The credit safety net

How unsustainable credit can lead to problem debt and what can be done about it

Foreword by Sir Hector Sants

Credit is widespread; an everyday part of life for people across Britain. For most people, most of the time, it is a convenient and flexible way of managing budgets and spreading the cost of larger expenses. However, too many people are getting into difficulties from using credit not to smooth, but to survive, whether that is high cost pay day lenders, credit cards or their bank overdraft. This report takes a fresh look at how some people are using credit as a safety net and examines why this can be unsustainable.

The report finds that over 4 million people are regularly using credit to meet everyday living costs and the costs of emergencies. When people are using credit like this over a prolonged period they can quickly fall into serious financial difficulties. This is because credit repayments become an additional essential cost that they have to meet, alongside life's essentials and the cost of the original emergency. This can lead to these families falling behind with their commitments and building up problem debt.

As the Chair of the Archbishop of Canterbury's Task Group to create a fairer financial system, and from working in financial regulation, I know what happens when credit use goes wrong. To counter this and provide a real alternative the Task Group harnessed the resources of the Church of England to support the growth of credit unions and other community finance organisations. The two core initiatives from this Group, the Church Credit Champions Network and LifeSavers are making a real difference to people's lives. The credit union sector has grown substantially over the past ten years with vital government investment and on-going cross sector hard work and collaboration. However, the job is not done yet, and credit unions themselves would acknowledge that they can't meet everyone's needs.

This report suggests strategies that, alongside credit union expansion, can improve the sustainability of credit use for those that are using it as a safety net. It asks questions about what more can be done to address the features in commonly used credit products that can lead to problem debt. It also asks what new solutions are needed for the most financially excluded who would struggle to access any form of commercial credit. Finally, it reminds us that supplying better credit is not the only way to help people who are struggling to get by. A healthier cushion of savings and stronger protection from punitive charges and creditor harassment will also help break the link between life's inevitable ups and downs and chronic, life-changing debt.

Improving the sustainability of credit use has come a long way since the financial crisis with the Financial Conduct Authority (FCA) tightening the regulatory framework on payday lenders and credits unions having over a million members. However, over 4 million people are still turning to credit regularly as a safety net and a third of them are falling behind on bills and credit commitments. There is a need to implement a broad strategy to ensure more people are able to use credit sustainably and fewer families fall into problem debt.

Executive Summary

There have been growing concerns about rising personal debt as levels of consumer credit borrowing increases. [1] At StepChange Debt Charity we know that problem debt holds back families' lives and costs the UK £8.3 billion through the pressure it places on health services, welfare and other support services.[2]

Problem debt is principally driven by income shocks and people struggling to adjust to changes in their family circumstances.[3] There is a range of safety nets to help people deal with income shocks including the personal safety nets of savings and spare income; there is also the welfare safety net.[4] However, some families have to rely on credit to keep up.

For many, credit is a sustainable tool to smooth out consumption, spreading the cost of larger purchases with manageable repayments. However, families on tight budgets who regularly use credit to meet their everyday and emergency costs can fall into problem debt. Using credit to meet these essential costs can be an appealing strategy particularly for those who want to remain independent and manage on their own. However, it is easy for debt levels to build when the repayment of credit has to be met out of restricted household resources, alongside keeping up with essential living costs.

The use of credit as a "safety net" to plug gaps in household finances is a widespread problem. Over 7 million people in Britain are turning to credit to pay for their everyday essentials and over 13 million would need to borrow money to cover an emergency cost.

In total, we estimate over 4 million people in Britain are likely to be using credit to meet everyday living costs, emergency costs and relatively small specific purchases. This group is largely made up of working families on lower and middle incomes, although some are households on the lowest incomes and in more insecure, 'casual' employment. Those using credit as a safety net to meet these needs are significantly more likely to be struggling financially as over a third (36%) of them were falling behind on bills and credit commitments, compared with just 7% of the overall population who are in financial difficulties.

We believe three connected issues help explain why using credit as a safety net can lead to problem debt. Firstly, there are features of, and lending behaviour associated with, commonly used credit products including credit cards, overdrafts and payday loans that can lead to problem debt where they are regularly used to plug the gaps in household finances. These problematic features and behaviours include irresponsible lending, costly and complex default fees and charges, the fact that individuals often have multiple products, and the structure of minimum payments.

The FCA has made progress in raising standards in the unsecured credit market but more needs to be done to reduce the 'debt risk' of credit products. The FCA should look to improve product governance across the unsecured credit market. Credit providers should demonstrate how they ensure that their products are suitable for the particular needs of more financially vulnerable consumers and perform effectively and sustainably under a variety of circumstances.

Banks and other lenders could also be doing more to support their own customers who have come through financial difficulties and have impaired credit records. They should be developing a new short-term credit product to provide a small-scale loan or overdraft at reasonable rates of interest to help these customers rebuild their credit file and reduce the likelihood of them having to turn to high cost credit in future.

We have identified a second category of unsustainable credit alongside the issues within mainstream product markets. Some of those using credit as a safety net are not able to access mainstream credit and are having to pay more to borrow from high cost lenders. This credit use is also not always sustainable as it can also lead to spiralling problem debt. Sometimes, this is because the high cost of repaying this credit puts substantial pressure on household budgets. On other occasions, those taking out this high cost credit may have such tight budgets that they are unable to afford any contractual repayments.

The need to provide affordable lower cost alternatives to the high cost sector has been a key debate since the explosion in payday lending. The main response to this alongside strengthening financial regulation has been to encourage the growth of community lending. The Department of Work and Pensions is investing £38 million into the on-going Credit Union Expansion Project (CUEP). The community lending sector including credit unions and community development finance institutions (CDFIs) is providing a growing source of affordable credit but still has limited reach and may be unable help the most financially vulnerable.

There is a need to further expand the supply of accessible, suitable and sustainable credit for those whose access to credit is currently limited to high cost products. The further development of partnerships between community lenders and other sectors should be encouraged. For example, local authorities should coordinate and share best practice in working with local community lenders. Banks and other lenders should also work with community lenders to introduce more widespread referral arrangements between banks and local community lenders, embedded in business as usual.

But for many people even current third sector credit products may not be a sustainable answer to their immediate money needs. We believe there is a need for a new range of products that can help financially excluded and financially vulnerable people manage pressure on household budgets without facing the risk of falling into unmanageable debt. The government should work with banks and community lenders to pilot a microloan scheme for Britain. This could use the Australian and Irish schemes as models: these have proved the benefits of providing no or low interest loans to the most financially excluded.

Credit of any type is not, and should not be, people's only option. There is a need to reduce the demand for 'crisis' credit use via a preventative strategy to improve the safety nets available for those who struggle on tight budgets and regularly face emergency income shocks:

With 2.6 million people in Britain currently in severe problem debt, there is a need to help people already in debt to turn to debt advice rather than seeking further credit to pay off their existing commitments and provide life's essentials. [5] Again, this needs supply- and demand-side interventions. The government should seek to ensure that adequate free debt advice is available by ensuring voluntary and statutory funding reinforce one another to maximum effect. It should reduce demand by introducing a breathing space guarantee to increase the appeal of debt advice as a safety net, and by ensuring central and local government policies and practices do not add to demand for debt advice. There is also a need to help lower and middle income households to build up a 'rainy day' savings buffer that that could reduce the demand for 'crisis credit' and prevent people falling into a debt trap. [6]

Therefore a three-fold strategy is needed to address the unsustainable use of credit and the resulting financial difficulties in Britain today. This includes:

- The need to reduce the 'debt risk' in current products for those using them as a safety net;
- The need for a broader supply of affordable credit for those that struggle to access commercial credit.
- The need for alternative safety nets for those who fall into difficulties, to tackle the demand for credit.

A multi-faceted approach is essential to ensuring credit is used less often as a safety net, and that when it is, it works sustainably as a safety net. The less we do to tackle problems within credit markets, the more we will need to do to provide people with alternative ways of coping with the risks of today's economy, such as saving, meaning they don't have to rely on those markets at all.

Contents page

Methodology

To understand where people are using credit as a safety net and why this can cause problem debt, we conducted a number of research projects.

National polling

We conducted a large national online poll with YouGov PLC to understand the scale and nature of the problem of using credit as a safety net across the population of Great Britain. The poll had responses from 3,348 GB adults. The fieldwork was undertaken 1st - 5th October 2015. The figures have been weighted and are representative of all GB adults (aged 18+). We conducted analysis of the poll's results to examine who is using credit as a safety net, the levels of financial pressure they faced, and what types of credit they were using. Where we extrapolate national figures from this data, these are calculated by StepChange Debt Charity using 2013 population estimates from the Office of National Statistics which indicate that there are 49,478,070 adults in Great Britain.

In order to establish who is using credit as a safety net, the YouGov PLC poll asked a series of questions about current and potential credit use including whether credit was used to meet common household expenditure in the past year, and how easy or difficult it would be to raise the money for an emergency cost or for a larger special purpose without borrowing. We consider that those who were using credit as a safety net as all those who:

- Had borrowed at least occasionally in the last year to meet their essential expenditure,
- Would find it difficult to raise £200-£300 in an emergency without borrowing,
- Would find it to save £500 for a special purpose.

A client survey

We conducted a survey of StepChange Debt Charity clients to find out their experiences of using credit and to explore where and why this had caused them difficulties in the past. The sample was 553 StepChange Debt Charity clients who came to the charity for advice in 2014-2015. The clients had all used credit as a safety net and experienced financial difficulties. The responses from this survey were used to provide qualitative evidence alongside a review of the existing literature on the issues and possible gaps in the credit market.

Using credit as a safety net

Millions of families across Britain are using credit as a safety net to keep up with everyday living costs, meet emergency costs and fund relatively small single purchases. In having to turn to credit to get by, these people are significantly more likely to be fall into problem debt. The following discussion explores why people use credit as a safety net and looks at patterns of this credit use across Britain.

A comprehensive study of financial inclusion in Britain in 2012 identified a range of key personal finance needs among people on low incomes. [7] These closely correspond to why people who struggle on tight budgets need to use credit as a safety net for example:

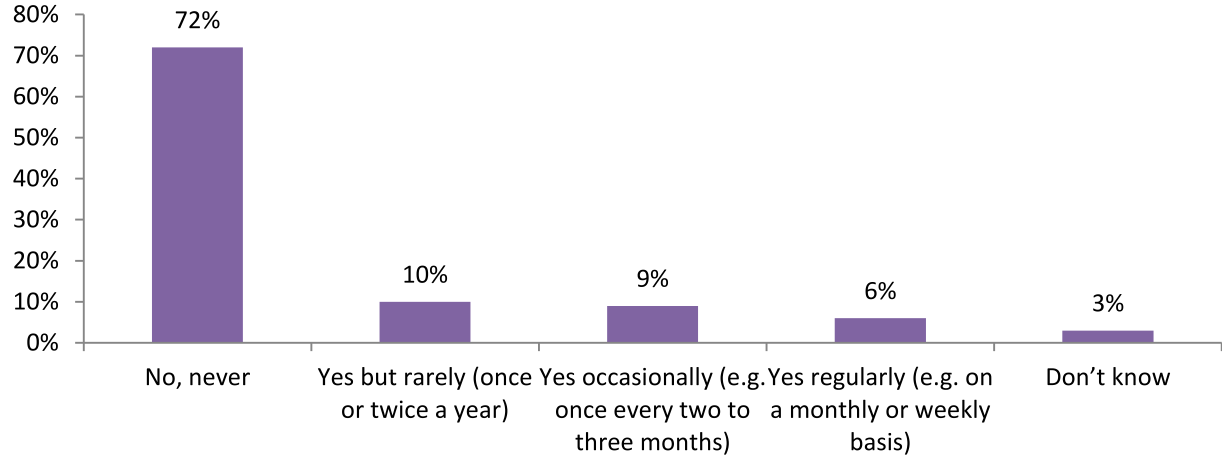
1. Day to day expenditure: regularly paying for everyday expenses including goods and services e.g. grocery shopping, health or dental services and to cover the cost of household bills.

2. Expected periodic needs: Anticipated purchases for special events or special purposes like Christmas, birthdays or replacing clothes e.g. school uniforms.

3. Emergency costs: Unpredictable expenses like fixing the boiler or replacing the washing machine or urgent expenses like covering burglary or fire/flood costs.

In order to explore use of credit as a safety net across Britain and to update this existing literature, we commissioned research exploring each of these three needs. Firstly we looked at who needed to borrow money or access credit for day-to-day needs. As figure 1 shows the vast majority of the population do not often need to borrow to meet this need. However, 7.4 million people (15%) have to borrow money or access credit for day-to-day expenditure. Within this group, nearly 3 million people (6% of the population) borrow regularly and just over 4 million (9%) borrow occasionally for these needs.

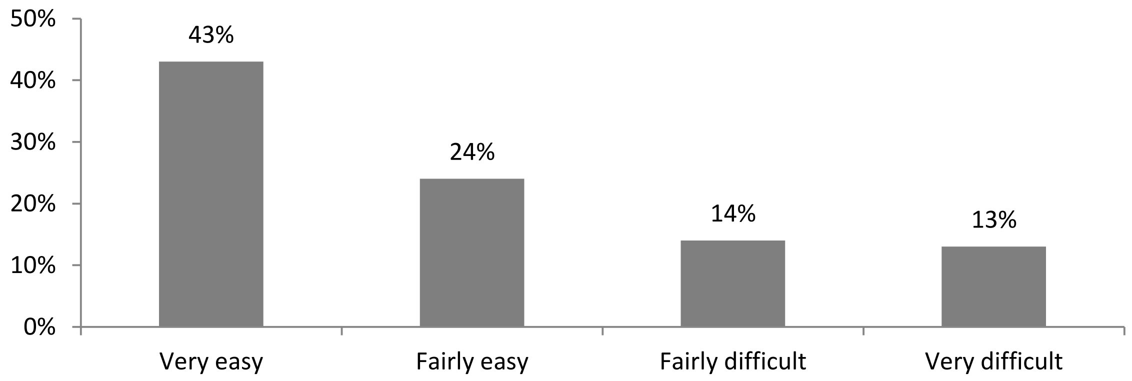
Figure 1: Borrowing money or accessing credit to meet day-to-day needs in the last 12 months



Sources: YouGov PLC online survey (1). Sample: 4,771 GB adults, fieldwork: 10 – 12 August 2015. YouGov PLC online survey (2). Sample: 4,442GB adults, fieldwork: 17th - 20 December 2013.

We also explored how people meet unpredictable periodic needs by asking how easy or difficult they would find it to raise money (about £200-300) for emergency expenses without borrowing. Again, the majority (67%) of the general population would find it very or fairly easy to raise this money without having to borrow. However, we found over a quarter of the population (27% or 13.3 million people), would find it difficult to cover these emergency expenses without borrowing.

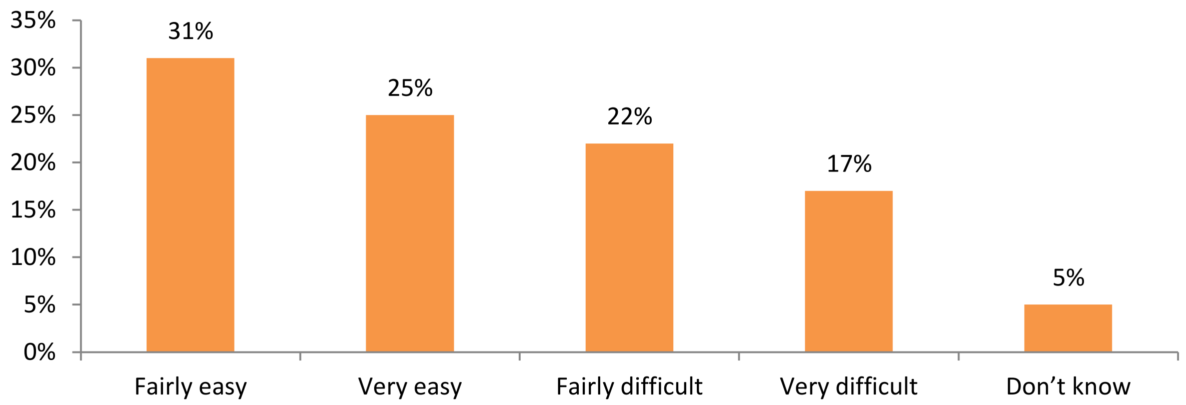
Figure 2: How easy would you find it to raise £200-£300 in an emergency without borrowing, either through access to credit (e.g. loans, credit cards etc.) or from other sources?



Source: StepChange Debt Charity commissioned online survey from YouGov. Weighted sample: 3,348 GB adults. Fieldwork was undertaken between 1st - 5th October 2015.

Significant numbers of people would also struggle to raise the money needed for expected periodic needs such as for Christmas spending or school uniform costs. We found that 39% of the people surveyed, equivalent to 19.2 million people, would find it difficult to save £500 for a particular special purpose.

Figure 3: How easy would you find it to save £500 for a special purpose?

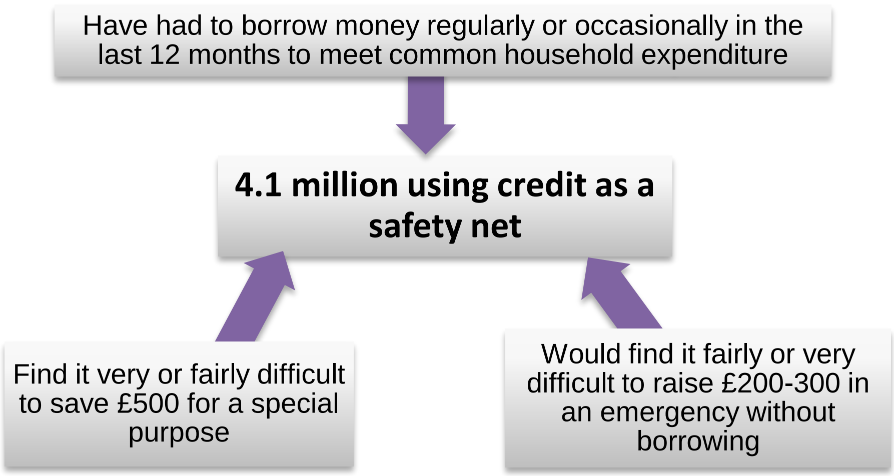


Source: StepChange Debt Charity commissioned online survey from YouGov. Weighted sample: 3,348 GB adults. Fieldwork was undertaken between 1st - 5th October 2015.

The following discussion explores the use of credit as a safety net in more detail by examining who faces a combination of all three of the needs we have identified above. Our research indicates **4.1 million** people in Britain fall into this group, as illustrated by the figure below:[8]

Figure 4: Number of people who are using credit as a safety net

This report finds that 4.1 million people likely to be regularly using credit as a safety net to meet the cost of both emergency income shocks and everyday living expenses.

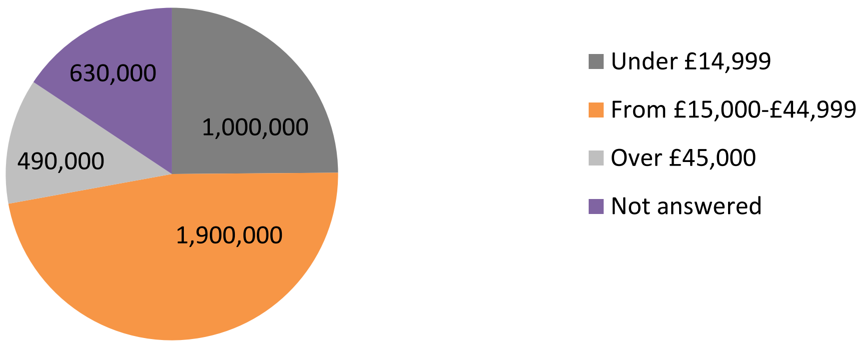


This group is broadly made up of two sub-groups:

- A quarter (25%) of this group are what could be defined as the most financially excluded in society with approximately 1 million people on the lowest incomes and in casual, low skilled work, unemployed or state pensioners (DE social grade).
- A larger proportion of the group (48%), just under 2 million people, are lower and middle income households and are what could be termed ‘struggling workers’. This group works in a range of professional, administrative and high to middle management positions (AB and C1 social grades).

These two segments could be larger than these estimates suggest, as 15% of those surveyed (equivalent to 630,000) did not record their income so were not placed in any groups.

Figure 5: Number of people using credit as a safety net by household income band



Source: StepChange Debt Charity commissioned online survey from YouGov. Weighted sample: 3,348 GB adults. Fieldwork was undertaken between 1st - 5th October 2015. Population figures calculated by StepChange Debt Charity based on estimated based on ONS mid-year estimates 2014.

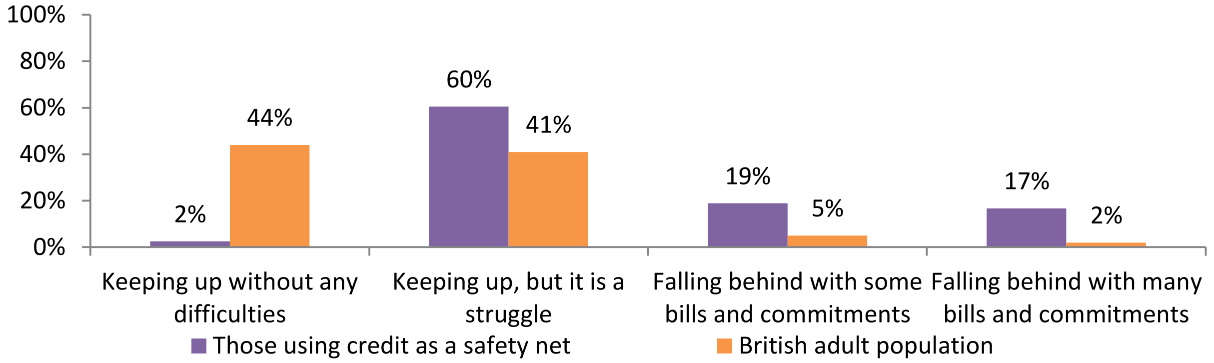
The dangers of using credit as a safety net

Our previous research found that people who used credit after experiencing an income shock were twenty times more likely to fall into severe problem debt than who were able to adjust their finances without credit.[9] This report found that the over 4 million people who are likely to be using credit as a safety net are significantly more likely to be in financial difficulty. As figure 6 shows:

- Nearly half of the general population (44%) are keeping up without any difficulties, compared to just 2% of the group using credit as a safety net.
- The majority (60%) of this group are keeping up with commitments but finding it a struggle compared with 41% of the general population.
- A significant minority (36%) are falling behind with bills and credit commitments compared to just 7% of the general population.

Therefore using credit as a safety net to plug gaps in household finances can be dangerous as it can lead to families falling behind with their commitments and getting into problem debt.

Figure 6: Extent of financial pressure experienced by those using credit as a safety net compared with the British adult population



Source: StepChange Debt Charity commissioned online survey from YouGov. Weighted sample: 3,348 GB adults. Fieldwork was undertaken between 1st - 5th October 2015.

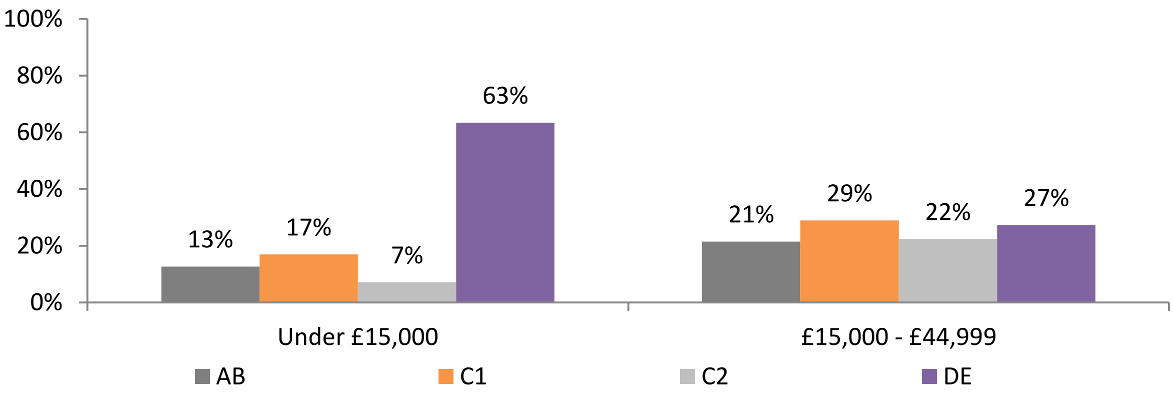
Who is using credit as a safety net?

Our research shows that the people using credit as a safety net are:

- More likely to be aged between 25-39 years old (78% of the group) and less likely to be young (just 6% are 18-24 years old) or older (16% are aged 60 years or older).
- The group are made up of significantly more women than men (61% women and 39% men).
- This group were broadly spread across the Britain in line with the geographical spread of the general population.
- In terms of employment, the group are spread across social grades but are slightly more likely to be in the DE social grade than the general population with 34% of this group in DE compared to 22% of the whole population.[10]

When looking at the social grade and household income of the group together, the two subgroups emerge: the one million more financially excluded group and the two million 'struggling workers'. As figure 8 below shows the financially excluded are mainly those working in low skilled, casual jobs or unemployed (DE social grade) and on the lowest incomes (under £15,000). Whereas, the two million 'struggling workers' are more likely to be on lower and middle income households (£15,000-£45,000) and are more likely to be in a range of administrative and management professions (across all social grades).

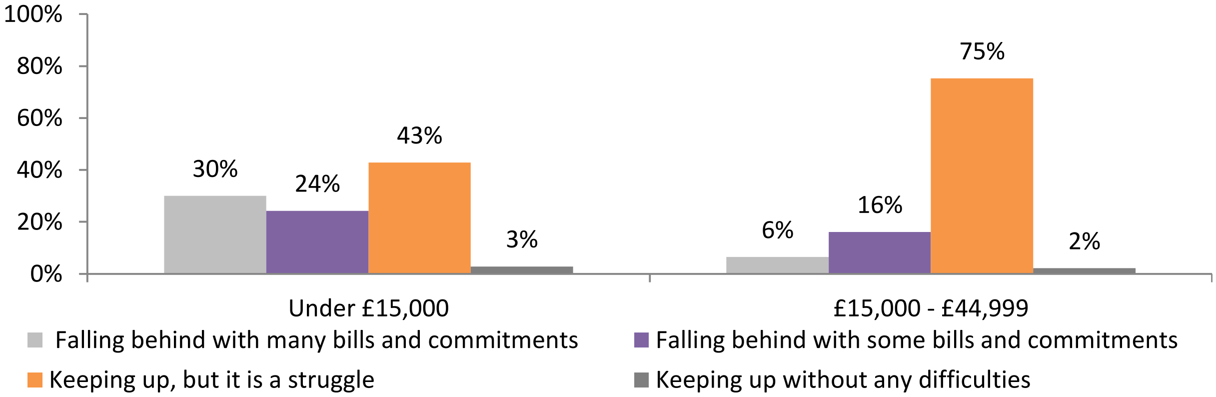
Figure 8: Those using credit as a safety net by household income and social grade



Source: StepChange Debt Charity commissioned online survey from YouGov. Weighted sample: 3,348 GB adults. Fieldwork was undertaken between 1st - 5th October 2015.

There is also a difference in the extent of financial pressure experienced by the two subgroups as figure 9 shows. The 'struggling workers' are less likely to be falling behind with bills and credit commitments as the vast majority of them (75%) are keeping up despite finding it a struggle. Those on the lowest incomes are more likely to be experiencing financial difficulties as over half (54%) of them are falling behind with many or some bills and commitments. Additionally, a significant proportion (43%) of the financially excluded group are also keeping up but finding it a struggle.

Figure 9: Extent of financial pressure experienced by those using credit as a safety net by household income



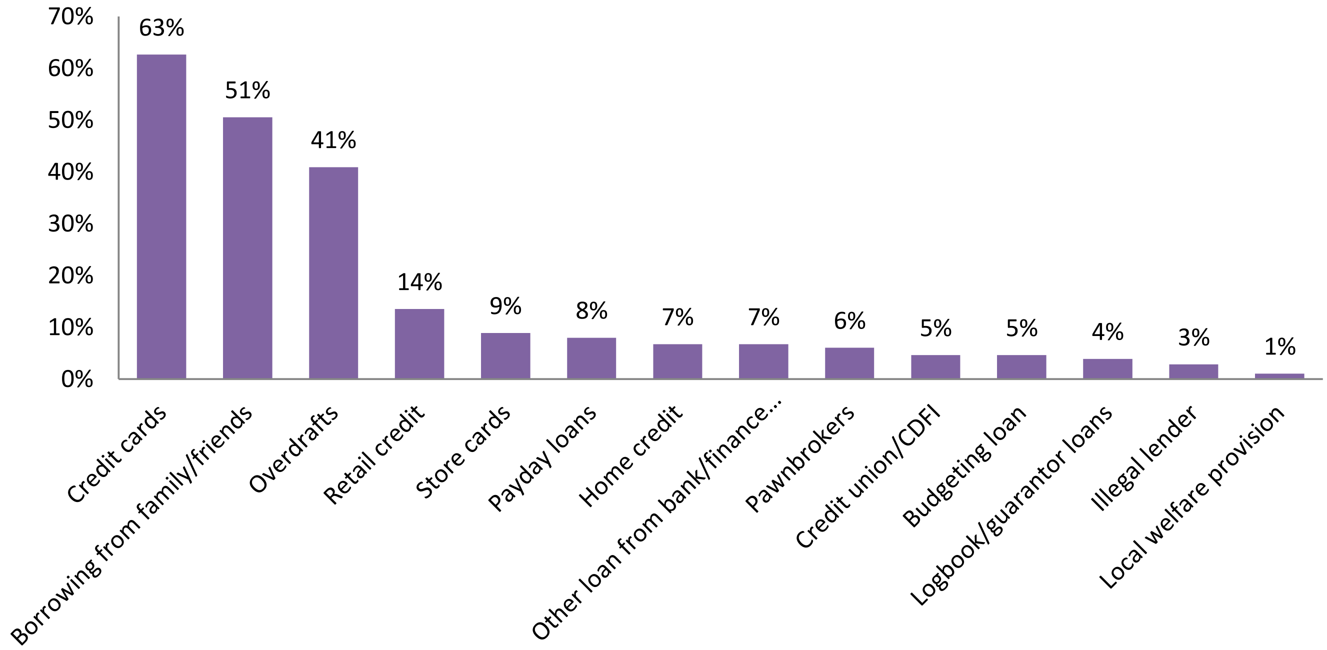
Source: StepChange Debt Charity commissioned online survey from YouGov. Weighted sample: 3,348 GB adults. Fieldwork was undertaken between 1st - 5th October 2015.

Types of credit used by people who use credit as a safety net

Figure 10 shows that a considerable proportion of this group are using credit cards (63%) and overdrafts (41%) and many are also borrowing from family and friends (51%). A significant minority are using non-mainstream forms of credit to get by, with 16% using high cost credit that includes payday loans, home credit, pawnbrokers, logbook loans and guarantor loans, and 14% using retail credit including hire purchase, mail order and rent to buy. Only a small proportion are using community lenders like credit unions (5%) and state provision like budgeting loans (5%).

An even smaller proportion reported that they had used illegal lenders (3%). Previous estimates from 2011 also found the illegal lending sector was used by 3% of low-income households suggesting that while reporting of illegal lending is inherently difficult and unreliable, this type of lending is a relatively small but serious persistent problem that needs to be tackled.[11] We welcome that the government has announced future funding of the illegal money lending team.

Figure 10: Types of borrowing used by the group who are using credit as a safety net



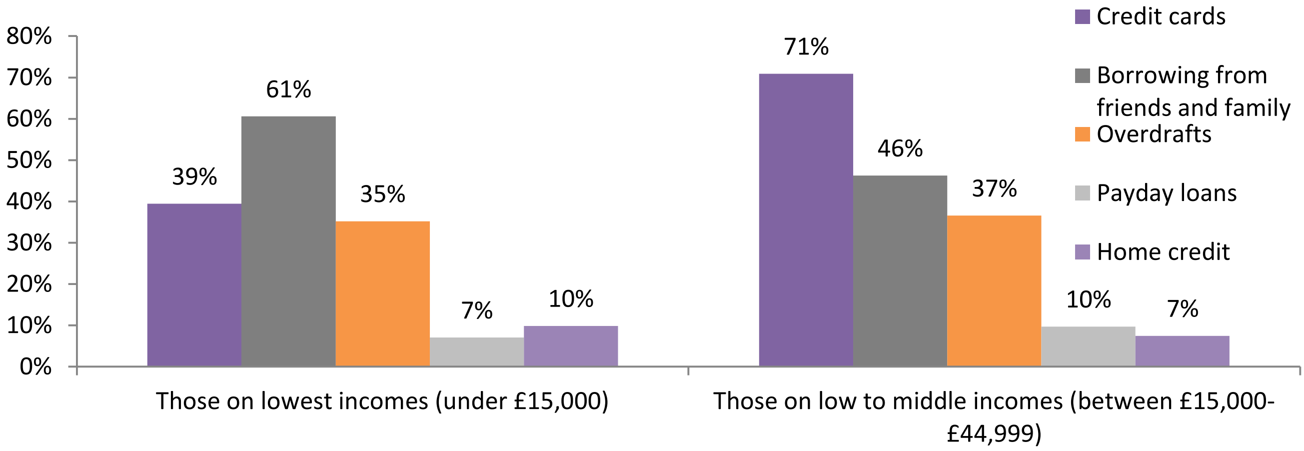
Source: StepChange Debt Charity commissioned online survey from YouGov. Weighted sample: 3,348 GB adults. Fieldwork was undertaken between 1st - 5th October 2015. This question was asked to a subsample of 466 Adults who had borrowed money occasionally or regularly in the past 12 months.

This evidence suggests that those in the group who are using credit as a safety net are more likely to be going into their overdrafts and using high cost credit than the general population.

41% of this group used their overdraft (either planned or unauthorised) whereas the Competition and Markets Authority (CMA) found that just 29% of all personal current account holders have been overdrawn in the last 12 months.[12] Figure 10 shows that 8% of this group used a payday loan whereas the FCA found that approximately 3% of population used payday loans in 2013.[13] Figure 9 also shows 7% of the group used a home credit loan in the past 12 months and in comparison the Office of Fair Trading (OFT) review of high cost credit in 2010 found that users of home credit equated to less than one per cent of all adults.[14]

There is a difference in the credit used by the 'struggling workers' and those more financially excluded on the lowest income. As figure 11 below shows near three quarters (71%) of the 'struggling workers' on lower and middle incomes are using credit cards. A significant proportion (39%) of those on the lowest incomes also use credit cards, although substantially fewer than the struggling workers. There were fairly similar numbers of those on the lowest incomes and those on low to moderate incomes using their overdrafts (35% compared with 37%). Slightly more of those on low to moderate incomes used payday loans (10% vs 7%) and slightly more of those on the lowest incomes used home credit loans (again 10% vs 7%). Those on the lowest incomes were also more likely to be borrowing from their family and friends than those on lower and middle incomes (61% compared with 46%).

Figure 11: Use of certain credit products by the group who use credit as a safety net by household income



Source: StepChange Debt Charity commissioned online survey from YouGov. Weighted sample: 3,348 GB adults. Fieldwork was undertaken between 1st - 5th October 2015. This question was asked to a subsample of 466 Adults who had borrowed money occasionally or regularly in the past 12 months.

This suggests that credit use among lower and middle income groups is not homogeneous and that both groups are mainly using mainstream credit to get by, but at different levels. The more financially excluded are more likely than struggling workers to be finding it difficult to access credit as they are relying heavily on borrowing from friends and family. Nonetheless, nearly half of these 'struggling workers' on lower and middle incomes are also relying on friends and family. This also shows that high cost credit use is not just confined to the most financially excluded on the lowest incomes with 17% using home credit and payday loans across both subgroups.

Summary

Many families in Britain are struggling on tight budgets and are using or would need to turn to credit to get by. 7 million people are turning to credit to pay for their everyday essentials at least occasionally; over 13 million who would need to borrow money to cover emergency costs; and over 19 million who would struggle to raise a larger amount of money for a special purpose.

There are over 4 million people in Britain who are likely to be using credit as a safety net as they would struggle to meet all three of these needs without turning to credit. This credit use can often spiral into problem debt as over a third of this group (36%) are falling behind on bills and credit commitments. Moreover, the majority (60%) of this group are 'struggling workers' living on a financial knife-edge as they are keeping up with their commitments but finding it a struggle.

The forms of borrowing and credit this group are using as a safety net are most likely to be credit cards and overdrafts and borrowing from family and friends. This group is also more likely to be using high cost credit like payday loans and home credit loans than the general population. Only a small proportion of this group are accessing community lenders like credit unions or state provision like budgeting loans.

How using credit as a safety net can cause problem debt

From a survey of StepChange Debt Charity clients and a literature review we have identified three main issues in the current credit market.[15] Firstly there are features of the most commonly used credit products that can increase the risk of people using this credit as a safety net falling into financial difficulties. Secondly, some people struggle to access mainstream credit and have to pay a premium when they need to borrow as they have to resort to high cost credit to cover their essential costs. They can also find it difficult to access or may not be aware of more affordable alternatives provided by community lenders like credit unions and CDFIs. Finally, some families are turning to credit in desperate situations where it might not be the most suitable option for them and can lead them further into difficulties. These households are often those on the lowest incomes and the most financially excluded. The following looks at each of these three issues in turn.

Where credit products can lead to problem debt

We found there are issues with product governance across the unsecured credit market that mean credit products can lead to problem debt for those using them as a safety net. These issues arise where products are not always suitable for the particular needs of more financially vulnerable families. These families are turning to credit products that are meant for short-term occasional borrowing to regularly plug the gaps in their household finances. This is unsustainable as those turning to credit recurrently as a safety net are more likely to struggle with repayments and take longer to repay which can result in the build-up of problem debt.

There are a range of features of credit products, and a range of practices among firms that provide them, that can mean that those using these products regularly as a safety net to plug gaps in their finances fall into problem debt. These include irresponsible lending, costly and complex default fees and charges, the fact that individuals often have multiple products, and the structure of minimum payments. These characteristics are shared by products across the unsecured credit market, and the following paragraphs focus on some of the most widely used credit products. It explores why these features and practices can cause financial difficulties for those using them as a safety net.

Credit cards and overdrafts

Credit cards and overdrafts are the most widely used form of commercial credit among the people who are using credit as a safety net. Our client survey and literature review point to certain features of credit cards and overdrafts which can cause those using them as an emergency credit facility to experience financial difficulties.

Unaffordable credit card debt represents the largest category of debt among StepChange Debt Charity clients as 65% of our clients have this debt type. Overdraft debt is also common among our clients with 60% of clients owing money on their overdraft.[16] One of our clients explained how using these credit products as a safety net led to financial difficulties:

"I ended up using a credit card that just kept extending my credit limit, my commission dried up at work and before I knew it I was in over my head borrowing from relatives to feed my children."

There are a number of features of and lender behaviour associated with credit cards and overdrafts that can lead to those using them as a safety net falling into financial difficulties. One of these features is credit card default fees and overdraft charges, as when those struggling on tight budgets miss payments these charges and interest build up and make repayments unmanageable. In our survey, clients expressed concerns about default fees and charges:

"I have missed payments in the past and no charges would be better for me."

"Unfair or high charges should not be allowed."

"If I didn't have the funds I wouldn't want extra charges put on top to make the situation worse."

This is affecting a significant number as the recent FCA credit card market study report found that around 2 million people (6.9% of cardholders) are in arrears or default with their credit cards.[17] The Competition and Markets Authority found that 19% of overdraft users are 'heavy users', defined as customers who used either an arranged or unarranged overdraft for nine months or more in 2014 and this credit use can be very costly in interest and charges (excluding students on interest-free arranged overdrafts).[18]

Overdraft charges can cause financial difficulties for those using them as a safety net due to the cost and complexity of charges. FCA research into overdrafts found that many people don't always see overdrafts as borrowing and there is confusion around the costs of overdrafts.[19] The cost of unauthorised overdrafts is a particular issue for those on tight budgets who regularly have to go over their limit to plug the gaps in their household finances. Research has found that many consider unauthorised overdraft fees excessive with more than two thirds of users say charges are too high or unfair. [20]

There are also features and lender behaviour with credit cards that can lead to financial difficulties for those struggling on tight budgets and using them as a safety net. Where borrowers are only able to make minimum payments on their credit cards, they build up large balances that can take more than ten years to clear. The FCA study found that 1.6 million people (5.2% of cardholders) make systematic minimum repayments. This included people that had made nine or more minimum repayments, while also incurring interest charges. One of our clients described the problem:

With a credit card type of loan if you don't pay big chunks off it takes forever to pay off."

Another issue is that people struggling to keep up turn to more credit to pay off other credit commitments which can result in debts becoming unmanageable. Our previous research found that nearly 3 million people are using credit to keep up with existing credit commitments.

This suggests issues with responsible lending, as affordability assessments are not preventing people struggling with their current commitments from continuing to use their existing cards, extending their credit limits or taking out more credit cards. The fact that some people are able to access multiple credit cards can lead to the build-up of unmanageable balances. StepChange Debt Charity clients with multiple credit cards have much larger credit card debts (£18,000 for those with five or more) than people with one card (£3,000 on average).

Product features within mainstream credit, like unexpected and confusing default fees and charges, the facility to continually make low minimum payments, and accessing multiple sources of credit, can lead to unsustainable credit and financial difficulties for those that struggle with everyday costs and have to regularly turn to credit to get by.

Higher interest credit products

Although used significantly less than mainstream credit, high cost credit is still used by 16% of those who are using credit as a safety net, with payday loans the most commonly used type of this form of credit (used by 8% of this group). The use of payday loans to pay for everyday essentials is well acknowledged. Research at the peak of payday loan market expansion in 2013 found that nearly four in ten of those using payday loans took them out to cover everyday living costs like food and fuel costs.[21] This use of high cost credit to regularly meet essential costs can be unsustainable as borrowers on tight budgets often struggle to meet repayments alongside trying to meet everyday living costs.

The features and lender behaviour of payday lending that have caused financial difficulties for borrowers have been widely reported. The OFT found that widespread irresponsible lending meant too many people were granted loans that they could not afford to repay.[22] Where they were unable to repay, product features like rollovers and repeat borrowing, alongside high interest and charges, vastly increased the size of the original loan. Another issue was that inadequate affordability checks were not preventing borrowers from accessing multiple simultaneous payday loans that led to unsustainable repayment costs. Using credit to manage other credit commitments was also a problem in the payday loan market, with research finding that in 2013 24% of payday loan users were using them to repay existing payday loans.[23] Many of our clients have experienced payday loan debt spiralling:

> *"Had payday loans in the past… Once you realize how much you have to repay you feel depressed, but then you can take another payday loan... and you just go down a spiral."*

The FCA have brought in a stricter regulatory regime for payday lenders which has tackled some of the worst practices of these lenders and led to improvements in this market. However, evidence from our clients as outlined in the chapter below suggests that more could still be done to address remaining problems in this market.

Credit cards, overdrafts and to a lesser extent payday loans are the most commonly used credit products by those that are using credit as a safety net. There are certain features of these products including irresponsible lending, costly and complex default fees, the fact that individuals often have multiple products, and the structure of minimum payments, that mean using them as a safety net credit facility can lead to problem debt. There is a need to improve the product governance of this credit and reduce the 'debt risk' for those using them as a safety net that will be addressed in the next chapter.

Access to credit

Some of those turning to credit as a safety net, particularly those on the lowest incomes are likely to struggle to access mainstream credit products.[24] In the survey, some of our clients told us that they sometimes struggle to access credit:

"For people with a bad credit history it is difficult to borrow money from a bank with decent interest rates."

"I have enough money to pay my bills etc. but if something goes wrong at home, I don't have the funds to pay it all on one go so a credit card would help in an emergency situation. But unfortunately I can't get one."

"I had bad credit and couldn't get low Apr but would have liked to."

People with 'thin' credit files or no credit history can find it particularly difficult to access credit.[25] This is because mainstream lenders mainly use 'automated risk assessment techniques' including credit scoring to make their lending decisions.[26] This means people on low incomes find it more difficult to access this credit because although the decision is not usually based on income it is based on range of other factors like housing tenure and employment status. These are used to assess the likelihood that the borrower will be able to manage the repayments and this can lead to the exclusion of certain lower incomes groups.[27]

These people can turn to high cost credit as a last resort when they have 'maxed out' or are unable to access mainstream credit.[28] Some of our clients outlined how they had to turn to high cost credit after being unable to access other sources of credit:

"As my credit rating was non-existent I had no option but to use doorstep lenders who were only too keen to 'help'."

"When I needed help I looked at lots of different options but in the end the only thing I could get was a payday loan."

"I never expect to get credit from high street lenders these days… I hate being shackled by high interest rates even after I have rebuilt my financial stability."

This credit use can be unsustainable as product features with high cost credit like payday loans can lead to financial difficulties as outlined in the previous section. Those on tight budgets can struggle to repay this credit alongside having to continue to meet their everyday living costs or when they are hit by another emergency cost. These missed payments and interest can lead to spiralling problem debt. Strengthening the product governance of mainstream credit is essential as outlined above. However, this would lead to stricter lending criteria that could result in greater struggles with access and more people having to turn to elsewhere to borrow.

There is a widely acknowledged need for an increased supply of affordable alternatives to high cost credit. This is in order to ensure that those who need to use credit as a safety net can pay less for this credit and can have access to credit that can be used more sustainably. We explore in the section below what community lenders have done to tackle this and in the next chapter present our recommendations of what more needs to be done to increase supply of affordable credit.

The reach of community lenders

Community lenders like credit unions and CDFIs have been widely championed as a more sustainable solution for people who need to borrow money and whose finances are tight. They have been championed and invested in by the government in order, as the minister DWP Lord Freud has stated, to provide an "antidote to predatory loans sharks or high-interest lenders".[29] However, our survey and literature review indicates that there are some issues that need to be addressed with the accessibility and scale of these community lenders.

Some of our clients were aware of the benefits of credit unions:

"I have found credit unions to be much more approachable than pawn shops and doorstep lenders."

"The interest in a credit union [loan] is very low."

However, these lenders are not widely used by the group who are using credit as a safety net with just 5% of this group using community lenders. Other evidence suggests credit unions serve just under 3% of the population with approximately 600 credit unions across the UK and just over 1 million members.[30] There is clear evidence that, although credit union membership is growing in Britain, our community lending sector is not the widespread, mainstream provider of financial services that it is in some other countries.[31]

There is a need to raise awareness of credit unions and other community lenders in order to expand their reach and ensure that more of those using credit as a safety net have access to them. Previous StepChange Debt Charity research found only 6% of people believed they would get a credit union loan quickly but 16% believed they would get funds quickly with a payday loan.[32] Similarly the Credit Union Expansion Project feasibility study research found that just 13% had heard of credit unions and only 8% thought they could help them.[33]

Other issues with further expanding the community lending sector includes access problems around the application process. Our survey indicates that most of our clients want to apply for credit online as it provides anonymous and fast access:

"Need to access quickly and convenient when online."

"[Online access is the:] *easier option, saves time, more private."*

"I would prefer to apply online as I would be embarrassed and nervous to have to speak to someone and worried about being turned down to my face."

Being able to access the credit quickly and conveniently was also a key issue for our clients and some faced difficulties specifically when applying for a credit union loan:

> *"The only problem I found with credit unions was the waiting time for funds and the number of face to face visits that were needed in the first instance to apply."*

Although some credit unions have been able to provide fast and online systems for joining and applying for credit, this is not widespread and some community lenders are unable to provide this. In contrast, the payday loan market has drawn in borrowers with widespread quick, online access with research finding that payday loans are appealing to some borrowers as they offered speed, convenience and anonymity.[34]

The investment and support given to community lenders has meant this sector is expanding and developing technologically. The CUEP should lead to greater automation and use of technology that will enhance the online and mobile accessibility of credit unions. There is a need to continue investment in and facilitate further expansion of the sector. This would help to improve the supply of more affordable credit for those struggling on tight budgets and using credit as a safety net.

'Crisis' credit use and the most financially excluded and financially vulnerable

A section of the 4 million people using credit as a safety net are turning to credit when they need money urgently in a crisis. FCA research found that some consumers in vulnerable circumstances are 'survival' borrowers who due to their very tight finances often have no option but to turn to credit due to lack of income.[35] This credit use can be unsustainable as those on very restricted budgets can struggle to meet the cost of repayments alongside meeting everyday living costs. This can result in missed payments and interest and charges mounting up into problem debt. Our clients described instances when they turned to credit in a crisis:

I was desperate when I last used a payday loan not realising it would push me further in to debt."

"Because if I needed it [to borrow money], *I needed it - waiting a week would not have been an option. How would I pay for travel to get to work, or food to eat, during that week?"*

Even with the expansion of community lending, there is still the question of where families on the lowest incomes and those already in financial difficulties who are most likely to be turning to credit in a crisis can access sustainable credit. Our research found that of the 4 million likely to be using credit as a safety net, around 1 million were in the most financially excluded groups including those on the lowest incomes and in casual work, on state pensions or unemployed.

The credit risk appetite and tight eligibility criteria of mainstream lenders, and even of some community lenders, means that they are not likely to be able to serve this vulnerable section of society. Previously the state provided an important social lending safety net that was accessible to the most financially excluded. Research from 2005 found that the Social Fund was one of the main sources of credit for those on very low incomes, as 21% of those in the lowest income quintile used it.[36] The discretionary Social Fund was abolished in April 2013 and replaced by local authority-run local welfare provision. The budgeting loan element of the Social Fund is still in place. Our research found that this provision is not widely used by those who are using credit as a safety net with 5% using budgeting loans and just 1% using local welfare provision. Those struggling on very low incomes and using credit to get by are therefore potentially less likely to be turning to the state as a social lending safety net.

This suggests those on the lowest incomes who need to turn to credit as an emergency safety net can struggle to access the sustainable credit they need to get by. Struggling with credit repayments can lead to them falling into financial difficulties as this group are also the most likely to be falling behind on their bills and credit commitments. There is a need to explore how this gap in the credit market can be addressed and also to tackle the broader question of how to build financial resilience and reduce this ‘crisis’ credit use. In the next chapter we outline how we need new strategies focused particularly on those who are the most financially excluded.

Summary

Our survey of clients and our review of the literature found three key issues in the current credit market that have wide-ranging policy implications. Firstly, credit products are used sustainably by many to smooth out consumption of larger expenses. However, using credit as a safety net can be unsustainable as those on tight budgets can struggle to meet their credit repayments alongside meeting everyday living costs. In order to meet these essential costs, families can miss payments and the resulting interest and charges build-up into problem debt. Another situation that causes difficulties is where a family faces a crisis, use credit to cover this and then need to cover another expense and turns to credit again. These extra repayments can put added pressure on stretched household budgets and lead to debts spiralling to unmanageable levels.

There are features of, and lending behaviours associated with, common credit products that can exacerbate the likelihood of problem debt building up where credit is used regularly to plug gaps in household budgets. Features like default charges may be costly, but they can be manageable for households that are only affected by them in the short-term. However, when this occurs regularly over long periods, for examples being regularly hit by default charges or making systematic minimum repayments, these costs can add up and lead to problem debt. More could be done to address the product governance and features of these widely used forms of credit in order to reduce the risk of those using these products as a safety net falling into problem debt.

Another issue was that some of those who regularly have to borrow to meet essential and emergency costs are unable to access mainstream credit and have to turn to high cost credit to meet these needs. This can be costly and lead to the build-up of problem debt when meeting credit commitments and everyday costs is too difficult. Improving the product governance, lending behaviours and features of credit products could lead to tighter lending conditions, exacerbating access problems. Greater supply and awareness of affordable credit alternatives like community lenders is essential to ensure those who have to turn to credit to get by have access to sustainable sources of credit that meet their needs.

Finally, some families on the lowest incomes and in more insecure employment have to turn to credit in a crisis where commercial borrowing may not be the most sustainable option. Those in severe financial difficulties struggle to juggle credit commitments alongside general living costs and are most likely to be falling behind. There is a need to also look at access to credit for those that may be outside the lending risk appetite of commercial lenders. There is also a wider preventative strategy needed to reduce the use of credit as a safety net in general and improve other safety nets, build financial resilience, and bolster the support available for those in problem debt. The loss of one income can make it hard for families to cope. Single people – dependent on a single income - are significantly more likely to end up in problem debt, but where couples fall into problem debt, the income shock is likely to see them end up with a single earner, making it harder to make ends meet.

Policy implications

There is a range of solutions needed to help people manage pressure on household budgets with a lower risk of falling into severe financial difficulties:

- There is a need to improve the sustainability of the most commonly used credit products by those using them as a safety net to meet their essential costs. This would involve making changes to the governance of these products and reducing the 'debt risk' caused by features of these credit products.
- For those who struggle to access sustainable, there is a need to expand the supply of more affordable and suitable lending.
- There is also a need to improve the alternatives to credit as a safety net particularly when it is used as a last resort in a crisis. This would involve increasing support to those already in problem debt and building financial resilience among vulnerable segments of the population.

Improving the product governance and reducing the 'debt risk' of commonly used credit products

Credit can provide a flexible, useful and valued service for many borrowers to smooth out their incomes and repay in manageable instalments. However, those who are living on tighter budgets often have to turn to credit to meet their essential costs and this credit can be unsustainable leading to financial difficulties. This is because these credit products are not designed for and do not always work for people who are using them to regularly meet essential costs.

In order to reduce the levels of financial difficulty among the 4 million people who are using credit as a safety net, it is important that measures are taken to improve the focus of product governance more towards mitigating risks for more vulnerable borrowers. Product governance is about how products are designed, marketed and managed and whether the products meet the needs of all those that use them. Under the principle of treating customers fairly, lenders should ensure that their products perform for customers under a range of conditions. But this is not always working well enough to stop people who are financially vulnerable from falling into unmanageable debt. **As a result, we urge the Financial Conduct Authority to review current standards for product governance to go further in protecting financially vulnerable borrowers. This improved product governance would mean greater regulatory scrutiny to ensure that products perform properly for the full range of customers they are sold to under a realistic range of conditions and changing customer circumstances.**

Enhanced product governance would ensure that credit products work and are as sustainable as possible for all those who use them. This would include paying particular attention to the impact of products on those who are more financially vulnerable. Product governance principles should include product design processes that:

- Take account of how financial difficulties can build-up for those who need to use products regularly.
- Look to address how using credit products to relieve pressure on household budgets can cause greater difficulties.

- Be aware of how constrained choice drives consumer behaviour and cause further financial difficulties in the longer term.
- There should also be an understanding of where features of credit products can cause borrowers to build-up unmanageable debts and why this occurs.

These are certain features of and lending behaviours associated with credit products that can exacerbate the ‘debt risk’ caused by using them regularly as a safety net. Our client survey and literature review have identified a number of factors that can cause difficulties for those using credit products as a safety net. These include:

- Irresponsible lending: Since the FCA took over regulation of the credit sector there have been some significant improvements in responsible lending. However, people are still building up unmanageable debt from being able to access multiple products; particularly in the credit card and payday loan markets. For example, over a third of StepChange Debt Charity clients with payday loan debts have three or more of these credit products.
- Costly and complex default fees: These have caused problems for our clients as outlined in the previous chapter. Previous research has found that fees and charges can be excessive. Overdraft charges can be disproportionate to the amount borrowed and credit card penalty charges can also be well above the actual costs incurred by the lender.[37]
- The structure of minimum payments: We share the concerns of the FCA credit card market review that minimum payments are currently too low to prevent people from building up expensive and unsustainable debt. It is also too low to stop it taking years to clear a balance at minimum payment. [38]

These features, like default fees and minimum payments can be costly but manageable for borrowers who only rarely experience them. However, these product features and lender behaviours are particularly problematic for households on tight budgets that are regularly turning to credit for essential costs over a prolonged period. **Credit providers should be tackling the features in their products that cause ‘debt risk’ and assist their customers where they are struggling to cope with their credit commitments. This would also involve the FCA looking to strengthen responsible lending standards, improve requirements on the structure of minimum payments and tackle practices that give rise to vulnerable people holding multiple products.**

Proactive support for those who have experienced financial difficulties

There is also more that banks and other mainstream lenders could be doing to develop products that with improved product governance features, and are targeted at customers who have rebuilt their finances. These customers will have experienced financial difficulties in the past and are no longer able to access sustainable credit sources to meet their needs.

This group are unique as they have rebuilt their finances but due to impaired credit records can only access higher cost credit, which may cause further difficulties.

We believe major high street banks can go further in supporting these customers. The majority of the group who are using credit as a safety net are employed in a range of professions on incomes of up to £45,000. Many of these people will be working in stable, full time jobs and will hold high street bank accounts, but may have experienced income shocks or got into temporary financial difficulties.

There is an opportunity for banks to provide an important service to their customers by developing "credit restoration" products. Such products would be targeted at customers who have experienced financial difficulties and taken action through a debt solution like a debt management plan. The product could provide them with a small-scale loan or overdraft to enable access to small amounts of money at short notice at reasonable rates of interest. This product could be based on the stricter product governance principles we suggest in order to ensure adequate safeguards against significant financial difficulties for customers. It could provide an alternative to other high cost credit and help them to rebuild their credit rating. There could also be a savings element built into this product so that those who are restoring their credit files are also encouraged to build future financial resilience. We will be doing more research later this year into what this product would look like and who could benefit from this offer.

Expanding the supply of more affordable credit: credit unions and other community lenders

Our client survey and review of the literature also identified that some of those who are using credit as a safety net struggle to access mainstream credit and are having to use high cost credit when they need to borrow. This credit use can be unsustainable where high cost credit commitments are difficult to repay for families on tight budgets already struggling with meeting their essential costs. It is widely recognised that Britain needs to build more affordable credit alternatives for those who are regularly having to turn to high cost credit.

Moreover, if the product governance measures we would like to see in the unsecured credit market, including strengthened affordability assessments are introduced, this could further reduce access to mainstream credit. This is because strengthening affordability assessments, and better analysis of how products perform in customers' hands when circumstances change, could exclude some customers from products they currently have access to, or put interest up to an unappealing level.

Expanding and modernising the community lending sector including credit unions and CDFIs is seen as a key solution to the need to expand access to and supply of affordable credit. The government is investing in community lenders, primarily credit unions, with £38 million for the on-going Credit Union Expansion project (CUEP). We welcome government and major banks' investment in community lenders. Nonetheless, one of the issues raised in the previous chapter was that community lenders are still not widely used by the group who are using credit as a safety net. Initiatives around credit unions and community lending could further expand their reach by building on best practice examples of partnership working with other sectors. Our evidence also suggests community lenders would raise awareness of their services and further meet potential customer needs if they were to harness new technologies and develop a greater online presence.

There is low awareness of community lenders and there can be issues with applying for loans as not all lenders provide the convenient and quick access our survey suggests borrowers want. Some credit unions and CDFIs have tried to address this. For example, the London Mutual Credit Union payday loan can be applied for online and can provide instant loan decisions with same day payment. The evaluation of this credit union payday loan found it was popular with users as it was easy to access, was lower cost and gave the option of longer repayment periods.[39] The CUEP is developing this approach. The Automated Lending Decision tool for credit unions as developed under the CUEP, is a bespoke credit scorecard and uses credit lending data to help members build a credit history. This has been rolled out to 70 credit unions around Britain enabling them to develop more efficient lending policies.

We believe that in order to further meet the preferences of people who are using credit as a safety net, community lenders should continue to build on modernising initiatives and develop their online presence. We welcome the joint government, community lender and private sector initiative to pilot an online portal to refer people to community lenders.[40] There are a range of other measures that the credit union sector is working on to build capacity and raise awareness. These include overcoming legislative and regulatory challenges, up-skilling staff and management, developing sustainable business models and appropriate investment mechanisms.[41] We would encourage the government to continue to work closely with the community lending sector to expanding the supply of more affordable credit sources.

The role of partnership in facilitating and encouraging the use of affordable credit sources

Partnerships with other sectors have gone some way to raising awareness and increasing the use of community lenders. We welcome and support the Church of England's Credit Champions drive to tackle the issue of raising awareness at a community level. Local authorities also have an important role to play in raising awareness and encouraging the use of affordable credit available in their area. A number of local authorities have provided a range of innovative initiatives. For example, Oldham has set up a high street shop to provide household essentials at fair prices and Leeds Council has developed a wide-ranging financial literacy and financial inclusion strategy for the city.[42] [43] There are two further examples below:

Glasgow Developing Credit Unions

Glasgow City Council has provided a programme of developing credit unions in the city since 2001 as the Council has recognised the important role they play in tackling financial exclusion among low income citizens.[44] Glasgow council established a Strategic Development Group for credit unions and a range of support measures including marketing and advertising initiatives with the development of a credit union website. The council has also supported local credit unions in occupying easily accessible shop front premises including using council owned properties. In order to support the development of community lenders, the council introduced 100 % business rate relief for credit unions. The results of these efforts have been significant as Glasgow has the largest credit union membership of all cities in the UK with 25 % of the city's population a member of a credit union.

Sheffield Money

Sheffield Money came out of the Sheffield City Council Fairness Commission. It is an innovative idea involving a council funded broking service working with community lending partners to provide loans and other financial services to local residents.[45] It partners with various local financial services providers including a CDFI, credit union, white goods provider and basic bank account provider to offer a wide range of services. It provides a website, city centre store and a phone application service to offer a range of services and quick access to loans in as little as 15 minutes. Debt advice is embedded in the scheme with a debt advisor available at the store. Sheffield Money is only in its first year of operation so its impact is not known but it is expected to save residents on the lowest incomes £20 million in a year by reducing their reliance on high cost lenders.[46]

There are clearly innovative examples of how local government can play a significant role in expanding and facilitating community lending in their local areas. **We would encourage local authorities to learn from each other, coordinate and develop best practice in working with local community lending partners to encourage the provision and take-up of affordable credit in their communities.**

Banks could also be doing more to partner with community lenders to encourage the use of more affordable credit sources for those unable to access mainstream bank credit products. We acknowledge that many banks cannot and will not lend to some of those in the group on the lowest incomes who are using credit as a safety net as they fall outside their credit risk appetite. However, we do believe there is more banks could be doing in this space. Certain major high street banks have successfully piloted and are rolling out a scheme where customers are signposted from the bank branch to a local credit union.[47] **We support this and would encourage banks to work with community lenders to undertake a broader pilot to expand these referral arrangements between mainstream lenders and credit unions or CDFIs to bring them nationwide and make them "business as usual".** This would raise awareness and use of community lenders and would mean customers who cannot access bank credit are given other options.

Solutions for the most financially vulnerable

The expansion of community lending is welcome but there are still concerns about where the most financially vulnerable can turn to access sustainable credit. As outlined in the previous chapter some of those using credit as a safety net are living on lower and middle incomes and regularly borrow to meet their essential costs. Some of this group are financially excluded and struggle to access any form of standard credit, whether provided by commercial firms or third sector lenders. Others are able to access credit to meet a particular short term need but find the repayments put more pressure on their budget and accelerate a downward spiral into problem debt.

We need a broader conversation on developing credit that is suitable for the needs of the more financially excluded and vulnerable. This needs to be part of a comprehensive preventative strategy to reduce the use of credit as a safety net to provide support for those in financial difficulties and build financial resilience.

Expanding the supply of affordable and sustainable credit for the most financially vulnerable

Some financially excluded families struggle to access any form of commercial credit from mainstream lenders and even from community lenders due to concerns about high risks of default. There needs to be greater affordable and sustainable credit options for them to access. Other financially vulnerable families can access commercial credit but can find this credit is unsustainable and not suited to their needs. We want current product governance to be improved and credit products to be designed to take more account of the financially pressure some of those wanting to borrow are under. The consequence of increasing product governance scrutiny however, will mean that there are may be further limits on who commercial lenders can lend to.

Growing the community lending sector could go some way to address providing more access to sustainable credit for the financially excluded and financially vulnerable. However, this sector alone may struggle to provide access to credit for all those on that need to use credit as a safety net. A low income credit gap has been identified where those excluded from mainstream credit are unable to access lower cost alternatives.[48] Research from the CDFI sector has found evidence of this gap with an estimate that the potential annual demand for community finance for loans to individuals is £3-3.5 billion while credit unions and CDFIs are providing approximately £0.5 billion worth of loans.[49] This leaves a substantial gap of around £3 billion. This suggests a gap between the provision of community lending available and the potential demand for this credit source.

New solutions outside the community lending sector may also be needed for the most financially excluded and the more financially vulnerable. The community lending sector may not be able to fully serve the most financially excluded and financially vulnerable. The credit union sector's aspiration to become more financially self-sufficient and the need to serve financially excluded groups are considered by some as irreconcilable aims.[50] In order to achieve greater financial sustainability, credit unions are seeking to broaden their membership base, and demographic profiling for the CUEP indicated that there was a need to expand the customer base of credit unions to less financially excluded customers to ensure profitability.[51] Of the community lenders, CDFIs are more set up to support financially excluded groups, as they are not subject to the interest rate restrictions that apply to credit unions, giving them the flexibility to price according to risk and cover costs. However, CDFIs are currently limited to just a few geographical areas and have an even smaller reach than credit unions. We suggest that this means the more financially excluded could in some areas still struggle to access credit from community lenders.

We are also concerned that the low income credit gap has increased due to a reduction in social lending. As highlighted in the previous chapter those on the lowest incomes were previously able to turn to the Social Fund for access to social lending in emergencies. However, our evidence suggests what is left of the Social Fund and new local welfare provision is not widely used among those who use credit as a safety net with just 6% in total using this provision. The future of local welfare provision is also unclear as the National Audit Office found many councils were struggling with reduced resources and competing priorities so would not be able to afford to continue offering this support without specific government funding.[52]

The most financially excluded and financially vulnerable are likely to continue to struggle to access credit even with an expanded community lending sector. This is because there is a gap between the community lending provision available and the level of demand among those that need to use credit as a safety net to get by. The decline in the use of government emergency support and loans is likely to have exacerbated this gap. We believe therefore that there should be a government-led effort to tackle the demand for affordable, appropriate and sustainable credit particularly among those more financially excluded groups. In order to meet this need and demand for sustainable credit, **the government should work with banks and other third sector organisations to develop an alternative microloan scheme particularly for the more financially excluded who are less likely to be served by mainstream banks or credit unions.** Other countries have led the way in developing such schemes with Good Shepherd in Australia and Ireland's new 'It Makes Sense' loans illustrated below:

Australia Good Shepherd microfinance

Good Shepherd Microfinance has teamed up with National Australia Bank and the Australian government to provide low income consumers in Australia with access to a no-interest loans scheme (NILS).[53] The programme has provided loans to over 125,000 people who had previously been excluded from mainstream credit. It works through local community organisations and has three high street store locations. Good Shepherd microfinance provides a range of other financial services alongside the no-interest loan scheme including a low interest loan scheme, savings and insurance products.

An evaluation of NILS found that the scheme improves the lives of particularly vulnerable Australians.[54] NILS clients are three times more likely to be severely financially excluded. The loans improve economic and social outcomes as more than a third of clients reported increases in savings levels and financial independence and nearly three quarters experienced positive changes in their standards of living, stress and anxiety levels. The evaluation also found that NILS was able to divert many clients away from high cost credit products like payday loans and goods rental services (known as rent-to-own in the UK).

Ireland's microcredit scheme: It Makes Sense loans

A partnership between the Credit Union Sector, the Irish government's Department of Social Protection, the Citizens Information Board, and not-for-profit groups, has created a pilot microcredit scheme.[55] The aim of the scheme is to reduce dependence on high interest moneylenders.

The scheme was launched in November 2015 and is running out of 30 credit unions across the country. It provides small sum loans (between €100 and €2,000) at low interest rates (maximum interest rate of 12%). It is available to people getting certain social welfare payments and can be repaid through deductions from these social welfare payments. Loans are to be granted within 24 hours of making the application (and becoming a credit union member).

We believe the government should work with banks, community lenders and third sector organisations to pilot a microloan scheme in Britain. Issues to consider would be:

- Funding: The funding for this scheme could come from a combination of the government, the banking industry and a specific levy on particular sectors. The government could underwrite these loans in the manner of student loans.
- Provider: it could be provided via third sector providers or through community lenders. Local authorities and major high street banks could play a role in signposting and encouraging use of these types of loans.
- What would the scheme look like: an accessible online platform would need to be developed and face-to-face lending could also be explored.
- Savings and debt advice: Both a way of encouraging savings and a debt advice element should be embedded into the scheme.

Improving alternative safety nets to credit and building financial resilience

For those who turn to credit in a crisis, more borrowing may not be suitable for those that are already in financial difficulties. There is also a need to provide support for those already in financial difficulties and to build financial resilience in order to reduce the numbers of people who regularly have to use credit as safety net.

For those in severe problem debt, more borrowing is not the answer. An alternative safety net would be to ensure free debt advice is available for those who need it. Accessing free debt advice can be critical in helping strugglers to get their finances back on track. Debt advice can make a real difference in helping people pay down their debt and improve their emotional well-being.[56] However, our previous research found there are currently 2.6 million people in severe problem debt and according to the Money Advice Service only 1.7 million are currently accessing debt advice.[57] **The government should seek to address this by promoting and**

raising additional funding for more free debt advice. Free debt advice is best financed by a mixture of statutory funding (through the FCA levy) and voluntary giving (from a range of different sources including creditors). Increased voluntary funding is also possible and desirable, as long as debt advice agencies demonstrate efficiency and effectiveness. [58]Extra funding could also be found via raising levy rates or creating new levies. But new levies take time to design and implement, and can have unintended consequences. In particular they could reduce voluntary donations.

More also needs to be done to encourage people in financial difficulties to seek free debt advice rather than turn to taking out more credit in a crisis. In order to do this **we have been calling for people in England and Wales to have a statutory 'breathing space' protection.** This would mean that when people seek debt advice their interest, charges and enforcement on their debts are stopped while they sort out their finances. This type of scheme already exists in Scotland, with people in other parts of Britain only getting this protection if they take the significant step of insolvency. The government is reviewing and going to consult on the need for such a scheme in England and Wales. We believe this protection would create a real incentive for people in temporary financial difficulties to get free debt advice. It would also encourage people to get advice earlier, rather than waiting over a year as around half of StepChange Debt Charity clients currently do. This would go some way to encouraging more people to seek debt advice before short-term difficulty becomes a crisis rather than turning to credit that could exacerbate their problems.

More preventative measures are also needed to reduce the use of the credit safety net, and to building financial resilience. One such measure would be helping lower and middle income families build up rainy day savings. Previous StepChange Debt Charity research found that nearly 22 million adults in Great Britain are not confident they are saving enough to cope with a rainy day.[59] We have proposed **credible low-cost measures to boost personal savings involving helping low to moderate income families build up a £1,000 reserve of savings through adapting the arrangements for pensions auto-enrolment, and by building better incentives for saving into the welfare system**.[60] We found that if every household in Great Britain had at least £1,000 saved it would reduce the number in problem debt by 500,000.[61] If greater numbers of families had savings to tide them over when they faced an income shock then less would need to turn to credit sources that could get them into further financial difficulty.

Therefore, reducing the 'debt risk' in the current credit market and expanding affordable credit supply is not enough alone and there are other approaches needed to offer alternatives to the credit safety net. These include ensuring the provision of adequate free debt advice and increasing financial resilience among lower and middle income families by building up their rainy day savings. Only a broad ranging strategy will help to break the link between life's inevitable ups and downs and devastating, chronic problem debt.

Policy recommendations

In order to reduce the 'debt risk' of credit products that are used by financially vulnerable people as a safety net:

1. **The Financial Conduct Authority should review how standards of product governance are working to meet the needs of financially vulnerable borrowers and prevent detriment. Improved product governance would mean greater regulatory scrutiny to ensure that products perform properly for the full range of customers they are sold to under a realistic range of conditions and changing customer circumstances.**
2. **Credit providers should tackle the features in their products that cause 'debt risk' and assist their customers where they are struggling to cope with their credit commitments. This includes ensuring that credit products have clear, fair and transparent fees and charges, and that early forbearance becomes standard. This would also involve the FCA looking to strengthen responsible lending standards, improve requirements on the structure of minimum payments and tackle practices that give rise to vulnerable people holding multiple products.**
3. **Our high street banks have an excellent opportunity to support an important section of their customers by developing a credit restoration product. This could be targeted at customers who have experienced financial difficulties but have recovered control of their finances. It could provide a small-scale loan or overdraft with an emphasis on supporting recovery and helping people to rebuild their credit file.**

In order to expand the supply of affordable credit:

4. **There should be further development of partnerships between community lenders and other sectors. For example, local authorities should coordinate and share best practice in working with local community lenders. High street banks and other lenders should work with community lenders to pilot scalable referral arrangements between mainstream lenders and local community lenders.**
5. **To help meet the need for affordable credit among the more financially excluded and financially vulnerable, the government should pilot a microloan scheme for Britain. This could use the Australian and Irish schemes as models of how to provide no or low interest loans to financially vulnerable households. Giving these families access to sustainable credit as a safety net.**

To bolster alternative safety nets to credit and build financial resilience:

6. **Low income families should be helped to build up a £1,000 reserve of savings through adapting the arrangements for pensions auto-enrolment, and by building better incentives for saving into the welfare system.**
7. **Government should promote and raise additional funding for more free debt advice. We also call on the government to reduce demand for debt advice by consulting on a comprehensive 'breathing space' protection scheme to provide a strong incentive for people to get free debt advice.**

References

StepChange Debt Charity

[1] Accessible: www.telegraph.co.uk/finance/personalfinance/borrowing/12081111/Consumer-borrowing-rises-at-fastest-rate-since-before-the-financial-crisis.html

[2] StepChange Debt Charity (2014), *The £8.3bn challenge: the social cost of problem debt in the UK*

[3] StepChange Debt Charity (2015) *Navigating the new normal: Why working families fall into problem debt and how we need to respond*

[4] Ibid

[5] Ibid

[6] StepChange Debt Charity (2015) *Becoming a nation of savers: Keeping families out of debt by helping them prepare for a rainy day*

[7] Kempson, E and Collard, S (2012) *Developing a vision for financial inclusion* London: Friends Provident Foundation

[8] StepChange Debt Charity commissioned an online survey from YouGov PLC. Total sample size is 3,348 adults. Fieldwork was undertaken between 1st - 5th October 2015. The figures have been weighted and are representative of all GB adults (aged 18+). Estimates of the number of adults affected have been calculated by StepChange Debt Charity. These estimates are based on 2013 population estimates from the Office of National Statistics which indicate that there are 49,478,070 adults in Great Britain

[9] StepChange Debt Charity (2015) *Navigating the New Normal: Why working families fall into problem debt and how we need to respond*

[10] The social grade classifications based on occupation are from the National Readership Survey. The grades are A: higher managerial, administrative and professional, B: intermediate managerial, administrative and professional, C1: supervisory, clerical and junior managerial, administrative and professional, C2: Skilled manual workers, D: Semi-skilled and unskilled manual workers, E: State pensioners, casual and lowest grade workers, unemployed with state benefits only.

[11] Ellison, A., Whyley, C., Forster, R. and Jones P.A. (2011) *Credit and low-income consumers: A demand-side perspective on the issues for consumer protection*, Dorking: Friends Provident Foundation,

[12] GfK NOP (2015) *Personal current account investigation: A report for the Competition and Markets Authority*

[13] The FCA investigation into payday lending found that there were around 1.6 million customers in 2013 which is approximately 3% of the 49,478,070 adults in Great Britain in 2013 (based on population estimates from the Office of National Statistics)

[14] Office of Fair Trading (OFT) (2010) *Annexe C: Supplementary analysis from the OFT's consumer survey and other sources of data,* page 14

[15] All the clients in the survey had used payday loans and/or home credit as well as a range of other types of credit

[16] Although all overdrafts are debts, problem overdraft debt includes where people are regularly going over their limits and having to use unauthorised overdrafts. It also includes where people have to stay in their overdrafts for a long period of time and finding it difficult to get out of their overdraft so are paying interest over a long period.

[17] Financial Conduct Authority (FCA) (2015) *Credit card market study: interim report*

[18] Competition and Markets Authority (2015) *Retail banking market investigation: provisional findings report* Appendix 7.5

[19] Jigsaw Research (2014) *Consumer Credit: Deep dives into Credit cards and Unauthorised overdrafts* FCA: London

[20] Accessible: press.which.co.uk/whichpressreleases/consumers-frustrated-by-unauthorised-overdraft-fees/

[21] Accessible: www.telegraph.co.uk/finance/newsbysector/banksandfinance/9663656/Almost-40pc-of-payday-loans-used-to-buy-food.html

[22] OFT (2013) *Payday Lending Compliance Review: Final Report*
[23] Accessible: www.telegraph.co.uk/finance/newsbysector/banksandfinance/9663656/Almost-40pc-of-payday-loans-used-to-buy-food.html
[24] The Carnegie UK Trust (2015) *Meeting the need for affordable credit*
[25] Financial Inclusion Commission (2015) *Improving the financial health of the nation*
[26] Collard, S and Kempson, E. (2005) *Affordable credit: The way forward* Bristol: Joseph Rowntree Foundation
[27] Ibid
[28] Jigsaw Research (2014) *Consumer Credit: Deep dives into Credit cards and Unauthorised overdrafts* FCA: London
[29] Accessible: www.gov.uk/government/news/credit-union-38-million-expansion-deal-signed
[30] Bank of England, 2014. Credit union annual statistics.
[31] In Ireland, over 70% of the population belong to a credit union. In America and Canada the figure is around 43%: Accessible: www.abcul.org/credit-unions/history-world-facts
[32] StepChange Debt Charity (2015), *An Action Plan on Problem Debt*
[33] Department for Work and Pensions (2011) *Feasibility Study Credit Union Expansion Project Report*
[34] Consumer Futures (2010) *Keeping the Plates Spinning: Perceptions of payday loans in Great Britain,* ESRO/Financial Conduct Authority (2014) *Consumer Credit Research: Payday Loans, Logbook Loans and Debt Management Services*
[35] FCA (2014) *Consumer credit and consumers in vulnerable circumstances*
[36] Ellison, A. et al (2011) *Credit and low-income consumers: A demand-side perspective on the issues for consumer protection* Dorking: Friends Provident Foundation
[37] Which? (2013) *Credit Britain: Making lending work for consumers*
[38] Financial Conduct Authority (FCA) (2015) *Credit card market study: interim report*
[39] Ibid
[40] Centre for Responsible Credit (2016) *Using insight and innovation to benefit low income households: A UK/US knowledge exchange*
[41] ABCUL (2014) What Credit Unions Need
[42] Accessible: www.coopinnovation.co.uk/case-studies/oldham-providing-fair-finance-through-a-shop/
[43] Accessible: www.local.gov.uk/health/-/journal_content/56/10180/3510646/ARTICLE
[44] LGiU (2015) *Financial Exclusion and Credit Unions: recent developments*
[45] Accessible: https://sheffieldmoney.co.uk/
[46] Accessible: www.theguardian.com/money/2015/aug/08/sheffield-money-payday-loans-rates-poverty
[47] Accessible: www.lloydsbankinggroup.com/our-group/responsible-business/our-community-programmes/supporting-credit-unions/
[48] Financial Inclusion Commission (2015) *Improving the financial health of the nation*
[49] Henry, N. and Craig, P., 2013. *Mind the Finance Gap: Evidencing demand for community finance*, London: CDFA/RBS.
[50] McKillop, D, Ward, A M & Wilson, J O (2011) *Credit unions in Great Britain: recent trends and current prospects. Public Money & Management,* 31(1), 35-42.
[51] Department for Work and Pensions (2011) *Feasibility Study Credit Union Expansion Project Report*
[52] Accessible: www.nao.org.uk/press-releases/local-welfare-provision/
[53] http://goodshepherdmicrofinance.org.au/
[54] Good Shepherd Microfinance (2014) *Life Changing Loans at No Interest*
[55] Accessible: www.citizensinformation.ie/en/money_and_tax/personal_finance/loans_and_credit/microcredit_loans.html
[56] Money Advice Service (2012) *The effectiveness of debt advice in the UK*.
[57] Money Advice Service (2015) *Financial Capability Strategy for the UK*
[58] StepChange Debt Charity (2015) *Financial Advice Market Review Response,* accessible: www.stepchange.org/Mediacentre/Researchandreports/FinancialAdviceMarketReviewresponse.aspx
[59] StepChange Debt Charity (2015) *Becoming a Nation of Savers*
[60] Ibid
[61] Ibid

Report written by Laura Rodrigues, Senior Public Policy Advocate

StepChange Debt Charity London Office
6th floor, Lynton House

7- 12 Tavistock Square
London WC1H 9LT
Email: policy@stepchange.org
Web: www.stepchange.org
Twitter: @stepchange

For help and advice with problem debts call
0800 138 1111 Monday to Friday 8am to 8pm
and Saturday 8am to 4pm
Or for online debt advice visit www.stepchange.org