2 Explaining financial exclusion and policy interventions

2.1 Defining financial exclusion

The most comprehensive analysis of financial exclusion was undertaken by Kempson et al. (2000) in their work for the Financial Services Authority (FSA). They argued that financial exclusion was initially perceived as a geographic issue (Pratt, Leyshon, and Thrift 1996a,b) related to the closure of bank branches in specific low-income communities where little or no financial services were available. The Kempson et al. (2000) work broadened the definition to include:

- exclusion by risk assessment and product design
- exclusion through the cost of service relative to income
- exclusion by ignorance (people external to the audience targeted by marketing promotions)
- self-exclusion by people who believe they will be refused financial services, or may not wish to engage with financial institutions.

Regan & Paxton (2003) preferred to describe financial exclusion in terms of 'depth and breadth'. For example opening a bank account doesn't necessarily increase inclusion if the account holder is unaware how to utilise the service. Although useful for understanding the links between different elements of financial exclusion, this definition does not distinguish between financial inclusion and financial capability. Practically such an approach is too open-ended, meaning policy makers can never 'solve' financial exclusion or indeed effectively measure 'success'.

2.2 Evidence of financial exclusion

Research by Bridges and Disney (2002) into credit usage among low-income households supports the concept of financial exclusion outlined above by Kempson et al (2000). They found that 49% of lone parents use mail order schemes and informal arrangements, as opposed to credit and store cards. Of the total sample 4.21% use moneylenders , among lone parents it was 5.13%. Lone parents have lower debts with moneylenders than couples with children (£208.83 compared to £730.13 respectively) but had greater difficulty maintaining payments (28.91% compared to 23.53%). Furthermore 40% of lone parents and 30% of low income couples were behind on utility and service bills. They also found that households deferred repayment of utility and rent/mortgage bills and instead repaid other lenders. Though these lenders charge higher interest rates, they are prioritised because of their more aggressive collection policies and the view among borrowers that utility and local authority or Registered Social Landlord officials are more 'sympathetic'. Financial exclusion can also be reinforced by firms, such as the fuel companies transferring lower income customers to prepayment meters, with 2 million

households on gas prepayment meters, and 3.7 million having similar arrangements with electricity suppliers (OFGEM 2003).

Finally propensity to default *'depend both on adverse characteristics, but also on access to credit in the first place. Thus, very 'high risk' households may be unable to obtain credit on which to default*' (Bridges and Disney 2002:19). The strongest correlation to default being receipt of housing and welfare benefits, except pensions, and housing costs. Moreover, lone parents with large numbers of children are more likely to default.

2.3 Why financial exclusion is occurring?

There is little doubt that the increasing interest in financial exclusion is partially related to the exponential growth in personal credit. By August 2004 household debt passed £1 trillion, a rise of 25% since September 2002. Research by the Institute of Fiscal Studies (IFS) found that 10% of the population with the biggest debts are at least £4,248 in the red. More worryingly amongst the poorest fifth of the population (earning less than £8,730) debts averaged £3,337. In contrast of those with more than £5,000 in savings investments only 36% were in debt. Perhaps unsurprisingly calls to the national debtline have risen from 60,000 in 1996 to 150,000 in 2002, with the biggest shift in enquiries being from negative equity then to credit card debts today. What is unknown is the impact of this unprecedented rise in debt during an economic or housing market slowdown.

With so much credit available it has become easier to identify those that are considered financial excluded, a matter to which the banks are acutely sensitive. This was evident in the publication of two reports entitled 'Banking Without Branches' by Kempson and Jones (2000) and 'The Contribution of British Building Societies to Financial Inclusion' by Marshall et al. (1999), commissioned by the British Bankers Association and the Building Societies Association, respectively.

The Kempson and Jones research examined bank and building society branch closures since 1988 and the effect on the communities. They found that the elderly were more reliant on branches, while younger people *"…were heavy users of banking services but had, by and large, arranged their finances in ways that did not necessitate frequent branch visits."* (2000:5). They argued that branch closure did not adversely affect the majority of the population. For those geographically isolated, other options including shared branches, community banks and using the post office as an agency. They also found that there was "considerable customer resistance" to telephone or electronic banking.

The work of Marshall et al (1999) included a comparison of bank and building society closures. They found that banks were more likely to close branches in socially disadvantaged areas. The new mortgage banks, it was found, were the most aggressive on branch closures. The report also revealed a degree of frustration towards the government's political opposition to branch closures. Nor was this opinion restricted to

the banks as many of the more commercial building societies felt they had no responsibility towards tackling financial exclusion.

'The problem the Government has got is that there is a large section of the population that is nearly un-bankable. Nobody wants them because they are not profitable. …The Government should provide welfare, not building societies.' (A quote from a building society chief executive 1999:19)

This acceptance of even the simplest form of financial exclusion is as a result of the changes that are occurring in the financial sector. The main driver in this change is the concept of 'shareholder value'. This positions the shareholder at the centre of decision making, rather than the long-term stability of the organisation or even the customer. Companies must ensure they maximise return on invested capital in the shortest possible time to allow dividends to continue growing.

An example of this trend is that financial institutions increasingly offer homogenous products and target their services at people with a good credit rating. The latter is assessed by using strict criteria, which include fixed monthly income, stability of employment, and minimum length of employment. As a consequence the poorest people are increasingly \`excluded\` through the type of products and services offered. For example, a low-income customer may only want to borrow £500, but the amount is too small for the bank manager to consider processing a loan and the customer may lack sufficient security to be granted an overdraft.

Consequently financial service providers seek to attract high-income and high expenditure customers, while withdrawing their products for those in the opposite category. The commercial logic of this position is undeniable: it costs the same to process a cheque of £10,000 as it does £10, yet the interest earned overnight in affecting a transfer between accounts justifies the former but not the latter. This cherry picking is prevalent among the newer banking entrants, such as the supermarkets who begin from a low cost base with no existing unwanted clients. Concurrently banks are reducing costs through closure of unprofitable branches and opening of telephone call centres and internet banking services.

There is little a community can do to resolve this matter as the clearing banks primary duty is to their shareholders and they face increasing competition from international, supermarket, and most importantly internet banks. This rivalry is destined to intensify and cause even more exclusion as conventional high street banks are forced to reinvent themselves as electronic banks. This will aggravate the existing inequalities in access and usage of financial services.

As the mainstream sector withdraws from disadvantaged communities, moneylenders replace them. However, as both Rowlinson (1994) and Dayson et al (1999) discovered, moneylenders are not an unappealing option to many current and potential clients. Culturally moneylenders have been the preferred option for many working class families as the mainstream lenders were historically viewed as exclusive middle class institutions.

Moneylenders also offered services that people want: flexibility, accessibility, convenience and social interaction. However, their critics claim they are manipulative and expensive, both of which can be an effective deterrent upon their usage and an issue of concern for those committed to tackle poverty.

Support for this analysis was evident in Palmer and Mayo (2002) research on sub-prime lenders. They found that these organisations loaned £16 billion in 2001. Of this, moneylenders, such as Provident, London Scottish Bank, Shopacheck, and Morses, had £3.3 billion share of the market. This longstanding form of small credit has been supplemented in recent years by non-status lenders who provide credit to those with impaired or a low credit rating. Additionally a new form of pawnbrokers, (Cash Converters, BrightHouse) have arisen who buy products from clients and sell back at a higher price within a given period, thereby avoiding the Consumer Credit Act (CCA 1974) . The exposure of UK consumers to these lenders has meant Britain is perceived as a 'safe-haven' for sub-prime lenders. In France BrightHouse (formerly known as Crazy Georges) were declared illegal and not permitted to trade. Furthermore under the CCA 1974 there have been only 29 cases against lenders charging extortionate credit and only 2 of these were found guilty. By comparison in Germany there are 100,000 cases against moneylenders each year, as unlike Britain, extortionate is double the market average interest rate.

Financial exclusion also extends to the business community with micro-enterprises in disadvantaged communities most at risk (Collard et al 2001). The Bank of England's (2002) annual review found that fewer self-employed people in disadvantaged communities had personal accounts than those in other areas. Of those with accounts fewer had separate business accounts. Additionally businesses in disadvantaged communities were less likely to produce business accounts. Perhaps unsurprisingly the lower incomes earned by businesses in disadvantaged areas made it more difficult to borrow money, and with less individual savings it was harder to raise start-up capital for new ventures (BoE 2002, Collard et al 2001). Structurally the Small Firms Loan Guarantee Scheme (SFLGS) was under utilised in disadvantaged communities. As typical micro-enterprises in these communities, such as retail, transport and other service sector business, were originally unable to access the SFLGS. While the minimum guarantee offered (£30,000) was invariably larger than the micro-enterprises (BoE 2002).

2.4 Responses to financial exclusion

With the election of the Labour Government in 1997 the national policy context changed and its priorities were shifted towards tackling social exclusion. Policy was developed through a range of Policy Action Teams. Two of these reports discuss Community Development Finance Institutions (CDFIs): PAT 14 on personal finance and PAT 3 on enterprise.

PAT 14 examined access to personal finance and found a direct link between financial exclusion and deprivation. The policy approach to these problems was summarised by Melanie Johnson:

> *"The way forward lies in developing new and alternative means to deliver and provide access to financial services as well as ensuring that existing services can reach the whole community."* (H.M. Treasury 1999b:Forward)

As a result, recommendations included more freedom and an increased role for credit union.

To date credit union development has been patchy and currently serves less than 1% of the population. Among the causes for this alleged 'failure' of credit unions to expand are:-

- they are constrained by the 1979 Credit Unions Act (PAT 14)
- there is too much emphasis on the common bond by the Registry of Friendly Societies (Fuller 1998)
- a lack of professionalism, with no paid employees or computerised systems (Jones 1999): can a trust relationship exist without professionalism or professional volunteers?
- too small to be effective (Dayson et al 1999)
- common bonds are too focused on disadvantaged communities: the poorest people have to save before they can borrow, and these areas have a small and less qualified pool of possible volunteers
- the top-down creation of credit unions by local authorities is out of step with credit union philosophy
- an unrealistic expectation is imposed on credit unions by policy makers
- a failure to understand cultural differences results in unfair comparison with American and Irish credit union development.

Rather than address these matters directly, policy has sought to overcome them by scaling-up credit unions and their support structure. Firstly the Credit Union Taskforce report (1998) recommended the relaxation of legislation and regulation and the creation of a Central Services Organisation (CSO). PAT 14 hoped that the CSO, in combination with higher quality regulation by the FSA, would increase the profile of, and public confidence in, credit unions. However, the CSO was unable to secure funding and has now been sidelined.

Rather, the main emphasis since the publication of PAT 14 has been the supply of Basic Bank Accounts. These are 'no frills' accounts offered by all the banks that are open to everybody. In Paxton & Regan (2003) review of progress on financial inclusion they argued that Basic Bank Accounts were widely available although there were still difficulties regarding appropriate identification and the awareness of basic bank accounts by individual bank branches was imperfect.

PAT 3 focused on enterprise and access to finance. It found that access to finance is more difficult in disadvantaged communities because of the limited amount of personal equity in those localities, which makes them more reliant on external finance. This is aggravated by a more precarious local economy, the proportionally high cost of making small loans, and `cultural distance`, making banks seem unapproachable and uninterested. This is a particular problem for women as they often begin with lower income and assets. The report argues that CDFIs can *"strengthen the social and economic fabric of disadvantaged communities"* and *"act as a bridge between a disadvantaged community and the mainstream economy"* (p14).

In relation to social enterprise, PAT 3 suggests that:-

- support for social enterprises is patchy
- there is an inability to evaluate or understand what is "success"
- the markets they operate in are weak and fragmented
- local and regional government provide too little support (e.g. through SRB)
- the potential for housing association involvement is under-employed
- social enterprises have difficulties accessing mainstream funding.

PAT 3`s strategy for tackling the shortage of finance in disadvantaged communities accepted that although banks are the main source of external finance, market based solutions alone could not address all market failures. It suggests that public resources should concentrate on loans rather than grants, and proposes that to help achieve this objective Community Finance Initiatives (CFIs) can:

> *"... play a valuable role, by acting as additional sources of credit in the community, focussed on market segments that are not commercial but which offer high social returns"* (H.M. Treasury 1999b:10).

2.4.1 Post Policy Action Team interventions

With respect to credit unions, secondary legislation was introduced relaxing the rules regarding the maximum amount that could be held in an account by minors, and these changes were supplemented by seven others in July 2002. These covered borrowing from external sources; differentiation in dividend rates; charge fees; flexible common bonds; regulate use of the title "Credit Union"; change the minimum coverage requirements for fidelity bonds; and multiply accounts (H.M. Treasury 2001b:1).

These legislative alterations have accompanied a tightening of the regulatory framework for credit unions, with regulation being undertaken by the FSA; a tightening of liquidity rules; and a 100% share protection scheme similar to that operated by banks and building societies. These structural changes form part of ABCUL's[5] declared desire to improve the quality and regard of the service delivered by credit unions. Part of this process has

[5] ABCUL = Association of British Credit Unions Limited.

been the introduction of the 'PEARLS' financial monitoring system for credit unions. The scheme, which is funded by Barclays, is being piloted in ten locations, and seeks to measure a credit union's protection, effective financial structure, asset quality, rates of return and costs, liquidity and signs of growth (Ethical Performance Best Practice 2002). Leeds City Credit Union has adopted the PEARLS monitoring system as part of the second phase of rolling out this programme.

In addition to credit unions the government has introduced a Post Office Card Account (POCA) for those who are unable or unwilling to access a bank account. This enables cash withdrawals at post offices but does not offer an overdraft facility (New Start 2002). Concern remains about overloading expectations on the banks and that the POCA is about saving the Post Office rather than tackling financial exclusion (English 2000).

The support for credit unions and POCA are part of the government's drive to encourage the savings habit. Collard et al (2001) demonstrated that the post office was a trusted intermediary among disadvantaged communities and that the financially excluded would be willing to place savings with them. Alongside these initiatives a number of building societies have entered into partnerships with housing associations to offer savings and loans accounts (Newcombe 2002). Although relatively easy to create, the first of these schemes, the New Horizons project in Cambridge, has thus far had a chequered record with success in drawing savings accompanied by high arrears levels on some loan products (Dayson 2004 forthcoming). The government are also piloting Savings Gateway's schemes in which those on low-income employment will receive £1 from the state for every £1 they invested, up to a maximum of £25 per annum. A review of the Savings Gateway (Kempson et al 2003) indicated that it had proved to be 'successful' with a 25% take-up among the eligible group.

Alongside the Savings Gateway pilots was a financial literacy initiative operated by the DFES. These projects sought to maximise interest in basic financial literacy among housing association tenants; entitled Community Finance Learning Initiatives (CFLIs). The performance of these have been more mixed, with those linked to a Savings Gateway pilot proving more effective. Generally the participating housing associations believed that the incentive of the Savings Gateway encouraged users to access learning opportunities.

In national policy terms Savings Gateway are considered part of the emerging area of 'asset based welfare', which stresses the importance of initial capital injections to engender social change. The forthcoming Child Trust Fund (CTF), which will offer all households a fixed sum for long-term investment at the birth of their children. It is hoped that the CTF will be most beneficial in lower income households, however to maximise the benefit there will be a need investment in financial literacy.

In 2000 the Bank of England produced a report on finance for small businesses in disadvantaged areas. Apart from endorsing CFIs, the report's key finding was that although the funding of enterprise in disadvantaged communities was similar to national averages, the margins charged by banks were 'significantly higher': 4.12% as compared

to 2.71% (Bank of England 2000:v). These figures were later adjusted to 3.8% and 3.5% respectively, and the corresponding figures for 2001 were 3.7% and 2.5% (BoE 2002). The Bank of England argues that this is due to ‘a differential in assessed risk’. The report argued that while bankable business could and should be served by mainstream providers, a combination of community loan funds, micro-credit schemes and social banks should serve near-bankable, marginal and social enterprises. In defining a role for CDFIs in disadvantaged communities, the bank endorsed above-market interest rates as it deterred those who could attract mainstream finance. Additionally CDFIs fulfilled a previously identified need for relationship banking and higher charges were an unavoidable function of multiple smaller loans. This process avoided the arbitrary selection process and credit rationing practised by the banks. Within their communities CDFIs can be more flexible, quicker and behave more mutually. The report concludes by promoting greater partnership between CFIs and banks, and more co-ordination of initiatives on a regional basis with RDAs and SBS working to prevent duplication and fragmentation. This process is already underway with a more regional coordinated strategy to the allocation of the Phoenix Fund to CDFIs.

After a short hiatus the policy debate around financial exclusion has reawakened with the announcement of a Financial Inclusion Taskforce and a Financial Inclusion Fund within July 2004 Comprehensive Spending Review (H.M.Treasury 2000). Though fuller details are not available until later in the year the Treasury did declare that ‘*the supply of free face-to-face money advice falls far short of demand’*, and that it *‘wishes to see a significant increase in capacity over the Spending Review period. The Government will invite proposals to expand the provision of advice from potential providers and will also pilot different models of debt outreach.’* (Section 5.27). In addition they announced a lowering of the repayment rate for the Small Firms Budgeting Loans and that *‘further work will also be taken forward with the private, voluntary and community sectors to develop models to make more affordable loans available.’* (Section 5.24). Furthermore, *‘the Government wants to explore mechanisms that allow profitable loans to be made available to those on low incomes at a much lower rate of interest. The Government, therefore, intends to work in partnership with the private and voluntary and community sectors to develop models which make more affordable loans available. Any pilots will be evaluated to ensure that the loans enhance people’s ability to manage their finances responsibly’* (Section 5.26).

The following week Gerry Sutcliffe and Chris Pond presented the DTI’s report on overindebtedness (Tackling Overindebtedness – Action Plan 2004). This stated that the government had seven strategic priorities:

• increasing levels of financial capability and awareness, so consumers have the confidence and understanding they need to take control of their finances, participating actively and effectively in the credit market;
• ensuring that all consumers – and in particular those on low income – have access to affordable and reasonable credit;
• ensuring all lending is responsible and protecting the most vulnerable consumers;
• encouraging a savings culture in order to avoid future debt;

• ensuring that consumers with problems are identified early, and steps are taken by creditors to help them without resorting to the courts;
• making sure that sufficient, high quality, appropriate, free debt advice and support is available to consumers with debt problems; and
• ensuring that where it is necessary to resort to courts, cases are handled efficiently, speedily and effectively, and without making the debts worse.
Theses strategic priorities were to be delivered through ten priority partnership initiatives, which can be classified as:

• Preventing consumers getting into difficulties, which include developing a national strategy for financial capability, and increasing the availability of affordable credit for those on low incomes, through increased activity in the credit union sector, reviewing the role of the Social Fund and the development of alternative models of affordable credit provision;
• Ensuring consumers can be confident in fair products
• Widening access to the right debt advice. This connected to a DCA consultation on providing non-court options for those with multiple debts.

In summary, with regards to financial inclusion there is strong evidence of initiatives being launched, and until recently this has not been accompanied by a coordinated strategy or delivery approach; though this situation appears to be changing. It is increasingly apparent that addressing financial exclusion will require a holistic approach involving awareness, education, advise on money management, debt counselling, savings and affordable credit.