 have created a panoply of offences in respect of misleading price indications. At the same time,

regulations made under Part 2 of the Consumer Protection Act 1987 and the EC General Product Safety Directive 2002 promote general safety requirements which must be complied with. Again, the Commission did not consider these matters.

4 The role of the OFT in consumer protection cannot be under-estimated, including the actions in respect of policing unfair contract terms, consumer credit, misleading advertising, estate agents, shopping from home. The OFT has the power to seek Stop Now Orders against traders who breach consumer protection legislation under Part 8 of the Enterprise Act 2002 and this enables injunctive action to be taken against traders who infringe consumer protection legislation. The role of the OFT is crucial in maintaining and enhancing standards within the consumer credit business.

The Consumer Credit Legislative Context

5 The principal legislative weapon of administrative control in terms of tackling the point of reference of the work of the Debt Commission is the Consumer Credit Act 1974. The Consumer Credit Act 1974 represents a single code governing all forms of lending and abolished the Moneylenders Acts 1900-1927, the Pawnbrokers Acts 1872-1960 and the Hire Purchase Act 1965. The main objective of the 1974 Act was: "to provide for the small individual borrower the protection he unquestionably needs without setting up artificial barriers between one sort of credit and another".

6 The current Act protects borrowers in a number of ways, including: a "cooling off" period allowing the consumer to cancel the credit agreement within a certain period of time; a creditor cannot demand early payment, try to get the goods back, or end the agreement without first serving a written notice, seven days before taking action; if the borrower has paid a third of the total price of the goods under a hire purchase agreement, then the creditor cannot take the goods back without first getting a court order; if a credit agreement is "extortionate", then the borrower can apply to the courts to ask them to look at the agreement; in the case where the seller of goods and the provider of credit are not the same, the borrower can make a claim against either party in the event of non-performance of the contract. The statutory controls apply only to "regulated agreements", that is, an agreement where one person (the creditor) provides an individual (the debtor) with credit not exceeding £25,000. The second type of agreement to which the Act applies is the consumer hire agreement. The control of business activities by financiers is also a significant characteristic of the existing legislation and this is mainly through licensing of financiers, the control of credit advertisements and prohibition of canvassing, notably of personal loans off trade premises. Furthermore, there are mechanisms under the Act, as well as the common law, which can relieve the debtor of an unwanted or over-burdensome commitments involving consumer credit, notably the right of withdrawal from a prospective regulated agreement; it may be possible for a debtor or hirer to rely upon common law rights to rescind or repudiate the contract; the right of cancellation; the right of termination of contract.

7 The regulation of consumer credit is also a matter for the European Union. Current European Community rules are based on the 1987 Consumer Credit Directive. In 2002, the European Commission presented a proposal for a new consumer credit directive

since it was considered that the old set of rules had failed to set minimum standards and had failed to keep pace with the developments and requirements of the modern consumer finance market. Further, the European Commission considered that the rules of the 1987 Consumer Credit Directive effectively had been overtaken by national rules. This is certainly the position in the United Kingdom, especially taking into account any new regime consequence upon the implementation of future reforms anticipated under the Consumer Credit Bill. On 29 October 2004, the Commission published an amended proposal for a new consumer credit directive. It is the view of the European Commission that the absence of a common set of rules and lack of success in achieving true harmonisation have resulted in a failure to achieve effective consumer protection across national borders. The approach of the European Parliament is that of minimum harmonisation of rules in this area. This means that provided each member state adopts the rules dealing with consumer credit, there is nothing to prevent that country from giving greater consumer protection to its consumers under domestic regulations. The main proposals in the new draft consumer credit directive are:

- The consumer will have a right of withdrawal at 14 days from the credit agreement.
- The consumer will enjoy an inherent right to settle early and the lender will only be entitled to claim a fair and objective indemnity if the consumer exercises that right.
- Any lender in offering a range of credit products will have a duty to advise the consumer which of the products on offer is more appropriate to that consumer's need.
- Credit above 100,000 and credit agreements were the consumer is required to repay within three months will be outside the regulatory provisions.
- Advertisements for consumer finance products will have to feature a box giving certain standardised information such as the APR, the cost of the monthly payments and any fees which are required to be paid.

8 Whilst the Consumer Credit Act 1974 received Royal Assent on 31 July 1974, it took over 10 years to bring the Act fully into force. The Act was brought into force in stages and for many of its provisions the commencement date was 19 May 1985. Effectively, the Act has been fully enforced for nearly 20 years. Since the introduction of the Act, the credit market has been wholly transformed and the current credit market bears little resemblance to that which existed in 1974. It is for this reason that the DTI has been engaged in a wholesale review of the Consumer Credit Act 1974 starting with the Government's White Paper *Modern Markets: Confident Consumers* (1999) and *Fair, Clear and Competitive: A Consumer Credit Market for the Twenty First Century* (2003).

9 Following the 2003 White Paper, a number of reforms have already been implemented by secondary legislation.[1] The Debt Commission supports the thrust of

1 See the Consumer Credit (Disclosure of Information) Regulations 2004 (SI 1481), the Consumer Credit (Agreements) (Amendment) Regulations 2004 (SI 1482), the Consumer Credit (Early Settlement) Regulations 2004 (SI 1483), the Consumer Credit (Advertisements) Regulations 2004 (SI 1484), the Consumer Credit (Miscellaneous Amendments) Regulations 2004 (SI 2619), the Consumer Credit Act 1974 (Electronic Communications) Order 2004 (SI 3236), the Consumer Credit (Enforcement, Default and Termination Notices) (Amendment) Regulations 2004 (SI 3237).

these proposals in so far as they promote a transparent credit market. Consumers have suffered informational problems pre-purchase because of the complexity and the lack of transparency of standardised information, for example, in the way the APR is calculated. In addition, problems have arisen from misinformation after a consumer credit agreement has been signed through the use of large early settlement fees and other hidden costs. The abolition of the early settlement rules based on the rule of 78 and replaced with a fair premium seems sensible and also the amendments made to the advertising of APRs to ensure that APR calculation is standardised, is appropriate. There is broad cross-party support for the White Paper and the Regulations that resulted from it. It is for this reason that there were no votes against any of the relevant statutory instruments resulting from the White Paper.

The Consumer Credit Bill

10 Significant reforms which begin to modernise the law of consumer credit are set out in the Consumer Credit Bill 2005. The main themes of the Bill reflect the general approach set out in the White Paper *Fair, Clear and Competitive: A Consumer Credit Market for the Twenty First Century* (2003), namely, improving the rights and redress for the consumer, improving the regulation of consumer credit business and also ensuring good workable regulation. The Commission supports the broad thrust of the main proposals and these are outlined below.

Widening the scope of protection. This is achieved through the abolition of the £25,000 limit for regulated agreements, unless the agreement is exempt, such as in the case of high net worth individuals or the agreement is entered into by the debtor or hirer, wholly or predominantly for the purpose of the business carried on, or intended to be carried on by him/her. The Commission is satisfied that adequate safeguards will be introduced by regulation in terms of declarations regarding high net worth individuals who, for practical reasons, may not choose to benefit from consumer protection provision under the proposed Act. Definitional problems may arise in respect of the meaning of "wholly or predominantly for the purpose of the business" carried out by the debtor or hirer, not least because this is not defined in the Bill and doubtless this matter will in due course need to be resolved by the courts.

Overhauling the licensing regime. This is achieved by creating more categories of licence, together with an improved fitness test based on the credit competency of the licensee. In particular, the Bill allows for a proportionate response in terms of breaches committed by licensees. Under the current law, the only option for the OFT is to withdraw the licence for breach. This is pernicious in the case of a licensee with branches located throughout the UK because it would appear that a single breach conducted by a single branch could result in what has been referred to as this "nuclear option". The Bill contains a graduated response in the restrictions that can be imposed, including civil penalties of an amount which it is arguable could be levied for each breach in the sum of £50,000.

A bloodhound role for the OFT. The OFT is given more powers to set detailed and relevant tests on who is fit to hold a consumer credit licence, to request more information from consumer credit businesses over fitness and practice issues, to place more detailed restrictions on the activities of licence holders, to impose requirement on particular licence holders where the OFT is dissatisfied with their conduct. The Commission considers that in principle these powers are both adequate and proportionate to regulate licensees' behaviour. However, the detail in respect of ongoing monitoring obligations are missing and will be left to the OFT and further guidance to be issued at a later time. In terms of the breadth of the power conferred to the OFT, which includes the right "to monitor as it sees fit, businesses being carried on under licenses" (clause 62 of the Bill), these raise issues of parliamentary scrutiny. It is the Commission's view that stakeholders must be fully consulted as to the proposals and that redress should be speedily available for any wrong determinations made by the OFT. The Commission considers that the role of the consumer credit appeal tribunal is crucial in this regard and this needs to be reflected in the primary legislation.

The abolition of extortionate credit in favour of court scrutiny on the basis of unfair relationships. The power provided to the court in relation to unfair relationships is, in the Commission's view, important particularly with regards to the following:

- The threshold of the unfair credit test is a lower hurdle than that of extortionate credit. It will move the focus of courts away from scrutiny of the credit agreement to the overall way in which the lender has dealt with a customer which could include scrutiny of advertising, what type of people are targeted, how credit is marketed and the circumstances of the borrower. The issue of data sharing may be important here and it could be argued under clauses 19-22 that in these circumstances, if a lender knowingly lends irresponsibly, the loan will not be enforced (see below).

- Under the Bill there is no provision for an interest rate ceiling. This approach appears to the Debt Commission to be sound (see chapter 6). Difficulties arise as to at what point the calculation of interest rates is made, for example, some credit card companies start calculating interest from the date of purchase, whilst some others wait until the purchase is posted to the account. Most credit cards offer interest-free periods for new purchases, but some apply them to all new purchases, while others apply it to those accounts on which there is no outstanding balance. At the same time, APR rates may be cross-subsidised by credit card companies through the imposition of hidden charges for late payment. For example, in late 2003, one in four people with credit cards incurred a penalty charge at some stage and it is estimated that the credit card companies took £427 million as a result.

- Extortionate credit can be achieved by means other than placing a ceiling on the annual percentage rate. Various techniques are used to increase the overall charge to consumers whilst, at the same time, keeping the APR of a loan within tolerable limits. The mechanisms used to hide the real cost can include: setting the basic price of the goods higher than the usual market rate so the APR is then charged on the inflated price; a minimum payment being set too low to repay the cost of the interest added, thereby causing the original debt to continue to grow and not be repaid within a reasonable period.[2] The imposition of a ceiling of interest rates could, in the Commission's view, have a detrimental effect on home credit. In evidence received, many of the small-value credit arrangements which are made in this context are, effectively, dependent on fixed-price charging for debt collection, which is beneficial to both parties, as this is clearly understood.

- In evidence received by the Commission, there were instances whereby people were encouraged to rollover debt on increasing rates of interest with additional charges. Such a practice would be scrutinised under the Consumer Credit Bill by the courts under the unfair credit test. In this respect, it is unfortunate that there is little detail in the Bill as to what is "unfair". The concept of an unfairness test is, however, known to English law and it operates in the context of the Unfair Terms in Consumer Contracts Regulations 1999. These Regulations contain a grey list that identifies what might be unfair. This is important for consistency and transparency in the law and such a grey list, if settled in the context of the Consumer Credit Bill could precisely cover the point in terms of rollover debts on increasing rates of interest with additional charges, as seen, for example, in the home credit context. The presumption, however, that all relations are, in effect, "unfair" unless proved otherwise, does appear to be excessive and could de-stabilise the law in this context. In the Commission's view, it is regrettable that the OFT has failed to provide to date definitive examples of unfair relationships which it might seek to address.

Enforceability of defective agreements. The Commission considers this to be an important counterbalance for financiers to the unfair relationships test. The issue of proportionality in respect of the enforceability of defective agreements is best dealt with by passing the discretion to the courts and the amendment to s127 of the current Consumer Credit Act, as set out in the Bill, provides for this. Passing discretion to the courts in this way will not remove consumer protection because agreements can still be found to be unenforceable.

The provision of clear information. Increasing information about the status of the loan to the consumer is good practice and this is recognised in the Bill in respect of the provision by lenders of financial statements. The debtor is already entitled at any time to request a statement of his account from the creditor but the Commission welcomes the provisions of the Bill which seek to inform consumers when they are in default and when they are charged. There is, however, an issue of proportionality in respect of the provision of information. It does not seem right to the Commission that consumer debtors should receive late payment notices when they are only two or three weeks late with payment and when they are only paying small amounts per week. Whilst the provision of information to borrowers about events affecting the status of their loans is an important safeguard against growing indebtedness, nonetheless, in the case of especially low income borrowers, the receipt of official notification by letter may unduly alarm and be

2 Cf. Jones *Would You Credit It?* 2005, p 40.

counter-productive. Other approaches in terms of notification, especially where they are sympathetic, might be more appropriate.

Greater use of time orders. The Commission supports such orders which are appropriate in those cases when time is required to remedy financial disorganisation and there is a reasonable prospect of this being successful.

An increased role for the Financial Ombudsman. The role of the Financial Ombudsman now extends to consumer credit licensees and is more of an adjudicating function, rather than investigatory, since it seeks to support accessible and lower cost dispute resolution. However, as currently drafted, there is little detail about the application of the Scheme. In evidence raised before the Commission, the issue of charging costs to the finance industry in respect of compulsory alternative dispute resolution was identified as being problematical, especially in respect of smaller transactions. While it is accepted that fees will be levied on an annual basis to fund the scheme, nevertheless, case fees are levied and if the costs ceiling is set too high, in effect, lenders will not use the service for small debt recovery.

The maintenance of voluntary termination clauses. Voluntary termination clauses are not included in the Bill, although an attempt was made at the committee stage to include an amendment to the Consumer Credit Act 1974 which would have effectively abolished such clauses. This was resisted by the Government and, in the Commission's view, this approach is sound. Voluntary termination clauses provide consumers under regulated hire purchase and conditional sale agreements with a right to terminate, provided that the debtor has paid one-half of the sum due under the agreement. In the Commission's view, this is an important safeguard for consumers in avoiding overly-burdensome debts.

- In evidence to the DTI, as part of the consultation process on voluntary terminations, the Finance and Leasing Association pointed out that in 2002, voluntary terminations peaked at 0.5% of all outstanding hire purchase and conditional sale contracts, resulting in an annual loss to the finance industry of £100 million. Since then, losses have eased although, in evidence, lenders' annual losses under voluntary terminations are now estimated at £83 million, potentially rising to £93 million pursuant to the abolition of the £25,000 consumer credit limit. The Finance and Leasing Association cites evidence from CAP that the scrapping of the limit could add £1,500 per car to prospective VT losses on high cost cars. The pattern of response to the consultation document suggests that the voluntary termination problem is effectively confined to the motor sector, although statutory voluntary termination rights apply to all regulated hire purchase and conditional sale agreements, irrespective of the nature of the assets. The Society of Motor Manufacturers and Traders and also the British Vehicle Rental Leasing Association made similar comments to those supplied by the Finance and Leasing Association to the DTI.

- In evidence to the Commission, Martin Brassell, Director of External Affairs of HPI, pointed out that the benefit of conditional sale and HP agreements to finance houses was that they enable sums to be advanced based on the current and projected value of the asset. The level of the indebtedness is therefore capped. The downside is that the asset is a depreciating one. However, it is possible to manage the risk by insisting upon a bigger deposit or option to purchase fee to better reflect the value of the goods over the term of the agreement. Agreement durations could also be shortened to reflect the lifetime value of the goods. Voluntary termination provisions give the lender an incentive to lend on goods that are fairly durable and prevent an important disincentive to lenders from tying consumers to products that perish or run out of useful economic life before the end of the agreement term.

- The Commission considers that the 50% rule represents an appropriate balance of benefit for both the hirer and the finance owner under hire purchase and consumer sale agreements. The removal or erosion of this rule could deprive the consumer of an important protection provision as it provides a legal mechanism by which consumers who are over-indebted can deal with their debt problems. Since the nature of hire purchase as a matter of legal form is that the hirer has a possessory title in the goods, the consumer cannot pass a good title in the goods to raise money to settle the agreement early, thereby potentially exasperating his or her debt problem. Whilst it is true in the context of motor vehicles, Part III of the Hire Purchase Act 1964 (as amended) provides that the hirer has a power to pass title in a motor vehicle subject to a hire purchase or conditional sale agreement, the scope of this legislation is limited because it does not apply to lease mechanisms and the benefit is confined to non-trade purchasers of vehicles who acquired them without notice of the relevant hire purchase or conditional sale agreement. Removing the voluntary termination exit from hire purchase deals would, in the Commission's view, potentially aggravate debt problems for consumers, resulting in further over-indebtedness.

11 The volumes of hire purchase and conditional sale agreements should not be under-estimated, as can be seen in the 2003 registration volumes for the various types of financial instruments recorded at HPI.

Type of agreement	New volume (000s)	Used volume (000s)	Total (000s)
Hire Purchase/PCP*	584	735	1319
Conditional Sale	212	226	439
Credit Sale	5	22	27
Personal Loan**	55	187	242
Other/unspecified	95	237	332
Total	951	1408	2359

*Contract Hire and Lease are excluded from this breakdown as these relate solely to business purchases. *PCP = Personal Contract Plan. **In the interests of responsible lending. Personal Loans are registrable at HPI if they are restricted use agreements sold through dealers, and the appropriate consents are in place.*

12 In the Commission's view, it would be regrettable if finance companies sought to avoid the voluntary termination provisions by resorting to security bills of sale. From the financier's perspective, there are advantages to a bill of sale, not least because financiers, through this mechanism, can avoid the need to obtain a court order and at any time during the agreement, a financier can immediately repossess the goods, even if only a single payment is delayed. A further advantage is that where any goods are sold subject to a security bill of sale without the authorisation of the finance house, the latter will be empowered to exercise a right of seizure and repossession against even an innocent purchaser of the goods. It is the Commission's view that the continued existence of bills of sale legislation in the context of a modern consumer credit regime is anomalous and that this legislation should be abolished.

Appendix 3

List of Witnesses

Mandy Aitken, Manager, IMPACT, Sheffield
Philip Arend, Senior Marketing Manager, British Gas
Ian Anderson, New Life Debt Advice Centre, Milton Keynes
Manoj Badale, Chairman, TDX Group
Karen Bennett, CEO, Money Advice Budgeting Service (MABS), Enterprise Credit Union, Huyton
Martin Brassell, Executive Director, HPI
Ben Broadbent, Senior European Economist, Goldman Sachs
Jeremy Brooks-Martin, Haddon Hall Advice Centre, Bermondsey
Andrew Buchanan-Smith, Speakeasy Advice Centre, Cardiff
Cabdikariim Cabdi Aadan, Somali Advice & Information Centre, Cardiff
Katie Clarke, Speakeasy Advice Centre, Cardiff
Michael Coogan, Director General, Council of Mortgage Lenders (CML)
Brad Cooper, CEO, GE Consumer Finance
Doug Curties, Chairman, Horsham Community Debt Advice Service
Ian Dancy, Haywards Heath Debt Advice Centre
Alison Davies, Director, NetCUDA
Dr. Karl Dayson, Salford University
Phil Duckworth, Loans Officer, East Lancs Moneyline
Mike Durke, CEO, The Phoenix Community Centre, Swansea
Clive Evans, Speakeasy Advice Centre, Cardiff
Graham Farrant, Former CEO, London Borough of Dagenham and Barking
Paul Featherstone, Development Officer, Swansea Credit Union
Seymour Fortescue, Chief Executive, Banking Code Standards Board
Stuart Freeman, Housing Advice Director, CHAS, Marylebone
Howard Gannaway, Financial Education Research Fellow, NIACE (National Institute of Adult Continuing Learning)
Brian Gill, St. Paul's Debt Advice Centre, Hammersmith
Theresa Gough, Cardiff CAB
Amanda Hale, Cardiff MIND
Martin Hall, Chairman, Finance & Leasing Association and Money Advice Trust
Jill Harrison, Head of Consumer Affairs, British Gas
Alexis Haywood-Old, Head of Lending, ASDA Financial Services
Gill Hind, Financial Capability Consultant, FSA
Bob Holman, Professor of Social Policy and social worker, Glasgow
Mark Hover, Chief Operations Officer, TDX Group
Malcolm Hurlston, Chairman, Consumer Credit Counselling Service
Helen Jenkins, Director and Senior Economist, Oxera
Paul Jones, John Moores University, Liverpool
Peter Kelly, Head of Financial Inclusion, Barclays Bank
Prof. Elaine Kempson, Personal Finance Research Centre, University of Bristol
Gillian Key-Vice, Head of Compliance, Experian
Mike Knight, Chair, Riverside Credit Union, Speke
John Lamidey, Director, Consumer Credit Association (CCA)
Ruth Lea, Director, Centre for Policy Studies
Eric Leenders, Director of Credit Issues, British Banking Association
Gareth Llewellyn Williams, Partner, John Collins Solicitors, Swansea
Fran Lovett, Mission in the Economy, Liverpool Diocese
Mark Lyonette, Chief Executive, Association of British Credit Unions Ltd (ABCUL)
David Magor, Chief Executive, Institute of Revenues, Rating and Valuation
Ed Mayo, Chief Executive, National Consumer Council
Sarah McGeehan, Information Director, Community Development Finance Association (CDFA)
Mel Mitchley, Director of Industry Relationships, Callcredit
Christine Moore, East Manchester Credit Union
Phil Mundy, Chair, Salford Moneyline
Shaun Mundy, Head of Consumer Communications, FSA

Jackie Nowell, Head of National Development, Citizens Advice Bureau
Paul Oliver, Formerly Operations Director, Cattles
Mark Onyett, Chief Executive, TDX Group
Shane O'Riordain, Head of Corporate Communications, HBOS
Nick Pearson, National Debt Advice Co-ordinator, adviceUK
Teresa Perchard, Director of Policy, Citizens Advice
Sandra Quinn, Director of Corporate Communications, Association for Payment Clearing Services (APACS)
Rob Parsons, Care for the Family
Professor James Powell, Pro Vice Chancellor, Enterprise and Regional Affairs, University of Salford
Faisel Rahman, Project Officer, East End Regeneration Business
David Rees, Group Legal Advisor, Provident Financial
Lynda Reid, Speakeasy Advice Centre, Cardiff
Jackie Richardson, Horsham Community Debt Advice Service
Steve Robinson, Director of Business Development, Equifax
Trista Rose, Head of Research, Consumer Credit Counselling Service
Rt Revd Dr Peter Selby, Bishop of Worcester
Edward Simpson, Senior Policy Advisor, Finance and Leasing Association
Scott Soutar, President, Credit Services Association
Greg Stevens, Corporate Affairs Director, Cattles
Colin Strickland, Manager, Riverside Credit Union, Speke
Kevin Sweeney, Manager, Blackpool Moneyline
Martin Taylor, formerly CEO of Barclays Bank
Alan Thornton, Debt on our Doorstep
Alan Titheridge, Head of Public Sector, TDX Group
Peter Tyson, Managing Finance Programme, North Liverpool CAB
Lord Vinson of Roddam Dene
Mark Waters, Church Action on Poverty
Alison Westron, John Collins Solicitors, Swansea
Mike Whitnall, Manager, Salford Moneyline
Mick Wilcox, Loans Officer, Blackpool Moneyline
John Wilson, StreetCred Credit Union, Rochdale
Claire Whyley, Deputy Director of Policy, National Consumer Council

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