# FUTURE FINANCE

## A new approach to financial capability

June 2015

THE CENTRE FOR
SOCIAL
JUSTICE

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# About the Centre for Social Justice

The Centre for Social Justice (CSJ) aims to put social justice at the heart of British politics.

Our policy development is rooted in the wisdom of those working to tackle Britain's deepest social problems and the experience of those whose lives have been affected by poverty. Our advisory groups are non-partisan, comprising prominent academics, practitioners and policy makers who have expertise in the relevant fields. We consult nationally and internationally, especially with charities and social enterprises, who are the champions of the welfare society.

In addition to policy development, the CSJ has built an alliance of poverty fighting organisations that reverse social breakdown and transform communities.

We believe that the surest way the Government can reverse social breakdown and poverty is to enable such individuals, communities and voluntary groups to help themselves.

The CSJ was founded by Iain Duncan Smith in 2004, as the fulfilment of a promise made to Janice Dobbie, whose son had recently died from a drug overdose just after he was released from prison.

Director: Christian Guy

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# Preface

Serious personal debt ruins lives. Over the past 11 years, the Centre for Social Justice's work has shown how people in our poorest communities can, too easily, become trapped in a spiral of debt from which they find it hard to escape. For those who are just getting by, the strain of a broken boiler or washing machine can be overwhelming. Without access to financial services that meet their needs, families are forced to take out expensive loans that they then struggle to pay off.

The damage can be crippling. As we have seen time and time again, whilst poverty is a cause of serious personal debt, it is also a consequence of it. Serious debt problems can undermine mental and physical health and so employment. Without work there is little chance of paying off rapidly accumulating debts. Trapped and seemingly without hope, many people consider, and too many attempt, suicide.

This is no niche issue – up to nine million people struggle with over-indebtedness and the problem is getting worse. It is estimated that this costs the UK economy £8.3 billion a year and that low levels of financial capability costs £3.4 billion. Worse still, there are 2.5 million children living in families with problem debt, hurting their prospects and the prospects of the country.

As the CSJ knows, there is more to be done to help people into work and to tackle low pay, but there is also a need for financial services that serve the needs of low-income families. For too long, these families have either had to use mainstream services that risk leading them further into debt, or they have been forced into the hands of high-cost lenders.

This report proposes a radical and essential alternative. By helping to develop a new marketplace for socially responsible Alternative Financial Institutions (AFIs) we can build a new generation of financial services specifically tailored to meet the needs of low-income families. This has the potential to bring down costs but also to grow new services that will help people budget, access timely debt advice, save and avoid future problems.

I would like to thank the JPMorgan Chase Foundation for their generous support in funding this groundbreaking research, the advisory group for their exceptional insight, and the report's author, Joseph Henson, for his great dedication to the subject.

The ideas here, if implemented, promise to change the landscape of financial services for some of the poorest people in our country, offering them better services to help confront financial problems, offering them greater financial stability, offering them hope.

**Alex Burghart**, Policy Director

# Special thanks

The CSJ would like to extend its heartfelt thanks to the many people and organisations who gave their time, expertise and research findings during evidence sessions with the Advisory Group and in interviews. Special thanks must be given to the entire team at both Moneyline and Fair Finance, not only for their work to provide affordable finance in Britain's most deprived communities, but also for giving up their time and granting us invaluable access to their business and their clients.

This report would not have been possible without the dedication and constant input of every member of the advisory group, who contributed invaluable analysis and feedback on their individual areas of expertise. Their willingness to give up so much of their valuable time to this project is a testament to the commitment each of them has to their own organisations and to tackling poverty in the UK.

Special thanks must be given to all members of CSJ staff who helped with editing and proofing, and to Claire Coutinho for her immeasurable contributions throughout the entire project, from conception to conclusion, as without her continual support and encouragement this project would simply not have been possible. Lastly, thanks must be given to Alex Burghart, Policy Director, for his guidance, trust and editorial input throughout the entire process.

We are extremely grateful to the JPMorgan Chase Foundation for their very generous support of this research. In particular, we would like to mention the tireless work of Hang Ho and Stephanie Mestrallet that went into developing this research project and their commitment to tackling finanical inclusion in the UK and around the world.

# About the JPMorgan Chase Foundation

J.P.Morgan

Across the U.S. and around the world, too many people lack the tools and resources to manage their daily financial lives, whether unexpected emergencies, or plan for the future. These individuals rely on costly non-bank financial services, such as payday loans or check cashing outlets, resulting in billions spent in fees and interest each year.

As such the JPMorgan Chase Foundation has decided to focus its efforts on enhancing the financial capability of low-income household and more broadly of underserved communities through the support of initiatives resulting in long term behavioral change.

With almost nine million people being over-indebted in the UK and only 17% of them receiving debt advice*, there is an urgent need for regulators, financial institutions and Trusts and Foundations active in the financial capability space to better understand the underlying and inter-linked reasons for over-indebtedness and people's motivation and habits in order to tackle this growing issue more effectively going forward.

J.P. Morgan has partnered with the Centre for Social Justice to work with a consortium of partners across the financial capability space in the UK to carry out this research project to assess the financial capability provision and its impact on long term behavior change, particularly amongst people who are vulnerable and at risk of financial exclusion. The objective of the collaboration is to take a comprehensive look at different financial capability provisions together, rather than in silos, share findings and insights, and provide some initial recommendations for actions that have come out from experience and expertise of experts on the front-line.

The project comes as the UK is entering into a new Parliament, and we hope the report will provide public, private and third sector organisations with useful insights as these institutions seek to reform existing provision and establish new infrastructure to meet new demands.

J.P. Morgan is grateful for all the contributions from organisations, individual experts and front-line staff who have been involved in this project. Especially, we would like to express our gratitude to the Centre for Social Justice for their leadership, analysis and convening activities to make the project happen.

While this report has been supported by the JPMorgan Chase Foundation, the contents and opinions in this paper are those of CSJ alone and do not reflect the views of the JPMorgan Chase Foundation, JPMorgan Chase & Co, or any of its affiliates.

* Sources: Centre for Social Justice *Maxed Out* 2013 and Money Advice Service *Indebted lives* 2013

# Members of the CSJ Advisory Group

**Diane Burridge, Chief Executive Officer, Moneyline**

Diane joined Moneyline one year into its operations at the beginning of 2003 from a background in the commercial manufacturing sector. Diane has been instrumental in realising the social vision of Moneyline by providing the operational expertise and platform to reach an ever-increasing customer base. In 2015 Moneyline will reach the growth milestone of £50 million lent in 100,000 loans. Since taking over the CEO role in 2013 Diane has undertaken an overhaul of the business model, delivering sustainability whilst maintaining the over-arching commitment to financial inclusion.

In 2012 she completed the Goldman Sachs 10,000 small business program followed by being awarded a scholarship in 2013 to attend Harvard Business School to complete their Strategic Perspectives in Non-Profit Management program including a study tour of US credit unions and micro credit lenders. Diane has extensive sector knowledge. She has been a member of the recent Cabinet Office Working Group on affordable lending, which has now been extended to pilot a national web portal for affordable credit.

**Professor Karl Dayson, Executive Director,
Community Finance Solutions at the University of Salford**

Professor Karl Dayson is the co-founder and Executive Director of Community Finance Solutions at the University of Salford. He is an internationally recognised specialist on microfinance and funding of excluded businesses, and a leading specialist on Community Development Finance Institutions (CDFIs) in the UK and Europe. Prof. Dayson has set up a dozen CDFIs across the UK, including Moneyline UK, where he was instrumental in developing credit assessment software that has reduced their outstanding arrears by one third.

He has over 15 years of experience in conducting research and providing policy advice on community finance for EU and UK government departments and trade associations. At the EU level, he has worked with the European Commission to develop the EU's strategic

support for microcredit institutions and drafted the European Code of Good Conduct for Microcredit Provision. In the UK, he was part of the team that conducted an evaluation of UK's CDFI sector in 2010 for the Department for Business, Innovation and Skills.

Prof. Dayson has also advised a number of local authorities and stakeholders on financial inclusion and business finance, including Glasgow City Council, Leeds City Council and Manchester City Council, as well as strategic agencies in Coventry and Warwickshire, North London, Hampshire, and Devon. His work with Leeds City Council, as part of the European Commission-funded Euro-Cities project that examined different approaches to tackling urban renewal, led to the creation of a financial inclusion strategy and Leeds being awarded Beacon Status for their work on financial inclusion.

Throughout his career, Prof. Dayson has published over 20 journal articles and three books in the field of microfinance, including the "Handbook of Microcredit in Europe: Social Inclusion through Microenterprise Development", for which he was awarded the 2008 European Microcredit Research Award for a paper on the sustainability of the UK CDFI sector. His forthcoming book concerns the role of technology in developing a new wave of global microcredit and is due to be published later in 2015.

**Theodora Hadjimichael, Policy and Research Manager, CDFA**

Theodora is the Policy and Research Manager at the Community Development Finance Association (CDFA), where she leads the organisation's research programme on building the evidence base of CDFI impact, and works with government departments to develop policy and programmes to support the sector. Before this she was an economic development consultant, where she worked with local authorities, national government departments, and trusts and foundations on programmes to increase their economic impact. Theodora has an MA in City and Regional Planning from the University of North Carolina, and a BS in Engineering from Tufts University.

**Faisel Rahman OBE, Managing Director, Fair Finance**

Faisel has a background in international development at the Grameen Bank and the World Bank, in Bangladesh. He also briefly worked as an underwriter for a syndicate at Lloyds of London and co-authored a number of books on charitable fundraising and trust funds in the UK.

In 2000 he returned to the UK and developed the first microcredit program in the UK and created an innovative debt advice service with local Housing Associations.

In 2005 he founded Fair Finance, and is currently its Managing Director. Fair Finance is a social business that aims to reduce financial exclusion and exploitation amongst poor and low-income communities in the UK.

In 2007 he was elected one of the first UK Ashoka Fellows in recognition of his work in social enterprise and the potential to make system changing impact through Fair Finance and in 2009 was recognised as a Young Global Leader by the World Economic Forum. In 2014 he was awarded an OBE by the Queen for services to Community Finance.

Faisel is currently the elected President of the European Microfinance Network and is a member of the Finance, Staffing and Operations Committees. He also writes an occasional column the Guardian Newspaper on issues around financial exclusion.

**Nick Watkins, Head of Insight and Evaluation, Money Advice Service (MAS)**

Nick joined the Money Advice Service in 2014 after more than twenty years at GfK, previously NOP. Nick has spent almost his entire career researching consumers, primarily in the area of financial behaviour. He has worked on most types of research from ethnography to passive measurement and large-scale tracking, including managing GfK's Financial Research Survey (FRS). Nick is now responsible for the innovative programme of research and evaluation at the Money Advice Service, including recently the re-design of the Financial Capability survey and the launch of the Evidence Hub. Nick holds a BA and MPhil in Industrial Economics from Nottingham University and is a Fellow of the Market Research Society.

**Sian Williams, Head of National Services, Toynbee Hall**

Sian is Head of National Services at Toynbee Hall, the world's first purpose-built university settlement and a pioneer in reducing poverty and disadvantage for over 125 years. She has been responsible for Toynbee Hall's financial inclusion programmes since October 2009, including Transact (the national forum for financial inclusion), financial inclusion training, research, evaluation and strategic consultancy.

During her time at Toynbee Hall, Sian has pioneered a new approach to financial inclusion that looks at the twin pillars of creating a financially inclusive environment and skilling people up to navigate that environment successfully. This approach includes examining and addressing the policies of organisations and institutions that can make it difficult for people to make good financial choices, and has co-led the development of the Financially Inclusive Tower Hamlets programme, which adopts this approach to tackle poverty.

Sian shares Toynbee Hall's financial inclusion expertise through forums such as the British Bankers' Association's Consumer Panel, the FCA Consumer Organisation Network, the Payments Council Consumer Forum, and works with government, industry and consumer groups in pursuit of Toynbee Hall's vision of full financial inclusion. Sian has most recently been supporting the Department for Work and Pensions' work on Universal Credit and credit unions, as well as working with HM Treasury and the banking sector on improving access to basic bank accounts. Sian also advises the financial services sector on financial inclusion issues, and is a trustee for the Money Advice Trust.

Sian previously undertook a range of policy, management, training and representational roles in the UK and overseas within her 15 year career as a British diplomat with the Foreign and Commonwealth Office.

**Matthew Field Assistant Researcher, Centre for Social Justice**

Matthew joined the CSJ in February of this year and is currently working on our serious personal debt research. Prior to joining the Centre for Social Justice, Matthew received a BA in History and Accounting and is now completing his doctorate work at Princeton University in the United States.

**Joseph Henson Author and Senior Researcher, Centre for Social Justice**

Joseph leads the CSJ's research on serious personal debt, financial inclusion and personal finance, authoring several reports on the topic including: *Maxed Out: Serious personal debt in Britain* and *Restoring the Balance: Tackling problem debt.* He was also a co-author on *Turning the Tide: Social justice in five seaside towns* and is interested in developing market-based policies to help tackle entrenched poverty in the UK. He has studied at the Europa Institut in Germany, Maastricht University in the Netherlands, the University of California in the USA and at BPP Law School in London. During his education he has completed a Master's programme in European Law and Integration, a Bachelor of Law, and a Bachelor of Arts in Economics and History with a specialism in the European Union Economics and Modern European History.

# Abstract

This report looks at the root causes of problem debt amongst low-income households in the UK through the lens of their financial capability. For too many years the issues of Financial Inclusion, Financial Education, Financial Capability, Financial Resilience, Affordable Credit and Debt Advice have been studied, and addressed in separate silos. The result is a failure to recognise that people's needs and the underlying causes of their debt are multi-faceted and change throughout their lives.

Tackling problem debt requires a new positive vision and approach centred around meeting the needs, wants and choices of people and families first, before deciding how to design and deliver the financial products and services that are demanded in a sustainable way. The radical rethinking of the issues set out in this report explores how innovative financial technologies (FinTech) and targeted investment in existing organisations could scale up a new generation of Alternative Financial Institutions (AFIs) offering financial products and services designed around the consumer demand of low-income households, rather than what people 'should do' or 'should want'

# Methodology

This report builds off of the CSJ's work over the past ten years and the experiences of its Alliance, a nationwide network of 350 poverty-fighting charities working in some of Britain's most deprived communities. Most recently, the CSJ published two reports on serious personal debt – *Maxed Out* (2013) and *Restoring the Balance* (2014) – as part of its ground-breaking Breakthrough Britain 2015 project, which mapped not only the extent of personal debt, but also the systemic drivers of debt amongst low-income households.

The research was informed primarily by an advisory group comprised of six experts from various fields and backgrounds, who attended numerous evidence sessions over a three month period. Their insight and experience helped CSJ researchers collect evidence from other organisations, analyse data, and develop both the principles and the technical details that underpin the recommendations contained in this report. Issues raised during the evidence sessions were explored further through an extensive literature review and during interviews with top civil servants, innovative FinTech firms and leading social investors, to name just a few.

CSJ researchers also held focus groups with clients of two CDFIs – Moneyline and Fair Finance – in order to better understand the realities of life for low-income households and obtain feedback on how the proposed recommendation could make a positive impact on their lives.

# Executive summary

Almost nine million people across the UK struggle with problem debt.[1] As the Centre for Social Justice has identified in previous reports, the personal cost of this debt can be overwhelming, hitting people's mental health, their performance at work, and placing a strain on personal relationships.[2] Serious personal debt is not just a consequence of poverty, it also causes poverty by damaging people's and families' ability to help themselves. Building on the work that the Centre for Social Justice has undertaken over the past 10 years, this report looks again at how new services can be developed to help people avoid serious personal debt and the damage it can cause.

This report looks at the root causes of problem debt amongst low-income households in the UK through the lens of their financial capability. We argue that for too many years the issues of Financial Inclusion, Financial Education, Financial Capability, Financial Resilience, Affordable Credit and Debt Advice have been studied, funded and provided in separate silos.

Tackling problem debt requires a new positive vision and a holistic approach centred around meeting the wants, needs and choices of people and families. This starting point then makes it possible to design and deliver the range of financial products and services required by low-income households. We believe that this can be done by building a market for new financial services which will not, in the long term, require ongoing government subsidies.

The radical rethinking of the issues set out in this report explores how innovative financial technologies (FinTech) and targeted social investment in existing organisations, could scale up a new generation of Alternative Financial Institutions (AFIs) which could be social enterprises, credit unions, Community Development Finance Institutions (CDFIs), or even for-profit firms, all of whom will focus exclusively on helping low-income customers.

By specialising in servicing this niche market, AFIs will be able to offer innovative financial products and services that are designed around the diverse needs of low-income households, greatly increasing their ability to attract customers. This means they will ultimately not need to rely on grant funding which has traditionally dictated that products be designed 'top down', based on what people 'should do' or 'should want'.

1 Problem debt: Debt that is of concern not due to its absolute value in monetary terms, but because of its size relative to the holder's disposable income, their inability to repay it, and because of the impact it can have on their health, relationships and life.

2 Centre for Social Justice, *Restoring the Balance,* London: Centre for Social Justice, 2014; The Money Advice Service (MAS), *Indebted Lives: the complexities of life in debt,* London: MAS, 2013

The result of this radical approach will be a range of scalable, innovative, cost-effective solutions that would help people maximise their financial capability and wellbeing throughout their lives, as well as help them manage their finances to avoid and recover from problem debt.

In order to achieve this goal, we set out a range of recommendations which seek to:

- Focus first and foremost on the wants and needs of low-income people;
- Develop a robust evidence base to build on and learn from the best and most innovative existing practice;
- Create a policy and regulatory system to help grow a competitive market for innovative AFIs that will better serve the needs of low-income families; and
- Support innovations in FinTech that will help AFIs grow and end their reliance on subsidies.

# Chapter one
# A new vision for tackling problem debt in the UK

## 1. Problem debt in the UK

The CSJ has established the extent and root causes of problem debt amongst low-income households in two previous reports: *Maxed Out* (2013) and *Restoring the Balance* (2014).[3] These have shown that problem debt can drive family breakdown, lead to mental health and addiction issues, prevent people from maintaining employment and even prevent children from achieving in school. The result is that many people in Britain's most deprived communities have been left trapped in a cycle of borrowing, debt and poverty:

- 8.8 million people struggle with over-indebtedness, which affects 2.5 million children;[4]
- Households in the UK now owe debts worth £1.47 trillion, more than the entire national debt in 2014;
- The failure to tackle over-indebtedness costs the UK economy at least £8.3 billion a year;[5]
- Low levels of financial capability in the UK costs the economy £3.4 billion each year.[6]

These facts highlight the need for decisive action to help protect low-income households from problem debt.

## 2. The lack of evidence and evaluations

Over the years there has been substantial academic literature and government sponsored research that has attempted to identify the various root causes of problem debt and the

3 Centre for Social Justice, *Maxed Out*, London: Centre for Social Justice, 2013; Centre for Social Justice, *Restoring the Balance* London: Centre for Social Justice, 2014

4 Money Advice Service, *Indebted lives: The complexities of life in debt*, London: Money Advice Service, 2013; StepChange and the Children's Society, *The Debt Trap. Exposing the impact of problem debt on children*, London: StepChange, 2014

5 Rowlingson, K. & McKay, S., *Financial Inclusion: Annual monitoring report 2014*, Birmingham: University of Birmingham, 2014

6 Centre for Economics and Business Research, *Potential benefits of implementing financial education*, London: CEBR, 2012

impact it has on low-income households.[7] However, the shortcoming of this research is that it has often focused on single issues in isolation and has largely failed to effectively address the multi-faceted nature of problem debt. For example:

- Research shows that accessing credit is both difficult and expensive for low-income households, which has led to a recent cap on the price of credit by the Financial Conduct Authority (FCA). However, this has failed to address the systemic underlying issues regarding the inability of traditional credit scoring mechanisms to accurately price risk amongst the majority of low-income households, which drives up prices;

- Debt advice is well established as being beneficial, but until recently most research has failed to recognise that many low-income households have different preferences for how and why they would like to access debt advice. The has led to suggestions that face-to-face services are always 'best' and has ultimately driven up the cost of providing debt advice, despite Money Advice Service (MAS) research showing that low-income households are the group most likely to seek internet advice services at the first instance;

- There is a substantial amount of research pointing to the need for a variety of debt-related support services, as well as long established forms of AFIs, such as credit unions and CDFIs. However, there is also a lack of robust standardised evaluation frameworks and transparent reporting of relevant performance-related evidence linked to this funding. This includes information on their spending, outcomes and performance of staff.

The lack of evidence has made it difficult for funders, including government, to direct their limited resources towards the best and most innovative providers, which are more able to address problem debt amongst low-income households in the UK.

### 3. Building a fairer financial system

The majority of issues that have been identified as being a 'cause' of problem debt for low-income households, such as expensive forms of credit or high bank penalty charges, are systemic issues of the current financial system. Consequently, these issues cannot be solved by simply adapting or lowering the price of the products and services that were originally designed for a different group of customers with different preferences and needs.

For this reason it is necessary to rethink how financial products and services are designed for low-income households. Central to this is considering people on low income as consumers, rather than recipients of care. While low-income households have widely varying wants and needs, the CSJ has identified that they often need access to:

- Financial advice and education on money and financial skills throughout their lives;
- A range of affordable financial products and services designed around them;
- A variety of quality financial institutions focused on serving them as customers.

7 See the resources available on the Money Advice Trust's InfoHub: http://www.infohub.moneyadvicetrust.org and the resources included in the Transact Library: http://www.transact.org.uk/

We argue that these needs can be met by a new generation of competitive and innovative AFIs. These are firms that would not only be able to serve low-income households, but would have business models and core values specifically built around serving this group and designing their services around them in order to provide long-term solutions without relying on grants and government subsidies in the long term.

# Chapter two
# Financial skills, advice and support

## 2.1 Get people talking and thinking about money

There have been improvements in recent years, but there is still a lingering stigma around issues of problem debt, which greatly influences how people think about their financial situation and the actions they are most comfortable taking to resolve it.

Attitudes towards money and stigma around debt influence people's behaviour in several ways:[8]

- People do not want to learn about money, or develop financial skills just for the sake of it;
- Students who complete financial education are less likely to repay their credit card in full;
- People do not like to talk about money especially when they are struggling with debt;
- One in seven people do not seek help because of the stigma associated with debt;
- People do not recognise when they are in problem debt or are often in denial;
- One in five people who need debt advice do not seek it, and half of those that do delay doing so for over a year.

In practice this means that there are several things which must be addressed in order to empower people to develop their financial capability and avoid falling into problem debt:

- Financial education and capability training should be delivered in a way that has real world applications and is easily accessible at key junctures in a person's life;[9]
- The Money Advice Service (MAS) needs to create standards to help financial firms, government and other organisations identify signs of financial distress so as to ensure people on low-incomes get the help they need as soon as possible;
- In order to stop people falling back into debt, funding needs to be directed to debt-related services that can provide 'after-care' following a debt crisis and help people to identify any root causes of their debt problems, such as a lack of functional numeracy skills, use of inappropriate financial services or deteriorating mental health issues.

8 Money Advice Service, *Indebted Lives: The Complexities of Life in Debt*, 2013 [accessed via: http://static1.squarespace.com/static/5406dac3e4b02d18666bcb68/t/544f8df6e4b0e1372c1c55da/1414499830876/indebted-lives-the-complexities-of-life-in-debt-november-2013-v3.pdf

9 Money Advice Service, *Impact Review of Financial Education for Young People*, London: Money Advice Service, 2012

## Recommendation

In order to address these issues and to increase the engagement rates and effectiveness of debt-related support services, MAS should continue to expand its lead role in helping to differentiate between the various organisations providing debt-related support services. Specifically they must continue to drive up standards through the on-going development of their common evaluation frameworks and performance metrics, as well as establish their new evidence hub, which publishes evaluations of various organisations, as a resource that is always used when funding services.

It is also important that they place a renewed emphasis on the importance of organisations that deliver holistic care, including early intervention services and 'after-care' to prevent people using the service again. None of this will be fully effective without the support of other funders, such as local authorities, who should build MAS's evaluation framework and evidence reporting criteria into their requirements for contracts put out to tender. This will help ensure that all relevant organisations begin to record and be evaluated on the same criteria.

### 2.2 Advice and skills training when people need it and want it

The Money Advice Service (MAS) was founded in the aftermath of the financial crash and is tasked with coordinating the UK's financial capability and debt advice strategies, as well as funding organisations that provide these services. MAS has made significant progress, but must continue to increase cooperation between the various organisations seeking to help people on low incomes. In particular, we believe they can be instrumental in providing a more seamless 'debt journey' for low-income households who fall into problem debt.

The CSJ's evidence sessions revealed several key issues:

- It is hard for both funders and service users to easily identify which type of service provider best meets users' needs, especially in times of crisis;
- Research found people want to access services in various ways, yet organisations mostly specialise in only one service (e.g. debt advice), offered via one channel (e.g. telephone);
- Organisations providing debt-related support services, as well as creditors, government and others use a variety of tools and methods to evaluate clients' financial situations;
- The combination of these issues makes it hard for a person to transfer between service providers or benefit from more integrated support (e.g. a debt adviser and a skills trainer).

There is a clear need to help facilitate better coordination between organisations that provide debt-related services, as well as creditors and other organisations operating on the fringes of the debt sector, such as debt collection agencies. Specifically, there is a need for MAS to make it easier for customers to utilise multiple services, such as a crisis face-to-face debt advice service and then an online-based long-term support service.

They are currently developing a Common Initial Assessment (CIA) and the new Debt Advice Steering Group which will provide "*a vehicle for brokering agreement on provision of a common front-end system across the main free debt advice providers, to triage consumers needing debt advice into the most appropriate channel*".

### Recommendation

MAS should licence or develop a tool that puts people in control of their own financial information and allows them to more easily transfer between service providers. Similar to the technology already developed by MoneyHub, such a system would automatically gather the required information about a person's financial situation after they provide their bank details, which can then be easily imported into the systems of a local Citizen's Advice Bureau with little manual input, substantially reducing costs. Similarly, if the customer wishes to then access a different support service they do not have to start from square one and with their consent, the next adviser will be able to see notes and information left by the previous adviser.

### Recommendation

MAS should work with key stakeholders and financial institutions to develop a range of 'aspirational' accreditation processes that drive up standards and help push organisations to develop more innovative services. This should involve and be led by extensive engagement with the public, through focus groups, polling and surveys. This research would build upon the work already done by MAS in *Indebted Lives* (2013), which quantified the different preferences people had in terms of accessing services. The following provide some examples of the new accreditation process that might result from such consumer engagement and designing services based on their wants and needs:

- Technologically Innovative – services that are targeted at engaging tech-savvy people;
- Local and Friendly – more traditional services with a 'know your adviser' approach;
- Cost effective and efficient – 'no frills' services, but that are quick, efficient and flexible;
- All-in-one – services noted for their ability to offer a whole range of integrated services;
- Professional – services aimed at attracting people worried about the stigma of debt.

The development of new evaluation frameworks and aspirational accreditation processes will help funders and low-income households struggling with debt to identify which services are most effective and best meet their needs. This will effectively create a more responsive and competitive market for debt-related services, while also encouraging cooperation between various organisations, regardless of their size or speciality.[10]

Recognition of vulnerable customers is also another area this report has identified as something that MAS should address and push for reforms, which will help tackle problem debt and the considerable hardship it can cause for some of the poorest people in society.

At present there is no central registry for people identified under the Financial Conduct Authority's guidelines for 'vulnerable customers', such as those with mental health issues. While one creditor may show forbearance after identifying the customer as 'vulnerable', the others may not and the person will suffer as a result. There is no information sharing even within one sector, meaning if a person switches energy companies on the recommendation of a debt adviser, in order to lower their expenditures on utilities, the new provider will have no easy way of knowing they were previously identified as 'vulnerable'.

10 Money Advice Service, Press Release, *Money Advice Service commissions Money Advice Trust to develop a standards framework for debt advice*, July 2012

### Recommendation

MAS should lead discussions with all the major regulators – Ofcom, Ofwat, Ofgem and the FCA – to ensure that a registry of vulnerable customers is created, but on the basis that 'vulnerable' people are always in control of their information and who it is released to.

This could be achieved by giving people the option to register with the service once they were first recognised by a creditor or other MAS-accredited body as being vulnerable. At this point, they would be given unique access credentials and their data encrypted, meaning a firm or government agency would only be able to find out they were a 'vulnerable' customer once the person used an automated online or telephone system to generate a one-time access code for the firm, allowing them to validate they were a 'vulnerable' customer.

## 2.3 Integrating advice and skills training into financial products and services

Technological innovations alone cannot solve over-indedebtness or increase engagement rates with debt-related support services. However, they can be leveraged by innovative organisations and AFIs to integrate tools and services that help people better regain control of their own financial situation and make it easier to seek help in a way they are comfortable with.

Some examples highlighted in this report include:

- **GoHenry** – a prepaid 'pocket money' visa card that builds on the financial education children learn at school through their everyday life and puts them in charge of their own money. Quantitive analysis of children's behaviour shows that over time they are more likely to save more of their money and their spending patterns change significantly. Anecdotal evidence also points to how the use of this service can help to break down the taboos around discussing money within families.

- **Squirrel** – this innovative smartphone app is paid for by employers and provided to their employees free of charge to employees in order to help them improve their financial wellbeing and decrease stress levels, which can lead to decreased productivity and absenteeism. It helps people manage their money by making things simple and flexible, rather than insisting a person budget a certain way, which can be hard to change. Examples include allowing employees to stagger their monthly income throughout the month, automatically set aside small amounts to reach savings goals, and help them recognise if they are paying too much for their electricity, or other bill.

While there is no shortage of examples of FinTech solutions such as those listed above, at present it is hard to make a commercially viable product that can be marketed to large numbers of low-income households for free. There are some innovative examples, such as making the business case to employers or housing associations to pay for the services in order to increase work productivity or decrease rent arrears, the latter of which is being done by Glasgow Housing Association. However, more specifically targeted funding is needed to kick start the development of products aimed at helping low-income people.

## Recommendation

Government, social investors and charitable trusts should consider providing seed funding for the newly established SoFiTech accelerator programme, fully detailed in Chapter Three. FinTech firms developing products with a clear 'social purpose' and which help people develop their financial capability, will be able to access a blended form of social investment, underwritten by grant funding. Promoting the development of these products, which AFIs could then offer, would help people build financial capability.

# Chapter three
# Better and more affordable financial services

Financial products are not the only cause of many debt problems amongst low-income households, but historically, they have not been designed to help them avoid problem debt either. There is a huge market demand amongst the seven to nine million who are not well served by existing mainstream financial services and are also not well served by the subsidised alternatives, such as credit unions and many CDFIs in their present form. (Policies to improve are discussed in Chapter Four.)

### 3.1 How people use financial services and why they do so

The following statistics highlight how many people are not well served by mainstream financial services or the alternatives:

- Around seven million people are worse off financially because of bank account fees, while as many as two million people still lack access to a transactional bank account;
- In 2012 more than two million people took out a high-cost loan and more than three million users of high-cost credit are in serious financial difficulties;
- More than 1.8 million social housing tenants are unable to access basic financial services online because they are unable to complete automated identity checks;[11]
- An estimated 310,000 people borrow from illegal moneylenders, a number that looks likely to increase following the Financial Conduct Authority's (FCA) interest rate cap on payday loans.[12]

These statistics reflect systemic issues in the UK's financial system that have not been addressed by previous policy interventions, in part because of several myths that exist about low-income households, as discussed in Chapter One.

While people's preferences for financial services vary considerably amongst low-income households, there are certain features they tend to desire:[13]

11 Experian, *Credit scoring boost for 93% of social housing tenants*, Press Release, 21 November 2013

12 Consumer Finance Association, *Out of Credit: The true cost for British borrowers who are denied credit under new lending rules*, Press Release, 20 October 2014,

13 Ellison A, Williams S and Whyley C, *The Payments Council: The electronic payment needs of people on low incomes*, London: Payments Council, 2010; Joseph Rowntree Foundation, *Financial Inclusion in the UK: Review of policy and practice*, York: Joseph Rowntree Foundation, 2008; Collard S and Hartfree Y, *Poverty, debt and credit: An expert-led review, Final report to the Joseph Rowntree Foundation*, Bristol: University of Bristol Personal Finance Research Centre, 2014

- Whereas higher income groups place a greater value on 'bonus features' and price when selecting products and services, lower-income groups tend to place a greater value on control, transparency and certainty;
- The desire for simplicity and ease of use are as important for this group as any other;
- Low-income households are willing to pay for products and services, especially if they give them features that are currently unavailable to them, such as greater control.

There is consequently a clear need to develop a new range of innovative financial products that meets the needs of low-income households.

### 3.2 Innovative financial products

Recent financial innovations have significant potential to help tackle poverty. The following are just two examples of innovative FinTech firms that have developed products that would likely benefit large numbers of low-income customers if they were emulated by AFIs in the UK. More importantly, they would actually be better than the current products offered by mainstream financial institutions and so encouraging consumers to use them would not require substantial government funding, as has been the case with some credit union services.

- **Monese** provides a current account that is free from monthly fees and can be opened in under three minutes using just a smartphone and any EU driver's licence. This would enable innovative AFIs to easily offer a linked banking service without having to apply for a banking licence and get around many of the issues associated with Know Your Customer (KYC) checks that digital banks face.

- **Pariti** provides users with an alternative perspective on their finances by automatically recognising their upcoming bills and expenditures based on their past bank activity. It also has features that make it easier to save and is working to utilise this data to develop a low-cost API for lenders based on automating the same type of underwriting procedures used by credit unions and CDFIs, but in a much more cost efficient way, which would greatly help them reduce costs and rapidly.

### 3.3 Delivering ethical and affordable financial services without subsidies

In order to develop more of these innovative financial products targeted at low-income households and a competitive market for innovative AFIs several things must happen:

- It is necessary to change the way low-income households are considered by politicians and financial firms, so that they are seen as a different cohort of customers rather than as people who must be served as a matter of social welfare policy;

- Public policy needs to move away from the 'harm reduction' approach when designing financial products for low-income households, such as the basic bank account, as people on low-incomes want and need products that are better than what is currently on offer and that is designed specifically for their wants and needs;

- People on low incomes have the same desire for product choice and variety as any other group and so there is a market demand for a new generation of AFIs specifically designed to serve this market.

### Recommendation

In order for AFIs to market and deliver innovative financial products and services to low-income households they must find ways to cover the costs without passing them on to the consumer. Some of the principles that must be considered are listed below:

- Products and services for low-income households can be made into ethical profitable options, but how they are marketed and delivered needs to be rethought;
- It is only possible to deliver affordable financial services to low-income households if they are delivered at scale and leverage financial technology to reduce costs;
- Open API cloud based banking platforms make it much easier for new innovative AFIs to scale up and integrate their services;
- Cross subsidy and integration between different products would lower the cost of delivery for AFIs (e.g. offering banking, savings and loans all through a digital platform);
- Banking products can be monetised through retailer tie-ins as low-income households still spend significant amounts on basic household goods.

First, it is necessary to help AFIs find ways to monetise financial products and services, that are not free to develop, without passing on the entire cost burden to them. After looking at business models of financial institutions from around the world this report sets out the following guidelines.

In order to develop new innovative FinTech solutions that would help AFIs grow and offer better and more diverse services that would suit low-income households it is necessary to create a special social FinTech accelerator programme. This would leverage in a form of blended capital (social investment underwritten by grant funding) and be linked with the FCA's innovation hub in order to provide regulatory guidance and a 'sandbox' test environment, which is essential to test and rapidly develop FinTech solutions. After completing the programme and developing a viable product, the social investors would be bought out by commercial investors so that funds could be recycled.

This fund and accelerator are essential as small FinTech firms struggle to complete the necessary application processes required by the FCA and access social investment without first proving their business model is viable through commercial funding, which is counterintuitive.

### Recommendation

The Cabinet Office, in partnership with Big Society Capital, HM Treasury and the Financial Conduct Authority should create an innovation fund and social FinTech accelerator programme (SoFiTech), both of which would sit under a new independent body, The SoFiTech Foundation, with the aim to support firms designing products specifically for low-income households.

**The SoFiTech Accelerator Programme**

- Products and services for low-income households can be made into ethical yet also profitable offerings through the use of FinTech;
- Seed funding from Big Society Capital or other would be used to cover operating costs until it was sustainable and to provide a quasi 'deposit guarantee scheme' for individual investors through a linked peer-to-peer social investment platform that would allow firms in the accelerator to access debt finance;
- Direct links with an FCA fast track approval scheme to decrease 'to market' costs and speed up innovation by ensuring the firms would be compliant with FCA regulation;
- Direct access and connection with the FCA Innovation Hub;
- Companies would have to meet certain ethical standards and requirements in order to apply for each round of the accelerator.

**The SoFiTech Innovation Fund**

- Creation of a linked p2p social investment platform and/or crowdfund platform to fund the new FinTech accelerator programme;
- Firms would have to raise a minimum level of funds on the social investment platform in order to be considered for the FinTech Accelerator programme;
- Charitable trusts would be able to issue renewable bonds or one-off grants that would serve as first loss protection for social investment up to a certain threshold. Funds could be targeted at specific firms or de-risked across the investment portfolio;
- Social Investors would be protected against first losses up to a certain percentage;
- Social investors linked with trusts/foundations would be able to use a secondary market to cross-guarantee the investments of other 'dual-role' investors.

# Chapter four
# A new vision for Alternative Financial Institutions

This chapter considers the potential of Alternative Financial Institutions (AFIs) to provide more helpful services to low-income families, and how a new generation of services can be developed and made sustainable.

AFIs are not a new concept and cover a variety of existing financial institutions that have a social purpose and aim to serve low-income households. They include the following main types of organisations:

- Credit unions;
- Community Development Financial Institutions (CDFIs);
- Social Enterprises and mutuals;
- Charitable finance organisations.

## 4.1 Choice, trust and affordability: the demand for alternative finance

Despite funding and promotion by government and other charitable organisations, existing AFIs, notably credit unions and CDFIs, have failed to achieve scale and attract low-income customers in the numbers that research shows would benefit from such services. This is

not only because of a lack of awareness, but also because many of these AFIs are simply unsustainable: such as by requiring constant new sources of grant funding, and being unable to innovate to provide the services and financial products their customers want.

Although low-income consumers all have different needs, the focus groups and interviews conducted by the CSJ revealed that people valued the following things that AFIs could offer them:[14]

- **Trust:** customers expressed that they had previously used mainstream financial services but no longer trusted them because of their experience, typically because of issues with loan repayments or penalty charges. Customers also mentioned that they trusted social enterprises more, as they felt it was focused on serving them specifically, rather than on making profits from wealthier customers.

- **Transparency, simplicity and flexibility:** the unpredictability and volatility of many low-income households' financial situation means they frequently praised and valued the transparency and simplicity of the financial products, as well as the flexibility of the firm with regards to repayments. The ability to reschedule loan repayments without penalty when their financial situation changed, such as after losing a job, was often cited as helping them maintain control of their finances and as a clear advantage over the more rigid systems and penalty fees associated with mainstream financial institutions.

- **Integrated support services:** the types of peripheral service low-income households are likely to find beneficial are often different to those needed by wealthier households. For instance, advice services regarding mortgages or investment portfolios are typically less demanded amongst this group than advice on benefit claims, employment support services and debt advice. AFIs in a competitive market focused on serving this demographic would have an incentive to offer support services that people wanted, would use and which would help them maintain or improve their financial situation, as it would help the business through lower default rates and higher levels of customer retention.

The research clearly shows that in order to develop a competitive market for AFIs their services must be designed from the beginning around the needs and wants of the customers they want to attract, rather than the policy objectives set by government or other funders. To achieve this it is necessary for AFIs to develop business models that are able to operate, at least in the long term, without relying on this type funding.

### 4.2 Sustainable models for Alternative Financial Institutions

The market for Alternative Financial Institutions, most notably credit unions and CDFIs, has been propped up for many years by government subsidies and grant funding as a matter of public policy, intending to ensure low-income households have access to affordable financial services.

14 Focus groups involved people currently using services provided by Moneyline and Fair Finance, two of the best performing CDFIs offering personal loans in the North West and London respectively.

- Credit unions have received £138 million in government grant funding through the DWP's Growth Fund and the more recent Credit Union Expansion Project;
- CDFIs have benefitted from £72 million in grant funding through the Department for Trade and Industry's Phoenix Fund and the Regional Growth Fund.[15]

The intention of such policies has always been to help credit unions and CDFIs grow to the scale where their business model is developed enough to be self-sustaining, yet in practice this has not happened. At present, only the very best performing CDFIs and credit unions are able to break even, but the challenges each face differ slightly.

- Credit unions are severely hampered by their regulations which make it hard for them to offer competitive financial services needed to attract members or to generate income from lending because of an interest rate cap on their loans;

- CDFIs struggle to access capital investment on the commercial markets despite the fact that many have proven their business model over several years. This is primarily because most commercial and social investors do not understand the business model and think it is too risky, so only provide small amounts of funding.[16]

There are examples of existing AFIs of all types that are able to grow and offer great services to their members without relying on government funding, and there are others who have a long-term plan to become financially self-sustaining. Some of these organisations are listed below and their success shows that the best aspects of existing AFIs should serve as the building blocks for the new generation of innovative AFIs proposed in this report.

- **Moneyline** is the UK's largest CDFI, based in the North West, which is highly transparent in regards to their funding sources and revenue streams, proving that even under the existing regulations and with the limited availability of investment capital it is possible for CDFIs to operate without government subsidy. They are the only CDFI to offer a linked savings account, which is hugely popular amongst customers as it provides an easy way to save regularly through rounding up loan repayments – as of 2015 they have helped customers save over £5 million;

- **Fair Finance** is a London-based CDFI that offers affordable loans to clients that are predominantly dependent on benefits, as well as debt advice services through a partnership with their charitable arm, Fair Money Advice. They were the first CDFI to access both commercial and social investment, and now operate sustainably without government funding. In order to aid their growth they have recently strengthened their board, specifically by bringing in experts on data and risk analytics to help set up new partnerships that can develop and implement FinTech solutions.

To develop ideas such as these, there is a need for a number of policy reforms and for a 'pump-primed' social investment market to grow the best organisations and encourage competition from new entrants. Given the small scale of existing AFIs there is no concern that

15 Ibid
16 Civitas, *Credit Unions: A solution to poor bank lending?*, London: Civitas, 2013

new entrants will harm the growth of established firms, but new competitors will improve the options available to low-income households and ultimately be able to provide them with better financial services that can help people improve their financial wellbeing.

Each of the models of AFI has its particular advantages and disadvantages, which make it hard for them to truly develop at present into a like-for-like competitor to mainstream financial institutions. However, this report sets forward the following plan in terms of the steps needed to grow a competitive AFI market quickly and without substantial government funding.

- In the short term, it is important to promote cooperation between CDFIs and credit unions in order that they can each benefit from the services of the other;
- In the medium term, investment in the best existing CDFIs should help them grow, scale and become more investment ready, once they have access to the necessary FinTech to reduce their operating costs, access capital investment and scale their business;
- In the long term, the competitive market for AFIs will be filled with a mixture of CDFIs, credit unions, charitable enterprises and for-profit social enterprises.

There are several barriers that CDFIs specifically face in terms of growing their business and which they must overcome if they are to become investment ready and develop into a true large scale alternative to mainstream financial institutions:

- Identifying which markets they should enter and where there is high demand amongst low-income consumers for their services;
- How to improve their business model and the range of products they offer in order to make themselves more of a true competitor to what is offered by mainstream financial institutions and help diversify their revenue streams;
- Difficulties accessing capital investment, from either social investors or commercial investors, which results largely from a lack of understanding of the business model.

**Recommendation**

The FCA, with the support and guidance of the Treasury, needs to make better use of its power to 'have regard' to consumers' access to financial services in deprived areas, with the aim of decreasing a barrier to entry and increasing competition in retail banking through a new generation of Alternative Financial Institutions focused on providing services to low-income households.

**Recommendation**

AFIs should offer a range of products and services, such as an innovative CDFI offering a digital banking service alongside its loan activities, as it will improve thier business model.

In order to ensure that resources are not wasted there is clear case for greater data sharing, as called for by the Community Investment Coalition, Big Society Capital and many other third-sector organisations. This report recommends that as the power to force action on this

issue already falls under the FCA's remit, government should push them to use it in order to help AFIs identify target markets where they are most likely to be successful.

Secondly, there is a need for AFIs to diversify their business model in order to make themselves more attractive to investment and to make their overall business offering more attractive to potential customers. At present, customers who access a loan from a CDFI and really like the service must still also have a bank account and often go elsewhere for savings and debt advice, rather than have the CDFI become a trusted financial intermediary for all of these services.

One of the most useful services that CDFIs could offer that would help make them more attractive and their services more useful to low-income consumers is a form of digital bank account. Previously, most CDFIs have considered this to be cost-prohibitive, but with new innovative alternatives to traditional current accounts, such as Monese (which is highlighted in Chapter Three), this could become a realistic alternative. However, even the most fully featured digital bank account targeted at low-income households cannot currently accept cash deposits, a feature demanded by many low-income consumers.

Furthermore, recent policy guidelines issued by the new Payment Systems Regulator state its intention to promote banking competition by opening up the payment systems, such as direct debits and faster payment facilities, which will greatly reduce the barriers to entry for innovative new AFIs. Similarly, the recent partnership between Post Office and the FinTech company, Advanced Payment Solutions, has signalled its intent to allow any new digital bank that meets certain minimum standards to allow its customers to deposit or take out cash in any Post Office Branch, of which there are more than all the mainstream bank branches put together.

Lastly, there are things local government can do, outside of directly issuing grants, that would help support the business viability of existing AFIs through being more creative with how they currently spend their money on certain programmes as well as through things like tax relief measures.

### Recommendation

The Payment Systems Regulator should require Post Office to offer their cash deposit service under open access terms to AFIs and other digital banks that meet set minimum requirements, with the potential of having slightly reduced deposit fees (if any) for AFIs with a clear social purpose and governance structure (for example, a digital bank subsidiary of a CDFI).

### Recommendation

Local authorities should provide business tax rate reliefs and offer service contracts for welfare assistance schemes to social enterprise partnerships that include AFIs, debt advice services and financial capability training programmes, as one integrated experience targeted at low-income households.

None of these measures alone will truly help turn all AFIs into rock solid viable enterprises, however, they will all help them prepare to receive more investment and help diversify their business which will help attract new customers.

### 4.3 Investing in Alternative Financial Institutions

Perhaps the biggest factor preventing the development of a competitive market for AFIs is that while there is a large market, it is not well understood and does not produce 'realisable assets', which means AFIs struggle to access capital from mainstream commercial sources. This severely limits their ability to grow, innovate and become a truly competitive alternative that low-income customers would prefer to use over mainstream financial services.

In order to help AFIs access capital investment, not just at the scale they need, but in the right forms, this report proposes recommendations to address the following issues that currently prevent AFIs from accessing sufficient investment:

- There is a need for a series of new detailed 'codes of conduct' for each broad category of AFI, similar to the European Union code of conduct for Microfinance institutions that wish to access money from the EU progress fund. These would help make the business structures and funding situation of AFIs more transparent for investors and make them more attractive propositions;

- AFIs need access to the FinTech solutions, such as automated credit scoring and cloud infrastructure, to scale their business and lower their cost of serving each customers to a level that makes the business model viable without relying on long-term subsidies.

**Recommendation**

In order to allow AFIs to access the capital investment needed to grow, develop and increase their commercial viability, a new independent body (The Alternative Finance Foundation) needs to assume responsibility for developing new codes of conducts and evaluation frameworks for the various types of AFIs, which will make it possible for investors and other funders to compare firms and price risk at more affordable levels.

In order to overcome these obstacles and develop a competitive market for AFIs, specifically with regard to growing new competitive CDFIs that offer a wide range of services, this report sets out the following recommendations.

First, the FCA needs to take action to allow CDFIs to implement cloud-based technologies that will significantly lower the cost of growing their businesses in the future.

Secondly, there is a need for a dedicated new independent body that would sit under the newly created SoFiTech body, in order to licence the FinTech solutions developed by firms in the accelerator to the best AFIs in order to help them grow.

Lastly, in order to help CDFIs and other AFIs access the capital on the scale that they need to meet the £3–£3.5 billion in demand for credit and serve the seven to nine million people currently underserved by mainstream finance, there is need for a new independent body that will specialise in getting AFIs investment-ready and help them access the right type of social and commercial investment. The body would have the power both to rate applicants, similar to the CARs system used in the USA as well as provide support to growing AFIs in a similar way to the Cabinet Office's existing programme for CDFIs. The organisation could also take over responsibility for developing and maintaining central portals, like the one being piloted by the Cabinet Office, that would help connect individual people with AFIs that would be able to meet their financial needs.

### Recommendation

The Financial Conduct Authority needs to issue clear guidance allowing and encouraging the use of cloud-based financial platforms by Alternative Financial Institutions. The use of cloud banking services should be allowed regardless of where the physical servers are actually located, so long as the provider meets certain pre-requisite standards set by the FCA and has implemented robust procedures to identify and mitigate any additional risks.

### Recommendation: Licensing and implementing FinTech solutions for AFIs

There is a need for new independent social enterprises to help facilitate the development of a competitive market for AFIs and enable the best existing firms to implement new FinTech innovations that will allow them to scale their business, reduce operating costs and end their reliance on grants and subsidies. The new Social Enterprise for AFI innovations (SEAFI) will hold the licences for white label FinTech products, either purchased on the open market, or those that are developed by a firm involved with SoFiTech, which it will then retain on a short-term basis at a price that reflects the cost and supports the running and development of the independent body.

Examples include:

- A CDFI-in-a-box white label system to help decrease the startup costs for new entrants;
- A variety of alternative credit scoring APIs that plug into an AFI's lending decision engine;
- A cloud based backend finance platform that is customisable depending on the type of AFI;
- A smartphone based tool that processes KYC checks for applicants using a driving licence.

In order to ensure AFIs get the most out of new FinTech innovations and reduce the cost of hiring in-house or contractors to implement product licences from the independent body, specialists will be made available, both on site and remotely, to help customise white label products to the AFI's specific business model.

## Recommendation: An independent body to evaluate and develop AFIs

There is a need for a new independent body (The Alternative Finance Foundation) to help facilitate the development of a competitive market for AFIs and enable the best existing CDFIs to access the capital funds these social enterprises need to:

- Grow their loan book;
- Develop their business; and
- Invest in the FinTech solutions required for them to scale their business and reduce their dependency on grants and subsidies.

A specialised division of the Alternative Finance Foundation should be funded through a collaboration between the Cabinet Office, Big Society Capital and the British Business Bank.

It would be tasked with helping the best AFIs and innovative new entrants to the AFI market to implement the new common evaluation frameworks and ensure adherence to the relevant Code of Conduct created by the AFF. In order to apply for funding from a new AFI-SIP (Alternative Financial Institutions Social Investment Platform) an AFI must be certified by the specialised division of the AFF.

This process will verify whether an AFI has adopted and integrated the relevant Code of Conduct into its business model, while also helping AFIs to demonstrate the viability and scalability of their business model, through independent evaluations in line with the new common evaluation framework for AFIs.

In order to help AFIs access social investment with the support of the AFF, it will create a new division that specialises in assessing AFIs on the basis of their investment risk, awarding them a 'credit rating'. The AFF will also leverage grant funding or patient capital in the form of renewal bonds, to create a form of blended social investment, which should stimulate the market by providing first loss protection for investors.

# Introduction

Almost nine million people across the UK struggle with problem debt.[17] As the Centre for Social Justice (CSJ) has identified in previous reports, the personal cost of this debt can be overwhelming, hitting people's mental health, their performance at work, and placing a strain on personal relationships.[18] Serious personal debt is not only a consequence of poverty, it is also a cause of poverty. Building on the work that the Centre for Social Justice has undertaken over the past 10 years, this report looks at how a more competitive market for alternative financial services and the development of more effective support services can help people avoid serious personal debt and the damage it can cause.

A new vision and approach to tackling the root causes of problem debt is urgently needed to fully address poverty in Britain's most deprived communities. This report argues that this new vision can only be achieved through a new holistic approach to problem debt, one that has at its core a focus on the wants and needs of the people it is trying to serve. There is currently a large segment of the British population, predominantly those on low incomes, that is not well served by the mainstream financial institutions. A new system will treat these people not as charity cases, but as customers. The result will be a more competitive marketplace where financial services are designed around the diverse wants, preferences and needs of low-income households.[19]

Problem debt has been rising in the UK for many years.[20] Successive governments, major charities, academics and the financial sector have all conducted detailed research and invested large sums of money in various programmes aimed at tackling this issue. Over the past ten years there have been numerous initiatives such as the National Strategy for Financial Capability, the Financial Inclusion Task Force and the Department for Work and Pensions'

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17 Problem debt: Debt that is of concern not due to its absolute value in monetary terms, but because of its size relative to the holder's disposable income, their inability to repay it, and because of the impact it can have on their health, relationships and life. Money Advice Service, *Indebted lives: The complexities of life in debt,* London: Money Advice Service, 2013

18 Thomas Brown, LLN 2014/029: *The Impact of Personal Indebtedness in United Kingdom Households, Especially on Children*, London: House of Lords, 2014

19 Low-income households: This term is used as a general term for households that have below average levels of incomes and whose general financial resilience is often low as a result of low savings and irregular or insecure income

20 Bank of England, *Quarterly Bulletin 2014 Q3: Household debt and spending,* London: Bank of England, 2014; Disney R, Bridges S, Gathergood J, *Drivers of overindebtness: Report to the Department for Business, Enterprise and Regulatory Reform*, Nottingham: University of Nottingham, 2008; Select Committee on Treasury, *First Report: Section 3 Over-Indebtedness and responsible lending*, London: Parliamentary stationary office, 2003 [accessed via: http://www.parliament.the-stationery-office.co.uk/pa/cm200304/cmselect/cmtreasy/125/12506.htm (25.05.15)]

Growth Fund.[21] Whilst well intentioned, they have failed to make a substantial dent in the number of people in serious personal debt.

Their efforts can be categorised under six broad themes that are each key to an aspect of how people fall into, avoid, get stuck in and resolve their debt problems. These six areas are:

- **Financial Inclusion:** ensuring people can access banking and other financial services;
- **Financial Education:** integrating core numeracy and literacy skills into education programmes as part of Financial Capability;
- **Financial Capability:** balancing people's abilities with the complexity of financial services;
- **Financial Resilience:** encouraging people to save money, budget and plan for crises;
- **Affordable Credit:** supporting responsible lenders to make borrowing safer and cheaper;
- **Debt Advice:** helping people seek relief from creditors and resolve their debt problems.

The delivery and commissioning of services designed to achieve objectives in these six areas has been done through a patchwork assortment of national and local government initiatives, grant-funded charities, small community credit unions and the mainstream financial sector through its Corporate Social Responsibility funding and quasi-commercial arrangements. The major retail banks have also been involved in funding financial education and debt advice charities and have done so for a variety of reasons, including the prospect of increased repayments through customer engagement with debt advisers as well as increased brand and product awareness amongst young potential customers through programmes in schools.

There is nothing wrong with commercial involvement in the delivery of services that help people avoid and deal with problem debt, in fact it should be encouraged. However, the focus on funding the newest and most innovative programmes can be counterproductive. Indeed, over time the focus of many organisations developing programmes and delivering services, including government, has shifted according to what is considered to be having the greatest impact on rising debt levels at any given time.

Far from being beneficial and reactive, this approach has many drawbacks. As an example, short-tenure contracts for delivery partners can limit their effectiveness and ability to innovate, as well as measure their outcomes over the long run. Perhaps of greater concern is that as the focus of the funders, lobby groups and delivery partners shifts, previous recipients of funding often find themselves having to do the same work with little or no money.

The changes in focus and funding between the six themes discussed above is symptomatic of an underlying issue that is key to understanding why, despite political will, charitable contributions and private sector funding, little long-term change has been achieved. The shift from one area, such as financial capability, at the expense of another, such as debt advice, is primarily because the programmes designed to address these issues often operate in isolated

21 Collard S, Hale C, *Evaluation of the DWP growth fund: Revised final report*, Bristol: University of Bristol Personal Finance Research Centre, 2008; National Audit Office, *The Financial Services Authority: A review under Section 12 of the Financial Services and Markets Act 2000, Part 5 – Financial Capability*, London: National Audit Office, 2007; Financial Inclusion Taskforce, *Financial Inclusion Taskforce research programme (2005–2011)*

silos. This is both costly and ineffective, as each silo has different delivery and evaluation frameworks meaning there is no common objective and little coordination.

The result is a fragmented network of small organisations that are hard to evaluate, often duplicate services, and are costly to run as they do not benefit from economies of scale or effective partnerships. Most importantly, they often fail to consistently deliver high quality services that are affordable and easily accessible for people across the entire country.

The fragmentation of the issues and of the services designed to help people improve their financial capability and wellbeing, is one of the major factors that has prevented significant progress being made towards tackling household debt in the UK.

After more than 10 years of working with frontline charities and social enterprises that provide affordable debt-related services in Britain's most deprived communities, the CSJ has identified the following key objectives as the basis of a fairer financial system:

- Advice and education on money, services and financial skills throughout people's lives;
- A range of affordable financial products and services that match what people want;
- A variety of quality financial institutions focused on serving people as customers.

In order to enable low-income households to achieve their financial goals, maximise their financial capability and maintain their financial wellbeing, policy makers and service providers should:

- Identify what low-income people want to do with their money, how they use it and what drives their behaviour;
- Determine what people want and need from financial services and how they help people improve their financial wellbeing and achieve the objectives of a fairer financial system mentioned above;
- Ensure that there is a robust evidence base and evaluation framework for programmes and delivery partners, based on commonly agreed standards, so that funding is directed only to the best organisations and programmes;
- Consider the sustainability and scalability of any programme, AFI or government policy, so that the best organisations are able to grow and offer financial services, advice and support to the millions of low-income people, who are either underserved or at risk of problem debt.

The vision presented in this report is entirely achievable without major reforms to the existing laws and regulations. Our focus is on developing organisations that are already doing fantastic work across the country, rather than starting from scratch. By focusing on what people want and need, supporting innovative firms in meeting that demand, there will be more and better quality services available that are not reliant on grants and long-term government subsidies.

The proposals outlined here offer the opportunity to help improve people's financial capability and simultaneously create a socially responsible marketplace in which a range of alternative financial institutions are competing with each other for the business of people who are not

currently well served by mainstream services. Ultimately, this approach has the potential to enable millions of people to take control of their financial wellbeing and avoid problem debt and all the difficulties it brings.

# chapter one
# A new vision for tackling problem debt in the UK

As part of its ground-breaking *Breakthrough Britain 2015,* the CSJ gathered evidence from our Alliance of over 350 poverty fighting charities, academic studies and from a range of organisations. Our work demonstrated the extent of household debt in the UK and the impact it can have on mental health, family stability, employment prospects and people's long-term financial health.

The findings of this extensive research were published in two reports, *Maxed Out* (2013) and *Restoring the Balance* (2014), providing a comprehensive evaluation and analysis of the problems faced by low-income households. These publications, which serve as the foundational evidence base for this report, found that:[22]

- 8.8 million people struggle with over-indebtedness, including 1.4 million families with dependent children;[23]
- 15 million people are falling behind on bills and relying on credit to make ends meet;[24]
- The failure to tackle over-indebtedness costs the UK economy over £8.3 billion a year;[25]
- Between seven and nine million people are poorly served by mainstream banks and other financial institutions, including two million who are without a basic bank account;[26]

22 Centre for Social Justice, *Maxed Out*, London: Centre for Social Justice, 2013; Centre for Social Justice, *Restoring the Balance* London: Centre for Social Justice, 2014

23 Money Advice Service, *Indebted lives: The complexities of life in debt*, London: Money Advice Service, 2013; StepChange and the Children's Society, *The Debt Trap. Exposing the impact of problem debt on children,* London: StepChange, 2014

24 StepChange, *Life on the edge: Towards more resilient family finances,* London: StepChange, 2014

25 Rowlingson, K. & McKay, S., *Financial Inclusion: Annual monitoring report 2014*, Birmingham: University of Birmingham, 2014

26 Centre for Social Justice, *Restoring the Balance* London: Centre for Social Justice, 2014; Financial Inclusion Commission, *Financial Inclusion: Improving the financial health of the nation,* London: Financial Inclusion Commission, 2015

- Alternative Financial Institutions (AFIs), currently provide £737 million of affordable credit through subsidised credit unions and Community Development Financial Institutions (CDFIs), well short of the £3.5 billion needed;[27]
- Only one in five people with debt problems seek help and more than half wait a year or more before doing so;[28]
- Low levels of financial capability in the UK cost the economy £3.4 billion each year.[29]

An 'Alternative Financial Institution' (AFI) is not a type of financial institution that is clearly defined by the Financial Conduct Authority in the same way as, for example, a 'bank'.[30] In the context of this report the term 'AFI' is used to refer to financial institutions that are by design or by default, a recognised provider of financial services to low-income households, most often with the intention of doing so at a lower cost.

Some common examples of AFIs covered in this report include the following:

- Credit unions;
- Community Development Financial Institutions (CDFIs);
- Social Enterprises;
- Charitable financial institutions.

A substantial amount of funding from a variety of charitable sources, industry Corporate Social Responsibility (CSR) programmes as well as national and local government has gone into trying to address the issue of serious personal debt. For example:

- The Financial Inclusion Taskforce has done commendable work in helping people access bank accounts, affordable credit and other basic financial services, with a budget of £250 million between 2005–2011;[31]

- The Financial Services Authority was given a budget of £90 million over five years to create a world-leading research programme on financial capability in the UK, as well as develop innovative delivery programmes in partnership with the third sector;[32]

- In recent years, the government has issued over £200 million in grant funding to Credit Unions and CDFIs to support their growth and development.[33]

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27 Bank of England Prudential Regulatory Authority, *Credit union quarterly statistics – December 2014*, London: Bank of England, 2015; CDFA, *Inside community finance: The CDFI Industry in 2014*, London: CDFA, 2015; CDFA, *Mind the gap: Evidencing demand for community finance, London:* CDFA, 2013

28 Money Advice Service, *Indebted lives: The complexities of life in debt*, London: Money Advice Service, 2013; StepChange, *Statistics yearbook: Personal debt 2013*, London: StepChange, 2013

29 Centre for Economics and Business Research, *Potential benefits of implementing financial education*, London: CEBR, 2012

30 Financial Conduct Authority and Prudential Regulation Authority, *Reader's Guide: An introduction to the Handbook*, December 2013 [accessed via: http://www.fca.org.uk/static/documents/handbook/readers-guide.pdf (21/05/15)]

31 Rowlingson, K and McKay, S, *Financial Inclusion: Annual monitoring report 2013*, Birmingham: University of Birmingham, 2014

32 National Audit Office, *The Financial Services Authority: A review under Section 12 of the Financial Services and Markets Act 2000, Part 5 – Financial Capability*, London: National Audit Office, 2007

33 Cabinet Office, *Scaling community lenders : The role of social investment*, London: Cabinet Office, 2005

However, despite this level of support and funding, problem debt has continued to rise year on year.[34] Households in the UK now owe £170 billion in unsecured consumer debts, up from just £53 billion in 1993.[35] On average households will owe almost £10,000 in unsecured debt by 2016, with total debt growing by around £20 billion, the fastest rate in over a decade.[36]

In order to develop a new approach towards tackling problem debt amongst low-income households it is necessary to first review past interventions and look for common underlying trends that should be avoided in the future.

## 1.1 Previous attempts to address problems debt

Over the last 15 years, government, financial institutions and charitable trusts have commissioned extensive academic research on the causes and impact of over indebtedness.[37] The amount of funding and interest in studying debt and personal finance means there are now numerous research institutions that focus solely on these topics including the Personal Finance Research Centre in Bristol, the Community Finance Solutions unit at the University of Salford and the Centre on Household Assets and Savings Management in Birmingham. This has been complimented by the work of think tanks and other non-academic research centres such as the Money Advice Service, the Centre for Responsible Credit, Citizen's Advice Bureau, the Money Advice Trust and the Institute for Fiscal Studies.

The result of this body of research is not only extensive but has also been consistent in relation to identifying several specific areas of focus, highlighting issues that are highly correlated to a multitude of 'causal factors' associated with problem debt amongst low-income households:

- Financial Inclusion;
- Financial Education;
- Financial Capability;
- Financial Resilience;
- Affordable Credit;
- Debt Advice.

Before setting out a new vision for tackling problem debt, it is important to understand what has already been done in each of these areas and why previous programmes have often not achieved their desired outcomes on the scale needed or produced cost-effective solutions.

34 Collard, S et al. (University of Bristol and Ecorys), *Evaluation of the DWP growth fund: Revised final report,* Bristol: University of Bristol Personal Finance Research Centre, 2008; National Audit Office, *The Financial Services Authority: A review under Section 12 of the Financial Services and Markets Act 2000, Part 5 – Financial Capability*, London: National Audit Office, 2007; Financial Inclusion Taskforce, *Financial Inclusion Taskforce research programme (2005–2011)*

35 The Money Charity, *Debt Statistics,* October 2013, London: The Money Charity, 2013; Bank of England, *LPMBI2O – Monthly amounts outstanding of total (excluding the Student Loans Company) sterling net unsecured lending to individuals (in sterling millions) seasonally adjusted,* London: Bank of England, 2013

36 PwC, *Precious Plastic 2015: How Britons fell back in love with borrowing*, London, PwC, 2015

37 See the resources available on the Money Advice Trust's InfoHub: http://www.infohub.moneyadvicetrust.org and the resources included in the Transact Library: http://www.transact.org.uk/

## Financial inclusion

Traditionally efforts to address financial inclusion have focused on increasing access to mainstream financial products for low-income and other vulnerable groups.[38] Some of the earliest work on problem debt in the 1990s correctly identified that people who did not have access to basic financial products and services were more likely to be those with low incomes, or fell into several overlapping categories of 'vulnerable consumer', such as the elderly and those with mental health issues.[39]

At the time a large percentage of low-income households were found to be 'unbanked', meaning they did not have access to a transactional bank account, existing solely in a cash economy, which largely excluded them from other financial services such as mainstream borrowing, insurance, and other financial products.[40]

The lack of basic financial products has several negative consequences including:

- A 'poverty premium' when paying bills and for everyday essentials;[41]
- Difficulties in dealing with a drop in income following unemployment or an unexpected increase in expenditure due to an emergency;[42]
- Problems matching up irregular income cycles with bills and other fixed expenditures.[43]

Taken individually, the increased expenditure on bills, the inability to cover an income shortfall through insurance or savings and the lack of affordable credit to help with budgeting, may not be a significant problem or cause debt problems. However, they all do place additional financial strains on low-income households that are often already on a financial cliff edge and can easily push them into a debt spiral.[44]

The work of the Government's Financial Inclusion Taskforce to address this issue was successful by many quantitative measures, reducing the proportion of low-income households without access to a transactional bank account from 20–25 per cent in the mid-1990s to just six per cent by 2006.[45] Efforts in this area have continued, with the Department for Business Innovation and Skills announcing a new 'Universal Basic Bank Account' in partnership with the British Bankers Association, to be launched in 2015.[46] Today there are fewer than two million adults without access to a transactional bank account and there is general agreement that

38 Vulnerability is used in this report to refer to people who fall into six broad overlapping categories, that are defined in the following report and that make people more susceptible to problem debt and poverty, except where specific reference is made to the FCA's definition and guidelines; Joseph Rowntree Foundation, *Financial Inclusion in the UK: Review of policy and practice,* York: Joseph Rowntree Foundation, 2008

39 Joseph Rowntree Foundation, *Financial Inclusion in the UK: Review of policy and practice,* York: Joseph Rowntree Foundation, 2008

40 Ibid

41 Save the Children, *The poverty premium: How poor households pay more for essential goods and services.* London: Save the Children and the Family Welfare Association, 2007

42 StepChange, *Life on the edge: Towards more resilient family finances,* London: StepChange, 2014

43 Financial Inclusion Commission, *Financial Inclusion: Improving the financial health of the nation,* London: Financial Inclusion Commission, 2015

44 StepChange, *Life on the edge: Towards more resilient family finances,* London: StepChange, 2014

45 Joseph Rowntree Foundation, *Financial Inclusion in the UK: Review of policy and practice,* York: Joseph Rowntree Foundation, 2008

46 HM Treasury, *New basic fee-free bank accounts to help millions manage their money,* Press Release, 15 December 2014 [accessed via: https://www.gov.uk/government/news/new-basic-fee-free-bank-accounts-to-help-millions-manage-their-money (25.05.15)]

more people have access to financial services now than 20 years ago, largely because of the work of the Taskforce led by Sir Brian Pomeroy.[47]

However, there are several key issues that have not been addressed at all by these extensive government programmes:

- Low-income households do not use mainstream financial products and services for a range of reasons unrelated to the price or their income, which remain unaddressed;[48]
- Access to a basic bank account does not mean that people actually use them, meaning they may not benefit from it at all, which is not reflected in any official statistics;[49]
- Use of a basic bank account might be free, but that does not mean it helps low-income households with other related issues, such as managing income flows, which ultimately can cause greater financial hardship than if they had paid for a different type of account;
- Because a bank account is free for the customer, does not mean it is free for the bank to provide it, making it likely they will try to discourage people from using it, 'upsell' other profitable products, or decrease its functionality to cut costs.[50]

Essentially, because mainstream products and services are not designed to meet the diverse needs of low-income households and the financial institutions that provide them are not designed to make a profit from this type of customer, both the products and the firms will likely only do the minimum that is required of them.[51] The result is that at best low-income households will have access to a limited range of financial products and services aimed at 'harm reduction', which will not necessarily help them avoid problem debt.

This report advocates a new approach to financial inclusion, which looks to put the wants and needs of low-income households at the centre of services. Low-income households need to be recognised as consumers, with diverse wants, needs and preferences. Adequately meeting those different wants, needs and preferences will only be possible if a creative competitive market for alternative financial institutions develops, which will enable people to choose from a range of products and services specifically designed to help them achieve their financial goals and maintain their financial wellbeing.

## Financial capability and financial education

The evidence base regarding financial capability and financial education is arguably less developed than in other areas. This is in large part because it is hard to quantify whether school-based capability training and financial education has changed long-term behaviour, helping people to manage their finances and avoid problem debt.[52] Again, the previous approaches to address the lack of financial capability in the UK, which was clearly identified by the Financial Services Authority (FSA) in a series of reports beginning in 2006, have been

47 Financial Inclusion Commission, *Financial Inclusion: Improving the financial health of the nation,* London: Financial Inclusion Commission, 2015, Rowlingson, K and McKay, S, *Financial Inclusion: Annual monitoring report 2014*, Birmingham: University of Birmingham, 2014

48 Joseph Rowntree Foundation, *Financial Inclusion in the UK: Review of policy and practice,* York: Joseph Rowntree Foundation, 2008;

49 National Consumer Council, *Basic Banking: Getting the First Step Right,* London: National Consumer Council, 2005

50 PwC, *There is no such thing as a free lunch: Why fees are the future for current accounts*, London: PwC, 2015

51 Joseph Rowntree Foundation, *Financial Inclusion in the UK: Review of policy and practice,* York: Joseph Rowntree Foundation, 2008

52 House of Commons Library, *SN/SP/6156: Financial and enterprise education in schools,* London: House of Commons Library, 2014

admirable but have not succeeded in truly improving people's capability or reducing problem debt.[53]

Specifically, several issues have hindered progress in this area:[54]

- A fractured, uncoordinated approach to delivery involving over 250 organisations;
- A lack of effective, robust and established standards for evaluation to help direct funding towards the most effective organisations and programmes;
- A failure to recognise that providing people with information and advice alone is not sufficient, as societal and individual attitudes also play a role and are hard to change;
- A one-sided approach focused on teaching people how to improve their knowledge and skills, without also acknowledging the need for appropriate financial services;
- Unrealistic expectations about what can be achieved through financial education in schools, especially when teachers do not have the right specialised skills.

The limitations of previous attempts to build financial capability are by no means small and involve changing the entire national debate around debt as well as continuing to build and re-evaluate the evidence base around financial capability. Therefore, unless there is a significant drive to link financial capability with other issues and ensure people are provided with debt and money advice services throughout their life in relevant ways, then it is unlikely that significant progress will be made.

The work of the Money Advice Service to take the lead role in coordinating the debt advice and financial capability sectors, including the Financial Capability Strategy is a vital first step and must be built upon.

### Affordable credit

The use of credit can be both a blessing and a curse. On the one hand, access to credit is as essential for those on low incomes as it is for any other person, as it helps people to manage cash flows, cover income shortfalls, manage unexpected expenses or make large purchases.[55] On the other hand, credit, by its very nature, can lead to a cycle of debt from which it is difficult to escape.[56]

The majority of people in the UK use some form of credit on a regular basis, most often in the form of credit cards, personal loans and overdrafts from mainstream financial institutions.[57] For

53 National Audit Office, *The Financial Services Authority: A review under Section 12 of the Financial Services and Markets Act 2000, Part 5 – Financial Capability*, London: National Audit Office, 2007

54 Financial Inclusion Commission, *Financial Inclusion: Improving the financial health of the nation,* London: Financial Inclusion Commission, 2015; Money Advice Service, *The consultation response and next steps: Financial Capability strategy for the UK,* London, Money Advice Service, 2015; Money Advice Service, *Financial capability Strategy for the UK: The evidence base,* London: Money Advice Service, 2014; House of Commons Library, *SN/SP/6156: Financial and enterprise education in schools,* London: House of Common's Library, 2014

55 Policis, *Credit and low-income consumers: A demand-side perspective on the issues for consumer protection,* Dorking: Friends Provident Foundation, 2011

56 Tim Edmonds, *Briefing paper number 05849: High cost credit,* London: House of Commons Library, 2014

57 Rowlingson, K and McKay, S, *Financial Inclusion: Annual monitoring report 2014*, Birmingham: University of Birmingham, 2014; Department for Business, Innovation and Skills, *Credit, debt and financial difficulty in Britain, 2012: A report using data from the YouGov DebtTrack Survey,* London: Department for Business, Innovation and Skills, 2013

most people, credit has reduced risks due to the greater certainty of their financial situation and ability to make regular repayments, but also because they can access mainstream credit either inexpensively or completely free of charge.[58] However, for people with low and/or irregular incomes, or whose overall financial situation is less secure for other reasons, the use of even small amounts of credit can quickly spiral out of control.

There has been a substantial amount of research into the use of credit amongst low-income households over the past 15 years, which has clearly identified the link between credit, debt and poverty.[59] However, much of this research has failed to really understand how and why low-income households use credit, which has contributed to efforts and policy interventions that have been well meaning, but have failed to really tackle the problems faced by low-income households when using credit or to reduce problem debt.[60]

Past interventions have primarily focused on two things:[61]

- Reducing the price and risk of credit for low-income households, primarily by introducing new regulations that are targeted at specific forms of credit which are thought to be the most expensive or 'exploitative'. Examples include home credit a decade ago and more recently payday loans;
- Expanding the availability of 'ethical' or 'affordable' forms of credit through subsidies to credit unions, CDFIs and the government's Social Fund.

These two categories of interventions, while well intentioned, have had a limited impact on reducing problem debt amongst low-income households. Specifically, regulatory interventions fail to address the real reasons behind why credit use is problematic for low-income households, and despite significant financial support, the growth and supply of affordable credit has failed to match the demand amongst low-income households.[62]

Recent attempts to tackle rising problem debt related to payday loans show the ineffectiveness of these interventions. Regulations brought in by the Financial Conduct Authority (FCA) in 2014, including a price cap and stricter requirements regarding affordability checks, have significantly altered the landscape for high cost short-term lending. Many firms have now exited the market or reduced their lending to low-income households.[63]

Evidence obtained by the CSJ, shows large numbers of people are either not turning to existing providers of affordable credit or they are struggling to meet the increased demands

58 Joseph Rowntree Foundation, *Financial Inclusion in the UK: Review of policy and practice,* York: Joseph Rowntree Foundation, 2008; Thomas Brown, LLN 2014/029: *The Impact of Personal Indebtedness in United Kingdom Households, Especially on Children*, London: House of Lords, 2014; FCA, *Consumer credit and consumers in vulnerable circumstances,* London: FCA, 2014

59 Collard, S and Hartfree, Y, *Poverty, debt and credit: An expert-led review, Final report to the Joseph Rowntree Foundation,* Bristol: University of Bristol Personal Finance Research Centre, 2014

60 Dearden, C et al., *Credit and debt in low-income families,* York: Joseph Rowntree Foundation, 2010

61 Collard, S and Hartfree, Y, *Poverty, debt and credit: An expert-led review, Final report to the Joseph Rowntree Foundation,* Bristol: University of Bristol Personal Finance Research Centre, 2014

62 Financial Inclusion Commission, *Financial Inclusion: Improving the financial health of the nation,* London: Financial Inclusion Commission, 2015

63 FCA, *PS14/16: Detailed rules for the price cap on high-cost short-term credit Including feedback on CP14/10 and final rules,* London: FCA, 2014

because they cannot access enough capital to lend out.[64] For instance, just two per cent of people that were denied a payday loan following the introduction of new regulations went to a credit union.[65] Similarly, evidence provided by Moneyline, the largest CDFI offering personal loans, showed that demand was up 40 per cent in the first quarter of 2015 and that they had to shut their doors completely in the first week of December 2014, as they simply could not meet the increased demand.[66]

Although some low-income households will be able cope without credit, three quarters of people said they were worse off financially after being turned down for a payday loan and thousands said they had no choice but to turn to an illegal moneylender.[67] Clearly, there is a need for a better solution to problem debt caused by credit use amongst low-income households, whose decisions to borrow are not primarily motivated by the price of the credit.[68]

Below we argue that a solution to this situation lies in stimulating a competitive market for Alternative Financial Institutions (AFIs) that can meet this demand for affordable credit independently of reliance on government subsidies.

## Financial resilience

Financial resilience refers to a person's ability to absorb income shocks, such as unemployment or an unexpected emergency expenditure, through savings and insurance products, reducing people's need to use credit, which can lead to problem debt.[69] Recent research shows that levels of financial resilience are low, especially amongst low-income households.

- 41 per cent of people do not have any savings at all and 13 million people would not have enough savings to support them for a month if their income fell by 25 per cent;[70]
- It is estimated that savings of just £1,000 would prevent half a million people from falling into problem debt;[71]
- Half of households in the bottom half of income distribution do not have home contents insurance and are three times more likely to be the victim of a burglary.[72]

These levels of financial resilience have not improved significantly despite being long-standing issues identified by researchers and policymakers, who have primarily attempted to address the issue in two ways:[73]

64 Consumer Finance Association, *Out of Credit: The true cost for British borrowers who are denied credit under new lending rules*, Press Release, 20 October 2014,

65 Ibid

66 Evidence provided to the CSJ by Moneyline

67 Consumer Finance Association, *Out of Credit: The true cost for British borrowers who are denied credit under new lending rules*, Press Release, 20 October 2014,

68 Policis, *Credit and low-income consumers: A demand-side perspective on the issues for consumer protection, Dorking: Friends Provident Foundation, 2011*

69 Financial Inclusion Commission, *Financial Inclusion: Improving the financial health of the nation*, London: Financial Inclusion Commission, 2015

70 Rowlingson, K and McKay, S, *Financial Inclusion: Annual monitoring report 2014*, Birmingham: University of Birmingham, 2014; StepChange, *Life on the edge: Towards more resilient family finances,* London: StepChange, 2014

71 StepChange Debt Charity, *An Action Plan on Problem Debt: How the next UK Government can reduce the £8.3 billion social cost of problem debt, London: StepChange Debt Charity, 2015*

72 Rowlingson, K and McKay, S, *Financial Inclusion: Annual monitoring report 2014,* Birmingham: University of Birmingham, 2014

73 Joseph Rowntree Foundation, *Financial Inclusion in the UK: Review of policy and practice,* York: Joseph Rowntree Foundation, 2008

- Encouraging savings through tax breaks and other financial incentives, including programmes like the Child Trust Fund and Savings Gateway Pilots;
- Promoting the uptake of home contents insurance through partnerships with housing associations.

However, as with the other areas mentioned previously, these interventions have been ineffective because they have failed to recognise and address the real issues and the realities of life on a low income, which make mainstream savings and insurance products unsuitable.[74] Attitudes and consumer behaviour are arguably the most important issues that prevent low-income households from building financial resilience, which cannot be addressed through the same mechanisms and incentives as for wealthier households.[75]

For instance, both the Money Advice Service and FSA identified that while the vast majority of people across the income spectrum recognise the benefits of savings, a much smaller proportion of people actually save regularly.[76] Similarly, as people's savings habits are largely unrelated to the financial incentives of savings products, especially for low-income households for whom these benefits are typically less substantial, the significant cost of programmes like the Savings Gateway are disproportionate to the impact they have.[77]

Therefore, the design of savings and insurance products, in terms of how they attempt to motivate regular savings and whether they are specifically tailored to the realities of life on a low income, is far more important than the financial benefit or cost of the product.[78] This report will set out more effective ways to enable low-income households, including those already struggling with problem debt, to build financial resilience. Specifically, through the creation of a competitive market for AFIs, which are able to integrate and encourage the uptake of products that increase financial resilience, as they are designed around the diverse wants, needs and preferences of low-income households.

## Debt advice

The benefits of receiving debt advice for people experiencing financial hardship or problem debt are well established and there are many charities that provide free services to low-income households.[79] However, there is far less evidence regarding the effectiveness of different types of debt advice, the long-term impact of receiving advice, or ways to consistently evaluate the organisations providing services.[80] The lack of standardised evaluations and evidence, effective cooperation and coordination of services, have limited the effectiveness of previous interventions.

74 Joseph Rowntree Foundation, *Financial Inclusion in the UK: Review of policy and practice,* York: Joseph Rowntree Foundation, 2008
75 Ibid
76 FSA, *Financial Capability in the UK: Establishing a Baseline,* London: FSA, 2006; Money Advice Service, *Financial Capability of the UK*, London: Money Advice Service, 2013
77 Institute for Fiscal Studies, *Final evaluation of the Saving Gateway 2 pilot: main report*, London: Institute for Fiscal Studies, 2007; Financial Services Authority, *Financial Capability in the UK: Establishing a Baseline,* London: FSA, 2006
78 Joseph Rowntree Foundation, *Financial Inclusion in the UK: Review of policy and practice,* York: Joseph Rowntree Foundation, 2008
79 London Economics, *Debt Advice in the UK Final Report for The Money Advice Service,* London: London Economics, 2012; Joseph Rowntree Foundation, *Financial Inclusion in the UK: Review of policy and practice*, York: Joseph Rowntree Foundation, 2008; Optisma Research, *The Money Advice Service Debt Advice Review 2013/14,* London: Optisma Research, 2014
80 London Economics, *Debt Advice in the UK Final Report for The Money Advice Service,* London: London Economics, 2012

There are a large number and variety of debt advice groups across the UK. Most of these have been active for many years and have been providing quality debt advice at no cost to the customer over that time. These providers and the research that they have carried out agree on the beneficial potential of debt advice, however, it remains difficult to quantify that benefit or to distinguish debt advice from other factors that may affect a person's financial situation. Part of the problem is that there is little if any standardisation across the debt advice sector.

One of the reasons for the difficulty in quantifying the impact of debt advice is that it remains separated from other stages in a person's 'debt journey'. Debt advisers struggle to identify those at risk of falling into serious personal debt because they are removed from the instruments of that debt (e.g. credit providers). A model in which debt advice was connected to a responsible lender would provide greater opportunities for early intervention as well as facilitate movement from borrowing to seeking help resolving debt issues. However, as of now, the London-based CDFI Fair Finance is the only organisation that the CSJ has found that truly integrates debt advice into its provision of community financial services.[81] Connecting lending and debt advice would provide the added benefit of creating an opportunity for cross-subsidisation thereby limiting the reliance of debt advice on grant funding.

## 1.2 Improving evidence and evaluation frameworks

The extensive research compiled by the CSJ over the past three years, outlined above, alongside new evidence obtained during this research process points to one trend above all else: the lack of an effective evidence base and standardised evaluation frameworks has limited the development of effective solutions.

This deficiency has made it hard for funders and government to identify which programmes are the most effective and scalable.[82] This makes it significantly more difficult to drive up standards through an ongoing process of continually targeting the best performing organisations when issuing new grants or service delivery contracts.

### Myths about the financial capability of low-income households

This evidence vacuum has also led to a set of persistent and pernicious myths about the financial capability of low-income households and their use of money:

- Levels of financial capability amongst this group are significantly lower than average;
- Low-income households make poor financial decisions and are unable to manage money;
- Many households make irrational decisions that are expensive and worsen their situation;
- People on low incomes only want to use cash and access face-to-face financial services and do not have access to the internet, use smartphones or want to utilise online financial services.

81 Fair Finance in evidence to CSJ
82 Financial Inclusion Commission, *Financial Inclusion: Improving the financial health of the nation*, London: Financial Inclusion Commission, 2015

In order to set out a new approach it is necessary to first dispel these myths.

### 1. Levels of financial capability amongst low-income households are significantly lower than average

Research by the FSA in 2006 conducted a baseline survey of financial capability in the UK, which was broadly mirrored in more recent research by the Money Advice Service in 2014.[83] Both reports found that levels of financial capability were low across the entire population – and were not just limited to people with low-incomes. However, research also shows that having low financial capability often has a greater impact on the financial wellbeing of low-income and other vulnerable groups.[84]

The following examples are measures of low financial capability that were observed across the entire population, showing that problems are not limited to those on low incomes. Indeed people across all income groups fail to regularly put aside enough money for emergencies.[85]

Basic numeracy and literacy skills, essential to making good financial decisions, are also worryingly low across the entire adult population, with little correlation to income:[86]

- Four out of five UK adults have low levels of numeracy, equivalent to primary school levels;
- Two out of five UK adults have low levels of literacy by the same metric.

### 2. Low-income households make poor financial decisions and are unable to manage money

Recent research – including focus groups convened for this paper – indicate that low-income households are actually better than average 'money managers'.[87]

Whilst the use of 'harmful' or expensive financial products, such as high-cost credit, is more prevalent amongst people on low incomes, this is predominantly because of a lack of choice and access, rather than because of poor decision-making.[88] For instance, the FCA found the majority of payday loan users had incomes of under £18,000, as opposed to the average of £26,500, but one in four people took out their last payday loan because they had no other source of credit.[89] More broadly, the CSJ found in *Restoring the Balance,* that three million people used some form high-cost credit because they had no access to any other form of

83 Financial Services Authority, *Levels of Financial Capability in the UK: Results of a baseline survey*, London: FSA, 2006 [accessed via: http://www.bristol.ac.uk/media-library/sites/geography/migrated/documents/pfrc0602.pdf (26.05.15)]; and Money Advice Service, *Financial Capability of the UK*, London: Money Advice Service, 2013 [accessed via: https://53b86a9de6dd4673612f-c36ff983a9cc042683f46b699207946d.ssl.cf3.rackcdn.com/mas-baseline-report-2013-3.pdf (26.05.15)]

84 Joseph Rowntree Foundation, *Financial Inclusion in the UK: Review of policy and practice,* York: Joseph Rowntree Foundation, 2008

85 Money Advice Service, *Financial Capability Strategy for the UK: The evidence base,* London: Money Advice Service, 2014 [accessed via: https://53b86a9de6dd4673612f-c36ff983a9cc042683f46b699207946d.ssl.cf3.rackcdn.com/financial-capability-strategy-for-the-uk-a-review-of-evidence.pdf (26.05.15)]

86 http://www.nationalnumeracy.org.uk/what-the-research-says/index.html, Money Advice Service, *The consultation response and next steps: Financial capability strategy for the UK*, London, Money Advice Service, 2015

87 Money Advice Service, *Financial Capability of the UK*, London: Money Advice Service, 2013; and Centre for Social Justice focus groups with Moneyline and Fair Finance clients, May 2015

88 Policis, *Credit and low-income consumers: A demand-side perspective on the issues for consumer protection,* Dorking: Friends Provident Foundation, 2011

89 Financial Conduct Authority, *Proposals for a price cap on high-cost short-term credit (CP14/10),* London: FCA, 2014 [accessed via: http://www.fca.org.uk/static/documents/consultation-papers/cp14-10.pdf (26.05.15)]

credit.[90] Research has also found that a lack of trust in mainstream financial organisations and the inappropriate product design of mainstream consumer credit drive people towards potentially risky forms of high cost credit.[91]

### 3. Many households make irrational decisions that are expensive and worsen their situation

People on low incomes often make financial decisions and choices that appear on the surface to be irrational or detrimental to their financial situation. However, in reality they are often highly logical choices. The reasons behind these decisions are often the result of people's limited options in financial products, lower levels of savings and generally having an income/ expenditure balance that is harder to manage.[92]

One good example is that low-income households are more likely to pay bills in cash and use a pre-payment meter for their utilities, such as gas and electricity, rather than take advantage of discounts available to customers paying by direct debit. Seemingly an illogical choice, this is in fact not the case, as low-income households are also significantly more likely to incur penalty charges when using direct debits, something which often costs more than the associated discounts available.[93]

This is even more likely and logical for people on irregular incomes – such as a zero hours contract – wage amounts can vary week to week and are unlikely to coincide with the dates that bills are due.[94] The desire for control over when money is taken from a bank account and which creditors are paid first, reflects a more general trend amongst low-income consumers which will be discussed below.

### 4. People on low incomes only want to use cash and access face-to-face financial services, do not have access to the internet, use smartphones or want to utilise online financial services

A common assumption is that community finance, debt advice, financial capability training and other related services are most effective at engaging low-income people when delivered in a 'face-to-face' situation.[95] However, if the only free debt advice or credit union services provided in a low-income area are face-to-face, then by default people are more likely to use them, and if they have a positive outcome, state a preference for that type of service in

90 Centre for Social Justice, *Restoring the Balance,* London: Centre for Social Justice, 2014

91 Policis, *Credit and low-income consumers: A demand-side perspective on the issues for consumer protection,* Dorking: Friends Provident Foundation, 2011

92 Friends Provident Foundation, *Developing a vision for financial inclusion,* Dorking: Friends Provident Foundation, 2012, pp26–27 [accessed via: http://www.bristol.ac.uk/media-, Friends Provident Foundation, Developing a vision for financial inclusion, Dorking: Friends Provident library/sites/geography/migrated/documents/pfrc1205.pdf (26.05.15)]

93 Friends Provident Foundation, *Developing a vision for financial inclusion,* Dorking: Friends Provident Foundation, 2012, pp26–27 [accessed via: http://www.bristol.ac.uk/media-library/sites/geography/migrated/documents/pfrc1205.pdf (26.05.15)]

94 Ibid

95 Research Unit for Financial Inclusion (Liverpool John Moores University), *Towards Financial Inclusion: The expansion of credit union financial services for low-income households in Northern Ireland,* Liverpool: Liverpool John Mores University, 2013 [accessed via: http://housingrights.org.uk/sites/default/files/policydocs/Towards%20Financial%20Inclusion.pdf (26.05.15)]; and Optimisa, *360 degree evaluation of Money Advice Service funded face-to-face debt advice,* London: Optimisa, 2013 [accessed via: https://53b86a9de6dd4673612f-c36ff983a9cc042683f46b699207946d.ssl.cf3.rackcdn.com/optimisa-report-final-for-publication.pdf (26.05.15)]

the future. Similarly, many people may respond that they prefer to use face-to-face services – especially in regards to banking and other financial services – because they are unaware of the alternatives, or think they are confusing and 'not for them'.[96]

Using debt advice as an example, recent research by the Money Advice Service found that how people wanted to access services varied considerably across demographics and with regards to the severity of financial problems.[97] In fact, 'low wage families' were the group most likely to use a website for initial contact with a debt advice service in comparison to other wealthier demographic groups.[98]

While it has been historically true, and still is to a lesser extent, that low-income households are less likely to have access to a laptop or fixed broadband connection, annual reports from Ofcom show this is rapidly changing.[99]

Similarly, while smartphone ownership and internet access are still by no means universal, growth of both smartphone and tablet ownership has been significantly faster amongst low-income households.[100] Ownership amongst lower socio-economic groups has increased by 70 per cent since 2012, compared with a 50 per cent increase amongst higher socio-economic groups.[101] Furthermore, while almost nine out of 10 people aged 16–24 own a smartphone, only 25 per cent of people over 55 do, indicating that digital access to financial services is much more likely to be related to age than income. In fact, three quarters of the 'target customers' identified by the Government prior to embarking on the Credit Union Expansion Project already use online banking, and 16 per cent use mobile banking services[102] Perhaps most importantly, more than one in four low-income internet users said the smartphone was their primary way of connecting to the internet, around 50 per cent higher than amongst those in the highest socio-economic category.[103]

This does not mean that low-income households all want to use digital services or that there will soon be no demand for face-to-face services. However, it is important not to pigeonhole low-income households and assume they are only interested in and/or will only use face-to-face services now and in the future.

96 Friends Provident Foundation, *Developing a vision for financial inclusion,* Dorking: Friends Provident Foundation, 2012, p27 [accessed via: http://www.bristol.ac.uk/media-library/sites/geography/migrated/documents/pfrc1205.pdf (26.05.15)]; and Financial Inclusion Commission, *Improving the Financial Health of the Nation*, London: Financial Inclusion Commission, 2015, p20 [accessed via: http://www.financialinclusioncommission.org.uk/pdfs/fic_report_2015.pdf (26.05.15)]

97 Money Advice Service, *Indebted lives: The complexities of life in debt,* London: Money Advice Service, 2013

98 Ibid

99 Ofcom, *The Consumer Experience of 2013,* London: Ofcom, 2014 [accessed via: http://stakeholders.ofcom.org.uk/binaries/research/consumer-experience/tce-13/TCE_Research_final.pdf (26.05.15)]

100 Ofcom, *The Communications Market Report,* London: Ofcom, 2014 [accessed via: http://stakeholders.ofcom.org.uk/binaries/research/cmr/cmr14/2014_UK_CMR.pdf (26.05.15)]

101 Ibid

102 Department for Work and Pensions, *DWP Credit Union Expansion Project: Project Steering Committee Feasibility Study Report,* London: DWP, 2012 [accessed via: http://webarchive.nationalarchives.gov.uk/20130102224139/http:/www.dwp.gov.uk/docs/credit-union-feasibility-study-report.pdf (26.05.15)]

103 Ofcom, *The Communications Market Report,* London: Ofcom, 2014, p274 [accessed via: http://stakeholders.ofcom.org.uk/binaries/research/cmr/cmr14/2014_UK_CMR.pdf (26.05.15)]

### Building the evidence base

There have been recent developments in terms of building an evidence base, which should be applauded and used as a foundation moving forward. In 2015 the Money Advice Service (MAS) – an independent organisation tasked with coordinating and improving the UK's debt advice and financial capability sectors – released its draft UK Financial Capability Strategy as well as its Financial Capability Evidence Hub, a centralised resource that evaluates reports and other evidence/evaluations of financial capability services.[104] It is also working to develop its Evaluation Toolkit to help organisations delivering financial capability services to improve the quality of their evaluations as well as make them more comparable to that of other organisations.[105]

MAS has received more than its fair share of criticism since it was set up in the aftermath of the 2007 financial crash and the dissolution of the FSA. As a result, in 2015 its activities and impact in terms of coordinating the UK's financial capability sector were the main focus of an independent review of the organisation published in 2015.[106] However, while these developments are still in their infancy and the UK Financial Capability Strategy is not yet complete, their significance should not be underestimated. Without consistent evaluation metrics, not just for financial capability but also for debt advice and the provision of products and services through Alternative Financial Institutions, it would be extremely hard to coordinate and develop the most successful forms of intervention or make the case for needing future funding.

It is necessary for MAS to continue this coordination but it needs support from mainstream financial institutions to support it. The specific areas and ways in which greater coordination would be most effective as well as how exactly to implement certain standards, such as for measuring over-indebtedness or reasonable debt repayments, will be discussed later in the report.

## 1.3 The problem of treating debt in silos

Interventions in each of the six major areas have had a limited impact for the variety of reasons outlined in this chapter, most notably the lack of evidence led solutions, consistent evaluations and the failure of interventions to truly recognise and understand the behaviour of low-income households. One overarching issue is that while the segmentation of research and interventions into these six broad areas has made sense in the past, subsequent research has highlighted that there is such a substantial degree of overlap between them, that a more holistic approach to tackling problem debt is needed.

104 Financial Capability Strategy for the UK, *Moving Full Steam Ahead Towards A More Financially Capable UK*, Press Release, 25 March 2015 [accessed via: http://www.fincap.org.uk/document/VLP4GyMAACQAPjd9/press-releases (26.05.15)]

105 Financial Capability Strategy for the UK, *Common evaluation toolkit* [accessed via: http://www.fincap.org.uk/common_evaluation_toolkit (26.05.15)]

106 HM Treasury, *Review of the Money Advice Service,* London: HM Treasury, 2015 [accessed via: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/414812/PU1736_MAS_review_document_19_March.pdf (26.05.15)]

For instance, just because a person took out an expensive payday loan for £200 does not mean that the cost was what caused them to not repay it on time. Similarly, if a person has poor financial skills and struggles to manage their money, simply addressing this issue alone will not necessarily help them avoid debt in the future if they unexpectedly become ill, lose their job or are unable to build up sufficient savings to avoid doing anything other than take out expensive forms of high cost credit in an emergency.

The lack of an effective evidence base combined with the status quo of addressing the six themes in isolation of each other have together led to a fundamentally flawed approach. Without evidence, it is hard to justify pursuing one programme or provider over another. This has meant that funders and commissioners have frequently changed between policy objectives, always pursuing the latest potential solution rather than integrating, developing and scaling up existing solutions.

It has also led to a failure to recognise that low-income households are consumers in their own right who need a set of products and services which are designed with their wants and needs in mind.[107]

In Chapters Three and Four this report will set out the need for a new generation of products, provided by financial institutions that are not 'poor man's banks', but rather innovative competitive firms whose sole business objective is to target the substantial market segment that is currently underserved and at risk of problem debt because there are no products, services or firms that truly help them maintain their financial health.

## 1.4 A new vision and a new approach to tackling problem debt

In order to reinvigorate efforts to tackle problem debt there is a need to encourage solutions that develop products and services around people's wants and needs, rather than simply defaulting to traditional mechanisms for helping people with problem debt.

The CSJ evidence sessions indicate that people need access to:

- Advice and education on money and financial skills throughout their lives;
- A range of affordable financial products and services designed around their wants and needs that enable them to maintain their financial wellbeing;
- A variety of quality financial institutions focused on serving them as customers.

In order to enable people to achieve these goals and avoid the mistakes of past programmes to tackle problem debt, government must take decisive action in coordination with the financial sector, charitable organisations and social enterprises to:

- Identify what low-income people actually want to do with their money, how they use it and what drives their behaviour;

107 Financial Inclusion Commission, *Financial Inclusion: Improving the financial health of the nation, London: Financial Inclusion Commission, 2015*

- Determine what people want and need from financial services and debt related services that help people improve their financial wellbeing and achieve the objectives of a fairer financial system mentioned above;
- Ensure that there is a robust evidence base and evaluation framework for programmes and delivery partners, based on commonly agreed standards, so that funding is directed only to the best organisations and programmes;
- Seek sustainability and scalability for any programme or AFI, so that the best organisations can offer financial services, advice and support to the millions of low-income people, who are either underserved or at risk of problem debt.

# chapter two
# Financial skills, advice and support

The starting point for any government looking to understand and tackle high levels of problem debt amongst low-income households must be the people and families affected by problem debt. This chapter sets out a fresh approach and way of thinking about how to empower people on low incomes before, during and after a debt crisis. By understanding how people think about money and debt, it is possible to design education, advice and support services around what people want and need at different points in their life. This approach makes services easier for people to engage with, while also maximising the benefit they receive from those services.

## 2.1 How people think about money and debt

In order to reduce problem debt amongst low-income households it is necessary to consider how people think about money and debt, as it influences how they interact with education, training and advice services, as well as how much they benefit from these services.

**Financial Capability:** A person's ability to make positive financial decisions and maximise their financial wellbeing, based on the information and choices they are given, such as how they manage their money or when choosing financial products or services.

There are certain commonly held attitudes that people have in relation to money and debt:[108]

- People do not want to learn about money or develop financial skills just for the sake of it;
- People do not like to talk about money especially when they are struggling with debt;
- People often do not recognise when they are in problem debt or are in denial.

108 Money Advice Service, Indebted Lives: The Complexities of Life in Debt, 2013 [accessed via: http://static1.squarespace.com/static/5406dac3e4b02d18666bcb68/t/544f8df6e4b0e1372c1c55da/1414499830876/indebted-lives-the-complexities-of-life-in-debt-november-2013-v3.pdf

## People do not want to learn about money or develop financial skills just for the sake of it

Since 2006 successive governments have pushed hard to increase levels of financial capability.[109] As a result of this, financial education now features as part of national curriculum and, since 2014, is being taught in all state-maintained secondary schools.[110] However, despite political support and significant spending on financial education programmes since 2006, there has actually been little quantifiable impact of the various programmes over the past ten years, not least in terms of reducing the overall level of problem debt.[111] This can be at least partly explained by three things:

- Formal financial education cannot easily change a person's pre-existing attitudes towards money and debt, as they are formed early in life;[112]
- Even the best financial education programmes will struggle to engage people and teach them financial skills if they do not want to engage or do not see the immediate benefit or relevance;[113]
- There is a limit to the amount of financial education and skills that can be learned during a person's school years, after which there are few opportunities for formal financial education.[114]

The ineffectiveness of financial education is a problem that is not isolated to the UK. Surveys by Jump$tart, an American financial education campaign group, consistently find that students enrolled in personal finance or money management courses perform no better on financial literacy tests than average.[115] One detailed survey even found that students who completed a financial education programme in school were less likely to pay off their credit card balance each month.[116]

It is in fact a myth that the majority of all debt problems are caused by people's poor financial skills.[117] However, low-income households that do lack financial skills are significantly more likely to fall into debt, as they typically have low levels of savings and cannot easily access cheap forms of mainstream credit.[118]

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109 National Audit Office, *The Financial Service Authority: A Review under Section 12 of the Financial Services and Markets Act 2000*, 2007, pp51–60 [http://www.nao.org.uk/wp-content/uploads/2007/04/0607500_5.pdf (18/05/15)]

110 For more information see the House of Commons Library briefing: House of Commons Library, *Financial Enterprise and Education in Schools*, 2014 [accessed via: www.parliament.uk/briefing-papers/SN06156.pdf (18/05/15)]

111 The statistics for personal debt bear out this conclusion: The Money Charity, *The Money Statistics: May 2015's Money Statistics, 2015 [accessed via:* http://themoneycharity.org.uk/money-statistics/ (19/05/15)]; and Money Advice Service, *The Financial Capability of the UK*, November 2013 [accessed via: https://53b86a9de6dd4673612f-c36ff983a9cc042683f46b699207946d.ssl.cf3.rackcdn.com/mas-baseline-report-2013-3.pdf (19/05/15)]

112 Money Advice Service, *Impact Review of Financial Education for Young People*, London: Money Advice Service, 2012

113 Ibid

114 National Research and Development Centre for adult literacy and numeracy, *Financial Literacy Education and Skills for Life*, 2005 [accessed via: http://www.nrdc.org.uk/content.asp?CategoryID=440&ArticleID=702 (18/05/15)]

115 The study does suggest, however, that there may be longer term emotional results of such education. The Aspen Institute Initiative on Financial Security, *Two Cheers for School Based Financial Education*, 2009, p1 [accessed via: http://www.aspeninstitute.org/sites/default/files/content/docs/pubs/Two%20Cheers.pdf (18/05/15)]

116 Goodman A. and Gregg P. eds., *Poorer children's educational attainment: how important are attitudes and behaviour? 2010 [accessed via:* http://www.jrf.org.uk/system/files/poorer-children-education-full.pdf (18/05/15)]

117 Step Change, *Statistics Yearbook: Personal Debt 2014*, March 2015 [accessed via: http://www.stepchange.org/Portals/0/documents/media/reports/statisticsyearbooks/StepChangeDebtCharityStatisticsYearbook2014.pdf (19/05/15)]

118 Money Advice Service, *A Financial Capability Strategy for the UK: The Evidence Base* [accessed via: https://53b86a9de6dd4673612f-c36ff983a9cc042683f46b699207946d.ssl.cf3.rackcdn.com/financial-capability-strategy-for-the-uk-a-review-of-evidence.pdf (19/05/15)]; Taylor, M et al., 'Financial capability, income and psychological wellbeing', *Institute of Social and Economic Research*, 18, July 2011 [accessed via: https://53b86a9de6dd4673612f-c36ff983a9cc042683f46b699207946d.ssl.cf3.rackcdn.com/research_jul11_wellbeing.pdf (19/05/15)]

Despite the questionable long-term impact of financial education at the national level, there are still clear benefits and a need for people, especially those on low incomes, to develop financial skills throughout life, such as:[119]

- How to create a monthly budget and choose products and services that make this simpler;
- The need to plan for emergencies and how appropriate products and services can help;
- How to calculate the cost and choose between various financial products tailored to them.

In order for formal financial education in schools to impact significantly on a person's overall financial capability it is vital that people also have the prerequisite levels of literacy and numeracy to make use of the information.[120]

Similarly, no amount of formal financial education will help people avoid, manage or resolve problem debt issues that are actually not primarily the result of a person's lack of financial skills, but rather a combination of the following:

- Established attitudes towards money and debt (these are currently not taken into consideration when designing products and services for low-income consumers);
- External factors beyond their control, such as a systemic mismatch between income and expenditures, long-term illness or reduction in benefits as a result of a section or policy change.[121]

Therefore, financial education and skills training should not be seen as a panacea to problem debt, but rather a toolkit or life skill that forms a key building block of a person's overall financial capability and changes over time. Furthermore, it is vital that programmes are built around what people want to learn and engage with at various points in their lives when it is relevant and most helpful for them. These can include the following::

- Basic literacy and numeracy skills taught at schools that are a prerequisite to financial skills;[122]
- Financial skills regarding managing a household budget and paying bills when young people leave home for university to enter work or begin a vocational training program;[123]
- Advice regarding pensions, regular savings and the use of credit upon entering the workforce or changing jobs;[124]
- Managing money on a limited budget and dealing with potential debt problems, which are 63 per cent more likely to occur when someone becomes unemployed and enters the benefits systems.[125]

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119 Money Advice Service, *A Financial Capability Strategy for the UK: The Evidence Base* [accessed via: https://53b86a9de6dd4673612f-c36ff983a9cc042683f46b699207946d.ssl.cf3.rackcdn.com/financial-capability-strategy-for-the-uk-a-review-of-evidence.pdf (19/05/15)]

120 National Bureau of Economic Research, *Numeracy, Financial Literacy, and Financial Decision-Making*, 2012 [accessed via: http://www.nber.org/papers/w17821 (18/05/15)]

121 StepChange, *Statistics Yearbook: Personal Debt 2013*, London: StepChange, 2014, p5 [accessed via: http://www.stepchange.org/Portals/0/documents/media/PersonalStatsYearbook2013.pdf (19/05/15)]

122 Atkinson, A, *Financial capability amongst adults with literacy and numeracy needs, Personal Finance Research Centre*, University of Bristol, 2007 [accessed via: http://www.bris.ac.uk/media-library/sites/geography/migrated/documents/pfrc0701.pdf (19/05/15)]

123 Money Advice Service, *Impact Review of Financial Education for Young People*, June 2012 [accessed via: https://53b86a9de6dd4673612f-c36ff983a9cc042683f46b699207946d.ssl.cf3.rackcdn.com/research_jun12_impactreviewoffinancialeducationforyoungpeople.pdf (19/05/15)]

124 Money Advice Service, *A Financial Capability Strategy for the UK: The Evidence Base* [accessed via: https://53b86a9de6dd4673612f-c36ff983a9cc042683f46b699207946d.ssl.cf3.rackcdn.com/financial-capability-strategy-for-the-uk-a-review-of-evidence.pdf (19/05/15)]

125 Ibid

### People do not like to talk about money especially when they are struggling with debt

There is a longstanding social stigma around personal debt as well as a prevailing narrative in regulatory and political circles that people have a responsibility to obtain the necessary financial skills to avoid problem debt and become 'informed consumers'.[126] These two concepts are intertwined and it is highly likely that they impact on people's attitudes towards money and debt. The consequence is that many people are reluctant to talk about money or to admit to having poor financial skills, especially if they are struggling financially, a situation which can only be changed with consistent effort over time.[127]

For this reason, the FSA and others have recognised that programmes or services designed to empower people to maximise their financial capability are significantly more effective when the person is engaged through a trusted intermediary (such as a midwife, GP etc.).[128] Similarly, research by MAS highlighted that people across the income spectrum have wide ranging individual preferences in terms of how they want to access debt advice services.[129]

That this has been widely recognised and is incorporated into delivery programmes for a wide variety of advice, training and even financial services, is undoubtedly a positive thing. However, it also implies that many people may not be getting the help and advice they need if there is no trusted intermediary to go to.[130] It is estimated that one in five people who want and would benefit from some type of debt-related support to do not receive it as they do not know where to go, while one in seven do not act because of the fear of the social stigma that is associated with problem debt.[131]

There are numerous life events where people could probably benefit from receiving independent financial advice, such as marriage, moving home, prior to retirement or after diagnosis with a serious illness.[132] Despite the fact that there are many more examples of situations where people could benefit from receiving independent financial advice, as well as the frequency of those events, research shows that fewer than one in five people seek financial advice each year.[133]

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126 OECD, *Improving Financial Education effectiveness through behavioural economics: OECD Key Findings and Way Forward*, 2013 [accessed via: http://www.oecd.org/daf/fin/financial-education/TrustFund2013_OECDImproving_Fin_Ed_effectiveness_through_Behavioural_Economics.pdf (18/05/15)]

127 Centre for Social Justice, *Maxed Out: Serious personal debt in Britain*, 2013 [accessed via: http://www.centreforsocialjustice.org.uk/UserStorage/pdf/Pdf%20reports/CSJ_Serious_Debt_report_WEB_final.pdf (18/05/15)]

128 The Financial Inclusion Commission, *Minutes of Evidence taken before the Financial Inclusion Commission on 16 January 2015*, 2015 [accessed via: http://www.financialinclusioncommission.org.uk/uploads/asset/attachment/53/UKFIC_-_Glasgow_Evidence_Session_16.01.2015_-_Session_2.pdf (18/05/15)]; National Audit Office, *The Financial Service Authority: A Review under Section 12 of the Financial Services and Markets Act 2000, 2007, pp51–60 [http://www.nao.org.uk/wp-content/uploads/2007/04/0607500.pdf (18/05/15)]*

129 Money Advice Service, *Indebted Lives: The Complexities of Life in Debt*, 2013 [accessed via: http://static1.squarespace.com/static/5406dac3e4b02d18666bcb68/t/544f8df6e4b0e1372c1c55da/1414499830876/indebted-lives-the-complexities-of-life-in-debt-november-2013-v3.pdf (18/05/15)]

130 Money Advice Service, *A Financial Capability Strategy for the UK: The Evidence Base* [accessed via: https://53b86a9de6dd4673612f-c36ff983a9cc042683f46b699207946d.ssl.cf3.rackcdn.com/financial-capability-strategy-for-the-uk-a-review-of-evidence.pdf (19/05/15)]

131 R3, *Struggling with debts without help*, London: R3, 2010 [accessed via https://www.r3.org.uk/media/documents/policy/policy_papers/personal_insolvency/R3_Struggling_with_Debt_paper_2010.pdf (19/05/15)]

132 Money Advice Service, *A Financial Capability Strategy for the UK: The Evidence Base* [accessed via: https://53b86a9de6dd4673612f-c36ff983a9cc042683f46b699207946d.ssl.cf3.rackcdn.com/financial-capability-strategy-for-the-uk-a-review-of-evidence.pdf (19/05/15)]

133 unbiased.co.uk, *The Value of Advice Report*, 2012, p5 [accessed via: https://www.unbiased.co.uk/Value-of-Advice-Report-2012.pdf (19/05/15)]

People with low incomes are also much less likely to seek independent financial advice, despite the fact they could suffer more severe consequences in the event of making a poor financial decision.[134] Research by the Money Advice Service found that only 40 per cent of people would be able to cope with an unexpected income shock of just £300, meaning many low-income households will have few options but to use high-cost credit and put themselves at risk of falling into serious personal debt as a result.[135]

**'Debt–related services'** is a term that encompasses all of the personal financial services that are intended to help people avoid, manage and recover from problem debt, including financial education, financial capability training, and debt advice. The majority of these services are provided by charities and social enterprises, but there are also a significant number of commercial firms that offer debt-related services, with the majority being debt management companies (DMCs). Local government will also sometimes have in-house debt advisers rather than contracting the services out, most often to the local Citizen's Advice Bureau if there is one, and there are now teachers delivering financial education in many state-maintainted schools, although a large number have contracted this out as well.

While things have arguably gotten better in recent years with regards to the stigma around debt and people's willingness to talk about money, the impact people's attitudes and opinions have with regards to accessing education, advice and skills training should not be underestimated.[136] It is therefore especially important that programmes and services designed for vulnerable consumers, or those on low incomes, take people's attitudes towards money and debt into account. Doing so would help to increase people's willingness to engage with services that can help people before, during or after a debt crisis.

Two good examples of innovative AFIs that already integrate debt advice and financial capability training services into their business model are two CDFIs: Fair Finance in London and Scotcash in Glasgow.

### People do not recognise when they are in problem debt or are often in denial

It is estimated that one in five people do not recognise they are over indebted and half of those who do wait a year or more before actually seeking debt advice, by which point it is often much harder to deal with.[137] There are several factors that help explain this, including social stigma, which paints debt problems as a personal or moral failure, self-denial or over-optimism, as well as a failure by many people to understand the true extent of their debt

134 unbiased.co.uk, *The Value of Advice Report,* 2012 [accessed via: https://www.unbiased.co.uk/Value-of-Advice-Report-2012.pdf (19/05/15)]

135 Money Advice Service, *The Financial Capability of the UK,* London, November 2013 [accessed via: https://53b86a9de6dd4673612f-c36ff983a9cc042683f46b699207946d.ssl.cf3.rackcdn.com/mas-baseline-report-2013-3.pdf (20/05/15)]; Personal Finance Research Centre, *The impact on business and consumers of a cap on the total cost of credit*, London: BIS, March 2013 [accessed via: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/136548/13-702-the-impact-on-business-and-consumers-of-a-cap-on-the-total-cost-of-credit.pdf (20/05/15)]

136 Inclusion Commission, *Minutes of Evidence Taken Before the Financial Inclusion Commission 16 January 2015,* 2015 [accessed via: http://www.financialinclusioncommission.org.uk/uploads/asset/attachment/53/UKFIC_-_Glasgow_Evidence_Session_16.01.2015_-_Session_2.pdf (18/05/15)]

137 For the figure who do not recognise their own indebtedness, see Money Advice Service, *Indebted Lives, the complexities of life in debt,* 2013, p10 [accessed via: http://static1.squarespace.com/static/5406dac3e4b02d18666bcb68/t/544f8df6e4b0e1372c1c55da/1414499830876/indebted-lives-the-complexities-of-life-in-debt-november-2013-v3.pdf (18/05/15)]; on length of time before seeking help see Step Change, *Statistics Yearbook: Personal Debt 2013,* 2014, p1 [accessed via: http://www.stepchange.org/Portals/0/documents/media/PersonalStatsYearbook2013.pdf (19/05/15)]

problems.[138] Until these societal and individual attitudes towards debt change, it will be significantly harder to increase the levels of people engaging with debt advice and to tackle problem debt.

## 2.2 Delivering education, advice and skills when people need and want it

Because debt varies in terms of duration, severity and the level of support people need, the type of advice people want and how they access also varies. By thinking first and foremost about a person and their 'debt journey', it is possible to improve how people engage with education, skills training and debt advice services throughout their lives, as well as significantly increasing levels of engagement and improving the cost-efficiency of delivering services.

The CSJ heard that there are three areas in which reforms would significantly improve the delivery of debt support services, especially in terms of providing more consistent and integrated services that are focused first and foremost on the diverse wants and needs of low-income households:

- Standardising definitions and procedures used to identify people who need support;
- Coordinating service delivery between providers so a person's 'debt journey' is uninterrupted;
- Funding providers based on their performance using a high quality and independent evaluation framework.

### Standardising definitions and procedures used to identify people most in need of support

There is a need for further standardisation within the debt-related services to ensure that more people receive the services they need. At present the landscape for debt-related service providers – debt advice, financial education and financial capability training – is highly fragmented, leaving people to deal directly with a wide variety of organisations, primarily charities of varying sizes, which all tend to specialise in one of three areas:

- Financial education (mostly based in schools);[139]
- Financial capability and skills training (broader programmes primarily for adults);[140]
- Debt advice (primarily delivered through online, telephone, or face-to-face).[141]

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138 StepChange, *Statistics Yearbook: Personal Debt 2014,* March 2015 [accessed via: http://www.stepchange.org/Portals/0/documents/media/reports/statisticsyearbooks/StepChangeDebtCharityStatisticsYearbook2014.pdf (19/05/15)]; and Money Advice Service, *Indebted Lives, the complexities of life in debt,* 2013 p10 [accessed via: http://static1.squarespace.com/static/5406dac3e4b02d18666bcb68/t/544f8df6e4b0e1372c1c55da/1414499830876/indebted-lives-the-complexities-of-life-in-debt-november-2013-v3.pdf (19/05/15)]

139 Money Advice Service, *Impact Review of Financial Education for Young People,* 2012 [accessed via: https://53b86a9de6dd4673612f-c36ff983a9cc042683f46b699207946d.ssl.cf3.rackcdn.com/research_jun12_impactreviewoffinancialeducationforyoungpeople.pdf (18/05/15)]

140 Money Advice Service, *The Consultation Response and Next Steps: Financial Capability Strategy for the UK,* March 2015 [accessed via: https://prismic-io.s3.amazonaws.com/fincap-two%2F7ac2f4a9-bf30-4da2-b191-3859eea9396c_uk_financial_capability_strategy_consultation_response_march2015_online.pdf (20/05/15)]

141 London Economics, *Audit of the supply of debt advice services across the UK,* December 2012 [accessed via: https://53b86a9de6dd4673612f-c36ff983a9cc042683f46b699207946d.ssl.cf3.rackcdn.com/audit-of-the-supply-of-debt-advice-services-across-the-uk.pdf (20/05/15)]

Following the financial crash in 2007 and the publication of the Thoresen Review, responsibility for coordinating both the strategy and provision of debt advice and financial capability services was transferred from the FSA to the newly created Money Advice Service.[142] The intention was to create an independent organisation that could coordinate and fund a fractured array of organisations, typically charities of various size and capacity.

The secondary goal was to drive up the minimum quality standards for the services they provide and create a way to evaluate and evidence the relative successes of those services, specifically in regards to outcomes for the people using the services.[143] Significant progress has been made on all fronts and a recent independent review of progress was broadly positive.[144]

The Money Advice Service has also been heavily involved in negotiating on behalf of a variety of debt-related service providers and with the key stakeholders in the financial sector.[145] A key objective of these negotiations is to create certain standardised definitions, procedures, frameworks for accreditation and evaluation frameworks.[146] Without standardisation in certain areas, the quality of services low-income households receive at any given point on their 'debt journey' could vary considerably depending on where they lived and which organisations were helping them.

Some examples of where standardisation would benefit low-income households include:

- A standardised definition of 'over indebtedness' accepted by everyone, in order that lenders can make better more consistent affordability checks and creditors are better placed to recognise when someone should be referred to debt advice;[147]
- How customers are 'triaged' following initial contact with a debt-related service to ensure they receive the type and level of support most appropriate to their needs and preferences;[148]
- Clear and effective procedures to seamlessly refer people to other services following an initial contact or identification of additional issues for which that they would like support.[149]

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142 HM Treasury, *Thoresen Review of generic financial advice: Final Report*, March 2008 [accessed via: http://webarchive.nationalarchives.gov.uk/+/http:/www.hm-treasury.gov.uk/media/8/3/thoresenreview_final.pdf (20/05/15)]

143 Money Advice Service, *Debt advice evaluation framework*, December 2013 [accessed via: https://53b86a9de6dd4673612f-c36ff983a9cc042683f46b699207946d.ssl.cf3.rackcdn.com/debt-advice-evaluation-framework_january-2013a.pdf (20/05/15)]

144 HM Treasury, *Review of the Money Advice Service*, March 2015 [accessed via: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/414812/PU1736_MAS_review_document_19_March.pdf (20/05/15)]

145 HM Treasury, *Money Advice Service, Financial Conduct Authority and HM Treasury Framework Document,* March 2013 [accessed via: https://53b86a9de6dd4673612f-c36ff983a9cc042683f46b699207946d.ssl.cf3.rackcdn.com/mas-fca-hmt-framework-document-final.pdf (20/05/15)]

146 Money Advice Service, Press Release, *Money Advice Service commissions Money Advice Trust to develop a standards framework for debt advice*, July 2012 [accessed via: https://53b86a9de6dd4673612f-c36ff983a9cc042683f46b699207946d.ssl.cf3.rackcdn.com/20120705_mas_-commissions_mat_to_develop_a_standards_framework.pdf (20/05/15)]

147 Bryan, M et al., *Over-Indebtedness in Great Britain: An Analysis Using the Wealth and Assets Survey and Household Annual Debtors Survey* (Report to the Department for Business, Innovation and Skills), Institute for Social and Economic Research, University of Essex, October 2010 [accessed via: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31897/11-747-over-indebtedness-in-great-britain-analysis.pdf (20/05/15)]; Money Advice Service, Research Report, *User Needs from Debt Advice: Individual and Stakeholder Views*, February 2012 [accessed via: https://53b86a9de6dd4673612f-c36ff983a9cc042683f46b699207946d.ssl.cf3.rackcdn.com/research_feb12_iff_report.pdf (20/05/15)]; European Commission, *Towards a common operational European definition of over-indebtedness*, 2008 [accessed via: https://www.google.co.uk/url?sa=t&rct=j&q=&esrc=s&source=web&cd=2&ved=0CCsQFjAB&url=http%3A%2F%2Fec.europa.eu%2Fsocial%2FBlobServlet%3FdocId%3D762%26langId%3Den&ei=xhVaVcDwAsG8sAGggIHIAw&usg=AFQjCNF2pH8YXI7O_Gn3sTdey-xrtjPfdw&bvm=bv.93564037,d.bGg (20/05/15)]

148 Money Advice Service, *2012/13 Debt Advice Business Plan: Community and Transition*, March 2012 [accessed via: https://53b86a9de6dd4673612f-c36ff983a9cc042683f46b699207946d.ssl.cf3.rackcdn.com/mas_debt_advice_business_plan_2012.pdf (20/05/15)]

149 Money Advice Service, *Achieving consistent and high quality Debt Advice: An approach to Standards and Quality Assurance from the debt advice sector: Consultation response,* June 2013 [accessed via: https://53b86a9de6dd4673612f-c36ff983a9cc042683f46b699207946d.ssl.cf3.rackcdn.com/the-money-advice-service-achieving-consistent-and-high-quality-debt-advice.pdf (20/05/15)]

Specifically, in order to better identify people struggling with problem debt and improve the quality and consistency of services, MAS must be supported and continue to develop the following things in partnership with mainstream financial institutions, trade associations, larger charitable organisations and other key stakeholders operating on the fringes of the sector (e.g. debt collection agencies):

- The Standard Financial Statement;[150]
- Accreditation processes and minimum quality standards;[151]
- Evaluation metrics and frameworks;[152]
- Definitions, minimum standards, and good practice guidelines to protect vulnerable people;[153]
- Standards for collecting and evaluating evidence to compare service providers;[154]
- Protocols for coordinating referrals and the 'warm handover' of people between services;[155]
- Funding guidelines for government, grant makers and businesses wishing to fund services to ensure the best organisations receive the most support and are able to scale their services.
- It should be noted at this point that MAS has already taken the lead on many of these initiatives, which is highly commendable. However, unless they are supported in their efforts to coordinate and improve the sector, both in terms of political support and also through the funding decisions of other service commissioners, these efforts could stall.

### Developing a Standard Financial Statement

Perhaps the biggest issue in terms of standardisation is the lack of a Standard Financial Statement, which assesses a person's income and expenditure, to be used by all creditors, debt advisers, debt collectors, policy makers and any other organisation that ever needs to assess a customers' information. Without this statement, two people in different cities with exactly the same incomes, expenditures and levels of debt, can be asked to pay two completely different amounts towards their debt repayments, as the debt advisers will not be using the same evaluation form to assess their financial situation and they may receive very different levels of service.

The situation becomes more confused when a single customer is served by two different types of organisations, such as a small charitable debt advice agency and large commercial provider of financial skills training through a referral under the Work Programme. The latter is significantly more likely to have identified them as vulnerable in regards to government services, but will not necessarily have relayed that information to the person's creditors, or the debt adviser.

150 Money Advice Service, *The Standard Financial Statement: A Consultation*, October 2014 [accessed via: https://53b86a9de6dd4673612f-c36ff983a9cc042683f46b699207946d.ssl.cf3.rackcdn.com/the-standard-financial-statement_consultation_final_20141014.pdf (20/05/15)]

151 Money Advice Service, *Achieving consistent and high quality Debt Advice: An approach to Standards and Quality Assurance from the debt advice sector: Consultation response,* June 2013 [accessed via: https://53b86a9de6dd4673612f-c36ff983a9cc042683f46b699207946d.ssl.cf3.rackcdn.com/the-money-advice-service-achieving-consistent-and-high-quality-debt-advice.pdf (20/05/15)]

152 Money Advice Service, *2014/2015 Business Plan,* April 2014 [accessed via: https://53b86a9de6dd4673612f-c36ff983a9cc042683f46b699207946d.ssl.cf3.rackcdn.com/money-advice-service-2014-15-business-final-v2.pdf (20/05/15)]

153 Money Advice Service, *The Consultation Response and Next Steps: Financial Capability Strategy for the UK,* March 2015 [accessed via: https://prismic-io.s3.amazonaws.com/fincap-two%2F7ac2f4a9-bf30-4da2-b191-3859eea9396c_uk_financial_capability_strategy_consultation_response_march2015_online.pdf (20/05/15)]

154 Money Advice Service, *Financial Capability Strategy for the UK: Common Evaluation Toolkit* [accessed via: http://www.fincap.org.uk/common_evaluation_toolkit (20/05/15)]

155 Money Advice Service, *Achieving consistent and high quality Debt Advice: An approach to Standards and Quality Assurance from the debt advice sector: Consultation response,* June 2013 [accessed via: https://53b86a9de6dd4673612f-c36ff983a9cc042683f46b699207946d.ssl.cf3.rackcdn.com/the-money-advice-service-achieving-consistent-and-high-quality-debt-advice.pdf (20/05/15)]

The discrepancies that exist across a range of situations clearly highlight that there is a large degree of fragmentation without the provision of debt-related services and there is significant room for improvement. Most importantly, in order to improve outcomes for low-income households and increase people's willingness to seek help, services and how they are provided should be tailored to the diverse wants and needs of people, rather than the priorities of those organisations providing the services.

Similarly, it is likely that the small charity in the example above will often be funded by individual donations from members of the community, whereas the large national provider is primarily funded through an agreement with financial institutions, whereby they are paid by creditors in relation to the amount of debts that are repaid by clients through the organisation's debt advice services.[156]

> There has, over the last few years, been much debate around both the funding structure of different sized organisations and the appropriateness of solutions applied to similar indebted situations. Smaller organisations operating within a community would, in my view, more likely suit clients seeking face-to-face advice and practical support, particularly for those who may not cope well with the telephone and internet approach.
>
> They are also in a better position to provide holistic support to their clients via a formalised joined up approach through engagement with other organisations operating in the same communities. These organisations should be given help to employ high service standards whilst securing a sustainable funding strategy that draws from many sources. What often happens is these organisations face many demoralising obstacles that are costly and prevent them from positively affecting their communities. It also hinders their ability to reduce the financial burden indebtedness brings on the nation.
>
> Phill Holdsworth – Independent Financial Services Consultant, Money & Debt Advice

There is nothing wrong with either funding approach in any way, but in order to allocate funding to the most effective and innovative organisations, funders of all types must have a way to quickly and easily compare any two organisations. For instance, in this example it is likely the individual funders may never know that if they had all made similar sized donations to the larger national debt advice charity, then the quality of the service and outcomes of the people seeking help could be improved, as it would have allowed for a new branch of the national charity to be opened in their local area and which would be at a lower annual cost due to economies of scale.

### Evidence and transparency

There needs to be greater transparency regarding how well organisations are meeting people's wants and needs with regards to the provision of debt-related services, so that funding from a whole variety of sources can be funnelled to the most effective organisations and ones that meet the specific wants and needs identified in any given community.

156 StepChange, *About us: Our Approach* [accessed via: http://www.stepchange.org/Aboutus/Ourapproach.aspx (20/05/15)]

MAS has made progress in this area recently, as it has created a central evaluation hub and toolkits for organisations to use to evaluate their service.[157] Similarly, they are working on developing an evidence hub and standards. However, while these developments are commendable, there is still room for a more aspirational and visionary approach.

In this instance, MAS should consult not only with the financial institutions, or even the organisations that deliver services, but also with low-income people who actually use the services. This could be done at a relatively low cost through a large open online consultation process, involving various stages such as:

- Smaller groups to get the opinions of specific customer demographics;
- Slightly larger and more diverse focus groups;
- Even larger telephone surveys allowing some degree of 'free response' to generate ideas;
- A culminating series of increasingly large and less open-ended online questionnaires.

An in-depth customer-led consultation process such as this, building off of MAS's previous customer research, would provide arguably the most comprehensive findings and understanding of how low-income people really want to use debt-related services, what they want from them and what their priorities are regarding the things that would help or harm them most. As low-income households are not a homogenous grouping, it is likely it would return a diverse range of groupings of customers, each with distinct priorities and separate vision for what their 'ideal service' would be like.

At this point MAS, using the findings of the customer survey, could develop and market one or more additional accreditation systems, based on the issues that matter most to service users and MAS's existing accreditation framework. Organisations could then request to go through an independently evaluated accreditation process if they wanted to.

### Recommendation

The Money Advice Service should develop a multi-tiered system of accreditation, based on their existing independent evaluated accreditation system, for organisations delivering debt advice, financial capability training and financial education. The standards for the highest level(s) of accreditation should be set deliberately at a level so that no organisation can reach them too quickly, but that is still within reach within the foreseeable future.

By marketing the various accreditation schemes heavily, both to end users and to funders, organisations will come under pressure from both sides to re-evaluate their organisation and try to seek improvements that match what the people they primarily are interested in serving are requesting, or alternatively, set milestones towards achieving a new level of accreditation that is requested by a major source of funding.

Either way, this system has the potential to drive innovation and competition between providers, but over the quality of service, rather than simply courting the same sources of funding.

157 HM Treasury, *Review of the Money Advice Service*, March 2015 [accessed via: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/414812/PU1736_MAS_review_document_19_March.pdf (20/05/15)]

## Coordinating the delivery of services and providing people with choice

When a person is in need of support, whether it is debt advice or some form of capability training, it is important that they have a choice of providers to ensure that the service best meets their needs and how they want to access it. Similarly, as many people do not readily come forward and seek help, for the variety of reasons discussed previously, it is important that if a creditor or other organisations identifies that someone may need additional support, that they do not fall through the cracks.

The fractured nature of debt-related services makes it very hard for them to coordinate their services, even under MAS's leadership and through adherence to common standards. Therefore, it is important that customers, especially vulnerable people as identified by the FCA guidelines, have greater choice and the ability to ensure they are getting the support services that are right for them. Providing people with the option of greater choice when seeking debt advice or other support services, can help create a 'quasi-market' for free-support services, as the evaluation frameworks and common standards established by MAS will allow funders to target services that are experiencing greater demand due to people's preferences when accessing support.

### Case study: The MAP Tool – creating and evidence base through coordination

Toynbee Hall, a leading charity in the field of financial inclusion, financial capability and debt advice, have developed another potential vehicle for such information sharing. The MAP Tool is simultaneously a financial health needs assessment and an impact measurement tool, which has been developed in partnership with a wide range of stakeholders across the UK providing financial well-being services.

On first use with a client, the MAP Tool gathers a range of appropriate data and produces an assessment of the client's financial well-being and their support needs. Used at appropriate points in the client's journey, the MAP Tool tracks change and highlights unmet needs. Organisations can, with the client's permission, pass the client's record to other relevant services during the referral process, thus ensuring advisers have a full picture of the client's journey without requiring the client to remember or repeat details.

There are two specific places where Financial Technology (FinTech) solutions and the principle of putting people in charge of their own data, could significantly help people improve their financial wellbeing and access support services these are:

- How vulnerable people are identified by creditors and other firms as needing additional support;
- How customer's access various support services at different points in their life.

### Empowering vulnerable people to decide when they are 'vulnerable'

Coordinating debt-related services is especially important for vulnerable consumers. At present, there is often little consistency between the behaviour and procedures of financial institutions and even amongst providers of debt-related services, on all counts, even in regards to simple things such as identifying whether a person is over-indebted and if they are considered to be 'vulnerable' using the guidelines published by the FCA.[158]

158 Financial Conduct Authority, *Consumer Vulnerability*, February 2015 [accessed via: http://www.fca.org.uk/static/documents/occasional-papers/occasional-paper-8.pdf (20/05/15)]

What this means in practice is that one creditor may have identified that a person has, for example, a mental health issue and has therefore exercised forbearance in regards to the debt owed to the firm. However, another creditor to whom a much smaller debt is owed may not have recognised the customer's 'vulnerability' and is still actively, sometimes even aggressively, pursuing them through the use of debt collection letters, telephone calls and, in the most extreme cases, calling in bailiff services.

Similarly, a customer who accrues a debt with a utility firm, but is shown forbearance by the firm after being identified as a 'vulnerable customer', has no guarantee that they will treated in the same manner by any creditor or even any other utility firm. The latter is of particular importance as people quite often switch energy providers, after consulting with a debt adviser, in order to reduce their expenditure on utility bills.

At the other extreme, it may be that four different creditors, potentially including a local government collections department as well as more traditional creditors, could all be taking special actions when dealing with the customer, specifically because they have identified them as being a 'vulnerable' customer. Such additional support could include sending additional letters, phoning more frequently, or arranging for a local debt advice support service to contact the customer. While this may be for the customer's benefit, there can be 'too much of a good thing'. Contact with creditors is one of the biggest causes of stress for people in debt, meaning the vulnerable person can become completely overwhelmed by the level of contact they now have with their various creditors, even when it is supportive.

The severity of this issue and the potential harm it can cause for some of the poorest people and those most in need of help, means there is a case for MAS to take a more direct role in pushing forward reforms and agreement, which should be endorsed by the Government. Specifically, we believe that they should push for the creation of a single centralised register for vulnerable customers, but where they are still in control of their data.

Whilst there are issues regarding privacy and data protection, it is important that they are resolved so as to protect vulnerable people from harm. One potential solution to the issue of data sharing would be to have a system entirely led by user-generated information. Under such a scheme, users would need to first be identified via the traditional mechanisms as being 'vulnerable', under FCA definitions and guidelines. This could be by a creditor, government agency or an accredited debt-related service provider. At this point, firms would have a duty to inform them about their rights as a vulnerable customer, which would include the right to request that their information was included on the new register.

From this point onwards the customer would be the owner and gatekeeper of his or her information and status as a 'vulnerable customer'. The system could be operated through a simple and secure web portal and/or an automated telephone system. Upon being initially registered, the customer would be given a unique security token that only they would know and which would allow them to access their information through the web portal or telephone system. As the customer would own their data, they could request it to be entirely removed and destroyed at any time if they wanted.

### Recommendation

The Money Advice Service should work with the key regulators – telecoms, gas, electricity, and water – as well as with the DWP and the Local Government Association, in order to develop a centralised 'vulnerable customer register'. Firms would only be able to see whether a person was on the register after they had been provided with a single-use access code generated by the vulnerable customer, using their security token. Giving people control over the rights to their data and who can access it, will help to reduce data protection and regulatory compliance issues.

### Increased cooperation between debt support services

The fractured nature of debt-related service provision means it is done through a diverse and quite sizeable range of organisations, both big and small, that have a variety of different methods for delivering services as well as different business models. Many organisations are extremely good at what they do, having refined their business model and streamlined their entire organisation around their services but, without necessarily taking into account the wants and needs of their service users.

This principle is true for all debt-related services, including financial education, debt advice and financial skills training. These services are primarily designed around the priorities of the organisation delivering them, or at least, what they decide is the optimum funding model and best form of service delivery, based on their research and experience.

Not only does this mean that a person can become locked into receiving the same type of service even if their situation changes, but it also means there is a low level of consistency across the entire sector.

For instance, when comparing the three big debt advice charities – StepChange, Money Advice Trust, and Citizens Advice Bureau – the first two organisations provide advice almost exclusively over the phone, while the CAB has historically focused on face-to-face debt advice, which can vary widely from one part of the country to another, an issue now mitigated by new online and telephone services. Specialised delivery models are arguably easier for firms to coordinate and can help streamline costs, however, they do not necessarily reflect MAS's research around what people want when accessing debt advice, meaning some people may have sub-optimal outcomes.

Specifically this report recommends that MAS continues to increase co-operation between various organisations seeking to help people on low incomes. Most importantly by providing a more seamless 'debt journey' that will improve outcomes and ultimately reduce problem debt amongst low-income households in the long run, decreasing the costs of providing this vital service. The Money Advice Service's common initial assessment is a useful tool to help achieve this.

The issues that need to be addressed in order to make this a reality are:

- It is hard for both funders and service users to easily identify which type of service provider best meets their needs, especially in times of crisis;
- People want to access services in various ways, yet many organisations specialise in only one service (e.g. debt advice), offered via one channel (e.g. telephone or face to face);

- Organisations providing debt-related support services, as well as creditors, government and others use a variety of tools and methods to evaluate a client's financial situation. This means that while one creditor may recognise a person as being overindebted and in need of support, another may not, or even offer them more credit;
- The combination of these issues makes it hard for a person to transfer between service providers or benefit from two providers cooperating (e.g. a debt adviser and a skills trainer), as both services will act independently from one another. This means that a person would have start from square one if they were to switch from a provider of face to face debt advice to a telephone-based provider – which is arguably the cheaper of the two in terms of funding required per customer.

There is a clear need to help facilitate better coordination between organisations that provide debt-related services, as well as creditors and other organisations operating on the fringes of the debt sector, such as debt collection agencies. Specifically, there is a need for MAS to make it easier for customers to utilise multiple services, such as a crisis face-to-face debt advice service and then form a long-term support service delivered at lower cost through an online or telephone system, but which can prevent future debt problems.

Allowing people greater flexibility and choice regarding when, how and from whom they access debt-related support services will not only produce cost savings, as research suggests there will be decreased reliance on face-to-face services, but it will also help funders allocate resources more efficiently and better identify the organisations that are delivering the services in a way that is most effective and most desired by customers.[159]

In order to facilitate this seamless transition between service providers and improve the outcomes for low-income households it is necessary to rethink how customers provide information to debt-related support services and put individuals at the centre of how organisations coordinate their services. For example, it is significantly easier to have an individual manage all of their own data than have a large number of organisations – all of different sizes, types, specialities and with different IT systems and regulatory requirements – cooperate and integrate their services. Providing a simple way that people can control and easily access all of their relevant information that a debt-related service provider or financial institution might need, as well as easily controlling and providing other people and services with access to it when necessary, ensures that people are always in control and can significantly streamline the integration of various services without them ever having to cooperate.

Examples of information that such a tool would capture include:

- Information regarding their financial details and situation;
- An assessment of their financial information by an automated algorithm;
- Comments from a variety of debt advisers and services;
- Relevant information on their mental health that creditors should consider as well as their status as a 'vulnerable customer' where applicable;

159 The latest figures from StepChange show a 37 per cent increase in contacts via mobile devices, a figure they expect to increase in the coming years, StepChange, *Statistics Yearbook: Personal Debt 2014*, March 2015, p5 [accessed via: http://www.stepchange.org/Portals/0/documents/media/reports/statisticsyearbooks/StepChangeDebtCharityStatisticsYearbook2014.pdf (19/05/15)]

- Information provided by case workers or court officials;
- Benefits information or advice given by welfare advisers at a job centre.

The technology to facilitate this is not complex and in fact has already been developed by a variety of FinTech firms as the underlying technology behind most personal financial management apps for smartphones.[160] These are mostly based on a service provided by Yodlee, which makes it possible to collect information about a person's financial situation directly from financial institutions, with the individual just needing to provide the relevant login details for their various accounts. Personal financial management services then provide a variety of ways to analyse and represent this data, in the same way that debt advisers may analyse someone's situation using their own proprietary tools and methods that they think are most effective.

### Case Study: MoneyHub – Helping people make better decisions about their financial future

The sheer amount of information for people to consider when making financial decisions is overwhelming and accessing advice to help decipher it is getting harder. MoneyHub is a personal finance app that gives people the ability to put all of their financial information in one place, makes sense of it and helps them understand what has been happening in their finances and where they are heading.

Founded in 2011 by Toby Hughes, the firm has grown rapidly, which it attributes to the customer-centric values embedded in the business. MoneyHub will not sell customer data, sell them a product or tell them what to do. It lets the customer choose how much information they want to share, see how things stand and, when they need additional support, they can reach out to others for help or advice.

MoneyHub was created as a technology for other institutions to build upon and it could easily be developed further to help people struggling to cope with managing their money.

However, the capturing and aggregation of data is the first pre-requisite step for all of these debt-related services. By putting people in charge of their own data, it is possible for them to seamlessly move between service providers without advisers ever needing to ask the same questions over and over. This could substantially decrease the time and cost of service provision or the need for organisations, which often compete for funding and are keen to differentiate themselves, to ever cooperate directly or develop expensive common IT systems.

### Recommendation

MAS should licence or develop a tool that puts people in control of their own financial information and allows them to more easily transfer between service providers. Similar to the technology already developed by MoneyHub, such a system automatically gathers the required information about a person's financial situation after they provide their bank details, which can then be easily imported into the systems of a local Citizen's Advice Bureau with little manual input, substantially reducing costs. Similarly, if the customer wishes to then access a different support service they do not have to start from square one and with their consent, the next adviser will be able to see the notes and information left by the previous adviser.

160 MoneyHub, in evidence to the CSJ

## 2.3 Enabling people's financial capability through products and services

Part of building a holistic approach to combating debt is the creation of services that help people develop their financial capability. As we discuss in Chapter Three, innovative new products, services and technologies being developed by FinTech firms, both in the UK and abroad, highlight the potential to increase the scale and cost-effectiveness of financial services for low-income consumers, whilst also providing a greater degree of choice about how, when and what type of services they want to use and which ones would help them the most. FinTech innovations have the potential to help people maximise their financial capability and wellbeing.

### Taking financial education from the classroom to the living room

The inclusion of financial education on the national curriculum is a significant milestone and noteworthy achievement.[161] However, as discussed above, there are limits to what overall impact this will have on reducing levels of problem debt amongst low-income households.

For these reasons it is important to look at innovative ways in which FinTech can be used to enhance the financial education programmes delivered in schools, specifically, by taking it out of the classroom and providing real-life examples of how those skills can be embedded into a child's every day and their interactions with their family.

There are several firms working to change the way children and families think, talk and handle a child's pocket money and spending, which have so far proved extremely successful, although there remain issues about how to make these products affordable for low-income households.

A variety of firms offer prepaid digital 'bank accounts' which aim to teach children financial capability through practical use. As children study financial education in school they will also have their own bank account with a scheduled income, savings goals and spending to manage. The skills they learn from using the card will serve them well as they get older and help ensure that they are able to maintain their financial wellbeing as young adults.

The two case studies below highlight the impact these innovative FinTech solutions can have in terms of changing children's attitudes towards money and teaching them financial skills. GoHenry is the established market leader in this area, whereas Osper is a very recent addition to the market, and while there are arguably advantages and disadvantages to both products, what is important is that there is clear demand for this type of service, and that they also have a noticeable impact on children's financial capability in a way education often cannot.

161 Personal Finance Education Group, *Financial education's place in the new National Curriculum confirmed*, 12 September 2013 [accessed via: http://www.pfeg.org/about-us/news/financial-education's-place-new-national-curriculum-confirmed (20/05/15)]

## Case Study: goHenry changes the conversation around money between children and parents, helping young adults develop money skills

The online and mobile 'family banking tool' goHenry helps children between the ages of eight and 18 earn, save, spend and learn about money. It combines web and mobile apps with a prepaid debit card with parental controls. Parents set rules and limits, can allocate pocket money and allowance automatically or set tasks and chores for their children to earn extra money. They and the kids can see their earnings, spending and saving on visual educational graphs. They can also set budgets and saving goals, and track and filter spending by retailer, size of spend and category. It is a way to give children financial independence so they can learn by doing, but under a watchful eye and with no danger of debt.

*"Using goHenry as a family has really made us much more careful and far better at saving. We encourage the children to save a certain percentage each week and we now think much more carefully as parents too about our money."* — Sharon Francis, goHenry customer

Data given to the CSJ by goHenry shows that childrens' financial behaviour changes positively over time after they start using the service. When children and teens first start using their goHenry card they typically make frequent small transactions, but then quickly progress to making larger less frequent purchases. The data suggests that children quickly move from spending to saving toward their purchasing goals, using the account to manage their pocket money to achieve their goals. goHenry recently introduced a unique Saving Goals feature into the account (one of many unique features that they offer), which allows children and teens to automatically save towards the things they want and need. It is a relatively new feature that has seen quick uptake and continues to be used widely across their base.

*"goHenry has made my children think about financial independence and responsibility and what the rewards can be when you take care of your money."* — Karen Wilkenson, goHenry customer

## Case Study: Osper – Digital pocket money improves children's maths and money management

Osper is a new competitor in the field of pre-paid debit cards for under 18s. Parents sign their children up and then link their bank account to the card allowing them to transfer money directly and quickly to their child's card. The whole relationship is managed through a full mobile banking app.

By encouraging children to move to digital money, an Osper account provides a way for them to interact with the online marketplace at an early age. With an Osper card children develop the budgeting and saving skills needed to be successful with digital money while still in a safe environment that parents can monitor and control and in which they cannot be punished by overdrafts.

Antonella, a young Osper card user, found that learning to keep track of her account, to budget and to save helped her improve her maths skills as well. Antolnella's school teacher remarked that her *"mental maths was getting seriously sharp"*. Antonella was more excited about the practicalities of Osper: *"What is really good about Osper is that I don't have money to look after, all those coins and continually counting. I just have to take care of my card and I always know how much money I have. And everyone takes it—it works everywhere!"*

The key to the improvement in Antonella's maths and budgeting is that Osper allows parents to set up a routine allowance for their kids, but also to pay them for one off chores. Because kids earn, save and spend out of the same account they benefit from doing the work to keep track of their finances. This process replicates the relationship between adults and employers giving children a head start when adjusting to adult life and full economic independence. Financial capability isn't taught by Osper, it is learned through practical engagement making financial education a continuous and reinforcing process.

Given that around half of people do not keep a budget, there is clearly a market for FinTech to help make budgeting easier and more integrated into people's lives.[162]

Previously, attempts to help people budget have focused on budgeting accounts, which set aside money into different 'jam jars' or 'envelopes' to ensure that people do not accidentally spend money that will be needed later in the month.[163] Many people find budgeting accounts extremely helpful and there are a number of commercial firms offering such products as well as credit unions including the following:[164]

- FFrees;
- London Mutual Credit Union;
- eAccount;
- ThinkMoney;
- CardOneBanking.

However, the success and widespread adoption of these accounts has been limited, largely because of the monthly fees associated with the accounts, which seem to many consumers to outweigh the benefits they provide.[165] Several housing authorities have taken a proactive approach by subsiding the cost of budgeting accounts in order to help tenants manage their money, as they have made the business case based on decreased rent arrears.[166]

### Recommendation

There is a need for government to facilitate social investment in FinTech firms developing innovative products and services that help people build financial capability and connect them with advice services. The way in which these innovations should be funded through a new Social Finance Technology Accelerator (SoFiTech), and made available to Alternative Financial Institutions will be discussed in Chapter Three.

162 Money Advice Service, *Financial Capability of the UK*, London: Money Advice Service, 2013
163 Financial Inclusion Commission, *Financial Inclusion: Improving the financial health of the nation, London: Financial Inclusion Commission,* 2015; Social Finance, *A new approach to banking: extending the use of jam jar accounts in the UK*, London: Social Finance, 2011
164 Ibid
165 Financial Inclusion Commission, *Financial Inclusion: Improving the financial health of the nation, London: Financial Inclusion Commission, 2015; Boorer, K, Universally speaking: How the Post Office can support benefit recipients through the transition to Universal Credit*, London: Consumer Futures, 2014
166 Alexander, N, *The unbanked in Glasgow and the impact of the universal credit: A report for Glasgow Housing Association*, North Berwick: Niall Alexander Consultancy, 2012; Civitas, *Credit Unions: A solution to poor bank lending?*, London: Civitas, 2013

# chapter three
# Better, more affordable financial services

Too often financial services are not well designed for those on low-incomes, and can do just as much to harm as good. Historically, this has been the case because those on low incomes have not been seen as a profitable enough segment of the market to focus products and services around.[167] As a result, there are between seven and nine million people who are currently underserved to varying degrees by financial services.[168]

This lack of appropriate financial products and services can drive those on low incomes into debt. It causes a number of well-documented problems:

- Financial hardship resulting from use of expensive products and services (for example, loans);[169]
- A 'poverty premium' on those goods and services that squeezes budgets (for example, paying bills in cash);[170]
- A lack of sufficient savings, insurance and financial resilience which drives the use of credit and can foster problem debt;[171]
- Poor financial decisions that can lead to debt problems (e.g. overspending or not saving due to a lack of beneficial money management products).[172]

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167 Joseph Rowntree Foundation, *Financial Inclusion in the UK: Review of policy and practice,* York: Joseph Rowntree Foundation, 2008

168 Centre for Social Justice, *Restoring the Balance: Tackling Problem Debt*, London: Centre for Social Justice, 2014, p20 [accessed via: http://www.centreforsocialjustice.org.uk/UserStorage/pdf/Pdf%20reports/balance.pdf (21.05.15)]

169 Gardner, J et al., 'High-cost credit and welfare reform'efo- Liam Foster, Anne Brunton, Chris Deeming and Tina Haux (eds), *In Defence of Welfare 2,* Bristol: Policy Press, 2015, pp.32–35 [chapter accessed via: http://www.social-policy.org.uk/wordpress/wp-content/uploads/2015/04/08_gardner1.pdf (21.05.15)]

170 Rowlingson, K and McKay, S, *Financial Inclusion Annual Monitoring Report 2014,* University of Birmingham, 2014, p25 [accessed via: http://www.birmingham.ac.uk/Documents/college-social-sciences/social-policy/CHASM/annual-reports/chasm-annual-monitoring-report-2014.pdf (21.05.15)]; and Hirsch, D, *Addressing the poverty premium: Approaches to regulation,* Consumer Futures, 2013 [accessed via: http://www.consumerfutures.org.uk/files/2013/06/Addressing-the-poverty-premium.pdf (21.05.15)]

171 Rowlingson, K and McKay, S, *Financial Inclusion Annual Monitoring Report 2014,* University of Birmingham, 2014, p6 [accessed via: http://www.birmingham.ac.uk/Documents/college-social-sciences/social-policy/CHASM/annual-reports/chasm-annual-monitoring-report-2014.pdf (21.05.15)]; and StepChange, *An Action Plan on Problem Debt: How the next UK Government can reduce the y/CHASM/annual-reports/chasmproblem debt,* StepChange, 2015, p6 [accessed via: http://www.stepchange.org/Portals/0/documents/media/reports/additionalreports/StepChange_Action_Plan_on_Problem_Debt_2015.pdf (21.05.15)]

172 Money Advice Service, *A Financial Capability Strategy for the UK: The Evidence Base [accessed via:* https://53b86a9de6dd4673612f-c36ff983a9cc042683f46b699207946d.ssl.cf3.rackcdn.com/financial-capability-strategy-for-the-uk-a-review-of-evidence.pdf (19/05/15)]; and Social Finance, *A New Approach to Banking: Extending the use of Jam Jar Accounts in the UK,* April 2011 [accessed via: http://www.socialfinance.org.uk/wp-content/uploads/2014/07/SF_JamJarAccountReport_FULLREPORT-1.pdf (21.05.15)]

In order to enable people to maintain their financial wellbeing, there is a need to improve choice and access to financial services, the affordability of financial products, and the quality of products available to low-income households.

This chapter sets out the mismatch between what those on low incomes want and need, and what is offered to them by mainstream financial institutions. Recent innovations in FinTech provide examples of how to change this and this report sets out the reforms that are needed to foster greater financial innovation that will help those on low incomes.

## 3.1 How those on low incomes use financial services

In order for financial services to help tackle poverty, Alternative Financial Institutions – and indeed any other financial firm or government body – must understand what people on low incomes actually want and need from them. As we set out in Chapter One, there are a number of myths about the financial requirements of those on low incomes – it is crucial that financial institutions do not build their services for this cohort around these myths.

It is not easy to set out precisely what low-income people want from financial products and services, not least because they have diverse preferences and needs that change over time. Indeed, a weakness of previous analyses has been the prevailing assumption that all low-income people have the same needs, disregarding what they want. Nevertheless, there are several key trends which financial institutions would do well to consider when thinking about the type and design of services to those on low incomes: [173]

- Low-income households are not part of one homogeneous group, and therefore cannot all be well served by one class of 'financially inclusive' products;
- Lower-income groups tend to place a greater value on control, transparency and certainty, compared with higher-income groups who typically place a greater value on 'bonus features' and price when selecting products and services;
- The desire for simplicity and ease of use are as important for this group as any other.

Too few financial services and products currently take account of these trends, and many providers still design their services for people on low incomes around the myths set out in Chapter One. This is the case across a number of different types of financial products. We look at practical examples of this below, across the following areas:

- **Banking products,** such as current accounts and basic bank accounts;
- **Credit,** such as personal loans, credit cards and overdrafts;
- **Savings,** such as ISAs, pensions and savings accounts;
- **Insurance,** such as home contents, car and life insurance policies.

173 Ellison A, Williams S and Whyley C, *The Payments Council: The electronic payment needs of people on low incomes,* London: Payments Council, 2010; Joseph Rowntree Foundation, *Financial Inclusion in the UK: Review of policy and practice,* York: Joseph Rowntree Foundation, 2008; Collard S and Hartfree Y, *Poverty, debt and credit: An expert-led review,* Final report to the Joseph Rowntree Foundation, Bristol: University of Bristol Personal Finance Research Centre, 2014

## Banking products

Transactional banking helps people track their spending, pay bills, make everyday purchases and access cash. Yet the design of transactional banking services tends to make it difficult for those on low incomes to use them in a way that matches their wants and needs. This is primarily because UK banking is built upon on a 'free in credit' model, which relies on selling customers additional products to subsidise the cost of the service.

Current accounts also have relatively high penalty charges, which are more often incurred by this group.[174] This is especially true for people with both low and irregular incomes, such as those who are self-employed or on a zero-hours contract, who often struggle to meet any regular fixed outgoings, such as monthly loan instalments or bills paid via direct debit. At best, many low-income customers are left in a situation where they are simply trying to keep their head above water and minimise penalty fees.[175]

Existing alternatives to traditional banking products are not necessarily any better. Many consumers find themselves having to either accept significantly reduced functionality and utility of their account, or pay monthly charges of up to £15 per month for a bank account with features that better matches their wants and needs.[176]

## Savings

Savings are a crucial buffer that can prevent people from spiralling into debt when they are confronted with unexpected expenses. These can arise from a variety of situations, such as unemployment, reduced income and serious illness.[177]

Unsurprisingly, low-income households save less than average. However, they do recognise the benefits of doing so and express similar desires and intentions to save as wealthier households.[178] While their inability to save is largely related to their limited disposable income, it is made considerably more difficult by a lack of appropriate savings products.

Saving is just as important, if not more so, for low-income households because it can provide a buffer to help them avoid debt, yet existing savings products are not designed for them and offer little incentive to save. This is because savings products are typically designed to reward large, long-term, illiquid forms of savings, such as ISAs or government bonds.[179]

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174 Financial Inclusion Commission, *Financial Inclusion: Improving the financial health of the nation,* London: Financial Inclusion Commission, 2015

175 Joseph Rowntree Foundation, *Financial Inclusion in the UK: Review of policy and practice,* York: Joseph Rowntree Foundation, 2008

176 Ibid

177 StepChange, *Life on the Edge: Towards more resilient family finances*, 2014 [accessed via: http://www.stepchange.org/Portals/0/StepChangeLifeontheEdgereport.pdf (21.05.15)]

178 Institute for Fiscal Studies, *Final evaluation of the Saving Gateway 2 pilot: main report*, London: Institute for Fiscal Studies, 2007; FSA, *Financial Capability in the UK: Establishing a Baseline,* London: FSA, 2006

179 Rowlingson, K, *Should people on low incomes be encouraged to save during an economic down-turn?,* Briefing Paper, Centre on Household Assets and Savings Management, December 2014 [accessed via: http://www.birmingham.ac.uk/Documents/college-social-sciences/social-policy/CHASM/briefing-papers/2014/should-people-save.pdf (21.05.15)]; and Rowlingson, K and McKay, S, *Financial Inclusion Annual Monitoring Report 2014,* University of Birmingham, 2014, p25 [accessed via: http://www.birmingham.ac.uk/Documents/college-social-sciences/social-policy/CHASM/annual-reports/chasm-annual-monitoring-report-2014.pdf (21.05.15)]

Even at the financially inclusive end of the spectrum, savings products from credit unions are rarely different from regular savings accounts and often pay little or no return.[180] Furthermore, government savings initiatives, such as the Savings Gateway pilot, have not been able to find financially viable ways of increasing savings amongst low-income households.[181]

## Credit

Access to affordable credit is vital for people who do not have sufficient savings to cover a drop in income or to help spread out the cost of larger purchases, such as a new washing machine. The need for short-term credit is arguably greatest amongst low-income households because of their irregular incomes and low levels of savings. Yet once again the system is not designed around the realities of life on a low income. For many low-income households, use of credit is a direct precursor to debt problems, which is due in part to the disproportionate cost they must pay to borrow and the terms under which they must do so.[182]

The problems surrounding the payday lending industry highlights these issues perfectly in that loans are typically expensive and issued in a form not suitable for low-income households.[183] The cost of borrowing should reflect the risk to the lender and so while it is logical that low-income households pay more when borrowing than wealthier households, it is illogical that all low-income households pay the same price when borrowing, as is the case with payday loans.[184]

Similarly, the concept of a payday loan is not suitable for many people on low incomes, because they typically have levels of disposable income available each month that are lower than the average size of a payday loan. This means that unless they find a way to dramatically increase their income during the month, it is unlikely they will be able to repay the loan the next month, especially once interest charges are added.[185]

Perhaps the largest problem is the way in which credit risk assessments are carried out, which artificially increases the price of credit for low-income people and often excludes them from cheaper forms of more mainstream forms of credit. Traditional forms of credit scoring are based on historical data about a person, including their previous loan and bill repayments, which has proven to be a good indicator of credit worthiness, or intention to repay, for the

180 Civitas, *Credit Unions: A Solution to Poor Bank Lending?,* London: Civitas, 2013 [accessed via: http://civitas.org.uk/pdf/CreditUnions.pdf (21.05.15)]

181 BBC News, *Budget: Saving Gateway scheme is scrapped,* 22 June 2010 [accessed via: http://www.bbc.co.uk/news/10376543 (21.05.15)]; and Harvey, P et al. (Ipsos MORI) and Emmerson, C et al. (IFS), *Final Evaluation of the Saving gateway 2 Pilot:* Main Report, HM Treasury, 2007 [accessed via: http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/d/savings_gateway_evaluation_report.pdf (21.05.15)]

182 Financial Inclusion Commission, *Financial Inclusion: Improving the Financial Health of the Nation,* March 2015 [accessed via: http://www.financialinclusioncommission.org.uk/pdfs/fic_report_2015.pdf (21.05.15)]

183 Edwards, T, *Payday loans: regulatory reform,* Briefing paper no. 06676, House of Commons Library, 14 April 2014 [accessed via: www.parliament.uk/briefing-papers/SN06676.pdf (21.05.15)]

184 Centre for Responsible Credit, *Does increased credit data sharing really benefit low income consumers?,* London: Centre for Responsible Credit, 2013 [accessed via: http://www.responsible-credit.org.uk/uimages/File/Does%20Increased%20Credit%20Data%20Sharing%20Benefit%20Low%20Income%20Consumers%20final.pdf (21.05.15)]

185 Collard S and Hartfree Y, *Poverty, debt and credit: An expert-led review, Final report to the Joseph Rowntree Foundation,* Bristol: University of Bristol Personal Finance Research Centre, 2014

majority of people.[186] However, low-income households are more likely to miss bill repayments, more likely to avoid using credit and are less likely to have other 'positive indicators' that are taken into account, such as entry on the electoral register or stable address history.[187]

The current methods of risk pricing employed by Credit Reference Agencies (CRAs) are simply not capable of assessing the relative credit worthiness of people on low incomes, as they will typically all have low credit scores regardless of their intention or ability to repay a loan.[188] As a result, there is little price differentiation amongst low-income customers and prices are inflated for the entire group as a whole, increasing the likelihood they will become trapped in problem debt when using credit.

Socially responsible lenders – such as credit unions and CDFIs – do provide an effective alternative. However, demand for their services vastly outstrips the limited supply and the firms offering them are often reliant on government or charitable funding in order to stay in business, due to their high operating costs.[189]

## Insurance

Insurance provides a means of smoothing over the cost of unexpected events and losses. While the benefits are recognised across the income spectrum, low-income households are both significantly more likely to experience events that might be covered by insurance policies, as well as be significantly less likely to purchase the insurance policies that would protect them.[190] Part of this can be attributed to a lack of available income to pay for insurance, but it is also due to the lack of appropriately designed insurance products.

One example of the unsuitability of insurance products relates to the availability of credit. Car or home contents insurance polices can cost hundreds or even thousands of pounds per year. This is not an issue for people that can access low cost forms of credit, as they can spread out the cost of an insurance policy.[191] However, for the reasons stated above, this is simply not an option for many low-income households.

Similarly, the terms of insurance polices mean they are often unsuitable for low-income households, as they can become invalid if a single payment is missed, which, as stated above, is significantly more likely to happen for families on a low and/or irregular income.

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186 Centre for Responsible Credit, *Does increased credit data sharing really benefit low-Income consumers?*, London: Centre for Responsible Credit, 2013 [accessed via: http://www.responsible-credit.org.uk/uimages/File/Does%20Increased%20Credit%20Data%20Sharing%20Benefit%20Low%20Income%20Consumers%20final.pdf (21.05.15)]

187 Centre for Responsible Credit, *Does increased credit data sharing really benefit low-income consumers?*, London: Centre for Responsible Credit, 2013 [accessed via: http://www.responsible-credit.org.uk/uimages/File/Does%20Increased%20Credit%20Data%20Sharing%20Benefit%20Low%20Income%20Consumers%20final.pdf (21.05.15)]

188 Centre for Responsible Credit, *Does increased credit data sharing really benefit low-income consumers?*, London: Centre for Responsible Credit, 2013 [accessed via: http://www.responsible-credit.org.uk/uimages/File/Does%20Increased%20Credit%20Data%20Sharing%20Benefit%20Low%20Income%20Consumers%20final.pdf (21.05.15)]

189 Community Development Finance Association, *Inside Community Finance: The CDFI Industry in the UK 2014*, London: CDFA, 2014 [accessed via: http://www.cdfa.org.uk/wp-content/uploads/2010/02/CDFA-ICF-Report-2014.pdf (21.05.15)]; and Civitas, *Credit Unions: A Solution to Poor Bank Lending?, London: Civitas, 2013 [accessed via:* http://civitas.org.uk/pdf/CreditUnions.pdf (21.05.15)]

190 Financial Inclusion Commission, *Financial Inclusion: Improving the Financial Health of the Nation*, March 2015 [accessed via: http://www.financialinclusioncommission.org.uk/pdfs/fic_report_2015.pdf (21.05.15)]

191 Collard S and Hartfree Y, *Poverty, debt and credit: An expert-led review, Final report to the Joseph Rowntree Foundation*, Bristol: University of Bristol Personal Finance Research Centre, 2014

The issues set out above across these four areas highlight some of the reasons why current financial products and services are not appropriate for low-income households. At best, the use of products that are not tailored to what low-income households want and need has a neutral effect on their financial wellbeing; at worst it drives them into debt. Without new and innovative financial products and services low-income households will continue to struggle to improve their financial capability and avoid problem debt.

## 3.2 Financial innovation for low-income households

### The importance of values

Before exploring the benefits of new innovative financial products and services it is important to reiterate the need to separate the values and business models of the various firms from what they offer to consumers. There are two main reasons for this:

- Innovative products that could substantially benefit low-income households can be just as harmful as unsuitable or overpriced products if the firm providing them is not interested in the financial wellbeing of their consumers;
- Currently FinTech firms, especially in the UK, are primarily driven by the desire for large profits, rather than for any social purpose. The result is that at present the innovative developments that could have real tangible benefits for low-income households, may not be packaged or marketed by the firm in a way outside observers would like or readily identify as being financially inclusive.

Perhaps the best illustrative example is that of Wonga, a highly publicised and frequently criticised payday lender.[192] Despite its numerous flaws and questionable business practices, especially in regards to debt collection, there is a lot that can be learned from Wonga.[193] One reason Wonga was able to grow so quickly was because the product and service it offered was marketed heavily to people that wanted it. The other reason is that the technological developments it pioneered allowed it to drastically reduce the time and complexity of issuing small short-term loans, something that was, and to a large extent still is, unmatched by mainstream financial institutions.[194]

Below we explore the recent development of FinTech products and highlight some promising examples of innovations across banking, and credit scoring and lending, where the advancements have been most pronounced.

192 BBC News, *Wonga: What makes money lender tick?, 11 May 2012 [accessed via:* http://www.bbc.co.uk/news/business-18019272 (21.05.15)]

193 See Financial Conduct Authority, *Wonga to make major changes to affordability criteria following discussions with the FCA (Press Release), 2* October 2014 [accessed via: http://www.fca.org.uk/news/wonga-major-changes-to-affordability-criteria (21.05.15)]

194 The Economist, *Revenge of the Nerds: An explosion of start-ups is changing finance for the better, 3 August 2013 [accessed via:* http://www.economist.com/news/finance-and-economics/21582512-explosion-start-ups-changing-finance-better-revenge-nerds (21.05.15)]

## Banking innovations

The emergence of digital banking has been a spur for greater financial innovation. Digital banking and other online financial services have grown considerably over the past decade, especially through the development of smartphone banking applications. Use of mobile banking services more than tripled between 2010 and 2014, so that now only 16 per cent of people in the UK never use online or mobile banking.[195] A 2014 survey found that almost half of people who had purchased a new financial product in the previous 12 months had done so through the internet.[196]

The move towards digital banking has significant benefits for financial firms, customers and the economy as a whole, as it reduces the costs associated with providing expensive branch networks and telephone banking services.

In the USA the switch towards digital banking has facilitated new entrants such as Bluebird and Simple (see the case study below) to offer bank accounts designed specifically for low-income households. They integrate industry-leading budgeting and spending control features that are easy to use, but most importantly, they are able to do so without needing to charge a monthly fee or relying on income from customers through penalty charges.[197]

### Case Study: Simple – Predictive banking

Simple is a digital bank account provider owned by BNP Paribas that operates in the USA. Unlike most other digital banks, which rely on some form of pre-paid' debit card that must be loaded with money via a cash 'deposit' or a bank transfer, Simple is a fully licensed bank, but without bank branches.

Simple use predictive algorithms to analyse a customer's historical spending and then attempt to forecast future spending. For example, the system identified regular payments, such as for bills, and their frequency, regular sources of income as well as average spending on certain categories of goods and services (for example, groceries, entertainment and restaurants). Predictions based on historical analysis of income and expenditures allow the smartphone app to present customers with their actual available balance, taking into account what they are likely to spend before they receive their next wage or benefits payment. This system also makes it incredibly easy for people to automatically set aside small amounts regularly into a separated 'wallet' to ensure they have enough money for expenses that are regular yet infrequent, such as the annual TV licence fee.

No such system can ever be perfect or operate without some human interaction, such as to confirm whether the frequency or amount of an electricity bill has been identified correctly. However, the accuracy of predictive banking systems will by definition increase over time as more data is accumulated and will also improve as new entrants improve the underlying algorithms. Similarly, people's ability and likelihood of maintaining a detailed budget plan is dramatically increased when it is made simple and user-friendly.

195 British Bankers [accessed vi (BBA) news, *Digital Disruption: UK Banking Report, 24 March 2015 [accessed via:* https://www.bba.org.uk/news/reports/digital-disruption-uk-banking-report/#.VUs-iM64mV4 (21.05.15)]

196 British Bankers.org.uk/news/reports/digit*Digital Disruption: UK Banking Report, 24 March 2015 [accessed via:* https://www.bba.org.uk/news/reports/digital-disruption-uk-banking-report/#.VUs-iM64mV4 (21.05.15)]

197 For the Simple website, see https://www.simple.com; for the Bluebird website, see https://www.bluebird.com

## Case Study: Moven – Realtime banking and budgeting

Moven is a new American company whose mission is to help everyone improve their spending habits by providing real-time feedback on everyday money decisions. Instead of focusing on deposits, payments, budgeting or financial literacy, Moven provides a free app and debit card that gives real time financial wellness feedback to help consumers build better money habits. Rather than enforce strict budgets, Moven provides financial awareness and lets the user adjust as necessary. With Moven, users get access to a number of tools designed to change behaviours as they happen.

- Spending Meter™ which has a predictive algorithm that compares how a user is spending to how they typically spend so they know when to slow down or to save;
- Instant Receipt which is an real-time notification each time you use the Moven debit card that not only tells you how much you've spent, but automatically categorizes your spend so you always know where your money is going;
- Money Path which is a graphical view of your predicted spend for the entire month so you can anticipate upcoming expenses and plan accordingly;
- Impulse Savings which is a real time feedback on when your spending is below typical so that you can take advantage of those moments to save towards items on your wish list.

Such features are simple and provide the transparency and control that are much sought after by low-income households. This is a hugely important element as fear of losing control is one of the key drivers of those choosing to remain unbanked. Also, because Moven's innovative digital financial wellness experience is cloud based, multiple banks around the world have partnered with Moven to deploy this service as a complement to their traditional services.

The creation of the Payment Systems Regulator (PSR) in April 2014 has made it easier for new digital banks to innovate.[198] One of the PSR's primary objectives is to make it much easier for new market entrants to access payment systems, such as direct debits and faster payments, under more transparent conditions and at a lower cost than was previously available.[199]

This is crucial to developing better and more affordable banking services for low-income households, as it will reduce costs for a new generation of digital banks, allowing them to compete effectively, and to offer this market better products, such as a full current account, which was previously not possible. It will also reduce their operating costs.

To make the most of digital banking's potential to serve low-income households more action is needed to ensure such households have access to financial services online. There are currently around 1.8 million social housing tenants that are unable to access financial services online, because they fail to pass through the traditional mechanisms for verifying a person's identity during an application process.[200]

Some firms have reported to the CSJ that around 40 per cent of potential customers fail to pass their online identity checks, meaning they are required to wait for a postal application which must be returned along with copies of various identification documents.[201] The majority

198 The PSR is an independent regulator that sits under the Financial Conduct Authority and is responsible for ensuring there is effective competition and consumer protection in the £75 trillion payment systems industry.

199 Payment Systems Regulator (Financial Conduct Authority), *A new regulatory framework for payment systems in the UK*, London: Payment Systems Regulator, 2015 [accessed via: https://www.psr.org.uk/sites/default/files/media/PDF/PSR%20PS15-1%20-%20A%20new%20regulatory%20framework%20for%20payment%20systems%20in%20the%20UK%20-%20Policy%20Statement.pdf (21.05.15)]

200 Experian, *Credit scoring boost for 93% of social housing tenants*, Press Release, 21 November 2013 [accessed via: http://www.experian.co.uk/blogs/latest-thinking/credit-scoring-boost-for-93-of-social-housing-tenants/ (21/05/15)]

201 Centre for Social Justice, *Restoring the Balance: Tackling problem debt*, London: Centre for Social Justice, July 2014, p75 [accessed via: http://www.centreforsocialjustice.org.uk/UserStorage/pdf/Pdf%20reports/balance.pdf (21/05/15)]

of these customers do not complete their application, as there is a break in the application process and it takes several days to post out a manual application form and which the customer must return with photocopies of relevant identity documents.[202] Innovative companies, such as Monese (see the case study below) have developed effective solutions to this issue.

### Case study: Monese – Digital current accounts for the unbanked

Monese is a new firm that offers an online-only current account service targeted at the unbanked, especially migrants from within the EU. These people often have trouble opening a bank account in the UK when they arrive, in large part because they can become caught in a vicious cycle of not being able to get a job, get a mobile phone or even access electricity services as they lack a bank account, yet banks typically require a recent document from one of these sources in order to open an account.

The Monese account is controlled and accessed through an incredibly simple, yet powerful smartphone app that offers integrated budgeting and remittance features designed specifically for this group. However, the real innovation of this all-digital current account provider is their ability to open new accounts in under three minutes using just the smartphone app. The sign up process complies with all regulations and has a near 100 per cent completion rate, yet people are only required to provide a photo of their EU driver's licence, which is taken through the app and used to verify their identity.

There are also banking products and money management solutions that are aimed specifically at people newly entering work or to help employees on a low and/or irregular income better manage their money and improve their financial wellbeing. The crucial importance of the two solutions highlighted below, SuitsMe and Squirrel, is that they have been developed in partnership with employers. This has helped to defray the costs of providing high quality banking services to people on low incomes

### Case study: SuitsMe – Digital current accounts for the newly employed

Suits Me was developed as a credit check free banking alternative specifically for temporary workers. There were two key facts in mind when creating the product and the service:

- A service that has relevant benefits and is cost effective for the employee;
- A solution that is easy to administer for the employer.

Lack of access to banking is a barrier to entering work, as a sort code and an account number are a pre-requisite to employment. With the technology that Suits Me have developed, a Suits Me account is opened by the employer via the Suits Me portal, a process that takes under a minute. In under an hour the employer and the employee have the sort code and account number.

For the employee, their Suits Me membership is full of benefits – two insurance policies, personal accident and life cover, and membership in a cashback rewards scheme. Suits Me sends members regular messages based on their transactional behaviour, to help them use the account in the most beneficial way possible.

Lastly, Suits Me have developed a FinTech solution – On Demand Pay – that gives the customer early access to a percentage of their earnings in case of a short term financial crisis. It is a non-judgemental online transaction and the funds are made available immediately.

Suits Me, working in partnership with temporary labour providers, is giving people access to financial freedom, coupled with the opportunity to get into work. Their aim is to have 10,000 active Suits Me customers by the end of their first year.

202 Alex Letts – CEO, Frees, in evidence to CSJ

## Case Study: Squirrel – Empowering employees financial wellbeing

*We spent 4 months last year carrying out extensive research with workers earning up to £25k p/a. They were a mixture of warehouse operatives, drivers, call centre agents and general office admin workers, many of whom openly admitted to being bad at managing their finances. For the people with the biggest propensity to overspend and fall into debt, we found that there was limited value in offering financial literacy and education based solutions, as these simply didn't change ingrained behaviour.*

*Those most successful at saving for emergencies and seasonal events were people who had given their money a purpose and separated out their income into distinct categories – namely bills, savings and spending pots. Many people had come up with manual systems for handling this, such as separate bank accounts, whilst others did it by separating out physical cash around the home or with friends and relatives.*

*The key learning for us was that the solution to better financial management was twofold. Firstly people should separate out essential spending and lumpy seasonal costs from their day to day spending money. Secondly, they should keep non-disposable income out of sight and therefore out of mind. The squirrel product we subsequently built does all this in the form of a separate account that sits above a users spending account and is controlled through a really simple and intuitive app. Attaching visual reminders of the purpose of the longer-term goals added to people's abilities to resist the temptation to spend these upcoming lumpy expenditures (such as Christmas, birthdays and holiday).*

*Once we had come up with the solution, we faced some hurdles in terms of how to price such a service. The culture of "free" bank banking in the UK is so ingrained in consumers that the expectation is that products and services of real value like ours shouldn't need to be paid for. Whilst there is evidence that this attitude is changing, we sought to find other ways we could keep our product free to individuals. Our realisation was that employers were paying a high price for people mis-managing their finances. We uncovered a lot of research showing how financial distress affected employers in terms of the productivity of their workers. Absenteeism, presenteeism, attrition, morale, fraud and theft were all negatively impacted by people's inability to budget and save effectively. There was therefore a strong case for employers to pay for a service that reduces these negative affects and improves profitability.*

*Moreover, we found that HR directors were well aware of these problems and were actively looking for solutions they could incorporate into their benefits and rewards packages. Many of these companies had already provided solutions to improve the physical and mental wellbeing of their employees, so helping them with something as important as their finances was a logical addition to this policy. So today we have 5 trial employers rolling Squirrel out to their employees for all of these reasons and paying for the service.*

## Credit scoring and lending innovations

The growth of high-cost credit and of some questionable lending practices amongst certain firms is a symptom of a deeper problem with risk assessments. Put simply, Credit Reference Agencies (CRAs) fail to sufficiently differentiate the relative credit worthiness of those on low incomes. This is primarily because the metrics CRAs use to evaluate potential borrowers are largely based on their historical use of mainstream financial services, which low-income households often avoid or struggle to use because of their unsuitability, meaning data about these people are either poor or non-existent.[203]

203 Gibbons, D, *Does increased credit data sharing really benefit low-income consumers?*, London: Centre for Responsible Credit, February 2013 [accessed via: http://www.responsible-credit.org.uk/uimages/File/Does%20Increased%20Credit%20Data%20Sharing%20Benefit%20Low%20Income%20Consumers%20final.pdf (21/05/15)]

Several large mainstream CRAs – Equifax, CallCredit and Experian – are well established in the UK and having recognised these issues, are currently working to improve their credit rating services to make better assessments for low-income households.

One example of such innovation is a scheme being rolled out by Experian to capture social housing rental payment data, which they estimate will decrease the cost of borrowing and prevalence of problem debt for 1.56 million people.[204] A further two million would benefit from increased access to online financial services, as they would be able to pass the traditional online identity checks carried out by mainstream firms.[205]

### Case Study: CallCredit – real-time data sharing

CallCredit is the newest of the three major credit reference agencies, alongside Equifax and Experian, that operate in the UK. In part because of their lower total market share, they have been more responsive in adapting to the changes in the credit market following the global financial crash and have taken the lead in developing new products to help alternative financial institutions conduct credit risk assessments for low-income households. As a result of the recent publicity and issues that have arisen around payday lending, which have led to stricter regulatory requirements for alternative lenders, they have made significant developments in terms of lenders affordability checks. Specifically, they are working to provide more up-to-date data about the loans people have recently taken out and their present financial situation, which was previously not well captured by CRA data.

The firm has also showed a willingness to offer bespoke credit scoring systems to socially responsible lenders, however, they are not cheap and at present the lack of demand and ability to invest in these services amongst AFIs means they are not a core part of their business.

While recent developments are welcome, they have primarily been driven by the increased regulatory requirements imposed by the Financial Conduct Authority, rather than market demand and have several significant issues including:

- Inconsistent reporting of data by lenders;
- A lack of true real-time data reporting to CRAs about loans and loan applications.

There are several firms working to reinvent the system from the ground up, providing a truly innovative way of assessing credit worthiness in a way that will enable lenders to differentiate between low-income households. The result of these innovations, if embraced by Alternative Financial Institutions, is that low-income households who are 'good borrowers' will be able to access credit at significantly reduced prices, which will in turn decrease their likelihood of falling into problem debt.

The case studies below highlight innovative firms seeking to solve slightly different problems with existing credit scoring systems that can artificially increase the cost of credit for people that could drive them into problem debt. The first, Pariti, is aimed at a more traditional

204 Forster, S and Wilkinson, G, *The Impact of Social Housing Rent-Payment Data on Credit Scoring*, London: Big Issue Invest, 2010 [accessed via: http://bigissueinvest.com/wp-content/uploads/2014/06/The-impact-of-social-housing-rent-payment-data-on-credit-scoring.pdf (21/05/15)]
205 bid

low-income market. The second, Aire, is aimed at supporting those who have no history or records with any UK financial institution, such as recent immigrants.

The comparison between both firms and the technologies they have developed is instructive as it shows that there is not just one issue to be solved in the current systems used by CRAs. Significant developments are needed in this area if all low-income households are to eventually have access to some form of affordable credit.

### Case Study: Pariti – Proactively helping build consumer financial health and access to low cost finance

Pariti is an innovative new FinTech firm with a clear social purpose: to provide people with the means to easily understand and improve their financial situation. The product they are developing makes it simpler for consumers to understand their present financial situation, provides tools and guidance to help improve their position, and aims to work with responsible lenders to unlock access to lower cost financial products. Complex algorithms working behind the scenes to constantly analyse information about the financial health of its customers – based on behavioural data points and transaction data from their financial accounts – to help proactively notify consumers before they fall into financial difficulty, optimise and prioritise debt repayments, incentivise savings practices and ultimately improve their financial wellbeing

The other aspect of their business is to use this information to create an alternative credit score for the person, based on their financial situation and what they can afford to borrow. This can ultimately be licensed as an API to socially responsible lenders, allowing them to better assess people's credit worthiness. This is fundamentally different to what is done by mainstream CRAs, who primarily base a large degree of their assessment on historical loan repayments.

The use of bank account transactional data takes what has historically been done manually by CDFIs and credit unions and combines it with more sophisticated forecasting techniques and behavioural incentives to make credit assessment more transparent for consumers, with clearer steps to improving their credit worthiness, whilst bringing significant cost advantages to lenders and potentially improving their lending decisions.

The ethos embedded in Pariti is key to their success and shows that FinTech firms can attract significant investment and have huge growth potential, whilst still also remaining socially responsible. Ultimately, it is firms like Pariti and innovations regarding credit scoring that are developed from the ground up, that will truly decrease the cost and increase the availability of credit for low-income households.

- The simplicity and ease of the Pariti app has helped make checking finances a daily habit for many of their users with daily use comparable to those of popular games rather than finance apps;
- The average Pariti user has around four different financial accounts, ranging from the larger mainstream banks through to specific credit-building products such as Aqua Card and Vanquis Bank

*"We're very much a mission-led business, that wants to set an example within the sector for how technology and collaboration can help address the problems of financial exclusion and problem debt. Our aim is to simplify the complexities of finance, empower consumers to improve their financial health and work together with responsible partners to improve access to low cost financial products. We want to create a fairer and more accessible ecosystem in which the incentives of both consumers and product providers are more closely aligned"* – Matthew Ford, Founder & CEO, Pariti

### Case Study: Aire — Affordability, Identity, Credit Risk, Education

Aire was founded with a mission to enable fair access to finance. Today, Aire is focused on the first piece of that process by allowing people to take control of their credit scores and profile.

Nearly 30 per cent of the UK adult population is not actively covered in the credit reference agencies. As a result they are often not able to access and apply for financial services products. Aire allows them to build an alternative profile by supplying their own data and credentials. After verification, the result is called the Aire Passport which can be presented to financial institutions and banks.

By working directly with the consumer, Aire is able to use additional data sets that are provided with consumer-consent, a feature they believe is extremely important to build a sustainable solution in the future. Aire does not scrape or data-mine data from social networks and respects the privacy of the consumer. They also focus on spending time understanding the user's behaviour and approach to financial credit, which is a strong facet of the Aire score.

The Aire Passport also carries the user's credit rating called the AIRE Score which stands for: Affordability + Identity + Risk + Education in relation to credit. They believe this is a much more forward-looking and yet holistic approach, that will create responsible lending in the economy. Aire is also a strong proponent of the initiatives to support consumer ownership of their data and stronger privacy protection.

At present Aire is focused on helping thin-file customers (ie: people with very little data in the traditional credit bureaus). As society changes, there are significiantly more people who move for professional, education or personal reasons. Society promotes mobility of people and yet does not allow them to take their financial records over boundaries. Likewise the rise of the self-employed working pattern is also leaving a lot of people outside the core financial system. Aire is on a long-journey and would like to extend the concept out to international markets as well, where a staggering 4.5 billion people do not have a formal credit profile and half of those are also unbanked.

Aire is on a long journey, it will take years of hard work and collaboration between regulators and business sector for a large scale rollout. The traction with TechStars accelerator, the mentor network and the FCA Innovation Hub have been of great help to speed up the adoption and raise awareness. Aire is always keen to partner and work collaboratively with others who also embody their vision of a financially inclusive society.

The team at Aire got started when they personally faced this problem. After spending a couple years petitioning for change to Whitehall and the existing bureaus, Aire was eventually set up as a company in January 2014. They are currently backed by leading investors from the UK and US including seed venture fund of TechStars and SparkLabs from the Bay Area.

*"Aire is a difficult company to build.. but a company that needs to be built."* – Annesh Varma, Founder, Aire

## 3.3. Providing a range of affordable financial services without subsidies

As mentioned previously, there are currently between seven and nine million people, who are underserved by mainstream financial institutions, which includes two million people that lack access to a transactional bank account and more than eight million people who struggle to access affordable credit. Having access to a range of appropriate financial products and services will not solve the malaise of issues that can drive low-income households into

problem debt, but it can help empower people to improve their financial wellbeing. More importantly, the lack of appropriate products, or an inability to access them for whatever reason, can have a significant detrimental impact on a person's financial situation.

For this reason, there are clearly millions of underserved people who would benefit from the types of new innovative financial products and services highlighted in this chapter, and perhaps most importantly, would benefit from being able to choose from a range of financial services provided by AFIs that are designed specifically around what various types of consumers want and need in order to help them manage their finances and avoid problem debt.

There are two fundamental differences between the present situation and the vision set out in this report:

- That low-income households are placed at the heart of how financial services are designed and provided to them, in order that those services are both desirable and beneficial; and
- That individual people on low incomes are treated as consumers and are offered a real opportunity to choose which products and services they want to use, based on their specific needs and preferences, rather than being told what they need.

The theory behind this new vision for financial services is arguably much simpler than the practicalities of delivering it, which require several significant developments to take place, including:

- Changing the national debate and preconception around how financial services are designed and accessed by low-income households, including how to pay for them;
- Ensuring funding is directed towards AFIs that have a business model which allows them to offer a diverse range of products and services, as well as generate revenue in new and innovative ways that can help lower the costs for customers and end their reliance on government or charitable funding in the long run;
- Developing an investment market that is able to raise capital from a variety of sources, and that includes a mixture of grant funding, commercial equity finance, social investment and debt finance;
- Creating a new independent social enterprise with close links to the FCA to raise capital through p2p finance and a new crowdfunding platform, which will used to fund an accelerator program for FinTech firms developing products that will specifically benefit AFIs;
- Supporting AFIs in implementing new and innovative FinTech solutions that will lower the cost of providing financial services to low-income households, specifically by providing a central resource hub and specialist technical support services through the new social enterprise.

### Changing the way low-income households are considered by politicians and financial firms

In the same way the CSJ developed a radical rethinking of the entire welfare system based on the idea that it should enable the people that use it to move out of dependency and into work, there is a need to have a new narrative around debt which focuses on the wants and needs of low-income households, rather than maintaining the status quo.

This is based on the following key principles:

- People on low incomes should be offered financial products and services developed in response to their preferences and the realities of life on a low income;
- There needs to be an acceptance of the reality that financial services, such as bank accounts and credit are not free to provide for anyone, and therefore it is necessary to rethink who should pay the cost of providing a range of services to low-income households and how those costs are built into the products themselves and the business models of the firms providing them;
- How financial products and services are categorised is far less important than what people actually want to achieve with those financial services. This means there is not a set list of products and services people on low incomes need, but rather things that they want to be able to do, such as pay for food and clothes or have enough money to repair their boiler no matter when it breaks. These things can be achieved in a variety of different ways, which can change over time and are based on an individual's specific preferences and circumstances.

## Delivering financial products and services through Alternative Financial Institutions

In order to provide better quality financial products and services for low-income households it is necessary to first accept the fact that providing financial services is not free, whether they are provided by an AFI – such as a credit union or CDFI – directly by the government, or by a mainstream financial institution.

There are four key things that AFIs need to do in order to offer products and services on the scale demanded without indefinite government funding, but without passing on all the financial costs to low-income consumers, which might worsen their financial situation:

- Increase their efficiency through the use of centralised IT systems and other FinTech solutions;
- Diversify their product offerings in order to cross subsidise the costs of offering financial products and services;
- Make use of new revenue streams, such as retailer tie-ins, to help defray the costs of offering financial services;
- Integrate the provision of debt-related services to attract more social investment, grant funding and improve the financial wellbeing and capability of their customers, which will increase revenues and decrease bad debt ratios.

In order for AFIs to market and deliver innovative financial products and services to low-income households they must find ways to cover the costs without passing them on to the consumer. Some of the principles worthy of consideration are listed below.

- Products and services for low-income households can be made into ethical profitable options, but how they are marketed and delivered needs to be rethought;
- It is only possible to deliver affordable financial services to low-income households if they are delivered at scale and leverage financial technology to substantially reduce costs;
- Open Advanced Programming Interface (API) cloud-based banking platforms make it much easiest for new innovative AFIs to scale up and integrate their services;

- Cross subsidy and integration between different products would lower the cost of delivery for the AFI (e.g. offering banking, savings and loans through a low cost digital platform);
- Banking products can be monetised through retailer tie-ins as low-income households still spend significant amounts on basic household goods.

### An innovation fund for Financial Technology aimed at low-income households

In order to develop new innovative FinTech solutions that would help AFIs grow and offer better, more diverse, services to help low-income households improve their financial wellbeing, the Government should create a special social FinTech accelerator programme. This would leverage in a form of blended capital (social investment underwritten by grant funding) and be linked into the FCA innovation hub. After completing the programme the social investors would be bought out by commercial investors so that funds could be recycled.

In the CSJ's evidence sessions several FinTech firms highlighted several issues that could be addressed by creating a new Social Finance Accelerator programme (SoFiTech):

- Many small FinTech firms struggle with the costs and time it takes to complete the extensive authorisation processes required by the FCA;
- Even after completing their application for authorisation, many struggle to get approval and recognition for truly innovative ideas, as they do not fit easily within the existing FCA regulatory framework and small firms typically do not have sufficient resources to lobby the FCA;
- It is very difficult to access social investment for FinTech ideas with a clear social purpose, without first proving their business model is viable through accessing more expensive forms of traditional commercial funding. This is counterintuitive and can discourage entrepreneurs from developing products for this market segment.

However, there is a also clear economic and social policy case for creating a new Social FinTech Accelerator Programme (SoFiTech) for the following reasons:

- Currently there is a huge amount of investment available for FinTech from angel investors, venture capitalists and other forms of commercial mainstream finance, totalling over £400 million in 2014, 42 per cent of the total FinTech investment in Europe.[206] This is because of the huge potential returns and is positive, but there is a need to stimulate funding for firms specifically developing products that will benefit low-income households as well;
- Products that are developed for the UK market have the potential to become industry-leading products at a global level and in developing countries where the potential market is exponentially bigger;
- Providing better financial services to low-income households based on FinTech solutions in the manner outlined by this report would help reduce overall levels of problem debt that costs the UK economy £8.3 billion each year;
- The development of FinTech solutions that help create a competitive market for AFIs that is able to serve low-income households would improve lives and generate significant cost savings for government, as in the long term there would be no need for large government grant funded programmes to help them develop technologies at scale.

206 Accenture, *'The Future of Fintech and Banking: Digitally disrupted or reimagined?'*, London: Accenture, 2015

There are a large variety of FinTech Accelerators operating purely in the commercial sector, which should be looked at, as well as more innovative accelerator programmes targeting social enterprises, which are emerging in the UK and aboard. Examples include the Financial Innovation Lab, Flip Finance, and the Financial Solutions Lab in the USA.[207]

There are also examples of social investment through emerging crowd-funding platforms including CrowdBNK and BuzzBNK, which should be considered when developing SoFiTech. Similarly, the Access Foundation, in partnership with Big Society Capital and Big Issue Invest, is currently developing more innovative forms of social investment, using forms of blended capital that can be developed further.[208]

## Recommendation

The Cabinet Office, in partnership with Big Society Capital, HM Treasury and the Financial Conduct Authority should create an innovation fund and social FinTech accelerator programme (SoFiTech), both of which would sit under a new independent body, The SoFiTech Foundation, with the aim to support firms designing products specifically for low-income households.

### The SoFiTech Accelerator Programme

- Products and services for low-income households can be made into ethical yet also profitable offerings through the use of FinTech;
- Seed funding from Big Society Capital or other would be used to cover operating costs until it was sustainable and to provide a quasi 'deposit guarantee scheme' for individual investors through a linked peer-to-peer social investment platform that would allow firms in the accelerator to access debt finance;
- Direct links with an FCA fast track approval scheme to decrease 'to market' costs and speed up innovation by ensuring the firms would be compliant with FCA regulation;
- Direct access and connection with the FCA Innovation Hub;
- Companies would have to meet certain ethical standards and requirements in order to apply for each round of the accelerator.

### The SoFiTech Innovation Fund

- Creation of a linked p2p social investment platform and/or crowdfund platform to fund the new FinTech accelerator programme;
- Firms would have to raise a minimum level of funds on the social investment platform in order to be considered for the FinTech Accelerator programme;
- Charitable trusts would be able to issue renewable bonds or one-off grants that would serve as first loss protection for social investment up to a certain threshold. Funds could be targeted at specific firms or de-risked across the investment portfolio;
- Social Investors would be protected against first losses up to a certain percentage;
- Social investors linked with trusts/foundations would be able to use a secondary market to cross-guarantee the investments of other 'dual-role' investors.

207 For information on these accelerators please refer to their websites, http://socialinvestment.org.uk/team-4/
208 For information on these accelerators please refer to their websites, https://www.crowdbnk.com; http://access-socialinvestment.org.uk; https://www.buzzbnk.org

# chapter four
# Alternative Financial Institutions

The financial hardship and high levels of problem debt that millions of low-income households currently struggle with does not have a single cause or solution. Similarly, as low-income households are not one homogeneous group, the financial products and services they want and that would help them also vary. However, what is clear is that mainstream financial services have failed to meet the wants and needs of millions of low-income households, meaning there is a huge demand for a new generation of innovative Alternative Financial Institutions (AFIs) with business models that allow them to provide products and services tailored specifically for this group. This chapter looks at how these AFIs can be brought to scale and made self-sustaining so as to help more low-income households avoid problem debt.

## Defining Alternative Financial Institutions (AFIs)

An 'Alternative Financial Institution' is not a type of financial institution clearly defined by the Financial Conduct Authority in the same way as, for example, a 'bank'.[209] In the context of this report the term 'AFI' is used to refer to financial institutions that are by design or by default, a recognised provider of financial services to low-income households that helps them maintain financial wellbeing.. Some common examples of AFIs covered in this report include the following:

- Credit unions;
- Community Development Financial Institutions (CDFIs);
- Social Enterprises;
- Charitable financial institutions.

Using the definition and emerging work from the Cambridge Centre for Alternative Finance, the term AFI can actually cover an extremely wide range of firms that are most typified by the mere fact they are not traditional or 'mainstream' financial institutions: [210]

209 Cambridge Centre for Alternative Finance at the Universary of Cambridge Judge Business School [accessed via: http://www.jbs.cam.ac.uk/faculty-research/centres/alternative-finance (02.06.15)]
210 Centre for Social Justice, *Restoring the Balance*, London: Centre for Social Justice, 2014.

- Newly emerging p2p lenders, such as Ratesetter and Zopa;
- Innovative FinTech firms developing alternative credit scoring mechanisms;
- Firms offering digital current accounts or electronic 'pocket money' for children; and even
- Online payday lenders, most commonly typified by firms like Wonga and its largest competitors.

Clearly, this broader definition includes some firms that are outside the interests of this paper. But what is most important is how people on low incomes view these firms. This is typically determined not so much by how they are regulated or what they are called, but rather by how the individual is treated by the firm, what financial products it allows them to access, and how beneficial they find those services in terms of achieving their goals and maintaining their financial wellbeing. Using this person-centric approach, the following definition attempts to set out the principles behind what is meant and covered by the term Alternative Financial Institution within the context of this report.

**Alternative Financial Institutions (AFIs) – redefining firms by function not form**

In order to better understand and distinguish financial institutions that are built from the ground up to serve low-income households. regardless of form or business model, AFI may cover both responsible for-profit firms, CDFIs, credit unions and other social enterprises. The key distinctive feature is that these firms have a business model, which does not rely on traditional means of monetising financial services that have produced products that are inappropriate for low-income households.

Examples include the free in credit banking model or firms that make lending decisions based solely on traditional credit rating systems provided by the major Credit Reference Agencies. It is these alternative business models that allow AFIs to specifically design products and tailor their services for low-income households, which ultimately means they can provide better and more affordable financial services that can help people maintain financial wellbeing and avoid problem debt.

## 4.1 Choice, trust and affordability: the demand for alternative finance

There are seven to nine million people who are currently not well served by mainstream financial services and who are at risk of falling into problem debt as a result.[211] As the CSJ has seen in its research, the business models of mainstream financial institutions, as well as the products and services they offer, are simply not geared towards serving low-income households. This is largely because the business model of mainstream financial services is built around designing products and services for a different part of the market. For instance, only a small proportion of a bank's income is generated from customers that solely use current accounts, which are cross subsidised through revenue generated from mortgages, a product that is not commonly used by low-income households.[212]

Because low-income households have diverse wants and needs they are not best served by one type of financial institution. The Government has previously made this mistake through its

211 PwC, *There's no such thing as a free lunch: Why fees are the future for current accounts*, London: PwC, 2015
212 Ibid

promotion of credit unions and CDFIs as the 'solution' to high-cost credit.[213] In both instances, customers are immediately limited in their choice of products and services.

The CSJ has identified several trends amongst low-income households regarding their preferences when choosing which financial institution to go to for a loan, bank account or other financial service, which highlight the benefit of promoting innovative AFIs. The following key themes recur in academic research and consistently came up in focus groups run by the CSJ in partnership with two CDFIs, Moneyline and Fair Finance.[214]

- **Customer Service**: customers were extremely complimentary of staff in both organisations, with many specifically citing the face-to-face nature of the service and how much time and effort was taken to clearly explain the terms of their loan. Similarly, the ability to call or walk in and talk to the same loan adviser if they had problems was cited as being something that was not possible with a bank and gave them more confidence when taking out loans and helped them to maintain repayments and avoid problem health..

- **Trust**: customers expressed that they had previously used mainstream financial services but no longer trusted them because of their experience, typically because of issues with loan repayments or penalty charges. Customers also mentioned that they trusted social enterprises more, as they felt it was focused on serving them specifically, rather than on making profits from wealthier customers.

- **Transparency, simplicity and flexibility**: the unpredictability and volatility of many low-income households' financial situation means they frequently praised and valued the transparency and simplicity of the financial products, as well as the flexibility of the firm with regards to repayments. The ability to reschedule loan repayments without penalty when their financial situation changed, such as after losing a job, was often cited as helping them maintain control of their finances and has a clear advantage over the more rigid systems and penalty fees they associated with mainstream financial institutions.

- **Integrated support services:** the types of peripheral services low-income households are likely to find beneficial are often different to those requested by wealthier households. For instance, financial advice on mortgages or investment portfolios are typically less demanded amongst low-income households than advice on benefit claims, employment support services and debt advice. AFIs in a competitive market focused on serving this demographic would have an incentive to offer support services that people wanted, would use and that would help them maintain or improve their financial situation, as it would help the business through decreased default rates and higher levels of customer retention. It is important to note that while there is no 'profit' in providing these services, it would help attract grant funds and social investment.

However, because low-income customers have varied needs and requirements, it is crucial that a variety of Alternative Financial Institutions are available so that people have a greater

213 DWP, *Credit Union Expansion Project: Feasibility Study Report*, London: DWP, 2012

214 Focus groups involved people currently using services provided by Moneyline and Fair Finance, two of the best performing CDFIs offering personal loans in the North West and London respectively.

choice of appropriate financial services that they trust and that will help them maximise their financial capability and avoid problem debt.

If low-income households are treated as legitimate consumers, a competitive market for AFIs can develop, offering the products, services and financial support people want and need to maintain financial wellbeing. AFIs that experience greater demand from low-income customers must also be enabled to grow faster than those for which there is a lower overall demand.

The growth of the payday lending industry is perhaps the best example of how low-income households acting as consumers can create a competitive market for AFIs. Following the financial crash, mainstream financial institutions decreased the availability of credit, especially for low-income households, creating a market opportunity that payday lenders seized upon.

However, it was not just their willingness to lend to this group that made companies like Wonga so successful, but rather it was because they responded to the consumer demands of this group and created an easy to use, non-judgemental, simple and transparent loan product, which was fundamentally different than traditional credit products (e.g. personal loans, overdrafts, or credit cards). Consumer surveys of Wonga's customers consistently find high levels of customer satisfaction. Even more interestingly, the reasons people like the company and chose the product, are very similar to the preferences cited by CDFI customers in the CSJ's focus groups. Examples include flexibility, clarity of loan repayments, quality service and not having to deal with a bank that does not serve them well.[215]

This comparison is not meant to vindicate the questionable practices exhibited at times by Wonga and some other payday lenders, or to gloss over the substantial financial hardship some payday loan products caused people, both of which are well documented by the FCA as the basis for increased sanctions and stricter regulations.[216] However, between 2006 and 2012, lending by the payday loan industry grew from £330 million to £3.7 billion, reaching a total of 1.8 million customers.[217] This rapid growth cannot be explained without some element of increased consumer demand and reflects that the product and service was something different than what mainstream financial institutions were offering, which was wanted and liked by customers.

In contrast, credit unions have not experienced the same type of success following the financial crash, despite offering lower cost loans and receiving substantial financial support in the form of grant funding from government, charitable trusts and corporate CSR programmes. British credit unions currently have around 960,000 members, up 43 per cent since 2008, and issue around £643 million in loans.[218] Similarly, only 22 out of 362 British credit unions offer a full current account service with budgeting features at present. Whilst this should expand rapidly under the Credit Union Expansion Programme, currently relatively few people, or around 3.5 per cent of all members, actually open this type of account.[219]

215 Wonga, *About Wonga* [accessed via: http://www.openwonga.com/uk/news-and-views/view/views-from-our-customers#.VVGii2C4mV4 (02.06.15)]

216 Financial Conduct Authority, Policy Statement PS14/16, *Detailed rules for the price cap on high-cost short-term credit Including feedback on CP14/10 and final rules*, London: Financial Conduct Authority, 2014

217 Competition & Markets Authority, *Payday lending market investigation - Final report,* London: Competition and Markets Authority, 2015; Financial Inclusion Commission, Financial inclusion: Improving the financial health of the nation, London: Financial Inclusion Commission, 2015

218 HM Treasury, *Consultation outcome – Call for evidence: British credit unions at 50*, 2014 [accessed via: https://www.gov.uk/government/consultations/british-credit-unions-at-50-call-for-evidence/call-for-evidence-british-credit-unions-at-50 (02.06.15)]

219 ABCUL, *Annual Report 2013-2014*, Manchester: ABCUL, 2015

*"We should be in no doubt that there is a huge market for payday loans in the UK. The rise of the product in the aftermath of the global financial crash in 2007, would leave most other industries envious. It is no surprise, that given the range of alternative financial services available, payday lenders currently outcompete credit unions and CDFIs. While there are many factors involved in this, it is easy to understand the appeal of the speed of service and relative anonymity that can be enjoyed with a payday loan.*

*"We know people who use payday loan are often those with the fewest financial means and for whom debt can be a shameful experience. For many, payday loans could look like an answer to their financial difficulties, even with the associated 'poverty premium'. My concern is the real price of this: because payday lenders compete primarily on the speed of their service, their underwriting practices became insubstantial and this gave rise to irresponsible lending on a mass scale. What other alternative financial service providers need to find is the balance between what consumers want (a faster service, online platforms etc) and responsible social purpose (responsible underwriting and lower prices)."*

Carl Packman, independent researcher and author of Payday Lending: Global Growth of the High-Cost Credit Market in evidence to the CSJ

For example, the UK's largest housing association, Affinity Sutton, partnered with Leeds City Credit Union in 2012 to offer a budgeting current account to all of its 161,000 tenants, yet only 775 accounts, or 0.48 per cent of eligible tenants have chosen to open an account.[220] This is in sharp contrast to the rapid growth of other for-profit AFIs that offer digital budgeting accounts without a monthly charge, such as Ffrees, which has opened just under 50,000 accounts in the first year since launching. This makes it bigger than the UK's largest credit union, founded in 1989, and that Ffrees already provides transactional banking to around 10,000 more people than all of the credit union's put together.[221]

## 4.2 Sustainable models for Alternative Financial Institutions

Regardless of how popular any one AFI, or type of AFI is, it is esessential that they all have a viable business model, at least in the long run, in order to provide affordable financial services on the scale demanded by the millions of people currently underserved by mainstream finance.

It is not possible to say which model of AFI is the 'best', either for the AFI, the people they serve or the economy as a whole. The situation varies considerably from country to country and is based on a range of factors, including the structure and regulation of their financial sector, as well the historical, political and economic context within which these AFIs have developed. The impact that this can have is clearly visible when looking at the two most prominent forms of AFI in the UK: credit unions and CDFIs.

For example, while credit unions are extremely successful and popular in many countries – Canada, Ireland and the USA – they have not gained significant traction in the UK where they still serve only around two per cent of the population, or 1.5 million people, of which

220 Affinity Sutton, *Annual report and financial statements 20–13/14*, London: Affinity Sutton, 2014

221 Glasgow Credit Union, *A proud history and a bright future*, 2014 [accessed via: http://www.glasgowcu.com/2014/07/proud-history-bright-future/ (02.06.15)], Ffrees, *Digital current account provider Ffrees raises third round of funding worth £2m* [accessed via: https://www.ffrees.co.uk/media/press_releases/ffrees-third-round-funding (02.06.15)]

around a third are based in Northern Ireland, and have a loan book of £718 million.[222] For comparison, credit unions in the USA now have over 100 million members, equivalent to one in three Americans, and have a loan book exceeding £197 billion.[223]

The CDFI sector in the UK is even smaller, with just 12 of 54 CDFIs involved in personal lending, issuing around £19 million in loans to around 42,000 people in 2014, far short of the estimated demand for affordable credit of £3–3.5 billion.[224] Again, this is relatively small in comparison, where there are more than 800 CDFIs, including 88 CDFIs licensed to accept deposits, which issued over £3 billion in loans in 2014.[225]

Not only are credit unions and CDFIs small in scale, which limits their ability to meet the demand for affordable finance amongst low-income households, but historically they have been heavily dependent on government grants and charitable funding in order to operate. In recent years, credit unions have received £138 million in government grant funding through the DWP's Growth Fund and the more recent Credit Union Expansion Project.[226] Similarly, CDFIs have benefitted from £72 million in grant funding through the Department for Trade and Industry's Phoenix Fund and the Regional Growth Fund.[227]

There is nothing wrong with grant funding from government that supports organisations with a clear social purpose to help people avoid problem debt and build their financial capability. However, the reliance on grant funding in the long term, which essentially props up financial institutions that otherwise would not exist, can have unintended consequences. Specifically, it could prevent the development of a competitive market for AFIs, which would include the best and most innovative credit unions and CDFIs, as well as other innovative charitable financial institutions or social enterprise models for delivering financial services.

> "Continued subsidy and revenue support has not only stunted the credit union sector's development but it has also left the sector vulnerable to the withdrawal of support."
>
> Association of British Credit Unions Limited (ABCUL)[228]

The widespread recognition of the credit union amongst politicians and other grant funders may make it difficult for entrepreneurs to gain traction and funding for a new and innovative product or business model, simply because it does not fit the established mould and

222 Civitas, *Credit Unions: A solution to poor bank lending?*, London: Civitas, 2013. ABCUL, Facts and statistics, Press release, 31.12.2015 [accessed via: http://www.abcul.org/media-and-research/facts-statistics (02.05.15)]

223 ABCUL, *US Credit unions serve 100 million*, 2014 [accessed via: http://www.abcul.org/media-and-research/news/view/476 (02.05.15)]; Federal Reserve, *Statistical release: Consumer credit – March 2015,* 2015 [accessed via: http://www.federalreserve.gov/releases/g19/current/g19.pdf (02.05.15)]

224 CDFI Coalition, *Community Development Financial Institutions: Fact sheet 2015*, Washington D.C., 2015; Note: The figure for lending by CDFIs in the USA is inclusive of all types of lending, such as to small businesses or for community regeneration projects, rather than just personal loans, which is £173 million in the UK.

225 Ibid

226 Cabinet Office, *Scaling community lenders: The role of social investment*, London: Cabinet Office, 2015

227 Ibid

228 Financial Inclusion Commisison, *Financial Inclusion: Improving the financial health of the nation*, London: Financial Inclusion Commission, 2015

recognised criteria for 'financially inclusive services' for low-income households. Ultimately it is low-income households that suffer if this innovation is stifled.

It is vital that in future, grant funding is direct towards the best and most innovative AFIs, no matter what form they take, allowing them to rapidly scale up the size of their business and improve the quality of the products they offer to low-income households.

### Creating transparency and standards for evaluating Alternative Financial Institutions

In order to promote and encourage the development of a competitive market for AFIs it is essential that funding and investment can be directed towards the best AFIs. A prerequisite for this is that there are common standards AFIs adhere to, which will enable government, philanthropic funders, social investors and mainstream commercial lenders to compare AFIs and identify those that have a viable business model, which is capable of scaling to the level demanded by low-income households.[229]

A strong example of a 'good practice' code of conduct is the Microcredit Code of Conduct drawn up to assist lending and investment in small businesses unable to access mainstream finance. This was commissioned by the European Commission and developed by the University of Salford in cooperation with a range of stakeholders, which included investors and microcredit providers.[230] Although it has only been four years since its implementation, levels of adherence to the code amongst microcredit providers across the EU are high, and the sector as a whole has been growing.[231] Whilst this code cannot be directly transposed to all AFIs in the UK, many of its principles are transferable. Key aspects of this code that apply to AFIs serving low-income consumers include:[232]

- Customer and investor relations;
- Governance structures and standards;
- Risk management protocols;
- Standards for reporting financial performance;
- Management of information systems.

Independent evaluations of both CDFIs and credit unions have highlighted the need to develop a similar code of conduct, alongside standardised performance metrics, for AFIs serving low-income consumers.[233] Specifically, these evaluations highlight some commonalities amongst existing AFIs, which contribute to the difficulties they face when raising capital.

229 Enterprise & Industry Magazine, *Promoting good practice in micro-credit*, European Commission, 2011 [accessed via: http://ec.europa.eu/enterprise/magazine/articles/smes-entrepreneurship/article_11018_en.htm (02.06.15)]

230 Dayson K & Vik P, *The European Code of Good Conduct for Microcredit Provision*, Brussels: European Commission, Directorate-General for Regional, Policy, 2011

231 Bendig M, Unterberg M, Sarpong B, *Overview: of the Microcredit Sector in the European Union*, Brussels: European Microfinance Network, 2014 [accessed via: http://www.european-microfinance.org/docs/emn_publications/emn_overview/Overview2012-2013_Oct2014.pdf (02.05.15)]

232 Dayson K, *The European Code of Good Conduct for Microcredit Provision,* Brussels: European Commission, Directorate-General for Regional Policy, 2011

233 GHK, *The National Evaluation of Community Development Finance Institutions (CDFIs): An Action-Orientated Summary for the Sector*, 2010, London: Department for Business, Innovation and Skills & the Cabinet Office [accessed via: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/32247/10-1019-national-evaluation-community-development-finance-institutions.doc; oldbell3, *An Evaluation of the Access to Financial Services through Credit Unions Project – First Year Report*, Merthyr Tydfil: Welsh Government Social Research, 2012; Longstaff B, *The Community Development Challenge: Evaluation - Establishing an outcomes and evidence base*, London: Community Development Foundation, 2008

If AFIs are going to compete effectively with mainstream financial institutions, they must be able to raise the funding needed for rapid growth, increased lending and the development of FinTech solutions that AFIs need to streamline and improve their financial performance and long-term sustainability.[234] The following is a list of some recurring issues that can prohibit AFIs from accessing capital:

- A lack of transparency of business models;[235]
- Inconsistent approaches to lending criteria and risk pricing;[236]
- Outdated technology that is unable to easily generate data about the business;[237]
- Difficulties in assessing and quantifying social impact.[238]

Given the variety of AFIs, which is in and of itself a good thing, it is impractical to develop one common 'code of conduct' that would be relevant to all of these businesses. However, the variety is not so extensive that it would be impractical to develop several codes, such as one of CDFIs, one for credit unions and so on. Requiring adherence to these codes as a prerequisite for applying for certain types of social investment, grant funding, or government backed investment through the British Business Bank or from local authorities, would help drive up the consistency, quality and transparency of AFI's business models.

Such transparency is crucial in order for investors, policy makers and other funders to assess which firms are realistically capable of achieving the scale needed to compete effectively with mainstream financial institutions and without long-term subsidies. It is beyond the scope of this report to define the exact evaluation frameworks that would be developed under such codes of conduct. However, there are several key metrics that are needed in order to help investors assess and compare AFIs, their current performance, potential for future growth and innovation, as well as the social purpose and values of the organisation:

- **Costs and revenue**: standard metrics for this would help prevent AFIs from overstating their financial performance and 'sustainability', such as use of a government property rent free;

- **Values and Social Impact**: an inherently imperfect and often unquantifiable aspect of any AFI. Requirements to at least separate the objectives and values of an AFI from its business performance, would help identify the true potential of the business to scale and achieve full sustainability.

- **Development and trajectory**: standardising the evaluation of an AFI's performance in terms of year-on-year growth, changes in cost structures and loan performance, as well as the proportion of income spent on investment in the business would significantly help investors identify scalable AFIs.

234 Cabinet Office, *Scaling community lenders: The role of social investment,* London: Cabinet Office, 2015
235 GHK, *Evaluation of Community Development Finance Institutions (CDFIs)*, Birmingham: GHK, 2010
236 Cabinet Office, *Scaling community lenders: The role of social investment*, London: Cabinet Office, 2015
237 GHK, *Evaluation of Community Development Finance Institutions (CDFIs)*, Birmingham: GHK, 2010
238 Cabinet Office, *Scaling community lenders: The role of social investment,* London: Cabinet Office, 2015

The Department for Business, Innovation and Skills (BIS) has recently commissioned a report by the consultancy firm PricewaterhouseCooper on the CDFI sector, the viability of the business model and the potential for investment through the British Business Bank.[239] This is a welcome development, but unfortunately research alone, no matter how well conducted, will not actually directly provide the funding AFIs need. It is important that this research is acted upon, as AFIs need significant amounts of capital in order to grow and scale their businesses to the level needed and to ensure low-income households have access to a better range of more affordable financial services.

Therefore, it is vital that BIS and others continue this type of research and that government establishes an independent body to take the lead in creating new codes of conduct for the various categories of AFIs. This greater degree of transparency is a key prerequisite for developing a functioning investment market that is often cited as the biggest barrier preventing CDFIs and other types of AFI from achieving scale and ending their reliance on grant funding in the long-term.

### Recommendation

In order to allow AFIs to access the capital investment needed to grow, develop and increase their commercial viability, a single government department which we would recommend be HM Treasury, needs to assume responsibility for developing new codes of conducts and evaluation frameworks for the various types of AFIs, which will make it possible for investors and other funders to compare firms and price risk at more affordable levels.

## Barriers that prevent the growth of competitive AFIs

It is too simplistic to attribute the lack of a competitive market for AFIs entirely to the difficulties of CDFIs and other AFIs in accessing the capital funding needed to grow their loan book, develop their business, and invest in the FinTech solutions needed to scale. Whilst it is a substantial part of the problem, there are several other key types of barriers preventing the development of a competitive market for AFIs that can meet the needs of people on low incomes and help them avoid problem debt. These barriers include:

- A lack of data sharing with mainstream financial institutions;
- The divide between deposit takers and lenders;
- Regulatory barriers;
- Access to appropriate and affordable capital;
- High operating costs.

## A lack of data sharing

In the UK there is a lack of data sharing with mainstream financial institutions that makes it significantly harder for new AFIs to enter the market – this is in stark contrast to the USA

239 HM Treasury, *Government looks to promote a sustainable future for community finance*, 2015 [accessed via: https://www.gov.uk/government/news/government-looks-to-promote-a-sustainable-future-for-community-finance (02.06.2015)]

where CDFIs and credit unions are thriving.[240] Data on the activities and performance of mainstream financial institutions in a given area would help AFIs target their limited resources at places and people that are underserved.[241] The ability to easily identify areas with strong consumer demand amongst low-income households for an AFI offering affordable financial services designed for that particular market segment and/or local area, would make it much easier for AFIs to enter the market.[242] It would also decrease the time the AFI would need to become commercially viable or reach sustainability.

### The divide between lenders and deposit takers

There is a clear divide between those AFIs that can accept customer deposits and those that are able to offer loans to people on low incomes. Existing regulations and access to capital, amongst other things, mean that no type of AFI can easily offer low-income households a full range of financial products and services, which is necessary to be competitive with a bank or other mainstream financial institution. It also makes it difficult for both credit unions and CDFIs to be successful, as generally speaking, credit unions have an excess of capital in the form of deposits but insufficient income due to regulatory constraints, while CDFIs struggle to access capital at interest rates that are viable under their business model.

This is perhaps most evidence in Glasgow, a city where the local government and community have supported and embraced a relatively competitive AFI market, which includes one of the most successful CDFIs, Scotcash, and a diverse range of 34 distinct credit unions that serve one in four local residents.[243] However, even in this relatively competitive market for AFIs, where one in four people are members of credit unions that are all technically able to offer bank accounts, seven out of eight people still rely on a traditional bank account for their day-to-day money management.[244]

This is primarily because very few credit unions are able to offer current account services with full direct debit facilities, due to the prohibitive cost of accessing the payments network, which means they do not offer the majority of people on low incomes what they want.[245] The parallel point is that while credit unions in Glasgow are typically unable to offer banking services, they do accept deposits into savings accounts and so typically have excess amounts of capital on deposit, far outstripping demand for loans.

In contrast, the CDFI Scotcash offers loans to the poorest people in Glasgow that credit unions are typically unable to serve without losing money, primarily because of the cap on the interest rate they can charge. Yet as CDFIs are unable to accept deposits and must raise capital through expensive commercial borrowing, it is likely they will soon struggle to meet the demand for

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240 Henry N, Sissons P, Coombes M, Ferreira J, Pollard J. *Tackling Financial Exclusion: Data Disclosure and Area-Based Lending Data*, Coventry University & Newcastle University, 2014 [accessed via: http://www.communityinvestment.org.uk/wp-content/uploads/2014/11/FINAL_Executive-Summary.pdf (02.06.15)]

241 The Centre for Responsible Credit, *Responding to the financial crisis in our communities: What we need our banks to do now*, The Centre for Responsible Credit, 2012 [accessed via: http://cdf.org.uk/wp-content/uploads/2012/05/Responding-to-the-financial-crisis-in-our-communities.pdf (02.06.15)]

242 Community Investment Coalition, *The case for disclosure of data about the provision of financial services at a geographical level*, Community Investment Coalition, 2013 [accessed via: http://www.communityinvestment.org.uk/wp-content/uploads/2013/07/Disclosure-wrap-up-report-final-July-131.pdf (02.06.15)]

243 Glasgow City Council, *Credit Unions in Glasgow* [accessed via: https://www.glasgow.gov.uk/index.aspx?articleid=10630 (02.06.15)]

244 Glasgow Centre for Population Health, *The Glasgow Indicators Project Overview,* Glasgow Centre for Population Health [accessed via: http://www.understandingglasgow.com/indicators/poverty/overview (02.06.15)]

245 Wright W, *Credit Unions: A Solution to Poor Bank Lending?,* London: Civitas, 2013

loans.[246] This strange divide exists in almost every city with a healthy credit union and CDFI, as one will have deposits, but cannot lend or offer banking to the poorest people in their city, while the other can offer loans, but does not have the capital to do so and cannot accept deposits or offer bank accounts.

## Regulatory barriers

Despite government support for increased competition, there are still examples of regulatory barriers that are preventing the development of highly innovative and competitive AFIs that could help low-income households avoid problem debt. The following examples are just a few of the regulatory issues that must be addressed:

- Credit unions are still hampered by membership restrictions, which along with the restrictions on investing members' deposits and the interest rate cap on credit union loans, mean it is hard for them to grow and generate sufficient revenue to end their reliance on grant funding;[247]
- The FCA has identified numerous barriers that prevent new AFIs from entering the market and offering innovative services, such as the high cost of accessing the payment systems and the difficulties in testing new products that do not fit within the FCA's pre-established criteria.[248]

## Access to appropriate and affordable capital

As mentioned previously, AFIs struggle to access affordable and appropriately priced capital funding, which is needed for lending, growth, and investment in FinTech. This is particularly true for CDFIs, because as they are not licensed deposit-takers, they are unable to accept deposits or offer bank accounts, which would provide an almost free source of capital.[249] The inability to access capital will be discussed below, but a few key explanations include:

- Poor understanding of AFI business models amongst commercial and social investors mean it is not cost effective for them to lend to CDFIs;
- A lack of consistent evaluation frameworks and transparent business models which deters investors who see the business as being too risky;
- Inefficiencies in the social investment market mean it needs reforms to provide the right incentives for investors to encourage them to lend to AFIs.

Conversely, credit unions have large amounts of capital for lending, in the form of members' deposits, but they are severely restricted in what this capital can be used for, making it hard for them to invest in new technologies or to grow the business.

## High operating costs

AFIs are able to effectively serve low-income customers in a way that mainstream financial institutions cannot because they can employ fundamentally different business models – such

246 Sharon MacPherson – in evidence to CSJ

247 Edmonds T, *Briefing Paper Number 01034 – Credit Unions*, House of Commons Library, 2015 [accessed via: file:///C:/Users/User/Downloads/SN01034.pdf (02.06.15)]

248 Financial Services Authority, *A review of requirements for firms entering into or expanding in the banking sector*, London: Financial Services Authority 2013

249 CDFA, *Reply to HM Treasury Consultation on reforming the consumer credit regime*, 2011 [accessed via: http://www.cdfa.org.uk/wp-content/uploads/2010/02/Reply-Consultation-On-Reforming-The-Consumer-Credit-Regime.pdf (02.06.15)]

as performing manual underwriting of loans through CDFIs rather than relying on credit scores. Unfortunately, their small size, difficulties in accessing the capital needed to invest in technologies, and some aspects of their business models which have not been streamlined, mean they have very high operating costs.[250] The result is that many CDFIs often struggle to achieve full sustainability.

### Improving the sustainability of AFIs and the quality of services they can offer

In order to develop a competitive marketplace for innovative AFIs that are able to serve low-income households on the scale needed to meet consumer demand, it is necessary to first highlight some of the best existing AFIs that have particularly distinctive business models. Specifically, the following case studies highlight aspects of each AFI that are not only key to their success, but that demonstrate how different types of AFIs can be built around a business model that is scalable and ultimately not reliant on long-term government subsidy.

The following case studies showcase the benefits of innovative and competitive AFIs:

**My Community Bank** re-launched in late 2013 as the UK's first digital credit union with a straightforward end-to-end customer journey and high quality user experience that customers would expect from any modern sophisticated financial institution. The core ethos behind the My Community Bank is "to do good we must be good at what we do". Just because someone has a low income, does not mean they should be offered a sub-par experience and rather, they should be offered tailored products and services that meet their needs. The credit union is driven by its customer-focused approach towards product design and innovation, making sure that what it offers reflects what members want, not what they should want. Planned is a fully featured current account, with overdraft facility and direct debits, delivered via a custom mobile app, which will be offered to all members with no monthly charge. This complements existing savings products which pays interest rates that beat the best high-street bank products.

Lastly, they are not just working to grow their own credit union, but are currently building an online web portal to connect potential customers with their local credit union, whether they know it exists or not. The user experience will be seamless, from end to end, offering people a simple single loan product, with a single price, but behind the scenes, customers will be connected with partner credit unions across the country. This will instantly help make credit union loans available to around 85 per cent of the country, which they expect to grow rapidly.

All of this is made possible not because of massive grant funding, but through careful and selective use of technologies, such as the innovative cloud banking platform Mambu, which have helped lower costs and scale the business. But this is only possible because of their community and customer focused approach to how products and credit unions should operate. Their ultimate aim is to leverage technology in order to bring community banking back to the community, where small corner shops in any community across the country can serve as local branches, where people can withdraw and deposit money and make remittances abroad.

Chief executive Mohsin Mehdi says, *"The UK Credit Union sector is on the move and My Community Bank aims to be in the vanguard of change by deploying advanced technology in pursuit of a great member experience."*

250 Cabinet Office, *Scaling Community Lenders The Role of Social Investment,* London: Cabinet Office, 2015

**Fair Finance** is an East London-based CDFI, winner of a Big Society Award, and a leading example of how ethical lending can be combined with sustainable development to help turn around the fortunes of both people and communities. Over the past eight years Fair Finance has lent out £4 million in loans to around 5,000 households and businesses through its five branches, saving the poor and financially excluded over £2 million in interest payments. It has also provide helped more than 5,000 people deal with over £20 million worth of debts through its sister charity, Fair Advice.

The key ethos behind Fair Finance is to provide loans to some of the most deprived people in London who have nowhere else to turn. Loans are typically given out to help people fund the unexpected costs of life, often incurred as a result of incredibly stressful situations. Examples include funeral costs, or the replacement or repair of household goods. Increasingly they are also used simply to help keep up with the rising cost of living or unexpected income shocks.These are all situations where many people turn to the payday lenders that crowd the high streets near all of the Fair Finance locations.

While operating under a philanthropic banner, the emphasis on professionalism and sustainability mean Fair Finance is able to help far more people with the same amount of money than they could through charity alone.Their intensive approach to lending, which includes detailed interviews with all potential borrowers, matches the processes of any bank and takes into account aspects of their life and finances that mainstream banks would never even consider.

The results are impressive: the default rate of their loans is just 10 per cent despite over half of all their accepted applicants having average incomes far below the national average.

This model proves that affordable credit can be sustainable when provided by innovative lenders who are in touch with the communities they serve.

**Moneyline** was set up in 2001 with the mission to address the growing need for access to affordable credit for low-income households.They support some of the most disadvantaged families in the UK, providing a positive route to financial inclusion through their consumer led products and services. Moneyline has 18 branches mainly in North West England and South Wales and with over £50m lent in over 100,000 loans.

Moneyline offers loans at low values over a short term often to those with few alternatives, their average loan is for £440 over a term of 30 weeks. Moneyline charge a small upfront fee along with an annual interest rate using a pricing structure that fairly reflects the higher credit risk and associated cost to serve these customers (currently 5% fee of the loan amount and £45 interest per £100 borrowed over 52 weeks). Yet through strong personal relationships with their customers they have achieved high loyalty that lowers credit risk.Their annual write-off rates are currently 8% of gross lending.

Moneyline customers save as well as borrow, depositing small amounts from their weekly income alongside their loan repayments. 65% of new customers save; many for the first time in their lives. Additionally, Moneyline plays a vital role in saving money for their customers through the cost of credit. In 2014 Moneyline lent £8.4 million to 18,400 people saving those people £2.5 million by not borrowing from Home Credit.

Moneyline have successfully transformed their business from being 100% grant funded to a 100% commercially sustainable business. This has been achieved over the last 18 months through improving their customer service, adjusting the pricing model and focusing on productivity with good cost control.

At a time when increased regulation of the market has meant that a number of lenders are moving their credit criteria further up the income distribution scale, Moneyline is ideally positioned to deliver affordable credit at scale, from a sustainable platform of operation.

**Fair For You** (FFY) is a charitable business offering an ethical alternative to Brighthouse through an online only platform. FFY has chosen to be a registered charity to ensure that at no point in the future will they have any overriding interest that sits above its customers.

FFY has been developed by a team that had previously turned around a community based credit union, part of which was to successfully deliver a growth fund contract Despite being considerably cheaper and issuing loans within one working day – they were frustrated at the significant growth of high cost lenders in Birmingham. Specifically the rent to own sector was identified as having an operating model that was harmful to their customers' finances.

Through grant funding from Esmee Fairbairn they carried out independent consumer research, exploring the modern borrowing needs of mothers of children (aged<10 yrs) in households with income below £20k. The original plan had been to launch a cheaper version of a rent to own. An average washing machine from a rent to own store costs £1560, but following the consumer research, the solution has been completely tailored to the needs identified.

FFY will provide small loans for the sole purpose of allowing lower income family households to purchase essential items for their home. The key concept is that consumers want a very slick journey when faced with an emergency such as a broken washing machine. FFY have scoped fully a solution which will incorporate the latest tools used by high cost lenders to assess affordability and propensity to repay.

The full customer journey has been developed to meet the needs of lower income families and to address the vulnerability seen when low income, combines with low financial literacy and low consumer power through having poor credit ratings, leave the customer with few choices of how they obtain the item they need. This is a technology based solution that will be rolled out nationally early in 2016 following the testing and roll out phase through 2015.

FFY have identified the aspects that matter more to customers than pricing – ease of access, very slick customer journey, high visibility throughout the journey, flexibility and quality communication are just a few of the key requirements. Customers will have high street price matched, quality branded items, which are supported by flexible loans that have high levels of forebearance and support to the customer. Very high visibility and communication through a smart phone app will meet the customers clearly expressed expectations.

FFY has found fund raising very difficult – it has declined to offer equity other offers that would mean being 'owned' and driven by organisations that have a requirement which have clearly been contrary to its consumers. It is able to offer a good return on loans to investors, and has built a supported and detailed business model that is highly sustainable. FFY however has found social investors are very cautious when considering a new and conceptual venture.

**Ffrees** was established to provide a digital alternative to customers who were either feeling excluded from, or unwanted, by the retail banking sector. The evidence suggests there is a huge latent demand for a much more inclusive, innovative and modern, digital-only banking service, with the benefits of lower costs, easier access and less red-tape. This has recently been supported by the July 2014 Accenture Online banking survey which says that 25 per cent of people would consider using a digital bank. This number will only grow in the future.

After a year in testing with some customers, Ffrees moved to its live production service platform in October 2014. Since then it has met with heavy demand, opening over 50,000 new accounts. Its current rate for account openings is over 200 new accounts per day, which given a marketing budget smaller than a retail bank CEO's salary, is remarkable. Ffrees is growing rapidly, eclipsing account throughput of £50m pa in its first year, and hopes to reach one million members by 2017. It also added an ethical loan product to its offering, which attracted over 500 applications in the first two weeks.

four

Normal high street banks have two huge advantages over traditional payday lenders: access to very cheap capital and, even more crucially, an installed customer base. However, the perceived default rate and, by extension, reputational risk, has prevented any conventional lender from offering any form of payday alternative. This points to a fundamental limitation in the use of credit reports and credit scores, as they simply break down below certain demographic thresholds.

**Uberima** has developed a proprietary credit risk capability which transcends both traditional and payday lending, leading to both lower default rates and lower variance in default performance. This control of variance enables access to risk-weighted high yield debt, much cheaper than venture capital funding (like the >£60m raised by Wonga).

Uberima has taken the savings from lower default rates and cheaper cost of capital and passed all of them to the consumer through lower interest rates.

Targeting the most recognisable brands (Wonga, Satsuma, QuickQuid, Sunny, et al), Uberima is looking to convert its price advantage into an aggressive switching campaign of the sort consumers are familiar with in other sectors, from car insurance to utilities. As an ethical, for profit, lender, Uberima has found a way to put the consumer first and is well positioned to materially disrupt this asset class.

*"Using our proprietary credit risk capability and innovative balance sheet, we are looking to build a trusted consumer brand by simplifying a huge amount of complexity around one simple idea – put the consumer first"*

Ged O'Neill, Chief Executive, Uberima

There are several recurring themes present in the practices of these organisations which underpin their success and which should be considered both by new AFIs looking to enter the market, as well as funders and policy makers when evaluating the potential for scalability and sustainability of any given AFI:

- Leveraging of technology to increase efficiencies and drive down costs;
- Products and services that are clearly built around the wants and needs of low-income people;
- Effective partnerships with other organisations to improve the quality of the services;
- Diversified range of products and services which provide diverse revenue streams.

"The consumption of financial services is undergoing a technological revolution. Rather than ignore this transition or assume the needs and desires of the financially marginalised are somehow different from the rest of society, this report embraces change and points to a future where: debt advice will be bespoke and delivered electronically; transaction services will be provided by software companies; and a new breed of innovative and tech-savvy alternative financial institutions will serve millions of people of people without the need for permanent support from the state. The report is a welcome challenge to the status quo and will hopefully lead to a new era of financial inclusion."

Professor Karl Dayson, University of Salford

### Improving data sharing

There is a need for greater data sharing between all types of financial institutions in order to foster the development of a highly competitive market for innovative AFIs. These firms could offer quality affordable financial services designed specifically to meet the needs of low-income households.[251] Data that should be shared includes not only information on lending and the provision of bank accounts, but also anonymised demographic information to help AFIs identify areas where consumer demand is likely to be high for their particular suite of financial services and fit their business model. Similarly, there needs to be greater real-time data sharing about lending activities, from all types of financial institutions, in order to help lenders meet the FCA requirements regarding affordability checks.

> "The UK has made great strides in the last two years in using financial services data to understand geographic patterns of financial exclusion. The process of voluntary disclosure of bank lending data by the British Bankers Association (BBA) and Council of Mortgage Lenders (CML) makes the UK second only to the USA at international efforts for greater transparency to support financial inclusion.
>
> This allows for greater competition and targeted intervention, resulting in financial products and services that are better suited to people on low incomes. But given levels of problem debts and the number of adults without access to basic financial services, there remains a need for more data sharing by a wider range of financial services providers. The FCA should take a lead on gathering and analysing data to see what further action is required to ensure appropriate financial products are available to those currently financially excluded."
>
> Jennifer Tankard – Director of Policy and Advocacy, Community Investment Coalition

In order to speed up the process of voluntary data sharing currently agreed to by the BBA and major financial institutions, the FCA needs to push forward stricter requirements on data disclosure between AFIs and mainstream financial institutions. It has the power to do so through how it chooses to interpret its powers, which say the FCA "may have regard" to a number of factors when considering the effectiveness of competition, including "the ease with which consumers who may wish to use those services, including consumers in areas affected by social or economic deprivation, can access them".[252] This should be easier and more cost effective following recent FinTech developments and the support of HMT for greater data disclosure through the use of common standards and by investing in new easy to access digital platforms.[253]

251 Community Investment Coalition, *The case for disclosure of data about the provision of financial services at a geographical level*, Community Investment Coalition, 2013 [accessed via: http://www.communityinvestment.org.uk/wp-content/uploads/2013/07/Disclosure-wrap-up-report-final-July-131.pdf (02.06.15)]; Henry N, Sissons P, Coombes M, Ferreira J, Pollard, J, *Tackling Financial Exclusion: Data Disclosure and Area-Based Lending Data – Executive Summary*, Coventry University & Newcastle University, 2014 [accessed via: http://www.communityinvestment.org.uk/wp-content/uploads/2014/11/FINAL_Executive-Summary.pdf (02.06.15)]

252 Financial Services Authority, Banking Standards: Written evidence from the Financial Services Authority, *Follow up information on FCA's role on consumer access*, London: Parliamentary Stationary Office, 2013 [accessed via: http://www.publications.parliament.uk/pa/jt201314/jtselect/jtpcbs/27/27iv67.htm (02.06.15)]

253 Open data Institute, *Data Sharing and Open Data for Banks: A report for HM Treasury and Cabinet Office,* London: Open Data Institute, 2014

## Recommendation

The FCA, with the support and guidance of the Treasury, needs to make better use of its power to 'have regard' to consumers' access to financial services in deprived areas, with the aim of decreasing a barrier to entry and increasing competition in retail banking through a new generation of Alternative Financial Institutions focused on serving low-income consumers.

In order to facilitate the development of a competitive market for new innovative AFIs, firms need to be more creative with regards to the types of products and services they are offering low-income households. By offering multiple products and services AFIs can gain more information about their customers, which will help to improve and lower the cost of services as well as potentially link them into things like debt advice at an early stage before a person enters a debt spiral.

Lastly, by integrating other services, such as financial capability training programmes or in-house debt advice, there is an opportunity to partially subsidise the AFI's operating costs, such as by having their charitable arm of the social enterprise rent or buy the building they are located in so that the AFI can claim tax relief. Offering services like debt advice and financial capability training is proven to lower default rates on loans and increase uptake of future products, such as insurance or a business loan, providing further opportunities for AFIs to generate income and grow their business. People are also more likely to engage with support services, such as debt advice, if a trusted intermediary is the one delivering the service and engaging with the customer based on their existing relationship, rather than 'cold calling' them. A trusted intermediary in this case could be a representative from a CDFI or credit union that has previously served the customer.[254]

One of the biggest challenges faced by new entrants into the financial sector, whether the new entrant is an AFI or traditional bank, is access to the various IT and payment systems that underpin the financial system in the UK. Specifically, new innovative digital banks offered by CDFIs and credit unions need an easy and cheaper way to offer their customers an account with full direct debit and faster payment facilities, alongside any budgeting tools or other associated features that might help low-income households avoid problem debt. The Payment Systems Regulator first policy statement has placed this objective high on their agenda, but it is important they follow through fully to help facilitate a competitive market for AFIs.[255]

There are substantial gains in efficiency and potential cost savings – both for AFIs and the state – that can be realised through the integration and provision of various debt-related support services into the business models of successful AFIs, which have historically been funded through government or charitable grants, as well as under CSR programmes.

254 Money Advice Service, *2012/2013 Business Plan: Delivering a transformed Money Advice Service*, London: Money Advice Service, 2012
255 Payment Systems Regulator, *PSR PS15/1: A new regulatory framework for payment systems in the UK*, London: Payment Systems Regulator, 2015

### Recommendation

AFIs should offer a range of products and services, that will help diversify their revenue streams, improve the efficiency of their core financial services, cross-subsidise certain less profitable parts of their business as well as increase customer engagement with debt related support services previously provided by specialist organisations that rely on grant funding.

Example: CDFIs which are able to offer customer's access to debt advice and an integrated digital current account, alongside the core loan product, would benefit from greater information about customers that could improve future lending decisions and decrease the costs for customers, while also decreasing the default rate on their loans and levels of problem debt experienced by customers.

There is a need for greater cooperation between the two largest forms of AFIs, credit unions and CDFIs, especially in the short term as new models of AFI are developed and allowed to fill holes in the market. This is because while CDFIs can lend to the poorest in society and credit unions can offer full deposit-taking banking services to customers, there is a divide between the two. CDFIs cannot offer formal banking and credit unions typically lose money on each small value loan they make, especially to the poorest served by the CDFIs.

Again, it is important not to continually reinvent the wheel in every circumstance, as there are good examples of CDFIs and credit unions that are already working together in partnership with their local government and organisations that provide debt-related support services, which showcases the potential benefits for customers of this integrated delivery model.

### Case Study: BOOST neighbourhood finance Bristol[256]

BOOST neighbourhood finance in Bristol is an innovative pilot project led by a partnership between South West Investment Group, a local CDFI, and a variety of other services and social enterprises in the area, that will provide an effective and integrated alternative to mainstream financial services. It will also help to increase engagement and the effectiveness of a variety of debt advice, financial capability and savings programmes, as well as with business advice and unemployment support services.

The CDFA, which initatied the programme with funding from the Department for Local Government and Communities, has yet to evaluate the programme, but will do so and hopes to roll out similar partnerships across the country.

*"We need to address the problems in communities and neighbourhoods across the country that are affected by decades of low economic activity and exclusion from financial services. Our vision is to increase the disposable income in local areas, reduce the market for pay-day loans and doorstep finance, and increase the number and success of enterprises based there."*

Ben Hughes, Chief Executive at the Community Development Finance Association (CDFA)

The success and development of such partnerships can be facilitated by innovative and forward thinking local councils, who have a role to play here in several key ways:

256 CDFA, *New community banking solution launched in Bristol*, CDFA, 2014 [accessed via: http://www.cdfa.org.uk/2014/05/01/new-community-banking-solution-launched-in-bristol (02.06.15)]

- Coordinate and map the provision of existing services based specifically on the local demand for services through their unique relationship with the public and providers, which will help to avoid duplication and help organisations learn from one another;

- Fund the best existing debt-related service providers and AFIs that demonstrate the principles around evidence reporting, evaluation frameworks and the business models discussed in this report;

- Establish high quality standards and adherence to existing standard codes of conducts as part of service level contracts;

- Improve the efficiency and effectiveness of engagement with debt-related support services through the use of the data the council holds on residents, as well as by linking the provision of any welfare support services and funding to the financial services and debt-related support services offered by local AFIs and other organisations.

### Recommendation

Local authorities should provide financial support, such as business tax rate reliefs, and where possible, offer service contracts for welfare assistance schemes to social enterprise partnerships that include (where applicable) credit unions, CDFIs, debt advice services and financial capability training programmes, under one integrated community partnership model, that designed to meet the specific local needs and consumer demands of low-income households in the area.

In order for new innovative AFIs to offer affordable financial services to low-income households on the scale demanded, the majority of them will need to embrace some form of digital presence and infrastructure. There would be a substantial benefit for both customers and AFIs if they were to invest in a bespoke digital bank account system or begin offering a digital bank account to their customers in partnership with an existing provider, such as Monese or Ffrees.

The main issue that is often cited with regards to digital only bank accounts and low-income households is that they do not use or like online financial services. This report has shown that assertion to be a myth. However, when households have so little margin for error and income is paid irregularly, they are more likely to need to pay cash into their bank account on short notice, which at present is either not possible with a digital bank, or incurs a charge of between one and three per cent of the deposited amount through a system like Paypoint.

One way to have the best of both worlds is by leveraging the Post Office's branch network and the services offered through their recently announced partnership with the FinTech firm, Advanced Payment Solutions.[257] This deal allows over a million digital banking customers to deposit cash at any of Post Office's 11,500 branches, which is more than all of the mainstream bank branches

257 Real Wire, *Advanced Payment Solutions (APS) links up with Post Office to become the first FinTech non-bank to offer banking services through its network*, Real Wire, 2015 [accessed via: http://www.realwire.com/releases/Advanced-Payment-Solutions-APS-links-up-with-Post-Office (02.06.15)]

put together. Such a solution will ensure customers can always deposit cash, while still allowing innovative AFIs to offer a better range of services and increase their commercial viability.

The Conservative party also committed to saving 3,000 rural Post Office branches and when in coalition they renewed the Post Office Card Account contract for a further seven years.[258] This means there is a clear case that the Post Office should be involved in promoting banking competition given how much money has been invested in the business by the government over recent years, such as to support the Post Office Card Account.[259] The recent partnership with Advanced Payment Systems has not gone unnoticed, with the CEO of Atom, a new challenger bank, stating in an interview that this was just the beginning and that Post Office's new service would facilitate a new generation of digital banks.[260]

**Recommendation**

The Payment Systems Regulator should require Post Office to offer their cash deposit service under open access terms to AFIs and other digital banks that meet set minimum requirements, with the potential of having slightly reduced deposit fees (if any) for AFIs with a clear social purpose and governance structure (e.g. a digital bank subsidiary of a CDFI).

## 4.3 Investing in Alternative Financial Institutions

The market for Alternative Financial Institutions, most notably credit unions and CDFIs, has been propped up for many years by government subsidies and grant funding as a matter of public policy. The specific goals of recent policy interventions and targeted grant based funding have varied, but the overarching objective is to ensure low-income households have access to affordable financial services, primarily cheaper forms of credit and transactional banking products. In recent years, credit unions have received £138 million in government grant funding through the DWP's Growth Fund and the more recent Credit Union Expansion Project.[261]

Similarly, CDFIs have benefitted from £72 million in grant funding through the Department for Business, Innovation and Skills' Phoenix Fund and the Regional Growth Fund.[262] The intention of such policies has always been to help credit unions and CDFIs grow to the scale where their business model is developed enough to be self-sustaining, yet in practice this has not been the case. At present, only the best performing CDFIs and credit unions manage to break even, but for slightly different reasons.

While well intentioned, the real impact of these policies over the past several decades has been to distort the market for financial services, particularly in regard to preventing the development

258 Conservative Party, *The Conservative Party Manifesto 2015* [accessed via: https://s3-eu-west-1.amazonaws.com/manifesto2015/ConservativeManifesto2015.pdf (02.06.15)]
259 Department for Work and Pensions, Department for Business, Innovation & Skills, *Post Office service for pensioners and benefit claimants to be safeguarded with new government contract,* 2014 [accessed via: https://www.gov.uk/government/news/post-office-service-for-pensioners-and-benefit-claimants-to-be-safeguarded-with-new-government-contract (02.06.15)]
260 City AM, *Atom Bank's chief Mark Mullen on using the Post Office to launch challengers*, 2015 [accessed via: http://www.cityam.com/211631/first-class-bank-using-post-office-launch-challenger (02.06.15)]
261 Cabinet Office, *Scaling community lenders: The role of social investment*, London: Cabinet Office, 2015
262 Ibid

of affordable financial products designed specifically for people on low incomes. One potential explanation is an unintended consequence of both subsiding the bottom segment of the market, while at the same pressuring mainstream financial institutions to serve all people, regardless of income.

This combination of market interventions can effectively remove or reduce any potential financial incentive for firms or entrepreneurs looking to develop commercially viable business models aimed specifically at providing financial services to low-income households. Government endorsement and unequivocal public support for a particular not-for-profit business model, such as credit unions, can potentially reduce the availability of funding, either through grants or traditional forms of investment, for anything that does not fit that model. This is because a commercial model will be seen by investors to be entering the market at a disadvantage and so be less likely to succeed and generate a return for investors. Another potential disadvantage could be difficulties securing any necessary or advantageous regulatory changes, or an inability to secure lucrative government service contracts when a credit union also submits a bid. Lastly, investors will consider the natural competitive advantage in pure economic terms, that the credit unions would ostensibly have, given that their source of investment capital and also peripheral marketing, was being provided free of charge by the government.

On the other side of the equation, firms that might otherwise attempt to enter the market and serve the millions of unbanked or underserved customers will find it significantly more difficult and expensive to acquire new customers and build their model if mainstream financial institutions offer them a free service. This is in large part because the existing mainstream banks are well established brands with significantly greater resources at their disposal and an existing level of consumer trust and awareness that make it hard for a new entrant to distinguish its offering if it cannot even compete on price.

The lack of competition in the market for retail banking services is something that has been widely recognised in a series of reports including recently by the Office of Fair Trading, the FCA and the Competitions and Markets Authority. Some of the findings of these reports include:

- High levels of market concentration, with the biggest four banks serving 77.2 per cent of all customers;[263]
- Despite low levels of customer satisfaction (below 60 per cent) with the big four providers, few customers switch providers despite recent technological developments to make switching quicker and easier;[264]
- Mainstream banks only make around two per cent of their income from basic banking services, but have managed to structure overdraft fees and penalty charges for many years in a way that means they do still manage to cover their costs of providing banking to low-income households. This is of course only possible because they benefit from massive existing economies of scale.[265]

The FCA identified a range of barriers to new entrants that increase their costs and decrease their ability to offer a full and competitive range of products and services, including a lack of

263 Competitions and Market Authority, *Personal current accounts: Market study update*, London: Competitions Market Authority, 2015
264 Ibid
265 Office of Fair Trading, *Review of the personal current account market*, London: Office of Fair Trading, 2013

access to payment systems needed to provide things like direct debits, as well as the high cost of regulatory compliance, especially in the context of a post global crash regulatory environment.[266]

There are even difficulties in developing an effective competitor to existing established mainstream financial services when government subsidies are available and a business is run as a not-for-profit social enterprise. This point was well illustrated by research done on the economic feasibility of a social enterprise competitor to Provident Financial, the largest provider of home credit that provided loans to around 1.1 million customers in 2014.[267] The report found that the firm would struggle to offer loans at a lower price than Provident, even though they made the following assumptions:[268]

- Investment capital was provided free of charge by charitable trusts or government;
- They were granted favourable market and regulatory conditions and exemptions;
- Other forms of indirect support from government, such as in terms of free marketing.

This piece of research by the Joseph Rowntree Foundation on the feasibility and potential benefits for low-income households of subsidising the creation of a new social enterprise to compete in the home credit market was conducted in 2009, which make the findings even more interesting when considered in that contest.[269] At that time payday lenders were almost non-existent and home credit firms, with Provident being the biggest and most well known, were the public 'whipping boy' for politicians and the media looking to paint them as 'predatory lenders' who charged 'exploitative' interest rates on loans to poor people.[270]

History has seemingly repeated itself in the past few years, as payday lenders have been mercilessly criticised for their loans and the 'exploitative interest rates'. This has driven many firms from the market and resulted in the commissioning of similar reports to the one mentioned above, which have examined the feasibility of how a credit unions could offer payday loans, despite being limited by a strict interest rate cap that makes such a product financial unviable.

[271]The research and regulatory investigations into the competitiveness of retail financial services have demonstrated that it would be very hard for any new entrant to realistically compete and offer financial services on the scale demanded by low-income households, unless they are able to do the following things:

- Offer customers products and services that are both distinct and in some way better than what is currently available, rather than just being cheaper
- Design a business model and the cost structures of providing financial products and services specifically around the preferences and needs of low-income households;
- Reduce costs significantly and improve the efficiency of their business through the use of new innovative FinTech solutions and shared IT systems.

266 Financial Services Authority, *A review of requirements for firms entering into or expanding in the banking sector,* London: Financial Services Authority, 2013

267 Provident Financial Group, *Annual Report and financial statement 2013/2014,* Bradford: Provident Financial Group, 2014

268 JRF, *Is a not-for-profit home business feasible?,* York: Joseph Rowntree Foundation, 2009

269 Ibid

270 Shropshire Star, *Doorstep lending in the Spotlight,* 2009 [accessed via: http://www.shropshirestar.com/news/2009/08/03/doorstep-lending-in-spotlight (02.06.15)

271 Financial Inclusion Centre, *Can payday loan alternatives be affordable and viable? An evaluation of London Mutual Credit Union's pilot scheme,* London, Financial Inclusion Centre, 2013

## How Alternative Financial Institutions can achieve scale through technology

In order for AFIs to truly be competitive and improve the diversity, quality and affordability of the financial products and services they are able to provide to low-income households, it is essential that they embrace recent innovations in FinTech, specifically with regards to the necessary IT and backend systems upon which all financial services are based and that can be very costly to build from scratch.

These FinTech services are not solutions in and of themselves to the problems AFIs have faced in the past, with regards to operating without government subsidy. However, they will help the best AFIs scale more rapidly and reduce their costs, which can then be passed on to customers in terms of more affordable products, or allow them to deliver a product or service that was previously only available if subsidised, such as a sophisticated budgeting account.

### Recommendation

The Financial Conduct Authority needs to issue clear guidance allowing and encouraging the use of cloud based financial platforms by Alternative Financial Institutions. The use of cloud banking services should be allowed regardless of where the physical servers are actually located, so long as the provider meets certain standards set by the FCA and has robust steps to mitigate the risk to consumers.

## Investing in expertise and FinTech solutions that will help AFIs scale and be competitive

Recent innovations in FinTech, such as cloud banking platforms, have huge potential in terms of helping to develop a competitive market for AFIs and reducing their operating costs to levels that enable them to compete independently of government subsidy. However, these new technologies are effectively useless unless AFIs, whether big or small, are also able to do the following things:

- Effectively implement FinTech products and services into their existing business models;
- Make full use of the functionality and benefits these services offer to maximise cost savings and increased efficiencies;
- Ensure they are compliant with all regulation at the UK and EU level, especially in regards to data sharing issues; and perhaps most importantly,
- Tailor the solution to their specific needs and ensure the aspects of their business that enabled them to be successful in the past, such as their knowledge of the local economy and existing support services, is not lost through the implementation of generic business practices and FinTech IT solutions, but is made more effective and scalable.

The cost of hiring someone with this level of technological expertise, either on a contractual service arrangement or by bringing the service in-house, is extremely expensive and would be cost prohibitive for most AFIs. This is especially true at present, as the majority of AFIs are small-scale operations, which would prevent them from implementing these technologies. However, in many instances their success is intrinsically linked to the fact they are small and deeply rooted in the local community, which gives them a competitive advantage over bigger mainstream financial firms.

In order to help create a competitive market for AFIs, which is reliant on implementing new FinTech IT solutions, while still retaining the competitive advantage that many AFIs have because they are small and have specialised knowledge of the local community, it is necessary that a new Social Enterprise be established in conjunction with SoFiTech, to help implement the FinTech products and technologies that come out of this new accelerator.

### Recommendation – Licensing and implementing FinTech solutions for AFIs

There is a need for new independent social enterprises to help facilitate the development of a competitive market for AFIs and enable the best existing firms to implement new FinTech innovations that will allow them to scale their business, reduce operating costs and end their reliance on grants and subsidies. The new Social Enterprise for AFI innovations (SEAFI) will hold the licences for white label FinTech products, either purchased on the open market, or those that are developed by a firm involved with SoFiTech, which it will then retain on a short-term basis at a price that reflects the cost and supports the running and development of the independent body.

Examples include:

- A CDFI-in-a-box white label system to help decrease the startup costs for new entrants;
- A variety of alternative credit scoring APIs that plug into an AFI's lending decision engine;
- A cloud based backend finance platform that is customisable depending on the type of AFI;
- A smartphone based tool that processes KYC checks for applicants using a driving licence.

In order to ensure AFIs get the most out of new FinTech innovations and reduce the cost of hiring in-house or contractors to implement product licences from the independent body, specialists will be made available, both on site and remotely, to help customise white label products to the AFI's specific business model.

### Funding the growth of a competitive market for AFIs

No innovative FinTech IT solutions or new business model for AFIs will be successful or allow them grow and serve low-income households on the scale demanded unless the best AFIs are able to access funding when they need it. Most importantly, it is important that there is not just more funding available, but that funding is made available in the right form and at the right cost for AFIs (depending on where they are in their business plan and what their specific needs are when accessing funding).

For example, a brand new CDFI will not immediately be able to generate sufficient income to cover its operating costs from day one – as would be true of any new business or financial firm – and therefore cannot be financed through a high cost form of investment capital. This is even true for much larger more established mainstream financial firms, such as Metro Bank, which is still regularly posting losses as it has not yet fully achieved the goals and milestones regarding acquiring customers, developing new products and establishing its brand image that are set out in its business plan. However, for more established and widely understood business models such as a mainstream bank, investors recognise this when designing the costs and structure of the investment funding, which is done in a way that allows the firm to grow to scale before investors' expectations regarding financial returns begin to increase.

At present, the lack of understanding regarding various AFI business models, as well as the inability of many investors to easily compare and trust the transparency of the business figures being presented to them, mean that there is a lack of both social and commercial investment in AFIs.

In order to overcome this, there is a need for a new specialised wholesale funder for AFIs, which is able to evaluate their business models more efficiently and provide investment advice to a range of potential funders that would never have been able to invest in this market before. Examples of potential new sources of capital include:

- Housing associations;
- Local government;
- Pension funds;
- Individuals who now control their retirement funds.

The Aeris credit rating system in the US (formerly CARS inc), is a good example of how an independent body that specialises in evaluating AFIs, specifically CDFIs in this instance, can help them to raise capital. This not-for-profit organisation can provide highly specialised investment advice to a range of potential investors and grant makers about the sustainability, social impact and business model of AFIs, enabling them to access previously unavailable sources of funding.[272]

Another key development that is needed is greater creativity with regards to the structure of capital funding for AFIs and the ways in which grant funding can be leveraged to increase social investment in this market, for which there has previously been little appetite amongst investors. The recent creation of the Access Foundation and several examples in other countries highlighted below show how grant funding can be used to underwrite and provide first loss protection to social investors that will help 'pump prime' the market for funding AFIs.[273]

> There is a need to focus now on the causes of debt problems and a more rounded approach to the issue, starting with the needs of people on low incomes. If, for example, we took the tech innovations of the likes of Wonga and the committed social purpose of credit unions and CDFIs we could make much more progress in helping people with debt problems. We need models of social investment, which respond more effectively to demand. It is time for a critical reminder to those of us who want to see social investment work that building models from the top down can only go so far. We need instead to invest in radical new models from the ground up which are focused on need, which are truly social and which can be more sustainable over the long-term."
>
> Dan Gregory, Head of Policy at Social Enterprise UK

272 Aeris, *Aeris (Formerly CARS Inc,) unveils new brand and products to mainstream CDFI investing*, 2014 [accessed via: http://www.aerisinsight.com/news/aeris-formerly-cars-inc-unveils-new-brand-and-products-to-mainstream-cdfi-investing (02.06.15)]

273 Access, Access is launched!, Access, 2015 [accessed via: http://access-socialinvestment.org.uk/access-is-launched (02.06.15)]

## Recommendation – A new independent body

There is a need for a new independent body (The Alternative Finance Foundation) to help facilitate the development of a competitive market for AFIs and enable the best existing CDFIs to access the capital funds these social enterprises need to:

- Grow their loan book;
- Develop their business; and
- Invest in the FinTech solutions required for them to scale their business and reduce their dependency on grants and subsidies.

A specialised division of the Alternative Finance Foundation should be funded through a collaboration between the Cabinet Office, Big Society Capital and the British Business Bank.

It would be tasked with helping the best AFIs and innovative new entrants to the AFI market to implement the new common evaluation frameworks and ensure adherence to the relevant Code of Conduct created by the AFF. In order to apply for funding from a new AFI-SIP (Alternative Financial Institutions Social Investment Platform) an AFI must be certified by the specialised division of the AFF.

This process will verify whether an AFI has adopted and integrated the relevant Code of Conduct into its business model, while also helping AFIs to demonstrate the viability and scalability of their business model, through independent evaluations in line with the new common evaluation framework for AFIs.

In order to help AFIs access social investment with the support of the AFF, it will create a new division that specialises in assessing AFIs on the basis of their investment risk, awarding them a 'credit rating'. The AFF will also leverage grant funding or patient capital in the form of renewal bonds, to create a form of blended social investment, which should stimulate the market by providing first loss protection for investors.

Specifically, we recommend that the AFI-SIP offer a range of capital investment products, varying dependent on the needs and stage of business development that an AFI is in. Examples include forms of long term patient capital, revolving capital, bullet capital and flexible forms of capital to fund loan books etc.

# Conclusion

The level of household debt in the UK has grown unchecked for over 20 years and it looks set to grow for another 20. Despite political will, funding from the financial sector and the tireless work of charities in Britain's most deprived communities, previous attempts to address the problem have had little noticeable impact.

There are still 8.8 million people struggling with their debts, the effects of which are also felt by their 2.5 million children, as they see firsthand how debt damages mental health, family relationships and employment opportunities.

The recommendations contained in this report do not tinker around the edges of public policy or call for more to be spent on solutions and ideas that have been tried before and failed. This report sets out a new vision for the future of Britain's financial system, ensuring that it will work for everyone, regardless of their income.

Access to money, credit, financial education and debt advice are not things that people should have to think twice about, as these are the bottom line essentials that people need to maintain their financial wellbeing.

However, we should not be aspiring to provide people with the bare minimums.

This report lays out the principles and architecture of how we can offer people much more than that. We set out a vision for a fairer financial system based on the following key objectives:

- Advice and education on money, services and financial skills throughout people's lives;
- A range of affordable financial products and services that match what people want;
- A variety of quality financial institutions focused on serving people as customers.

Only by starting with individuals and what they want and need throughout their life, can financial products, support services and education programmes help enough people to truly tackle the UK's problem debt crisis.

THE CENTRE FOR
SOCIAL
JUSTICE

The Centre for Social Justice
4th Floor, Victoria Charity Centre,
11 Belgrave Road
London
SW1V 1RB

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www.centreforsocialjustice.org.uk
@CSJthinktank