

## Credit and low-income consumers: A demand-side perspective on the issues for consumer protection

**Policy makers are currently exploring options for a new regulatory and consumer protection regime for the credit industry. This study explores the benefits, risks and detriments associated with credit use by low-income consumers, who are among the most vulnerable credit users, to provide a robust evidence base to feed into current policy and regulatory thinking.**

### Key findings

Credit use is widespread among those on low incomes, and for many is the only way to make ends meet. Overdrafts and credit cards have become the leading sources of credit for those on low incomes. Non-standard credit is an important source of credit for those on low incomes, however. Many of those using mainstream products also use non-standard products while a minority of non-standard credit users have no other options.

Non-standard credit, used primarily by low-income borrowers, has a high annual percentage rate (APR) and is high-cost. Low-income borrowers coping with competing pressures on very tight budgets can, however, find it difficult to avoid patterns of behaviour which will increase the cost of using low APR mainstream credit. Over-limit fees, charges for unmet direct debits, penalty charges and extended minimum payments on credit cards increase the cost of mainstream credit for a significant minority of low-income credit users. As a result, low-income borrowers can face similar costs for credit whether they choose mainstream or non-standard products. Mainstream credit, however, appears associated with higher levels of indebtedness and a greater incidence of debt that is difficult to pay off.

The better off among those on low incomes benefit from mainstream credit, achieving a low cost of credit while not incurring unmanageable debt. Those on the lowest incomes tend to incur high behaviour-driven costs on mainstream credit and can struggle to avoid unmanageable debt that they cannot pay off. Some low-income borrowers focus, primarily by choice, on high-cost products, such as catalogue club books and home credit, and manage effectively with these products.

Social lending, despite its many successes, will not be in a position to provide a sufficient alternative to private sector high cost lending for the foreseeable future, both because the sector as yet lacks the capacity to meet demand on that scale and because small-scale, small-sum lending requires subsidy within a low-cost model.

### Key recommendations

- Thinking on consumer protection in credit markets would benefit from a more holistic, multi-dimensional and cross-market approach that avoids a single product sector focus and thinks in terms of the interplay between products and the way that the consumer uses them. Regulation needs to address risks attached to products and their pricing structures and product features right across the market.
- A policy focus on the price of credit as the primary cause of problems amongst low-income credit users is misconceived. A more nuanced understanding of the balance between the cost of credit and the various risks to consumers' financial well-being and security is required.
- Regulation would best protect low-income consumers by ensuring their ability to choose between high and low APR products that suit their circumstances and the risks they face.
- Interventions that seek to control the price of credit will not necessarily result in either lower-cost credit or more favourable outcomes for low-income consumers.

### What's inside

- Policy context
- About the study
- Demand for credit
- Use of credit by low-income consumers
- The cost of credit
- The role of different types of credit in creating indebtedness
- Outcomes of low-income credit use
- Social lending as an alternative to high-cost credit
- Key recommendations

## Policy context

The global financial crisis has led to a series of comprehensive reviews of the issues around credit market regulation, both in the UK and globally. The Coalition Government has brought fresh impetus to policy making in this area with a number of reviews and consultations and the proposed creation of a new Financial Conduct Authority. The UK is thus at a pivotal point in the development of a new consumer protection and credit market regulatory regime.

Low-income households, being those most vulnerable to problem debt and to difficulties in managing credit, have been a key focus of regulator concerns.

## About the study

This study was carried out by Anna Ellison, Rob Forster and Claire Whyley for Policis, and Paul A. Jones of Liverpool John Moores University. It aims to bring a consumer perspective and an understanding of the dynamics of the types of credit people want and need to the public and regulatory debate. It seeks to provide a robust evidence base about how people on low incomes use credit, why they choose the credit they use and the problems they face with the credit available to them.

## Demand for credit

The study found that credit is widespread among people on a low income; for many it is the only way to manage on an income that is often inadequate to meet their needs – 69 per cent of low-income households and 10.55 million low-income individuals are credit users.<sup>1</sup>

Credit use is driven by a lack of savings safety nets, and competing pressures on budgets that are too tight to accommodate peaks of expenditure, unanticipated events or the purchase of expensive essentials. Sixty-eight per cent of low-income households have no savings, and seven in ten would find it difficult or impossible to raise £200–£300 in an emergency.

It is clear that credit meets a pressing need, but it is equally clear that the benefits and risks of credit are finely balanced. Credit use adds to the stress on household budgets and increases the risk of financial distress.

## Use of credit by low-income consumers

The major trend in credit use among those on low incomes in recent years has been the expansion of access to mainstream overdrafts and credit cards, now the leading sources of credit for those on low incomes. Overdrafts are used by 3.3 million low-income consumers, with a further 1 million inadvertently becoming overdrawn in the course of their banking. Credit cards are used by 3.1 million low-income individuals. This compares with 2.4 million home credit users and 1.3 million payday loan users.

There is a high degree of crossover between mainstream and non-standard lending. Fifty-eight per cent of low-income individuals who use non-standard

lending also use mainstream credit. Nonetheless, a significant minority of non-standard lending users are highly constrained in their credit options, with around a quarter of both home credit and payday loan users having no other credit options.

For many of those on low incomes, managing competing pressures on a tight budget and without a savings safety net is a constant of life, reflected, for a significant minority, in late and missed payments on bills and direct debits, including credit repayments, which can be difficult to avoid. Almost a third of those on low incomes are in arrears on household bills. Against this background, slightly fewer than one in five low-income credit users have missed payments on mainstream personal loans, as have three in ten low-income credit card users, rising to four in ten of those using revolving credit on credit cards.

## The cost of credit

The expansion of mainstream credit has meant that behaviour-driven costs associated with over-limit fees, bounced direct debits and penalty charges increasingly shape the actual cost of credit for many of those on low incomes. Two-thirds (67 per cent) of low-income credit users, some 6.7 million individuals, pay behaviour-driven costs on their mainstream credit use. On an annualised basis 3.6 million, or 44 per cent of the 8.2 million low-income borrowers, incur behaviour-driven costs. These account for a total of £630 million per annum and an average per head of £174 per annum.

Under uneven payment conditions or where minimum payments are made for an extended period on credit cards, the cost of credit associated with products with a low APR can approach, or even exceed, that of products with a high APR.

The actual cost to the consumer of an overdraft is a little over £10 per £100 if no over-limit fees are incurred (a scenario that applies to a little over four in ten, or 42 per cent of, low-income overdraft users), but can rise to £57 per £100 if seven over-limit fees per year are incurred (a scenario that applies to a little over one in five, or 21 per cent of, low-income overdraft users, some 0.9 million individuals).

Similarly, with credit cards, if a borrower makes minimum payments over an 18 month period, a little under the average length of time for those on low incomes claiming to have made minimum payments for an extended period without missing payments (a scenario that applies to 12 per cent of low-income credit card users and 19 per cent of the 65 per cent of low-income card users who only make the minimum or partial payments each month), the cost of credit increases to an average of £44 per £100. If minimum payments are extended for three years, with no payments missed (a scenario applying to 6 per cent of low-income card revolvers, defined as those who do not pay their outstanding credit card balance in full at the end of each month), the actual cost of credit to the consumer

<sup>1</sup> Low income is defined for the purposes of this study as those falling into the bottom 50 per cent of household incomes.

rises to £78 per £100. If the average number of missed payments for those making minimum payments is combined with making minimum payments over three years (a scenario also applying to 6 per cent of low-income card revolvers), the cost of credit to the consumer rises to £116 per £100. This compares to a cost of £15 per £100 and £25 per £100 for a store-based and online payday loan respectively, for the 71 per cent of payday borrowers who repay their loan to the contract term, and an average cost of £51 per £100 for the 29 per cent of payday borrowers who refinance their loans, an average of 2.1 times.

The cost of home credit borrowing will vary with the contract term. A home credit loan repaid over 50 weeks will cost £75 per £100 borrowed, regardless of whether payments are missed. Where the loan is refinanced, as is the case with 13 per cent of home credit loans, the average cost of the average value refinanced loan repaid over the average extension of 85 weeks rises to £90 per £100 borrowed. By contrast, DWP Growth Fund supported lending from credit unions costs the consumer circa £13 per £100, but with an effective subsidy of £17 per £100 borrowed on the average loan.<sup>2</sup>

Problems arise not only from high costs, but also from the risk of escalating and entrenched debt that cannot be paid off. A significant minority of individuals using some mainstream products can pay a high cost for their credit while not being able to reduce their debt. Two-thirds of low-income cardholders are revolvers, with 26 per cent habitually making minimum payments over an average of 19 months. One in five (21 per cent) low-income cardholders and three in ten (31 per cent) revolvers have drawn out cash on their credit cards. Two-thirds (67 per cent) of those who have made minimum payments for an extended period have missed a payment while 19 per cent have at some point been three months behind on their cards. This not only increases the cost to the consumer, but also increases the risk of default, particularly where payments are being made to finance the cost of credit obtained historically which no longer has any benefit for the borrower.

## The role of different types of credit in creating indebtedness

Mainstream borrowing appears to result in higher overall indebtedness and, in the case of revolving credit particularly, can, for some low-income credit users, lead to debt that is very difficult to pay off. Non-standard lending products are very high-cost but they tend to be small-scale and are repaid over a relatively short term. For those with both mainstream and non-standard debt, non-standard debt tends to be a small part of overall indebtedness.

The average mainstream borrowing for low-income credit users is £3,350, ranging from £2,850 for non-standard credit users to £3,750 for mainstream credit users. Average mainstream borrowing for low-income

credit card users is £4,050, rising to £4,950 for those taking cash advances.

A quarter of home credit users have mainstream credit. For those who do not have mainstream borrowing, total indebtedness is a little short of £1,000, of which home credit debt represents 60 per cent. Of home credit users that do have mainstream borrowing, indebtedness is over 1.8 times the average for all low-income credit users, at £6,150. Home credit debt is only 7 per cent of total debt for these borrowers.

Payday borrowers tend to have high levels of mainstream credit use and often have a history of problematic mainstream borrowing. Eighty-six per cent of payday users have a credit card, with 34 per cent having made minimum payments for an extended period and 31 per cent having 'maxed out' their card (i.e. they are at or over their credit limit). Eighty-one per cent have a mainstream loan or credit agreement. Average mainstream borrowing is £6,450 per head.

## Outcomes of low-income credit use

The outcome of credit use, and of use of different types of credit product, differs significantly between segments of more or less affluent and more or less pressured consumers. Some low-income consumers benefit from the use of mainstream credit, but for others mainstream credit can be both high-cost and high-risk. Some large and better off segments benefit from mainstream credit use, achieving a lower cost of credit while not incurring unmanageable debt. These borrowers represent 5.1 million individuals, a little over half of low-income credit users. Others, however, largely those on the lowest incomes, incur high behaviour-driven costs and can struggle to avoid debt that they cannot afford to pay off. They often turn to high-cost lending in the wake of problems with mainstream credit. These segments account for circa 3 million borrowers and a little under a third of low-income credit users.

Yet other segments of credit users focus primarily on high-cost products, such as catalogue club books and home credit, and manage effectively with these products, accounting for circa 1.9 million overall, a little under a fifth of low-income credit users.

## The potential for social lending to act as an alternative to high-cost credit

Despite the success of the Growth Fund scheme, which extended subsidised loans to the financially excluded, the scale of such lending has been small relative both to wider credit union lending and to the high-cost sector and has required significant subsidy. While the sector is poised for further modernisation and to build scale, social lending, despite its advances and successes, will not reach a position in the foreseeable future to act as a sufficient alternative to either high-cost credit or those using mainstream credit and incurring high levels of behaviour-driven costs.

<sup>2</sup> The DWP Growth Fund, which ran from July 2006–March 2011, was intended to support credit unions both to grow their operations and extend subsidised small-scale affordable credit to low-income financially excluded borrowers.

## Key recommendations

It is critical that the new regulatory and consumer protection regime is shaped by empirical evidence and an in-depth understanding of the reality of consumer dynamics, particularly for low-income credit users.

- Thinking on consumer protection in credit markets would benefit from a more holistic, multi-dimensional and cross-market approach.
- A policy focus on price as the primary driver of detriment is misconceived. A more nuanced understanding of the interplay of cost and risk is required.
- Regulation needs to be sufficiently sensitive and flexible to address risks attached to products right across the market, including behaviour-driven costs and APRs, without stifling individuals' access to credit, or market innovation.
- A market that features a multiplicity of high and low APR products allows low-income consumers to choose the product that best suits their circumstances and the risks that they face.
- Interventions that seek to control the price of credit will not necessarily result in either lower-cost credit or more favourable outcomes for low-income consumers. There is the potential also for considerable unintended effects, which may include constraints on access to credit, the potential to increase unmanageable debt and the expansion of illegal lending.

---

## Further information

This summary and the full report, *Credit and Low-income Consumers: A demand-side perspective on the issues for consumer protection* by Anna Ellison, Claire Whyley, Rob Forster and Paul A. Jones, are available in print and as a pdf from Friends Provident Foundation ([foundation.enquiries@friendsprovident.co.uk](mailto:foundation.enquiries@friendsprovident.co.uk) and [www.friendsprovidentfoundation.org](http://www.friendsprovidentfoundation.org)).

Published by Friends Provident Foundation, an independent grant-making charity. The views expressed in this summary are those of the authors, and not necessarily those of the Foundation.