The Financial Inclusion Centre
Promoting fair, affordable financial services

A FINANCIAL INCLUSION 'MANIFESTO'

MAKING FINANCIAL MARKETS WORK FOR ALL IN A POST FINANCIAL CRISIS WORLD

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About The Financial Inclusion Centre

The Financial Inclusion Centre (The Centre) is an independent research and policy innovation think-tank dedicated to promoting financial inclusion and fair, efficient, competitive, and accountable financial markets. The Centre supports its aims through a number of core activities.

Research and analysis

We aim to be a leading centre for research into financial exclusion and consumer behaviour in financial services focusing on: analysing the impact of exclusion on consumers; analysing the root causes of exclusion so that solutions are effective; providing insights into consumer behaviour so financial capability initiatives have greatest impact and products are better designed to meet consumers needs; and assessing the impact of government and regulatory policy, and 'environmental' factors such as changing socio-economic and demographic trends on consumers.

Innovation and partnership

We don't just research and analyse issues, we believe in promoting inclusion through innovation and partnerships, developing practical policy measures and innovative solutions that provide access to fair and affordable financial products and services. We actively promote fair and efficient financial markets and an effective regulatory system to promote consumer confidence and greater take-up of financial products by consumers. As consumer advocates we continue to campaign against poor practices but make a point of working in partnership with industry to ensure consumers' financial needs are met. We help firms develop fair and transparent products that consumers trust and understand, and provide independent consumer audits for firms. We believe consumer advocates can help markets evolve by working with providers rather than just campaign against practices. We are developing innovative solutions based on partnerships between the financial services industry and the third sector to meet the needs of consumers who are not economically viable for mainstream financial services providers.

Planning and advisory services

With our expertise and experience, we also work with social partner organisations to develop and implement strategies for combating financial exclusion. This includes: helping partners develop focused, targeted financial inclusion and capability strategies; providing practical help in setting up organisations to combat exclusion such as credit unions; and building capacity in the third-sector to help it play a more effective role in meeting the needs of excluded and marginalised consumers.

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INTRODUCTION

The unprecedented crisis in the financial system has triggered equally unprecedented interventions by policymakers and regulators[1]. The direct costs involved are estimated at @3.5% of UK GDP (a total of £50bn[2]). So far, the authorities[3] have understandably prioritised stabilising the financial system to make sure the banking system continued to function and savings were protected, and slashing interest rates to significantly reduce borrowing costs. Indeed, the crisis reminds us of just how important the banking and financial system is to the functioning of society, and why a different approach to regulating and running the system is needed.

We are not out of the woods yet and complacency must be avoided due to the risk of a secondary crisis, but these interventions appear to have been successful (in the short term at least) in stabilising the system. But, we must not forget how the financial crisis affects the most vulnerable consumers in society. Even if the economy stages a strong recovery, and despite welcome support measures[4], vulnerable citizens will continue to be penalised in the form of higher risk of unemployment and repossessions[5], and becoming victims of unfair financial practices.

Moreover, on top of short term effects, we should not underestimate how the crisis is fundamentally reshaping financial markets. Forcing banks and insurance companies to behave more prudently and responsibly is absolutely necessary but there are serious consequences to be recognised. The retail financial industry[6] will understandably increasingly focus on medium-higher income/ lower risk consumers. Vulnerable consumers will pay a higher price for access to financial services, be pushed into the sub-prime markets, or be denied access altogether. Concerted positive action is needed to prevent the chronic financial exclusion crisis in the UK being exacerbated.

Therefore, The Financial Inclusion Centre (The Centre) has developed i) a range of consumer protection measures designed to protect vulnerable consumers from the immediate and ongoing effects of the financial crisis and ii) proposals for longer term regulatory and structural reforms we think are needed to promote a fair and inclusive financial system that is aligned with the needs and interests of all in society. There are 30 measures in total packaged together in the form of a Financial Inclusion 'Manifesto'. Each of the individual policy measures would warrant a separate report. So, we have summarised the key elements of the measures in this document.

We hope to stimulate a debate and generate innovative ideas for those in the financial inclusion field. Comments are very welcome. If anyone is interested in finding out more details about specific proposals, or how these would be implemented, we would be very happy to elaborate.

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[1] this has included improving deposit protection schemes to protect consumers' savings, the de facto nationalisation of some of the UK's major banks, massive injections of public funds into the banking system, dramatic cuts in benchmark interest rates, a programme of quantitative easing by the Bank of England, and the establishment of an Asset Protection Scheme (APS) to offer banks insurance against future risks and losses.

[2] however, this figure excludes the other crisis related spending such as quantitative easing which are of a magnitude greater, and are estimated to run to hundreds of billions of pounds.

[3] Government, Bank of England and Financial Services Authority

[4] for example, The Homeowners Mortgage Support Scheme, and improved Court Protocols on repossessions

[5] especially in the regions

[6] banking, lending, insurance and savings sectors

WHY DO WE NEED A FINANCIAL INCLUSION MANIFESTO?

The Government has introduced a range of measures to protect vulnerable households including: the Mortgage Rescue Scheme, Homeowner's Mortgage Support Scheme, new Court Protocols on repossessions, and persuading major lenders to be sympathetic to borrowers in difficulty. These measures, combined with concerted intervention by the Bank of England to reduce interest rates, have protected thousands of households from the worst effects of the financial crisis. But, welcome as these measures are, more needs to be done to protect the most vulnerable households in the UK from the immediate effects of the crisis.

Some real progress has been made towards the longer term challenge of promoting financial inclusion. But the financial crisis changes everything. We argue that existing financial inclusion strategies are not 'fit for purpose' to deal with the long term effects of the crisis, and that we need a concerted programme of robust structural reforms to promote sustainable financial inclusion, and much needed corporate accountability in the banking and financial system.

For example, we think the case for a UK Financial Inclusion Act (FIAct) similar to the US Community Reinvestment Act (CRA), and charge caps on expensive sub-prime loans is compelling. We recognise that some measures would take some time to introduce. However, action must be taken now to protect consumers and we must take advantage of any opportunities to make a start on a long term reform programme. Introducing a set of Financial Inclusion Disclosure (FIDs) measures to require banks to disclose data on access to banking and lending is a priority.

There is no escaping the fact that additional funding is needed to tackle exclusion. We are reluctant to simply argue for more funds on the grounds that society has spent £billions rescuing the banks. However, it does seem only fair to point out that spending less than one half of one per cent (1/2%) of the direct costs spent on rescuing the banks would release £250m for financial inclusion initiatives. Every measure outlined in this action plan could be fully funded by a reasonable financial inclusion levy on banks and other significant financial institutions.

However, we emphasise that regulation and funding are not the only answers. Everyone with a stake in promoting inclusion (government, the financial services industry, civil society groups, and consumers themselves) must share the responsibility and play a greater, more active role in making things work.

Innovation and partnership between the financial services industry and civil society groups will be critical. The financial authorities have used considerable ingenuity to devise innovative structural interventions to underwrite banks potential losses and support the banking system – for example, the asset protection scheme and the quantitative easing programme. This is in stark contrast to what we think is a comparative poverty of ambition and imagination shown by stakeholders in developing structural, practical solutions that would promote sustainable, long term financial inclusion. We urge the 'City' to work with civil society groups and put its unrivalled financial skills to creating social useful financial instruments to tackle one of the greatest public policy challenges facing the UK.

SUMMARY OF MEASURES

The measures which comprise the Financial Inclusion Manifesto are described in more detail in the next section of the report. However, these are summarised below with page numbers for ease of reference. The measures are split into two groups according to the purpose of the measures:

- priority consumer protection measures; and
- regulatory and structural reforms.

Some of the measures we are proposing are radical. However, the Centre argues that, given the scale of the financial exclusion crisis, we must fundamentally change the way we think about financial inclusion. In our view, financial inclusion is not just about 'opportunities' or 'access' *per se,* or the number of products consumers hold. We must adopt an outcomes-based or 'equity' approach to defining financial inclusion and be guided by a vision of fairness and social justice - closer to the way access to healthcare, education and utilities are thought about in the UK.

Adopting a financial inclusion vision based on fairness and social justice means policymakers and campaigners would recognise that it is not enough to provide vulnerable consumers with opportunities. We must ensure ***core financial needs*** are met[7], ensure consumers have equal rights of access, and refuse to accept the poor are second class citizens who should pay more or deserve second class products and services. And we must be objective about how best to meet those needs: sometimes the market is the best solution; for others not-for-profit organisations are best suited; in other cases, the state or regulatory interventions provide the only realistic option.

PRIORITY CONSUMER PROTECTION MEASURES (p19)

The proposals outlined below are intended to protect vulnerable consumers from the immediate and ongoing consumer detriment caused or exacerbated by the financial crisis. The types of consumer detriment include: restricted access to properly functioning basic bank accounts, and further bank branch closures; sustained high levels of arrears and repossessions (disguised to some degree by the emergence of sale and rent back schemes); potentially unfair pricing practices by lenders exploiting vulnerable consumers unable to switch to better deals; aggressive and unfair behaviour and practices by legal and illegal sub-prime lenders; distressed loans being sold onto unregulated companies; the behaviour of commercial debt management providers; and pressures on the NFP debt advice sector to cope with the increase in demand for objective money advice.

1. Statutory Financial Inclusion Disclosure measures (FIDs) and financial inclusion audits (p19): to promote corporate accountability and allow financial inclusion policies to be monitored properly, banks and other significant financial institutions should be required to disclose data on basic bank accounts and lending to disadvantaged consumers and communities.

2. Financial Inclusion Protected zones (p20): government should create 'protected zones' – areas most affected by the crisis and recession. These zones would attract special protection measures and 'blitzed' with targeted policy interventions.

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[7] See Vision for financial inclusion for definition of core financial needs

3. Transparency on mortgage arrears and repossessions (p21): a priority is for individual lenders to be required to disclose data on arrears, repossessions, numbers of borrowers participating in various support schemes, policies on treating borrowers in arrears, and details of penalty fees for borrowers in arrears.

4. Protecting vulnerable consumers in the mortgage market (p22): the FSA is committed to introducing tougher regulation on mortgages. This is welcome. But this should be supported by other measures including tough, transparent enforcement action against lenders who breach regulation, and production of clear, mortgage compliance statements to make it clear what FSA expects of lenders and to help consumers/ advisers know their rights. Sub-prime lenders are a priority.

5. A Be Fair! Checklist for lenders (p24): introducing tougher mortgage regulation will take time. Therefore, we have developed an interim Be Fair! Checklist for lenders – a set of measures to ensure borrowers are treated fairly. We urge fair minded lenders to adopt this.

6. A National Mortgage Rescue Scheme (p27): the existing mortgage rescue scheme (MRS) is welcome. However, take up of the scheme is low. We argue for improvements including an increase in the funding available to £400m to create a truly nationally coordinated, locally delivered scheme, plus reforms to the way the MRS is administered including greater transparency to ensure that all lenders are behaving responsibly.

7. Investigation into irresponsible lending (p28): to accompany ongoing reform of mortgage regulation, the FSA, OFT and Financial Ombudsman Service (FOS) should undertake a joint investigation into the extent and causes of irresponsible lending including remedies available to borrowers affected by reckless lending practices.

8. Investigation into unfair contracts, pricing, and practices in lending markets (p28): a thorough investigation is needed into unfair contract terms and practices (including pricing models) in the secured and unsecured lending markets. This should assess whether vulnerable 'sub-prime' consumers who have little real choice in the market are being trapped and exploited by contracts, and what remedies are available to protect consumers,

9. Sale and Rent Back (SRB) Schemes (p30): the growth of SRBs has disguised the true scale of repossessions in the official, published data. Tougher regulation is being introduced which is welcome. However, regulators need to establish what can be done to 'rescue' those consumers who may already be victims of SRB schemes. Moreover, additional structural funding mechanisms should be developed to allow social landlords to purchase properties on sale and rent back basis – for example, through local authority bonds, or social investment bonds.

10. Regulating commercial debt management plan providers (p31): commercial DMPs have been a real source of concern for many campaigners and the potential for future detriment is huge in the aftermath of the financial crisis. Current regulation of DMPs is ineffective. New regulation is urgently needed including capping charges, with tougher controls on the marketing and promotion of DMPs. All lenders should commit to 'hot-key' borrowers to debt advice charities, not to commercial DMP providers.

11. Regulating distressed debt sales (p33): similarly, vulnerable borrowers may be at risk from lenders selling distressed debt to unregulated firms whose behaviour is unconstrained by reputational risk. Distressed debt sellers and buyers should be regulated by FSA, and subject to robust conduct of business rules to ensure borrowers are treated fairly. Lenders wishing to sell distressed debt books should be required to obtain express consent from regulators.

12. Capping charges on expensive loans (p34): financially excluded consumers can face exorbitant charges on legal loans. There are arguments for and against capping charges. However, on balance we recommend that charges should be capped. Unfettered charges contributed to the current level of overindebtedness in the UK allowing legal sub-prime lenders to aggressively 'sell' unsustainable volumes of debt. Legal sub-prime lenders also appear to act as a channel for borrowers into the hands of illegal loan sharks, not act as a bulwark. Charges should be capped at 3% per month. To address the risk of displacement into the hands of illegal lenders, this should be phased in over 3 years and accompanied by a major programme of capacity building in the alternative lending sector (community based lenders, social fund and growth fund), and creating a Community Money Advice Service to work in vulnerable communities (see below).

13. Expanding and improving the Growth Fund and Social Fund (p36): these initiatives have had some success. However, given the expected reduction in access to affordable credit and limited capacity of NFP community lenders, we recommend the Growth and Social Fund (GSF) should be increased both by an additional £100m. However, the delivery should be enhanced. The GSF should be used in combination with our proposed Community Money Advice Service (CMAS), and focused on priority zones to proactively target households trapped in a cycle of unfair debt. To encourage a move towards sustainable savings, the GSF should be used as a feeder fund for community lenders, borrowers should be encouraged to participate in money management plans operated by the CMAS or money advice charities and/ or join a credit union.

14. A Loan Shark Rescue Fund (p37): £50m of the enhanced GSF should be ring fenced to create a loan shark rescue fund for the most vulnerable communities.

15. A Community Money Adviser Service (p37): we propose that a new Community Money Adviser Service (CMAS) be set up consisting of 300 Community Money Advisers based in the 100 protected zones. These new community advisers could be based in local authorities, social landlords, and community based charities and would in effect be the financial equivalent of community health visitors,acting as 'change agents' to: proactively promote financial inclusion and capability in the heart of communities; provide financial healthchecks; improve awareness of choices available to consumers; raise awareness of community lenders, and help consumers avoid legal and illegal sub-prime lenders. We estimate that this CMAS would cost just £13m per annum to run.

REGULATORY AND STRUCTURAL REFORMS (p40)

The financial crisis will fundamentally reshape financial markets – exacerbating financial exclusion trends that were already in train. Forcing banks and insurance companies to behave more prudently and responsibly is absolutely necessary but there are serious consequences which must be recognised.

The retail financial services industry[8] will understandably increasingly focus on more profitable, medium-higher income/ lower risk consumers. We expect to see a significant increase in the numbers of consumers who will find it harder to get access to fair, affordable, products and services that meet their core financial needs.

Furthermore, the financial crisis has led to a major consolidation in the banking and mortgage markets which increases the risk of anti-competitive practices.

At a more general level, there are real concerns that the financial crisis will undermine efforts to ensure consumers make sufficient financial provision for the future – whether building up enough savings for a rainy day, insuring against risks and shocks that life throws at them, or building up a decent pension.

Improving financial capability standards and access to objective advice will be a priority to ensure consumers are able to make the right decisions in very trying financial circumstances, and have the confidence to plan for the future.

Concerted positive action is needed to promote sustainable financial inclusion. So, this second set of measures set out below are intended to address longer term exclusion effects and promote a fair and inclusive financial system that is aligned with the needs and interests of all in society.

16. New statutory objectives for financial regulators (p41): we argue that existing statutory financial regulation objectives are not fit for purpose to deal with the post financial crisis challenges. Regulators should have four consumer protection objectives[9]: consumer protection; promoting fair, efficient, competitive markets; promoting financial capability; and promoting financial inclusion and provision.

17. A Financial Inclusion Agency (p41): a new Financial Inclusion Agency (FIA) should be established to promote financial inclusion and oversee relevant financial inclusion measures eg. monitor financial inclusion disclosure measures (FIDs). The FIA should be situated within established regulatory framework rather than create another regulator[10].

18. A UK Financial Inclusion Act (p43): we argue that the case for a UK version of the USA Community Reinvestment Act (CRA) is compelling. This UK Financial Inclusion Act (UK FIAct) should be built around and enshrine the financial inclusion measures described in this manifesto.

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[8] Banking, lending, insurance and savings sectors

[9] Separate to the important financial stability objectives

[10] This could be the FSA, the Equality and Human Rights Authority, or the Consumer Protection Agency as proposed by the Conservative Party.

19. A financial inclusion levy (p44): it is only fair that banks and other significant financial institutions (BOFIs) should be subject to an annual financial inclusion levy in return for the financial support provided by society. Further modelling is required but we propose that this levy should be set at just 0.5% of annualised BOFI profits. We estimate this would raise £250m which should be used to meet costs of measures to promote financial inclusion.

20. Access to banking – universal service obligation (USO) (p44): we view access to a fully functional bank account as a necessary precondition for citizens to participate in society. Therefore, banking should be classified as a universal service obligation (USO) enforced by a legal right of access and regulatory monitoring by an independent agency.

21. A new approach to regulating consumer lending (p45): access to fair, affordable credit is hugely valuable for consumers but managed improperly consumer debt is one of the biggest sources of detriment for vulnerable consumers. The current approach to regulating consumer lending is not robust enough and has been too permissive. Detrimental practices continue to emerge as non-mainstream lenders introduce market 'innovations'. The default approach to consumer credit regulation followed by regulators fostered aggressive/ reckless lending and seems to allow practices to continue until and unless overwhelming evidence of major detriment can be found. Any regulatory response that follows closed the stable door after the horse has bolted. Furthermore, we think this permissive approach has discouraged responsible behaviour by consumers undermining capacity to save/ insure for the future. A new approach is warranted. The FSA should become the single regulator for consumer credit; consumer credit providers should be subject to authorisation and conduct of business regulations relating to marketing and selling of consumer credit. A new risk-based approach to consumer credit is needed with new products and services subject to a pre-approval process (or disapproval process) before being launched on market.

22. Best practice compliance checklists (p47): FSA, OFT, FOS, industry trade bodies and consumer groups should work together to develop best practice compliance statements covering marketing and selling, relationships with consumers, and treating customers fairly. These compliance statements would make it clear the behaviours and practices considered acceptable in retail financial services. These would help consumers and their representatives understand their rights. We believe the market would work better and firms have more confidence if they were able to identify practices which are likely to breach regulations and legislation. Firms should display on their websites: policies and practices; compliance with best practice compliance statements; and remedial actions where breaches have been identified.

23. Financial capability funding (p48): sustained financial capability interventions are needed to promote self-determination and self-sufficiency amongst consumers. Moreover, financial capability is a pre-emptive intervention ie. if effective, it reduces the risk of consumer detriment occurring in the first place thereby requiring less intrusive regulation. We urge Government to make a further £20m available to financial capability over the next two years.

24. Promoting savings and asset building (p48): it is critical to rebalance regulation to discourage unsustainable lending and promote savings and asset building. The proposals outlined above should lead to more responsible lending, and we argue that regulators should be given a statutory objective to promote financial inclusion and provision. In addition to this, we recommend that Government convene a working party consisting of Government departments, consumer groups, and regulators (with industry trade bodies as advisers) to examine whether genuine regulatory barriers to saving can be safely removed. Furthermore, we encourage Government to investigate the creation of a lifetime savings account with incentives or matched funding for lower income households. This could be funded by limiting tax relief on pension contributions to basic rate tax for everyone. However, further evaluation needs to be undertaken to understand the impact on existing pension savings.

25. A Financial Inclusion Innovation Fund (p49): we recommend the establishment of a £20m financial inclusion innovation fund to research and develop alternative solutions for excluded consumers. Priorities for R&D could include: benchmark core insurance and protection products; benchmark home equity scheme developed with local authorities, social landlords, and charities to allow homeowners to release small amounts of equity to pay for long term care and other needs; new forms of securitisation schemes based on rental incomes to allow social housing providers to expand affordable housing provision; or new versions of local authority bonds to increase infrastructure funds for local government.

26. Social Investment Bonds (SIBs) (p50): public sector funding for community organisations is likely to come under pressure due to the need to reduce the public sector deficit. Alternative sources of capital for social investment projects and community based lenders will be critical. We urge the government and the City to develop Social Investment Bonds (SIBs) as a new asset class to channel sustainable investment and loan capital from long term investors such as pension funds, local authorities, corporate and philanthropic investors. If just 1/100th of one per cent of assets managed in the UK was invested in SIBs this would provide around £50m of capital for social investment purposes.

27. The Social Investment Bank (p50): we fully support the establishment of the Social Investment Bank to provide wholesale capital for social businesses.

28. Promoting competition in the banking sector (p50): real fears have emerged that the consolidation in the banking sector that has taken place since the crisis has undermined effective competition in the market[11]. Measures are needed to protect against anti-competitive practices. Nothing should be ruled out including capping margins and market share. However, the plurality and diversity that was lost as a result of the demutualisation of building societies in 1990s needs to be reintroduced into the market. Therefore, we urge the Government to actively pursue the remutualisation of Northern Rock.

29. The role of UKFI (p51): the overarching objective of UKFI is to protect and create value for taxpayers, with regard to financial stability and competition. But the taxpayer is not the only stakeholder with an interest in how the banks within UKFI's remit are run. We argue that UKFI

[11] For example, the top four lenders took 64% of gross mortgage lending in 2008, while net interest margins have risen to highest in over a decade. See, Are banks and building societies playing fair? The Financial Inclusion Centre, 2009, www.inclusioncentre.org.uk

should be given new public objectives with regards to lending to industry, consumers, treatment of borrowers, and financial inclusion. The governance of UKFI needs to be reformed. There are no representatives on the board of UKFI with a public/ consumer interest background. All but one of the UKFI board members has a banking or investment industry background (the exception is one senior civil servant from HMT). The Government should appoint two board members with a recognised public interest background. Moreover, UKFI needs to be more transparent and accountable. The individual banks within UKFI's remit should be required to publish information on lending to communities and SMEs and treatment of borrowers in financial difficulty.

30. Forging a new banking landscape (p52): a sounder, more prudently managed financial system should emerge if the prudential regulatory reforms underway are carried through. But it would be a shame if post-crisis the banks were allowed to behave the in the same way they did pre-crisis despite having been bailed out by £billions of taxpayers' funds and leaving society with a massive debt legacy. The crisis provides a once-in-a-generation opportunity to reform the financial system so it is better aligned to meet the needs of all in society and is: better governed and more accountable to society; pluralistic and diverse; truly competitive and efficient; fair and inclusive; and produces socially useful products and services. Our proposals for new statutory objectives for financial regulators would contribute to the creation of such a system. However, we argue that a new banking landscape is needed. We support the separation of major banks into consumer/ utility banks and investment banks operating under differentiated regulatory systems. In terms of diversity, we propose the creation of a National Mortgage Bank (NMB), remutualisation of Northern Rock, and establishment of a People's Bank built around the Post Office infrastructure.

CONSUMER IMPACT SUMMARY

The Financial Inclusion Manifesto contains the summary of the key measures we are advocating to tackle the consumer detriment identified during the project. However, it is important to refer to the Consumer Impact Assessment to understand the context as it contains the summary of the research and analysis we carried out to assess the impact of the financial crisis and recent recession on vulnerable consumers and to identify priority areas for action. The Consumer Impact Assessment can be found on our website at www.inclusioncentre.org.uk.

The impact assessment was based primarily on published research. However, given the nature of the subject, and the fact that we are trying to identify potential risks, hard evidence is not always readily available. Therefore, to complement our assessment of published research, we sought the views of a number of consumer groups, think-tanks, and front-line organisations who engage with vulnerable consumers to get their views on where they saw the greatest risks to consumers.

The key areas of concern that emerged during the research are:

- General banking: the financial crisis is likely to lead to higher bank charges, restricted access to properly functioning basic bank accounts, and further bank branch closures.
- Housing market/ mortgages: sustained high levels of arrears and repossessions (disguised to some degree by the emergence of sale and rent back schemes); negative equity; aggressive behaviour and practices by sub-prime lenders; lower income/ 'higher-risk' consumers facing restricted access to affordable mortgage credit; and anti-competitive practices in the mortgage market.
- Overindebtedness and unsecured credit: a generational problem of overindebtedness and 'deleveraging'; distressed loans being sold onto unregulated companies; restricted access to fair and affordable credit with growing numbers of consumers being pushed into the sub-prime sector/ loan shark/ illegal lending market adding to existing serious consumer detriment in the sector.
- Debt advice and financial scams: vulnerable consumers exposed to scams and misselling by unscrupulous and aggressive financial providers, the growth of commercial debt management companies, and the impact on third sector money/ debt advice sector who will have to cope with the increase in demand for objective money advice.
- Longer term exclusion effects: as well as consumers being exposed to short term risks, the financial crisis will result in structural changes in the financial services sector. We expect to see a significant increase in the numbers of consumers who will find it harder to get access to fair, affordable, products and services that meet their core financial needs.

Impact of the financial crisis on different groups of consumers

Consumers are not homogenous and the impact of the financial crisis and recent recession on different groups of consumers will be determined by a complex set of factors such as region, ethnicity, gender, income profile, assets, job security and so on.

However, at the risk of gross simplification, we believe it is possible to identify four broad groups who are or will be affected to varying degrees by the crisis:

- The 'well-off'/ asset rich/ high income group;
- The 'mass affluent' who are comfortably-off, with secure employment status, and medium income and assets;
- The 'working poor' with insecure, unpredictable employment, little or no savings/ insurance and/ or high levels of overindebtedness;
- The chronically financially excluded group who are heavily dependent on benefits, and have been traditionally exposed to sub-prime or illegal lenders.

The 'well-off' may be seeing a reduction in net wealth, but this group is not our concern. Moreover, although many consumers in 'the mass affluent' group may have suffered a reduction in wealth on paper[12] they are doing comparatively well out of the crisis. The reduction in mortgage interest rates - driven by the reduction in benchmark interest rates – will have undoubtedly resulted in reduced mortgage payments and increased disposable incomes for many households in this group.

We are particularly concerned about the 'working poor' and chronically excluded groups of consumers. The 'working-poor' group are more likely to face insecure employment as a result of the recession, are vulnerable due to existing high levels of overindebtedness, and may face increased risk of financial exclusion as a result of financial institutions retrenching to focus on lower risk/ medium-higher income consumers.

Chronically financially excluded consumers will continue to face major detriment and will be exposed to the growth in financial scams and aggressive expansion by sub-prime lenders such as payday loan companies, and affected by limited resources available to debt advice charities and the third sector as a result of increased demand and funding cuts.

The measures in the Manifesto are designed to protect primarily the working poor and chronically financially excluded groups. However, some of the measures, particularly on regulatory reform, would make the market work better for all consumers.

[12] Recent estimates by the Halifax for the BBC estimate that the average household saw a reduction in net wealth of £31,000 in 2008 as a result of falling property and pension fund values - see http://news.bbc.co.uk/1/hi/business/8241480.stm

A NEW VISION FOR FINANCIAL INCLUSION

Some of the measures we are proposing are radical. However, the Centre argues that, given the scale of the financial exclusion crisis, and if we want to protect the interests of the most vulnerable in society, we must fundamentally change the way we think about financial inclusion.

In our view, financial inclusion is not just about 'opportunities' or 'access' *per se,* or the number of products consumers hold. We must adopt an outcomes-based or 'equity' approach to defining financial inclusion and be guided by a vision of fairness and social justice - closer to the way access to healthcare, education and utilities are thought about in the UK.

Financial products and services are a means to an end – ie. they exist to meet consumers' ***core financial needs*** which in turn contribute to meeting social needs and promoting social inclusion. For the purposes of financial inclusion, we define consumers' core financial needs to include:

- a functioning, transactional bank account;
- access to fair and affordable credit to smooth peaks and troughs of income;
- sufficient insurance to protect against risks and shocks;
- sufficient provision for a decent income in retirement;
- income and assets to maintain a reasonable standard of living, and participate in society;
- access to fair, affordable mortgages (or access to social housing);
- financial provision for social/ long term care;
- access to objective financial advice and information to make appropriate choices and decisions.

Certain needs will always be a priority throughout a consumer's lifetime (eg. access to transactional banking). Other core needs will take on a higher priority at different stages of a consumer's lifetime depending on how household financial circumstances or social needs change. Making sure these core financial needs are met should be the basis of policy action in the financial inclusion field as this would be likely to make the greatest difference to the lives of financially excluded consumers.

Taking this into account, our vision and definition of financial inclusion is:

Consumers are fully financially included if their ***core financial needs*** are met by fair and affordable, accessible, value-for-money, secure and appropriate products/ services.

This requires three conditions to be met. Consumers should have;

- equivalent rights of access to appropriate products, and access to redress if things go wrong;
- access to the necessary information, support and advice to make appropriate choices and decisions; and

- the necessary financial capability to use these products and services effectively.

Adopting a financial inclusion vision based on fairness and social justice means policymakers and campaigners would:

- recognise that consumers are financially excluded if they are penalised for being economically or socially disadvantaged[13];

- understand that it is not enough to provide consumers with access to markets or opportunities to participate in markets - we must ensure that the ***core financial needs*** of vulnerable consumers are met and they have the same rights to fair treatment and suitable products as more fortunate consumers;

- support vulnerable consumers so that they are treated fairly and, where necessary, intervene through regulation or legislation ensure fairness and social justice;

- refuse to accept that it is somehow 'natural' that the 'poor pay more' to meet have their core financial needs met – it does not have to be this way although it will remain so if the market paradigm prevails.

We are neutral as to how best to meet excluded consumers' core financial needs. In certain cases, the market will provide the best mechanism, in others third sector organisations such as community based lenders will offer the best option while, for certain groups, regulatory interventions are needed or the state may be the only realistic provider. What matters is that an objective assessment is made of how best to meet the needs of excluded consumers.

Markets are amoral and allocate value according to economic power and influence. It is not patronising or paternalistic to accept that vulnerable or disadvantaged consumers fare badly in market based systems, nor is it a criticism of markets to recognise that market providers respond better to more autonomous consumers who exercise market influence.

The approach to financial inclusion that prevails in UK financial services seems to focus on removing the 'barriers' to opportunity and access (in the assumption that the market will then provide for excluded consumers) or encouraging financial institutions to provide services for vulnerable consumers (for example, on basic bank accounts). UK policymakers do not operate a policy of consciously and deliberately trying to *ensure* fairness and social justice. We think this seriously understates the scale of financial exclusion, the consequent impact on vulnerable consumers, and has undermined efforts to promote sustainable financial inclusion by allowing the financial services industry to justify self-regulation as the proportionate response to the ongoing financial exclusion crisis in the UK.

[13] The most obvious cause of financial exclusion is poverty/ low incomes. However, we feel others are better placed to argue for measures such as increases in benefits/ minimum wages and so on.

It is important to note that, with the exception of access to banking services[14], this does not mean that we believe that all commercial financial services providers should be subject to a universal service obligation or automatically expected to cross-subsidise low income consumers.

However, it does mean that policymakers and campaigners should strive to develop alternative products and services to rival or even surpass the products available to consumers who are commercially viable for the mainstream, retail financial services market. Financially excluded consumers (or poorer households for that matter) should not be condemned to second class products and services.

[14] Banking services are an exception. We argue that banking should be a universal service obligation and consumers should have a legal right of access to a functioning transactional bank account. But it would not be feasible to build an alternative transactional banking system from scratch. The only practical way to provide access to transactional banking services is to utilise the existing banking infrastructure (although part of the need for transactional banking could be met through the Post Office network or shared banking outlets).

THE FINANCIAL INCLUSION MANIFESTO

PRIORITY CONSUMER PROTECTION MEASURES

The proposals outlined below are intended to protect vulnerable consumers from the immediate and ongoing consumer detriment caused or exacerbated by the financial crisis. The types of consumer detriment include: restricted access to properly functioning basic bank accounts, and further bank branch closures; sustained high levels of arrears and repossessions (disguised to some degree by the emergence of sale and rent back schemes); potentially unfair pricing practices by lenders exploiting vulnerable consumers unable to switch to better deals; aggressive and unfair behaviour and practices by legal and illegal sub-prime lenders; distressed loans being sold onto unregulated companies; the behaviour of commercial debt management providers; and pressures on the NFP debt advice sector to cope with the increase in demand for objective money advice.

1: Financial Inclusion Disclosure measures (FIDs) and statutory financial inclusion audits

Banks and other significant financial institutions should be subject to statutory financial inclusion audits and financial inclusion disclosure measures (FIDs). These FIDs should be monitored by an independent agency (self-regulation is not appropriate). The purpose of these disclosure measures is to: promote corporate accountability; allow proper monitoring of how the financial crisis is affecting vulnerable consumers and communities; and evaluate the effectiveness of policies to promote financial and socio-economic inclusion.

Scope and coverage

The financial inclusion disclosure (FIDs) measures should cover the following products and services[15]:

- Banking – current accounts and basic bank accounts;
- Lending – mortgages and unsecured credit (data on access, price and treating customers fairly on repossessions and arrears);
- Lending to small medium size enterprises (SMEs);
- Community development lending and investment.

Where appropriate, the relevant data should be collected and published at 3 levels:

- Bank branch/ office level;
- Inclusion Assessment Area – this should be based on Super Output Areas or alternatively, postcode, ward or borough level. The priority are the 'protected zones' – that is, the areas most affected by financial and social exclusion[16];
- UK corporate level ie. data should be aggregated from branch and assessment area level to allow for an overall assessment of the financial institutions financial inclusion performance.

[15] Ideally, insurance products should be included to assess the effects of insurance exclusion on vulnerable communities
[16] The Financial Inclusion Centre is currently drawing up a list of protected zones

These FIDs should apply to all FSA and OFT regulated firms. However, as a priority, the top ten lenders by market share could be covered in the first wave of audits. Disclosure of information on treatment of borrowers in arrears and facing repossession are a priority.

Publication of information

Improved disclosure will be critical.

- individual banks and significant financial institutions should be subject to independent statutory financial inclusion audits based on the FIDs. These audits would perform a similar role to the powerful Community Reinvestment Act (CRA) in the USA and Home Mortgage Disclosure Act (HMDA)[17]
- a new Financial Inclusion Agency (FIA) should produce an annual financial inclusion report measuring progress against a statutory financial inclusion duty (see above).

Details of the FIDs can be found in Annex I.

2: Financial Inclusion Protected Zones

As the financial crisis and recession emerged, there was speculation that this time around it would be different and we would see a 'middle-class' recession with areas of the country reliant on banking and financial services particularly hit. There has been some evidence of that. However, it is now clear that the effects of the recent recession and ongoing financial crisis have been felt most in those areas of the country that are usually hit hardest by economic downturns. These areas are also most vulnerable to effects of financial exclusion.

Therefore, we recommend that the Government draw up a list of areas most affected by the financial crisis and financial and social exclusion that would benefit from special protection measures and sustained interventions. We called these priority 'protected zones'.

The Centre is currently working on the best way to define a protected zone and the specific factors and metrics to be used to identify zones. These priority zones would be identified using:

- multiple-deprivation factors including: income levels, unemployment levels, housing patterns, health indicators; and
- financial exclusion indicators such as access to bank branches, take-up of products, affordable credit gaps (as measured by the need for affordable credit compared to capacity of community based lenders and scale of extortionate/ illegal lending in the area).

Protected zones would attract special measures to combat financial exclusion including:

[17] The approach to disclosing information in the USA under the CRA provides a striking contrast to that followed by UK authorities where self-regulation has been favoured. Individual US banks are assessed by the US banking regulators to establish the impact of their behaviour on deprived communities and their treatment of vulnerable households. Banks have to disclose how many loans they have made to households on lower incomes, minority ethnic groups and so on. Banks are rated according to their performance. These ratings are published on regulators' websites. It is even possible to search the regulators' website to find out how well banks perform at individual branch level and group level. These reports are taken into account by regulators when approving mergers and acquisitions and applications to open new bank branches.

- banks should be required to conform to 'last branch in town' provisions. This means banks would not be able to close a branch if it is the last branch in a protected zone unless alternative access to banking services can be guaranteed;

- well-resourced, sustainable initiatives to address the growth in the sub-prime market in vulnerable communities and the need for unbiased debt and money advice;

- a network of community money advisors should be established to deliver financial capability programmes in disadvantaged communities and tackle loan shark activities;

- Government should proactively develop alternative, community banking services. Alternative access in this case could include shared-branch banking model[18], community banks, or viable credit unions. Access to banking services could be delivered through own branch network or in partnership with other institutions. The existing infrastructure provided by the Post Office network provides an obvious foundation on which to build a national community bank network;

- innovative, special infrastructure funding measures – for example, social investment bonds, and social housing/ local authority bonds to attract additional funding for housing associations and local authorities.

A summary of some of these specific special measures can be found throughout the Manifesto.

3: Transparency on mortgage arrears and repossessions

We are concerned there is a lack of transparency with regards to the behaviour of individual financial institutions during the financial crisis. On the face of it, the behaviour of the major lenders would appear to be helping ease the situation for households facing repossession. However, we believe there is no room for complacency and that the behaviour of lenders may not be all that it seems.

To begin with, we think the growth in sale and rent back schemes (see below) has disguised to a large extent the true extent of the number of households facing repossession (according to the OFT an estimated 50,000 SRB transactions have taken place).

Moreover, based on anecdotal reports from experts in the field, there would seem to significant differences in the way specific lenders are treating customers in financial difficulty. Certain lenders are behaving more aggressively than others – sub-prime lenders would appear to be a particular problem. Furthermore, we are concerned that the very low take-up of the Mortgage Rescue Scheme (MRS) suggests that lenders are not doing enough to help borrowers take advantage of options that would clearly be of benefit to them.

Robust regulation and disclosure measures may take some time to implement. Therefore, to protect borrowers and promote corporate accountability, a priority for the Government, FSA, and UKFI

[18] As proposed by the Campaign for Community Banking Services see http://www.communitybanking.org.uk/objectives.htm

should be to require individual financial institutions to report on a quarterly basis important information such as:

- numbers of mortgage arrears, repossessions and enforcements against borrowers;
- number of borrowers who are participating in the various Government schemes – including the Mortgage Rescue Scheme, Homeowners Mortgage Support Scheme, and who are benefiting from lender forbearance programmes;

Lenders should also be required to publish in a prominent position on their websites:

- their policies on treating borrowers in arrears; and
- details of penalty fees charged on mortgages in arrears.

It is important that this applies to non-mainstream lenders not just lenders that have voluntarily agreed to join the Lending Panel set up by the Government. The Government and regulatory authorities should produce public reports on a quarterly basis.

4: Protecting vulnerable borrowers in the mortgage market

Concerns have been raised about consumer detriment in the mortgage market generally – for example, reckless lending and the subsequent treatment of borrowers in arrears and facing repossession. However, as we highlight in the Consumer Impact Assessment, and in previous reports[19] the sub-prime[20] mortgage and unsecured lending markets are a particular cause for concern.

In the mortgage sector, sub-prime lenders have been found to: be less willing to negotiate with borrowers in difficulty; more likely to enforce repossessions; be more likely to breach regulations; while sub-prime mortgage contracts often have high and potentially unfair charges (similar evidence has emerged of potentially unfair practices in the sub-prime unsecured lending and debt advice sectors).

Sub-prime mortgage loans are by their nature more expensive than standard loans, given the higher risks faced by lenders. However, the rates still being charged by some sub-prime lenders are striking. For example, standard variable rates (SVRs) of 8.6% and even 12.5% on sub-prime mortgages have been reported – this compares to the market average SVR of 4.79%[21]. Moreover, previous research by The Centre found that arrears fees of £40-£50 per month were typical which can compound the overindebtedness faced by borrowers[22].

Without access to commercially sensitive information it is difficult to say whether such high rates are justified. However, there is legitimate cause for concern that sub-prime lenders may be exploiting the vulnerability of sub-prime borrowers by imposing high charges and unfair terms and conditions.

[19] See Perfect Storm, The Financial Inclusion Centre and National Consumer Council, www.inclusioncentre.org.uk
[20] We use a broad definition of sub-prime to include non-mainstream mortgages (adverse credit/ impaired credit/ self-certified mortgages) and non-mainstream credit (adverse credit loans/ door step lending/ loan sharks).
[21] See http://www.mortgagestrategy.co.uk/1005928.article?cmpid=MSE01&cmptype=newsletter
[22] See Perfect Storm, The Financial Inclusion Centre and National Consumer Council, www.inclusioncentre.org.uk

To begin with, sub-prime lenders do not face the same reputational constraints on behaviour as mainstream lenders. Therefore, they are less likely to respond to media or Government pressures to modify behaviour and treat borrowers sympathetically.

Moreover, by definition, sub-prime borrowers have very few options. If they are unhappy with the cost of their mortgage they will find it difficult to take their custom elsewhere (unlike higher income/ lower risk borrowers) due to restricted availability of sub-prime mortgages – this has been exacerbated by the ongoing financial crisis. Therefore, they are in a weak bargaining position, vulnerable to exploitation.

There is an existing body of regulation in place which is meant to protect consumers from detrimental practices in the mortgage market, and the FSA has already issued statements to lenders regarding fair treatment of borrowers. However, as a result of findings which emerged during its mortgage market review[23], the regulator has produced further specific proposals aimed at protecting borrowers in arrears. The key proposals include:

- making it clear to firms that they must not add early repayment charges on arrears charges and interest levied on those charges;
- clarifying that firms must not apply a monthly arrears charge where the firm and the customer have agreed an arrangement to repay the arrears;
- compelling firms to consider all options for borrowers, with repossession always being the last resort;
- confirming that payments by customers in financial difficulties must first be allocated to clearing the missed monthly payments, rather than to arrears charges, which can be repaid later.

We strongly support these proposals. However, we argue that they should be supported by other robust measures. The ongoing financial crisis provides an opportunity for the FSA to prioritise the protection of vulnerable consumers and demonstrate tougher, faster public enforcement action against sub-prime lenders who have breached regulations.

To protect consumers, as well as the proposals outlined above, the FSA should:

- take tough and transparent enforcement action against lenders who have breached existing treating customers fairly regulations;
- issue clear, robust regulatory statements to remind lenders not to exploit current market conditions by imposing unreasonable interest charges and/ or redemption fees on sub-prime borrowers unable to switch to better value providers;
- publish a list of mortgage providers it considers are not complying with the requirement to treat customers fairly, and require lenders to publish remedial action being taken to comply with regulations;
- require lenders to publish on their websites policies on treating borrowers fairly (see below, Be Fair! Checklist);

[23] http://www.fsa.gov.uk/pages/Library/Policy/DP/2009/09_03.shtml

- require lenders who have breached the rules to contact borrowers to alert them to the potential for redress;
- undertake a joint investigation with OFT and Financial Ombudsman Service (FOS) into the extent of irresponsible and unfair lending in the UK lending markets (see below);
- undertake an immediate joint investigation into unfair contracts in the mortgage markets with a focus on sub-prime mortgages (see below) including product pricing structures;
- produce a clear mortgage compliance statement for lenders and borrowers. This statement should make it clear what lenders need to do to comply with regulations regarding treating borrowers fairly. However, it could be sometime before the necessary regulatory process is followed through. This would leave borrowers vulnerable. Therefore, we urge all lenders and trade associations to adopt this Be Fair! Checklist on a voluntary basis until regulation is introduced (see below). However, the Be Fair! Checklist should form the basis of regulatory mortgage compliance statement.

5: A Be Fair! checklist for lenders

The seriousness of the financial crisis means that robust regulatory interventions and enforcement are needed to protect the most vulnerable consumers. Self-regulation is not effective as a long term solution. However, it may take some time to introduce enhancements to regulations and legislation. Therefore, we urge all lenders to adopt a series of voluntary standards to protect consumers. This is an interim solution and this checklist should form the basis of a regulatory mortgage compliance statement issued by the FSA.

<u>Dedicated teams and strategies</u>

All lenders should set up internal intervention teams dedicated to helping consumers in financial difficulty and avoiding escalation of problems. These teams should develop strategies and to intervene at each of the key stages outlined below to prevent escalation of debt problems.

<u>Targeted interventions</u>

Lenders should develop appropriate interventions to target vulnerable borrowers at each of the following key stages including:

- <u>predelinquency stage</u>: at this stage, dedicated information and awareness programmes are needed to raise borrowers' awareness of overindebtedness and help them manage budgets. The purpose is to prevent consumers getting into financial difficulty in the first place;
- <u>early stage arrears</u>: at this stage, the objective should be to help borrowers who have missed one or two payments to prevent the problem escalating. Consumers at this stage will not have accumulated large outstanding balances and therefore will have more options open to them;
- <u>serious arrears:</u> at this stage, consumers will find it more difficult to catch-up with arrears without some specialist help or advice from independent sources;
- <u>repossession stage</u>: at this stage, the lender will be actively considering repossessing the property. Lenders should treat borrowers sympathetically and avoid pressurising borrowers.

Objective financial advice

In all cases, lenders should commit to referring borrowers to not-for-profit debt advice agencies so they can receive objective advice regarding the options open to them. Preferably this should be done by lenders 'hot-keying' borrowers through to debt advice charities.

Lenders should not charge borrowers in difficulty for debt counselling nor act as introducers to commercial debt advice providers.

Many of the major lenders already agree to tell borrowers about debt advice charities. However, other trade bodies especially those who represent the sub-prime sector need to ensure that their members also subscribe to similar standards.

Interest rate relief and reduced payment options

Lenders should develop rate relief and reduced payment options in conjunction with third sector agencies to protect borrowers in financial difficulties and help avoid repossessions.

Interest rate reductions or reduced monthly payments should be available to consumers who face a temporary reduction in their disposable income because of unforeseen circumstances. The reduction in mortgage payments should be calculated so that it reduces monthly mortgage payments to a level which ensures that consumers have Fair Disposable Income (FDI). This formula for the FDI should be tailored for the local area and should be agreed with advice charities.

Lenders should apply a 'fair' interest rate to any unpaid interest that accrues over the term of the mortgage or catch up period – ie. the interest rate applied should not include any direct or indirect penalties (see suspension of penalty fees).

Borrowers should be offered the option of deferring the unpaid interest to the end of the loan, as long as the financial consequences of doing so are fully explained to them.

Borrowers should also be offered the option of rescheduling or extending the loan period to reduce monthly payments. Again the consequences of doing so must be explained to the borrower as the unpaid interest may be compounding for a longer period.

Special attention needs to be paid to developing longer term plans for borrowers who face permanent reductions in income because of the death or disability of the main household breadwinner.

Suspension of penalty fees

Previous research by The Financial Inclusion Centre found that in the sub-prime market, penalty fees of £40-50 per month for borrowers in arrears are common[24]. All lenders should suspend penalty fees

[24] See Perfect Storm, The Financial Inclusion Centre, May 2008, http://inclusioncentre.org.uk/doc/perfectstormsummaryreport.pdf

for borrowers who participate in catch-up programmes and/ or temporary interest rate reduction programmes.

<u>Arrears, repossessions, and collections</u>

All lenders should use repossessions as a genuine last resort. The major mortgage lenders on the Government's Lending Panel have agreed to a moratorium on repossessions - committing not to repossess for at least three months after an owner-occupier falls into arrears. Some mortgage lenders have gone further and committed not to repossess for at least six months after a borrower is in arrears on the mortgage.

However, anecdotal evidence suggests there are considerable differences in behaviour between lenders. But, it is not possible to tell which lenders are behaving responsibly due to the unacceptable lack of transparency and disclosure on mortgage arrears and repossessions.

Moreover, many of the major sub-prime lenders are not part of this voluntary initiative. Therefore, we urge trade bodies to ensure that all lenders should wait until six months arrears have been built up before instigating repossession.

Lenders should follow the process outlined above to ensure that borrowers have been given a fair chance to address their financial problems. Borrowers should only be referred to internal collections teams if they have been unwilling to cooperate with the lender and/ or a debt advice charity.

Lenders should also not attempt to persuade borrowers in arrears to make monthly mortgage payments using alternative credit facilities (such as credit cards). This should apply to credit generally, not just mortgages.

All lenders should agree to use private sector collection agents only as a last resort. Moreover, before collection agencies are allowed to contact and chase borrowers for debt, they must be required to direct borrowers to not-for-profit debt counselling charities, and offer borrowers the opportunity to allow charities to act as advocates on their behalf.

However, as a priority, meaningful transparency and disclosure measures must be implemented to introduce some accountability to the financial sector (see above).

<u>Credit ratings</u>

To avoid penalising borrowers who may have got into difficulties but have made genuine attempts to manage debt, lenders should also agree that consumers participating in arrears management programmes will not have their credit rating affected.

At a more general level, we urge the Government and credit ratings agencies to develop alternative credit scoring systems that encompass positive behaviours. Moreover, for consumers who do not have a track record of credit, alternative scoring techniques should be developed based on rent and utility bill payments.

6: A national mortgage rescue scheme (MRS)

The existing mortgage rescue scheme (MRS)[25] is welcome. However, we think it is too fragmented and insufficiently funded to cope with the cumulative number of repossessions expected over the next few years. Moreover, the surprisingly low number of borrowers[26] who have been helped to date suggests that major reform of the way the scheme is run is needed. Therefore, we make two recommendations aimed at establishing a national MRS.

Firstly, we recommend that the amount of money made available for the mortgage rescue scheme should be increased to £400m.

Secondly, we make a number of recommendations on how to improve the operation of the scheme if it is to reach those most in need.

A new national scheme should be built around a partnership approach. Scheme oversight and funding should be coordinated centrally while the scheme itself would be delivered by third sector organisations such as housing associations.

Importantly, the approach adopted by the Government needs to change. Currently, the Government seems to be adopting a fairly passive approach which relies primarily on borrowers approaching local authorities to see if they qualify for the scheme. The Government should adopt a more proactive approach and work with local authorities, advice agencies and lenders to identify borrowers in difficulty.

Moreover, there is no verifiable, published analysis to allow consumer organisations to assess whether lenders are complying properly with the scheme provisions.

Therefore, to improve the effectiveness of the national MRS, the following measures should be adopted:

- funding should be targeted on priority areas (see protected zones) and vulnerable sub-prime borrowers.

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[25] The Mortgage Rescue Scheme (MRS) is a £285m package of measures designed to prevent some of the most vulnerable families losing their homes and experiencing the trauma of repossession. MRS operates by bringing together local authorities, Registered Social Landlords (RSL), lenders and debt advice agencies. There are two elements to the scheme. **Shared equity** - designed to help householders who have experienced payment shocks and need some help in paying their mortgage. RSL provides an equity loan enabling the householders' mortgage repayments to be reduced.; **Government Mortgage to Rent -** designed to help the most vulnerable households on low incomes with little chance of sustaining a mortgage – a RSL purchases the property and the applicant pays rent to the RSL at a level they can afford

[26] The scheme was intended to have the capacity to hlp 6,0000 borrowers over a two year period. As at end 2009, a cumulative 276 borrowers had accepted an offer from the scheme.. However, there were a further 1,294 'live' applications where action was taken to stop immediate repossession.

- a new MRS panel consisting of representatives from consumer organisations, debt advice and housing charities, local authorities, and government should be established to coordinate the MRS, and monitor lender behaviour. Lenders should have advisory status on the panel;
- all mortgage lenders should be required to publish data on arrears and repossessions on a quarterly basis (see above);
- all mortgage lenders should be required to submit to the MRS panel lists of borrowers who are facing repossession along with details of financial circumstances, and action taken by lenders. If data protection is a problem, information should be anonymised;
- repossession lists should be analysed to ensure that lenders are following protocols for advising borrowers of the availability of the MRS;
- borrowers facing repossession should be contacted to inform them of the existence of the MRS.

7: Investigation into irresponsible lending

To accompany the FSA's mortgage market review[27], the FSA, OFT, and Financial Ombudsman Service (FOS) should conduct a joint investigation into the extent of irresponsible and unfair lending in the UK lending markets. This investigation should look at:

- the effectiveness of lenders risk management systems including data sharing operations;
- whether lenders' senior management exercised sufficient due diligence and duties of care when lending to consumers;
- the disclosure of risks and costs to consumers;
- the impact of commission payments and sales bonuses on lender/ intermediary behaviour;
- the level of consumer detriment caused by market failure;
- possibly remedies including enforcement and financial penalties; and
- redress available to consumers eg. nullifying unfair and unfavourable contract terms such as penalty fees.

8: Investigation into unfair contracts terms, pricing and commercial practices in the mortgage, unsecured credit, and commercial DMP sectors

As with the FSA and mortgages, the Office of Fair Trading has a significant body of legislation at its disposal to protect consumers in the unsecured lending markets (including the provision of debt advice).

This includes the ability to revoke credit licences if firms are not fit for business[28], measures to protect against unfair relationships[29],[30] and unfair contract terms[31].

[27] http://www.fsa.gov.uk/pages/Library/Policy/DP/2009/09_03.shtml
[28] http://www.oft.gov.uk/shared_oft/business_leaflets/credit_licences/oft969.pdf

The legislation can be quite complex to interpret. For example, even extremely high charges that might seem extortionate to ordinary consumers, are not necessarily unfair in the eyes of the law or even covered by the law (as the recent decision by the Supreme Court on unauthorised overdraft charges demonstrates) . However, charges may be considered unfair if they are not disclosed fairly and transparently.

Other examples might include:

- where the interest rate, or other fees or charges, are so much higher than those in the particular market sector, or payable by borrowers in similar situations, as to make the relationship as a whole unfair to the borrower;
- the borrower may be unaware that a fee would be charged in a particular case, or the level of the fee, or how this might impact on the debt;
- the lender may have failed to disclose relevant information, or may have done so in a false or misleading manner, misrepresenting key elements;
- the information may also have been unclear or ambiguous, and so may not have been readily comprehensible.

The net result is that consumers may have found themselves entering into a transaction without being in full knowledge of the facts. Moreover, consumers are also supposed to be protected from unfair practices and behaviours that materially distort, or is likely to materially distort, the economic behaviour of the 'average' consumer.

In our view, there is reason to believe that some of the behaviours by firms and terms in the contracts in the sub-prime mortgage, unsecured credit, and commercial debt management plans (DMPs) sectors exhibit the characteristics described above (details of these practices can be found in the accompanying Consumer Impact Assessment).

Further information on commercial DMPs can be found below but other examples include extremely high SVRs being levied on sub-prime mortgages (see above), and margins on credit card rates at record levels[32].

Without access to commercially sensitive information it is impossible to say with certainty whether these terms and practices are unfair. Therefore, we urge the FSA and OFT to conduct a joint comprehensive investigation into unfair contract terms and practices in these markets.The FSA should convene a working group with the Office of Fair Trading, FOS and consumer representatives to investigate more closely whether:

- the terms in sub-prime mortgages and unsecured loans markets are unfair and run contrary to the unfair contracts regulations;
- the product pricing structures used by lenders have the effect of exploiting borrowers locked into sub-prime mortgages;

[29] http://www.oft.gov.uk/shared_oft/business_leaflets/enterprise_act/oft854.pdf
30 The Consumer Protection from Unfair Trading Regulations 2008 (CPRs) implement the Unfair Commercial Practices Directive (UCPD)
[31] http://www.oft.gov.uk/shared_oft/reports/unfair_contract_terms/oft311.pdf
[32] See 'Are banks and building societies playing fair?' The Financial Inclusion Centre, www.inclusioncentre.org.uk under publications

- the net margins on unsecured credit products such as credit cards and overdrafts are justified;
- the terms in commercial DMPs contravene unfair contracts regulations and the selling and marketing of DMPs contravene unfair commercial practices regulations.

The working group should establish a plan of action for dealing with any breaches and ensuring consumers obtain due redress.

9: Sale and rent back (SRB) schemes

SRB schemes have emerged as a major source of concern for consumer representatives. Data on the size of the industry is very hard to find. However, the OFT suggests that there are upwards of 1,000 firms, together with an unknown number of non-professional landlords, who have conducted about 50,000 transactions to date[33]. This raises the interesting question of whether repossession levels seen in the official data have been understated due to the existence of these SRB schemes.

The OFT has already taken action against a number of SRB operators about the misleading marketing information[34]. Some of the claims and promises made to consumers included consumers being able to: stay in their properties after they are sold for as long as they wish at a fair rent; buy back their properties at an agreed point in the future; or take advantage of a low rent period and benefit from flexible rental terms.

HMT has decided that the FSA will regulate these schemes. However, the FSA has said that a detailed regulatory regime for SRB will take some time to achieve and implement, so it is adopting a two-stage approach:

- an interim regime: to provide basic protections for consumers has been introduced;
- full and detailed regulatory regime: a more comprehensive regime will then be introduced – the expectation is that this begins in the second quarter of 2010.

These actions are welcome. However, there are some fundamental questions to be asked about SRB schemes particularly those operated by commercial providers. As with commercial debt management plan (DMP) providers (see below), we fundamentally question the basic social utility of these commercial SRB providers. There would be no need for this type of provider if vulnerable consumers had access to a properly resourced, fair, transparent, alternative scheme operated by social landlords that worked on the same principle as the Government Mortgage to Rent element of the Mortgage Rescue Scheme (MRS).

Therefore, we recommend that the Government investigate how best to introduce additional structural funding to allow social landlords (such as housing associations and local authorities) to purchase properties on a sale and rent back basis. This would have the additional benefit of

[33] http://www.oft.gov.uk/news/press/2008/118-08
[34] http://www.oft.gov.uk/news/press/2009/08-09

increasing the pool of properties available for sustainable social housing. There are a number of possible mechanisms for leveraging additional funding:

- the existing Government Mortgage to Rent scheme could be expanded and converted into a standalone structural fund;
- local authority bonds; and
- social investment bonds (see below).

Furthermore, better future regulation of the market offers little comfort for the many extremely vulnerable consumers who will have already been victims of unscrupulous practices in the SRB market. The key challenge now will be to establish what action can be taken to protect victims from further detriment and remedies are available to undo the damage already done.

Therefore, we urge the OFT to undertake a further investigation to establish what actions can be taken to protect these consumers and initiate a campaign to contact those affected.

10: Regulating the commercial debt management sector

The growth in the commercial debt management plan (DMP) has been a source of real concern for consumer representatives. The OFT should urgently take action to protect consumers from the detrimental practices of these commercial providers – including the high level of charges.

Our research has found that a borrower with £15,000 debt using a commercial debt management company could end up paying nearly £3,000 in charges (see Consumer Impact Assessment). This simply adds to the debt burden and means that borrowers could end up taking an extra year to clear off their debts compared to using a not-for-profit advice agency and is particularly galling given that free debt advice from not-for-profit debt advice charities is widely available.

As we describe above, the OFT has a significant body of legislation at its disposal to protect consumers in the unsecured lending markets including the provision of debt advice. However, we are concerned that this legislation (or the way is being implemented) does not provide vulnerable consumers with sufficient protection against commercial DMP providers.

With regards to unsecured lending markets, consumers are supposed to be protected from entering into a transaction without being in full knowledge of the facts, and from unfair practices and behaviours that materially distort, or is likely to materially distort, the economic behaviour of the 'average' consumer.

It is difficult to see why an 'ordinary' consumer in full possession of information about the options available to him/ her would knowingly choose to use the services of a commercial DMP provider rather than contact a debt advice charity (there may be exceptions for owners of small businesses who have very complex affairs).

The OFT also operates the Consumer Codes Approved Scheme (CCAS)[35]. This scheme formally approves and promotes voluntary business-to-consumer codes of practice which set higher standards of customer service. One of the approved codes is run by the Debt Managers Standards Association (DEMSA). However, this association appears to have only four members from debt management sector[36].

The obvious answer is for the Government to simply prohibit commercial debt management provision (or at least impose much stricter pre-approval terms when licensing firms). It is difficult to see what socially useful purpose these organisations serve given the existence of not-for-profit debt advice agencies.

The argument that these commercial providers provide additional capacity and benefits for consumers is not sustainable in our view. If these commercial providers are able to find a market for their services it is surely because consumers are insufficiently aware of the availability of not-for-profit debt advice charities and/ or the debt charities do not have sufficient capacity to meet consumers needs.

Given the scale of the debt problems facing many households and the clear detriment represented by commercial DMP providers, it is incumbent on the authorities to make the necessary capacity available and to better promote awareness of NFP debt advice charities.

However, Government is unlikely to prohibit outright these providers. But the potential for consumer detriment is so great that new measures are needed urgently to protect consumers.

New regulations relating to best practice and acceptable behaviours in the commercial DMP market should be urgently introduced covering:

- 'best interests': OFT should issue clear and robust guidance on what represents borrowers best interests with regards to DMPs using clear illustrations to ensure that providers understand the OFT's requirements;
- critically, fees should be capped and must be clearly, transparently and fairly disclosed in a prominent position on promotional material regardless of which distribution channel is used by DMP providers. Illustrations should be used to explain the impact of fees on debt repayment schedules;
- the pitfalls of using DMPs should also be prominently, clearly and objectively communicated to potential clients;
- DMP providers and introducers must alert borrowers of the existence of not-for-profit debt advice providers;

Moreover, all lenders should commit to refer or 'hot-key' borrowers to debt advice charities and not refer them onto commercial DMP providers.

[35] http://www.oft.gov.uk/shared_oft/Approvedcodesofpractice/oft748.pdf
[36] http://www.demsa.co.uk/members.htm

11: Regulating distressed debt sales

Lenders are under pressure to protect their positions or cut losses on loans at risk of default. One way of doing this is to sell on distressed debt to third party firms who take on the responsibility for collecting the debt.

There are different approaches to distressed debt sales. However, in simple terms it involves a lender/ creditor selling non-performing loans to a specialist buyer after trying unsuccessfully to recover the debt. The price paid for the distressed debt can vary but is usually very heavily discounted from the 'face-value' of the loan. Typical prices recently have been between 5%-20% of the debt's face value. The price reflects the buyers' views on how difficult it is likely to be to recover the debt.

The size of the debt resale market is difficult to gauge as there is very little published research on the subject. However, estimates suggest that in *2008,* around one-third of defaulted unsecured debt (around £9 billion)–was sold on by banks and other creditors[37].

A number of factors suggest that the market for distressed debt sales could grow significantly:

- new accounting regulations increase the cost of holding defaulted debt for lenders which will encourage them to consider selling more debt and selling it earlier;
- companies from other sectors such as utilities and telecommunications are reported to be looking at debt sales as an alternative to debt collection;
- the financial crisis has affected the market for complex investment products so investment banks are considering entering the debt sales market. Similarly, institutional investors such as private equity funds who can take a long view on investments are finding portfolios of deeply discounted distressed debt portfolios attractive.

Clearly, if the original lender has already tried unsuccessfully to recover the debt, there is the potential that the new buyer will resort to more aggressive techniques unless constrained by regulation or reputational risk. However, specialist debt buyers are usually not regulated, nor are they mainstream household names so they are not constrained by reputational risk. Therefore, we think there is a considerable risk of vulnerable consumers being exposed to aggressive practices.

To protect consumers, we make a number of recommendations:

- all originators of loans and providers of secondary services such as distressed debt purchases should be authorised and regulated by the FSA;
- debt sellers and buyers should be subject to robust conduct of business regulations relating to marketing and promotions, conflicts of interest, and treating customers fairly including ensuring that affected borrowers have access to unbiased, NFP debt advice;

[37] http://www.financialhelpline.co.uk/news/archive/UK_consumer_debt_sales_market_sees_dramatic_growth

- lenders wishing to sell distressed debt portfolios to third party agencies should be required to apply for express consent from regulators before selling the debt. Regulators should ensure that the interests of borrowers are fully protected under the terms of the debt resale[38];
- lenders selling debt portfolios should be required to communicate clearly to affected borrowers explaining the consequences of debt resales, how their rights are affected, and 'hot-key' borrowers to NFP debt advice providers.

12: Capping charges on loans

One of the most obvious consumer detriments faced by vulnerable consumers is the exorbitant charges they pay on legal sub-prime loans of various types.

The APR on a one year £1,000 loan from a mainstream lender ranges from around 8%-19%, while a consumer borrowing from a home-credit company s/he can expect to be charged 122%-325% APR. Moreover, research has found that if borrowers need small, short term loans the APR charged by home credit companies on a £100 loan over 3 months can range from 600% APR to over 1,000% APR[39]. Similarly, the typical APR for borrowing £100 for one month from a payday lender is 1,290%[40]. By comparison, a typical credit union loan would cost roughly 22% APR[41].

Lenders complain that the APR method of comparing the cost of short term loans can make sub-prime/ doorstep credit seem exorbitant. However, many consumers will be stuck in a cycle of revolving credit and as a result the actual cost of credit will be extremely high and the APR is a reasonable reflection of the comparative cost of credit.

However, things can be even worse for consumers who are forced to borrow from unlicensed lenders or loan sharks. According to the Government, a loan from a loan shark is on average three times the cost of the same loan from a legal lender, and that interest rates of between 8000% and 117,000% have been uncovered[42].

Illegal lenders by definition operate outside of the regulatory system, so the only way to tackle these people is through legal interventions and prosecution, and by raising awareness amongst target groups of the risks involved with illegal lenders.

However, that still leaves the issue of what to do with hugely expensive yet legal lenders. One way of dealing with the high cost of unsecured loans would be for government or regulators to cap charges applied to expensive unsecured loans. This has been extensively debated and there are arguments for and against capping charges. These arguments are complex and we can only summarise these in this report.

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38 in effect, this would be similar to the process life insurance companies have to go through to satisfy the FSA that policyholders interests are protected when closed life insurance funds are sold to third parties
39 Source: Moneyfacts/ LendersCompared.org.uk as at end February 2009
40 Source: Moneysupermarket.com – as at end February 2009
41 Some credit unions charge less - see http://www.abcul.org/page/about/borrowing.cfm
42 http://campaigns.direct.gov.uk/stoploansharks/common-myths.html

On the one hand, opponents argue that a charge cap would restrict the ability of legal sub-prime/ door step lenders to serve large parts of the market they currently serve. The consequences of this would be to simply push more people into the hands of illegal loan sharks. Opponents also argue that rather than cap charges it is better to rely on financial education and information to promote competition in the sub-prime market thereby putting downward pressure on lending costs.

On the other hand, supporters of charge caps argue that, as well as the social justice point (ie. that it is morally wrong to let disadvantaged households be exploited in such a way) there is the policy argument that allowing non-mainstream lenders to charge such high APR rates simply sustains a business model which enables sub-prime lenders to aggressively promote and sell expensive debt to households who can ill afford to meet repayments. It is hard to argue with the view that these high APRs actually contribute to chronic overindebtedness.

Moreover, there is evidence to suggest that, far from acting as a bulwark between vulnerable consumers and illegal loan sharks, high cost legal lenders such as home credit providers may be acting as a channel pushing consumers towards illegal lenders[43].

We accept that there is a risk that some consumers would be exposed to illegal lenders if the business model of legal sub-prime lenders was curtailed by charge caps. However, on balance we have concluded that allowing the market to set charges represents the far greater risk. Unfettered charges sustain a detrimental business model which must have contributed to current level of overindebtedness and is likely to be contributing to illegal lending rather than act as a bulwark between vulnerable households and illegal loan sharks.

Furthermore, there is no reason to hope that relying on information solutions and market forces will be effective at bringing down charges. Consumer behaviour in markets such as the sub-prime lending sector does not conform to conventional economic market theories based on addressing information asymmetries. Consumers in the home credit market have been found to price insensitive and price competition amongst providers is weak[44].

Therefore, we conclude that it is better to introduce a cap on loan charges. We propose that the rate should be capped at 3% per month. This rate should be phased in over 3 years.

Moreover, in recognition of the risk of borrowers being displaced into the illegal sector, it is critical that this lead time is used to build capacity in the not-for-profit community lending sector (see Expansion of the Growth Fund and Social Fund, and Community Money Adviser Service, below).

[43] Research published in 2006 highlights the significant degree of crossover between home credit use and illegal lending. 53% of illegal lender users claim to have used a home credit firm in the previous 12 months. Indeed, amongst illegal lender users, the highest incidence of recent problem debt was with home credit firms. See p33, Illegal Lending in the UK, 2006, PFRC/ Policis on behalf of the DTI, http://www.berr.gov.uk/files/file35171.pdf

[44] See para 11, http://www.competition-commission.org.uk/inquiries/current/homecredit/notice_of_possible_remedies.pdf

13: Expansion of the Growth Fund and Social Fund

The DWP Growth fund has been successful in extending access to affordable credit through credit unions and other third sector lenders. So far, almost 46,500 loans, with a total value in excess of £20 million have been made to financially excluded people. The average loan has been £432. HMT announced that a further of £38 million over the 4 year period 2008-11 to increase consumer access to affordable credit through credit unions and other third sector lenders.

These initiatives are welcome. However, given the degree to which access to fair and affordable mainstream credit is being restricted we do not think these additional funds will be sufficient to cope with the expected increase in demand for loans.

Despite the clear advantages of not-for-profit community based lenders in terms of low cost loans, they have achieved comparatively little penetration in disadvantaged communities compared to commercial home-credit companies/ door-step lenders/ payday lenders.

Community based lenders have nowhere near enough capacity, whether in terms of financial or human resources, to meet the need for fair, affordable credit. Looking at the last available data (2005/6), consumers borrowed over £4 billion from commercial non-mainstream lenders of all types including home credit-door step lenders, sub-prime lenders, and catalogue companies[45]. Community based lenders such as credit unions and community development finance institutions accounted for @ £340 million[46]. .

There is a very real risk that the numbers of consumers who are left with no choice but to use expensive or even unregulated lenders will grow significantly. Recent research undertaken by The Financial Inclusion Centre for Circle Anglia estimated that consumers borrowed nearly £30m from illegal loan sharks at Christmas 2009 and will end up repaying over £80m (the average APR charged is estimated to be 825%)[47].

Increasing capacity amongst community based lenders would also allow government to cap charges on legal sub-prime lenders whilst managing the risk that consumers would be 'displaced' into the hands of illegal loan sharks (see above).

Therefore, we recommend that the Government substantially increase the amount of funding available to third sector agencies through the Growth Fund to £100 million to provide additional capacity for community based lenders to provide loans to vulnerable consumers.

Similarly, the social fund has provided welcome respite for many vulnerable households through emergency loans. However, worryingly, we expect that with prolonged unfavourable economic conditions and expected growth in the unlicensed lending market, more households in need of

[45] Home credit companies alone lent £1.3 billion and received £1.8 billion in loan repayments in 2005, while credit unions had outstanding loans of £337. Source: Table 7, Short Changed, New Philanthropy Capital, July 2008. However, this probably underestimates the true scale of high cost lending in the UK. Members of the Finance and Leasing Association (FLA) lent around £40 bn in consumer credit in 2008. Many of the FLA's members fall outside the mainstream/ high street lender category.

[46] once Government loans are factored in this rises to under £1 billion.

[47] See The Real Cost of Christmas, The Financial Inclusion Centre – commissioned by Circle Anglia, January 2010, http://inclusioncentre.org.uk/doc/The_Real_Cost_of_Christmas_FINAL_VERSION.pdf

emergency, short term loans will be vulnerable to exploitation by extortionate lenders (both legal and illegal). So, alternative sources of affordable lending are needed from a combination of public funds and other sustainable private sector funding mechanisms (see Social Investment Bonds, below).

We recommend that the social fund also be expanded by a further £100 million. However, an increase in funding would need to be accompanied by other measures to ensure it is used more effectively:

- the Government should use the increase in the Growth Fund and Social Fund in combination with the network of Community Money Advisers we are proposing (see below) to proactively target households who are trapped in a cycle of unfair or expensive debts – in effect, these funds should operate as debt/ loan shark rescue fund;
- any increase in funding should be focused on ’Protected Zones' (see above);
- as part of a plan to encourage a move from chronic debt to sustainable savings, the social fund should be used as a 'feeder fund' for credit unions and other community based NFP financial institutions. For example, consumers using the social fund should then be required or urged to participate in a money management plan organised by community money advisers and/ or join a credit union.

14: A loan shark rescue fund

Helping victims of illegal loan sharks should be a priority. Therefore, we recommend that £50m from the Growth Fund and Social Fund should be reserved to create a Loan Shark Rescue Fund. This money should be targeted on communities within Protected Zones (see above) in which loan sharks are known to operate. The loan shark fund should be used to identify and help consumers who are at a high risk of turning to loan sharks for emergency loans.

15: A Community Money Adviser Service

The Government should create a new Community Money Adviser Service consisting of a network of 300 Community Money Advisers to work in the 100 areas most affected by financial exclusion (see Protected Zones, above). These Community Money Advisers would act as ‘change agents’ to:

i) proactively promote financial inclusion and financial capability (in effect, these community money advisers would be the financial equivalent of community health visitors); and
ii) improve the financial choices available to consumers in disadvantaged and vulnerable communities by promoting and raising awareness of community based lenders, and helping consumers avoid sub-prime lenders/ loan sharks.

Despite the clear advantages of not-for-profit community based lenders in terms of low cost loans, they have achieved comparatively little penetration in disadvantaged communities compared to commercial home-credit companies/ door-step lenders/ payday lenders.

Demand for non-mainstream credit is expected to grow significantly as a result of the financial crisis while the capacity of some licensed sub-prime lenders has been reduced[48]. There is a real fear that there will be a growth in the number of consumers who will have no choice but to turn to less scrupulous or unlicensed lenders.

Community based lenders have struggled to compete against the business models and distribution strategies followed by commercial doorstep lenders/ home credit companies, and other lenders such as payday loans companies. And it is unlikely that community based lenders will ever be able to compete effectively unless they adopt more effective strategies of their own or are supported by government and other external agencies.

A JRF sponsored report looked at the feasibility of establishing a standalone, not-for-profit (NFP) home credit business[49]. The report concluded that a standalone provider would be possible. The report authors calculated the APRs a NFP lender would need to charge to be sustainable. However, these would seem to be unacceptably high even with a subsidy. For example, the authors estimated that to reduce the APR on a typical 56 week loan to < 100% APR would require a subsidy of £89 million over 10 years. Reducing the APR to 50% would require a subsidy of £286 million.

It would be very difficult politically for a not-for-profit lender to charge this level of APR especially given the low rates currently charged by community based lenders such as credit unions. So, although the challenges may not be insurmountable, a standalone not-for-profit home credit provider as envisaged in that report is unlikely to be viable and probably too purist. Trying to set one up from scratch may not necessarily be the most realistic or sensible way of providing access to affordable loans given the set up costs and risks involved.

We think it is more sensible to make use of the existing infrastructure provided by established community based lenders and government schemes such as the growth fund and social fund. But, community based lenders still need additional, sustainable capacity (both human and financial resources) to meet the needs of communities and compete head on with commercial credit providers.

Moreover, with regards to financial literacy, the UK also faces significant legacy problems. Financial capability strategies may take a generation to pay dividends. A combination of self-help tools (information and education) *and* active engagement with target groups may prove more effective at improving financial capability.

[48] As a result of Cattles scaling back operations

[49] See, Is a not-for-profit home credit business feasible? Joseph Rowntree Foundation, March 2009, http://www.jrf.org.uk/publications/not-for-profit-home-credit

This is why we believe that a network of Community Money Advisers could be effective in promoting access to affordable loans ***and*** delivering financial capability initiatives direct into communities to help consumers themselves adopt more positive financial behaviours.

These Community Money Advisers should not be confused with the Government's Financial Inclusion Champions who coordinate policy interventions. Community advisers would focus on outreach with individual consumers and communities to ensure their needs are met and have access to products and services.

Depending on where they are based, Community Money Advisers could take on the following roles:

- promote fair, affordable credit union loans in communities who are targeted by sub-prime lenders;
- work directly on placement with credit unions as business development officers to increase membership;
- deliver financial capability strategies to the heart of communities;
- provide financial 'healthchecks' for consumers - helping households identify savings on utility bills, sign posting to debt advice/ money guidance charities, raising awareness of NFP community based lenders;
- advise consumers on eligibility for benefits, assist with applications;
- coordinate multi-disciplinary approaches to financial inclusion for example, by working with specialist mental health charities to meet the financial needs of consumers with special needs;
- act as a feedback mechanism or early warning network on the ground for regulators and consumer enforcement agencies;
- develop and coordinate community financial support/ peer group networks

Community Money Advisers could work (either directly or on secondment) for community based organisations such as credit unions, CDFI[50]s, citizens' advice bureaux, housing associations, community based charities, and local authorities and be based in priority protected zones – ie. areas of greatest financial exclusion need (see above).

Further work needs to be done on funding and structure of such a network but we estimate that a network of 300 paid Community Money Advisers could be funded for around £13 million per annum. Alternatively, the network could be run on a mainly volunteer basis with a small core staff providing support to the network of volunteer advisers. This would be similar to the model operated by The Pensions Advisory Service (TPAS)[51], and would require much lower levels of funding.

These Community Money Advisers could take advantage of innovations such as the Debt Remedy and Money Matters web based financial healthcheck tools developed by the Consumer Credit Counselling Service (CCCS)[52]. We would like to see these Community Money Advisers go out into communities with portable netbooks loaded with these financial healthcheck tools to help consumers make sense of their financial circumstances.

[50] Community Development Finance Institutions – for explanation of CDFIs see http://www.cdfa.org.uk/
[51] see http://www.pensionsadvisoryservice.org.uk/about-us.aspx
[52] See http://www.cccs.co.uk/

REGULATORY AND STRUCTURAL REFORMS

In addition to the short term effects, we think the financial crisis will fundamentally reshape financial markets – exacerbating financial exclusion trends that were already in train.

Forcing banks and insurance companies to behave more prudently and responsibly is absolutely necessary but there are serious consequences which must be recognised. The retail financial services industry[53] will increasingly focus on medium-higher income/ lower risk consumers.

The consequences of this structural change is that we expect to see a significant increase in the numbers of consumers who will find it harder to get access to fair, affordable, products and services that meet their core financial needs.

For example, lower income/ 'higher-risk' consumers will face restricted access to affordable mortgage and unsecured credit, be pushed into the sub-prime markets, or be denied access to credit altogether.

Retail banks will face a powerful commercial imperative to concentrate on more profitable consumers and communities which will further put pressure on access to banking services. An increase in the use of risk based/ differential pricing means that consumers considered to be a higher risk or less profitable for banks are likely to face higher direct bank charges.

Furthermore, the financial crisis has led to a major consolidation in the banking and mortgage markets which increases the risk of anti-competitive practices.

At a more general level, there are real concerns that the financial crisis will undermine efforts to ensure consumers make sufficient financial provision for the future – whether building up enough savings for a rainy day, insuring against risks and shocks that life throws at them, or building up a decent pension.

If lower-medium income consumers are faced with higher charges on core financial products (whether because price discrimination is becoming more prevalent and/ or competition is ineffective) this self-evidently will reduce the amount of spare income they have to save for the future or take out insurance.

Improving financial capability standards and access to objective advice will be a priority to ensure consumers are able to make the right decisions in very trying financial circumstances.

Concerted positive action is needed to prevent the existing, chronic financial exclusion crisis in the UK being exacerbated. So, this second set of measures set out below are intended to address longer term exclusion effects and promote a fair and inclusive financial system that is aligned with the needs and interests of all in society.

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[53] Banking, lending, insurance and savings sectors

16: New statutory objectives for financial regulators

We argue that, given the scale of the financial services related challenges facing UK policymakers, the existing regulatory objectives given to the FSA and other regulators are too narrow and are not 'fit-for-purpose'.

We propose that the FSA, or in the event of a Conservative election victory, the proposed Consumer Protection Agency (CPA), should be given four equal, complementary consumer regulatory objectives[54]:

- **Consumer protection**: this core existing consumer protection objection should be retained to ensure that regulators focus on consumer protection in financial services.
- **Fair, efficient, and competitive markets**: a new objective should be added to require regulators to proactively create markets that work in the consumer interest. The new objective would require financial regulators to continually bear down on financial markets to ensure they are treating customers fairly, are efficient and competition is working in the consumer interest not simply rely on creating the *conditions* for markets to work and expanding choice. This is a subtle but important difference. Financial regulators should make more explicit use of product regulation as a means of making markets work.
- **Financial capability**: to complement the markets objective outlined above, regulators should have a clear objective to improve financial capability in the UK.
- **Financial inclusion and provision**: to address the low level of personal financial provision amongst UK consumers, financial regulators should also be given a general public policy objective to promote financial inclusion and wider financial provision amongst the UK population. The key aims should be to ensure that consumers have access to transactional banking services, build up savings and assets to participate in society, provide for retirement, insure against risk, and are able to access long term care provision in retirement. Financial inclusion is a specific sub-set of this wider financial provision objective and requires special measures – see below.

17: A Financial Inclusion Agency (FIA)

The chronic financial exclusion crisis in the UK is one of the gravest public policy challenges facing policymakers – this is certain to be exacerbated by the effects of the financial crisis[55]. We think self-regulation has failed to address the chronic nature of financial exclusion and a fundamental change in thinking is required.

[54] These are separate to the financial stability objectives.
[55] We estimate that at least 5 million households are materially affected by financial exclusion in some way. Other organisations put the figure higher. For example, a recent report from New Economics Foundation estimates that 8 million households are not commercially viable for mainstream lenders.

Therefore, we advocate that a new dedicated Financial Inclusion Agency (FIA) is created with an explicit duty to promote financial inclusion and provision as a means of reducing the socio-economic inequalities faced by vulnerable individuals and communities. Specifically, the new FIA should take over responsibility for overseeing the following measures:

- Financial Inclusion Disclosure measures (FIDs);
- special measures targeted on priority protected zones;
- a Community Money Adviser Service;
- overseeing a UK Financial Inclusion Act;
- administering a financial inclusion levy;
- overseeing a universal service obligation in banking;
- coordinating the work of the existing financial inclusion champions;
- working in partnership with the Financial Services Authority (FSA), Office of Fair Trading (OFT), and Equality and Human Rights Commission (EHRC) to ensure financial regulation protects vulnerable consumers;
- monitoring the impact of financial inclusion policies;
- ensuring the impact of regulation on financially excluded groups is factored in when policy is developed; and
- reporting and accountability to Parliament.

There are two main options for establishing the FIA – either creating a new standalone agency or situating the FIA within an existing organisation.

A standalone agency would be attractive as it would ensure the UK would have a single dedicated organisation focused on tackling financial exclusion.

However, it may be easier to establish the FIA as a separate agency within an established regulatory framework. There are two possible candidates for this role. The Equality and Human Rights Commission (EHRC) could take over this role. However, given the nature of the challenge and the need to collect information from financial institutions, the best choice would seem to be the Financial Services Authority (FSA). The FSA as the UK's main financial regulator already has an established relationship with all major UK financial institutions and would therefore provide economies of scale and avoid the need for much duplication of effort. The new FIA could be set up under the same arrangements as the proposed Consumer Financial Education Body (CFEB)[56].

Of course, the future of the FSA depends very much on the course of the next election. The Conservatives have pledged to split the FSA and establish a dedicated Consumer Protection Agency (CPA). The proposed CPA would be a natural home for a FIA.

18: A UK Financial Inclusion Act (FIAct)

The measures we propose in this report would go some way to protecting consumers from the immediate effects of the financial crisis. However, we argue that the scale of financial exclusion facing the UK (both current and potential), and the failure of self-regulation, warrants wider, fundamental reforms. The case for a UK Financial Inclusion Act (FIAct) – a UK version of the powerful USA Community Reinvestment Act (CRA) – is compelling.

A new UK FIAct should be built around:

- the new disclosure regime outlined above designed to promote greater corporate responsibility and accountability (see FIDs);
- statutory financial inclusion audits and regular assessments by an independent authority to ensure compliance with regulatory requirements specific to financial inclusion;
- a universal banking obligation;
- the establishment of protected zones which attract special financial inclusion policy measures;
- banks required to conform to ‘last branch in town’ provisions - banks would not be able to close a branch if it is the last branch in an economically disadvantaged community (see Protected zones, below) unless alternative access to banking services can be guaranteed.
- a statutory financial inclusion levy on banks and other financial institutions to provide long term funding for financial inclusion initiatives focused on protected zones.

There may be merit in creating a dedicated financial inclusion regulator, if a full scale UK version of the USA Community Reinvestment Act (CRA) is established. However, to take advantage of synergies, rather than create a brand new authority, establishing a new Financial Inclusion Agency within the FSA structure could be an ideal mechanism for overseeing the UK FIAct and undertake financial inclusion audits. Alternatively, the Consumer Protection Agency (CPA) proposed by the Conservatives would also be an ideal authority.

[56] Provisions for the creation of CFEB have been included in the recent Financial Services Bill. CFEB is being established by the FSA and will take the lead on national financial capability work. It will have its own separate board.

19: A statutory annual financial inclusion levy

In return for the support provided by society to rescue and stabilise the financial system, we think it is fair that major banks and other financial institutions (BOFIs) should be required to pay an annual financial inclusion levy to i) meet the regulatory costs of a new FIAct and inclusion agency and ii) make a contribution towards supporting new initiatives to promote financial inclusion and protect the most vulnerable in society.

Examples of these initiatives might include:

- a Financial Inclusion Innovation Fund;
- enhancing the growth and social funds, and
- a Network of Community Money Advisers.

These initiatives are described below.

Further modelling is required but we suggest as a preliminary measure the levy should be set at 0.5% (one half of one per cent) of annualised profits[57]. Based on the recent profits of the banks and financial services industry we estimate that this would raise @£250m. Ideally, this should be increased by matched funding from public funds.

20: Universal service obligation/ right of access to banking

Access to basic financial services (including a transactional bank account) is a necessary precondition if citizens are to be able to participate fully in a modern society. Moreover, financial exclusion contributes to wider economic and social exclusion.

In line with our views on treating financial inclusion as a fairness and social justice issue (see above), we argue that access to a bank account should be treated along the same lines as access to healthcare, education, and utilities.

With other financial products, it is probably more effective to develop alternative provision to meet the needs of excluded consumers – for example, providing access to affordable loans through community lenders or basic insurance products. However, this is not feasible with transactional banking services given the infrastructure requirements.

Therefore, access to banking should be classified as a universal service obligation (USO). This should be enforced by giving consumers a legal right of access to a basic bank account. However, a right of access *per se* is not sufficient. These transactional bank accounts should be fully functional to allow vulnerable consumers to benefit from direct debit facilities. Moreover, compliance with the USO

[57] Annualised over 5 years

needs to be monitored by an independent agency through regulatory tools such as mystery shopping – see Financial Inclusion Agency, above.

The European Commission is currently considering how best to ensure that by a certain date every EU citizen or resident has access to a basic bank account. The UK government should pre-empt this and introduce a right of access in the UK as soon as is practically possible.

21: A new approach to regulating consumer lending

The consumer lending sector seems to be one of the biggest sources of continuing consumer detriment in financial services (for example, the behaviour of sub-prime and other high cost lenders). Moreover, new detrimental practices seem to be continually emerging as non-mainstream financial firms respond to 'opportunities' provided by overindebtedness and the ongoing financial crisis (for example, the growth in payday lenders, sale and rent back providers, commercial debt management providers, and distressed debt sales) .

Furthermore, consumer detriment in the sector affects some of the most vulnerable households in society who are unable to get access to fair, affordable credit products and services from better regulated, high profile, mainstream financial providers whose behaviour is constrained by reputational risk.

We argue that the sheer scale of existing and potential consumer detriment in this sector warrants a radical new approach to regulating consumer credit. So, we make a number of high level recommendations for reforming consumer credit regulation.

In our view, the existing approach to regulating consumer credit is too permissive, reactive, and fragmented.

The regime for obtaining a consumer credit licence is not robust enough. Moreover, the trigger for regulatory interventions is too onerous. This is understandable of course as regulators have to follow the necessary due process. However, this can leave consumers vulnerable, and means that regulatory interventions often end up 'closing the stable door after the horse has bolted'.

At the moment we have a fragmented system where the FSA has responsibility for overseeing bank accounts but once the account becomes overdrawn, the OFT takes over responsibility. This makes it more difficult than is necessary for coherent, regulatory oversight of banking.

At a more general level, the UK seems to have got the balance between savings and borrowing badly wrong – ie. it has become too easy to borrow, and correspondingly too difficult for consumers to save.

The UK's relatively permissive consumer lending regime has allowed lenders and intermediaries to aggressively and, some would say, recklessly sell consumer credit. In other words, extending access to greater credit choice has been the default position. This has been a risky policy approach as consumers have already been 'primed' to borrow by aggressive marketing and advertising of consumer goods. We believe that this 'priming' made many consumers susceptible to selling of consumer credit and must have contributed to the high levels of overindebtedness in the UK.

Moreover, there is a strong case for arguing that this permissive approach to borrowing in the UK must have undermined consumers' willingness and capacity to save - as can be seen by the corresponding high levels of overindebtedness and low savings ratios in the UK. Selling easy access credit – which turns into debt that has to be repaid after all – must undermine ability to put money aside to build assets for the future.

So, if we are to achieve the necessary rebalancing between savings and borrowing, regulation should be reformed to change the default position to make it more difficult for lenders to aggressively 'sell' discretionary credit and discourage unnecessary borrowing[58].

The more robust approach to prudential regulation being adopted by the FSA should ensure that lenders lend more prudently. However, we think this needs to be complemented by some additional measures.

Therefore, we make a number of additional recommendations to i) improve consumer protection and in turn, ii) promote access to affordable credit on a sustainable basis:

- the FSA should become the single regulator for all secured and unsecured lending and lenders;
- consumer credit providers should be subject to a full authorisation process similar to that operated by the FSA rather than the current licensing process. This authorisation process should cover fitness and competence of firms and individuals. This should apply to originators of loans and secondary providers of services such as debt management companies and buyers of distressed debt;
- all consumer credit providers (secured and unsecured) should be subject to robust conduct of business regulations relating to marketing, promotions and advertising (including at the point of sale), and conflicts of interest (eg. DMP providers paying fees to introducers);
- a new risk based approach to regulating consumer credit products should be adopted. That is, products and services aimed at specific consumer sectors or involving new practices should be subject to a *pre-approval* process. New products and services should be submitted to regulators for assessment to identify potential detriment and develop appropriate regulatory response. In practice, this would mean that 'innovations' such as payday loans, or commercial debt management plans would be assessed for potential detriment in advance rather than allow detriment to emerge before action is taken by regulators.;
- charges on loans should be capped (see above).

[58] NB: we are not against access to credit – indeed we count access to fair and affordable credit to smooth out peaks and troughs of income as one of the core financial needs. However, we think this is very different to discretionary 'lifestyle' credit which has been sold far too aggressively)

22: Best practice compliance statements

The FSA, OFT, FOS, and trade bodies such as the BBA, ABI, CML, FLA [59], and Lending Standards Board should work with consumer organisations to producing new guidance and statements of best practice in retail financial services aimed at firms and consumers. These best practice statements would be suitable for all major financial product sectors (including savings, insurance and pensions). However, transactional banking, mortgage and credit products and practices are a priority given the potential for detriment in the wake of the financial crisis.

The FSA and OFT already produces a number of guides and factsheets for consumers and issued a range of guidance for lenders on a number of matters relating to the mortgage and credit markets. However, we do not think that these guides are very consumer friendly. Moreover, from our experience, many financial services providers seem to find it difficult to interpret what treating customers fairly or reasonable behaviour means actually means in practice.

We believe the market would operate better if regulators produce clear statements of good practice aimed at industry and consumers (and their representatives such as advice agencies).

The objective of these practice statements should be to:

- make it clear to firms operating in the mortgage and credit markets the behaviours and practices the FSA and OFT consider to be in breach of legislation. This should be done through statements of good practice with clear examples of behaviours that potentially breach the spirit and letter of legislation and regulatory principles;

- alert consumers to the sorts of detrimental practices they should avoid and to the potential for redress;

- help debt advice charities and other consumer organisations understand consumers' rights and understand the application and scope of consumer protection and financial regulations.

Financial firms should publish in an easily accessible place on their websites:

- their policies and practices;

- how these comply with the relevant regulations and best practice compliance statements; and

- where policies and practices are in breach of requirements, what remedial action is being taken.

[59] Financial Ombudsman Service, British Bankers Association, Association of British Insurers, Council of Mortgage Lenders, Finance and Leasing Association

23: Increased funding for financial capability

Many of the existing not-for-profit advice agencies do a great job acting in effect as ‘emergency services’ for vulnerable consumers in financial difficulties. But we are concerned that insufficient funding is being made available for pre-emptive interventions – ie. improving financial capability to help reduce the risk of consumers getting into financial difficulty in the first place.

Therefore, we recommend that the Government should make an additional £20 million available over the next two years for financial capability initiatives over and above the funding already committed. However, it goes without saying that care must be taken to identify and evaluate types of interventions that have been demonstrated to be effective at encouraging positive consumer behaviours.

24: Promoting long term savings and asset building

As we outline above, we think it is critical to change the balance of regulation to discourage overindebtedness and encourage long term savings and asset building especially amongst financially excluded consumers.

It is relatively easy to identify those weaknesses in consumer credit regulation that have encouraged reckless lending (and borrowing by consumers). So, we have made some recommendations on a new approach to consumer credit regulation which we believe would encourage more sustainable lending,

However, obvious regulatory barriers to saving and asset building that could be safely removed (without jeopardising consumer protection and undermining consumer confidence) are not so easy to identify.

Representatives from the savings/ investments/ insurance industry often argue that existing conduct of business regulations are disproportionate and make it uneconomic for providers to sell savings and investment products to consumers on lower-medium incomes. The view is that rules could be streamlined and the sales process made more efficient without undermining core consumer protection standards. This would reduce distribution unit costs thereby allowing firms to extend their reach to greater numbers of consumers.

On the other hand, consumer representatives argue that the industry is exaggerating the regulatory burden in an attempt to reduce consumer protection standards which would allow firms to sell greater volumes of products, reduce costs and increase profits. They argue that there is a core level of consumer protection standards needed to promote consumer confidence and to ensure that sales staff meet general duties of care to consumers when selling investment based products.

Furthermore, they argue, it would not commercially viable for retail financial services providers to serve lower-medium income consumers regardless of the regulatory landscape. Or, even if it was possible to sell to lower-medium income groups, they would not be interested in doing so and would use any reduction in consumer protection simply to sell greater volumes of products to more profitable consumers, thereby increasing risk of misselling.

It is difficult to reconcile these positions without further detailed analysis of consumer and provider behaviour and modelling of distribution costs. However, we believe strongly that a new approach is needed to promote savings and asset building particularly amongst lower-medium income groups.

- firstly, as we mention elsewhere, we propose that financial regulators be given a statutory regulatory objective to promote financial inclusion and provision – this would include promoting savings and asset building.

- secondly, we recommend the Government convene a working party consisting of consumer groups, regulators, and industry representatives to examine whether genuine regulatory barriers to asset building can be removed without undermining necessary consumer protection standards.

- however, there are some further measures which should be considered to promote long term savings and asset building amongst lower income consumer groups who may find it difficult to put money aside for the future. One possible option is for Government to establish a lifetime savings account with incentives or matched contributions provided to qualifying lower income households. The cost of providing incentives could be met by limiting tax relief on pension contributions to the basic rate for everyone contributing to a pension. But further evaluation would need to be undertaken to understand the impact of such a flat rate tax relief structure on existing pension savings.

25: A Financial Inclusion Innovation Fund

A considerable body of research already exists on the scale and causes of financial exclusion in the UK. That the UK faces a chronic financial exclusion problem is not in dispute amongst most objective analysts. However, we take the view that more needs to be done to develop new, sustainable solutions to tackle financial exclusion. Therefore, we recommend that government urgently and significantly expand the level of resources available to third sector organisations to develop accessible, fair, and affordable alternative financial services for excluded consumers.

Specifically, we propose that a £20 million financial inclusion innovation fund should be established to develop alternative solutions and business models. Priorities for innovative research and development are:

- a benchmark, core insurance and protection product for consumers on lower incomes or who live in high risk areas or social housing;
- a benchmark home equity scheme developed with local authorities and charities to allow homeowners to release small amounts of equity to top up incomes or pay for long term care charges;
- new forms of securitisation schemes based on rental income to allow social housing providers to expand access to housing finance;

- long term fixed-rate mortgages and mortgage products which allow more of the interest rate risk to be transferred from consumers to providers, and mechanisms for allowing Government to underwrite part of the risk attached to loans made to vulnerable consumers.

26: Social Investment Bonds (SIBs)

In addition to pressures on public sector spending, there are fears that donations and other income from private sector sources (such as corporate and individual donors) may decline as a result of the ongoing financial crisis[60].

Alternative sources of capital will be needed. Therefore, we urge the government to provide development funding to develop the concept of Social Investment Bonds as a new asset class to channel long term investment and loan capital into community based lenders. For example, if just 1/100th of one per cent of assets held by long term investors such as pension funds, corporate and philanthropic investors was invested in social investment bonds (SIBS)[61] this would provide around £50 million of capital for social investment purposes.

27: The Social Investment Bank

We support the idea for the Social Investment Bank. We urge the government to establish and fund the bank to provide access to sustainable investment and capital for third sector organisations and social entrepreneurs involved in promoting financial inclusion.

28: Competition in the banking sector

The financial crisis has resulted in a major concentration of market share in the mortgage and transactional banking sectors in the hands of a few big players. This has given rise to serious concerns about lack of competition those sectors. For example, the largest four lenders took 64% of gross mortgage lending in 2008 (the top five took 71%)[62], while the net interest margin between mortgage and savings rates widened to the highest in over a decade[63].

The Government has already announced plans to break up Lloyds Banking Group and RBS and sell-off the remaining “good” parts of Northern Rock. This will lead to the creation of three new high street banks and has the potential to introduce additional competition in the medium-longer term. However, it is unlikely that new entrants would have any significant impact on incumbent mortgage providers in the short-medium term.

Therefore, additional interventions are needed to protect against anti-competitive behaviours in the short-medium term. There are a number of options open to the authorities.

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[60] See for example, http://news.bbc.co.uk/1/hi/magazine/7937183.stm

[61] SIBs are a concept being developed by The Financial Inclusion Centre as a mechanism for long term investors to provide capital for not-for-profit lenders such as credit unions or community development finance institutions (CDFIs).

[62] Source: 2008 Largest Mortgage Lenders, CML Research 13/8/ 2009

[63] See Are banks and building societies playing fair?, The Financial Inclusion Centre, 2009

The Government should apply a 'sunset clause' after which the OFT would reinstate 'normal' competition policy and instigate a full investigation into the effect on competition of the various mergers and acquisitions that have occurred as a result of the market crisis.

Furthermore, given that the main fear is that the remaining large, powerful lenders are in a position to exploit dominant positions to increase prices in the mortgage market, it may well be that the authorities will have to consider capping market share by requiring the largest lenders to sell part of their mortgage books and price and product regulation (ie. by capping margins or prices on mortgage products).

However, it needs to be remembered that explicit product regulation could not be done through the FSA as the regulator is not a price regulator - although the FSA could certainly intervene if lack of competition was allowing lenders to treat customers unfairly by imposing detrimental pricing structures.

However, now that the Government has decided to break up some of the major banks, we hope it uses this opportunity to introduce radical, structural reforms to promote effective competition and to better align the banks with the needs of society, for example, by remutualising Northern Rock (see below).

29: The role of UK Financial Investments (UKFI)

UKFI was set up in November 2008 to manage the UK Government's investments in financial institutions including RBS, Lloyds TSB/HBOS, Northern Rock, and Bradford and Bingley. UKFI clearly provides a significant opportunity to influence the behaviour of the UK's banking sector so that it better meets the needs of society and future generations of consumers and entrepreneurs. However, there are concerns about the absence of any clear public policy objectives for UKFI, the lack of transparency in its operations, and institutional governance.

In terms of transparency and accountability, UKFI has produced - with HMT - an Investment Mandate, Business Plan, and Framework Document[64]. These documents set out the objectives for UKFI and the framework within UKFI operates.

As it stands, the overarching objective of UKFI is to 'protect and create value for the taxpayer as shareholder, with due regard to financial stability and the promotion of competition'. UKFI makes it clear that its role is to manage the Government's investments, not to manage the banks[65].

But it must be obvious that under the current conditions, the taxpayer is not the only 'stakeholder' with an interest in how the banks within UKFI's remit behave over the short and long term. There are no formal mechanisms for holding banks to account with regards to treating consumers fairly during the financial crisis. For example, for some reason the Government does not require individual banks to publish data on lending in disadvantaged areas or numbers of repossessions. So it is very disappointing that the Government did not see fit to at least to provide UKFI with this duty to oversee the performance of these particular banks within its remit.

[64] See http://www.ukfi.gov.uk/publications/
[65] See http://www.ukfi.gov.uk/images/dynamicImages/UKFI%20Annual%20Report%202008-2009v2.pdf

Therefore, we urge the Government to review the remit of UKFI and provide it with explicit, near-term and longer term strategic objectives and priorities. These objectives and priorities are intended to allow public banks to carry out core public functions and should be seen as preparation for the longer term reforms (see below). These objectives should be publicised along with formal reporting mechanisms to provide accountability.

Short-term objectives
UKFI should after consultation with public interest representatives agree specific and measurable objectives to ensure the banks meet core public interest duties in the following categories:

- lending to industry;
- lending to consumers;
- treatment of customers in financial difficulties; and
- financial inclusion.

Strategic objectives
In preparation for restoring banks to private ownership, UKFI should adopt the following strategic objectives:

- restore bank balance sheets to prudent levels, and ensure they are in a position where they no longer need public support, nor represent a systemic risk to the financial system (in effect ring fencing these banks);
- identify existing activities within the banks operations that do not meet core, public interest objectives. These activities should be divested or closed and banks prepared for refloating as new, narrow utility banks.

UKFI Governance
Moreover, we have concerns about the governance of the UKFI board. With the exception of one board member from HMT, all of the UKFI board members have banking or investment industry backgrounds. None of the members have a public interest background – for example, as a consumer representative or employee representative. We do not make any personal criticism of the individuals involved but it is inappropriate that eight of the nine board members of the body which is meant to be overseeing the public interest are from the banking/ investment industry, while not a single person has a dedicated public interest representative background.

Therefore, we recommend that the Government appoints at least two board members with a recognised public interest background. Moreover, each of the boards of the banks within UKFI's remit should contain dedicated public interest representatives.

30: A new banking landscape

The reforms of prudential regulation currently underway must be carried through to avoid the risk of a similar financial crisis recurring. If these regulatory reforms are completed, a sounder more prudently managed banking system should emerge.

However, this is not enough. It would be unfortunate if future generations concluded ruefully that the authorities' determined interventions simply served to allow financial markets to continue to behave in the same way in a post-crisis world as they did in the pre-crisis world - despite having been bailed out by £billions of current and future taxpayers funds and leaving society with a massive debt legacy.

The financial crisis provides a once in a generation opportunity to implement radical, structural reforms to promote effective competition and to better align the banks with the needs of society. We need a banking and financial system that is:

- better governed;
- more accountable to society;
- pluralistic and diverse;
- truly competitive;
- inclusive and structured to meet the needs of all in society; and
- produces socially useful products and services.

The critical point to remember is that the new post-crisis banking system is not going to emerge organically, through relying on market forces. It requires direct public policy interventions on the part of politicians and regulators with vision and courage to forge that banking system.

One the greatest challenges facing policymakers and regulators with the existing banking model is how to manage the potentially conflicting objectives of: i) promoting prudent lending while at the same time ii) promoting financial inclusion and encouraging long term lending for enterprise and innovation. We think this will be very difficult, if not impossible, to achieve without major structural reform of the banking sector.

The long term strategic public policy objective should be to creating a banking sector consisting of three broad definitions of banks regulated under different regimes:

- **Consumer/ utility banks**: these banks would be restricted to core retail and commercial banking services and have clear, public interest objectives to maintain access to banking services for consumers and lending to industry. Utility banks should be given public policy objectives with regards to access to banking services – including branch networks, rights of access to basic bank accounts, and lending. To meet the competing priorities of acting prudently and maintaining lending and access to banking services, the return on capital should expected to be closer to that for utilities rather than the level recently achieved by UK banks. These banks should have dedicated public interest non-executive directors;

- **Investment banks**: these banks would be allowed to engage in riskier activities but would be regulated under a much stricter regime.

- **Strategic Investment Bank**: furthermore, in addition to the above separation, the government should establish a long term strategic investment and lending bank similar to the ICFC set up in 1945 which became 3i[66]. We are pleased that this seems to have been accepted in the recent Pre Budget Report.

We appreciate the argument that separating existing banking structures into consumer banks and investment would not necessarily prevent new banking failures. However, we do not argue the case from that perspective. We argue that separation into consumer/investment banking operations would allow for a much more effective resolution of crises and make it easier to protect public funds.

But, the key reason for separating consumer banks and investment banks is that this would create a banking infrastructure that is better aligned with public policy objectives such as ensuring lending is maintained to consumers and industry, promoting financial inclusion, and maintaining the transactional banking system the economy depends so much on. These objectives would be better regulated with socially important banks being treated as utilities.

The decision by the Government to break up Lloyds/HBOS Banking Group and RBS, and sell-off the remaining "good" parts of Northern Rock, provides an ideal opportunity to carve out and establish new utility or People's Banks.

The expectation is that there will be three 'new' banks created from the existing structures. The creation of these three banks along with converting the Post Office into a People's Bank provides the opportunity to forge a whole new banking landscape consisting of diverse institutions to promote competition and ensure the needs of all in society are met.

The options we favour for creating a diverse banking landscape are:

- **a National Mortgage Bank (NMB)**: the government could create a national mortgage bank. In effect, this would be a mortgage version of National Savings and Investment (NS&I). The strategic objective of this NMB would be to provide a competitive stimulus for private sector lenders and to act as an infrastructure funding bank for the social housing sector and to provide access to mortgage finance for lower income consumers (similar to the original role envisaged for Fannie Mae and Freddie Mac in the USA);

- **Re-mutualisation:** if the government wants to introduce real competition into the banking and mortgage markets, it should use this opportunity to partially reverse the mass conversion of building societies to banks in the 1980's and 1990's. Effective competition requires plurality and diversity, not just greater numbers of providers in a market. The demutualisation of many of the major building societies seriously undermined effective competition in the mortgage market. So, rather than sell back the failed institutions to potential buyers wishing to create new shareholder-owned banks, the government should establish two new major mutual banks along the lines proposed in the recent report produced by the Building Societies Association (BSA)[67]. Re-mutualising one or more of the

[66] Investors in industry
[67] See http://www.bsa.org.uk/docs/presspdfs/remutualisation.pdf

new consumer banks carved out of the existing structure would provide a bulwark of mutual financial institutions (along with Nationwide BS) to compete against shareholder-owned institutions. This would provide some of the necessary plurality and diversity in the market. Northern Rock is the obvious candidate.

- **People's Bank:** we believe that the structural reforms outlined above would establish a more diverse, competitive, sustainable and efficient banking market for consumers that are *commercially viable* for mainstream financial services providers. However, further reforms are needed to meet the core financial needs of vulnerable, disadvantaged consumers and communities. The existing infrastructure provided by the Post Office network provides an obvious foundation on which to build a national community bank network. Therefore, we urge the Government to take forward proposals to create a People's Bank built on the Post Office network.

The Financial Inclusion Centre
March 2010

ANNEX I: FINANCIAL INCLUSION DISCLOSURE MEASURES

The key measures we are campaigning for are:

1. **Financial Inclusion Audits**: individual banks and significant financial institutions to be subject to independent statutory financial inclusion audits. These audits would be based on a set of FIDs covering banking and lending – details of these FIDs are set out below. These audits would perform a similar role to the powerful Community Reinvestment Act (CRA) and Home Mortgage Disclosure Act (HMDA) in the USA.

2. **Independent Oversight:** these individual financial inclusion audits should be monitored by an independent agency (not self-regulated by the banking industry). This independent agency should produce an annual industry wide financial inclusion audit.

Scope and coverage

The financial inclusion disclosure (FIDs) measures should cover the following products and services[68]:

- Banking – current accounts and basic bank accounts;
- Lending – mortgages and unsecured credit;
- SME lending;
- Community development lending and investment.

Where appropriate, the relevant data should be collected and published at 3 levels:

- Bank branch/ office level;
- Inclusion Assessment Area – this should be based on Super Output Areas or alternatively, postcode, ward or borough level. The priority are the 'protected zones' – that is, the areas most affected by financial and social exclusion[69];
- UK corporate level ie. data should be aggregated from branch and assessment area level to allow for an overall assessment of the financial institutions financial inclusion performance.

The financial inclusion disclosure measures should apply to all FSA and OFT regulated firms. However, as a priority, the top ten lenders by market share could be covered in the first wave of audits.

Publication of information

This information should be published annually in the form of a statutory financial inclusion audit. The intention is that, eventually, the data collected would form the basis of comprehensive annual financial inclusion performance assessments. We are currently developing a blueprint for these performance assessments based on the US CRA assessments.

Firms should supply relevant information to an independent body which should be used to produce an annual industry wide financial inclusion audit.

[68] Ideally, insurance products should be included to assess the effects of insurance exclusion on vulnerable communities
[69] The Financial Inclusion Centre is currently drawing up a list of protected zones

Income definitions
For each of the product tables below, income categories are defined as follows:

Low income	defined as less than 50% of median assessment area income
Moderate income	defined as between 50% and 80% of median assessment area income
Middle income	defined as between 80% and 120% of median assessment area income
Upper income	defined as greater than 120% median assessment area income

BANKING (current accounts and basic bank accounts)

The purpose of the data is to allow an assessment of banks performance in providing access to bank accounts in vulnerable areas (in this case the protected zones). Data should be collected and published separately on current accounts and basic bank accounts.

Bank accounts	**Number applied for**	**Number rejected**	**Number opened**	**Number closed**	**Number in operation**
Low income					
Moderate income					
Middle income					
Upper income					
Gender - Male - Female					
Ethnicity (group classifications to be confirmed)					
Total					
Total number of branches in inclusion assessment area:					

Over time, quantitative data should be complemented by qualitative research/ mystery shopping exercises to understand in more depth how banks are treating banking customers attempting to open bank accounts and whether banks are actively promoting basic bank accounts in protected zones etc.

LENDING (mortgages, other secured lending, and unsecured lending)
The purpose is to allow an assessment to be made of lenders performance in providing access to mortgages and credit, the cost of loans, and treating customers fairly. Data should be collected and published on mortgages, other secured lending, and unsecured lending.

LOAN NUMBERS	**Prime loans**			**Sub-prime/ high cost loans**			**Total**		
	Number applied for	Number rejected	Number arranged	Number applied for	Number rejected	Number Arranged	Number applied for	Number rejected	Number arranged
Low income									
Moderate income									
Middle income									
Upper income									
Gender - Male - Female									
Ethnicity (group classifications to be confirmed)									
Total									

LOAN VALUES AND COST	**Prime loans**				**Sub-prime/ high cost loans**				**Total**			
	Value of loans agreed	**Average cost (APR)**	**Cost range**	**Typical fees**	**Value of loans agreed**	**Average cost (APR)**	**Cost range**	**Typical fees**	**Value of loans agreed**	**Average cost (APR)**	**Cost range**	**Typical fees**
Low income												
Moderate income												
Middle income												
Upper income												
Gender - Male - Female												
Ethnicity (groups to be confirmed)												
Total												

TREATING BORROWERS FAIRLY

ARREARS/ REPOSSESSIONS/ CHARGING ORDERS	**Prime loans**						**Sub-prime/ high cost loans**						**Total**					
	Number in arrears	**Value o f arrears**	**Number repossessed/**	**Value of repossessed**	**No of debts resold**	**Value of debt resold**	**Number in arrears**	**Value o f arrears**	**Number repossessed**	**Value of repossessed**	**No of debt resold**	**Value of debt resold**	**Number in arrears**	**Value o f arrears**	**Number repossessed**	**Value of repossessed**	**No of debt resold**	**Value of debt resold**
Low income																		
Moderate income																		
Middle income																		
Upper income																		
Gender - Male - Female																		
Ethnicity (groups to be confirmed)																		
Total																		

Please note that for unsecured lending products, data should be collected on charging orders rather than repossessions.

LENDING TO SMEs

The purpose of collecting the data is to allow an assessment to be made of lenders' performance in providing access to loans to SME's in protected zones.

Loans to firms with annual revenues	Number	Value of loans	Average cost of loan % interest rate	Range of cost
Under £250k				
£250k-500K				
£500k-£1m				
£1m-5m				
Over £5m				
Loan values				
Under £50k				
£50k-100k				
£100k-£500k				
£500k-£1m				
Over £1m				

COMMUNITY DEVELOPMENT LENDING AND INVESTMENT

The purpose of collecting this data is to assess lenders performance in supporting community development programmes and initiatives. This is to understand the contribution financial institutions make to vulnerable communities over and above normal commercial activities.

COMMUNITY DEVELOPMENT ACTIVITY	Number	Value of loans/ investment	Average cost of loan % interest rate
Lending for social housing			
Economic development/ regeneration loans			
Other CSR activities			

The **Financial Inclusion Centre**

Promoting fair, affordable financial services

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