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Locked in, kept out

The extent of competition within the UK home credit industry

Steve Brooker and Claire Whyley

JOSEPH ROWNTREE
FOUNDATION

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Summary

Background and aims

Consumers on low incomes often require credit simply to make ends meet and to buy essential goods and services. Despite the massive expansion in consumer credit that took place during the 1990s, in 2002 over one in five adults, or 7.8 million people, were denied access to mainstream sources of credit. Low-income consumers frequently pay a higher price for their credit even though they generally borrow very small sums of money. This is because the products available to them in the sub-prime sector charge higher rates of interest, sometimes incur additional fees and charges, and may carry punitive terms and conditions. There is a growing evidence base of the damaging effects of exclusion from mainstream credit and of how low-income households could benefit from more affordable and appropriate credit facilities. The home credit industry has been singled out for particular criticism because of the much higher than average APRs (Annual Percentage Rates) associated with the industry, although it puts forward a number of arguments in defence, and certain practices such as roll-over loans, early settlement rebates and pressure, however subtle, for continued borrowing. The most recent dedicated study into the industry is a decade old and none of the research to date has focused on the competition dynamic. Home credit customers are especially vulnerable since they live on low incomes and have few, if any, alternatives, so it is vital to ensure they are getting value for money.

This report seeks to explore, as part of a wider National Consumer Council (NCC) project, the extent of competition within the UK home credit market and the extent to which an absence of effective competition could be having an adverse impact on consumers. The overall aim of the project was to increase competition in the low-income credit market and, as a result, widen access to affordable loans offering good value for money to this customer base.

Study areas and methodology

The report is based on the findings of two phases of research and centres on the experiences of the customers of the home credit industry. This industry offers small, short-term unsecured cash loans, primarily to low-income groups. An agent who calls at the customer's home collects fixed repayments, in cash, on a weekly basis. There are 519 businesses in the UK belonging to the industry trade body, although four national companies dominate the market.

The first research phase involved secondary analysis of survey data from the Continuous MORI Financial Services Tracking Survey, which was based on a statistically representative sample of 24,269 adults who were interviewed between July and December 2003. This enabled us to identify the size and characteristics of

the home credit customer base. The second phase of the research involved depth interviews with 21 home credit customers and five collection agents to explore their attitudes towards, and experiences of, the industry. Guidance from the Competition Commission was used to assess the broad extent of competition in the home credit market with respect to the conduct of customers.

Profiling home credit customers

The quantitative data suggests the size of the UK home credit market is around 2.3 million customers, or 5 per cent of the population. However, one in ten people have used home credit at some time in their lives, which suggests a deeper penetration of the UK population than had previously been recognised.

Home credit use is much more prevalent among women than men, which reflects the home-based delivery of the product and the purposes for which loans are used. Home credit customers also tend to be relatively young, with people aged 21–44 comprising seven-tenths of current or recent users. While married and cohabiting couples, and single never-married people make up the bulk of home credit customers, people who are divorced or separated are over-represented compared to the general population, which suggests a link between relationship breakdown and home credit use. There is also a direct relationship between the number of children in a household and the likelihood of that household being over-represented among home credit customers. For example, 16 per cent of current or recent home credit users have three or more children, compared with 5 per cent of all households.

Predictably, there is a correlation between personal income and home credit use, with the pattern of income distribution and take-up of home credit operating on a sliding scale. It follows that home credit users tend to be drawn from the lower socio-economic groups. In terms of employment status, people who stay at home to care for a family were three times as prevalent among home credit customers as they were in the general population, and those who were unemployed or seeking work were twice as prevalent. The vulnerability of home credit users is highlighted by their potential to experience other features of financial and social exclusion. For example, there is a high proportion of social tenants and a very low proportion of homeowners compared to the general population. Home credit customers also experience comparatively low educational attainment – 70 per cent of current or recent home credit customers completed their full education by the age of 16 compared to a quarter of the general population.

In examining why people use home credit, it is possible to identify the background circumstances customers share, which relate to an ongoing inability to manage on a

low income or particular events that act as triggers. The home credit customers we interviewed shared a striking similarity in terms of their financial circumstances. These included long-term low household income, a slow build-up of debt and belonging to families with a history of struggling on low incomes. The respondents also shared exclusion from mainstream credit products and bad experiences of dealing with mainstream credit providers, but there was a high degree of self-exclusion as well. Use of home credit is also part of their family and local traditions. Positive associations with home credit, the reliance on the recommendations of local networks and a very limited awareness of alternatives combined with a familiarity with borrowing on the doorstep, made taking out their first home credit loan easier. The events that can act as triggers relate to an urgent need for a relatively small sum of money for a variety of reasons or a crisis of some kind. In respect of the former, these include paying an overdue bill, buying a school uniform, replacing an essential household item, Christmas time and a number of miscellaneous expenses that overstretch the household budget. The sorts of crises that act as triggers include relationship breakdown, health problems and sudden changes in employment status.

Attitudes to home credit

The characteristics and circumstances of home credit customers mean that they have specific, and quite inflexible, requirements of credit products if they are to be confident and successful in making use of them. Home credit offers a unique service in terms of both its characteristics and delivery mechanisms, and meets the needs of its customer base well. It provides a trusted service, which is familiar to them from their local networks.

Home credit gives simple, straightforward and speedy access to the relatively small amounts of money these consumers need, with little risk of refusal. It also offers repayment systems that are compatible with low-income consumers' household budgeting strategies. Repayment in cash is crucial for those who do not have or are reluctant to use current accounts, fits with the way in which they manage their income and outgoings, and offers a much higher degree of control compared to electronic transactions. Home credit provides consumers with the stability they need to manage their budget because repayments are fixed and there are no charges for default or late payment, although firms include this risk in the price. The regular home collection service also helps customers to maintain discipline in their repayments and to keep on top of their finances. At the same time, however, consumers value the flexibility of a system that enables them to miss the occasional payment without penalty when they have short-term cash-flow problems. This is supported by a friendly, trusted relationship with an agent who recognises and understands their circumstances. Even if customers are experiencing long-term

financial problems, the emphasis is on restructuring loans so that they can be repaid, rather than heavy-handed arrears-management procedures.

In contrast, alternative credit products from across the spectrum of providers are less successful in offering the combination of product characteristics and delivery mechanisms necessary to meet the needs of home credit customers. Use of these different sources of credit where it does occur is generally aimed at broadening access to credit rather than replacing home credit loans. This has implications for competition because it suggests customers do not have direct alternatives to switch to if they are dissatisfied with home credit.

The competition dynamic

The Competition Act explicitly includes the conduct of customers as a market feature that might potentially adversely affect competition. The depth interviews reveal the presence of information asymmetries and switching costs, which act to constrain effective competition in the home credit market.

Levels of financial literacy are particularly low among the types of consumer most likely to be using home credit. This affects the way home credit customers engage with the product. People weigh up the financial cost against the service benefits of home credit and are prepared to pay some premium for it. However, they do not make true price-based decisions. Consumers judge affordability in terms of the total amount added onto a loan and the level of weekly repayment, rather than by considering interest rates. Further, recall of interest rates and APRs is very low. The implications are that, if customers are satisfied with the service and do not make price-based decisions, there is no incentive for them to search for better deals or for firms to reduce prices.

Because other credit products are less successful in meeting the requirements of home credit customers, there is little switching from home credit to other credit products. In addition, there is a low level of switching between different home credit providers, with little evidence that consumers switch between companies in order to secure a better deal. Where switching does occur it tends to be reactive rather than proactive and, as a result, is unlikely to exert pressure on home credit companies to compete with one another. Most customers who had switched providers or used more than one company at the same time had done so for a range of reasons that were not related to either price or service. Crucially, the majority of home credit customers who took part in the depth interviews said that they would not switch to a new provider even if they were offering lower interest rates.

Consumers face significant switching costs if they wish to change home credit suppliers. The practice of step-up loans may 'lock in' the customer to a lender and encourage repeat purchase because switching to a new supplier would require starting with small amounts all over again. For consumers on low incomes, who exist on small economic margins, early settlement penalties are especially punitive. Roll-over loans appear to be a very common practice. The way interest charges for these loans are structured ties customers into loans. The psychology of the relationship between the customer and agent, which is often built on friendship and conducted in the emotionally significant environment of the home, could act to dissuade consumers from leaving their agent and moving out of the home credit market.

Conclusions and implications for policy

This research is particularly timely because consumer credit is subject to major legislative change for the first time in a generation, which presents an excellent opportunity to advance pro-poor policy around the field of credit. Our findings are that the conduct of home credit customers acts to constrain effective competition in this market. However, the characteristics of the home credit product meet the needs of the customer base well and the home credit industry provides a valuable source of credit to consumers on low incomes. To remove home credit from the market or to drive it underground could be to the detriment of low-income consumers and would risk exacerbating existing problems of financial exclusion.

This research does not claim to be conclusive in relation to all aspects of the home credit sector and potential consumer detriment. Wider research and investigation, including in relation to economic components of the market, would help to explain the factors in the market that may constrain competition and lead to consumer detriment.

Detailed consideration of the possible remedies to a lack of competition in the home credit market is also beyond the scope of this project. The range of remedies that could be considered embraces changing the behaviour of customers (demand-side approach) to changing the way the industry is structured and changing the behaviour of firms (supply-side approach). First, there are clearly demand-side problems relating to financial capability that should form a part of any package of solutions. There are two main supply-side approaches to improving competition in this sector: stimulating alternative provision of affordable credit or imposing controls on the industry. We anticipate that any programme of remedies would include a mixture of these two supply-side approaches. However, we would place greater emphasis on the former approach, which would prove more sustainable in the long term.

1 Context

The policy context

The 1990s saw a massive expansion in consumer credit with a greater array of products becoming available to a wider range of consumers than ever before. The proportion of households with access to consumer credit facilities has increased from 61 per cent in 1989 to 73 per cent in 2002 (Kempson, 2002, p. 16). Just over half (53 per cent) of all households in Britain had active credit commitments in 2002 and there is also evidence to show that consumer credit use is heavier than it was a decade ago (Kempson, 2002, p. 16).

At the same time, however, in 2002 over one in five adults, or 7.8 million people, were denied access to mainstream sources of credit (Datamonitor, 2002, p. 3).[1] Largely, this is because they have characteristics and circumstances that lenders deem to represent a high risk of default. These include long-term low and/or unstable income and poor credit histories. However, there is an element of self-exclusion as well. Many consumers simply never try to obtain credit from mainstream providers because they believe, often correctly, that they would be refused, or because they perceive the products and/or providers to be inappropriate for their needs.

Access to credit was, initially, neglected in investigations of and initiatives around financial exclusion because borrowing was not perceived to be a priority for low-income households. It was widely believed that increased access to credit for those on low incomes could, in fact, be detrimental by reducing their already limited disposable income and further destabilising the household budget. Finally, it was hoped that the provision of other affordable and appropriate financial services, such as bank accounts, insurance products and savings facilities, would reduce the need for credit among people on low incomes.

But access to credit is essential for all consumers to function effectively in their everyday lives, even if they choose not to use it. While more affluent consumers use credit to improve their lifestyle and maintain cash flow, consumers on low incomes require credit simply to make ends meet and to buy essential goods and services. Their credit use is borne out of necessity rather than luxury. The Office of Fair Trading (OFT) has made the distinction between the ‘management of poverty’ and the ‘facilitation of affluence’ (OFT, 1991, p. 7).

Consumers excluded from mainstream credit provision have a limited range of options available to them. If they are unable to borrow from family or friends or apply for a Social Fund loan, and do not belong to a credit union, it is likely that they will be forced to seek credit from the sub-prime sector. But the products in this sector – home credit, mail-order catalogues, pawnbrokers and so on – charge much higher rates of interest. Some of these products may also incur additional fees and charges,

and carry punitive contractual terms and conditions. It is a sad paradox that low-income consumers frequently pay a far higher relative price for their credit compared to the generally very small sums of money that they borrow.

The damaging effects of exclusion from mainstream credit have been reported in a number of research studies (Kempson and Whyley, 1999a, 1999b; Jones, 2002) and data provided by agencies such as Citizens Advice, Consumer Credit Counselling Service, National Debtline, and the Department of Trade and Industry (DTI) OverIndebtedness Taskforce (NACAB, 2001; Debt on our Doorstep, 2001; DTI, 2001, 2003a). This evidence base has led to increasing concern and recognition over the last two years over the way in which high-cost credit can lead low-income consumers into a spiral of debt. It has also provided evidence of how low-income households could benefit from more affordable and appropriate credit facilities. Rather than exposing more evidence of consumer detriment, the focus of this study is to identify the causal factors behind these effects.

While concerns have been expressed about the sub-prime market as a whole, the home credit industry has been singled out for particular criticism by consumer protection and advice agencies, as well as in academic studies and policy reports (Kempson and Whyley, 1999a; NACAB, 2001). To date, the main criticisms have focused on the cost of home credit, manifested in the much higher than average APRs (Annual Percentage Rates) associated with this industry, and certain practices such as roll-over loans, early settlement rebates, home selling and pressure, however subtle, for continued borrowing (Rowlingson, 1994; Kempson and Whyley, 1999b; Jones, 2002). There have been claims that the APRs charged cannot be justified either by the costs or risks associated with delivering the product and that persistently high prices reflect, and are perpetuated by, an absence of effective competition (Gibbons, 2003).

The home credit industry justifies the charges by pointing to the particularly high fixed costs associated with conducting business on the doorstep compared to other credit agreements, and the high risk of default associated with the customer base. It argues that the APR calculation is inappropriate for its industry because it exaggerates the cost of short-term loans and does not factor in how the loans incur no penalties or additional charges, even in the case of default. In addition, it points to very high levels of customer satisfaction as evidence of the essential and highly valued role of the home credit sector for low-income consumers (OLR, 2000).

Despite the high level of interest in sub-prime lending, the most recent dedicated study of home credit was completed a decade ago (Rowlingson, 1994). A number of studies since then have included home credit as part of wider investigations into

affordable credit and financial exclusion (Kempson and Whyley, 1999b; NACAB, 2001; Jones, 2002). However, none has considered the market from a competition viewpoint. When markets work well, competition has numerous beneficial effects: prices and costs are driven down, and innovation and productivity increase, so increasing the quality and, more generally, the diversity of choice available to customers (Competition Commission, 2003, p. 8). Home credit customers are especially vulnerable since they live on low incomes and have little other choice but to use this product in order to manage their household budgets. Therefore, it is vital to ensure that the home credit market is operating competitively and offering its customers value for money.

Aims and methods

The primary aim of the study was to explore, as part of a wider NCC study (Whyley and Brooker, 2004),[2] the extent of competition within the UK home credit market and the extent to which an absence of effective competition could be having an adverse impact on consumers. In the case that consumer detriment and a lack of competition were found, the desired outcome of the project as a whole was to increase competition in the low-income credit market and, as a result, widen access to affordable loans offering good value for money to this customer base.

To help us make our competition assessment, we referred to guidance issued by the OFT (2003) and Competition Commission (2003) for this purpose. The guidance recommends that evidence to indicate market failure can relate to one or a mixture of:

- the conduct of customers
- the conduct of suppliers
- structural features of the market.

The research conducted for this report focuses on the conduct of customers. The theory relating the conduct of customers to competition is introduced in Chapter 4. It represents one strand of a wider NCC investigation into the home credit industry, which used a range of data sources to provide information about the conduct of suppliers and structural features of the market. These included small-scale local surveys to establish the nature and extent of home credit use in deprived areas of England and consultation with a range of organisations involved in consumer protection and advice.

This report is based on secondary analysis of survey data from MORI Financial Services (MFS) and qualitative research with home credit users and collection agents, also conducted by MFS for the NCC. The data enabled us to:

- identify the size and characteristics of the home credit customer base
- explore the attitudes and experiences of home credit users
- explore the views, attitudes and experiences of collection agents working within the home credit industry
- analyse this information to determine whether there are features of the home credit market that are acting as constraints on competition.

The statistical data on the home credit customer base is from the Continuous MORI Financial Services Tracking Survey. The sampling frame was based on 210 out of 641 parliamentary constituencies in Great Britain, which were selected to be representative of the whole country by region, class and other variables. Each interviewer is required to carry out ten interviews within specified quotas every fortnight, amassing a sample size of 24,000 every six months. Respondents were selected by means of a 12-cell quota based on gender, class, age and working status, and were devised by an analysis of the 1991 Census. The period used for this research was July–December 2003.

The qualitative research consisted of two parts. The main sample was 21 one-hour, face-to-face depth interviews conducted in the home with current customers of home credit companies. As with all qualitative research, the sample was not intended to be statistically representative but was specifically selected to include a wide range of the characteristics that are common to home credit customers, covering gender, social class, working status, household type, age, dependants and marital status. Respondents were recruited from the general public in Bradford, Birmingham and Greater London; these areas were chosen on a North-South geographical basis. The interviews covered triggers to use of home credit, the initiation and maintenance of the customer–agent relationship, awareness and consideration of alternative products, and attitudes and behaviour towards the home credit product. The fieldwork took place in late October 2003.

In addition, 45–60 minute tele-depth interviews were conducted with four current collection agents and one retired collection agent. The NCC recruited this sample by placing letters and advertisements in the local press in the Midlands and North of England. The interviews covered agents' perceptions of the market, how they build

and maintain a customer base, details about the loan and the service provided, and perceptions of their customers' understanding and awareness of home credit products and their levels of debt. The fieldwork took place in early November 2003.

The results of each of the phases of research are reported in the chapters that follow.

The study area

The home credit industry, also known as weekly collected credit, offers small, short-term, unsecured cash loans, primarily to low-income groups.[3] An agent who calls at the customer's home collects fixed repayments, in cash, on a weekly basis. Companies offer a range of loan sizes and repayment terms, ranging from 14–120 weeks. Customers are generally eligible only for fairly small loans to begin with, in the region of £50 to £100, building up to larger amounts as the customer builds their relationship with the lender and proves to be reliable in making repayments. The interest rate applied to the loan is fixed throughout its term and there are no additional charges or penalties attached to loans, even if the customer defaults on a payment. A common practice is to 'roll over' one loan into the next, whereby a new loan is issued before the previous loan has been fully repaid. Statistical analysts Datamonitor estimate that the average customer borrows twice each year with a total yearly loan amount of £500 (Datamonitor, 2002, p. 234).

The Consumer Credit Association (CCA) – the main trade body representing home credit companies – has 519 member businesses operating in the UK and Republic of Ireland. There are four national companies – Provident Financial, Cattles, London Scottish Bank and S & U – that together claim 71 per cent of market share. In addition there are a number of regional operators and a plethora of small, highly localised firms.

2 Profiling home credit customers

This chapter builds a profile of home credit customers in the UK. First, it considers the results of the Continuous MORI Financial Services Tracking Survey as it relates to home credit use. It specifically provides a profile of UK home credit consumers based on secondary analysis of data from 24,269 respondents. This data presents the first opportunity to achieve a detailed demographic breakdown of home credit users based on independent quantitative data. Second, we use the qualitative research to identify triggers to people's use of home credit.

Number of home credit customers

Without access to the records of the companies, it is difficult to determine an accurate figure for the number of home credit users. Karen Rowlingson's study arrived at a figure of three million customers, based on information from the Consumer Credit Association (CCA) and customer survey data from one large lender (Rowlingson, 1994, p. 51). In 1999, the CCA estimated there were around three million people who had loans with a home credit company. This figure was based on estimates of the number of collection agents in the UK, the proportion of them working full time and the number of loan accounts they would need to make a round financially viable. However, the OFT Vulnerable Consumers Survey put use of home credit at around 1–2 per cent of the population, or 450,000–900,000 people (Kempson and Whyley, 1999a, p. 21).

The MFS data suggests the size of the UK home credit market is around 2.3 million customers or 5 per cent of the population. The discrepancy between industry estimates and this figure is likely to relate to the fact that some companies count each loan on their books as a separate customer when, in reality, many customers have more than one loan. Nevertheless, as some customers use more than one home credit company at the same time, the market – in terms of the number of loans – could be slightly bigger than the MFS figures suggest.

While 5 per cent of the population have used home credit during the past 12 months, 10 per cent have used it at some time in their lives, which suggests a deeper penetration of the UK population than had previously been recognised. It also suggests movement in and out of home credit use, for which there could be different reasons. Some people may successfully move out of sub-prime lending into mainstream credit products. Some people may resort to home credit as a short-term measure in times of unexpected difficulty but later regain control of their financial situation. Some people may be occasional customers who wait more than 12 months between loans. A further explanation might be that consumers switch to different sub-prime products, although this is unlikely. In Chapter 3, we suggest that there is no direct alternative to home credit in terms of product characteristics that meet the

needs of these customers and people use different products alongside each other to broaden their access to credit rather than replace home credit loans.

Demographic breakdown

Home credit use is much more prevalent among women than men – 69 per cent of current home credit users are women. Presumably, this is due to the home-based delivery of home credit, which itself is operated by mostly female collection agents. In the case of a couple, it is likely that the woman manages the loan for joint use.

Home credit customers also tend to be relatively young, with people aged 21–44 comprising seven-tenths of current or recent users. Those aged 21–34 are particularly likely to be over-represented among home credit customers compared with their prevalence among the population as a whole. This age group makes up just over a quarter of the general population, but accounts for almost half of current or recent home credit customers (see Table 1). This finding is consistent with OFT research on vulnerable consumers, which found that 38 per cent of young people were in the bottom three income deciles (OFT, 1998, p. 45).

Married and cohabiting couples, and single never-married people make up the bulk of home credit customers but this is simply because these groups are also the most prominent in the general population (see Table 2). People who are divorced or separated were over-represented among home credit customers compared to the general population, which suggests a correlation between relationship breakdown and home credit use. People who were separated from a partner, for example, make up 5 per cent of current or recent home credit users, although they comprise just 2 per cent of the general population.

Table 1 Age of home credit customers (%)

	16–20	21–24	25–34	35–44	45–54	55–64	65+
Used in last 12 months	6	15	33	22	13	6	4
Used 12 months+ ago	2	7	23	20	18	12	18
Weighted base*	10	7	19	17	14	12	20

** i.e. the general population*

Table 2 Marital status of home credit customers (%)

	Married	Living together	Single	Widowed	Divorced	Separated
Used in last 12 months	34	22	27	3	9	5
Used 12months+ ago	41	15	18	12	10	4
Weighted base	47	11	26	9	6	2

The data shows a direct relationship between the number of children in a household and the likelihood of that household being over-represented among home credit customers, although it should be acknowledged that families with children make more use of all credit products than people without (see Table 3). For example, 16 per cent of people recently or currently using home credit have three or more children, compared with 5 per cent of all households. Data relating home credit use to life stages indicates that 25 per cent of people who have used home credit in the past 12 months have a young family, which compares to 10 per cent of the population overall. Further, having a child was also one of the life events people recalled leading to home credit use, which is consistent with Rowlingson's sample in which half of people interviewed had been in couples with young children when they first became customers (Rowlingson, 1994, p. 63).

As we would expect, there is a correlation between personal income and home credit use, with the pattern of income distribution and take-up of home credit operating on a sliding scale (see Table 4). Just over half (52 per cent) of current or recent home credit customers have annual incomes below £9,500 and two-thirds (65 per cent) have incomes below £13,499. People with higher incomes are significantly under-represented among the home credit customer base.

Table 3 Number of children in household (%)

	None	1	2	3	4+
Used in last 12 months	35	24	23	10	6
Used 12 months+ ago	59	15	16	6	3
Weighted base	71	12	12	4	1

Table 4 Personal income (%)

	Less than £9,500	£9,500–13,499	£13,500–17,499	£17,500–24,999	£25,000–29,999	£30,000+
Used in last 12 months	52	13	7	3	2	1
Used 12 months+ ago	44	13	9	5	3	2
Weighted base	31	11	9	6	4	6

Table 5 Class (%)

	AB	C1	C2	DE
Used in last 12 months	4	14	19	63
Used 12 months+ ago	8	20	21	52
Weighted base	23	28	21	28

Home credit users tend to be drawn from the lower socio-economic groups, which is unsurprising given their income profiles (see Table 5). Two-thirds (63 per cent) of current or recent home credit customers are from social class DE, while this group makes up fewer than three in ten (28 per cent) of the population as a whole.

Although home credit is clearly not limited to those without paid employment, this group, predictably, makes up a significant proportion of the customer base (see Table 6). Two groups, in particular, are especially over-represented. People who stay at home to care for a family comprise almost a third (30 per cent) of current or recent home credit customers. They are three times as prevalent among this customer group as in the population as a whole. In addition, those who are unemployed and seeking work are twice as prevalent among home credit customers as they are in the general population. As Rowlingson (1994, p. 52) points out, however, even though unemployed people have less disposable income, it is at least regular and reliable, and their financial circumstances can only improve. However, the long-term unemployed is one category of customer to which firms may refuse to give loans, along with lone parents living on state benefits, hostel dwellers and people living in high-crime areas (Kempson, 2003, p. 17).

Nevertheless, three in ten (29 per cent) current or recent customers are in full-time employment and one in ten (13 per cent) work part-time, showing that low-paid workers as well as those without employment income use home credit. As Rowlingson (1994, p. 52) observed, in order to minimise the risk of default, home credit companies seek to attract customers with regular incomes. As we would expect, however, people with paid employment are under-represented among home credit customers compared with their prevalence in the population as a whole.

A useful indicator of the vulnerability of home credit customers and their potential to experience – social and financial – exclusion is highlighted by the notable proportion of social tenants among them (see Table 7). More than half (53 per cent) of current or recent customers rent their home from a local authority, despite the fact that just one in five (20 per cent) people in the general population fall into this group. Similarly, almost one in five (17 per cent) current or recent home credit customers are tenants of a housing trust or association, while fewer than one in ten (6 per cent)

Table 6 Work status (%)

	Working full time	Working part time	Housewife	Retired	Unemployed	Student	Other
Used in last 12 months	29	13	30	5	11	3	9
Used 12 months+ ago	35	13	17	18	9	2	6
Weighted base	41	11	10	23	5	7	4

people in the general population rent homes in this way. Likewise, only one in five (19 per cent) of current or recent home credit users are homeowners compared to 64 per cent of the general population. These figures are consistent with research by the OFT, which found people in the lower household income deciles were more likely to rent from the sources described than to have a mortgage (OFT, 1998, p. 50).

OFT research on vulnerable consumers and financial services also found a strong association between low income and a low level of educational attainment (OFT, 1998, p. 13). In this context, it is interesting that 70 per cent of current or recent home credit customers in the MFS survey completed their full education by the age of 16 (see Table 8). Four in ten (43 per cent) of current or recent home credit customers had finished full education at this age compared to a quarter (25 per cent) of the general population.

Table 7 Housing tenure (%)

	Being bought on a mortgage	Owned outright	Rented from local authority	Rented from housing association/ trust	Rented from private landlord	Other
Used in last 12 months	15	4	53	17	1	–
Used 12 months+ ago	22	15	39	15	9	1
Weighted base	37	27	20	6	9	1

Table 8 Age completed full education (%)

	14 or under	15	16	17	18	19	20	21	22	23	24	25–30	31+
Used in last 12 months	5	22	43	8	8	3	1	2	1	1	–	1	1
Used 12 months+ ago	10	25	34	7	5	3	1	3	2	–	–	2	3
Weighted base	8	16	25	7	8	3	2	6	4	2	2	4	3

Background to first home credit use

In examining why people use home credit, it is possible to identify the background circumstances that customers share and particular events that trigger taking out a cash loan for the first time.

Although the depth interview respondents differed in terms of their age, gender, family and employment profile, they demonstrated a striking similarity in terms of their financial circumstances. A common denominator is long-term low household income – poorly paid work and periods living solely or mainly on benefits makes it

impossible to build up financial reserves, which can be called on for one-off expenses and in emergencies. The difficulties involved in long-term survival on a low income also result in a slow build-up of debt. Commonly, our sample belonged to families with a history of struggling on low incomes. In times of difficulty this made borrowing money from relatives unlikely.

The respondents also shared rejected applications for mainstream credit products and bad experiences of dealing with mainstream credit providers. The financial circumstances of home credit customers, such as long-term low and/or unstable income, are deemed by lenders to represent a high risk of default. In addition, these consumers may also have a damaged credit rating, which can have a long-term impact on their ability to obtain credit from mainstream lenders.

However, there is a degree of self-exclusion as well, which is illustrated well by customers' attitudes toward banks. The majority of home credit customers we interviewed had some kind of bank account, but they displayed a distrust of banks and a view that banking products were largely irrelevant to their needs. This is explored further in the next chapter.

Use of home credit is often part of family and local traditions. For many customers, home credit was part of their childhood with their mothers and grandmothers taking out loans before them. They grew up with positive images of home credit, which symbolised a helping hand in times of trouble when it seemed no other options were available. The research highlighted how people rely heavily on the recommendations of family and friends in relation to products like loans. But this community shares a very limited general experience of financial products and low financial literacy. This results in a narrow awareness of alternatives, and difficulty in weighing up the advantages and disadvantages of the different credit options available. Further, familiarity with the practice of borrowing from collection agents who call at the door makes it easier for customers to enter into their first transaction with a lender. This makes home credit seem more 'normal' than arranging an overdraft or taking out a bank loan:

> *[It was]* a family tradition and you knew that when he came it was going to be goodies. When I was young I remember the lady coming round and my mum saying 'Right, we are rich this week. We are going out for the weekend.'
> (Single female, 38, dependants, not working)

Against this background, there are often particular events that trigger people's first use of home credit. Typically, these relate to an urgent need for a relatively small sum of money for a variety of reasons, or, less frequently, a crisis of some kind.

The urgent need for a small sum of money takes a number of forms. This includes paying an overdue bill, buying school uniform or replacing an essential household item such as a washing machine. Christmas is a time of year that places an added strain on household budgets, so buying presents and the other extras associated with Christmas is a further trigger. A number of miscellaneous expenses may require a cash loan to stretch the budget in order to simply make ends meet. Although, on the face of things, these needs may not appear urgent, because they are pressing and there is no obvious solution, home credit seems the best option:

> It was coming up to Christmas a while back – not last Christmas, the one before – and money was a bit tight and I have got five grandchildren and I just wanted to get them something nice.
> (Single female, 54, no dependants, working)

> The kids' school uniform to go back to school, that is what made me get that.
> (Married female, 34, dependants, works part time)

A crisis or series of crises puts pressure on an already tight budget. One example is relationship breakdown, usually when a male partner leaves a female with responsibility for their children and their household debts:

> My husband left me with plenty of debt and it was the only solution to get out of it because with being a single parent I didn't have nothing to provide. I had to live with the children and feed them and this and that and pay bills. It became a difficult point for me. Someone came to the door and was going to evict me.
> (Single female, 36, dependants, not working)

A small number of respondents described situations in which serious health problems in the family had resulted in financial difficulties, which they had temporarily resolved with a home credit loan. Lastly, an employment crisis – for example, redundancy or loss of job – could result in a sudden loss of income that necessitated quick access to a source of credit.

These triggers also help to explain why the majority of home credit customers are women. The circumstances in which loans are used often relate to roles traditionally carried out by women, for example child-rearing, replacing household goods or smoothing the household budget. It also reflects how adverse events necessitating first use of sub-prime products may impact more severely on women. One of the common triggers for home credit use is when relationship breakdown means the earning male leaves the female partner with responsibility for their children and their household debts.

The triggers this research identifies are consistent with the findings of previous studies. Rowlingson (1994) found when people first became home credit customers they were on low incomes but were not in dire financial straits. They used cash loans to provide basics such as children's shoes and clothes, or to buy bedding and other household furniture. Some of Rowlingson's sample, those who were young, single women when first taking out a loan, were keen to acquire goods and had the means to repay the loan (Rowlingson, 1994, p. 65). A further study found people used cash loans to meet regular small payments, pay bills or purchase small items – that is, to make ends meet – while larger amounts tended to be used for the purchase of larger consumer goods or for special occasions such as Christmas, marriages or birthdays (Kempson *et al.*, 1994, p. 214).

3 Attitudes to home credit

This chapter considers customers' attitudes to home credit. It describes why the home credit product meets the needs of its customer base well, in a way that other sub-prime lending products do not, and the implications this has for competition.

Attitudes to home credit

The characteristics and circumstances of home credit customers described in the previous chapter mean that they have specific, and often quite inflexible, requirements of credit products if they are to be confident and successful in making use of them. It is evident from the depth interviews that home credit is very popular with its customers. This is because the characteristics and delivery mechanisms of the home credit product mean that it is uniquely placed and, therefore, highly successful in meeting the key requirements of its customer base. In contrast, other credit products from across the spectrum of providers are less successful in meeting the needs of home credit customers. This has implications for competition because it suggests customers could not switch to alternatives if they were dissatisfied with home credit.

These features of the home credit product are explored below.

Trust and familiarity

Like all consumers, especially in relation to financial transactions, people on low incomes like to feel that they are dealing with trustworthy organisations that they recognise and with which they, and others like them, are familiar (Kempson and Whyley, 1999b).

Awareness and understanding of home credit companies, their products and processes is very high among its target customer base, despite the fact that many of its actual and potential customers are not engaged with many aspects of the financial services industry. This is largely because, due to doorstep calling, home credit companies have a very strong local presence in the types of areas from which they draw their customers. Not only is it important that home credit companies are well known among their target customer base, it is also significant that potential customers become aware of them on their own familiar territory, without having to venture into unfamiliar and, potentially, daunting surroundings. In addition to their high levels of awareness and experience of home credit companies, most existing and potential home credit customers know of other people who make use of these companies. The interviews illustrate the importance of the experiences of friends and family members in building trust and familiarity with home credit lenders and their products and services. Indeed, in using home credit, some customers are following a long-standing generational pattern of use:

> My grandma has got loans with them so I knew the guy who did them anyway.
> (Co-habiting female, 34, dependants, working)

Simple, straightforward and speedy access

The fact that home credit offers an easy, non-bureaucratic application process, which does not require customers to complete lengthy forms or visit the lender's premises, is another valuable aspect of home credit for customers.

The depth interviews indicate that customers rarely have to wait more than a few days for an agent to call. In addition, as many new loans are taken out just as, or before, the previous loan has been fully repaid, customers frequently discuss their next loan as part of their agent's weekly visit. The lack of formal application and credit-checking procedures means that customers can get an immediate decision about their loan and, with smaller sums, generally receive the money at the same time. The wait in respect of larger sums of money is usually not more than a few days.

This simple and quick approach to loan applications is not only important to customers in terms of convenience but also often crucial, given their credit needs. Given the high proportion of home credit customers who borrow for pressing, one-off needs, such as to pay or clear arrears on outstanding bills, it is vital that they get the money they need quickly and easily.

Being able to discuss credit needs and make a loan application in the familiar environment of their home is very important to home credit customers, as is having face-to-face contact with their agent. Many customers view their discussions with agents about further loans as a joint process during which the agent will work with them to determine how much they need to borrow and what they can afford to repay (OLR, 2000, p. 1). Crucially, the friendly relationships that most borrowers develop with their agents and their confidence that the agent understands their needs means they do not feel that they have to justify or explain their need to borrow:

> If you go for a loan somewhere else you have to answer a lot of questions. You have to answer a fair few with us, but I feel as if we don't pry. 'What do you want the money for?' and that. It is their business. We just make sure they have sufficient funds to pay it back.
> (Collector)

Small amounts of money

The type of consumers that make use of home credit generally want to borrow relatively small sums of money, typically less than £150. Qualitative research evidence from this and other studies illustrates that small amounts of money are required, particularly at the time of the first loan, because loans are for very specific needs and consumers are wary of borrowing more than they can comfortably repay:

> The smallest loan they *[the bank]* were doing at a time was a £500 loan and I didn't want £500.
> (Married female, 29, dependants, not working)

Confidence of success

Clearly, it is important to all consumers that, if they invest the time, emotional and energy costs in seeking access to credit, they would like to be confident of a reasonable likelihood of success. It is, arguably, even more important to low-income consumers that they can be confident that their loan application will not be refused. The pressing, often urgent, nature of their needs means that they cannot risk wasting time on an unsuccessful application. In addition, many low-income consumers have little experience or understanding of other credit products and, as a consequence, are especially nervous about applying for credit from mainstream providers. The depth interviews indicate that home credit customers have low expectations of success and perceive refusal to be deeply humiliating.

Some have real past experience of having a credit application refused, often without fully understanding the reasons for it. It is not uncommon for these consumers to develop misconceptions about why they were unsuccessful, which then influence their future decisions about credit applications. Word of mouth is also an especially powerful influence among this group, who have little contact with other credit providers or people who might provide a counter-perspective. Research evidence shows how this type of consumer can be heavily influenced by the experiences – real or perceived – of their friends and neighbours (Kempson and Whyley, 1999b).

Consequently, a high proportion of home credit customers are likely to *perceive* themselves to have little likelihood of making successful credit applications outside the home credit industry, although it is not possible to establish whether this is an accurate perception since figures on home credit 'refusals' are not in the public domain. However, the absence of a formal credit check and the fact that home credit 'applications' are often made as part of a relatively informal conversation with a collection agent means that consumers are able to make a good assessment of their likelihood of success:

> *[With (home credit provider) there is]* no making you feel small … *[Whereas with (mainstream credit provider)]* when you are standing in a shop, in the bank with a queue of people behind you and just the glass and they are shouting through the glass at you, 'No madam, you can't have one of them. It is not accepting your credit', you feel about like that much *[i.e. one inch tall]*. You think 'Nice. Thank you. I will tell the rest of the street. They didn't hear you.'
> (Single female, 54, no dependants, working)

Cash-based systems that do not require a bank account

The need for a cash-based system is highly significant for home credit customers because, although the proportion of home credit customers who have access to a bank account has increased since the last detailed study, many still do not have one (Rowlingson, 1994, p. 81). The interviews show that, of those that do have an account of some kind, the majority have only a saving or very basic bank account, which does not offer facilities such as overdrafts and credit cards. They also do not provide direct debit payments, which are required to make repayments for many mainstream credit products.

In practice, the accounts held by home credit customers are generally used very little. Some are completely dormant, and have been for some time, usually because they were originally opened in order to receive wages for someone who is no longer in paid employment. Others are used only for very basic and prescribed purposes – such as receiving wages and paying housing costs – but are not utilised for ad hoc expenses or day-to-day money management. This is consistent with other research showing varying levels of engagement with current accounts and, in particular, emphasising that access to an account does not necessarily indicate active and ongoing use (Kempson, 1996; Kempson and Whyley, 1999b).

Consequently, many low-income consumers are unable to, or prefer not to, use credit facilities where loans are paid by cheque or straight into a bank account.

Repayment systems that are compatible with household budgeting strategies

There are three key requirements to making repayment systems compatible with low-income household's budgeting strategies. First, it must be possible to make repayments in cash. Second, repayments must be acceptable at a frequency that suits household money management. Third, repayments must be fixed and not subject to change or 'hidden charges' during the course of the loan.

Preference for cash

The fact that loans can be repaid in cash is another highly valued, possibly essential, element of home credit. In part, this is because of the lack of access to or reluctance to use current accounts, outlined above. Related to this, however, is the fact that a cash budget is essential to successful money management for most low-income consumers (Kempson *et al.*, 1994, 2000; Kempson, 1996, 2003; Kempson and Whyley, 1999b). Their income, from employment or social security benefits, is often received in cash. Even where income is, initially, paid by cheque or directly into an account, as happens with the new Direct Payment system for social security benefits, low-income consumers are highly likely to withdraw the whole amount and still manage day-to-day expenditure in cash.

Cash affords people with constrained financial circumstances a much higher degree of control of their budget than would be the case with electronic transactions. Low-income consumers like to be able to see how much money they have available at all times and to know, instantly, of any changes. Cash can also be physically allocated to different types of expenditure and, crucially, cannot be overspent. Consumers who operate a cash budget know exactly how much money they have available at any one time and how much is left to spend.

Being able to incorporate home credit repayments into a cash budget is a further aspect of the popularity of this form of borrowing among consumers with low incomes.

Repayment frequency

Being able to make repayments according to the existing household budgeting cycle is also important to low-income consumers, who show an overwhelming preference for a weekly or, sometimes, fortnightly budget (Kempson *et al.*, 1994, 2000; Kempson, 1996, 2003; Kempson and Whyley, 1999b). This is mainly because people tend to develop their budgeting cycle according to the frequency with which they receive their income. Low-income consumers generally receive their income, whether from wages or social security benefits, on a weekly or fortnightly basis. Weekly or fortnightly budgets are also preferred by low-income consumers, however, simply because they mean money has to be managed over a shorter time period. This makes it easier to retain control and predict patterns of expenditure, and reduces the potential to fall behind on payments and for unexpected events to disrupt the budget:

> But the other advantage being that it is repayable each week. I mean it might sound peculiar but if you are paying back £15 a week it is more manageable sometimes than paying £60 a month, which will be on a monthly direct debit in some respects.
> (Married male, 47, dependants, working)

Home credit loans, unlike most other forms of credit, can be repaid at a frequency that suits the customer rather than simply the lender. The majority of customers choose to repay their loans on a weekly basis, although some find fortnightly repayments more convenient. In this way, home credit loans can easily be incorporated into the household budget maximising the customer's ability to manage and maintain repayments. In addition, customers are clearly reassured by the fact that, should they miss a weekly or fortnightly payment, their arrears are smaller than if they had missed a monthly payment.

No changes or 'hidden charges'
Stability and predictability is a central theme in managing a budget on a low income. Home credit might charge high rates of interest compared with other, especially mainstream, providers, but a key aspect of the home credit product is that no additional charges are made throughout the term of the loan. Repayments are fixed and do not change, except at the customer's request. There are no penalty charges for default or late payment and the interest rate remains fixed throughout the loan.

This gives borrowers the stability they need to ensure that they can manage the repayments without disrupting their household budget.

Repayment systems that afford discipline

Low-income consumers, like the majority of consumers, want to maximise their chances of maintaining repayments on their credit commitments and minimising the risk of default (Kempson and Whyley, 1999b). Again, it is arguable that maintaining a good discipline of repayment is more important for low-income consumers, because their access to credit is – or is perceived to be – more limited than is the case for the average consumer. As a result, it is considered vital that they do not risk closing off the limited sources of credit that are available by falling behind with repayments. In addition, people with very constrained financial circumstances face particular pressure because, should they fall behind, they will find it extremely difficult to secure sufficient additional resources to pay off arrears.

While low-income consumers like to retain the maximum degree of control over their finances, they also value any mechanisms that reduce their likelihood of overspending or missing repayments. They express a strong preference for payment systems that take out ongoing expenses and any money they owe as soon as they receive their income, leaving them access only to their disposable income (Kempson *et al.*, 1994; Kempson, 1996; Kempson and Whyley, 1999b). If they could manage a monthly budgeting cycle, direct debits would fulfil these requirements. In the absence of any automatic electronic payment systems that offer weekly or fortnightly direct

debits, home collection provides a highly valued discipline over repayment that helps low-income consumers keep on top of their finances.

Home credit agents not only call at the customer's house at a frequency to suit them, but also often arrange to visit on the day that the borrower receives their income. Home collection of repayments takes the responsibility – and, it is argued, the choice – of actively making the payment away from the customer. Knowing the collector will call exerts pressure on the customer to ensure that they have the money ready to hand over and having the collector call on the day that the household income is received means that the repayment is made before the customer is tempted to spend their money elsewhere. The nature of the relationship between customer and agent means that customers also feel very reluctant to 'let down' their agent.

The fact that home credit customers, even when in dire financial straits, often prioritise their loan repayments over essential expenses such as rent or utility bills is a source of great concern to money advisers and other commentators (NACAB, 2001). Nevertheless, it demonstrates the success of home credit in instilling repayment discipline among customers who mainstream lenders would perceive to have a high risk of default and is an extremely popular feature of home credit among customers (OLR, 2000, p. 7).

Repayment systems that are flexible

While a disciplined repayment system might seem incompatible with one that also offers flexibility, these two factors are inextricably linked, both in the needs of low-income consumers and within the home credit product. While people with constrained finances need a repayment system that affords the maximum likelihood of repayment, they also require that same system to be able to cope with short-term cash flow problems, which might necessitate that discipline being temporarily suspended.

Research evidence clearly illustrates that, while customers value the discipline of home collection, they are also confident that their agent will be understanding and, crucially, non-judgemental, should they need to miss an occasional payment. Further, a missed home credit repayment does not carry any financial or interest penalties that could further destabilise their situation. Customers can either pay extra in subsequent weeks to make up the deficit, or add additional weeks to the term of their loan. This makes no difference to the interest they are charged or the total amount they repay (see above).

Home credit customers frequently mention the reassurance they feel of knowing that they can miss occasional payments, should their circumstances dictate, without being pressured by their agent or facing costly penalty charges. They also recognise that missed payments on other types of credit would carry more serious consequences:

> If you haven't got that money, even though you offered a pound or 50p, it is something to pay. So you are not hiding behind the door saying 'I haven't got no money', so you don't feel embarrassed.
> (Single female, 38, dependants, not working)

Understanding and recognition of financial circumstances

It is very important that low-income consumers perceive the companies and agencies with which they interact to recognise and understand their circumstances. This is particularly important in relation to financial matters and in the context of past experiences with mainstream financial institutions that have been unable to meet their needs. Home credit companies achieve this via their collection agents, who provide the main interface between the company and its customers.

Home collection agents are generally drawn from the local area and, as they have often used home credit themselves, customers feel a strong affinity with their agent. Much qualitative research evidence shows the extent to which home credit customers value their relationship with collectors who they frequently view as friends or 'like one of the family' (Kempson *et al.*, 1994; Rowlingson, 1994; Kempson, 1996; OLR, 2000; Jones, 2002). This friendly, trusting relationship between customer and agent provides a key context for customers to develop their relationship with the home credit company itself. It also means that most customers trust their agent to understand, should they fall into financial difficulty, not least because many agents have personal experience of similar problems.

This means not only that low-income consumers can use home credit with a greater degree of confidence but also that they perceive there to be less stigma involved in admitting to problems. Consequently, agents are generally very aware of the financial circumstances of their customers at all times and this provides an important foundation for default management in the home credit industry:

> They are not nasty, they are very good and they are understanding. They know you have children and some weeks you can go a bit short. You do get a letter through. The lady that comes to me is very nice. She is understanding. If I haven't got the money I just double up the following week.
> (Co-habiting female, 37, dependants, works part-time)

No penalties, charges or heavy-handed debt collection

Another key aspect of the delivery of home credit to low-income consumers is the fact that charges are not made in the event of default, unless customers are deemed to be unwilling, rather than unable, to repay. In fact, home credit loans are structured in expectation of a small number of missed payments. This is central to the flexibility of home credit, outlined above.

Even depth interview respondents who had experienced long-term financial problems – because of job loss or ill health, for example – had found home credit companies to be sympathetic and understanding. They had found the emphasis to be on restructuring loans so that they could be repaid, rather than on heavy-handed arrears-management procedures. Customers are aware that they will not face a build-up of late payment penalties and that, provided they make every effort to repay, their future access to credit will not be affected.

Qualitative research evidence shows that not only does this approach increase the confidence with which low-income consumers can use home credit, it also often renders customers more willing to resume and maintain repayments. It is for this reason that money advisers who deal with low-income consumers in serious financial difficulty often feel that home credit companies should, in fact, write off debts earlier rather than take this sympathetic approach to payment difficulties, which might, in fact, encourage customers to prioritise clearing home credit arrears over essential household bills.

Attitudes to other credit products

NCC research has found that other credit products, in the mainstream, sub-prime, community and public sectors, are less successful in offering the combination of product characteristics and delivery mechanisms necessary to meet the needs of home credit customers. Use of these different sources of credit in combination with home credit is generally aimed at broadening access to credit rather than replacing home credit loans. This suggests home credit customers would not switch to other credit products even if they were dissatisfied with home credit (Whyley and Brooker, 2004). Examples to illustrate this finding are given below.

Mainstream credit products

The vast majority of respondents had a bank account of some kind, but they displayed a distrust of banks and a view that banking products were largely irrelevant to their needs. Respondents were of the view that banks did not understand the difficulties involved for people with low incomes and had no interest in

accommodating customers with chaotic lifestyles because their systems were fairly rigidly geared to higher earners with stable incomes. Examples of this included the banks' inflexibility about missed repayments and the severe financial penalties that could follow, the fact that banks would lend only relatively large amounts of money, and a fear that revolving credit like loans, overdrafts and credit cards could lead to long-term debt because there was little pressure to repay and the long repayment period meant debt could easily spiral out of control:

> They offered me an overdraft, but I thought once you get the overdraft it is paying that back and keeping in the red. At the time I thought 'No'. I knew the interest *[from the doorstep lender]* were a bit more but at least once it is paid it is out of the way.
> (Married female, 29, dependants, not working)

It was also clear that previous bad experiences with banks had left customers feeling humiliated and reluctant to expose themselves to similar knock-backs in future. These findings are consistent with previous qualitative research that the NCC undertook with disadvantaged consumers about their basic financial needs (King and Klein, 2003):

> I don't think I have got a lot of confidence. I am afraid of being knocked back again because I have applied for a Switch card a couple of times with *[name of bank]* and as I said I had a couple of CCJs *[County Court Judgements]* a couple of years ago …
> (Single female, 54, no dependants, working)

Sub-prime credit products

Sub-prime credit products come closer to meeting the needs of low-income households than mainstream products. Nonetheless, no single source completely matches the requirements of low-income consumers.

Mail order credit, which is the closest match to home credit in terms of product characteristics and has the highest overlap in usage, illustrates this point well. Most low-income consumers would be familiar with and trust mail order companies, which are a well-known and long-standing source of credit in these communities. The widespread continued use of mail order credit among people from social class DE means that most low-income consumers will have access to a reference group of other users, probably including their own family, friends and neighbours. In addition, locally recruited agents provide the interface between customers and mail order companies, as with home credit.

Mail order credit is also relatively simple and quick to access, transactions are conducted face-to-face, in the customer's own home, with the agent guiding the customer through the process. Mail order credit can be used for small-scale borrowing and does not require customers to have a current account. In addition, repayments can be made weekly, in cash, and the agent calls to collect repayments from the customer's home, instilling a discipline similar to home credit.

The main drawbacks of mail order credit for low-income consumers are that they may fail a credit check and may not be afforded the same flexibility over missed payments that they get with home credit. In addition, as it is possible to purchase goods on mail order credit before existing commitments have been fully repaid, there is the potential for this type of credit use to spiral out of control in a similar way to overdraft facilities, credit and store cards. Crucially, however, mail order credit is available only for the purchase of goods and cannot provide small cash amounts that can be used to make ends meet. Given that low-income households frequently need to use credit simply to balance the household budget and make ends meet, they must have access to cash loans as well as retail credit.

A second example is pawnbroking loans. Again, like mail order, pawnbroking is a long-standing, familiar service, which is trusted as professional and discreet. Pawnbroking also involves relatively quick and simple procedures, with no formal application process or credit check. There is no set minimum amount that can be borrowed and the amount of the loan can be flexible, depending on the value of the goods involved. A current account is not needed, either to receive or repay a loan from a pawnbroker. However, there are a number of drawbacks. Access to pawnbroking loans requires appropriate goods to pawn. Further, pawnbroking loans are generally repaid in one lump sum rather than by instalment and there is no means of imposing a discipline on repayment. Lastly, while flexibility can be built into pawnbroking loans, failure to repay a loan will ultimately mean forfeiting the goods.

The pattern repeats itself with respect to other sub-prime products, although there is not the space in this report to consider them in detail. Retail and buy-back store loans, like mail order, are available only for the purchase of goods. In addition, this form of credit is not associated with small amounts of money, there is no system of collecting repayments, and flexibility is limited because there are costs attached to missing payments and the goods may be lost altogether. The consumer also generally pays a higher price for using this service; it would be potentially cheaper for someone to take out a home credit loan and buy the product at the cheapest outlet. Sub-prime credit cards are growing in popularity at the 'top end' of the sub-prime market, but not all low-income consumers can be confident in accessing them, either because they do not have a bank account, or because their financial

circumstances or credit history means that their application would be refused. Further, although the product is flexible in that penalty charges are not incurred as long as the minimum repayment is made, these repayment arrangements may be too flexible for low-income consumers, as there is little incentive to pay off more than the minimum, resulting in the build-up of long-term debt.

A full discussion of how well these products, and community or public sector products such as credit unions and the Social Fund Budgeting Loan scheme, meet the requirement of low-income consumers, is available in a separate report (Whyley and Brooker, 2004).

4 The competition dynamic

This chapter assesses the extent of competition in the home credit market, in relation to the conduct of customers. First, it outlines competition theory in relation to the conduct of customers. Then, it argues that the presence of information asymmetries and switching costs contributes to a lack of effective competition.

Competition theory

When working effectively, competition involves a process of rivalry between firms who strive to win business by achieving the lowest level of costs and prices, developing new products or services or exploiting their strengths, skills and other advantages to meet customer needs more effectively than competitors. This process is good for consumers and firms alike. Competition encourages innovation and diversity of offerings. It also gives a strong incentive for firms to compete on price and quality of customer service. When competition does not work effectively, consumers can suffer (OFT, 2003, p. 1).

The Competition Act explicitly includes the conduct of customers as a market feature that might potentially adversely affect competition (Competition Commission 2003, p. 28). Guidance issued by the OFT also recommends that evidence to indicate a market is not working well can relate to the conduct of customers (OFT, 2003).

Competition works well when consumers can make an informed choice between a range of suppliers and are free to choose the one that most suits their needs. The Competition Commission indicates that evidence that customers do not search out alternative products or suppliers effectively, combined with evidence on the existence of information asymmetries may suggest that competition is not effective (Competition Commission, 2003, p. 28). Below we outline the Competition Commission's guidelines on these issues.

However, the conduct of customers is only one part of the picture. Another relevant market feature to include in a competition assessment is market structure, for example market shares and concentration, and barriers to entry, expansion and exit. A second aspect relates to the behaviour of firms, for example the rate of innovation, pricing strategies and profitability. A further aspect relates to market maturity. Features of mature markets include similar functionality in product offerings; sales levelling off and tougher competition from a stagnant or reducing customer base; profits going down; and inefficient firms leaving the market. Our qualitative research is not designed to explore these market features, so this report discusses them no further. A wider assessment of the market is available in a separate NCC report (Whyley and Brooker, 2004).

Information asymmetries

The Competition Commission (2003) guidance states that customers' purchasing decisions are based on the information they have about products. Complete information would include knowledge of all available alternative products and their characteristics, their prices and the switching costs that customers incur in changing suppliers. The characteristics of a product include all the things that the customer values such as durability, functionality, compatibility, etc. Firms in markets with well-informed customers have the incentive to supply goods that match the preferences of customers, as customers could take their business elsewhere if other suppliers were matching their preferences more closely.

In many markets, customers do not have adequate information: information may be unavailable or costly to acquire or customers may be unwilling or unable to get it. In such markets, customers can compare prices or the quality of only products they know, or are aware of, and thus their perspective of the market is reduced. Firms may exploit this gap in knowledge and compete less intensively on prices or quality because, regardless of the actual number of suppliers in the market, customers are unlikely to switch readily to other products.

Home credit customers are unlikely to be able to switch confidently from home credit to other credit products for a number of reasons related to information asymmetries. First, low levels of financial literacy will prevent them from making informed comparisons. Second, weaknesses in the APR as a comparator across credit products makes it hard to accurately assess the costs of home credit in relation to other types of credit. Third, home credit customers tend to make affordability, rather than price-based, decisions.

Financial capability

While low levels of financial literacy have the potential to inhibit competition in all credit markets, they are particularly likely to do so in relation to the home credit market because levels of literacy have been found to be particularly low among the types of consumer most likely to be using home credit (NACAB, 2001). This was confirmed by our consumer interviews. While home credit users have excellent budgeting skills, their experience and understanding of financial products are generally very limited. Like many consumers, however, it is evident that home credit customers find interest rates very difficult to understand. In addition, the limited experience of other credit products among many home credit customers means that many have little understanding of other forms of credit. This makes it very difficult for them to make comparisons between home credit and other loan products:

> Say you borrow £500 and you have to pay something like £1,000. It is like you are paying back £200 on top.
> (Single female, 38, dependants, not working)

Weaknesses in the APR as a comparator across credit products

It has also long been acknowledged that, even if consumers were willing and able to make comparisons across credit products, there are a number of weaknesses in the APR as an effective comparator. APRs are intended to be a standard measure of the total costs of borrowing that is applicable across all forms of credit. Most mainstream credit providers agree that, while not necessarily ideal, the APR is the most effective comparator available. It has been argued, however, by consumer groups, researchers, and, especially, credit providers in the alternative market, that the APR is highly problematic, for a number of reasons.

1. Consumer understanding of APRs is generally low. Research commissioned by the OFT showed that less than half of the people questioned were able to state accurately what 'APR' stood for and only one in ten were able to identify the exact definition from a list of four possible options (OFT, 1994).

2. Doubts have been expressed as to whether APRs are, in reality, comparable across all types of credit. Variations in the way that APRs are calculated can mean they can be far from a standard measure. The CCA has described exclusion of some costs and charges, such as payment protection insurance, from the APR calculation as 'completely arbitrary' (CCA, cited in Kempson and Whyley, 1999a).

3. The home credit industry argues strongly that the APR is not a good measure of cost in relation to small, short-term loans. The OFT, itself, has noted that the mathematical formula for calculating APRs can distort the apparent costs of credit for loans of less than 12 months in particular (OFT, 1994).

4. A number of commentators have expressed doubts as to whether APRs are, in fact, meaningful to consumers in their decision making about credit. The OFT found that just two in five people who had used credit in the five years prior to the survey said that they had considered APRs in their decision making (OFT, 1994).

This issue is explored in relation to home credit customers, in particular, below.

The relevance of APRs to home credit customers

Most home credit customers are not aware of what APR means or how to use it to compare across products. In addition, they are quite clear that this measure of the cost of credit is largely irrelevant to them. Most are aware that they are being charged high rates of interest and that other loan products charge lower rates. They do not, however, know how much more they are charged or what this difference means in monetary terms. More importantly, however, they are quite clear that, while they are given information by their agent when they take out a loan, their interest lies more in issues relating to affordability than overall price:

> He seemed very nice and very helpful. He explained a lot, I didn't understand a lot of it but I wasn't really too fussed as long as I got the money, which I shouldn't have been, I should have listened to him a bit more but I thought he was alright though. He did *[go through the terms and conditions and paperwork]* but I am terrible – I wasn't really taking a lot of notice.
> (Single male, 26, no dependants, not working)

> Well, they do seem a bit mystified sometimes. When I first started they used to say 'How much will it cost me?' and I used to say 'That will be £60 interest on every £100'. That is 399.7 APR, which I think is very expensive. But they weren't interested in any of that. All they said was 'No. No. How much a week?' That is all they are interested in. They don't understand or want to know anything else about it really.
> (Collector)

Non-priced-based decision making

Instead of using interest rates and APRs, consumers judge affordability in terms of the total amount added onto a loan and the level of weekly repayment. This is a rational approach when dealing with tight budgets, as being able to incorporate the weekly repayment into the household budget is far more important to these consumers than the total cost of the credit. It does, however, mask the true cost of a loan and, while most home credit customers know exactly how much 'extra' they are paying on top of the amount they originally borrowed, few know what the same loan from a different provider would cost. In addition, they are aware that other lenders will not collect repayments from their home or be flexible about missed repayments. Many are prepared to pay more for this service because, without it, they would struggle to use credit with confidence:

> It is a lot really, but when you are in that situation you are just going to do it aren't you? But they are quite high, and it does seem an awful lot considering that £100 is £150. It is a lot of money on top but what can you do, you have to do it.
> (Single female, 46, dependants, not working)

Without a basic knowledge and understanding of the levels of interest they are paying, home credit customers are unable to compare similar products or make informed switching decisions. If it is the case that customers are satisfied with the service and do not make price-based decisions, then there is no incentive for them to search for better deals or for firms to reduce prices.

Switching costs

The Competition Commission (2003) guidance states that switching costs arise when there is a cost incurred by changing supplier that is not incurred by remaining with the current provider. These costs may take many forms including inconvenience, monetary costs, administrative hurdles or a lack of information about the products of alternative suppliers. The existence of switching costs may mean that suppliers can charge high prices to captive customers. Switching costs may decrease customers' incentives to search for, or switch to, alternatives that could better meet their needs. Evidence that customers rarely switch suppliers, combined with evidence that significant switching costs exist, suggests that competition is not effective (Competition Commission, 2003, p. 28).

The degree of switching that takes place between different credit products

As we highlighted in the previous chapter, other credit products, in the mainstream, alternative, community and public sectors, are less successful in offering the combination of product characteristics and delivery mechanisms necessary to meet the needs of home credit customers.

Where different types of credit are used concurrently they tend to be utilised for very different purposes and are generally not used as a substitute for home credit (Kempson and Whyley, 1999b; Kempson *et al.*, 2000). Mail order, retail and buy-back credit, for example, may be used alongside home credit, where appropriate, but cannot be used interchangeably because they always require the purchase of goods. In addition, while some consumers have been found to use loans from pawnbrokers and home credit companies for similar purposes, others made a distinction between them (Collard and Kempson, 2003, p. 12). Research also shows that similar distinctions are made between home credit loans and loans from credit unions and the Social Fund Budgeting Loan scheme (Whyley *et al.*, 2000; Jones, 2002). In

addition, consumers' lack of confidence in their likelihood of being successful in a budgeting loan application and their expectation that, should they be successful, the amount they request will be reduced means that these loans are not perceived as an alternative to home credit (Whyley *et al.*, 2000).

The degree of switching that takes place between home credit providers

The depth interviews indicate a low level of switching between different home credit providers. Some low-income consumers have loans with more than one home credit company, but there is little evidence that consumers switch between companies in order to secure a better deal. Where switching does occur it tends to be reactive rather than proactive and, as a result, is unlikely to exert pressure on home credit companies to compete with one another. A very small number of people who were interviewed had switched to a different company because they perceived (not always accurately) it to be offering lower prices or a better service. However, these customers tended to have switched only because a different company called at their door at a time when they were already unhappy with their existing provider. They had not actively sought a different provider and some did not rule out returning to their original provider should they be unable to borrow the amount they needed from the new supplier.

Most customers who had switched providers or used more than one company at the same time had done so for a range of reasons that were not related to either price or service. Some had had to borrow from more than one provider because they were new customers and unable to borrow the total amount they needed from a single lender. Others had started to use more than one company for more pragmatic reasons, for example, when the agent they used moved to a different company and they wanted to retain a relationship with both the lender and their original agent. Some multiple home credit users had simply been called on by more than one company and taken out loans accordingly. It was not unusual for customers to continue borrowing from more than one company, from choice rather than necessity, simply to maximise their access to credit.

Crucially, the majority of home credit customers that took part in the depth interviews said that they would not switch to a new provider even if they were offering lower interest. This was largely because of the strong relationship they had built with their existing agent(s) and because they feared the concept of changing to an unknown company and, in particular, an unknown agent. In addition, although most customers knew of more than one home credit company, most thought that the different companies offered the same service and prices and, consequently, there was no financial benefit to 'shopping around'.

Switching costs

The depth interviews suggested that, should consumers be inclined to switch, a number of features of the home credit industry act as barriers to switching. First, the practice of step-up loans may ‘lock in’ the customer to a lender and encourage repeat purchases because switching to a new supplier would require starting with small amounts all over again. Second, early settlement penalties are especially punitive for consumers on low incomes. Third, the way interest charges for roll-over loans are structured ties customers into loans, and encouragement from trusted agents to take out roll-over loans is likely to act as a significant switching cost to customers wishing to move out of the home credit market. The psychology of the relationship between the customer and agent may leave the customer vulnerable to exploitation.

Step-up loans

It is the normal practice of home credit companies to first lend small amounts to new customers, making larger amounts available once customers prove themselves to be reliable with repayments. The prevalence of these ‘step-up loans’ is confirmed in qualitative research conducted by NCC and others (Rowlingson, 1994, p. 59):

> *[I borrowed £50. I would have liked]* … probably about £500 just so I could put it down to a lot of my debts so that I haven’t got so much hanging over my head. *[It wasn’t as much as I’d have liked]* … but it is a starting point. As long as I pay it back on a regular basis then when I have paid off the full amount then maybe if I borrow the next £50 … I think he said the second or third time maybe they would increase it. It is as soon as they get that little trust.
> (Single male, 26, no dependants, not working)

Step-up loans are how home credit companies minimise the risk to themselves of customers defaulting on loans, especially in the absence of formal credit-checking procedures. However, it may have the effect of ‘locking in’ the customer to a lender because, if they wished to switch to another lender, they would have to start with small amounts all over again. This is particularly problematic because home credit companies do not share data about their customers via credit reference agencies, which prevents customers from building up a portable credit history (Whyley and Brooker, 2004).

Customers are not locked in as traditionally understood by companies price discriminating between new and old customers through, for example, generous introductory offers. However, the structure of the loan does give the customer an incentive for repeat purchase rather than changing products or suppliers.

Early settlement rebates

Early settlement rebates refer to the amount of interest that is refunded to borrowers who repay their loans in full before the term of the loan is complete. They are determined by the Consumer Credit Act Regulations, which apply to all credit providers. Early settlement rebates have been the subject of an ongoing debate as part of the DTI's major consultation on the 1974 Consumer Credit Act (DTI, 2003b, p. 39). In particular, it has been acknowledged that current methods for calculating these rebates are weighted in favour of lenders and are, as a consequence, unnecessarily punitive for consumers (NCC, 2002). Early settlement rebates that do not accurately reflect the costs that borrowers save by repaying loans early can tie consumers into relationships with existing suppliers by significantly reducing the cost benefits of switching, even if new suppliers can offer better terms and conditions.

Interviews with home credit collectors suggest that customers do receive a small rebate if they repay a loan early, but not the full amount of interest for the weeks in question. For consumers on low incomes, who exist on small economic margins, early settlement rebates are especially punitive and make it highly unlikely they will switch to other credit products until they have fully repaid their home credit loans.

Roll-over loans

Roll-over loans – whereby borrowers take out further loans before they have fully repaid their current loan – are common practice in the home credit market. The remainder of the existing loan is consolidated – or 'rolled over' – into the new loan and interest charges are recalculated to reflect this.

The practice of roll-over loans has attracted criticism for a number of reasons. First, borrowers end up paying interest on interest as their outstanding balance, including interest charges, is rolled over into the new loan on which interest is also payable. However, it should be recognised that this is a feature of credit cards where the borrower does not clear the balance each month; interest is added to the following month's balance *ad finitum* if further purchases are made. Second, research evidence suggests that home credit customers are subjected to – albeit generally subtle and benign – pressure from agents to take out new loans just before they have fully repaid their existing loan (Rowlingson, 1994, p. 104; Jones, 2002, p. 20). This practice, in combination with low early settlement rebates (see above), means that customers are increasingly likely to be 'locked into' home credit use because they always have an outstanding balance to repay, and further raises the costs of switching.

The collector interviews provide evidence that roll-over loans are part of the business plan. Collection agents stated that between 50 and 90 per cent of their business came from existing customers, initiated partly by collectors and partly by customers. One described how managers use computer software to identify when a loan may be renewed and this information is relayed to the collector by putting it ‘on the clip’. Collectors earn their income on a commission basis, so it is in their financial interests to retain reliable customers. One collector felt there was pressure on them to encourage roll-over loans:

> … there is too much pressure put on reps to get more business. This is the problem … I mean that is basically that reps, no matter what company they are in, are under a lot of pressure. That has always been the case.
> (Collector)

The social relationship between collection agents and customers, the physical environment in which transactions take place and the flexible nature of loan repayments may play an important role both in discouraging switching and in encouraging continued borrowing.

For many, home credit is a community tradition, with which they are familiar from childhood. Rowlingson (1994, p. 32) and others have found that collectors were often from similar socio-demographic backgrounds as their customers – seen as ‘one of us’. The depth interviews highlighted how customers frequently view collectors as friends:

> Yes, *[collector’s name]* is fine, I get on great with her. We have a laugh. Well we are like mates, friends sort of thing.
> (Married female, 65, no dependants, not working)

Some respondents claimed these relationships were not so close as to make it impossible to switch lenders if a better offer appeared, but this sort of relationship is clearly open to manipulation. Others were more cynical and claimed that subtle techniques were employed:

> The way I look at this door-to-door selling, they do badger people. They say they don’t badger but I have seen the way they do it. They train them how to get people to take the stuff. *[They say]* ‘We are not badgering you. You don’t have to take it’, but they really are. They do it in a nicer way. It is not like putting a gun to your head and saying you have to take this. I wish I had never done them *[company]*, I would have saved myself a fortune.
> (Single male, 35, no dependants, working)

A few respondents indicated that they would stick with their current lender even if other companies were offering a cheaper offer. There is evidence that customers are highly aware that collectors are financially dependent on their continued borrowing. The result is that customers may maintain loans with a lender even when they do not need them.

Home credit is also seen as a lifeline in times of trouble – someone to bail you out financially when no other option seems available. Users of home credit are generally denied access to mainstream credit, or believe they will be, or find it inappropriate. They also display low awareness of sub-prime alternatives. It seems natural for the customer to fear that their only lifeline may be taken away if they ‘upset’ their agent by discontinuing their borrowing arrangements.

An aspect of the service highly valued by customers is how home credit companies accommodate customers who are experiencing temporary financial difficulties by allowing them to miss a week’s repayment:

> I explained the situation. ‘My finances have gone down at the moment’ and they accepted that. That is what I like. The personal service and they are willing. Most companies like take you to court. I offered them £2 a week until I sorted myself out and then it went back on top.
> (Single female, 38, dependants, not working)

On the surface, flexible loan repayments is a unique strength of the home credit service, but, equally, it may place consumers in a vulnerable position, as the customer may feel obligated to their agent. Switching may be deterred if a sense of obligation to the supplier has been developed.

5 Conclusions and policy implications

This final chapter brings together the conclusions of the study and sets out implications for policy. First, it profiles the users of home credit and the triggers to home credit use. Next, it describes customers' attitudes to home credit as shaped by their credit needs and circumstances. Third, we discuss how the conduct of home credit customers has competition implications. Finally, we discuss implications for future policy, including the broad range of remedies that could be implemented.

Summary of findings

This study combined qualitative research with a quantitative analysis of home credit customers based on an independent and statistically representative sample. This methodology has proved effective in achieving a detailed demographic breakdown of home credit users, and developing an understanding of people's motivations for using home credit and their attitudes towards this product. This evidence base has enabled us to assess, as part of a wider NCC project, how effectively competition is working in the home credit market with respect to the conduct of customers.

The study sought to explore, as part of a wider NCC project, the extent of competition within the UK home credit market and the extent to which an absence of effective competition could be having an adverse impact on consumers. The desired outcome of the project as a whole was to increase competition in the low-income credit market and, as a result, widen access to affordable loans offering good value for money to this customer base.

Profiling home credit customers

The quantitative data suggests around 2.3 million people currently use home credit, although one in ten have used it at some time in their lives. The home credit industry serves a primarily low-income customer base, drawn from the lower socio-economic groups, including high proportions of people without paid employment and social tenants. Home credit customers are also disproportionately likely to have large families and suffer relationship breakdown. Their financial circumstances are generally constrained and, often, unstable. They commonly share long-term low household income and a slow build-up of debt, and often belong to families with a history of struggling on low incomes. Some customers have a history of bad debt. Particular events may also act as triggers to use of home credit, such as an urgent need for a relatively small sum of money for a variety of reasons or a crisis of some kind.

Attitudes to home credit

Home credit customers' characteristics and circumstances mean they have specific, often inflexible, credit needs. The home credit product is unique in its ability to

address all of them. These product characteristics include trust and familiarity; simple, straightforward and speedy access to the relatively small amounts of money they need, with little prospect of refusal; cash-based systems that do not require a bank account; repayment systems that are compatible with low-income consumers' household budgeting strategies, including a preference for cash and repayment frequency; no changes or hidden charges; repayment systems that afford discipline but at the same time are flexible; understanding and recognition of customers' financial circumstances; and no penalties, charges or heavy-handed debt collection. In contrast, other credit products, in the mainstream, alternative, community and public sectors, are less successful in offering the combination of product characteristics and delivery mechanisms necessary to meet the needs of home credit customers.

The competition dynamic

The conduct of customers is a market feature that might potentially adversely affect competition. The presence of information asymmetries and switching costs acts to constrain effective competition in the home credit market. Home credit customers' levels of financial literacy are particularly low, which affects the way they engage with the product. They do not make true price-based decisions, but instead judge affordability in terms of the total amount added onto a loan and the level of weekly repayment, rather than by using interest rates. Further, recall of interest rates and APRs is very low. This means there is no incentive for them to search for better deals or for firms to reduce prices.

There is little switching from home credit to other credit products and a low level of switching between different home credit providers, with little evidence that consumers switch between companies in order to secure a better deal. Consumers face significant switching costs if they wish to change home credit suppliers. These include the practice of step-up loans, low early settlement penalties and roll-over loans. The psychology of the relationship between customer and collector may work to prevent customers from leaving their agent.

Implications for policy

This research is particularly timely because consumer credit is subject to major legislative change for the first time in a generation. The DTI has conducted a series of consultations on revising the 1974 Consumer Credit Act, one of which focused on the field of extortionate credit. A White Paper was published at the end of 2003 (DTI, 2003b) and is expected to precede a Consumer Credit Bill planned for the 2004/05 Parliamentary session. The House of Commons Treasury Select Committee is expected to conduct an inquiry into financial inclusion, which will include sub-prime

lending. These developments present a time-limited opportunity to advance pro-poor policy around the field of extortionate credit.

In thinking about policy solutions, the starting point should be that the home credit industry provides a valuable source of credit to consumers on low incomes. Our findings are that the characteristics of the home credit product meet the needs of the customer base well. It follows that to remove home credit from the market or to drive it underground could be to the detriment of low-income consumers and would risk exacerbating existing problems of financial exclusion.

This research does not claim to be conclusive in relation to all aspects of the home credit sector and potential consumer detriment. Wider research and investigation, including in relation to economic components of the market, would help to explain the factors in the market that may constrain competition and lead to consumer detriment.

In the case that consumer detriment and a lack of competition were found, the range of remedies that could be considered embrace changing the behaviour of customers (demand-side approach) to changing the way the industry is structured and changing the behaviour of firms (supply-side approach). First, there are clearly demand-side problems relating to financial capability that should form a part of any package of solutions. There are two main supply-side approaches to improving competition in this sector: stimulating alternative provision of affordable credit or imposing controls on the industry. We anticipate that any programme of remedies would include a mixture of these two supply-side approaches. However, we would place greater emphasis on the former approach, which would prove more sustainable in the long term.

Improving financial capability

Our research demonstrated low-income consumers often have poor financial literacy, which results in significant information asymmetries. Work by the Financial Services Authority (FSA) has shown that two-thirds of consumers think that financial matters are too complicated for them and that they do not know enough to choose suitable financial products. In addition, a quarter of adults have ‘very low’ numeracy, meaning they are unable to perform even the simplest calculation (FSA, 2003, pp. 6–8). This research highlights the importance of the basic skills agenda and the FSA’s plans to develop and implement a national strategy for financial capability. The interests of low-income consumers should be a priority focus for this strategy. Another welcome development in this regard is the Community Finance and Learning Initiative, led by the Department for Education and Skills. This project aims to help people access

free basic skills training in literacy and numeracy, and understand how best to manage their finances, get on top of their debts and begin to think about saving, as well as to act as a bridge into basic financial services.

Improving access to affordable sources of credit

This approach is to increase competition in the market by broadening the range of products to which low-income consumers have access. The challenge for providers is to develop affordable credit products that meet the unique needs of home credit customers. Forthcoming research funded by JRF to develop a blueprint for a source of low-cost credit aimed at people excluded from mainstream lenders is, therefore, very welcome (Kempson *et al.*, 2005, forthcoming).

Credit unions are often proposed as the most likely contender in this regard, and, indeed, on the surface they meet many of the desired attributes for an affordable credit product. They are locally based, run by people who understand the circumstances of low-income consumers, involve face-to-face transactions in cash with frequent repayment, and recruitment is driven mainly by word of mouth and personal recommendation by friends and family (Whyley and Brooker, 2004). As yet, however, they have not met their potential. Because they do not have universal coverage in the UK and are often small in size, they are not reaching significant portions of their target population. Awareness and understanding of them is low and some continue to suffer the stigma of the ‘poor man’s bank’. The absence of a home collection service for repayments and the requirement to save are unsuitable product features for home credit customers, although the introduction of loan guarantee schemes may remove the last problem (Whyley and Brooker, 2004). These schemes too have experienced their difficulties, although research by Jones (2003) has identified the key criteria for their success.

Forthcoming research, funded by the JRF, to identify ‘role model’ credit unions and disseminate best practice will provide a valuable contribution to this area (McKillop, 2006, forthcoming). Building the capacity of credit unions, alongside reforming and extending the role of the Social Fund Budgeting Loan scheme, and identifying and developing promising community-based initiatives, may help provide competition to the home credit industry.

Regulatory measures

The consumer credit White Paper (DTI, 2003b) proposes a range of regulatory and other measures that are relevant to home credit in its review of the Consumer Credit Act, including discussion of interest rate caps, reform of the APR calculation to make

it more streamlined and standardised, and the encouragement of responsible lending. Further, a future Consumer Credit Directive may include a duty to lend responsibly. In addition, this research has uncovered specific practices in the home credit industry – roll-over loans and low early settlement rebates – which merit further consideration by the appropriate authorities.

Notes

Chapter 1

1 Datamonitor (2002, p. 3) defines this as: 'an individual who is systematically refused credit from mainstream lenders (banks, building societies and large finance houses), whatever the size and nature of their application'.

2 Following a 'super-complaint' made by the NCC on 14 June 2004, on 20 December 2004, the OFT referred the supply of home credit to the Competition Commission for further investigation.

3 In addition to cash loans, home credit companies often sell vouchers and hampers on credit, which this study does not investigate. Unlike cash loans, it is legal for the industry to cold-canvass vouchers and hampers. However, the small print on credit agreements for these products may include permission to canvass cash loans. The Government has expressed concern that consumers are not aware of this and is consulting on using secondary legislation to improve transparency in this area.

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