

# from feast to famine

the rationing of consumer credit in the financial crisis

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The Financial Inclusion Centre

The **Financial  
Inclusion  
Centre**

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## About The Financial Inclusion Centre

The Financial Inclusion Centre is an independent, not-for-profit think-tank. Its aims are to promote greater financial inclusion and provision; to ensure consumers are financially secure and their core financial needs are met; to promote access to fair and affordable financial and services; and to promote efficient financial markets. The Centre supports its aims through a number of core activities - research and analysis, promoting inclusion through innovation and partnerships, and planning and advisory services.

Millions of households and individuals are affected by serious levels of financial exclusion and insecurity. This is one of the greatest public policy challenges currently facing society and if policymakers, industry, consumer advocates, and other stakeholders don't work together to develop solutions, millions of individual consumers will be condemned to bleak financial futures. Moreover, if we don't manage to ensure that consumers are provided for, then society picks up the cost.

Whilst many organisations such as academic institutions, charities and other third sector organisations are carrying out work in the financial inclusion field, undertaking detailed research into the numbers of people affected by financial exclusion and helping people in distress, the Financial Inclusion Centre was set up to understand the causes of financial exclusion and under-provision and crucially, to develop innovative and practical solutions.

[www.inclusioncentre.org.uk](http://www.inclusioncentre.org.uk)

## About Consumer Focus

Consumer Focus campaigns for a fair deal for consumers. We do this through research, policy, analysis and lobbying and by working with policy makers, providers and others who can make a difference to consumers' lives. We have a special remit to represent the interests of disadvantaged and vulnerable consumers.

[www.consumerfocus.org.uk](http://www.consumerfocus.org.uk)

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## Summary

The scale of the unprecedented financial crisis and the speed with which it has spread from the UK's wholesale financial markets to the high street (as they say in the USA, from Wall Street to Main Street) suggests that radical action is needed to protect consumers. The sudden, reduced availability of affordable credit (both mortgage and unsecured) is of particular concern.

An unsustainable credit boom was allowed to develop in the UK (see Section 1). But that credit bubble has burst (see Section 2). Lenders have belatedly rediscovered prudence, or at least had prudence enforced on them by capital markets, and there is a risk that the effects of this self-imposed prudence could be exacerbated by regulation as lenders are required to hold more capital on their balance sheets. A return to prudent, sensible lending is overdue and it is reasonable to ask how and why regulators allowed lenders to indulge in so much reckless lending.

We are seeing a significant change in the way that consumers at all income levels are having or will have to deal with their finances. While it is true that past lending excesses need reining in and there is a need to move from a debt to a savings culture, it needs to be recognised that access to affordable credit is essential for struggling households to make ends meet. The combination of the credit crunch and a deep recession makes it important that the transition described above is carefully managed. The turning off of the credit pipeline is having a serious impact on many consumers and society more broadly (see Section 3). The effect on the housing market is the most obvious impact. More generally, consumers without a savings cushion to protect themselves from adverse financial circumstances may still need access to fair, affordable credit.

With mainstream lenders becoming more risk-averse and rationing credit by applying tighter lending criteria, it seems inevitable that financial exclusion will grow and more consumers will be pushed into the non-prime markets<sup>1</sup> or denied access to credit altogether. There will be a high price to pay. Without access to fair, affordable credit, vulnerable consumers will: be denied the choices many of us take for granted such as the ability to own our homes; face high lending costs and unfair terms and conditions – APRs in the sub-prime sector are punitive; be exposed to scams and aggressive practices from unscrupulous financial services firms claiming to offer solutions to desperate consumers.

The Government has mounted concerted action to rescue the financial system and protect the savings of 'Middle England' by raising the level of deposit protection schemes. This is understandable as confidence in the financial system is paramount. Similar concerted action is now needed to protect vulnerable consumers without savings who need access to fair, affordable credit or who may already be in serious debt.

There are no easy answers but we believe that policymakers, regulators, the financial services industry and civil society should have two main objectives: improve and enforce the existing consumer protection regime and take action to ensure that lines of credit are kept open for vulnerable consumers. We have set out some ideas for improving the consumer protection regime in Section 4.

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<sup>1</sup>We use a wide definition in this case to include non-status, sub-prime borrowers.

In terms of maintaining access to fair, affordable credit, the broad options available to policymakers are easy to identify, although some of these may be ruled out as being politically impractical in the current environment. In this paper we suggest consideration of the following options:

- regulatory or structural interventions: regulators could adopt contra-cyclical prudential regulatory models to encourage lenders to lend<sup>2</sup>; alternatively, the Government could underwrite loans to 'riskier' borrowers – both of these are happening to some extent.
- universal service obligations: the Government could force banks to lend to 'riskier' borrowers, in effect regulating banks as if they are utilities. An alternative to this would be for the Government to set down annual performance targets for banks with regards to loans – particularly for those banks in which the taxpayer has a stake.
- 'national' bank options: the Government could take the previous option a stage further and lend directly through the banks it has a stake in – in effect turning these banks into mortgage and loans versions of National Savings and Investment.
- promoting and supporting alternative lending channels: the Government could increase the financial resources available to non-profit lenders, including government, through the social fund. The Post Office, credit unions and other community-based lending organisations could be used as alternatives to commercial lenders.

This pamphlet puts forward ideas to stimulate debate rather than offering a definitive roadmap. A considerable amount of work would need to be done to: quantify the level of consumer detriment that might arise from the financial crisis; identify the proportionate response; understand the changes to the regulatory framework needed to implement any of these options; and develop a policy framework to allow the Government to reconcile the competing objectives of ensuring taxpayers receive a reasonable return on investment from their stake in banks while providing credit to borrowers perceived as being risky. The key point is that all options should be considered as a matter of urgency, given the severity of the financial crisis.

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<sup>2</sup> *Contra-cyclical regulation works on the basis that if asset or credit booms develop, regulators impose tighter capital requirements to rein in lending. Conversely, in theory, regulators could relax capital requirements to encourage lending during downturns.*

## Introduction and background

The scale of the financial crisis and the speed with which it took hold in the UK financial system is remarkable. In particular, one of the most striking consequences has been how quickly lenders' attitudes to consumer debt have changed.

During the decade in the run-up to the financial crisis, concerns were raised about the huge growth in household debt in the UK (see *Section 1 - Years of plenty*). This growth was partly funded by the banks using wholesale market funding and off-balance sheet financial instruments, rather than customer deposits. However, the financial crisis and credit crunch have resulted in wholesale funding drying up with lenders now facing a huge funding gap (between the amount of money out on loan and the retail deposits they hold).

We are seeing what can be termed 'a great deleveraging'. The years of plenty are over, at least for the time being. The change in the market may not have happened overnight but we have witnessed a rapid onset when measured against the usual length of economic cycles. Credit – both secured and unsecured – is being rationed and will continue to be rationed. Research by the Bank of England confirms that lenders are becoming more risk-averse by applying tighter lending criteria and turning down a greater number of loan applications (details can be found in Appendices I and II). The number of products on the market has shrunk. If we are not careful, there is also a risk that this recent self-imposed prudence by lenders will be exacerbated by regulators overreacting and requiring banks to become too risk-averse.

The Government is rightly determined to prop up the banking system and acted quickly to protect the savings of Middle England. This had to be done to restore confidence. Moreover, banks were desperately trying to close the funding gap by offering attractive headline interest rates on certain savings accounts (although these higher aggregate savings rates were not maintained). So, certain households with savings benefitted twice. That has now changed as average interest rates have fallen dramatically to 0.17 per cent in February 2009<sup>3</sup>, leading to a significant reduction in the interest rates paid on savings<sup>4</sup>.

In an ideal world, consumers would not need access to credit but would build up savings to see them through difficult financial circumstances such as temporary shortfalls in income or to buy the goods and services they need. However, last year saw the household savings ratio<sup>5</sup> reach a 50-year low, although there was a slight recovery in the second and third quarters<sup>6</sup>.

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<sup>3</sup> [www.bankofengland.co.uk/statistics/ms/current/index.htm](http://www.bankofengland.co.uk/statistics/ms/current/index.htm), Table G1.4

<sup>4</sup> The margins between lending rates and savings rates widened considerably during 2008 compared to the average for the previous 10 years. Lenders did not pass on the full cut in benchmark rates to borrowers. However, they did not pass on the full cut to savers either which means that although the average rates on savings accounts have fallen, savers have been cushioned (see 'Are banks and building societies playing fair?', The Financial Inclusion Centre, February 2009, [www.inclusioncentre.org.uk](http://www.inclusioncentre.org.uk)).

<sup>5</sup> The Household Savings Ratio is expressed as a percentage of total resources (gross household disposable income with an adjustment for net equity in pension funds).

<sup>6</sup> ONS, Quarterly National Accounts, 3rd Quarter 2008.

So, for them, borrowing is a necessity, not a discretionary lifestyle choice, and raising the amount of savings protected will not benefit them directly<sup>7</sup>. We need similar robust, concerted action to protect the most vulnerable financial consumers who need access to fair, affordable credit.

The rationing of credit makes it inevitable that there will be a significant growth in financial exclusion and, specifically, the number of consumers who will be pushed into the sub-prime lending markets. The new economic, commercial and regulatory environment will make it less attractive for mainstream lenders to lend to the 'working poor', adding to the traditionally excluded groups. Households considered a high risk will be hit hardest as lending is likely to be concentrated on 'lower-risk' households. There will be a significant reduction in mainstream credit funding for vulnerable households, which will be priced out of or denied access to mainstream credit and so pushed into sub-prime sectors. If this happens there will be a high price to pay for consumers.

Moreover, the recession will expose vulnerable consumers to scams and aggressive tactics by less reputable financial services firms which pretend to offer consumers a way out of their financial difficulties.

Urgent action is needed to protect vulnerable consumers and ensure they have access to fair, affordable credit. We set out some preliminary ideas to stimulate debate in Section 4.

## **Financial Inclusion Centre and Consumer Focus**

### **April 2009**

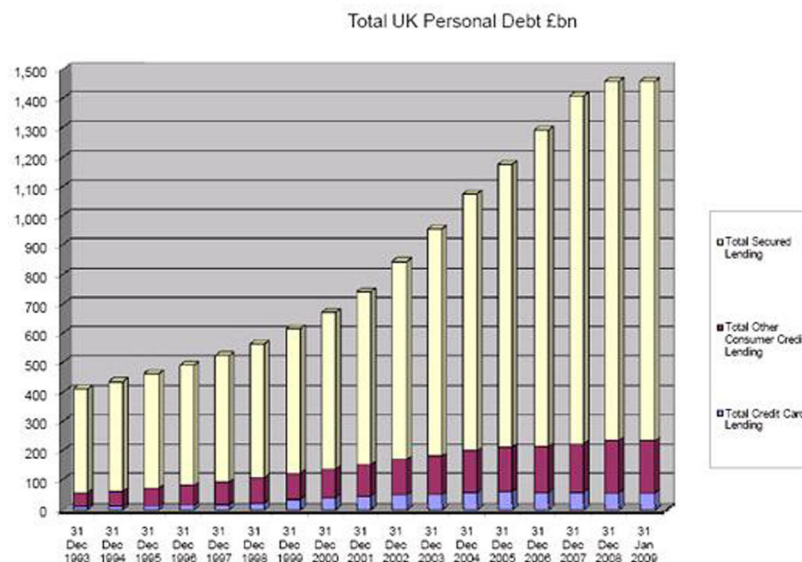
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<sup>7</sup> *Of course, in theory, raising the deposit protection scheme should promote confidence in the systems and encourage more people to save. In more normal circumstances this, in turn, would provide more capital for banks to lend to consumers. However, banks are likely to use much of any additional capital received to repair their balance sheets, not lend. Moreover, what lending there is will be concentrated on lower risk borrowers.*

## 1 - The years of plenty

Before we go on to consider how lenders' behaviour has changed it is useful to put the credit crunch into context and show just how pervasive debt has become in UK society.

**Chart 1: Growth in total personal debt**



Source: Credit Action, Debt Statistics, March 2009 (drawn from Bank of England data)

Total UK household debt as at end January 2009 was £1,457 billion<sup>8</sup> – nearly £1.5 trillion. Such a huge figure is hard to grasp and is perhaps better understood when converted into debt per household.

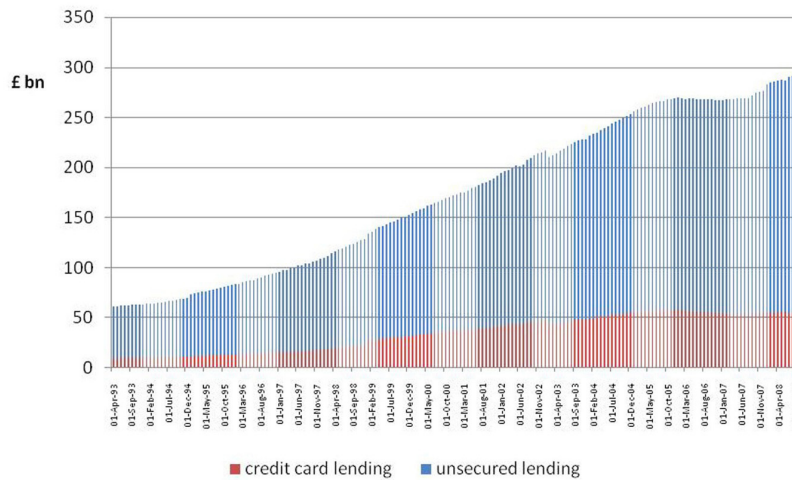
According to Credit Action, average household debt (including mortgages) is now £59,730 – for the 11.7 million households which have a mortgage, the average debt is just over £104,300. Excluding mortgages, average household debt is £9,600.

Not surprisingly, mortgage debt makes up the vast bulk of total household debt in the UK. However, unsecured debt (unsecured loans and credit cards) has also grown considerably – five fold during the past five years – although growth in credit card lending appears to have slowed.

<sup>8</sup> Source: Credit Action, Debt Statistics, March 2009, <http://www.creditaction.org.uk/debt-statistics.html>



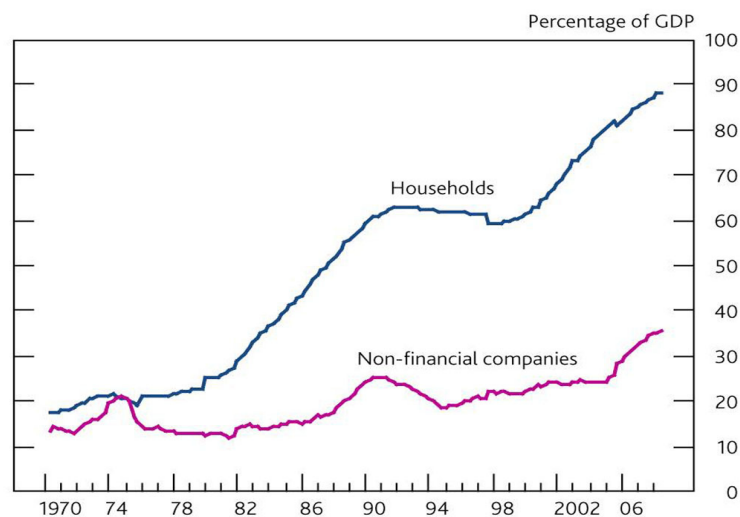
**Chart 2: Growth in unsecured debt**



Source: Bank of England

Another way of looking at the scale of UK's personal debt burden is to look at debt as a proportion of the UK's gross domestic product (GDP). This measure illustrates how debt has grown over time in relative terms by comparing the growth in personal debt with the growth in how much the country has earned (as measured by its economic output). As the chart below shows, lending to UK households (not including lending to companies) reached nearly 90 per cent of the UK's GDP in 2008 – well above the long-term averages. Growth in lending far outstripped the growth in GDP.

**Chart 3: Growth in secured and unsecured lending as a percentage of GDP**

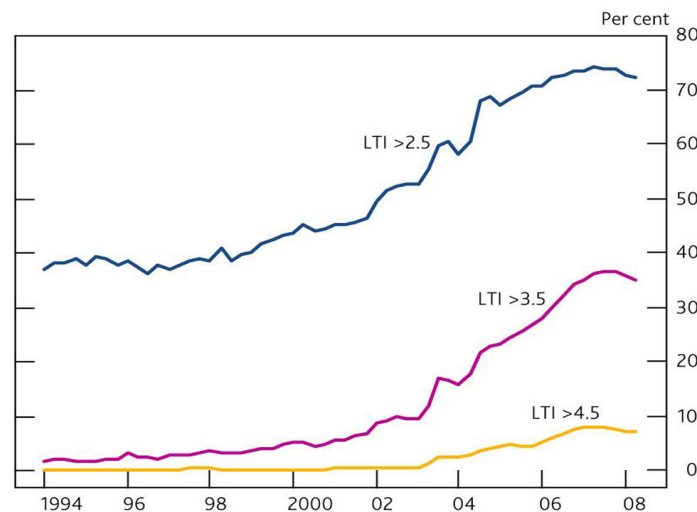


Source: Bank of England

Much of the growth in household debt is accounted for by secured lending (including mortgages). As Chart 3 indicates, lenders in the UK took on significantly more credit risk in the mortgage market since 2000.



**Chart 4: Banks relaxed lending criteria**



Sources: FSA, Survey of Mortgage Lenders and University of Essex<sup>9</sup>.

Chart 4 shows the impact of extended lending criteria from 2004 onwards. While much of this lending was categorised as sub-prime or impaired credit, borrowers who mortgaged/ remortgaged were often nowhere near what the media sometimes portrays as sub-prime credit customers. Many of these homeowners who borrowed at the post 2004 high-income-to-loan ratios are in a difficult situation because they have no or limited remortgage options at the end of their loan. What help these borrowers can expect from their lender or the state is a fundamental question.

The chart shows that by 2007, more than 35 per cent of mortgages had loan-to-income ratios of more than 3.5 times. Indeed, about nine per cent of mortgages had loan-to-income ratios of more than 4.5 times.

It is only fair to point out that some commentators argue that the growth in national UK personal debt does not present that great a problem as the growth in debt has been accompanied and offset by a corresponding growth in national assets (including property wealth). However, we do not necessarily subscribe to this argument<sup>10</sup>. Asset price deflation, notably in housing, changes this equation dramatically and is likely to play havoc with debt sustainability.

<sup>9</sup> Chart shows the proportion of total mortgages with loan to income ratios greater than 2.5, 3.5 and 4.5. FSA data are used from 2005 Q2 onwards. The back-run has been constructed using the changes in the series from the Survey of Mortgage Lenders data set.

<sup>10</sup> Technically, the fact that household assets have grown as well as debt may be correct. However, we have concerns about this argument. Debt is real – consumers must pay it back. It does not disappear in absolute or comparative terms unless incomes outstrip debt growth, debt is inflated away by inflation or borrowers default on their debts. Property wealth is ‘intangible’ and has to be realised in some way if it is to be useful. This can be done by trading down or unlocking equity through equity release schemes – options that are open to a minority of households in the current climate. Moreover, many households will not be sitting on positive housing wealth if they bought their home recently and further falls in house prices will erode the nominal value of property wealth – indeed, many households will now be facing negative equity.

Also, interest rates during the previous five years have been relatively low in nominal terms when compared to the highs of the late 1980s and early 1990s. Moreover, an increasing number of mortgages were arranged on relatively low fixed rates. Against this background, industry put forward the argument that it was logical for lenders to relax lending criteria and lend at increasingly higher multiples of incomes (however, as we point out, this rosy outlook was predicated on favourable economic conditions being maintained).

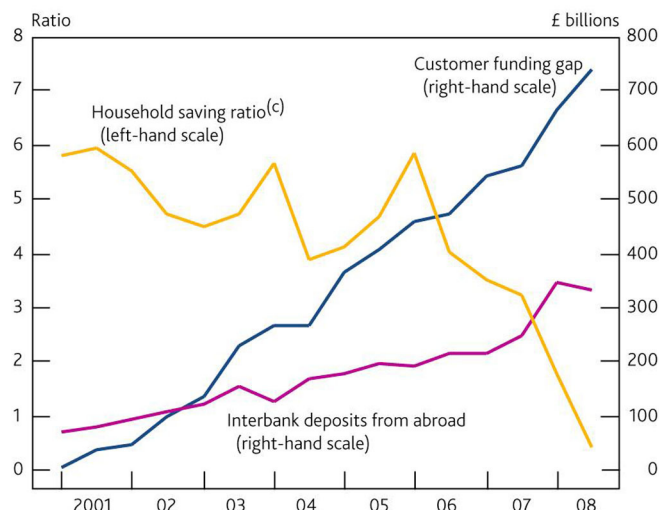
This expansion in lending and relaxation of lending criteria seems to have been based on the expectation that favourable economic conditions would continue on the back of a significant growth in wholesale market funding (see below). This, of course, has turned out to be optimistic and has left lenders' balance sheets and borrowers exposed and vulnerable to systemic financial risks and adverse changes in the economy.

### Rising debt, falling savings, funding gap

The huge growth in personal debt has been accompanied by a fall in the household savings ratio (see chart below). This is significant as it determines the assets households have available to see them through difficult times and therefore determines, to some degree, the need for credit.

The fall in the savings ratio is also significant because it has contributed to the funding gap of UK banks. The funding gap basically represents the difference between the amount of lending made by banks and the level of customer deposits held. The funding gap of major UK banks is huge – it stood at approximately £740 billion at end June 2008<sup>11</sup>. The gap has widened considerably since the beginning of the decade as banks have increasingly sought to fund lending through the wholesale markets – but the credit crunch arrived and this source of funding has suffered accordingly.

**Chart 5: UK banks funding gap**



Source: Bank of England

<sup>11</sup> Bank of England, *Financial Stability Report*, October 2008, Issue no 24, p39

## 2 – The bubble bursts

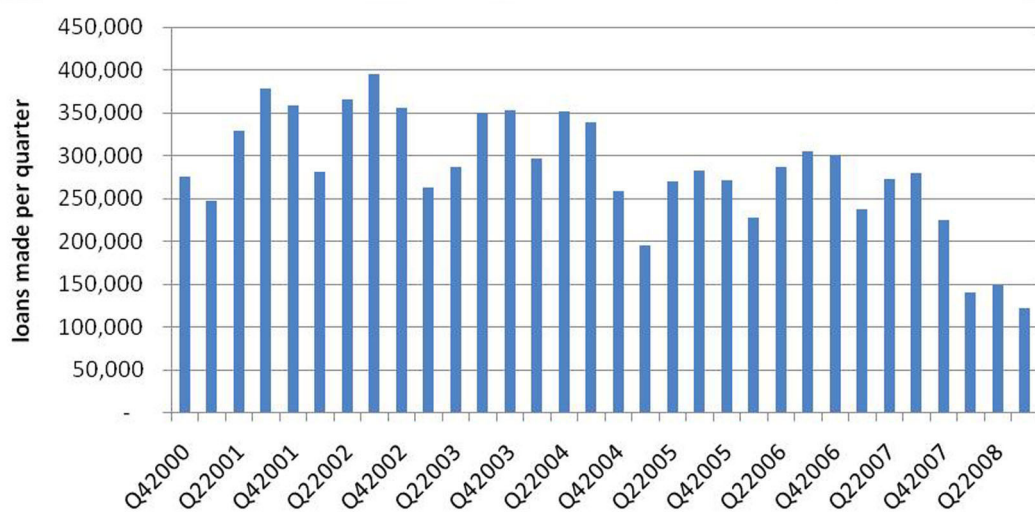
So, overall, the scene was set for a crisis. Whether or not the unsustainability of the credit boom was foreseeable is difficult to judge. However, as it turned out, the credit boom could not continue and when the credit crunch arrived, its impact was dramatic.

What is alarming about the current financial crisis is the speed with which market sentiment and lending policies changed. We are not seeing a gradual rebalancing between debt and savings; the shock to the financial system has been dramatic and rapid.

The effects were first felt in the wholesale interbank lending markets as banks stopped lending to each other. But the financial crisis is already having an impact on the end-user, ie, consumers and small businesses. In 2008 gross mortgage lending declined by 29 per cent compared with the previous year. At February 2009 gross lending continues on a downward slide and was 60 per cent lower than a year ago<sup>12</sup>.

A clear example can be seen in the number of mortgages made during the past few years (see Chart 6, below). There were 122,000 house purchase mortgages advanced in Q3 2008 compared to 305,500 in Q3 2006.

**Chart 6: Mortgage advances fall dramatically**



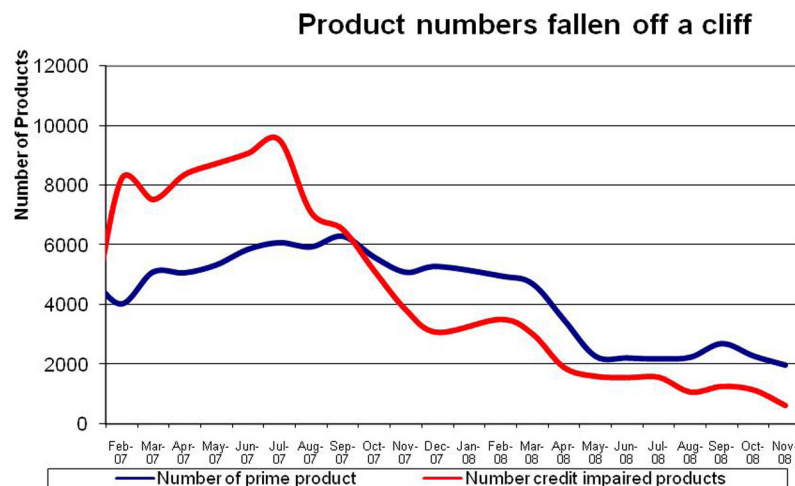
Source: CML

Another example of this can be seen in the reduction of the number of mortgage products on the market. The total number has fallen dramatically during the past year or so. While there have been seasonal dips in mortgage advances, none were as substantial or sustained as the present time. The number of prime mortgage products has shrunk by around two-thirds, having fallen from a peak of around 6,000 to around 2,000 currently.

<sup>12</sup> Council of Mortgage Lenders, *Housing finance at a glance*, March 2009

In line with the market becoming more risk-averse and wholesale market funding drying up, the sub-prime market has been particularly badly hit. At its peak there were around 9,800 sub-prime products on the market. This has now fallen to around 800 – a reduction of approximately 90 per cent. Greater simplicity in the range of mortgage products is no bad thing but the scale of change demonstrates more profound forces are at work.

**Chart 7: Reduction in number of mortgage products**



Source: Moneyfacts

The deleveraging and rerating of risk we are witnessing is reinforced by the dramatic fall in the number of low deposit deals available (see Table 1, below). The total number of products listed in the table below has fallen from more than 3,100 to less than 1,000<sup>13</sup> – a fall of 70 per cent. The latest Bank of England figures suggest that credit availability to households with loan-to-value ratios above 75 per cent tightened by more than expected in the first quarter of 2009<sup>14</sup>. Mortgages where higher deposits are required have been comparatively unaffected and in one case – 15 per cent deposit deals – the number of products available appears to have risen. However, although the number of higher deposit deals appears to have remained fairly constant during the year, this does not mean that actual mortgage lending has remained stable.

**Table 1: low deposit deals are an endangered species**

Mortgage Type	Number @ Nov'07	Number @ Nov'08	Fall/rise in numbers	% change
5% deposit	1,126	35	-1,091	-97%
10% deposit	1,152	66	-1,086	-94%
15% deposit	198	228	+30	+15%
20% deposit	216	189	-27	-13%
25% deposit	449	421	-28	-6%

Source data: Moneyfacts

<sup>13</sup> Please note that this table is for illustration. It does not represent the total number of products on the market – the actual total number will be greater as all the different types are not listed here in Table 1.

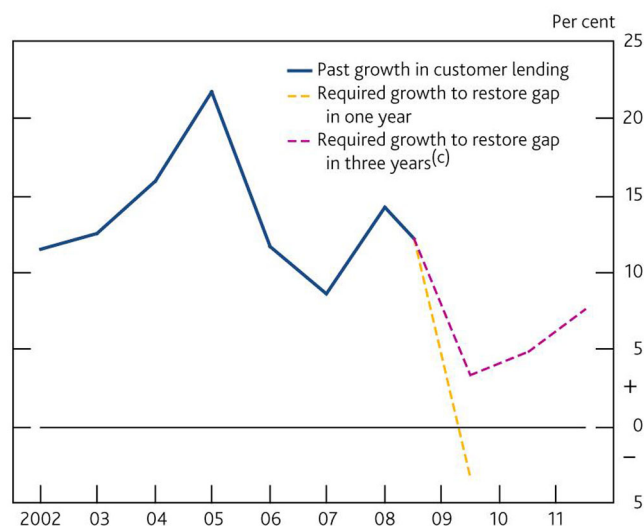
<sup>14</sup> Credit conditions Survey, Q1 2009.

### Is the worst yet to come?

Although we have already seen the number of available products falling and credit growth slowing it is likely that worse is to come. The full impact on 'vulnerable consumers' (such as those on low incomes, those who are over-indebted or those who are considered a high risk by mainstream lenders) will probably be played out during the next few years. It is important to stress that the effects on consumers will depend on the response of the Government, FSA, the industry and consumers and their representatives.

Lenders now have to repair their balance sheets. Banks have already announced capital raising programmes while the Government has sought to help by embarking on a recapitalisation support programme. However, this on its own will not be enough and banks will have to close the funding gap by other means. This is significant for consumers as lenders have to attract higher levels of deposits and have already started to restrict the growth in lending (in certain cases reduce lending). Evidence of this can be seen by considering the latest Bank of England research, such as the Financial Stability Review and Credit Conditions Survey along with market analyses from various information providers.

**Chart 8: Growth in bank lending will need to be curtailed to restore customer funding gap**



Source: Bank of England, Financial Stability Report

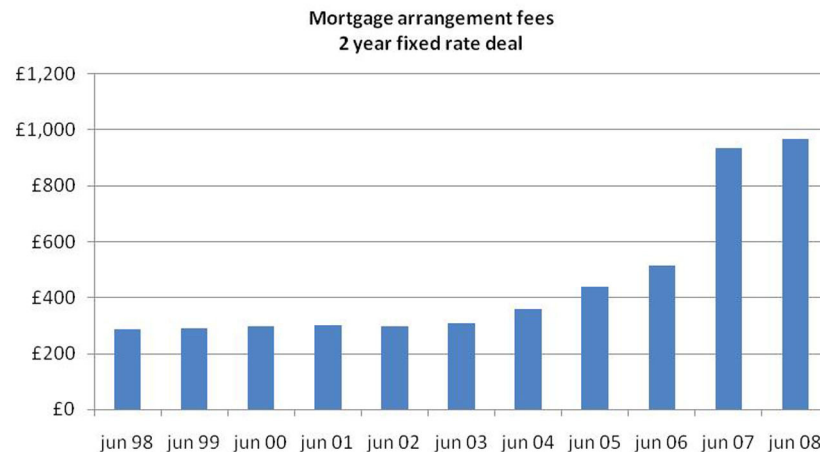
The above chart shows how much the Bank of England estimates lending patterns would have to change to restore the customer funding gap<sup>15</sup> to 2003 levels. If the banks were required to close the funding gap over three years the rate of growth in lending is likely to fall considerably. However, if they were required to do it over one year, this would suggest that lending would actually fall.

This is being felt by consumers in a number of ways. Credit is being 'rationed' by a reduction in the outright supply of credit, availability being rationed by lenders through the use of tighter lending criteria or lenders trying to improve profit margins by increasing prices on lending products

<sup>15</sup> The funding gap represents the difference between the amount of lending made by banks and the level of customer deposits held. Banks can close the funding gap by reducing growth in lending, increasing the amount of customer deposits or a combination of both. The Bank of England modelled two main scenarios – if banks closed the gap over one year and three years.

(in this case, rather than raise headline interest rates lenders are likely to recoup lost revenue through higher administration and arrangement fees). These higher prices represent a barrier to remortgaging, although some consumers on fixed deals would be better off remaining on the SVR in any case.

**Chart 9: Will mortgage fees continue to rise?**



Source: Moneyfacts

The key finding in the latest Bank of England Credit Conditions survey is that availability of credit has been reduced again in Q1 2009<sup>16</sup>. Reduced risk appetite and expectations for house prices were reported to have been the main factors contributing to this tightening.

Lenders also reported that they had reduced availability of unsecured credit. Credit scoring has tightened significantly for both credit cards and other loans.

The survey also found that the overall spreads (that is, between the cost of borrowing for lenders and rates charged to borrowers) on secured lending to households have widened. However, 'non-price' terms (that is loan-to-value ratios and loan-to-income ratios) have tightened. This all suggests that margins have increased, although by how much is difficult to say.

Following the recent dramatic cut in base rates<sup>17</sup>, the pressure on mortgage margins will be intensified – banks are also under pressure not to penalise savers by passing on the full base cuts. Lenders will have to recoup revenue in other ways – for example, by further increasing arrangement fees or increasing margins on other products.

Defaults on secured and unsecured lending have risen over the previous quarter and are expected to rise further over the next quarter<sup>18</sup>.

<sup>16</sup> Credit Conditions Survey, Q 1 2009.

<sup>17</sup> 1.5 per cent cut since December 2008.

<sup>18</sup> Bank of England, Credit Conditions Survey, Q 1 2009.



### How have lenders been rationing credit?

The reduction in lending has been instigated through a combination of tightening credit scoring criteria, a reduction in the proportion of household loan applications being approved and by a decline in maximum loan-to-value ratios. Moreover, where borrowers met lending criteria, actual credit limits were reported to have been reduced. It is not expected that the availability of unsecured lending will change in the next three months with further impacts on the most disadvantaged<sup>19</sup>.

This is in keeping with our view that the financial crisis could lead to a two-tier credit market. Low-risk borrowers who enjoy high levels of home equity will find lending markets open to credit applications whereas higher risk borrowers will find themselves paying a high price to borrow or be denied access to credit altogether.

### Why has secured lending reduced?

There are a number of reasons for the reduction in secured lending. Firstly, lenders' appetite for risk has changed – they are becoming more risk-averse. Furthermore, as outlined above, funding from the wholesale markets has decreased. Moreover, for technical and regulatory reasons, during the past year lenders have been less able to transfer credit risk off-balance sheet. This reduces lenders' ability to leverage loans and reduces the availability of mortgage lending.

More generally, the deteriorating economic conditions mean that incomes will be squeezed and more borrowers will have difficulty making mortgage repayments.

### Why has unsecured lending reduced?

The main reasons for reducing unsecured credit availability seem to be a changing appetite for risk and the deteriorating economic conditions<sup>20</sup>. As with secured lending, lenders appear to be less willing to take a risk when lending on an unsecured basis. This is due, in part, to a reaction to the excesses of the past decade and a more fundamental concern about the state of the economy which will affect consumers' ability to repay loans.

Rather than focus on expanding their share of the unsecured loans market, lenders are likely to come under pressure to take aggressive action to protect their interests by using charging orders to convert unsecured debt into secured debt. Changes to the county court procedure to allow unsecured creditors to gain charging orders, even where debtors are complying with the terms of an instalment order, will intensify the problem of aggressive debt recovery.

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<sup>19</sup> Bank of England, *Credit Conditions Survey, 2009 Q1*.

<sup>20</sup> Bank of England, *Credit Conditions Survey 2009, Q1 Appendix II*.



### 3 - A heavy price to pay

The factors explained above – the need for lenders to repair balance sheets, a changing appetite for risk among lenders, and evidence of increasing debt default rates– mean that credit availability will be further reduced.

This will have a number of consequences for society and for specific groups of consumers – summarised below. It is difficult to predict what the impact will be on consumers or how many will be affected – not least because this depends on the speed and effectiveness of interventions by the Government, regulators, the financial services industry and civil society to protect consumers.

- Mortgages – there is a need to protect households vulnerable to negative equity, increases in mortgage arrears and repossessions. As well as ensuring that lenders treat borrowers fairly in terms of arrears management/repossessions, there is a hidden issue of unfair penalties imposed by sub-prime lenders (which can be in region of £50 a month for every month in arrears). Another consequence is that the cost of mortgages may rise, a situation potentially exacerbated by competition concerns arising from the consolidation of mortgage providers. Finally, the reduced availability of mortgage finance means that more consumers will have to rent in the private sector and may also be vulnerable to aggressive treatment from landlords.
- Maintaining access to credit lines – one of the medium-term effects of the financial crisis will be an increase in the number of new borrowers denied access to credit or pushed into
- sub-prime markets. Another pressing fear is that current borrowers may see their existing credit lines cut (eg, overdraft and credit card limits being reduced) triggering problems for consumers whose financial circumstances are already stretched.
- Lenders' attitudes to unsecured loans – once unsecured loans start to deteriorate lenders may become more aggressive by taking out charging orders on unsecured debt. As explained above, there has been a rise in default rates and losses on unsecured loans, which are expected to increase further. We may also see an increase in mainstream lenders cutting their losses by selling on debt to specialist debt collection firms. Linked to this, there may be an increase in scams and aggressive marketing of solutions, such as debt consolidation and equity release schemes, being targeted towards over-indebted or vulnerable households.
- Advice – the third sector financial advice community may be unable to cope with increased demand, despite increased funding which the Government announced in the Pre-Budget Report.
- Pensioners – pensioners will face particular risks, including falling annuity rates and poor returns on their savings due to low interest rates.

#### Economic impact

The reduction in credit available to consumers and industry is expected to be a contributory factor to the recession. In turn, the scale of the recession and unemployment levels will determine how badly households are affected by changing credit conditions – the number of households facing arrears or repossession is expected to rise considerably (see below). Those households hit by reduced incomes or unemployment will be most affected by arrears and repossessions.

#### Housing market issues

One of the most visible consequences of the credit crunch has been the impact on the housing market, which has struggled to contend with a dysfunctional mortgage industry. Moreover, falling house prices can have significant knock-on effects on consumer wellbeing and household finances.

The Land Registry House Price Index reports falls in house prices in the year to January 2009 of 15.1 per cent. The report indicated that house sales also continued to fall in January. Although Nationwide Building Society and the National Association of Estate agents have reported a slight recovery in the figure in the first quarter, average sale prices are still well below 2008 levels.

Much of the collapse in confidence in the housing market can be explained by consumers holding back on moving or buying as the economy heads into recession. However, it is also reasonable to assume that the huge fall in transactions is partly down to the rationing of mortgage credit. As explained above, the availability of high LTV mortgages has all but dried up – indeed there are so few mortgages of this type around that the Bank of England has stopped publishing data on average interest rates on 95 per cent LTV mortgages.

All homeowners are affected by falling house prices, largely through reduced or negative equity. Some, such as first time buyers, may benefit from falling prices if it makes getting on the housing ladder more affordable, although this pre-supposes that they can secure a mortgage agreement. Recent first time buyers may be facing negative equity (where the mortgage debt is greater than the value of the property). Recent estimates by the Bank of England suggest that if house prices continue to fall, the number of households facing negative equity could rise from the current level of around 500,000 to 1.2 million by 2011. But, even this estimate is considered optimistic by some commentators who have suggested that the numbers could be far in excess of this figure.. As well as undermining consumers' willingness to spend, negative equity will further weaken lenders' balance sheets and their potential to lend.

### **Rising arrears and repossessions**

Repossessions in 2008 increased 65 per cent during 2007 to 46,748 according to the Financial Services Authority. The Council of Mortgage Lenders (CML) predicts a further rise to 75,000 in 2009.

Arrears in the sub-prime sector are running significantly higher than in the mainstream market. Sub-prime lenders also tend to be quicker to repossess if borrowers fall into difficulty.

The worrying aspect of the rise in repossessions and arrears is that the recent growth has occurred during a relatively benign economic climate. Yet the UK economy appears to have declined faster and harder than expected, leading to fears that arrears and, ultimately, repossessions will increase further unless concerted action is taken by the Government and regulators to protect consumers.

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<sup>21</sup> January 2009, Date of release 27 February 2009.

<sup>22</sup> Bank of England Financial Stability Report, October 2008.

<sup>23</sup> Citigroup economist Michael Saunders argues that the BoE survey uses a method that asks respondents to self-report the value of their homes. He argues that previous BoE research has shown that homeowners tend to overstate the value of their homes by 20 per cent and understate debts by between 10-15 per cent. Adjusting for this bias, a fall in house prices of 15 per cent on top of the 15 per cent fall we have seen so far this year, would leave between 2.5 and 3 million in negative equity.

<sup>24</sup> Mortgage Lending and Administration Return Statistics, March 2009.

<sup>25</sup> <http://www.cml.org.uk/cml/publications/marketcommentary>

## Financial exclusion

As well as impacting on the economy, levels of financial exclusion in the UK will grow. At a general level, if household incomes are reduced, increasing numbers of consumers will become commercially unviable for the mainstream financial services industry, which is likely to concentrate on 'better-off' households. This will impact on all product sectors.

However, this pamphlet focuses on the impact on credit markets. Access to affordable credit is already a problem for consumers on lower incomes or with impaired credit ratings. These groups are not commercially attractive for mainstream lenders and are forced to turn to the sub-prime market or are denied access to credit altogether. Estimates put the number without access to mainstream credit at three million<sup>26</sup>.

Vulnerable households, such as those on lower incomes, have been disproportionately affected by rising household utility and food bills, making it difficult to build up a savings cushion to protect themselves against the recession. Many lower income households don't have the option of saving for the future and have no choice but to borrow to maintain an acceptable standard of living. This is not a question of making cheap and easy credit available to fuel a consumer society; financially excluded households need access to fair, affordable credit to survive.

Consumers excluded from mainstream credit can pay a huge price for borrowing<sup>27</sup>. The number of consumers facing exclusion is expected to grow substantially. The new economic, commercial and regulatory environment will make it less attractive for mainstream lenders to lend to the 'working poor', adding to the traditionally excluded groups. Mainstream banks are under pressure to restore balance sheets and are likely to make adjustments to lending patterns<sup>28</sup>. But 'riskier' households could be hit hardest because lending is likely to be concentrated on 'lower-risk' households. The effect is likely to be a significant reduction in mainstream credit funding for vulnerable consumers, in particular those on lower incomes or who are considered to be a high risk by mainstream lenders. They will be priced out of market, denied access to credit or pushed into sub-prime sectors.

A worrying development is the recent announcement by the lender Cattles (the second biggest home credit lender) that it is reducing new business volumes by 75 per cent in 2009 and cutting jobs by 1,000<sup>29</sup>. Cattles lends to what it describes as 'non-standard' customers and as a result charges higher interest rates on loans compared to mainstream lenders. Unlike building societies, which rely mainly on deposits from savers to provide the capital for loans, Cattles relies on wholesale market funding. However, the uncertainty in this market has restricted its ability to expand its loan books. The reason this is worrying is that, while Cattles and other non-standard

<sup>26</sup> *Short Changed*, New Philanthropy Capital, July 2008, [http://www.philanthropycapital.org/research/research\\_reports/community/financial\\_exclusion.aspx](http://www.philanthropycapital.org/research/research_reports/community/financial_exclusion.aspx)

<sup>27</sup> For example, someone borrowing £300 for a year with Provident Financial (the home credit company) might expect to pay back £504 in total – an APR of 183 per cent. In fact, APRs of over 1,000 per cent for short-term loans are not uncommon in the sub-prime market (and these are licensed, regulated lenders). With a typical credit union they might expect to pay back £321 – an APR of roughly 22 per cent. Calculated using <http://www.lenderscompared.org.uk/> and <http://www.abcul.coop/page/calculate.cfm#repayment>.

<sup>28</sup> Chart 5.12 of the Bank of England Financial Stability Review, October 2008, shows the level of adjustment banks would need to make to restore funding gaps to 2003 levels. If the adjustment is made over three years, the rate of increase in lending would be well below the average of the past five years. If adjusted was made in one year, lending would actually be reduced.

<sup>29</sup> [http://www.cattles.co.uk/index.php?stock\\_exchange\\_announcements](http://www.cattles.co.uk/index.php?stock_exchange_announcements)

lenders charge high rates to borrowers, they at least provide a buffer between vulnerable borrowers and the most unscrupulous and aggressive lenders – especially illegal loan sharks. The fear is that we will see growing numbers of vulnerable households turning to loan sharks because they have nowhere else to go for financial support.

Not-for-profit (NFP) lenders such as credit unions and community development finance institutions (CDFIs) provide an alternative to commercial sub-prime lenders for financially excluded consumers. Despite the apparent advantages of NFP lenders, they have achieved fairly limited penetration compared to the scale achieved by commercial non-prime lenders (such as home credit firms). New Philanthropy Capital (NPC) has collated evidence which suggests that non-prime lenders of various types lent at least £4.3 billion in 2005. In comparison, the total lent by NFP lenders (including Government) amounted to around £1 billion.

### **Consumer protection**

One of the consequences of the financial crisis is that consumers in desperate need of cash might be persuaded into taking up financial products that aren't in their best interests, for example sale and rent-back schemes. The OFT has recommended regulation for this sector and the Government consultation closes on 1 May; it is important that the Government acts on the recommendations and feedback as a matter of priority. Similarly, regulators must be vigilant that consumer protection safeguards are working in other parts of the sub-prime economy that thrive during times of economic hardship.

Further, the drying up of credit options may tempt consumers to use unlicensed money lenders, who charge punitive rates of interest and resort to intimidation and violence to call in their loans. Additional Government funding to expand the number of specialist trading standards teams set up to crack down on these individuals is welcome in this context.

### **Lenders taking action to secure debt and cut losses**

As a reaction to the quality of credit deteriorating, there is a chance that lenders will take a hard line to protect their interests by using charging orders to convert unsecured debt into secured debt. As the table (overleaf) shows, there has been a dramatic growth in number of charging orders granted in England and Wales during the period from 2000 to the end of 2007.

With signs that the quality of unsecured debt is deteriorating further, lenders will be tempted to use charging orders more frequently.

Another way lenders can protect their position or cut losses is to sell on distressed debt to third parties who take on the responsibility for collecting the debt. The risk for consumers is that specialist debt buyers are usually not mainstream household names and are not constrained by reputational risk. This could lead to a more aggressive approach to arrears and repossession enforcement.

<sup>30</sup> The FSA reports that the number of credit unions in September 2007 were 378 in England, 122 in Scotland and 32 in Wales. 2007 Credit Union Annual Statistics.

<sup>31</sup> See *Short Changed*, New Philanthropy Capital, Table 7: Credit Options for the financially excluded, p68/9.

<sup>32</sup> Credit unions made around £257million in new loans in 2005, while CDFIs increased their lending and investment by around £77 million (only £3m of this was for personal loans). £688 million was provided through The Social Fund in 2006/7.

Table 2: Growth in charging orders

Period	Charging orders, England and Wales	
	Applications made	Orders granted
2000	16,014	9,689
2001	21,870	15,487
2002	30,781	21,408
2003	35,052	25,217
2004	45,516	33,235
2005	65,780	49,218
2006	92,933	67,090
2007	131,637	97,026

Source: Ministry of Justice<sup>33</sup>

### Government response

The Government has responded with a number of initiatives to protect consumers from the consequences of the financial crisis. These include:

- the Homeowner Mortgage Support Scheme (HMSS): this is designed to complement the Support for Mortgage Interest (SMI) Scheme and is intended to provide a bridge for homeowners experiencing financial problems to give them time to find new employment or recover income. The scheme is voluntary and will allow lenders to reduce a borrower's monthly mortgage payments, with the deferred payments rolled up and added to the principal. The deferred payments can then be paid at a later date when the borrower's financial circumstances improve. The attraction for lenders is that the Government will guarantee the lender against a proportion of any loss incurred on the deferred interest payments in case the borrower defaults. The scheme will be voluntary and subject to eligibility criteria. The eight largest lenders have agreed in principle to participate in the scheme.
- the Government has reached agreement with major lenders to wait at least three months before initiating repossession proceedings so that all other options can be explored.
- the Government is bringing forward its £200 million Mortgage Rescue scheme to start early in more than 50 local authority areas.
- a further £15.85 million has been announced to extend free debt advice to be made available to all consumers across the country.
- a new mortgage pre-action protocol that came into effect in December 2008 which makes it clear to lenders that repossessions should be a last resort.
- the waiting period before Income Support for Mortgage Interest (SMI) is paid is being shortened from 39 weeks to 13 weeks (this came into effect on 5 January 2009).
- An asset purchase facility from a new £50 billion fund to buy assets from banks, institutions and financial markets to help increase the amount of funding available to companies.

<sup>33</sup> *Judicial and Court Statistics 2007, September 2008.*

<sup>34</sup> *The 8 largest lenders covering 70 per cent of the mortgage market are HBOS, Nationwide, Abbey, Lloyds TSB, Northern Rock, Barclays, RBS, HSBC.*

**Government response continued...**

- An extension of lending commitments to large companies and an increase in lending of £6 billion in the next 12 months by RBS through conversion of the Government's stake of preference shares to ordinary shares.
- Removing barriers to bank lending by specific agreements covering quantity and type of lending in return for insuring certain bank assets.
- The credit guarantee scheme for new unsecured borrowing
- A further £50 billion of guarantees on new mortgage lending.<sup>35</sup>

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<sup>35</sup> *Chancellor's Statement to the House of Commons, 19 January 2009.*



## 4 - Possible solutions

With mainstream lenders becoming more risk-averse and rationing credit by applying tighter lending criteria, financial exclusion will grow and more consumers will be pushed into the non-prime markets<sup>36</sup> or denied access to credit altogether.

Moreover, vulnerable borrowers are likely to be exposed to more aggressive detrimental market practices as lenders protect their positions in a deteriorating economic climate.

The Government has mounted concerted action to rescue the financial system and protect the savings of 'Middle England' by raising the level of deposit protection schemes. This is understandable as confidence in the financial system is paramount.

Similar concerted action is needed to protect vulnerable consumers without savings who need access to fair, affordable credit or who may already be in serious debt. We believe policymakers, regulators, the financial services industry and civil society have two main objectives:

- improve and enforce the existing consumer protection regime
- take action to ensure that lines of credit are kept open for vulnerable consumers

### Consumer protection measures

The Government has responded to the crisis by introducing a number of welcome initiatives to protect consumers in the mortgage market (see previous Section). However, these measures need careful monitoring and must be accompanied by public reporting mechanisms so that civil society can judge whether lenders are playing their part in tackling the crisis by complying with voluntary measures.

Moreover, while the Government seems to have persuaded mainstream lenders to sign up to these initiatives, it has not had the same success with sub-prime lenders who do not face the same reputational constraints. Yet it is in the sub-prime lending markets where consumers are most vulnerable to aggressive practices or unfair products. We fear that the sub-prime sector is not being held accountable in the same way as mainstream lenders.

Therefore, as well as radical measures to ensure financially excluded consumers have access to credit (see below), a number of immediate improvements to the existing consumer protection regime are suggested including:

- as a priority, the Government, FSA and OFT should issue a clear statement of practices it considers unacceptable in the secured and unsecured debt markets. This statement of practices should cover: treatment of arrears and repossessions; the use of charging orders and debt sales; promotion of debt 'solutions' to borrowers in financial difficulty including debt consolidation and advice. In a previous report, *The Perfect Storm*, we suggested a set of good practice guidelines for the FSA and lenders to follow for treating customers fairly in arrears. FSA needs to enforce principles-based regulation robustly and transparently and should use these guidelines to report on lenders' progress throughout the crisis.

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<sup>36</sup> We use a wide definition in this case to include non-status, sub-prime borrowers.



- the OFT needs to monitor compliance with guidance on fair business practices and enforce breaches robustly;
- the OFT should initiate an investigation into the mortgage market in light of consolidation in the banking sector;
- the Government should move urgently to regulate sale and rent-back schemes following the OFT market study (the FSA is currently consulting on a scheme);
- the regulation of debt sales (where lenders sell on distressed debt to third parties) work now allocated to the FSA needs to be given priority and completed according to the specified timetable;
- the FSA and OFT should urgently convene a working group to investigate the contract terms in sub-prime mortgages;
- the Government should co-ordinate the urgent creation of a national mortgage rescue scheme rather than leave to the CML to develop;
- FSA and OFT should step up monitoring of debt consolidation firms and advice agencies, and the general promotion and marketing of credit.

### **Maintaining access to fair, affordable credit**

While it is desirable that we return to more prudent, sensible lending practices, many consumers need the option of credit to manage their affairs. There will be a high price to pay for consumers without access to fair, affordable credit, who will:

- be denied the choices many of us take for granted, such as the ability to own our homes;
- face high lending costs and unfair terms and conditions – APRs in the sub-prime sector are punitive;
- be exposed to unsuitable products and aggressive practices from unscrupulous financial services firms claiming to offer solutions to desperate consumers already in debt.

There are no easy answers. Government and regulators face a difficult challenge in their desire to reconcile:

- the excesses of the previous decade while introducing more robust regulation to restore confidence in the financial system, and making sure the taxpayer's stake in banks is protected;
- protecting borrowers from lenders aggressively enforcing their interests and finding ways of ensuring that banks lend to consumers they consider to be high risk.

In terms of maintaining access to fair, affordable credit, the broad options available to policymakers are easy to identify, although some of these may be ruled out as being politically impractical in the current environment. In essence the main options are:

- regulatory or structural interventions: regulators could adopt contra-cyclical prudential regulatory models to encourage lenders to lend<sup>38</sup>. Alternatively, the Government could underwrite loans to 'riskier' borrowers. A further option for encouraging lending would be to create an institutional mechanism such as a national mortgage rescue scheme to buy up distressed mortgages or underwrite mortgage payments of borrowers in difficulty. This

<sup>37</sup> *The Financial Inclusion Centre and National Consumer Council, The Perfect Storm: background paper, May 2008.*

<sup>38</sup> *Contra-cyclical regulation works on the basis that if asset or credit booms develop, regulators impose tighter capital requirements to rein in lending. Conversely, in theory, regulators could relax capital requirements to encourage lending during downturns.*

mechanism could allow banks to swap ‘toxic’ mortgage assets for government bonds, thereby repairing balance sheets and stimulating lending;

- universal service obligations: the Government could force banks to lend to ‘riskier’ borrowers, in effect regulating banks as if they are utilities. An alternative to this would be to set down annual performance targets for banks with regards to loans – particularly for those banks in which the taxpayer has a stake;
- ‘national’ bank options: the Government could take the previous option a stage further and lend directly through the banks it has a stake in – in effect turning these banks into mortgage and loans versions of National Savings and Investment;
- promoting and supporting alternative lending channels; the Government could increase the financial resources available to non-profit lenders, including government, through the social fund. The Post Office, credit unions and other community-based lending organisations could be used as alternatives to commercial lenders.

This pamphlet puts forward ideas to stimulate debate rather than offering a definitive roadmap. A considerable amount of work would need to be done to: quantify the level of consumer detriment that might arise from the financial crisis; identify the proportionate response; understand the changes to the regulatory framework needed to implement any of these options; and develop a policy framework to allow the Government to reconcile competing objectives of ensuring taxpayers receive a reasonable return on investment from their stake in banks while providing credit to borrowers perceived as being risky. All options should be considered as a matter of urgency to protect vulnerable consumers during the recession.

### Supporting initiatives

To complement the above initiatives, the Government, FSA and Bank of England could introduce the following measures:

- task force: while it is understandable that the Government, FSA and Bank of England focus their collective attention on maintaining the stability of the financial system through the tri-partite arrangement, a working group/ task force needs to be set up to monitor the impact of the credit crunch on vulnerable consumers and develop a collective response to manage the crisis;
- reporting requirements: lenders should be required to report publicly every month/ quarter on the number of arrears, repossessions and charging orders applied for; unsecured lenders should also be required to report ongoing default rates on their loan books;
- Community Reinvestment Act (CRA): it is time to reconsider the introduction of a UK version of the USA’s Community Reinvestment Act<sup>39</sup>. This would take further evaluation but the UK needs improved transparency measures with regards to financial exclusion. The Government should prioritise the development of key performance indicators relating to individual financial institutions’ performance on financial exclusion – for example, the number of loans made to different socio-economic groups. The information for individual firms should be publicly reported on a regular basis.

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<sup>39</sup>The Community Reinvestment Act of 1977 was set up to address discrimination in loans made to individuals and businesses in vulnerable, disadvantaged communities. Banks that receive government insurance are evaluated by regulatory authorities to determine if the institution has met the credit needs of communities. An important feature is that a bank’s compliance record is taken into account by regulators when the bank wants to expand its operations. Information about the CRA ratings of individual banks is publicly available from the website of the Federal Financial Institutions Examination Council (FFIEC).

# From Feast to Famine

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