Think Ahead

Britain's debt, how much is too much?

Policies to encourage savers and support the over-indebted

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This report examines household financial resilience, its links with income, credit use and over-indebtedness. The report looks at these issues in relation to three identified at risk groups; the self-employed, those on variable incomes and students. Against these groups the report makes policy recommendations to help encourage saving and reduce personal unsecured debt. The report then looks at innovations which are taking place specifically in the 'fin tech' sector which offer huge potential.

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Executive summary

The reported significant increase of consumer credit and debt since the financial crisis has been mirrored by a growing amount of evidence indicating a massive over-indebtedness by vulnerable groups in UK society.

The reported significant increase of consumer credit and debt since the financial crisis has been mirrored by a growing amount of evidence indicating a massive over-indebtedness by vulnerable groups in UK society. In looking at both the issue of debt and savings, this report focuses on three such vulnerable groups:

- self-employed workers, who are often subject to earnings that can vary considerably over time, and whose business and personal finances can overlap, causing money-management difficulties
- a significant proportion of employees earning wages that are low and vary from month to month (eg those employees subject to 'zero-hours contracts')
- those participating in higher education funded by personal borrowing.

There is also evidence of financial resilience and its links with income, credit use and over-indebtedness. Strategically, however, it is important to recognise that in relation to these vulnerable groups there are varying 'states' of financial hardship and well-being. This report identifies four categories that act as a framework and a roadmap for analysis and some proposed interventions, which are then developed into 'recommendations'. These consumer categories include those:

- who are in a 'negative' position, vulnerable and exposed to shocks/detriment
- who are back to a 'neutral' position – still vulnerable but with a platform to build on
- who have the ability to withstand financial shocks/meet short-term financial needs, and
- who have sufficient means to meet medium to long-term financial needs.

Despite the benefits of savings for the identified vulnerable groups, many find it difficult to save. The report examines a number of possible solutions. One of the more inspired of these is proposed by StepChange, which focuses on those in employment. The proposal is an addition to the auto-enrolment system for pensions.

The evidence to date from the payday lending market, which represented a significant proportion of the HCSTC market, is that the FCA's intervention has been profound in effectively restricting the more severe levels of debt and interest payments.

The scheme focuses on persuading employees to allocate a percentage of their pension to a savings product. Once the savings have reached a certain sum, this is then matched by a percentage of the employer's contribution, which also attracts tax relief. Savings can then be accessed to meet the employee's requirements.

Recommendation 1:
Advocate StepChange's recommendation that the existing auto-enrolment system for pension savings be extended to include a savings element.
The regular payment of debt mirrors savings-type behaviour. Therefore on maturity of a loan the payments should be diverted into a savings product. Schemes encouraging this behaviour would also need to be adopted; for example, tax incentives.

Recommendation 2:
Use the end of debt repayment to convert borrowers into savers.
Evidence indicates that many self-employed people are hampered by variation in their incomes from week to week, which results in difficulty in budgeting and setting aside appropriate sums for savings. Others groups, such as students, similarly experience problems managing money and are unable to save. Some promising savings and budgeting solutions are being developed using financial technology (fintech), such as mobile phone apps. A number of examples are provided in the report. The introduction of the Application Program Interface (API), due in 2017, is a major initiative that will support the financial management of these vulnerable groups.

Recommendation 3:
Although the standardised API will not be in place for another year, the government should work closely with banks and technology companies to ensure that advanced savings and budgeting functionality can be made available to the identified 'at risk' groups as soon as possible.
Students in higher education have two major challenges in managing their finances. The first challenge is the funding of courses and their living expenses during the period of study and, secondly, the challenge of managing the repayment of the tuition fees and maintenance grants after their studies.

One way of addressing the first challenge is to introduce monthly maintenance payments instead of paying one-third of the annual amount at the beginning of each term. This would help students in managing their finances over time. This already happens in Scotland.

Another initiative, which should do much to alleviate students' financial management difficulties during and after higher education, is the introduction of a savings account with incentives. Under-18-year-olds should be offered a matched savings account based on an ISA incentive, whereby when the account holder saves, say, £1,000 the government would match this amount once the young person enters further or higher education.

Recommendation 4:
Move to monthly maintenance payments for students in England and Wales in line with Scotland's system, or work to improve functionality in student current accounts to facilitate easy monthly budgeting.

Recommendation 5:
Matched savings for students in the form of means-tested a 'Save to Study' ISA.
Turning attention to the credit market, without adequate savings people need to use credit to smooth their income and meet unforeseen expenses. In practice, there is evidence that the credit market does not meet the needs of a large proportion of society. Those on low incomes or with impaired or limited credit histories form what is called the 'non-standard' credit market, accessing a broad array of products ranging from high-cost credit cards to Home Collected Credit. The identified 'at risk' groups form a significant proportion of this non-standard market.

The Financial Conduct Authority (FCA) has played an important role, by introducing a cap on the Total Cost of Credit (TCC) in the High-Cost Short-Term Credit Market (HCSTC) in January 2015. The evidence to date from the payday lending market, which represented a significant proportion of the HCSTC market, is that the FCA's intervention has been profound in effectively restricting the more severe levels of debt and interest payments. Although the new regulatory approach has been encouraging, it is too early to judge its ultimate success.

The increasing use of credit cards and the debt levels of vulnerable groups are of great concern.

Recommendation 6:
The FCA continues to monitor developments in the HCSTC market, especially after lenders receive full authorisation.
The increasing use of credit cards and the debt levels of vulnerable groups are of great concern. When credit cards are used in a disciplined way then clearly they represent an excellent tool for managing variable income and needs. Unfortunately, the recent FCA Credit Card Study (FCA 2015b) highlights a rather worrying state of affairs among vulnerable borrowers. The study indicates that 60% of the cardholders pay off their balances each month. The other 40%, of card holders who account for 60% of the total balance (£34bn), pay interest. When this latter group's borrowing behaviour is broken down a disturbing picture emerges:

- 2m cardholders were in arrears or default
- 1.5m have missed three or more months' repayments and are either in or have been in arrears
- a further 2m cardholders have persistent high levels of credit card debt that they may be struggling to pay
- 1.6m make systematic minimum payments
- 5.1m cardholders on current repayment patterns and assuming no further borrowings will take more than 10 years to pay off their balances.

Mapping this detriment on to the financial resilience roadmap shows that interventions are needed at three points to support credit card borrowers:

- debt advice and financial capability interventions to help those borrowers already in trouble
- targeted interventions to help those at risk to avoid getting into problematic debt and to build financial resilience, and
- the development of affordable, better-value credit options for those who are incurring very high borrowing.

Recommendation 7.1:
The FCA should have particular regard for the potential for consumer detriment in the high-cost credit card market, as highlighted in its recent interim report on the whole credit card market. In particular, there should be a clearer duty on lenders to intervene to help borrowers with persistent debt problems.

Recommendation 7.2:
The FCA should tighten up its rules to ensure that lenders verify borrowers' incomes and conduct frequent affordability assessments and client reviews to ensure that borrowers with persistent debt problems are identified early.

Recommendation 7.3:
The evidence gathered as part of the FCA's credit card study suggests that much more could be done to improve lenders' models for assessing affordability and borrowers' ability to repay. Arguably, lenders have insufficient incentive, given the economics of the higher-risk segment of the credit card market, to improve the predictability of credit models. Therefore, the FCA should coordinate further analysis of lenders' credit analysis models to promote innovation and competition.

Recommendation 7.4:
The FCA should use behavioural finance insights to (1) identify and prevent lenders' marketing, promotional and business practices that exploit consumers and (2) identify and promote effective interventions that encourage positive borrowing patterns, such as paying off more than the minimum payment each month.

Recommendation 7.5:
Four firms account for the majority of outstanding balances in the higher risk segment of the credit card market. The FCA should pay special attention to these and ensure that all lenders are supporting consumers.

The undisputed evidence of the ever-increasing over-indebtedness and aversion to saving in the UK requires immediate attention.

Socially responsible credit providers, eg credit unions and Community Development Finance Institutions (CDFIs), provide an alternative to the commercial credit markets. Considerable resources have been invested in this sector, which has seen impressive growth in recent years. For example, activity in the credit union sector is at an all-time high with 1.2m people using this source of finance from 362 credit unions. A number of barriers constrain growth (eg the nature of regulation) and currently the regulators are looking at ways to lower these barriers.

There are two innovations that can arguably increase the supply of capital to community lenders – social lending bonds (SLBs) and ethical lending markets. SLBs are aimed at social investors (such as philanthropists, ethical investors and pension funds) and are structured to provide investors with a reasonable financial return and allow them to make a social impact with their investments. The investments would be structured portfolios of government low-risk investments and more risky corporate bonds.

Recommendation 8:
Develop a market for social lending bonds.
Provision of financial services through smartphone applications has grown enormously in recent years and forecasts indicate that the rate of growth of innovation and use will continue. This development has given the opportunity to introduce an ethical lending market. A lending market is an online platform that connects lenders and borrowers. Such markets already exist, eg Zopa. These initiatives in the commercial market can be mirrored by community lenders, with the government's support, establishing a lending market that puts responsible lending and borrowers' needs ahead of profitability.

Recommendation 9:
Government should work with existing commercial marketplace lenders, credit unions and CDFIs to develop an ethical lending marketplace.

Savings are on a downward trajectory, and the numbers of both the self-employed and students are rising. The above recommendations are aimed at ensuring current groups at risk are helped, but also seek to curb debt demand through encouraging saving. The recommendations will lead to productivity gains, both now and in the future, helping to push up real wages, which will in turn reduce the demand for welfare. Ultimately, these recommendations support the government's aim of creating a budget surplus by 2020.

The undisputed evidence of the ever-increasing over-indebtedness and aversion to saving in the UK requires immediate attention. The methods of encouraging savings and other recommendations proposed in this report will make a substantive contribution to addressing the hardships of many in UK society.

Contents

1. Introduction

Financial resilience, in the forms of adequate savings, insurance and access to responsible credit, provides a buffer against unexpected expense and loss of income.

Financial resilience, in the forms of adequate savings, insurance and access to responsible credit, provides a buffer against unexpected expense and loss of income. Without adequate financial resilience, households are vulnerable; an unexpected expense or loss of income can easily turn into unplanned borrowing and potentially lead to so-called 'problem' debt, i.e. debt that carries a high cost of repayment and can be unaffordable in the short or longer term.

Existing levels of financial resilience in the UK are worryingly low with many households having low or no savings to fall back on (see Table A1). Furthermore, society is changing in ways that can make it harder for people to build and maintain financial resilience. For example, changes in the labour market have resulted in increasing numbers of workers being 'self-employed'[1] where earnings can be variable and there are often overlaps between business and personal finances,[2] which may make good money management difficult. Similar problems are experienced by a significant proportion of employees who earn wages that are low and vary from month to month (eg those on zero-hours contracts).[3] Additionally, increasing participation in higher education funded by personal borrowing brings with it new challenges to building financial resilience in both the short and long term.

These changing economic factors have implications for economic growth because of the link between financial resilience and productivity. Financial insecurity reduces workers' productivity. Research conducted on behalf of Barclays estimates the cost to employers of employees' personal financial problems at 4% of payroll, with 20% of employees admitting that their personal financial problems interfered with their work (Thomas 2014). Fintech start-up Squirrel estimates that 40% of all staff turnover can be attributed to financial distress and that absenteeism due to financial distress costs UK businesses 5% of their bottom line (Squirrel 2014). Research commissioned by StepChange estimates the social cost of problem debt at £8.3bn per year with £2.3bn of this cost due to job loss or lost productivity (StepChange 2014).

Low UK productivity is hindering economic growth. The Bank of England estimates that average annual productivity growth has been around zero since 2007 and that the economy is approximately 15% smaller than it would have been had annual productivity growth been just 2% over those years. Increasing productivity is also one of the keys to increasing real wages (Cunliffe 2015). Improving the financial resilience of UK households therefore has the potential to improve economic performance and increase real wages.

This report reviews what policy interventions and innovations should be taken to improve financial resilience in the UK, presenting examples of best practice and considering mechanisms to support the self-employed. Regulation of the consumer credit market by the Financial Conduct Authority (FCA) has improved but although the cap on the Total Cost of Credit (TCC) in the High-Cost Short-Term Credit (HCSTC) market has significantly reduced the previous high level of consumer detriment,[4] it has not created the culture change required to increase levels of financial resilience. A solution to improving financial resilience requires changes on both the demand and supply side. This report suggests policy recommendations that tackle both.

On the demand side, targeted interventions are needed to change what has become a pervasive culture of credit use to a more balanced culture of both saving and responsible credit use. These interventions include:

- changing incentives to save
- harnessing inertia through auto-enrolment into saving
- the development of money management tools and apps for 'at risk' groups.

1 According to the Office for National Statistics (ONS), self-employment is now at its highest level in both percentage and absolute terms since records began in 1971 with 15% of workers, or 4.6m people, now classified as self-employed (Office for National Statistics 2014).

2 See, for example, Money Advice Trust (2015): 'Seven out of 10 of those who had taken out a personal loan used it to prop up their business.'

3 The ONS's most recent estimate of the number of people employed on a zero-hours contract in their main job is 744,000 or around 2.4% of people in employment, up from 624,000 in the previous year (Office for National Statistics 2015). The problem of irregular incomes is not confined to the UK; it also affects 31% of the population in the US (Sharf 2015).

The experience with payday lending demonstrates that government support and intervention can be successful.

On the supply side, recent experiences with payday lending clearly illustrate that competition alone cannot be relied upon for good outcomes in consumer credit markets. The experience with payday lending demonstrates that government support and intervention can be successful. Such support could be used to bridge the gap in the provision of credit that meets borrowers'

needs in a responsible and sustainable way, enabling and encouraging people to build up short-term financial resilience.

Therefore this report identifies and explores a number of interventions and innovations designed to improve access to alternative, responsible sources of credit that could help households build up a financial cushion through saving. It focuses specifically on the needs of three groups that are currently at most risk of being unable to build sufficient financial resilience:

- self-employed workers
- workers with low and variable earnings
- students.

The report is presented in four stages.

1. A review of the existing evidence relating to household financial resilience and its links with income, credit use and over-indebtedness.

2. A discussion of saving and budgeting, focusing specifically on the needs of students, self-employed people and people on low and variable incomes, and of developments coming from the financial technology (fintech) sector that may help these groups.

3. A review of the current state of the non-standard credit market in order to understand both the impact of recent regulatory changes and the difficulties of accessing responsible and affordable credit faced by all households with low financial resilience. There are comments on both the commercial and community lending sectors. Information from lenders' financial statements and earnings calls is used to comment on recent developments in the commercial non-standard credit market.

4. Finally, looking to the future, the report outlines how the supply of capital to community lenders could be increased through the development of Social Lending Bonds (SLBs) – designed to improve the supply of sustainable long-term capital to the sector – and an ethical 'lending marketplace'[5] that would provide a pool of capital on which community lenders could draw.

Throughout the chapters, targeted interventions that would enhance financial resilience are identified.

4 For example, the number of complaints about payday loans received by Citizens Advice Bureaux in the first quarter of 2015 is half that received in the first quarter of 2014 (Citizens Advice 2015a).

5 This is not the first time an ethical lending marketplace has been suggested as a potential way of helping community lenders. The Centre for Social Justice outlined an idea for a marketplace to facilitate peer-to-peer investment in ethical finance providers in its 2014 report 'Restoring the Balance' (Centre for Social Justice 2014). The marketplace proposed in the current report differs in that it would be a source of funds to be lent rather than a source of investment.

2. The evidence relating to household financial resilience and its links with income, credit use and over-indebtedness

Below is an examination of the current consumer credit landscape, shedding light on the links between household financial resilience, income, credit use and over-indebtedness.

2.1 DATA ANALYSIS

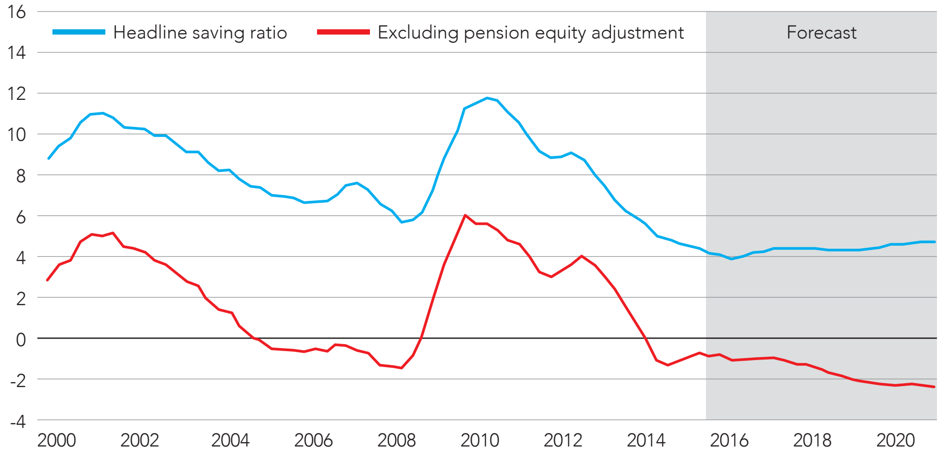
Below is an examination of the current consumer credit landscape, shedding light on the links between household financial resilience, income, credit use and over-indebtedness.

Figure 2.1 below shows that the UK household savings ratio has fallen back to below its pre-crisis levels, suggesting that levels of financial resilience are deteriorating, with little sign of improvement forecast up to 2020.

Although the headline-savings ratio conceals a wide range of experiences among households, according to the Family Resources Survey (FRS), (Table 2.1 below) 35% of households have no savings, with a further 13% having less than £1,500 (DWP 2014a). As Table 2.1 shows, however, lower-income households are much more likely to have no savings. Around half of households earning under £500 per week have no savings.

Having no or low savings undermines financial resilience, as households are

Figure 2.1: Changes in the UK household savings ratio



Note: Both series show four-quarter moving averages. The estimate of the saving ration excluding the pension equity adjustment is calculated as household disposable income less consumption, as a proportion of household disposable income.

Source: Office for Budget Responsibility (2015: Chart 3.24)

35%
of households have no savings

Table 2.1: Savings levels among selected households

Weekly income	No savings (% of households)	Under £1,500 (% of households)
<£100	52	10
£100<200	54	11
£200<300	50	12
£300<400	48	13
£400<500	43	14
All Households	35	13

Source: Family Resources Survey (2014): Table 2.8

Having no or low savings undermines financial resilience, as households are vulnerable to financial shocks such as having to find money to meet emergency needs.

vulnerable to financial shocks such as having to find money to meet emergency needs. This can cause them to resort to borrowing. Savings have a vital role to play in preventing people from falling into debt problems, which carry huge social costs.[6] Even small amounts of savings can have a big impact; StepChange estimates that 500,000 households would have avoided problem debt if they had had just £1,000 saved (StepChange 2015a). As shown below, there appears to be a strong relationship between no, or low levels of, savings and use of unsecured credit.

There also appears to be a link between low levels of savings and having high debt-to-income ratios and repayment-to-income ratios. Nearly one in four of those without savings has a debt-to-income ratio of more than 60%. Households on lower incomes are also more likely to have high debt-to-income ratios.

Households with no or very low savings and lower incomes are more likely to be in arrears, subject to insolvency action, and find keeping up with payments a heavy burden.

Table 2.2: Relationship between levels of savings and use of unsecured credit

Level of savings	Use of unsecured credit (%)
None	79
<£1k	70
£1k–10k	58
£10k–20k	44
> £20k	27

Source: BIS (2013a): Figure 5: Use of unsecured credit by selected household characteristics 2012

Table 2.3: Relationship between savings, household incomes and debt/repayment to income ratios

Levels of savings	Debt to income >60%: (% of households)	Repayment to income ratio >30%: (% of households)
None	23	16
<£1k	19	16
£1k–10k	16	13
£10k+	13	9

Source: BIS (2013a): Table A24 – Proportions of borrowing households with high levels of unsecured debt by household characteristics

6 The social cost of problem debt is estimated at £8.3bn per year (StepChange 2014)

The fact that low levels of saving lead to debt, which then makes it even less likely that money can be put aside into savings creates a vicious circle.

Similarly, there seems to be a close relationship between levels of savings and household incomes and being in financial difficulties or facing financial stresses.

In summary, households with low levels of savings are more likely to use unsecured credit and more likely to experience difficulties repaying credit when they do use it. The causality here appears to run both ways, to quote research by StepChange using data from the Wealth and Assets Survey:

'Although it is clear that a low income is a major determinant of poor savings habits, other factors play a big role. When asked to choose from a range of reasons for non-saving, many in the classification groups identified said they did not save because they wanted to pay off existing debts or because their debt repayments were too high to enable saving' (StepChange 2015b).

The fact that low levels of saving lead to debt, which then makes it even less likely that money can be put aside into savings creates a vicious circle. It is therefore important to consider both savings and credit when thinking about financial resilience.

Table 2.4: Relationship between savings, household incomes and 'problem debt'

Levels of savings	Structural arrears (% of households)	Insolvency action/ arrears (% of households)	Keeping up is a heavy burden (% of households)
None	22	31	36
<£1k	12	18	16
£1k–10k	4	7	6
£10k+	2	2	3
Annual income			
<£13,500	22	16	38
£13,500–25,000	14	13	27
£25,000–50,000	10	8	18
£50,000+	6	4	10

Source: BIS (2013a): Table A33 – Objective financial difficulties by household characteristics, and Table A35 – Level of structural arrears and payment burden by household characteristics

Table 2.5: Relationship between savings, household incomes and being in financial difficulties and facing financial stress

Levels of savings	In financial difficulties (% of households)	Financial stress (% of households)	Either (% of households)
None	31	26	57
<£1k	18	16	34
£1k–10k	7	6	13
£10k+	2	2	4
Annual income			
<£13,500	22	16	38
£13,500–25,000	14	13	27
£25,000–50,000	10	8	18
£50,000+	6	4	10

Source: BIS (2013a): Table A44, Proportion of households either in financial difficulties or considered to be experiencing financial stress by household characteristics

Organisations should work to a model in which reasonable risks can be taken, with a clear and competent justification of the reasons why they are necessary.

2.2 THE JOURNEY FROM FINANCIAL INSECURITY TO FINANCIAL RESILIENCE: A ROADMAP

Figure 2.2 below is a 'roadmap' describing the journey that households need to go on to move from a position of financial insecurity to a position of financial resilience and, ultimately, a position of financial security. We will use this table as a framework to help us identify where interventions should be targeted.

In order to improve the financial resilience and security of vulnerable households, a range of interventions are needed to deal with the 'legacy' of existing over-indebtedness and to prevent future detriment that may arise as a result of deteriorating household finances. This means developing interventions to ensure that:

- households that are in financial difficulties – such as being over-indebted or in arrears – are supported through the provision of good-quality debt advice
- financial capability is improved so that vulnerable households can budget effectively and make better financial decisions
- households in vulnerable financial circumstances have access to fair, affordable credit where necessary to meet sudden financial shocks
- households build up a financial 'cushion' in the form of emergency, accessible savings and/ or insurance.

Financial resilience and financial security are interlinked; being financially resilient is a necessary stepping stone on the journey to long-term financial security. The government has developed policies to promote long-term financial security, but arguably more needs to be done to foster financial resilience. It is welcome that significant resources are being devoted to pensions' tax relief and to auto-enrolling, encouraging people to save for an extended period of economic inactivity in retirement. Similarly, the 'Help to Buy' and 'Save to Buy ISA' schemes offer welcome assistance to homebuyers to support people in owning assets. Nonetheless, in the context of rising numbers of self-employed, workers with low and variable earnings, and student, the government should focus on tackling financial resilience. This would arguably help to reduce the welfare bill, as the more financially resilient people become, the fewer would seek last-resort assistance from the benefits system owing to over-indebtedness.

Table 2.6: Defining financial resilience and financial security

The journey to financial resilience and longer-term financial security				
Stage	**Financial vulnerability/ insecurity**	**'Square one'**	**Financial resilience**	**Financial security**
Definition	Consumers in a 'negative' position, vulnerable and exposed to shocks/ detriment	Consumers back to a 'neutral' position – still vulnerable, but with a platform to build on	Ability to withstand financial shocks/meet short-term financial needs	Sufficient means to meet medium to long-term financial needs
Main factors	• Restricted access to transactional bank account • Over-indebted/vulnerable to subprime lending/trapped in vicious cycle • No savings • Exposed to risk, no/little insurance cover • No pension/under-pensioned • Housing problems, mortgage/rent arrears • Low/unstable incomes, poverty • Poverty 'premium'/paying more for basic goods and services	• Effective budgeting/'making ends meet' (if possible, as may be outside control) • In the financial system (functional bank account) • Paid off unmanageable/ unproductive debt • Still underinsured/ under-pensioned	• Income surplus • Effective use of banking system • Emergency savings (three months' income) • Access to fair, affordable credit • Basic insurance cover • Some form of 'safety net' • Beginnings of pension provision, but still underprovided for	• Proper insurance cover, not just for contents but income replacement • Paying off/paid mortgage • Significant pension provision • Long-term savings/asset accumulation • Debt/assets lifecycle model positive position

3. Savings and budgeting

The medium-term benefits of saving are clear, yet many people find it difficult to save.

3.1 DIFFICULTIES OF SAVINGS AND POSSIBLE SOLUTIONS

The medium-term benefits of saving are clear, yet many people find it difficult to save. Table 3.1 identifies reasons people find it difficult to set aside money for savings and potential ways of overcoming these.

Recent work by StepChange presents a compelling argument that an unparalleled opportunity exists to auto-enrol people into a short-term savings account that would sit alongside their pension pot. The following summary of StepChange's proposals is adapted from the discussion paper *Becoming a nation of savers*, which contains a much more detailed analysis of how auto-enrolment could be adapted to provide accessible savings, including fully worked and very clear examples (StepChange 2015b).

StepChange identifies the following advantages of using the auto-enrolment system for pensions to help households build accessible savings:

'...there are clear reasons for using auto-enrolment as a basis for increasing accessible savings:

- it is already in place and working effectively with a suitable system of earnings thresholds and eligibility requirements
- existing workplace savings schemes could be harnessed rather than replaced
- it is due for review in 2017, which gives an opportunity to make appropriate additions to the scheme
- it contains an auto-enrolment nudge – reversing the default so people save unless they opt not to, using inertia to deliver good outcomes
- it contains a match – both employer and tax contributions boost individual saving
- if the thresholds and eligibility criteria are kept the same, utilising it will not cost the government any more money. Matching is also a frame people understand.'

Employees would allocate a percentage of their pension contributions to a savings product (either an accessible savings 'jar' within a pension pot or a linked savings

Table 3.1: Reasons people do not save

Reasons people do not save	Potential solution
Saving requires the deferral of consumption and gratification while the use of credit provides almost immediate gratification.	Smartphone apps with decision trees, referred to by Qapital as IFTTT (If This Then That) rules (see below).
Opportunities to save are not as widespread as opportunities to borrow. For example, many retail interactions now come with the option of borrowing on a store card or through a hire purchase agreement. Many mobile telephone contracts are actually credit agreements; home insurance can also involve credit – many people enter a credit agreement if they choose to pay in monthly instalments and this can add a big percentage to the total annual cost.	Auto-enrolment via pension auto-enrolment system. Smartphone apps with decision trees (see below).
Savings schemes, especially for small amounts, are costly to run.	Leverage the existing pension auto-enrolment system.
The discipline of debt – failure to repay debt carries immediate sanctions and this compels many people to make agreed repayments. Failure to save may be detrimental in the long term, but carries no immediate penalties.	'Nudge' people who finish repaying debt into taking out savings plans rather than more debt. Possibility of using debt repayment-based savings plans along the lines of the 'Self Lender' model (see section 3.2 below).
Low-interest-rate environment, exacerbated by Funding for Lending, means returns offered on savings are not attractive. Tax-based incentives to save, such as the ISA, do not benefit low-income groups who do not pay tax.	Matched savings for students in the form of means-tested 'Save to Study' ISA.

Someone who makes regular debt repayments is exhibiting savings-type behaviour.

account), with the remainder being invested in their pension in the normal way. Once the employee had built-up £300 of savings on their own, a matched percentage of the employer's contribution and the government tax relief on contributions (in addition to the employee's own contributions) would also be diverted to savings. This would continue until the savings balance reached £1,000 at which point all further contributions and tax relief would be 100% invested in the pension. If savings were drawn down and the balance fell below £1,000, the process would automatically start again until the savings balance was back to £1,000.

There is a risk that people could fail to build up adequate pension savings by repeatedly filling their accessible savings jar or account to a low level via matching and then spending it causing government and employer money to 'leak' from the system. In order to mitigate this risk, StepChange proposes a system of prize-based incentives to maintain a high savings balance (StepChange 2015b).

The National Employment Savings Trust (NEST) – the default option for pension auto-enrolment – is open to self-employed members. A particularly salient feature is that if someone joins NEST as an employee and subsequently becomes self-employed they can continue to contribute to their pension through NEST. More needs to be done to encourage this; organisations such as Citizens Advice Bureau and StepChange could ensure that the self-employed are directed to do this.

When considering the age profile of the self-employed – in the UK fewer than 5% of 15 to 24-year-olds who work are self-employed (Hatfield 2015) – this becomes quite a powerful feature. If NEST can reach these young people while they are employed, there is a real possibility that they can then reap many of the benefits of auto-enrolment throughout their working lives.

Recommendation 1: Advocate StepChange's recommendation that the existing auto-enrolment system for pension saving be extended to include a savings element.

3.2 USING THE DISCIPLINE OF DEBT TO BUILD SAVINGS

Someone who makes regular debt repayments is exhibiting savings-type behaviour. The maturity of a loan therefore presents an opportunity to convert the money previously devoted to regular debt repayments into a regular savings amount. Debt advice charities are well placed to 'nudge' people coming off debt repayment plans into using payments to pay into a regular savings account.

Commercial lenders could also be required to suggest appropriate savings products to borrowers who have successfully repaid loans rather than using the end of a loan as an opportunity to sell new borrowing facilities.

Recommendation 2: Use the end of debt repayment to convert borrowers into savers.

The development of apps such as that outlined below suggests one mechanism for doing so.

SELF LENDER

An interesting but untested concept is 'Self Lender'. Self Lender is a US start-up that has raised just over $2m from investors (Wilhelm 2015) and has almost 15,000 potential users signed up, although it has not yet commenced operations (Self Lender 2015).

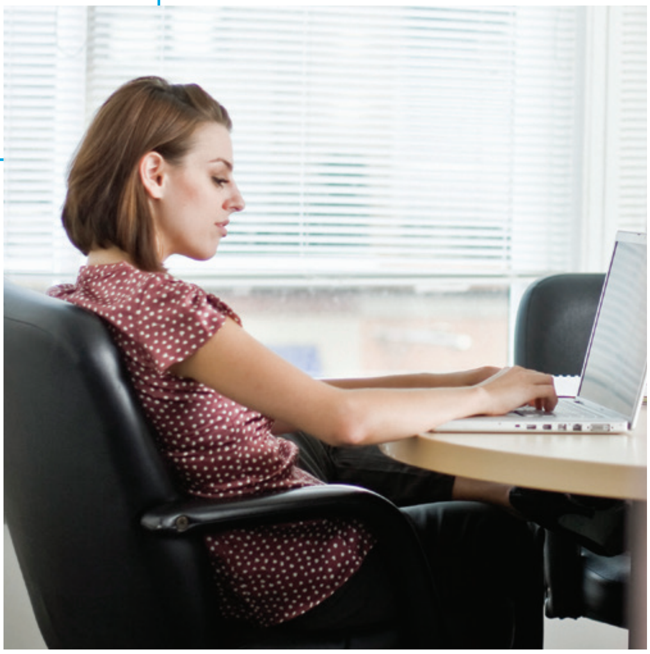
Self Lender turns a loan on its head: rather than receiving money upfront from a creditor the individual makes a 'loan' to themselves, which they then repay through regular payments either from a bank account or in cash. The user receives no money upfront, but all the money 'repaid', ie saved, is returned to them at the end of the loan.

By re-categorising what is essentially a savings plan as a loan, Self Lender is able to report repayment behaviour to credit reference agencies, thereby enabling its users to build a credit history. There are costs involved; users pay $5 per month for the service and missing a scheduled repayment carries a $3 penalty (Self Lender 2015).

> Self-employed people are often found using a personal current account with limited functionality to run a small or micro business.

3.3 SELF-EMPLOYED WORKERS, WORKERS WITH LOW AND VARIABLE EARNINGS, AND STUDENTS. AN OUTLINE OF THESE AT-RISK GROUPS AND PROPOSED INTERVENTIONS

Self-employment and working variable hours often result in income variations from week to week or month to month, making it more difficult to budget effectively and



to set aside appropriate amounts of money for savings. As noted in the Center for Financial Services Innovation paper Spikes and Dips (Morduch and Schneider 2013), income variability makes it hard to manage financially even when total income over the year is adequate to meet expenses. This effect is so pronounced that 77% of households participating in the US Financial Diaries research study said that increased financial stability was more important than moving up the income ladder (Morduch and Schneider 2013). Self-employed people face the additional challenge of setting aside money to pay income tax.

According to evidence gathered by Business Debtline, not only do many self-employed people have exceptionally low levels of financial resilience,[7] they also frequently overlap business and personal finances. Self-employed people are often found using a personal current account with limited functionality to run a small or micro business (Money Advice Trust 2015). Clearly, they would benefit from a broader range of financial management tools, particularly if these could be provided at low cost.

Fintech could offer some promising saving and budgeting solutions over the next couple of years. In particular, the development of a standardised Application Program Interface (API), is to be hugely welcomed. This is due for completion in 2017 and: 'will allow the development of third-party apps that are compatible with the systems of all UK banks, and that can securely use customer banking data (with their permission)' (HM Treasury 2015)

As the government has correctly identified, a standardised API has enormous potential to free up the transactional data contained in people's main bank accounts, which is currently visible only to the account-holding bank. In the US, a number of innovative smartphone applications (apps, eg Level, Qapital), discussed in detail below, use these kinds of payment and cash flow data to help the self-employed and those on low and variable earnings (see note on 'Even' in box below) to smooth their incomes and reduce their use of credit. Brief outlines of how these apps work are given below, but fundamentally these apps all have a similar offering: they automatically apply the rules a highly financially capable person would apply to their own cash flows. By automating the process, apps can free up time to concentrate on earning rather than managing money and, by harnessing good intentions and inertia, increase the likelihood of saving.

Recommendation 3: Although the standardised API will not be in place for another year, the government should work closely with banks and technology companies to ensure that advanced savings and budgeting functionality can be made available to the identified 'at risk' groups as soon as possible.

7 For example, '91% of self-employed callers surveyed have no savings'. Of those who did have savings, over a third had less than £1,000 (Money Advice Trust 2015).

Fintech could offer some promising saving and budgeting solutions over the next couple of years.

LEVEL

Level is a free budgeting tool that interfaces with a user's bank accounts and credit cards, and tracks spending. It provides up-to-date information on the amount the user can safely spend in a given day, week or month. Level tracks spending and cash flow, and uses this information to provide breakdowns of spending habits, making it easier to budget. It also provides forecasts of bank balances. This functionality has the potential to help freelancers to keep track of work-related expenses and separate them from personal spending. It can also help manage variable income associated with project work (Level 2015).

QAPITAL

Qapital is a rules-based savings scheme that provides the user with a low-interest, accessible savings account, and a smartphone app. Card transaction data from the user's current account is accessed by Qapital. Qapital then applies 'rules' or 'recipes', which have been set in advance by the user, to determine how much money to move from the current account (at the user's primary bank) to the savings account (usually at a different institution).

'Rules' include matching spending on certain items with savings amounts, setting a budget for spending in a particular category and saving the difference if the user's spending comes in under budget, rounding up the change from card transactions into the savings account. Qapital has just released a new tax-saving rule that allows self-employed users to save a set percentage of earnings to help pay tax bills.

'Recipes' or If This Then That (IFTTT) rules are more innovative and involve using data from the user's phone to track their activities and save small amounts when certain things happen. An example of a recipe would be saving when a user tweets using a particular hashtag.

This is free to the user. Costs will eventually be covered by the interchange fees from an associated Qapital Visa Debit card, which is yet to be launched.
Qapital has ambitions to expand overseas (Qapital 2015).

EVEN

One tool designed for employees with regular but variable earnings is Even, which automatically saves during good pay periods and provides cash 'boosts' during lean pay periods.

Even aims to reduce reliance on short-term credit by taking variable income and turning it into a steady monthly pay cheque. The app connects securely to the user's bank account and uses salary information from the previous few months to calculate an average monthly salary (this average is recalculated each month). In months when the user's earnings are above average the surplus is automatically swept into a segregated, non-interest-bearing savings account. In months when the user's earnings are below average, money is automatically drawn from the savings account to increase available funds – referred to by Even as a 'boost'.

Savings are accessible and can be withdrawn at any time. If a user has insufficient savings to 'boost' their salary up to the average, Even extends an interest-free advance for the required amount; this is repaid the next time the user generates a surplus.

This is a profit-making enterprise and the service comes at a cost of $3 per week (Even 2015).

> One of the biggest money management challenges facing students in England and Wales is the way the maintenance loans and grants are paid.

3.4 STUDENTS

Students face two challenges to building financial resilience. The first challenge is to establish short-term financial resilience: how to fund living costs over and above the level of any maintenance grants and loans received during the period of study. The second challenge is long-term financial resilience: how will the repayment of tuition

fees and maintenance loans affect future generations' ability to service debt and accumulate assets? The long-term repayment of debt means that money management and saving will be vitally important for this generation.

Following reforms made in 2012, students will now leave education with an average student loan debt of over £44,000, according to the Institute for Fiscal Studies (IFS). Only 5% of graduates will have fully repaid this amount by age 40 and almost three-quarters of graduates will continue to repay into their early 50s, eventually having some portion of their debt written off (Crawford and Jin 2014). This additional long-term financial commitment means that future graduates will need strong money management skills and, crucially, a strong culture of saving in order to build financial resilience over their working lives.

This section of the report explores interventions that could help students manage their money more effectively during their studies and calls for the introduction of a new Save to Study ISA, which would mirror the design of the government's recently announced Save to Buy ISA.

One of the biggest money management challenges facing students in England and Wales is the way the maintenance loans and grants are paid. Under the current system, students receive three large maintenance payments, which are timed to coincide with the start of each academic term. Many students' expenses, however, necessitate regular monthly payments. The fact that Easter is not a fixed date further compounds this problem. Scottish students now receive monthly maintenance payments.

This could be resolved directly by changing to monthly payments or indirectly by encouraging banks to offer 'jam jar' accounts for students, allowing them to segregate out money into monthly jars. There are currently no student accounts that offer this kind of functionality.

According to the *Student Income and Expenditure Survey 2011/12*, just over half of full-time students had savings at the beginning of the academic year and the (mean) average amount of savings per student was just over £1,500. In a country where 50% of households have savings of less than £1,500 this looks very encouraging. In practice, the distribution of savings among full-time students tells a different story. The median amount for all full-time students was just £200 at the beginning of the academic year, dropping to a predicted £100 by the end of the academic year, with many students having low or no savings.

Much can be done to improve levels of financial resilience through encouraging saving and better budgeting.

39%

of full time students had an overdraft

Of the full time students, 39% had an overdraft. Among these the mean average balance was £894 and the median was £800, suggesting that the distribution was relatively unskewed – this makes sense as banks are unlikely to extend a student overdraft beyond £1,000 (BIS 2013b). A savings buffer of £1,000 could, therefore, save the majority of students from having an overdraft at all. Encouraging saving among the 16–19-year age group would both help them prepare for further education and build a savings culture. A matched savings account for under-18s who are considering tertiary education should be provided along the lines of the new 'Help to Buy' ISA, which could be called the 'Save to Study' ISA. The account holder could save up to £1,000 in the account. When the holder entered further education the government would match the saving with an additional amount based on the household income means test, perhaps £250 per £1,000 for those in the lowest income bracket, reducing to zero for those in the highest income bracket.

Recommendation 4: Move to monthly maintenance payments for students in England and Wales in line with Scotland or work to improve functionality in student current accounts to facilitate easy monthly budgeting.

Recommendation 5: Matched savings for students in the form of a means-tested 'Save to Study' ISA.

Much can be done to improve levels of financial resilience through encouraging saving and better budgeting. Nonetheless, households also need access to fair, affordable credit where necessary to meet sudden financial shocks. The next section reviews the non-standard credit market in order to investigate the impact that increased regulation by the FCA has had and to identify the changes needed to improve the quality of credit products available to financially vulnerable households.

4. The non-standard credit market

Without adequate savings people need to use credit to smooth their income and meet unforeseen expenses.

4.1 REASONS FOR THE GROWTH OF THE NON-STANDARD CREDIT MARKET

Without adequate savings people need to use credit to smooth their income and meet unforeseen expenses. Financial services do not meet the needs of all households. Those on low incomes with impaired or limited credit histories form what is called the 'non-standard' credit market, accessing a broad array of products ranging from high-cost (defined here as an APR of 30% or more) credit cards to Home Collected Credit. Figure 4.1 provides an overview of some of the principal products in this market along with estimates of the numbers of borrowers using them.

The 'nonstandard' credit market has been growing steadily since 2008 and is now estimated to be 12m (Provident Financial 2015) up from over 10m in 2011 (Provident Financial 2012). One reason for the increase in the size of the non-standard market is the general contraction in credit provision by mainstream lenders following the 2007–8 global economic crisis. Changes in the labour market have also played a significant role. For example, Provident Financial noted in its 2014 annual report: 'We expect the UK non-standard credit market to show steady growth in 2014 and beyond, reflecting structural changes in the employment market which is increasing the number of part-time, casual and temporary workers' (Provident Financial 2014).

Those on low and variable earnings, one of the three 'at risk' groups identified in this report, appear to form part of the non-standard lenders' target market.

While lenders have built large and profitable businesses serving the needs of non-standard borrowers, the products they offer have a very high Total Cost of Credit (TCC). There is considerable evidence that borrowers accessing non-standard credit are relatively price insensitive. There are a variety of reasons for this; many borrowers in this market lack access to lower-cost mainstream credit and many have experience of being rejected by other lenders and, therefore, place a high value on their relationship with an existing lender (see eg University of Bristol 2013). This lack of price sensitivity prevents prices from being driven down by competitive forces, as they would be in a well-functioning market. There is a very real gap in the provision of financial services that meet this population's needs in a responsible and affordable way, which would enable and encourage people to build up short-term financial resilience.

The lack of price competition in this market means that regulation has a particularly important role to play in protecting borrowers. Therefore, the impact of recent regulatory changes on the commercial non-standard credit market is briefly examined below.

Figure 4.1: The commercial non-standard credit market

Creditworthiness of borrower

Product	Number of users	Typical APR	Description
High-cost credit cards	3,400,000	30% – 60%	Identical to standard credit card with high APR
Instalment loans	200,000	35% – 100%	Repayable in instalments over six months to two years
Mail order	5,000,000	40%	Cost of goods purchased may be spread over months or years with credit card-style minimum payments
Payday loans	1,000,000	1,200% – 1,500%	Single-period loan normally repayable within a month
Bill of sale loans	60,000	400%	Loan secured on title of borrower's vehicle
Rent to own	350,000	50% – 100%	Consumer goods sold on hire purchase
Home collected credit	2,000,000	400% – 1000%	Small loans, repayments typically collected in person by an 'agent' on a weekly basis over many months

Source: Adapted from information in Provident Financial (2013 and 2014), All Party Parliamentary Group on Debt and Personal Finance (2014), UK Cards Association (2014), Citizens Advice (2014a) and Shop Direct website.

There appear to be some warning signs that the high-cost credit card market may be expanding, possibly in response to the contraction of the payday lending market.

27%

drop of both revenue and volume of loans, since increased regulation on the payday lending market

4.2 IMPACT OF REGULATORY CHANGES

There is no doubt that regulatory scrutiny of all areas of the consumer credit market has increased with the transfer of regulatory authority from the Office of Fair Trading (OFT) to the Financial Conduct Authority (FCA).

The most significant change has been the introduction of a cap on the TCC in the High Cost Short Term Credit (HCSTC) market in January 2015. The introduction of the cap brought with it the concern that a reduction in the supply of payday loans would cause an increase in the supply of other credit products with even higher levels of associated consumer detriment. There was also concern about the potential for lenders to 'game the cap' by marketing products that technically fall outside the cap's scope, but that are economically equivalent to HCSTC. The fear was that an intervention aimed at improving the lot of borrowers would actually make them worse off.

It is too early to make definitive statements about the effects of the new regulatory regime. There is evidence that lenders have responded to the FCA's more forceful approach by changing their business models; in particular:

- payday and other short-term lenders are sticking strictly to the FCA's rules, resulting in a significant reduction in loan volumes
- there appear to be some warning signs that the high-cost credit card market may be expanding, possibly in response to the contraction of the payday lending market. There may be some risk of consumer detriment in this market.

Each of these developments is discussed in more detail below.

4.2.1 Payday and other short-term lenders are sticking strictly to the FCA's rules resulting in significant reduction in loan volumes

ACCA's previous report, *Payday Lending: Fixing a Broken Market* (Beddows and McAteer 2014), identifies the risks of consumer detriment inherent in online payday lending business models and calls for an interest rate cap, restrictions on rollovers, default fees and interest accrued post-default as appropriate policy interventions to improve the functioning of the HCSTC market.

The impact of increased regulation on the payday lending market has been profound. According to the Competition and Markets Authority, both revenue and volume of loans dropped by 27% during 2014 and four of 11 major lenders stopped granting these short-term loans (CMA 2015). High-profile lender Wonga.com reported a significant reduction in business, leading to restructuring in 2014 (Wonga 2015).

The only sources of evidence as to likely developments in the market during 2015 are the financial statements and earnings calls of large, listed US lender Enova International (previously part of Cash America), which operates as QuickQuid, Pounds to Pocket and Onstride.

Enova reports that, in the first quarter of 2015, the volume of UK lending was down by over 50% compared with the first quarter of 2014. Much of this reduction in volume was attributable to the application of tighter underwriting criteria – consistent with genuine efforts to assess the affordability of loans – since the introduction of the price cap, losses as a percentage of revenues have reduced from around 35% in Q1 2014 to around 10% in Q1 2015 (Enova 2015a). To put it simply, the loans being made now are much more likely to be genuinely affordable.

Enova certainly does not appear to have been 'gaming' the cap. Specifically, the 'Flexcredit' line of credit[8] product was withdrawn on 2 January 2015, with the result that existing customers could only repay and could no longer draw down additional borrowing (Enova 2015a). They could, of course, re-borrow by applying for one of Enova's instalment or payday loans. It appears, however, that repayments significantly outweighed re-borrowing, perhaps indicating that the cycle of 'rolling over' has been broken for at least some borrowers (Enova 2015b).

8 Flexcredit was marketed as a flexible alternative to payday loans and could, technically, have fallen outside the scope of the cap. The costs associated with Flexcredit were very high and the potential for consumer detriment was similar to that associated with the payday loan product.

While it is too early to judge the ultimate success of the new regulatory approach, there are some very encouraging signs here.

There is also evidence that Enova is applying higher underwriting criteria, consistent with better assessment of affordability, in its instalment lending too. As early as the third quarter of 2014 it noted: 'a reduction in international short-term and instalment loan balances due to changes made in our UK business as a result of new regulatory requirements' and 'a decrease in new customer activity in (instalment lending in) the UK due to recent changes initiated in that market' (Enova 2014).

Mirroring the contraction in lending in this sector, the number of complaints about payday loans received by Citizens Advice Bureaux in the first quarter of 2015 is half that received in the first quarter of 2014 (Citizens Advice 2015a).

While it is too early to judge the ultimate success of the new regulatory approach, there are some very encouraging signs here. It is important that the FCA continues to monitor developments in this market, especially once lenders receive full authorisation.

Recommendation 6: The FCA should continue to monitor developments in the HCSTC market, especially after lenders receive full authorisation.

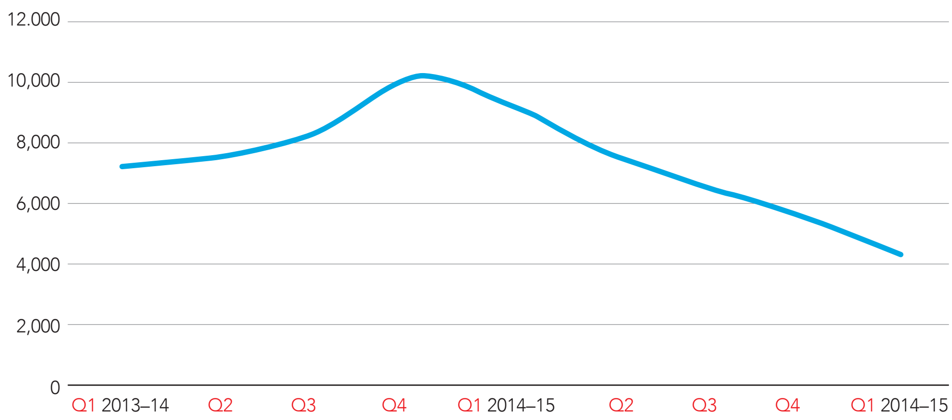
4.2.2 Are high-cost credit cards an emerging risk?

Around 3.4m credit card accounts carried an APR over 30% in 2013 (the most recent year for which industry-wide data could be obtained) (UK Cards Association 2014). These cards are primarily provided by four large lenders: Capital One, Barclays (under its Barclays Initial brand), Provident Financial and New Day. Provident Financial's Vanquis Bank suite of cards has experienced rapid growth in the past few years (discussed in more detail below) with New Day also reporting strong growth in balances over the course of 2013 (New Day Ltd 2014).

In response to continued strong demand, possibly attributable to the contraction in the payday lending market, both these lenders have recently introduced new cards: Vanquis Bank's 59.9% APR 'Black Diamond' card launched in 2014 and New Day's 39.9% APR 'marbles' card, which had been closed to new business, was reopened in May 2015[9] (New Day Ltd 2015).

The credit card is a highly flexible form of borrowing with the borrower having complete control over the timing and amount of repayment; unlike other loans a credit card balance may be repaid in full at any time without any additional charges being incurred. Credit cards also allow

Figure 4.2: Payday loan debts – issues have decreased since action was taken in April 2014



Source: Citizens Advice (2015b)

9 In fact, credit card lending across the entire market has been expanding in recent years. Total borrowing outstanding on credit cards has risen from £55.2bn at the end of 2012 to £61.2bn at the end of Q1 2015 (UK Cards Association 2015). The Bank of England Credit Conditions Surveys also suggest that credit card lending to borrowers of relatively low creditworthiness increased during the first half of 2015. The Q4 2014 survey noted: 'The availability of credit card lending appeared to increase in Q4 2014: credit scoring criteria loosened and the proportion of applicants being approved increased. At the same time, lenders reported a significant decline in the credit quality of new credit card lending.' The Q1 2015 survey states that total demand for credit card lending reduced but that: 'Credit scoring criteria were reported to have loosened significantly and there was a reduction in the credit quality of new credit card lending.'

Credit cards also allow people to borrow very small amounts, which would be expensive to lend in any other form.

people to borrow very small amounts, which would be expensive to lend in any other form. As the Center for Financial Services Innovation note in its paper Spikes and Dips, this flexibility makes the credit card – when used in a disciplined way – an ideal tool for managing variable income (Morduch and Schneider 2013).[10]

Where balances are not cleared, however, the high interest rate charged on even mainstream credit cards can make them a very high-cost form of debt. This is even more pronounced for high-cost credit cards with APRs in the 30%–60% range. Where minimum payments are made, interest can be charged over many months or even years, resulting in a very high Total Cost of Credit on what may have started as a small amount of borrowing. There is a risk of consumer detriment in this market.

75%

of these non-standard borrowers rent rather than own their home

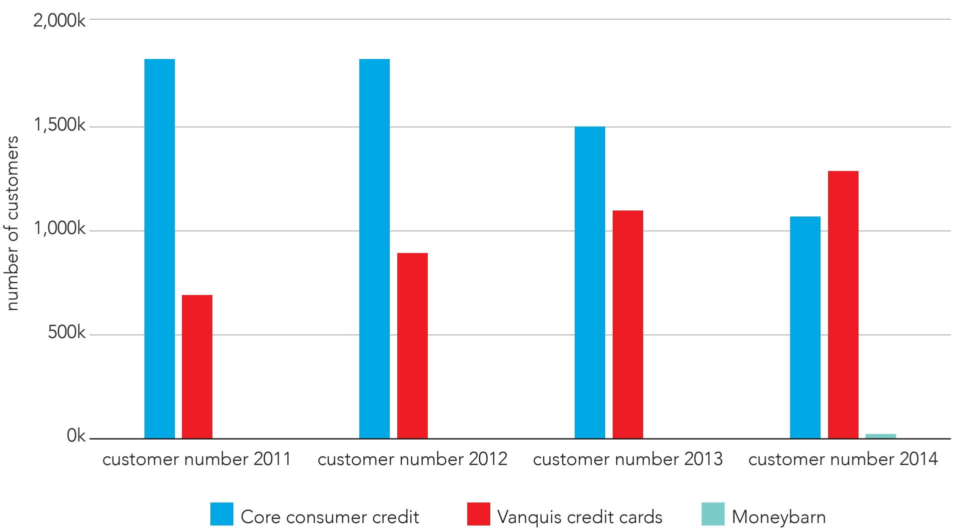
Information contained in Provident Financial's financial statements suggests that borrowers using their high-cost cards have a tendency not to clear their balances, but to increase their borrowing over time. In recent years Provident Financial has expanded its credit card lending to non-standard borrowers of higher credit quality with incomes in the £15,000 to £35,000 range; around 75% of these borrowers rent rather than own their home. Customer acquisition has been very rapid with 411,000 new borrowers acquired in 2013 and a further 430,000 in 2014. Its target is to reach 1.8m borrowers this year and 'looking beyond 2015, we expect the demand for non-standard credit cards in the UK to remain strong' (Provident Financial Annual Report 2014).

A potential cause for concern is that growth in receivables has outpaced the rapid growth in customer numbers so that the average customer balance has grown every year up from £490 in 2007 to £846 in 2014 (Provident Financial 2015). Increasing the average balance is an important part of the business's strategy; its target for 2015 is not only to increase customer numbers to 'between 1.5 million and 1.8 million', but to achieve an 'expected average customer balance of approximately £1,000' (Provident Financial 2015).

When borrowers run balances on their cards at 30% or 60% APR they will face a very high Total Cost of Credit.

Further evidence of the detriment vulnerable borrowers face in the credit card market can be found in the interim findings from the FCA's *Credit Card Market Study* (FCA 2015b). The FCA assesses the experience of higher- and lower-risk[11] credit card borrowers and uses a number of indicators to assess the scale and nature

Figure 4.3: Provident's shift from doorsteps to credit cards



Source: Dakers 2015

10 Many credit card users in the UK are able to take full advantage of this flexibility, with 61% repaying in full before the end of interest-free period (UK Cards Association 2014). The British Bankers' Association further estimates that 41% of all credit card balances incur no interest at all (British Bankers' Association 2015).

11 Lower-risk consumers are those with an established credit history, while higher-risk consumers include those who are either new to credit, have had negative credit events in the past, have lower incomes, or are sole traders or self-employed.

Higher-credit-risk borrowers have much less choice of products and providers than lower-risk consumers.

of debt that is potentially problematic, including levels of defaults and arrears, credit-limit use, systematic minimum payment behaviour, debt service costs, and time to repay debts.

Higher-credit-risk borrowers have much less choice of products and providers than lower-risk consumers. The market is fairly

concentrated for the lower-risk market, as four firms account for two-thirds of outstanding balances in this segment, but just four firms account for virtually all the outstanding balances in the higher-risk segment.[12] This calls for innovation and greater competition for this segment of the market; just 60% of cardholders claim to pay off their balance each month (older customers are mainly in this group). The other 40% of accounts have 60% of the total balance (£34bn) on which interest is being paid. This could be problematic for vulnerable borrowers if interest rates rise in the UK. Those with mortgages could be particularly vulnerable. If mortgage rates rise, this could make it more difficult to service mortgage debt and, in turn, service unsecured borrowing such as credit card debts.

Credit risk assessment is an important part of the lenders' decision-making process and card providers regularly update their credit-scoring estimates for borrowers. Even so, the FCA found that firms tend not to verify income data, despite the importance it plays in affordability assessments. Moreover, firms tend not to conduct regular affordability assessments once an account is active (FCA 2015b: paras 6.31, 6.36. 6.37).

Interestingly, although the credit card market is relatively sophisticated and mature, it appears there are significant gaps in the body of research into the degree to which lending and marketing practices, especially balance transfer acquisition, credit-limit increases and interest rate changes are associated with subsequent default or financial difficulties for the borrower, and the effectiveness of lenders' models in assessing affordability and, in particular, at taking into account future changes in the borrower's financial position (Bijak et al. 2015).

Of those holding cards, 6.9% (around 2m) were in arrears or default, 1.9% (600,000) have been in default or have been in arrears for at least six months, and 4.9% (1.5m) have missed three or more repayments and are either in or have been in arrears. Not surprisingly, these consumers are more prevalent in the high-credit-risk and more deprived demographic segments of the population.

A further 6.6% of cardholders (around 2m) have persistent high levels of credit card debt, which they may be struggling to repay. This group of borrowers is profitable for firms and the FCA concluded that there was little evidence to suggest that firms are intervening to help consumers address persistent debt burdens, unless they miss payments.

A further 5.2% of cardholders (around 1.6m) make systematic minimum repayments. This group of borrowers is making slow progress on repaying its debts and incurring higher costs than is necessary into the bargain. Again, these consumers are profitable for firms.

With regard to balance transfers, almost half of accounts repaid the full amount of the balance transferred by the end of the promotional period. This increased to 60% three months later and 71% six months later.

Persistent high use of credit limits can also be an indicator of debt problems and financial vulnerability. The FCA found that 6.6% (2.1m) of active consumers

12 Indeed, the Herfindahl-Hirschman Index (HHI) – the common measure used to establish the level of concentration in a market – for the high-risk market is just over 3,000 compared with just under 1,600 for the lower-risk segment. It is worth noting that an HHI of over 1,000 is considered to be concentrated. Source: FCA (2015b): para. 3.38,

Those with a mortgage and high credit-limit use rates are particularly vulnerable as they could see significant increases in total debt servicing costs.

29%

of respondents claimed to have spent more on their credit card than they had budgeted for

maintained a credit limit use of on average 90% or more over the year while incurring interest. Although this was present across all credit risk groups and demographic segments, it was more prevalent in higher-risk consumer segments. Again, this group could be vulnerable if there are increases in UK interest rates. Those with a mortgage and high credit-limit use rates are particularly vulnerable as they could see significant increases in total debt servicing costs.

The cost of credit for consumers with and without problem debt differs considerably (FCA 2015b: 81, Figure 19). Those in arrears or with persistent levels of debt incurred the highest cost. For those consumers without problem credit card debt indicators, around three-quarters pay an estimated cost of credit that is below 5% and around 94% paid an estimated cost of 20% or less. For those consumers in arrears or with persistent debt, however, over 15% paid an effective cost of 50% or more; and 10% of those in severe arrears, 7% of those in serious arrears, 4% of those in persistent debt and 3% of those making systematic minimum repayments paid an effective cost of 100% or more.

Of those accounts not exhibiting problem credit card debt indicators, 86% are estimated to repay their credit card debt within five years. In contrast, for accounts identified as being in serious arrears, persistent debt or making minimum repayments, the figure is much lower at 55% to 65% (FCA 2015b: 81, Figure 20).

Of credit cards active in January 2015, 8.9% (5.1m accounts) will – on current repayment patterns and assuming no further borrowing – take more than 10 years to pay off their balance (FCA 2015b: 80, para 6.71). Those in arrears or with persistent levels of debt take the longest to repay. Borrowers with poor earnings prospects will face a debt burden for the foreseeable future, unless remedial action is taken to help them free up resources to pay off debt more quickly. Interventions will take on even greater urgency if interest rates rise.

The FCA has also assessed the proportion of consumers in various risk deciles (as measured by likelihood of default) who exhibited one or more of the indicators of problematic debt (see above for definitions). Of those in the highest risk decile, 63% exhibited one or more of the indicators, while nearly 30% in the second decile exhibited one or more of the indicators – this compares with 15% on average across all the risk deciles (FCA 2015b: Annex 6: 7, Figure2).

Around half of consumers surveyed by the FCA reported some level of concern about their credit card debt. Of those surveyed, 17% reported being 'very concerned' about their outstanding balance, 34% reported being 'slightly concerned', and 48% reported being 'not really concerned' or 'not at all concerned'. Those with credit cards targeted at consumers with a poor credit history (a 'low and grow' product) were the most likely to report being concerned (FCA 2015b: Annex 6: 15).

Over one-third of the consumers surveyed claimed that they were usually unable to repay the full amount on their credit card each month (ie revolved balances). Over the past year, 29% of respondents claimed to have spent more on their credit card than they had budgeted for and 24% claimed it took them longer to repay their balance than they had expected (FCA 2015b: Annex 6: 15).

The FCA has concluded that the market appears to be working well for the majority of consumers who use credit cards. Indeed, the majority seem to be repaying their balance in full each month. Looking beyond this headline conclusion, however, it is concerning that a significant minority of borrowers appear to be facing real detriment. Two groups of borrowers stand out:

- borrowers already struggling under a problematic debt burden, and
- borrowers who are at risk of problematic debt because they are paying more in debt servicing costs and taking longer to pay off their debts than they need to.

In total, it would appear that around 5.6m credit card borrowers (nearly one in five of credit cardholders) are in some way financially vulnerable – either already struggling or at risk of problem debt.

It is worth pointing out that most credit card holders appear not to be using credit cards as a true form of borrowing – that is, they repay the money advanced on the

> Of the number who borrow and pay interest on their credit card borrowings, a very large proportion of these are in some sort of financial difficulty.

credit card in full or for the most part each month. Of the number who borrow and pay interest on their credit card borrowings, a very large proportion of these are in some sort of financial difficulty.

Moreover, higher-risk borrowers incur much higher costs for their credit and have fewer options to choose from – as mentioned, four providers account for nearly all of the outstanding balances in this segment. This suggests a need for interventions to promote greater competition and more innovative solutions to meet the needs of this group of consumers.

There is also evidence of poor financial capability skills among the higher-risk borrower groups, with large numbers unable to repay the full balance on their account each month, persistent high borrowing up to credit limits, large numbers spending more than had planned, and taking years to pay off outstanding debts.

The credit card market is certainly not working well for higher-risk borrowers.

Mapping this detriment on to the financial resilience roadmap, interventions are shown to be needed at three points to support credit card borrowers:

- debt advice and financial capability interventions to help those borrowers already in trouble
- targeted interventions to help those at risk to avoid getting into problematic debt and to build financial resilience, and
- the development of affordable, better-value credit options for those who are incurring very high borrowing costs on credit card borrowing.

The interventions recommended elsewhere on improving debt advice and financial capability, building financial resilience and developing the socially responsible alternative credit market will benefit vulnerable credit card borrowers.

There are, however, five further specific recommendations to protect the interests of higher-risk borrowers in the credit card market.

Recommendation 7.1: The FCA should have particular regard for the potential for consumer detriment in the high-cost credit card market, as highlighted in its recent interim report on the whole credit card market (FCA 2015b). In particular, there should be a clearer duty on lenders to intervene to help borrowers with persistent debt problems.

Recommendation 7.2: The FCA should tighten up its rules to ensure that lenders verify borrowers' incomes, and conduct frequent affordability assessments and client reviews to ensure that borrowers with persistent debt problems are identified early.

Recommendation 7.3: The evidence gathered as part of the FCA's credit card study suggests that much more could be done to improve lenders' models for assessing affordability and borrowers' ability to repay. Arguably, lenders have sufficient incentive, given the economics of the higher-risk segment of the credit card market, to improve the predictability of credit models. Therefore, the FCA should coordinate further analysis of lenders' credit assessment models to promote innovation and competition.

Recommendation 7.4: The FCA should use behavioural finance insights to (1) identify and prevent lenders' marketing, promotional and business practices that exploit consumers and (2) identify and promote effective interventions that encourage positive borrowing patterns, such as paying off more than the minimum payment each month.

Recommendation 7.5: Four firms account for the majority of outstanding balances in the higher risk segment of the credit card market. The FCA should pay special attention to these and ensure that all lenders are supporting consumers.

The next section considers socially responsible credit providers and outlines how the supply of funding to community lenders could be increased through the development of Social Lending Bonds and an ethical 'lending marketplace'.

ACCA maintains that there are many similarities between external auditors in the public and private sectors.

4.3 THE CURRENT STATE OF THE SOCIALLY RESPONSIBLE ALTERNATIVE CREDIT MARKET

Much has been made of the potential for community lenders – credit unions and Community Development Finance Institutions (CDFIs) – to step into the breach and increase the provision of responsible, affordable credit. Considerable effort and resources have gone into developing this

sector: credit union membership is growing steadily and is now at an all-time high with around 1.2m people using 362 credit unions. In 2014, the sector had over £1bn of deposits and made £718m worth of loans (ABCUL 2014). Over the same period, CDFIs lent £19m to 42,000 individuals (CDFA 2015). This progress is very welcome but, to put these figures in context, in 2012 payday lenders alone lent £2.8bn to 1.8m people (CMA 2015). There is clearly still some way to go.

4.4 WHAT NEEDS TO CHANGE?

Several supply-side barriers could inhibit the ability of the community lending sector to grow: regulation; availability and use of existing capital; lack of operational capacity in the sector (governance, human resources, marketing); and distribution barriers.

The FCA and the Prudential Regulation Authority (PRA) are currently consulting on necessary changes to the regulatory framework.

Many credit unions do require additional deposits to lend more to members; other credit unions are sitting on large surplus deposits that are not being deployed efficiently. This suggests the need for:

- intra-sector interventions such as shared-treasury services to allow credit unions with surplus deposits to use these deposits to support other credit unions, while generating a better return for their own members, and
- support for credit unions to help them market and distribute loans more effectively to generate the necessary returns to sustain growth.

Efficient distribution is important for growth and sustainability in the community-lending sector. The economics of distribution are critical in determining the unit costs of reaching the optimal number of customers. Moreover, efficient distribution is needed to ensure vulnerable borrowers do not slip through the net. If community lenders are to improve the economics of distribution and extend coverage, new models for distribution, in particular referral mechanisms and partnerships with established organisations that already have access to potential customers (housing associations, trade unions, other affinity organisations), are a priority.

CDFIs, in particular, appear to be finding it difficult to access funds to on-lend.[13] Unlike credit unions, CDFIs are not deposit takers and this gives them the flexibility to lend responsibly to the highest-risk borrowers, ie those most at risk of full exclusion. It is therefore especially important that they are able to access sufficient capital. Moreover, increasing the amount of 'patient' longer-term capital available to lend should be beneficial for CDFIs.

There are two innovations that could increase the supply of capital to community lenders: Social Lending Bonds (SLBs) – which would address the need for patient, long-term capital particularly well – and an ethical lending marketplace.

13 CDFIs secured only £2m in new funding for lending to individuals in 2014 (CDFA 2015)

5. Social lending bonds and ethical lending markets

SLBs are aimed at social investors (such as philanthropists, ethical investors and pension funds) and are structured to provide investors with a reasonable financial return and allow them to make a social impact with their investments.

5.1 SOCIAL LENDING BONDS (SLBS)

SLBs are aimed at social investors (such as philanthropists, ethical investors and pension funds) and are structured to provide investors with a reasonable financial return and allow them to make a social impact with their investments. They are designed to channel sustainable long-term capital into the community-lending sector.

Arguably, to promote sustainable capital, potential investors should expect to receive a reasonable return on their investment, as well as be allowed to invest for a social purpose. To do this, a SLB portfolio would consist of a mix of low-risk government/corporate bonds and social investments (see Box 1, below). The SLB funds can be structured in such a way that the precise asset allocation can be varied according to the 'risk-profile' of investors, or to reflect the preferences of the 'philanthropic' investor.

SLBs could be run by a managing trustee board that would invest the social investment component in qualifying financial institutions – community development financial institutions (CDFIs) looking for additional loan capital, or social/ micro enterprises. As with the conventional investment decision process, the managing board would undertake due diligence before selecting social investments.

BOX 1: EXAMPLE OF 60/40 BOND STRUCTURE

The SLB asset allocation allows investors to invest for a social purpose, while at the same time providing a reasonable rate of return. The following example assumes an SLB with 60% invested in UK gilts and 40% in social investments (for example, credit unions and CDFIs). The yield on 10-year gilts is currently 1.84%.[14] Research suggests that CDFIs can generate a yield of 9.0% on their investments (CDFA 2010). Allowing for further write-offs, charges and investment costs, it would be prudent to assume that the social investment component of the bond portfolio could earn a return of 4% after charges. Therefore, an SLB with a 60/40 asset allocation could generate a 'blended' return of @3% per annum in the current market, depending on how well the social investment portfolio performed.[15] The SLB could be structured differently to reflect investor preferences. For example, an SLB could have two sub-funds – a gilt sub-fund and social investment sub-fund, which would allow investors to allocate investments according to preferences. At inception, any investments would be held in high-quality liquid investments until suitable social investments were identified.

Recommendation 8: Develop a market for social lending bonds.

14 As of end September 2015 http://markets.ft.com/research/Markets/Bonds

15 This is a simple weighted average of the returns assumed from the gilts portfolio and social investment component. It is based on a return of 1.84% from gilts making up 60% of the portfolio, and a return of at least 4% from the social investment component that would make up the other 40% of the portfolio. This generates a weighted average of 2.7%. A return of 4.8% from the social investment component would produce a return of 3% precisely.

A lending marketplace is an online platform that connects investors (lenders) with borrowers.

5.2 DEVELOPING AN ETHICAL LENDING MARKETPLACE

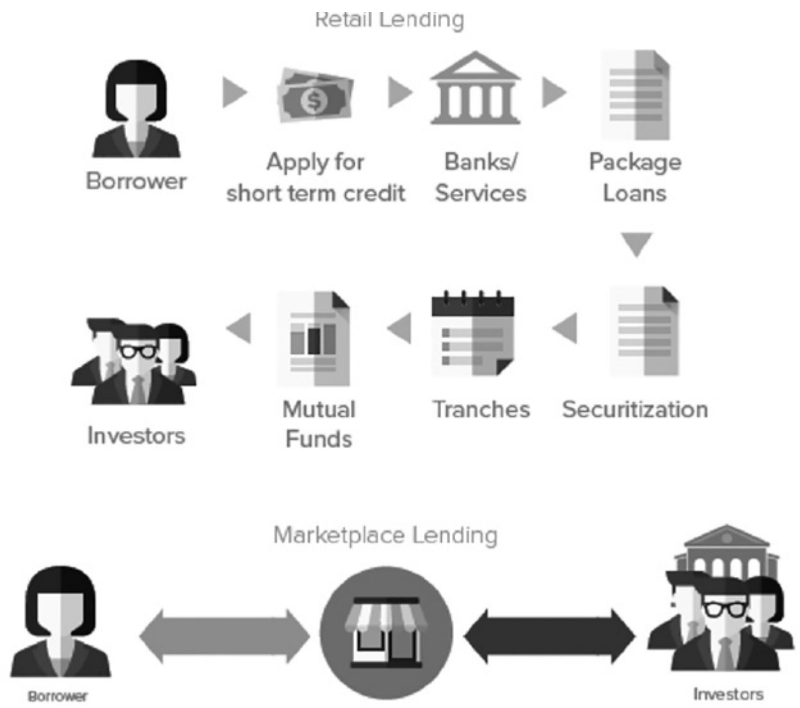
As discussed in Chapter 3, 'Savings and budgeting', provision of financial services appears to be on the cusp of revolutionary change away from branch-based services and towards smartphone-based applications. Not only is the delivery of financial products being transformed, but the ways in which funds are sourced to make loans also look set to change. If the US experience is replicated in the UK, cost savings due to both disintermediation and technological efficiency gains, coupled with the low returns available on traditional savings, will lead 'lending marketplaces' (encompassing both peer-to-peer lending and institutional lending) to playing a much greater role in the supply of consumer credit in the UK. Peer-to-peer loans will become eligible for Individual Savings Account (ISA) status later this year, providing a further incentive to investment in this sector.

5.3 WHAT IS A LENDING MARKETPLACE?

A lending marketplace is an online platform that connects investors (lenders) with borrowers. The biggest lending marketplaces lending to individuals in the UK are Ratesetter and Zopa. Investors are individuals or, increasingly, in the US at least, funds[16] that invest a specific amount of money for a fixed term. The marketplace assesses the creditworthiness of prospective borrowers and accepts or rejects their application and assigns an appropriate risk-based interest rate to the loan. Investors' money is then lent to accepted borrowers on a fractional basis, ie each investor lends a small fraction of their investment to a specific borrower, so that the investor's risk is diversified across a number of loans rather than being lent directly to a single borrower.

Lending marketplaces cut out many of the barriers to entry associated with traditional banking, such as the branch network and cumbersome legacy systems; and perhaps most importantly, because these platforms do not take deposits, but only investments, investors are exposed to default losses. The ability to pass through default losses means that lending marketplaces do not need to hold regulatory capital, they do not participate in the Financial Services Compensation Scheme and they can, in theory, take more credit risk than a deposit-holding institution.

Figure 5.1: Marketplace lending is disintermediating the borrowing and investing experience



Source: Lending Club, JP Morgan; Foundation Capital (2014)

16 A lending marketplace that only allows individuals to lend is called a peer-to-peer lender; here the generic term 'lending marketplace' is used.

Commercial lenders operating in the non-standard credit space do not tend to use deposits as a source of funding.

5.4 WHY USING INVESTORS RATHER THAN DEPOSITORS MATTERS

Credit unions take deposits from savers and lend them out, and because savers need to be protected from losses, credit unions need to hold a certain level of loss-absorbing (regulatory) capital. Both the need to protect depositors and to have sufficient liquidity on hand to cover withdrawals from deposit accounts constrain the amount of risk credit unions can take when they lend. Increasing the level of deposits in credit unions does not, therefore, necessarily increase the availability of responsible credit to those in need. Similarly, some credit unions are very well funded with high levels of deposits but experience little demand for loans, while other community lenders have high demand for loans but insufficient funds to lend.

Commercial lenders operating in the non-standard credit space do not tend to use deposits as a source of funding. The big US payday lenders, Cash America and Dollar Financial, who have been operating profitably in the UK are finance companies rather than banks. Just like Wonga.com, they are financed by investors rather than depositors.

5.5 WHY ARE GOVERNMENT INTERVENTION AND SUPPORT WARRANTED?

Innovation does not, in and of itself, guarantee wider financial inclusion or better financial products. In contrast with peer-to-peer lending to businesses, which has resulted in improved funding for small and medium-sized enterprises (SMEs) that encounter difficulties in borrowing from other sources,[17] to date 'for profit' marketplace lending in the UK appears to have reached only a demographic that is already well served by banks. Research conducted by NESTA shows that while marketplace lending to individuals in the UK is growing rapidly, with £547m worth of loans made to 62,000 individuals in 2014, these loans were made exclusively to borrowers of very high credit quality. In fact, more than half of borrowers had been offered a loan by a bank (NESTA 2014).

Arguably, targeted government support and intervention will be required to ensure that the benefits of this new funding model reach the financially vulnerable. There are new opportunities opening up and this is the time to ensure that the socially responsible sector does not get left behind.

5.6 COULD MARKETPLACE LENDING WORK FOR EXCLUDED BORROWERS?

There have been two failed attempts to establish lending marketplaces to serve the non-standard credit market: 'The Lending Well' and 'Invest and Borrow'. The Lending Well was set up in 2012 to provide peer-to-peer payday loans and closed in March 2013 owing to difficulty finding 'high-quality' borrowers (P2P Money 2013). It is not clear that it ever made a single loan. Wonga.com launched Invest and Borrow in May 2013, but by January 2014 it had closed. Again it is not clear whether it ever made any loans. Invest and Borrow aimed to make loans of between £100 and £2,000 for between three and six months at an APR of 75%, well below that charged by payday lenders (AltFi News 2014).

These two businesses failed during a period of considerable upheaval in the HCSTC market. In the case of The Lending Well, the biggest problems may have been that the single payday loan product's design was not really compatible with responsible lending and that lending money to borrowers who were able to borrow from other payday lenders at a time (late 2012 to early 2013) when Continuous Payment Authority was being aggressively deployed would have been very high risk. In the case of Invest and Borrow, Wonga.com underwent a period of difficult trading and announced large-scale job losses shortly after the platform was launched, which may have accounted for its decision to close this part of its business and focus on its core operations.

The fact that commercial lending marketplaces have previously tried to enter the non-standard credit space, coupled with increasing public interest in this kind of investment (which will soon be eligible

17 'A third of those who raised funds via P2P [peer-to-peer] business lending or invoice trading, reported that they would have been "unlikely" or "very unlikely" to get funding elsewhere. 79% of businesses had attempted to get a bank loan before turning to P2P business lending, with only 22% being offered finance.' (NESTA 2014)

There is now an opportunity for community lenders, with the government's support, to establish a lending marketplace that puts responsible lending and borrowers' needs ahead of profitability.

for tax relief as part of an ISA), makes it likely that they will seek to do so again now the regulatory landscape has cleared. In the US, lending marketplaces such as Lending Club and Prosper have been creeping down the credit curve, offering investors the opportunity to lend not only to prime borrowers but to those at the very top of the subprime spectrum (Demos and Dugan 2014).

There is now an opportunity for community lenders, with the government's support, to establish a lending marketplace that puts responsible lending and borrowers' needs ahead of profitability.

The government should work with credit unions and CDFIs (ideally in partnership with one of the existing lending marketplaces) to set up an online marketplace and to develop an underwriting algorithm based on the best practice of leading credit unions such as London Mutual Credit Union. This would have to be done slowly and carefully to avoid excessive default losses, but there is enormous potential here to offer low-cost loans to those in need.

It would be good to see credit unions and CDFIs control the underwriting themselves, applying to the platform for the funds to lend on only once they were satisfied with the suitability of the loan for the applicant. The originating credit union/CDFI should also retain part of the loan so as to share the risk between investor and originator.

In order to ensure that vulnerable borrowers do not slip through the net, retail banks could be required to refer rejected applicants, just as they are required to refer rejected SMEs to alternative finance providers (HM Treasury 2014).

As outlined in Chapter 3, when loans are repaid borrowers should be automatically referred to their nearest credit union to set up a regular savings plan mirroring the repayments they have already been making on their loan.

5.7 SOURCING INVESTORS ETHICALLY AND EFFICIENTLY

Creating a centralised pool of funds for community lenders to draw on offers significant economies of scale compared with the current model whereby each organisation individually sources funding. As with any peer-to-peer investment, investors need to be fully aware that their investment is exposed to losses. Initially, social investors and relatively well-off investors should be targeted to make investments that will form a small part of diversified portfolios. Large depositors in credit unions could also be made aware of the possibility of investing in an ethical marketplace, thus enabling surplus deposits to be deployed efficiently by other credit unions and CDFIs.

The new alternative finance ISA wrapper will provide some incentive. A further incentive could be provided in the form of Social Investment Tax Relief (SITR), a scheme that allows investors in social enterprises to offset 30% of their investment against their income tax liability. While lending businesses are not eligible for the existing SITR scheme, similar arrangements could be put in place for a government-approved lending marketplace, making loans only via not-for-profit community lenders. If necessary, an even stronger incentive to invest could be provided; borrowing from the structure of the existing Enterprise Investment Scheme (EIS), losses could also be offset against investors' income tax liabilities.

Borrowing from the government's own model of lending its own funds to SMEs via Funding Circle (DWP 2014b), some government direct government investment could be provided in the early stages.

Recommendation 9: Government should work with existing commercial marketplace lenders, credit unions and CDFIs to develop an ethical lending marketplace.

6. Conclusion

This report has examined evidence that low levels of financial resilience leave many households in the UK vulnerable to financial shocks.

This report has examined evidence that low levels of financial resilience leave many households in the UK vulnerable to financial shocks. Financial insecurity impairs workers' productivity; workers who are stressed by juggling their finances are not as productive as their financially secure counterparts. Employers are well placed to tackle this problem and many now support their workers' financial well-being. Nonetheless, there are growing numbers of people whose productivity is not 'owned' by a single employer – in particular, the self-employed and those on low and variable earnings who may be employed casually and have more than one employer; as a result, they fall outside the scope of such assistance. The financial resilience of those who are currently studying also has implications for future labour productivity. Therefore, some well-targeted government intervention and support is required to reach these groups.

There are exciting times ahead in the financial services sector with rapid change happening in the delivery of financial products and the supply of funding. Some of this change is receiving support and encouragement from the government through its fintech strategy and through policies such as the soon-to-be-launched peer-to-peer ISA. It is especially important, then, that the benefits reach everyone in society. Innovation has not always served vulnerable borrowers well in the past; to ensure that it does so in the future, consumer groups, community lenders and regulators must stay 'ahead of the curve' – a huge challenge given the size and diversity of the market, and commercial organisations' significant resources. This report has focused on probable future developments in financial services and ways of 'future-proofing' recommended interventions.

The report has explored and outlined interventions aimed at improving the situation of financially insecure households, focusing wherever possible on the three 'at risk' groups identified in Chapter 1, in two ways: by boosting levels of saving and increasing the supply of affordable, responsible credit.

Leveraging existing infrastructure provides the lowest-cost solutions and, in this regard, there are two 'low hanging fruits' waiting to be plucked on the savings side

> Savings are on a downward trajectory, the self-employed as a group are growing and student numbers are rising.

of the financial resilience equation. The first, identified by Stepchange, is the extension of the existing system of auto-enrolment for pension saving to include an accessible savings element; the second is the use of the end of debt repayment as a starting point for regular savings.

Simply increasing the supply of credit without regard to underwriting practices is not a solution here. In consumer credit markets more is not necessarily better. The credit constraints faced by many financially vulnerable borrowers lead to a lack of price sensitivity in the non-standard credit market; this market does not always function well for its users. Good regulation has a crucial role to play and, although the evidence is very limited at this stage, there are some tentative, encouraging signs that the rate cap imposed on the HCSTC market is having the desired effect. The FCA should, however, remain vigilant for any emerging risks in neighbouring markets serving displaced HCSTC borrowers.

There is scope to improve the quality of credit supplied to financially vulnerable households by linking up the responsible underwriting and concern for overall financial well-being practised by community lenders to a much larger pool of funds than that currently available to them. There are two mechanisms through which this can be accomplished: social lending bonds and an ethical lending marketplace.

There are, of course, limitations to the work presented here. More work is needed to assess the feasibility of an ethical lending marketplace. Poverty and the distribution of wealth both have implications for the lack of financial resilience in many households; a fuller discussion of these issues is beyond the scope of this report. There is a marked lack of detailed information on the financial situations of the self-employed and of workers on low and variable earnings. Much necessary work to assess what can be done to support the self-employed, in the form of an independent review of self-employment, is currently being undertaken by the government.

Savings are on a downward trajectory, the self-employed as a group are growing and student numbers are rising. The above recommendations are both aimed at ensuring that current at-risk groups are helped, and seek to curb debt demand through encouraging saving. The recommendations will lead to productivity gains, both now and in the future, helping to push up real wages, which will in turn reduce the demand for welfare. Ultimately, these recommendations support the government's aim of creating a budget surplus by 2020.

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Annexe: data on financial resilience

This Annexe provides some key data on levels of financial resilience among lower-income households and the self-employed groups that are the focus of this work.

This Annexe provides some key data on levels of financial resilience among lower-income households and the self-employed groups that are the focus of this work. Unfortunately, comprehensive data is not available for each group on each of the main product areas that are included in the main text. As the data below shows, the self-employed and lower-income households fare badly on the main financial resilience and security indicators.

LEVEL OF SAVINGS

As explained in the main report, households on lower incomes are, not surprisingly, more likely than other households to have no savings.

Table A2 provides a more detailed breakdown of the level of savings by weekly household income. A rule of thumb is that households should try to ensure that they have at least three months' worth of income in the form of easily accessible savings to cope with short-term financial needs. The proportion of households with different levels of income that have built up three months' worth of savings is an estimate.[18]

As the table shows, across all income bands only around 30% of households appear to have savings worth three months of their specific income. The important thing to note is that lower income households are more likely to have no savings at all.

Research commissioned by the Money Advice Service (MAS) found that over the period 2006 to 2013, five million fewer people said that they make sure that have money saved for a rainy day. The proportions have dropped from 75% in 2006 to 63% in 2013 (Money Advice Service 2015: 11).

30%

of households appear to have savings worth three months of their specific income

Table A1: Savings levels among selected households

Weekly income	No savings (% of households)	Under £1,500 (% of households)
<£100	52	10
£100<200	54	11
£200<300	50	12
£300<400	48	13
£400<500	43	14
All Households	35	13

Source: Households by amount of savings and investments, and total weekly household income (Family Resources Survey 2014: Table 2.8)

Table A2: Detailed breakdown of savings by household income

	Weekly income										
Level of savings	<£100	£100 – £200	£200 – £300	£300 – £400	£400 – £500	£500 – £600	£600 – £700	£700 – £800	£800 – £900	£900 – £1,000	>£1,000	All
No savings	52	54	50	48	43	36	34	29	24	24	15	35
<£1,500	10	11	12	13	14	15	14	17	17	15	11	13
£1,500–£3,000	7	5	6	6	6	6	7	8	8	8	7	7
£3,000–£8,000	9	11	11	11	11	12	13	13	16	16	15	13
£8,000–£10,000	3	3	3	2	2	3	3	3	3	3	4	3
£10,000–£16,000	5	5	5	6	5	6	7	8	7	7	9	7
£16,000–£20,000	1	3	2	2	2	2	3	2	4	3	3	3
>£20,000	14	9	11	13	16	20	19	21	20	20	35	20
estimates of > three months income	n/a	34	32	31	30	33	32	31	30	27	35	

18 It was estimated by working out the equivalent of three months' income for each of the weekly household income bands. This then allowed an estimation of what proportion of households within each of the weekly household income bands had savings greater than this threshold. Note these are very much estimates, but give an indication of how few households in each band actually met this threshold.

FINANCIAL VULNERABILITY

As Table A3 shows, a lower proportion of self-employed are in arrears on any sort of debt. Significantly more self-employed households are, however, spending large proportions of household income on repaying unsecured and all other debt repayments. Over 12% of self-employed people are spending 25% or more of their income on repaying unsecured debt compared with 5.5% of employee households. The number of self-employed spending 50% or more of their household income on repayments of total debts is three times the number of employed people in that position.

Moreover, statistics from Citizens Advice covering the period December 2013 to February 2014 (Citizens Advice 2014b) show that:

- 33% of self-employed people who came to the charity in the last three months of that period received advice on debt problems (the same proportion as those who are unemployed) compared with 29% of employees; and
- more than 1 in 10 self-employed people who were helped with debt issues had advice on bankruptcy, compared with 7% in work and 5% unemployed.

As of the end of 2014, the self-employed made up nearly one-quarter, 24%, of bankruptcies compared with 11% pre-financial crisis in 2007 (Insolvency Service 2015: Table 7a, Bankruptcies by self-employment status). As self-employment represents around 15% of total employment, it suggests that the self-employed are more likely to become bankrupt.

As Table A4 shows, households on lower incomes are much more financially vulnerable on a number of measures. Households on lower incomes are more likely to have higher debt-income ratios and higher repayment-income ratios.

Households with lower incomes are more likely than others to be in arrears and subject to insolvency action, and to find keeping up with payments a heavy burden. They are also much more likely to be in financial difficulties or facing financial stress.

Table A3: Indicators of financial vulnerability

	Any arrears	Unsecured repayments >25% of HH income	All repayments >50% of HH income	Any debt-heavy burden
Employees	10.4	5.5	4.7	16.8
Self-employed	9.4	12.2	14.3	17.2

Source: Bryan et al. (2010): Table 7

Table A4: Relationship between household incomes and debt/repayment to income ratios

	Debt to income >60%	Repayment to income ratio >30%	Structural arrears	Insolvency action/ arrears	Keeping up is a heavy burden	In financial difficulties	Financial stress	Either in financial difficulties or stress
Annual income								
<£13.5k	35%	29%	16%	22%	20%	22%	16%	38%
£13.5k–£25k	24%	15%	10%	14%	16%	14%	13%	27%
£25K–£50k	14%	10%	6%	10%	11%	10%	8%	18%
£50k+	5%	7%	3%	6%	6%	6%	4%	10%

Source: BIS (2013c): Table A24, A33, A44

MORTGAGE DEBT

Research produced by the FSA/FCA as part of its Mortgage Market Review showed the degree to which the self-employed are more likely than employees to be in financial difficulty with their mortgages.

As Figure A1 shows, self-employed borrowers who took out a mortgage between 2005 and 2012 (especially those with self-certified incomes) are significantly more likely to be in financial difficulty with their mortgage.

According to the FSA/FCA, self-employed borrowers were almost three times as likely as employees to be in arrears of two months or more and twice as likely to have their property repossessed. Moreover, the performance of self-employed mortgages significantly deteriorates when other risks are factored in – for example, credit impairment, debt consolidation, right-to-buy, borrowing at a high loan to value (LTV).

In addition to being rated higher-risk, recent self-employed borrowers are more likely to be still borrowing into retirement than the average borrower. Of those self-employed borrowers who took out a mortgage between April 2005 and June 2012, 35% will be borrowing into retirement compared with the average of 26%.

The attitudes of lenders towards the self-employed in the future will be important for their access to credit and its impact on business financing.

Access to mortgage credit

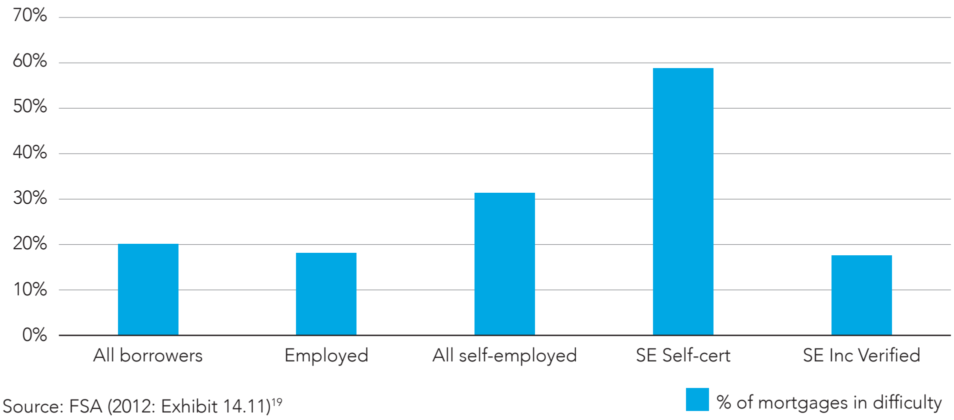
Access to mortgage credit for the self-employed is important for two reasons. It is important in its own right for helping the self-employed to buy their own homes, but it has also been important for funding business development through remortgaging.

As Figure A2 shows, the proportion of new mortgage sales to self-employed borrowers at the height of the market in 2007 (pre-crash) was just under 18%, and has since gradually reduced to account for around 11% of the total in 2012. No data is available on the actual number of mortgages advanced to the self-employed over that period, but the total number of mortgages advanced fell in the same period. So the self-employed took a reducing share of a declining market, implying that the numbers of mortgage advances to the self-employed fell much more than the chart shows. This could have implications for their access to affordable credit for business purposes.

35%

of those self-employed borrowers who took out a mortgage between April 2005 and June 2012, will be borrowing into retirement

Figure A1: Self-employed mortgages in difficulty

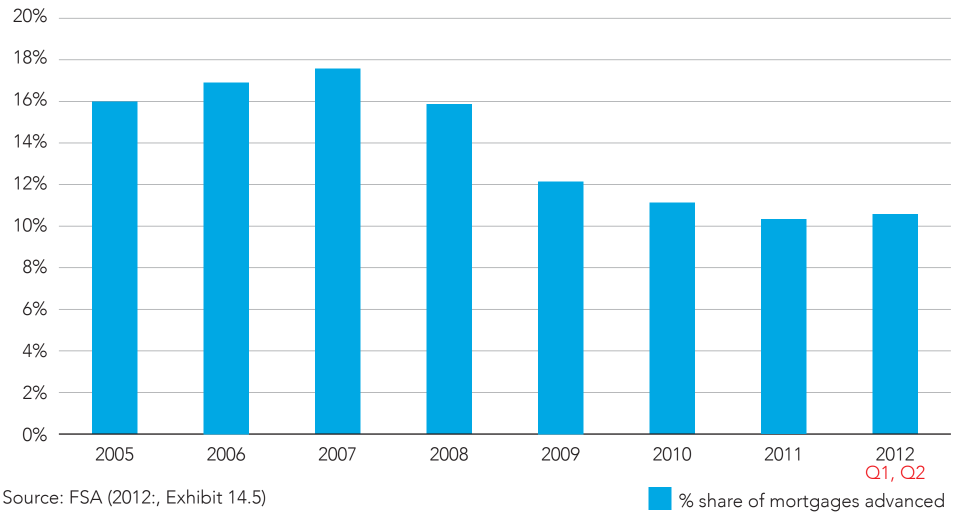


Source: FSA (2012: Exhibit 14.11)[19]

11%

of new mortgage sales were to self-employed borrowers in 2012

Figure A2: Self-employed taking lower share of mortgages



Source: FSA (2012:, Exhibit 14.5)

19 Mortgages in financial difficulty in this case include the following categories: Live – past payment shortfall <2 monthly payments, Live - past arrears >=2 monthly payments, Live – current payment shortfall <2 monthly payments or unknown, Live – current arrears >=2 <=6 monthly payments, Live – current arrears >6 monthly payments or possession order, Live – in possession. These relate to mortgages taken out between April 2005 and December 2011. Source: FSA (2012: Exhibit 14.11).

PENSION COVERAGE

As Table A5 shows, the self-employed have significantly lower pension participation than employees. Fewer than one in five are participating in a pension – only 12% of women.

Other sources suggest that the proportion of self-employed individuals contributing to a pension may be even lower. The most recent data from HMRC suggest that 420,000 self-employed individuals contributed to a pension in 2013/14 (HM Government 2014). There are around 4.5m self-employed individuals in the UK. This implies that only 10% are contributing to a pension.

According to recent research, 53% of those in work were considered to be saving adequately for retirement, but only 33% of the self-employed were providing 'adequately' for retirement compared with 64% in the public sector and 48% in the private sector (Scottish Widows 2014).

Figure A3 highlights the long-term decline in pension provision among the self-employed – falling from over 60% in the mid 1990s to 21% among males in 2012/13.

Not surprisingly, households with lower incomes tend to have lower pension participation rates.

INSURANCE COVERAGE

Another indicator of financial resilience and security is having insurance to fall back on in the event of an unforeseen risk or shock.

As Table A7 shows, the self-employed appear to be less likely to have coverage in most key categories of insurance than equivalent occupation categories. The categories concerned here are contents insurance, mortgage protection, life insurance and income protection. In each of those core categories the self-employed have comparatively low levels of provision. It is worth noting that the numbers of households with income protection appear to be so small that this insurance is not reported in the survey.

Research by poverty campaigners suggests that half of the poorest households – as measured by those in the lowest income quintile – do not have home contents insurance. This contrasts with under one in five of households in the middle quintile and one in ten households in the richest fifth quintile. Nor does it appear that any real progress has been made, as the proportions without insurance and the gap between poorest and better off are similar to a decade ago. Households with no home contents insurance are more than three times as likely to be burgled as those with insurance. The same research found that more than half of renters (in the social and private sectors) did not have contents insurance compared to home owners.

Table A5: Pension participation by employment status, percentage of adults

	Male	Female	All
Employees	47	48	48
Self-employed	21	12	18

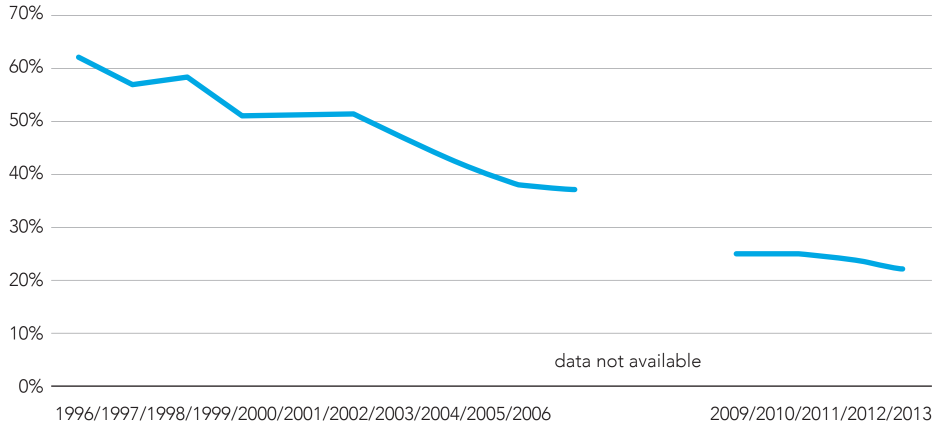
Source: Family Resources Survey (2014: 93, Table 6.1)

Table A6: Pension participation by income band, percentage of adults

Weekly income	Pension participation (%)
<£100	7
£100–£200	4
£200–£300	4
£300–£400	7
£400–£500	12
£500–£600	19
£600–£700	24
£700–£800	30
£800–£900	35
£900–£1,000	33
>£1,000	49
All households	26

Source: Family Resources Survey (2014: 95, Table 6.3)

Figure A3: Long-term trends – % of self-employed men currently contributing to a pension



Source: Family Resources Survey/DWP (2013: Figure 7.10)

Table A7: Self-employed and insurance

	Structure (%)	Contents (%)	Medical (%)	Mortgage protection (%)	Life (%)	Income protection (%)
Large employers and higher manual	83.6	93.8	19.5	33.2	33.2	*
Higher professionals	74.4	84.5	19.5	22.1	22.1	*
Lower managerial and professionals	75.7	87.5	14.7	28.7	28.7	*
Intermediate	67.8	80.7	14.4	24.2	24.2	*
Small employers and own account workers	73.3	79.2	11.3	19.2	19.2	*
Lower supervisory and technical	67.3	78.2	7.4	29.5	29.5	*
Semi-routine occupations	45.6	62.1	*	16.3	16.3	*
Routine occupations	46.9	65.7	*	15	15	*

Source: *ABI Data Bulletin*, May 2012 – from ONS Living Costs and Food Survey 2010

EA-BRITAINS-DEBT

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