Scaling affordable credit provision

Roundtable readout

October 2022

Contents

Background

In September 2022, Fair4All Finance convened a roundtable of community finance providers, for profit purpose-led lenders, high cost short term credit lenders, mainstream finance providers and other potential investors, hosted by EY.

The purpose was to bring together a diverse range of perspectives on how a scaled affordable credit market can be delivered to those that need it. The roundtable explored why the expansion of affordable credit is important and what the barriers, constraints and opportunities are (including financial and policy mechanisms).

Across the organisations and industry sectors represented there was a clear consensus on the issues and need for collective action by the sector, government and the regulator.

Executive summary

The consensus is that there is a large and growing gap in provision of affordable credit to people in financially vulnerable circumstances – estimated to rise to **at least £3bn by 2025.** There are too many market disincentives for this gap to be filled without intervention/collective action to create a sustainable ecosystem. The UK is not the world leader – and should be.

Financial inclusion is an engine of growth and at least **17.5m people** could get a stepping stone to financial resilience, unlocking their full potential to contribute to economic growth if we solve this challenge. If we don't act there is a risk that the gap could be filled by fraudsters/illegal moneylending and cause significant social harm.

Creating a sustainable ecosystem will require significant change

The £3b gap presents a significant market opportunity for growth. It will need significant participation of commercial players alongside community finance. For this to happen there are some important issues to address. These are set as questions to be explored in the next stage of this work.

How can we signal that providing affordable credit is a good thing to do?

The perception of credit, of lending to people in financially vulnerable circumstances and the perceived risk of being pilloried in the Daily Mail acts to put off banks and investors from getting involved in this space.

We are all clear that credit is not the right solution for every individual or in every circumstance. However, it is important that the role of credit as a valuable service to manage 'lumpy' expenditure is reinforced. Endorsement from HMT, the FCA and the PRA could be part of the solution to this.

How can we create a regulatory environment that provides more certainty and sustains consumer protections?

The regulatory environment needs to provide certainty and clarity to providers to focus on positive customer outcomes. There is a perception of conflict between FCA principles and FOS prescriptive interpretation that is delivering unintended market consequences and poor consumer outcomes. Retrospective application of regulation creates significant uncertainty.

Currently financial penalties appear disproportionate to potential harm to the customer and the level of profits of businesses. With no friction to making claims, a fixed £750 fee is payable by the provider for each claim, whether or not successful. It is the same for HSBC as for small community finance providers.

‘Significant change is required to regulation as the current landscape is creating uncertainty that is causing paralysis for lenders and investors alike’

How do we create structures and incentives to sustainably fund and service affordable credit provision to customers in financially vulnerable circumstances?

Some form of risk sharing model is needed to ensure that customer groups in the most financially vulnerable circumstances are served. Without such a model they will never be served by regulated providers, causing significant social harm as they go without or turn to illegal moneylenders.

We need a framework and mechanism to support different customer sub segments in different ways and reflect the different risk levels and costs of delivery (currently borne by the customer in higher interest costs).

There also need to be incentives for the whole ecosystem to serve these customers – a regulatory/societal contract to ensure businesses will play here. We need to explore a broad range of market plays to deliver this, learning from what already works well in other countries.

There was some support for the Financial Inclusion Commission and Fair By Design proposal for Government to introduce a cross-cutting ‘must have regard’ to financial inclusion for the FCA, including annual reporting on the state of financial inclusion in the UK and the measures that the FCA has to promote financial inclusion.

How could we enable innovation and investment in tailored product design for this customer group?

The evidence shows that when products are designed specifically recognising the lived reality of people in financially vulnerable circumstances, they can work well commercially and deliver good consumer outcomes.

The needs of this customer base require different approaches to flexibility of repayment, revolving credit facilities and arrears management among other areas that don't always fit neatly into current regulation and policy guidance. This mismatch acts as an inhibitor to innovation. We need a construct to allow businesses to play confidently in this space.

'Everyone in the value chain needs to work together otherwise the 'poor man' pays'

The fundamentals already in progress – which everyone can be engaged in

These are a **key focus of Fair4All Finance's work** to date:

- **Continue to scale community finance provision**

  More support and investment from mainstream finance and social investors would accelerate scaling this provision – for this to happen any real or perceived regulatory hurdles need to be addressed

- **Raise awareness of and signpost to community finance provision**

  Can be turbo charged using nudges, signposting and cross industry working between mainstream finance, government and the affordable credit sector, as well as awareness campaigns involving MaPS and other agencies

- **Reset the debate on APR**

  APR continues to be an emotive measure in the press, consumer groups and some investors. Collating existing research and having an open debate about its merits and limitations and the alternative measures available could stop it being a barrier for future investment

- **Scale and develop products and services tailored to people in financially vulnerable circumstances**

  To include consolidation loans, integration of benefits calculators and other support tools and revolving credit facilities

- **Deepen understanding of customer needs and behaviours to inform good customer journey design**

  There is a need to invest in data science and mine open banking data to understand demographics in more depth

Detailed notes

Why is credit useful?

Access to affordable credit is an essential service for people to manage variable expenditure and income. When used well it provides a vital stepping stone to financial resilience.

While credit is not appropriate for everyone, for many in financially vulnerable circumstances it enables them to be productive members of society, be it funding deposits for childcare through to funding white goods.

What do we mean by affordable credit?

Typically, we are considering unsecured loans of under £1,000 with average loans of c£400. Two thirds of customers are women, often with children. Borrowing is often for 'life events' – white goods, school uniforms, Christmas and holidays – and is seasonal in nature. For this type of borrowing (small and less than a year):

- APR is a somewhat arbitrary measure and customers don't understand it
- Customers are more interested in the affordability of cash repayments, often looking at £10/£20 per week repayments
- Customers generally know how to manage their money
- Customers are uncomfortable with the level of personal information they often need to give in the loan affordability process for what is seen as a relatively small loan (examples given of being required to ask about gym memberships, newspaper subscriptions etc)

Who are the customers who fall outside of mainstream provision?

Given deteriorating microeconomic conditions, credit needs remain very high and we estimate that there are around 14m people who struggle to access fair and affordable credit, including around 5m currently unserved by the credit market.

At least 8.3m people struggle to access credit due to limited credit history

- **5.8m** people have little or no credit history making them 'Invisible' to the mainstream credit economy

- **2.5m** were narrowly rejected for a credit card or personal loan due to insufficient information (88% of whom are unlikely to default according to Experian). Fair4All Finance have recently launched a segmentation into people in financially vulnerable circumstances which found that at least half of the two most vulnerable segments (Credit crisis families and Forgotten families) were rejected for credit at their last application

Those with limited credit history include

- Young people who have not yet established a credit record
- Older people who may have either paid off their mortgage and have limited use for credit, or who have not previously relied on credit and therefore have no file
- The 'unbanked' who are often credit invisible (estimated at 1.52m UK adults by the Financial Inclusion Commission).
- Recent immigrants (or potentially returning expats) who may have little or no credit footprint and therefore struggle to open bank accounts and/or rent property
- Low Income families relying primarily on cash based transactions (estimated at 14m people by the Social Metrics Commission)
- People who rely partially or wholly on government benefits
- People who suffer a life shocks (ie where they fall ill, lose their jobs or have a quiet month on a zero hours contract) can be (unfairly) penalised for up to six years and excluded by lenders reliant on credit scores

Alongside this 5.5m people have variable incomes which may impact their ability to establish affordability of credit

Over **1m** people are on zero hours contracts and there are many in regular employment who see irregular swings in their monthly pay

- **Self employed**

  Around **4.5m** individuals reported self-employment income for the tax year 2019 to 2020. Many of these people may experience challenges in accessing credit due to irregular income patterns. Not all of those in this category will be in financially vulnerable circumstances.

- **Volatile pay patterns**

  Based on anonymised transaction data from over seven million **Lloyds Banking Group** accounts, research showed that 80% of lower earners (those with annual take home pay of around £10,000 a year) with a steady job have **volatile pay**, compared to two thirds of those on higher earnings (with take home pay of around £35,000 a year).

The market challenge needs to be broken down into sub segments to understand the needs associated with each segment, and products and services can then be designed for them. This should include the risk level that investors will look at and what protections they will expect for their investment.

Providers already operating in this space have built up substantial data sets on this customer base, mainstream providers less so as they have not had this customer group in their target market.

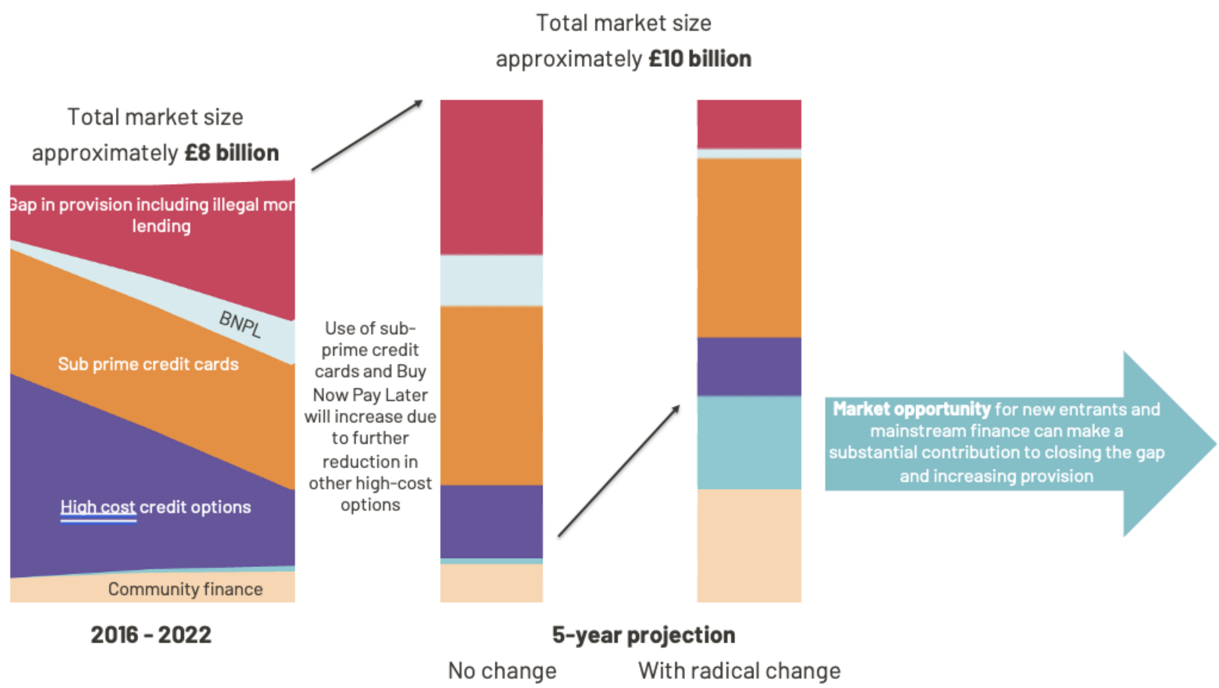
Specifically, it would be helpful to quantify

- How many people are part of the gig economy?
- What are the credit impairments that affect a credit score and how long do they continue to impact a credit score?

What's the scale of the need?

We considered the estimates of the current state of the market, the need and how it could scale to within the current legislative and regulatory framework, and the potential with more catalytic system changes.

The overall gap in regulated credit provision was estimated to be £1b - £1.5b in 2020 (source: FCA, 2020). With an estimated 1.1m people now using illegal money lending (Centre for Social Justice, 2022) and considering the impact of the cost of living crisis on people's credit risk, Fair4All Finance estimate this gap has potentially doubled to £2 - £3b.



The data and assumptions that underpin this overall schematic are set out in Appendix 1.

From the discussion whilst people broadly agreed with the estimated scale of the market, there was a prevailing view that we would see contraction of both high cost credit options and subprime credit cards given the prevailing economic conditions and the continued challenge of uncertainty around affordability.

What works well?

Understanding customers enables tailored products that deliver positive outcomes

The fundamental elements that drive good outcomes are in three broad areas:

Flexibility built in by design

- Product design builds in flexibility of repayments with no penalties

Friction in the system recognises human behaviour

- Speed of decision making – customers will seek out those who can provide a yes
- Open banking can be useful – with a note of caution that customers can be reluctant to share their data and may have multiple accounts however it does provide useful evidence on affordability
- Proactive support for customers such as benefits checkers
- Soft declines where people are supported with a conversation to understand why they were declined

Design to encourage building a payment and savings habit

- Save as you borrow type schemes that enable people to build resilience while they borrow
- Salary saving/deductions type products
- Kick back loans – some of the interest at the end of a loan is paid back as savings
- Prize linked saver schemes to incentivise savings
- Benefits backed lending combined with save as you borrow
- Integration of benefits calculators, and simplification of the process to access benefits that people are entitled to
- Good payers' incentives
- Whilst not a direct overlap with this population, NatWest now have 4.5m of their customers using tools to try to build their credit score, up from zero 18 months ago.

In parallel, levels of financial education are still too low, so continued investment in financial capability and more coordinated and integrated interventions are required.

Investment in technology and data science is a key enabler to doing this well.

Fair for You Case Study

Fair for You lend on an appliance or pre-paid card. Never cash. Customers also don't care about APR. They are a UK wide, online lender with flexible payments.

An innovation this year has been acting as the delivery partner behind the Iceland's Food Club which has an average loan of between £25 and £75.

Following an 18 month trial they have had extraordinary demand (50k applications in 10 days) reporting a positive impact on physical and mental health.

The right risk being associated with the right level of investment

Different types of investment are needed to enable providers to scale and grow and some sources are pretty scarce. We need to ensure that the right risk is associated with the right level of investment and that it is spread across multiple parties

Area	Needed for	Provided by
Equity	• Build and scale infrastructure and capability	• Typically private investors, social investors and foundations • Fair4All Finance have provided over 80% of equity fund raises into this sector over the last two years
Junior debt/mezzanine funding	• To provide a risk 'buffer' for senior debt	• Typically social investors
Senior debt	• Needed to scale lending	• Currently scarce and/or expensive even for providers operating at scale • Expensive due to perceived risk

Many potential investors do not lend to providers in this market due to, in the order cited

1. Uncertainty on retrospective regulatory claims
2. Reputational concerns from being anywhere near the subprime market – the 'Daily Mail' test. There is deep concern, almost paranoia, about potential bad outcomes for customers which then reflect poorly on the investor
3. Perceived credit risk and associated capital holding requirements
4. Lack of scale and/or profitability track record in smaller providers

A provider with five years of lending to community finance noted that their lending committee used to look mainly at credit risk and default rates. Now it is all about potential of regulatory challenge including affordability checks.

Social investors noted that there is value in growing community finance that is not being captured in terms of societal and economic benefit of lending to this customer group. It would be useful to look at the overall incentives model and learn from what has worked in the impact investing model.

What are the barriers and challenges?

The barriers and challenges can be summarised into three broad areas

Operational challenges

A lending business can be broken down into five key areas and the challenges in each are summarised below

Area	Issues	Opportunities
Cost of acquiring customers	• Different providers have different experiences – while there are multiple routes to market (Facebook, price comparison websites, aggregators, employers, Google) that larger players have been able to channel effectively, many smaller providers lack scale and/or resources to generate sufficient awareness and customer pipelines	• Development of platforms to make it easier and more cost effective for smaller providers • Address fraud listings on search engines • Signposting and referrals to providers
Cost of onboarding customers	• Cost of credit checks is a barrier when lending small amounts of credit	• Could an industry wide solution be negotiated for this customer base to bring costs down? • Could open banking be used as an alternative for part/all of the process? Fintech CDFIs reported that 80% of applicants readily consent to using open banking
Cost of servicing customers	• Claims management companies are driving up complaints. After four complaints each complaint costs £750 whether successful or not and this	• Funding of FOS and model of who bears the cost of unsuccessful claims to consider – currently there is no friction for Claims management companies

Area	Issues	Opportunities
	fuels the negative perceptions of risk • Automation of customer journeys	playing a volume model
Bad debt cost	• There is varying experience on bad debt – from some at a 10% default rate, others describing 50% repaying to schedule, 25% struggling and 25% never paying back	• Share best practice on what works
Financing cost	• Capital is needed to scale lending; target returns on equity range from 10-15% (banks) through to 25% for other investors	• Establish sustainable mechanism to allow funding to the market at an affordable price • Explore usage of Community Investment Tax Relief (CITR) and other tax reliefs as an incentive for investment into CDFIs

Regulatory challenges

The overarching view was that banks are keen to lend however they are deeply concerned they could be 'trying to do the right thing but perceived to be doing the wrong thing'. Those with experience of other countries reported that the UK is more draconian than other geographies and this leads to a higher aversion to risk from banks.

The critical thing we heard again and again was the need to address the concern that regulation will change and apply retrospectively resulting in both financial sanctions and reputational damage. The burden of proof being placed on the provider for good customer outcomes which is retrospectively judged is seen as a big risk and where banks have been burnt in other areas.

Some of the issues and challenges cited were

- A perception that FOS and the FCA don't talk and that a prescriptive approach is taken in interpreting principles that doesn't improve consumer outcomes and is also applied retrospectively. An example given was a provider being told they needed to ask customers about gym memberships and newspaper subscriptions. Customers find this level of questioning intrusive for a £400 loan and it also lacks insight into the reality of peoples' lives

- Claims management companies operate to chase complainants. The cost of a claim is the same for HSBC as it is for a small community finance provider at £750 and is paid by the provider whether or not a claim is successful
- A lack of alignment of regulators – for example capital holding levels for certain asset classes acts as a disincentive for banks to invest their capital in this customer group
- Lack of alignment of regulatory position and the actual needs of customers. For example, the regulatory perspective appears to be that customers borrowing frequently are in persistent debt however experience is that borrowing is largely cyclical
- Lack of regulatory certainty about alternative lending has been one of the contributors leading to a lack of financing options as funders and investors are driven away from the market

Reputational risk

Providers and investors are concerned about the perception of APR and any risk of being associated with getting things wrong in serving this customer segment – the Daily Mail sniff test. There needs to be a better way to communicate why providing credit to this segment, while not for everyone, can be transformational for many.

Banks are also concerned about fuelling repeat credit and/or persistent debt or being perceived as acting in this way. Anecdotal evidence was shared that amongst specialist credit funds, people have experienced a greater risk appetite from US senior debt investors (evidenced by higher advance rates) than their UK counterparts.

HMT, the FCA and the PRA could help in aligning measures to support the market engaging in this space.

This should be explored further.

What options should we explore to collectively address the market failure?

We wanted to capture all the ideas and options raised during the roundtable discussion. A prioritisation and assessment of the impact of each measure is required to understand the requirements on government, the regulator and market actors to address the market failure.

How can we signal that providing affordable credit is a good thing to do?

- We can do more with ESG to set out what makes a 'good' proposition and measure impact, learning from impact investing models
- Signalling from regulators and government could be helpful in providing 'air cover' for providers entering this space

How can we create a regulatory environment that provides more certainty and sustains consumer protections?

Ideas for consideration included

- Do we need different regulations for the sub and near prime market
- Redefine how cost of credit is referred to for short term credit – away from APR
- Stamp from Fair4All Finance? A 'badge of credibility' building on the Affordable Credit Code of Good Practice

How do we create structures and incentives to sustainably fund and service affordable credit provision to customers in financially vulnerable circumstances?

Ideas to explore included

- Learning from other geographies such as Mexico
- A shared vehicle (funded by the whole industry) to allow collective sharing of risk
- What could be learnt from the British Business Bank?
- Debt advice has taken significant funding from the financial services sector – what can we learn from that mechanism?
- Solutions should include trusted intermediaries between mainstream and community finance to ensure a degree of separation
- Explore usage of Community Investment Tax Relief (CITR) and other tax reliefs as an incentive for investment into CDFIs
- There is a role for sovereign guarantees and/or government subsidy

On incentives to encourage market participation

- Need to ensure there is alignment on drivers and outcomes between investor, investee and customers – may be different for different organisations and customer groups
- A more effective regulatory sandbox environment and clear regulatory and governmental endorsement of community finance and alternative forms of lending to provide the industry with comfort that they won't be penalised for innovative product design and ways of lending
- Consumer incentives to borrow from credit unions or CDFIs so to support their sustainable scale

Other areas to drive scale

- Leveraging the skills and resources from mainstream banks
  - Investment

- Expertise
- Support with scaling to drive economies of scale and help bring down the cost of doing business
- Data
- Innovation and product design

- Channels to market
  - Further investment needed in aggregators and price comparison websites
  - Known fraudsters are allowed to get top billing on search engines
- Credit reference agencies
  - Should be seen as a utility as if it is a key part of the lending decision it should be very low cost or funded centrally

Subsidy

- Unless we can achieve a shift in perception on interest rates subsidy will be needed

Thank you

Many thanks to all the participants from across the banking, high cost credit, community finance and other sectors, and to Chris Woolard and EY for hosting.

Appendix 1

The assumptions and data behind the estimated scale of the market

£b	2016	2019	2022	2027 No Change	2027 Radical Change
Community Finance	0.5	0.6	0.6	0.7	2.2
Other – more providers	0.0	0.1	0.1	0.1	1.8
High cost credit options	3.8	2.6	1.4	1.4	1.1
Subprime credit cards	2.3	2.3	2.3	3.5	3.5
BNPL	0.2	0.5	0.8	1.0	0.2
Gap	1.0	1.7	2.6	3.0	1.0
Total	7.7	7.7	7.8	9.7	9.7

Key assumptions

There is a danger that numbers provide spurious accuracy however we have included to give the rationale for the estimates which have been based on existing data from the FCA and the Bank of England.

Community finance

- Credit unions c£1.4b loans outstanding 2016, increase to c£1.7b 2021; around half of this in England, the remaining in Scotland, Wales and Northern Ireland (YE Sept 2021, Bank of England). Fair4All Finance estimate that annual loan originations are two thirds of loan book, and that currently less than half of lending is to financially vulnerable groups. Potential for high growth
- CDFI lending very targeted, £30m provision last year (source: Fair4All Finance), growing rapidly to potentially £50m 2022

High cost short term credit

- £1.1b 2016 declined to c£0.2b 2021 (FCA, 2022)

Other forms of high cost credit have declined significantly over the same period

- Catalogue c£0.8b of originations in 2016 (approx 40% of £4b market outstanding debt estimated to be subprime)
- Home collected credit £1.3b 2016 to £0.3b 2021 (FCA, 2022), given the exit of all (bar one) major players, we expect this to be near zero going forward
- Guarantor loans: c£0.4b 2016 (FCA), rapid growth and then significant decline. No new entrants in past three years
- Rent to own £0.6b 2016 (FCA), decline and market exit by most players

Subprime credit cards

- £2.3b 2016, we expect this has remained broadly static since then (FCA)
- Following pattern of subprime credit cards in other financial downturns, and noting the new monthly record spending on credit cards in February 2022 (Bank of England), we expect this to increase (estimated by 50%)

Buy Now Pay Later

- Rapid growth over past few years, now a very large though uncertain market, likely <10% provided to people in vulnerable financial circumstances (based on forthcoming Fair4All Finance customer segmentation research)

Other forms of unsecured credit have not been included

- Other forms of unsecured credit including running account, pawnbroking not included
- Liabilities on utility, rental, council, other bills not included

Other useful information

Credit supply set to shrink as borrower defaults rise (The Times, October 2022)

https://www.thetimes.co.uk/article/credit-supply-set-to-shrink-as-borrower-defaults-rise-8096v9r6s?shareToken=ba62df38e2308a2223515a344711f20a

Appendix 2

The current differential in provision

Average high street banking product

Term: 1 to 7 years

Amount: starting from £1,000 up to £35,000

Requirements for the loan: be in paid employment or have a regular income, have a good credit score, with no history of bad credit, such as County Court Judgements (CCJs) or bankruptcy

Customers not served by high street banking products

Term: typically less than 1 year

Amount: 80% are borrowing **below £1,000** (typically £350 to £400)

Customer profile: irregular income; no credit history or very little history