Poverty, debt and credit:
An expert-led review

Final report to the Joseph Rowntree Foundation

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Contents

1 Introduction

This research reviews the evidence on the links between debt, credit and poverty as part of the Joseph Rowntree Foundation's programme to produce an anti-poverty strategy for the UK.

Poorer households are known to be at increased risk of over-indebtedness and tackling debt is included within the UK Government's Child Poverty Strategy[1]. Consumer credit is a part of everyday life for many people, helping to smooth the ebbs and flows of income and expenditure and manage financial resources flexibly. However, the concern is that use of consumer credit, particularly use of high-cost credit, can lead to financial difficulties and over-indebtedness.
This review seeks to unpick the research evidence to provide an over-view of the extent to which problem debt and consumer credit use *cause* poverty; and the extent to which poverty *results in* problem debt and consumer credit use.

1.1 Research aims

The review addresses three core questions:

1. What is the relationship between debt, credit and poverty in the UK?
2. How can credit and debt policies and practice interventions reduce and prevent poverty - what is the evidence on what works?
3. What interventions and strategies are recommended for inclusion in an anti-poverty strategy for the UK?

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[1] DWP and DfE (2011) *A New Approach to Child Poverty: Tackling the Causes of Disadvantage and Transforming Families' Lives*, Cm 806. Norwich: The Stationary Office.

'Debt' was defined as *problem* debt, where individuals are unable to make contractual payments on consumer credit or household bills. 'Credit' was defined as non-mortgage consumer credit.

1.2 Defining poverty

The basic definition of poverty used by JRF in its anti-poverty strategy is ‘When a person’s resources (mainly their material resources) are not sufficient to meet their minimum needs (including social participation)’.

The research described in this review was not necessarily carried out from a poverty perspective. In order to conduct this review, therefore, it was necessary to include research evidence that either defines poverty in different ways to JRF or does not include a specific definition of poverty.

Most commonly, studies of consumer credit and problem debt refer to people on low incomes, defined in a range of ways such as below 60 per cent median income or in some cases with no clear definition. In the absence of any other poverty measure, we have used low income (and circumstances associated with having a low income such as unemployment) as a proxy for poverty. Where possible, we have described the measure of low income that was used.

1.3 Research methods and scope

The review focused on studies published in the last 15 years and on evidence from the UK. Evidence from studies carried out in the US, Canada and Australia was also included as these are the main countries that have conducted research on credit and debt. Evidence from

Northern European and Scandinavian Member States was only included where particularly relevant.

The scope of this review excluded savings which is covered by a separate evidence review on 'Savings, wealth and assets'. However there are overlaps between these reviews in that saving is a factor in understanding households' use of consumer credit and their risk of experiencing of problem debt.

The review was an expert-led synthesis of the literature and drew on PFRC’s extensive library of materials supplemented by searches of: academic bibliographic databases; government, third sector and industry sources; research organisation publication lists; and web searches. The quality of the evidence collected was reviewed using a standardised appraisal tool. Whilst the review prioritised high quality evidence, it is important to note that very little of the literature on debt and credit is published in peer-reviewed journals and that much of the evidence on the impacts of policy and practice interventions does not have comparison or control groups against which impacts can be robustly measured.

1.4 Report structure

The first section of this report (Chapter 2) reviews on the evidence on the links between poverty and debt. Chapter 3 reviews the evidence on the links between poverty and use of consumer credit. Evidence on policies and practice interventions, including financial products, and the extent to which they are effective in tackling poverty are reviewed in

Chapter 4. Finally, conclusions from the evidence and their implications for a UK-wide anti-poverty strategy are presented in Chapter 5.

2 The relationship between debt and poverty in the UK

Debt is defined here as problem debt, which is where households are unable to meet contractual payments on consumer credit or household bills (including housing costs). This section reviews the evidence in relation to six questions:

1. What proportion of poor households has problem debt?
2. What are the characteristics of poor households with problem debt?
3. What types of problem debt do poor households have?
4. To what extent does poverty cause problem debt?
5. To what extent does problem debt cause poverty?
6. To what extent does problem debt make it more difficult for people to move out of poverty?

2.1 What proportion of poor households has problem debt?

There is no single source of data on levels of problem debt in the UK. Data from the 2012 BIS DebtTrack survey found that 12 per cent of households were one or more months in arrears on bills and credit payments, falling to seven per cent who were more than three months in arrears (BIS, 2013). Analysis of the 2006-2008 Wealth and Assets Survey (Bryan et al., 2010) found that 10 per cent of households were in arrears with a least one payment.

Although there are no statistics on the extent of problem debt among households defined as being poor, there is clear and consistent evidence that problem debt is independently related to household income, whereby households on the lowest incomes are at greater risk of experiencing financial difficulties and problem debt (Bryan et al., 2010; Civic Consulting, 2013; European Commission, 2008; Kempson, 2002).

One measure of this is the unsecured debt repayment-to-income ratio, which estimates the amount of money that households spend repaying unsecured credit commitments as a proportion of their income. While households with higher incomes have higher levels of debt in absolute terms than lower income households, when measured as an unsecured debt repayment-to-income ratio (based on gross incomes) low-income households have higher levels of borrowing. Three in ten households (29%) in the lowest income band (less than £13,500 per annum) had a repayment-to-income ratio in excess of 30 per cent, compared to 10 per cent or less for households with an annual income of £25,000 or more (BIS, 2013). Analysis of the Wealth and Assets Survey[2] (Bryan et al., 2010) estimated that almost one in five (19%) of households with an annual income of less than £10,000 had unsecured debt repayments that exceed 25 per cent of their income, compared with less than five per cent of those with incomes exceeding £30,000 per annum.

Another measure that shows clearly the link between problem debt and low income is the proportion of households that are in arrears on household bills or credit commitments. The 2006-2008 Wealth and Assets Survey estimated that 15 per cent of households with the lowest gross annual incomes (less than £10,000) had arrears compared to an average of 10 per cent for all households and compared to just five per cent of households with an annual income of £50,000 or more (Bryan et

[2] Income data is not measured accurately in the first two waves of the Wealth and Assets Survey and is subject to measurement error.

al., 2010). Among households in the bottom half of the income distribution (Ellison et al., 2011) 31 per cent were in arrears on household bills - rising to 34 per cent of those in the lowest income quintile, and 18 per cent had missed payments on personal loans - rising to 22 per cent of those in the lowest income quintile.

2.2 What are the characteristics of poor households with problem debt?

Some of the characteristics of households with problem debt are the same characteristics associated with households in poverty, reflecting the link between problem debt and low income. Being a tenant, rather than a home-owner, is associated with an increased risk of having problem debt, with the risk being higher for social tenants than for private tenants (Bryan et al., 2010; Disney et al., 2008; European Commission, 2008; Kempson et al., 2004; Kempson, 2002).

In one study, debt problems were twice as prevalent among tenants compared to homeowners (Disney et al., 2008); in another, being a tenant had the largest impact on predicting over-indebtedness (Collard and Finney, 2013). The 2006-2008 Wealth and Assets Survey showed that nearly a quarter (23%) of social tenants and 19 per cent of private rented tenants were in arrears on one or more commitments, compared to just seven per cent of households that owned their home with a mortgage (ONS, 2009).

Not being in work is also associated with an increased likelihood of over-indebtedness. This applies to those who are unemployed, looking after the family or home full-time, or are out of work due to ill-health or disability, but does not apply those who are retired (BIS, 2013; Bryan et al., 2010; European Commission, 2008; Kempson et al., 2004; Kempson, 2002). The 2006-2008 Wealth and Assets Survey found that households headed by someone who was unemployed or looking after the family home were more than three times more likely to be in arrears on at least one commitment (37 and 34 per cent respectively) compared to the overall average (10 per cent) (ONS, 2009). Problem debt has also been shown to be higher among households headed by part-time workers (Kempson et al., 2004; Kempson, 2002), those working in manual and lower status occupations (Bryan et al., 2010) and among low earners (Collard and Finney, 2013).

However, problem debt is not only a function of income. Other characteristics associated with a higher likelihood of problem debt independent of other factors (amongst the general population, not just poor households) include:

- Being younger. Households under the age of 30 have the highest risk of being over-indebted (Bryan et al., 2010; European Commission, 2008).
- Having dependent children in the household (Bryan et al., 2010; Disney et al., 2008; European Commission, 2008; Kempson et al., 2004). Studies particularly show higher levels of indebtedness among larger families (Bryan et al., 2010; European Commission, 2008; Kempson et al., 2004).
- Having no savings or only small amounts of savings (BIS, 2013; European Commission, 2008; Kempson et al., 2004).
- Having a larger number of credit commitments (Disney et al., 2008; European Commission, 2008; Kempson et al., 2004). One study

showed that having one credit commitment doubled the risk of arrears; two commitments trebled it and having three or more increased the risk from eight to 38 per cent (Kempson et al. 2004).

- Attitudes to spending and debt, whereby those who have a strong spending orientation, are compulsive shoppers or who buy things on credit when they can't really afford them are more likely to be over-indebted (Bryan et al., 2010; Collard and Finney, 2013; European Commission, 2008). However, these attitudes and their association with over-indebtedness may be a reflection of financial behaviour rather than a cause (Bryan et al., 2010).
- Having low psychological well-being and poor mental health. However the direction of the relationship can be either way: financial difficulty and arrears can cause stress and anxiety, just as mental health problems can contribute to or cause arrears (Disney et al., 2008).

2.3 What types of problem debt do poor households have?

The evidence shows that low-income households are more likely to be in arrears on household bills than in arrears on consumer credit (Bridges and Disney, 2004; Dearden et al., 2010; Kempson et al., 2004; Kempson, 2002). This in part reflects the fact that not all low-income households use credit.

For example, analysis of FACS[3] showed that among the poorest families (with household incomes less than £15,000) around one in five were in

[3] FACS (Family and Children Study) was initially based on interviews with low-income parents with dependent children living in Great Britain during 1999. From 2001 onwards, higher-income couples were included to yield a complete sample of all British families with dependent children.

arrears with household bills compared to one in seven who were in arrears with consumer credit. Arrears on household bills were also more persistent than those on credit commitments or housing costs (Kempson et al., 2004). Rent arrears among low-income families in the FACS survey were also found to be high, reported by 34 per cent of households (Bridges and Disney, 2004).

Within the different types of household bills, the FACS survey found that arrears were highest for council tax (18% of low-income families) and water bills (15%), followed by telephone bills (13%) and gas (12%). This compares to just 7 per cent who were in arrears with their electricity bill (Bridges and Disney, 2004). The use of electricity prepayment meters helps explain why fewer low-income families were in arrears with their electricity bill compared with other utility bills (Bridges and Disney, 2004).[4]

How low-income families manage different types of debt and arrears is also influenced by the severity of any penalty that might be incurred. Water bills were often treated as a low priority by low-income households if money was tight as they were aware that water would not be disconnected, unlike gas or electricity. Similarly, catalogue payments were prioritised less highly because catalogue firms were considered to be fairly undemanding in respect of debts (Dearden et al., 2010). The fact that credit commitments, such as hire purchase, incurred interest and other charges for late payment was a possible reason why fewer

[4] The Centre for Sustainable Energy was commissioned by JRF to conduct a review of fuel and poverty, which covers issues such as payment methods and fuel debt.

households had consumer credit arrears compared to arrears on household bills (Bridges and Disney, 2004).

2.4 To what extent does poverty cause problem debt?

As discussed earlier, there is clear evidence that low-income households are more likely to experience problem debt than higher income households.

Quantitative studies identify drops in income as the major cause of financial difficulty and problem debt within the general population (BIS, 2013; Collard et al., 2013; European Commission, 2008; Kempson et al., 2004; Kempson, 2002). In surveys between 42 and 45 per cent of households attributed their arrears to a loss of income (Kempson et al., 2004; Kempson, 2002). The main reason for this drop in income was redundancy; other reasons included giving up work due to ill health and relationship breakdown. By comparison, low income was given as a reason for falling into arrears by between 14 and 15 per cent of households, although the studies do not report how this differs by income. Increased or unexpected household expenses, such as replacing household items, the birth of a child and rising living costs, was cited by between 11 and 12 per cent of households (Kempson et al., 2004; Kempson, 2002).

Studies also show that households get into financial difficulties and arrears as a result of other reasons including being over-committed on credit, not having savings, over-spending, and poor money management or low financial awareness (European Commission, 2008; Kempson et al., 2004; Kempson, 2002).

There are no quantitative studies that have examined the drivers of financial difficulty and over-indebtedness among **just** low-income households, or how these drivers might differ across low and higher-income households. How poverty can cause problem debt within low-income households is best illustrated by Dearden et al.'s (2010) longitudinal qualitative study of credit and debt in 60 low-income households which showed the complexity and interaction of factors that can lead low-income households into problem debt. This may help explain why, in quantitative surveys, problem debt is only attributed to low income in a relatively small proportion of cases.

Whilst for some households in the longitudinal qualitative research problem debt started as a result of a single specific event, such as losing a job or starting a family, for others it resulted from a sequence of events or accumulation of adverse circumstances over a period of time, with no single trigger or cause. Low income was an underlying cause whereby household finances were precarious and easily susceptible to disruption by a fall in income or an increase in demands on expenditure that, in the absence of savings or other resources to draw on, led households to using credit and defaulting on payments. These findings concur with qualitative evidence from advice agencies that identified very low-income households as susceptible to any small change in income or expenditure, whereby a fall in income or the failure of a household good exposed them to repayment difficulties or led them to borrow money (Disney et al., 2008).

That low income in itself is not a major driver of problem debt is perhaps surprising. An evidence review of households' experiences of living on a low income (Kempson, 1996) found that money management was most difficult for people who were new to managing on a low income as a result of either job loss, being widowed, relationship breakdown, setting up home for the first time, or giving up work following the birth of a child. It was a time when they ran a high risk of getting into arrears, with bill juggling or use of credit common responses to managing on a low income. The longer that people spent living on a low income the better some got at being able to cope financially. Furthermore, once people had got into arrears, creditors required them to pay their bills in ways (e.g. pre-payment meters or direct deductions from benefit) that prevented them from getting into further arrears.

2.5 To what extent does problem debt cause poverty?

This review did not find any evidence to show that problem debt causes poverty. A systematic evidence review of poverty dynamics (Smith and Middleton, 2007) identified labour market change and household change as the main triggers of poverty. Credit use and problem debt were not mentioned as factors. This is largely because the studies included in the review measure income that does not take account of income being spent on servicing debts.

What the evidence does show, however, is that the consequences of problem debt can adversely impact on standards of living and well-being as servicing debts reduces disposable income (Harris et al., 2009; Civic Consulting, 2013). In other words, problem debt can deepen people’s poverty, even if it is not the direct cause. As a result of repaying problem debts households have less disposable income to live on and have to cut back on other areas of spending. In higher-income households this can mean cutting back on non-essential items; in lower-income households it can mean cutting back on basic necessities such as food, clothes and domestic fuel use. It can also lead to social exclusion (for both adults and children) as households reduce spending on social activities, or become isolated from friends due to feelings of shame and stigma as a result of their financial difficulties and lack of money.

Other reported consequences of problem debt, over and above the impact on disposable income, include stress and depression, relationship difficulties and financial exclusion from mainstream credit. At its worst problem debt can lead to homelessness through eviction or repossession, being disconnected from utility supplies and court summons (Kempson, 1994).

2.6 To what extent does problem debt make it more difficult for people to move out of poverty?

The consequences of problem debt, as outlined above, can exacerbate poverty and increase the risk of remaining in poverty. As found by Berthoud and Kempson (1992), once low-income families got into difficulties with debt it was almost impossible to get straight again unless there was a dramatic improvement in their circumstances. However, overall there is limited (recent) evidence on the extent to which problem debt makes it more difficult for people to move out of poverty.

The evidence refers to a 'debt trap': a cycle in which people service their debts (i.e. they pay the minimum repayment amount and other charges that are owed), but are unable to pay off the capital they originally borrowed (Ellison et al., 2011). It is also used to describe the negative psychological impacts of having problem debt where people feel too overwhelmed by their financial circumstances to be able to address them (Dearden et al., 2010; Disney et al., 2008). There are no figures available on the number of households in this position.

Qualitative evidence reports that adverse impacts of problem debt on people's mental health, well-being and self-confidence may also undermine their ability to seek employment (Dearden et al., 2010; Civic Consulting, 2013) which is a key route out of poverty. In one study qualitative evidence found that being in arrears was a barrier to work due to people’s fear that creditor forbearance (in the form of reduced repayments) would end and creditors would demand increased or full repayments when they moved into employment. However, this was not identified as a barrier to work in the survey data (Kempson et al., 2004).

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3 The relationship between credit and poverty in the UK

For the purpose of this review, 'credit' is defined as non-mortgage consumer credit. This section reviews the evidence in relation to six questions:

1. What proportion of poor households use consumer credit?
2. What are the characteristics of poor households that use consumer credit?
3. What are the types of credit used by poor households?
4. Why do poor households use credit?
5. What are the impacts on poor households of using credit?

3.1 What proportion of poor households use consumer credit?

Analysis of the 2008-2010 Wealth and Assets Survey found that half of all British households (49%) had some form of non-mortgage borrowing[5] (ONS, 2012). These findings are similar to other studies that have also found that around half of households were active credit users (BIS, 2013; Finney et al., 2007). At an individual (rather than a household) level 37 per cent of adults had an active (non-mortgage) credit commitment (excluding student loans) (Collard and Finney, 2013).

Among individuals with credit commitments, the majority had just one commitment - estimates vary between 42 and 52 per cent of adults with one commitment and around a quarter with two commitments. Between a quarter and a third had three or more commitments (Collard and Finney, 2013; Finney et al., 2007).

[5] This includes student loans. Excluding loans from the Student Loans Company this figure falls to 48 per cent of households.

There has been relatively little analysis of credit use by household income. Analysis of the Baseline Survey of Financial Capability (2005) showed that the proportion of households with active credit commitments fell to 37 per cent among households in the lowest income quintile (compared with 47 per cent on average) and among households with no one in work (32%) (Finney et al., 2007). However, multivariate analysis found that income was not significantly related to credit use independently of other factors, such as housing tenure, work status and age.

The 2006-2008 Wealth and Assets Survey (which does not include an accurate household income variable[6]) similarly showed that those who had never worked or were long-term unemployed were the least likely to have any non-mortgage borrowing at 35 per cent of households (ONS, 2009), as compared to 61 per cent of employees and 62 per cent of those looking after the family home. It also found that among those who did borrow, low-income households borrowed less. Taking housing tenure and work status as indicators of household income, the average amounts borrowed by social housing tenants (£3,900), those who had never worked or were long-term unemployed (£3,200), and those looking after the family home (£3,200) were much lower compared to households that owned their home with a mortgage (£8,600) or were headed by someone who was an employee (£8,100).

[6] Income data is subject to measurement error.

A quantitative study of lower-income households (defined as households with the lowest 50% of incomes) also showed that fewer households in the bottom income quintile had used credit compared to households in the 20-50 per cent of incomes. Most of those who did **not** use credit did so out of choice (75%). Following the global financial crisis and recession, some lower-income households reported deliberately trying to avoid using credit and to pay down their debts (Ellison et al., 2011).

3.2 What are the characteristics of poor households that use consumer credit?

As discussed above there has been relatively little analysis that focuses on the characteristics of low-income credit users. Analysis of all credit users (across the income range) has identified a number of characteristics associated with credit use which shows that credit users are not evenly spread across the population.

Quantitative studies show that borrowing and use of credit follows a lifecycle pattern with higher use at younger ages (when incomes are likely to be lower) and among families with children (when household financial pressures are likely to be high) (BIS, 2013; Bryan et al., 2010; Finney et al., 2007; Kempson et al., 2004; Kempson, 2002). The arrival of a baby is also linked to higher than average levels of credit use (Kempson, 2002). By age, borrowing is highest among people aged between 20 and 50 and then declines steeply with age, to around four in ten households (37%) aged 55 and over (BIS, 2013), becoming uncommon among households aged 75 and over, at around just one in ten using credit (Finney et al., 2007). Due to student loans, borrowing is particularly high among 18 to 24 year olds, with 53 per cent of people in this age group having unsecured debts of £10,000 or more (BIS, 2013).

Credit use is also associated with changes in income and those with stable incomes have lower than average rates of borrowing (36 per cent compared with 47 per cent of all households). Households who experience both a fall and a rise in income (over a twelve month period) are more likely to be credit users (74%) (Kempson, 2002) and is also associated with heavy credit use in terms of the number of credit commitments (Finney et al., 2007).

Borrowing is also more common in households with small to moderate savings between £500 and £3,000 (Finney et al., 2007). Credit use declines among households with savings above £10,000 and among those with no savings at all (who are likely to also have lower incomes) (BIS, 2013; Finney et al., 2007). This is because those with no savings are more likely to be excluded from the credit market, or may find it too risky to take on credit commitments, while high levels of savings provide an alternative to using credit (Finney et al., 2007).

Home ownership is a 'gateway' to credit use so that people owning a home with a mortgage are more likely to have unsecured credit commitments - estimated at around 6 in 10 households, compared to around half of tenants (Finney et al., 2007; Kempson, 2002).

By ethnicity, credit use is lowest among people from Indian and Pakistani backgrounds as well as those describing their religion as Muslim, with one in four using credit. This is likely to be related to the teaching of Shariah law which prohibits the payment and receipt of interest (Finney et al., 2007).

Attitudes towards spending, saving and credit use are highly predictive of credit use. People with a strong or moderate spending orientation are more likely to use credit. In particular, users of high-cost credit tend to have stronger spending orientations (Collard and Finney, 2013). Favourable attitudes towards using credit are, not surprisingly, associated with a greater propensity to use credit and are a strong predictor of being a heavy credit user (Finney et al., 2007).

3.3 What are the types of credit used by poor households?

As outlined by Ellison et al (2011) the UK credit market is very diverse offering a wide range of products and serving a broad spectrum of risk, whereby those on low incomes are able to access a range of products including home credit, payday loans and rent-to-own credit. A quantitative study of lower-income households (with incomes in lowest 50% of households) showed that the majority wanted to borrow only small amounts. More than half (56%) wanted to borrow less than £500 and one in five (22%) wanted to borrow less than £50 (Ellison et al, 2011).

Among British households as a whole, the most common types of borrowing are credit and charge cards (25%), formal loans (19%) and overdrafts (17%), followed by hire purchase (13%), mail order (8%) and store cards and charge accounts (5%). Informal loans (from friends, family and other individuals) accounted for just over 1 per cent of non-mortgage borrowing (ONS, 2012).

Reflecting this overall pattern of credit use, the most common sources of credit used by the poorest 50 per cent of households are credit cards, formal loans and overdrafts. However, their use of these products is lower compared to households with higher incomes (BIS, 2013; Ellison et al., 2011). Households on lower incomes are more likely than higher-income households to use mail order catalogues, the Social Fund, home credit, pawnbroker loans, payday loans and to borrow from family and friends (BIS, 2013; Collard et al., 2013; Ellison et al., 2011; Kempson, 2002). One study (Ellison et al., 2011) estimated that among credit users in the lowest income quintile around a third (31%) borrowed from friends and family, a quarter used the Social Fund (26%) and 16 per cent used home credit. Similarly, in another study of people living in the lowest quintile of UK household incomes, among households in receipt of benefits, or only part-time or occasional earnings, the Social Fund was the most common source of borrowing, used by a quarter (25%) of these households in the past 12 months[7]. This compared to just 9 per cent who had used mail order and 8 per cent who had used home credit (Collard and Kempson, 2005).

High-cost credit, including home credit, pawnbroker loans and payday loans, represents a minority of overall credit use, estimated at around 2.5 per cent of all households (BIS, 2013), but its users are most likely to be households in the lowest earnings quintile either in low-paid work or dependent on income-replacement benefits (Collard et al., 2013; Ellison et al., 2011). The evidence shows that different types of high-cost credit are used by different types of people (Collard et al., 2013; Ellison et al., 2011):

[7] The Social Fund was abolished in April 2013 - see Section 4.1.4.

- Home credit customers were mostly women on a low income and living in social housing.
- Pawnbroker customers were mostly women, on a low income and living in social housing, but tended to be younger than home credit users and a significant minority were from a non-White ethnic group.
- Nearly all payday loan customers were in paid work, were better off financially than users of other high-cost credit and had a younger age profile. They were also more likely to have mainstream credit.

The literature identifies three main reasons why people use high-cost credit rather than mainstream credit that has lower headline costs (Banks et al., 2012; BIS, 2013; Collard et al., 2013; Ellison et al., 2011; Kempson et al., 2000). One is because they are unable to access mainstream credit due to a history of debt problems, poor credit record, or low income. One study (BIS, 2013) found that 16 per cent of high-cost credit users had had credit card applications rejected and 11 per cent had had Social Fund loan applications rejected. Among those who have mainstream credit, another reason for using high-cost credit is because they have reached or exceeded the credit limit on their mainstream credit commitments (typically credit cards and overdrafts). The third reason is choice, whereby high-cost credit is the preferred option. High-cost credit can be preferred over mainstream credit because it better meets low-income households' needs for borrowing small sums of money over short time periods, it can be quick and easy to obtain, repayments can be more manageable and flexible, and fixed term products gives people better control over their debts as compared to open-ended revolving credit (such as overdrafts and credit cards).

Use of credit union loans is low compared to other types of credit use. One study estimated that just two per cent of households in the bottom 50 per cent of household incomes had used a credit union (Ellison et al., 2011). Compared to users of home credit, credit union customers were better off with fewer dependent on welfare benefits and with slightly higher household incomes. Credit unions were also used by people who made only minimal use of credit.

Users of illegal money lenders are primarily in the lowest income quintile and concentrated in the most deprived communities (Ellison et al., 2011), but it is estimated that only around three per cent of households in the lowest income quintile use them - equivalent to less than 0.5 per cent of the UK adult population (Ellison et al., 2006). Illegal lenders are used when there are no other options available, either because there are no local legal lenders to go to or because credit from legal lenders has been refused (Ellison et al., 2006).

3.4 Why do poor households use credit?

Credit is used to bridge a shortfall between income and expenditure. The evidence identifies three main situations in which credit is used by the general population.

The first is to cover expenditure peaks such as birthdays, Christmas and the start of the school year, and to spread out the cost of major purchases and cash emergencies such as replacing white goods, car repairs and holidays (Collard et al., 2013; Ellison et al., 2011; Gibbons et al., 2011). There is no evidence that shows whether poor households use credit in this way more or less than other households. However, among low-income households a key driver of this type of credit use is not having (sufficient) savings: 83 per cent of households in the lowest income quintile say they would find it difficult or impossible to raise £200-£300 in an emergency without borrowing. Similarly, 88 per cent would struggle to save £500 to fund a special purchase and half (48%) would find it impossible (Ellison et al., 2011).

The second type of credit use is to meet everyday expenses such as food, rent, household bills and clothing (Collard et al., 2013; Gibbons et al., 2011). Where credit is used for these reasons and interest is incurred, this can be a sign of financial stress or difficulty. A survey of the general population (BIS, 2013) showed that nine per cent of households used credit to meet day-to-day living expenses 'all the time', with a further 13 per cent doing so 'once in a while'. A key driver for this type of credit use was an unexpected fall in income, such as job loss, or other change in circumstances that made their financial situation worse (Collard et al., 2013; Finney et al., 2007). There is no evidence as to how this behaviour varies by level of household income, but it is particularly common among users of pawnbrokers and payday loans, where over half of people using these types of credit said they borrowed to meet everyday expenses (Collard et al., 2013).

A third type of credit use identified among high-cost credit customers is to avert financial difficulties such as: paying bank charges for unauthorised overdrafts or bounced payments, falling into arrears with bills or other loans, and to avoid court proceedings for non-payment of bills. This type of credit use is also associated with a major fall in income (Collard et al., 2013) and using (high-cost) credit to pay charges or to repay other credit generally signals financial stress or difficulty. Aside from the fact that high-cost credit users tend to have lower incomes, there is no more detailed evidence about how this behaviour varies by level of household income.

Mainstream loans, revolving credit and home credit are more likely to be used to fund major purchases and expenditure peaks. Home credit is particularly used to fund Christmas, birthdays, holidays and entertainment. Whereas cash advances on credit cards, pawnbroking and payday loans are more likely to be used to bridge cash emergencies to cover everyday expenses and to pay bills (Collard et al., 2013; Ellison et al., 2011).

3.5 What are the impacts on poor households of using credit?

Buying goods and services on credit is more expensive overall than buying them outright. Gibbons et al. (2011) estimate that buying some of the items in the Minimum Income Standard[8] on credit (rather than outright) adds between 1.5 and 18 per cent to a household's weekly budget, depending on the household type and the type of credit used. For a couple with two children the additional weekly cost of buying items such as furniture, electrical goods, Christmas and birthdays on credit could be as much as £31.30 per week if using high cost credit (rent-to-own stores and home credit) compared to £5.12 per week if using a mainstream personal loan.

[8] The Minimum Income Standard for the United Kingdom calculates the weekly cost of the goods and services that households need in order to reach a minimum acceptable standard of living.

In order to make credit repayments, lower-income households may have to cut back on expenditure and curtail living standards (Gibbons et al., 2011; Kempson et al., 1994) including:

- cutting back on food expenditure through buying cheaper brands and lower quality food, and by going without meals;
- going without new clothes;
- reducing expenditure on social activities and not taking holidays; and
- rationing fuel use;
- all of which can lead to stress and anxiety

The extent to which this exacerbates the experience of poverty depends on the level and affordability of repayments. Where credit commitments are small and repayments affordable these impacts are likely to be small. Where credit commitments are large and repayments less affordable these impacts are likely to be larger and increase the risk of falling into arrears.

The impact of credit repayments on low-income households' ability to manage will also depend on the number of credit commitments a household has. Quantitative evidence shows a strong link between the use of consumer credit and being in financial difficulty, with the risk increasing the more credit commitments people have (Kempson et al., 2004; Kempson, 2002). However, this link does not identify the direction of the relationship and the extent to which it reflects the extra strain that borrowing can put on household budgets, or that people who use consumer credit are those most likely to be in financial difficulty anyway (Kempson, 2002).

From the perspective of credit users, the evidence (discussed below) suggests that, for the majority, the overall benefits of using credit and the items or services it enables them to have, outweighs the impact of making repayments and having less money available to spend on other things. There is, however, a significant minority of high-cost credit users for whom credit use has made their financial circumstances worse and who find it difficult to meet everyday needs while also making credit repayments. We lack evidence about how the experience of credit use varies across low-income households, e.g. between households in the bottom income quintile compared to households in the bottom 20 to 50 per cent of households incomes.

In a survey of high-cost credit users (not all of whom would be poor) the majority felt that their financial situation had not changed as a result of using credit (between 66 and 71 per cent) and between 14 and 17 per cent felt better off. Between 11 and 24 per cent felt worse off financially (Collard et al., 2013). Those who felt better, or no worse off, considered their repayment amounts to be affordable, or the loan amount to be very small. Positive impacts were reported as a result of averting consequences such as bank charges, court action or being evicted, and from the benefits of being able to go on holiday or attend a special occasion.

In another study of lower-income households (in the lowest 50 per cent of household incomes), two-thirds of home credit users (67%) felt the overall impact of using home credit was positive. While 30 per cent felt that it was difficult to afford essentials while paying back home credit, 79 per cent could manage their repayments easily with careful budgeting

(Ellison et al., 2011). Similarly, 73 per cent of payday loan customers felt the overall impact of using payday loans was positive. Half of payday loan users (52%) felt they could manage payday loan repayments easily, while 12 per cent felt that it was difficult to afford essentials when paying back a payday loan. A fifth of home credit users (20 per cent) and 15 per cent of payday loan customers felt they had made their financial difficulties worse. In addition, getting a payday loan has been found to compound financial difficulties and trap users in a cycle of credit dependency (Banks et al., 2012; Collard et al., 2013).

Negative impacts of using credit are also discussed in relation to credit cards and overdrafts (Ellison et al., 2011) which are considered to be of potentially higher risk to low-income households than high-cost credit, because the amounts borrowed are larger and because the terms are open-ended. Modelling by Ellison et al. (2011) based on a number of different scenarios found that mainstream credit could be more expensive than high-cost credit when charges for missed payments and over-limit fees were added and as a result of making only minimum payments on revolving credit over an extended period of time. These repayment patterns trapped customers into a long-term cycle of servicing debt they could not pay down, undermining their income on a long-term basis.

The evidence set out in section 3.1 suggests that the majority of low-income households do not use credit. Kempson et al.'s (1994) study of 74 low-income families with children identified two distinct approaches to money management: those who juggled bill payments and used credit; and those who were careful money managers who actively avoided using credit and getting into arrears. Whilst this latter group of families were successful in making ends meet they did so through sacrificing their material welfare by going without essentials such as food, heating and social activities. Although their financial circumstances were stable (as compared to households who used credit and were in arrears) they nonetheless suffered from stress and depression. This suggests that not using credit can also result in material deprivation for some low-income households, if they are unable to meet expenditure peaks or pay for major purchases.

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4 Policy and practice interventions and their impact on poverty

This chapter reviews the evidence on a range of policy and practice interventions and the extent to which they might help reduce or prevent poverty. We focus on five main types of interventions: financial products; credit regulation; financial capability and skills; debt advice and support; and debt solutions.

4.1 Products for low-income households

The types of products that might help reduce or prevent poverty include small-sum loans; rent-to-own credit; insurance; the discretionary Social Fund; and budgeting accounts.

4.1.1 Small-sum loans

Research shows that the most appropriate source of credit for people on low incomes is small, short and fixed-term loans, but the likelihood of mainstream banking providers lending small sums directly to financially excluded and low income households is extremely low (OFT (2010) Review of High Cost Credit: Annex C, cited in Kempson and Collard, 2012). The Financial Inclusion Taskforce found that banks had no appetite to enter the market for small value loans (Financial Inclusion Taskforce, 2010) because it was not commercially viable. Banks also felt that credit unions and other not-for-profit lenders were better-placed to provide these loans (Financial Inclusion Taskforce, Third Sector Credit Working Group, undated).

There have been a number of pilot schemes that have sought to deliver affordable small-sum loans as an alternative to high cost credit and payday loans. These are described below, but, apart from an impact assessment of the UK's DWP Growth Fund, there is a lack of robust evidence as to their impact on low-income households and their experience of poverty.

The **DWP Growth Fund** provided loan capital to third sector lenders, mainly credit unions and community finance development institutions (CDFIs) to lend to financially excluded households. In doing so, the Growth Fund aimed to disrupt the role of high cost credit in the lives of borrowers. It also provided revenue to support the delivery of loans and funding to develop the capacity of third sector lenders.

Between July 2006 up to the end of September 2010, 317,798 Growth Fund loans were made in deprived communities, with a total value of over £137 million. Analysis of the survey data indicates that 79 per cent of Growth Fund borrowers were in the two lowest income quintiles (Collard et al., 2010).

The average value of a Growth Fund loan was £478 and the majority of loans (93 per cent) were provided at an APR of 28 per cent or less. In addition to affordable loans, most lenders offered savings accounts and some offered bank accounts. The evaluation found that 29 per cent of Growth Fund applicants had savings in a savings account, whereas previously they had none; and 13 per cent of banked applicants had a bank account as a result of their contact with a Growth Fund lender (Collard et al, 2010).

An impact assessment of the Growth Fund (based on analysis of Growth Fund borrowers and a matched comparison group living in deprived non-Growth Fund areas) estimated total interest savings per Growth Fund borrower of between £377 and £425 over the lifetime of their current credit obligations. Among the other reported outcomes, 39 per cent of successful applicants felt their money management skills were better since they had started using a Growth Fund lender. Similar proportions said they felt more in control of their finances (41 per cent); more financially secure (39 per cent) and less worried about money generally (37 per cent) (Collard et al., 2010).

Following the Growth Fund evaluation, a feasibility study was conducted into the expansion and modernisation of credit unions (DWP Credit Union Expansion Project, Project Steering Committee, 2012). This in turn resulted in DWP awarding a contract worth £38 million to ABCUL (the largest credit union trade association) in April 2013, to modernise and expand the credit union sector. ABCUL aims to have up to one million more credit members by 2019, and for credit unions to offer a wider range of financial services alongside personal loans (DWP and HM Treasury, 2013).

Linked to this, to give credit unions greater flexibility in their lending decisions from April 2014 they are able to charge 3 per cent per month interest on a reducing loan balance (around 42.6% APR), up from 2 per cent per month (ABCUL, 2013).

The **US Small-Dollar Loan Pilot Program** (FDIC, 2010) sought to test the feasibility of banks offering affordable small loans as an alternative to high-cost credit products such as payday loans and fee-based overdrafts. Thirty banks participated in the two year pilot from 2008 to the end of 2009. The average loan was $700 (USD) taken out over ten to twelve months. The maximum APR banks could charge was 36 per cent (including set up fees). A key finding from the pilot was that ninety days was the minimum loan term needed for borrowers to repay their loan. The loans were not always profitable in the short-term, but were used by banks as a business strategy to develop or retain long-term relationships with customers and to generate long-term profitability by using small dollar loans to cross-sell additional products. However, there is no evidence as to how successful the loans were from the borrower's perspective.

A pilot by **London Mutual Credit Union** (LMCU) (Evans and McAteer, 2013) to deliver **affordable payday loans** at an APR of 26.8 per cent and that allowed borrowers to pay over longer periods and did not apply additional fees or charges for missed payments or early repayments, had high levels of customer satisfaction. The pilot adopted a 'loss leader' model (due to the cap on interest rates that credit unions can charge), but with the aim of attracting new members under the payday loan banner who would become long-standing members and go onto use other services. Although the pilot had generated an overall loss at the end of the 12 month evaluation (an average of £2.30 per loan), it was projected that when all new members, many of whom went on to take out other loans and to accumulate savings, had been with the credit union for nine months, the pilot would realise an overall profit (£3.06 per loan), making the model financially sustainable. Whilst showing potential to deliver a viable alternative to payday loans, the eligibility criteria of earning more than £12,000 per annum would preclude low-income households in receipt of out of work benefits or in low-paid part-time work.

Home credit comes close to meeting the needs of low-income households in terms of borrowing small amounts of money that is quick and easy to access, has weekly repayments and does not penalise borrowers for missed payments (Collard and Kempson, 2005). Research to model the feasibility of a **not-for-profit home credit** service (Kempson et al., 2009) concluded that whilst in theory it was possible to develop such a service, there were too many practical obstacles to make it viable, particularly in terms of who would deliver it. There was limited interest among credit unions and community development financial institutions due to the high APR that would need to be charged and the risk it would pose to their financial sustainability due to potentially high levels of default. Furthermore, a not-for-profit home credit service would still be relatively high cost, charging an APR of over 120 per cent to break even and would only be slightly cheaper to customers (£1/week on an average 56 week loan of £288) than commercial home credit providers.

In Australia the delivery of affordable small-sum loans to low-income households is well-established. **Good Shepherd Microfinance**, Australia’s largest microfinance organisation, delivers (through accredited local community groups) a **No Interest Loan** Scheme (NILS) as well as a **low interest loan** (StepUP) to people on low incomes who are excluded from affordable mainstream credit (Good Shepherd Microfinance, 2013).

NILS has been running for 30 years and provides loans of up to $1,200 (AUSD) with a repayment period of between 12 and 18 months. NILS is a circular community credit scheme with loan repayments used to fund loans to other people. Use of NILS Loan is restricted to the purchase of essential household goods and services such as household appliances and furniture, some medical and dental services and educational essentials such as computers and text books. Launched in 2004, StepUP loans are not-for-profit loans available for amounts up to $3,000 (AUSD) with repayments made over six months to three years. The loan is provided by the National Bank of Australia and accessed via community providers. The interest rate charged is 3.99 per cent APR with no additional fees or charges. StepUP loans, in addition to the purchase of essential goods and services, can also be used for buying cars, car repairs and house repairs. Applicants and loan recipients are supported by microfinance workers.

Good Shepherd Microfinance (GSM) is financially supported in the provision of NILS and StepUP loans by Federal and State governments and the National Bank of Australia. In 2012/13 GSM received over $1 million AUD dollars from the National Bank of Australia and $153,000 AUD dollars from the Queensland Government (Good Shepherd Microfinance, 2013a). This financial support covers costs including defaulted loans, administration costs and funds the employment of microfinance workers.

The NILS and StepUP programs are designed to improve the material and social wellbeing of borrowers, but as yet there has been no robust evaluation of their impacts. Self-reported improvements among some recipients of StepUP loans include improved living conditions and quality of life, financial confidence and self-esteem; and reduced levels of stress and anxiety (The Centre for Social Impact, 2013; Mouy, 2010).

4.1.2 Rent to Own

The rent-to-own market (such as BrightHouse) has expanded rapidly over the past few years (Ellison et al., 2011). Customers make weekly payments for household items under a rental agreement, after which they have the option to purchase the goods. Although not classed under 'high-cost credit', the cost of purchasing goods via rent-to-own is considerably more expensive than buying goods out-right on the high street due to: cash mark-ups on high street retail prices, interest charged on the rental agreement, and the cost of insuring goods against fire and theft during the rental agreement (Gibbons, 2012).

'The Store', based in County Durham and set up by a partnership between Derwentside Homes, Social Housing Enterprise Durham and Prince Bishops Community Bank, was designed to provide an affordable alternative to commercial rent-to-own shops. Estimated to be around 40 per cent cheaper than other for-profit rent-to-own stores, The Store charges customers an administrative fee of £95 per loan and a 24.19% APR.

Evaluation of The Store's business model concluded that with some pricing adjustments and sales growth it could be both sustainable and replicable (Alexander and Grimes, 2013). In 2012, The Store sold £165,000 worth of goods to 373 individuals, with most customers paying weekly over a 104 week rental term (ibid.). However, a potential limitation of The Store in terms of providing access to affordable credit for low-income households is that, in order to be sustainable, its business model is based on keeping arrears to 10 per cent or less. As a result, two-thirds of The Store's applicants were rejected, mostly because of County Court Judgements or defaults on other payments (ibid.).

4.1.3 Insurance

Insurance has been a focus of financial inclusion policy and the work of the Financial Inclusion Task Force in terms of promoting appropriate and affordable home contents insurance to low-income households, particularly social housing tenants (Financial Inclusion Task Force, 2008; Kempson and Collard, 2012). Analysis has shown that far fewer households in the lowest income quintile have home contents insurance (less than half), even though they tend to live in areas with higher crime rates and are at greater risk of being burgled (Centre for Social Justice, 2013; Kempson and Collard, 2012).

There have been a number of studies exploring the issue of home contents insurance for low-income households, including:

- The barriers to take-up (Ipsos MORI, 2007; Collins, 2011).
- Feasibility studies into the delivery of affordable home contents insurance (Dayson et al., 2009; Good Shepherd Microfinance, 2013).
- Evaluations of schemes delivered in partnership between social housing providers and insurance companies to develop appropriate

and affordable products for tenants (Aynsley, undated; Toynbee Hall, 2005; Alexander, 2011).

However, there is no robust evidence on the longer-term impacts of taking out home contents insurance on low-income households' finances or experience of poverty. An evaluation of the DWP Financial Inclusion Champions Initiative (Signoretta et al., 2011) included a small number of qualitative interviews with social housing tenants who had taken out home contents insurance through their housing provider. It found that the most widely perceived benefit of having insurance was peace of mind, and for some existing insurance policy holders it had reduced their outgoings as a result of being able to access cheaper cover.

4.1.4 The Discretionary Social Fund

Prior to its abolition in April 2013, the discretionary Social Fund (providing Community Care Grant, Budgeting Loans and Crisis Loans) was a key source of financial assistance for those who were eligible to apply. Non-repayable Community Care Grants were intended to help people in specific circumstances to live independently in the community. Interest-free Budgeting Loans were designed to cover the cost of large intermittent expenses such as replacing household appliances, furniture and clothing. Crisis Loans, also interest-free, were designed to assist people with an emergency or disaster where short-term needs could not be met. Crisis Loans were also paid to new claimants whilst they were waiting for their first payment of benefits - known as 'alignment payments'. Budgeting and Crisis Loans were repaid directly by deducting the money from benefit payments.

In 2010/11 over 1.1 million Budgeting Loans, more than 2.6 million Crisis Loans and over a quarter of a million Community Care Grants were awarded, totalling over £815 million (DWP, 2011). The amount of financial assistance given in Budgeting Loans (£446 million) greatly exceeded the amount spent on Crisis Loans (£228 million) and Community Care Grants (£141 million), although much of the money spent on Budgeting Loans is recovered from repayments.

Demand for Social Fund loans and grants outstrip the available cash-limited resources. Fewer than half of Community Care Grant applicants (42 per cent) received an award at the initial decision stage, compared to around three-quarters of Budgeting and Crisis Loan applicants (70 and 78 per cent respectively) (DWP, 2011). In qualitative research with Social Fund applicants their main experience was of being refused an award or of receiving an award below the amount they applied for that did not meet their needs (Legge et al., 2006). Despite various criticisms of the Social Fund (for example, Legge et a.l, 2006; Kempson and Collard, 2012) it has provided financial support to low-income households on a relatively large scale.

Under the abolition of the discretionary Social Fund, funding for Crisis Loans (not including alignment payments) and Community Care Grants was passed onto local authorities and the devolved administrations to deliver new localised schemes. While it is too early for the impact of these changes to have been evaluated, initial analysis of the new support models (Gibbons, 2013) suggests that fewer people will be able to access financial help. The system of Budgeting Loans is largely unchanged and delivery remains with DWP. 'Budgeting Advances' replace Budgeting Loans for Universal Credit claimants, while Budgeting Loans continue to be available to those on legacy benefits who have not yet moved onto Universal Credit. Budgeting Advances will '*ensure that those with the lowest incomes claiming Universal Credit will continue to have access to an interest-free alternative to high-cost lending for emergency and unforeseen expenses*' (DWP, undated).

Budgeting Loans and Budgeting Advances meet the needs of low-income households in terms of providing low-cost, small, fixed-term loans to help meet periodic and lumpy expenditure. However, the introduction of Budgeting Advances does not resolve the problems associated with Budgeting Loans because loans are still only available to people who have been claiming qualifying benefits for at least 26 weeks; and being a discretionary, cash-limited scheme, a significant proportion of applicants are turned down or do not receive the full amount.

Budgeting Loans have also been criticised for their high repayment rates (Legge et al., 2006; Kempson and Collard, 2012). Under Budgeting Advances there is a risk that this may worsen, with maximum loan periods reduced to 12 months compared to 24 months for Budgeting Loans. Thus, while Budgeting Advances and Loans are a no-cost form of credit, they may not necessarily be affordable in terms of the weekly or monthly repayment amount. The other main change under Budgeting Advances is that claimants will be limited to having just one loan at a time (DWP, undated).

4.1.5 Budgeting Accounts

While there has been significant success over the past decade in increasing banking inclusion it is estimated that there are still over a million people who do not have access to a transactional bank account (Financial Inclusion Taskforce, 2010). Research also shows that the standard transactional account model does not work for everyone, with a one in five failure rate (that is accounts being closed or no longer used) among people who have recently opened a new bank account (Ellison et al., 2010). Furthermore, many low-income households who have a transactional bank account do not make full use of its facilities, particularly in relation to electronic payment methods.

Those who do not have a transactional bank account (the unbanked) have the lowest incomes and include high proportions of people in receipt of state benefits and social housing tenants. Among the newly banked, those who benefit least from having a bank account share a similar profile to the unbanked in that they have the lowest incomes, are more likely to be in receipt of state benefits, live in social housing, and be struggling with arrears on household bills and meeting credit repayments (Ellison et al., 2010).

For low-income households a key barrier to opening and maintaining a bank account is the risk of incurring costly penalty charges for exceeding overdraft limits and failed direct debits, which can outweigh any benefits of using an account. Also, setting up direct debits to pay bills on a fixed monthly basis does not fit with low-income households’ preference for managing money over a shorter time frame (on a weekly or fortnightly basis) and their need for flexibility in juggling bill payments when money is tight.

Budgeting, or 'jam jar', accounts have received particular interest as a potential option for meeting the needs of low-income households (Social Finance, 2011; Williams, 2012). DWP is also interested in these types of accounts (DWP, 2012) as a means of helping claimants manage their money under the new Universal Credit payment arrangements, where claimants will receive their benefit in a single monthly lump sum payment (that includes money for housing costs).

These accounts automatically separate income into different 'jars' within the account for paying regular bills and for day-to-day spending, so that money allocated to bills is protected and cannot be spent on other things. Any money left over in the day-to-day spending 'jar' can be automatically moved into a savings 'jar'. The benefits of budgeting accounts are that they prevent customers from spending more than they have, they do not charge penalty fees and are available to people with poor credit histories. Their disadvantages are that they are currently offered by only a few providers and customers are charged monthly for their use. A review of bank account provision in the UK, Europe and United States (Social Finance, 2011) found that most bank accounts do not offer budgeting features. In the UK there were four providers of accounts with jam jar features and one in the US (PNC Virtual Wallet).

Despite this interest in budgeting accounts, there has not yet been any in-depth research conducted on the experiences of people with budgeting accounts and whether they meet low-income households' needs in terms of day-to-day budgeting and money management and whether they help people to stay out of debt and arrears.

4.2 Credit regulation

We noted earlier (section 3.3) that users of high-cost consumer credit tend primarily to be people on low incomes. The National Audit Office found that high-cost credit users were vulnerable to unscrupulous practices by licensed lenders because of their lower than average incomes, but also because of their lower financial understanding (NAO, 2012; OFT, 2010). It estimated that, across the UK credit market as a whole, unscrupulous behaviour by credit firms cost consumers at least £450 million in 2010-11, with the most vulnerable consumers potentially most at risk (NAO, 2012). It concluded that a far tighter regulatory regime would be required under the Financial Conduct Authority (FCA), which will be responsible for consumer credit from April 2014. Others have similarly called for tighter credit regulation, particularly in relation to high-cost credit and payday lending specifically, in order to better protect consumers in vulnerable situations, such as on low incomes, and so reduce consumer harm (Hirsch, 2013).

Two issues of credit regulation seem most directly associated with poverty. First, irresponsible lending can push people on low incomes into financial difficulty and so deepen their experience of poverty, because they are enabled or encouraged to borrow more than they can afford to repay. Recent studies have highlighted concerns about the affordability assessments conducted by payday lenders (OFT, 2013; Which?, 2013) and online payday lenders in particular (Collard et al., 2013). Also worrying was the fact that lenders generated significant revenue from payday loans that were refinanced or rolled over because borrowers were unable to repay what they owed when the money fell due (OFT, 2013).

Better regulation and enforcement of responsible lending could therefore prevent people on low incomes taking out loans they cannot afford to repay, by ensuring that all lenders carry out adequate checks of affordability before extending a loan, and by restricting or banning the refinancing or rolling over of payday loans.

Second, a reduction in the cost of high-cost credit would make it cheaper for people on low incomes to borrow money. This is the intention of a cap on the cost of credit. The FCA has the power to introduce an interest rate cap. In November 2013, the Chancellor of the Exchequer also announced plans to introduce a cap on the total cost of payday loans (covering the interest but also other charges such as default fees) as part of the Banking Reform Bill[9]. The level of the cap on the total charge for payday loans will be decided by the FCA and the cap implemented from January 2015.

The evidence on the impact of caps on the cost of credit for borrowers relates to interest rates caps, which exist for example in many European countries, Australia and the US. A study conducted for the UK government concluded that the evidence did not show unequivocally that interest rate caps reduced the cost of borrowing for customers,

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[9] 'Government to cap payday loan costs', HM Treasury News Story, 25.11.13, www.gov.uk/government/news/government-to-cap-payday-loan-costs [accessed 18.12.13]

particularly those on low incomes. There was no evidence about the proportion of customers who actually paid less for high-cost short-term credit after interest rate caps were introduced in a credit market than they did before (Collard et al., 2013).

The empirical evidence that credit price restrictions result in an increase in illegal money lending is mixed. No studies have examined the levels of illegal lending directly before and after the introduction of credit price restrictions. One research study compared the levels of illegal money lending in countries with and without interest rate restrictions (Policis, 2004). It found higher levels of illegal lending in France and Germany (which both have interest rate restrictions) than in the UK (which does not have an interest rate cap). Taking into account this research and stakeholder interviews conducted in EU members states, a study for the European Commission found inconclusive evidence that interest rate restrictions lead to a substantial illegal market in credit (iff/ZEW, 2010).

Elsewhere, experiential evidence from the US (such as market evidence, expert or stakeholder opinion which may be anecdotal and unsubstantiated) indicated that that a clamp down on (licensed) online payday lenders in one US state (Pennsylvania) led to a proliferation of unlicensed online lending. There was also anecdotal evidence that, following a clamp down on payday lenders in Pennsylvania, consumers crossed state borders to obtain payday loans (OFT, 2009).

There was evidence, however, that interest rate caps resulted in smaller lenders exiting the market, while those that remained tightened their lending criteria and improved risk assessment. This resulted in reduced access to credit for some, particularly people on low incomes, but also a potential reduction in the proportion of people who were unable to repay their loan as they should (Collard et al., 2013). These effects do not seem to have been quantified, however.

4.3 Financial capability and skills

The term financial capability covers people's knowledge, understanding, skills and confidence to deal with financial matters. There have been numerous financial education and training programs in the UK designed to improve the financial capability of a range of groups, including people on low incomes, social housing tenants, the unemployed and the financially excluded.

An international evidence review of over seventy evaluations of financial capability initiatives (Atkinson, 2008) concluded that the evaluation evidence is not sufficiently robust to show whether and how financial capability training makes a difference, or how best to deliver it. Similarly a US review of 41 evaluations of financial education and counselling programs (Collins and O'Rourke, 2010) concluded that the evaluation evidence was inconclusive and that better studies were needed. Methodological flaws in the design of evaluations include:

- Selection bias (due to a lack of a randomised control group) whereby those who engage in financial education programs are the most motivated and future-orientated people contributing to over-estimation of positive impacts.
- A reliance on self-reported measures that may not reflect actual behaviour.
- A lack of longitudinal data where short follow-up periods may not capture lasting outcomes.

- A lack of an explicit theory or framework of change whereby some outcomes could be statistically significant due to random chance alone.

Evaluations conducted as part of the Citizens Advice Financial Skills for Life partnership (Rocket Science, 2012; Rocket Science, 2011; Widdowson, 2009; NIACE, 2008; ECOTEC, 2006) all suggest positive impacts on participants in relation to: improved financial confidence and knowledge, better money management, payment of debts, increased saving, opening of bank accounts and reduced stress. However, the evaluations evidence lack quantifiable impact measures.

A more robust evaluation of a financial skills training program delivered to social housing tenants, that included a comparison group, showed positive impacts that could be attributed to the training, although the sample sizes were small (Collard et al., 2012). Participants were seven times more likely to take some kind of action than the comparison group. Actions taken included: changes to money management and spending, saving or saving more, changing bank accounts or opening a credit union account, and improvements in financial confidence.

Overall, the evidence suggests that financial capability training can make a positive difference, it is just that the evidence for this is not (yet) sufficiently robust. A large-scale programme led by the World Bank to evaluate initiatives to enhance financial capability in low and middle-income countries aimed to address this evidence deficit. Of ten completed evaluations (most of which involved a randomised control trial and all but one targeted at adults), three indicated evidence of effectiveness, six showed mixed evidence of effectiveness and one showed evidence of a lack of effectiveness (World Bank, 2013).

4.4 Debt advice and support

A number of UK research studies report positive impacts of debt advice that help to ameliorate the impacts of poverty. Although the studies did not focus specifically on poverty, nonetheless most of the advice users represented in the research had low incomes. In addition, the studies reported here all involved users of free-to-client debt advice services.

The evidence showed two financial benefits that service users may achieve through debt advice. The first was increased income, generally from benefit income maximisation (Pleasence et al., 2007; Gillespie et al., 2007; Buck et al., 2009; Dayson, undated). For example, analysis of administrative data for financially excluded advice users who had received a lump sum payment showed that the average one-off amount they got was £1,362 (Buck et al., 2009). Other types of financial help that advice users may gain as a result of debt advice included trust fund awards to pay off utility arrears (Dayson, undated).

The second financial benefit of debt advice was a reduction in the amount owed by individuals to their creditors, either through repayment arrangements or debt write-off negotiated by advice services (Evans and McAteer, 2011; Buck et al., 2009; Orton, 2008; Pleasence et al., 2007). One survey of debt advice users found they owed on average £7,585 less after advice (Pleasence et al., 2007). Among financially excluded advice users who had pursued debt write-off, analysis of administrative data showed the average amount written off by creditors was £11,516 (Buck et al., 2009).

Other benefits of debt advice include self-reported improved financial circumstances (Optimisa Research, 2013; Orton, 2008). In a randomised control trial of the offer of debt advice, debt advice users reported improvements in their financial circumstances that were over and above those experienced by a control group of people with problem debt who did not receive advice (Pleasence et al., 2007; Pleasence and Balmer, 2007). Advice users also reported improved understanding of their finances; and feeling better able to cope with their financial situation (even if their debt problems were not fully resolved) (Orton, 2008; Pleasence et al., 2007).

There is no evidence that debt advice enables low-income households to escape poverty. A longitudinal qualitative study found that low-income debt advice users continued to have low incomes in the two years following advice; none of them had started to save, and over half of the 53 advice users in Year 3 of the study had borrowed money between Years 2 and 3 (Orton, 2010).

A small number of UK studies have looked at the costs and benefits of debt advice and find evidence that the benefits outweigh the cost of advice. Using rent data for tenants from three London social landlords that had received debt advice and a control group of tenants from a fourth London landlord that had not (but that had at least six weeks rent arrears), one study estimated that the average arrears for the control group was £1,400 but would have been £1,040 had they received debt advice, representing a potential benefit of £360 per tenant. It also estimated that landlords saved on average £139 per tenant in relation to the associated costs of pursuing rent arrears and taking action (Evans and McAteer, 2011). Another study focused on one social landlord found that tenants were likely to exit the landlord's in-house debt advice service on average £1,300 per year better off. After taking into account delivery costs, the return on investment per beneficiary was estimated to be over £1,100 (Dayson, undated).

Although it will not necessarily impact directly on poverty, how creditors respond to people in financial difficulty can affect the debt repayment arrangements that are agreed and, in turn, the level of disposable income that people are left with on a weekly or monthly basis. A number of studies have found that creditors either would not accept the reduced repayment offers made by people in financial difficulty (Collard, 2013) or else pressured people in debt to increase their repayments once a repayment arrangement had been set up (Hartfree et al., 2012; Lending Standards Board, 2011). Customers in similar circumstances were also treated differently by the same creditors in relation to the cessation or continuation of interest and charges on arrears (Lending Standards Board, 2011), which could impact significantly on people's ability to reduce the overall amount they owed.

4.5 Debt solutions

There is a range of debt remedies available to debtors to resolve problem debt. Formal insolvency solutions in England, Wales and Northern Ireland include bankruptcy, Individual Voluntary Arrangements (IVAs) and Debt Relief Orders (DROs) where debts remaining at the end of the period are written off. In Scotland the equivalent solutions are sequestration, Trust Deeds and LILA (sequestration for people with low income and low assets). There are also informal debt remedies, such as debt management plans and token payments, where debtors and creditors reach an agreement, although these are not legally binding and do not guarantee the cessation of further enforcement action or that interest and other charges will be stopped (Collard, 2009).

In 2012, there were almost 110,000 individual insolvencies in England and Wales. Of these, the most common type of insolvency was IVAs (43%), followed by bankruptcy (29%) and DROs (28%). In Scotland, over the same time period, there were 18,000 individual insolvencies of which the most common was Protected Trust Deeds (48%), followed by sequestrations (non-LILA route) (31%) and LILA (21%) (The Insolvency Service, 2013). Looked at as a proportion of the population, the BIS 2012 DebtTrack survey showed that less than 0.5 per cent of its sample of British households had been declared bankrupt in the last two years, while one per cent had a current IVA and five per cent had a debt management plan (BIS, 2013).

Both DROs and LILA are relatively new debt solutions aimed at low-income households. Introduced in April 2009, DROs are targeted at people who do not own their own home, have little surplus income and assets, and debts of £15,000 or less. Prior to their introduction the only debt relief solution available to debtors with no assets or surplus income with which to repay their creditors was bankruptcy (The Insolvency Service, 2010). The cost of entering into a DRO (£90) is also much cheaper than the costs charged for bankruptcy (£700). Introduced in

Scotland in April 2008, LILA was similarly intended to provide debt relief to people who had too few assets to contribute to a trust deed or to petition for bankruptcy. LILA introduced a new route into bankruptcy for debtors with low incomes (earning no more than the national minimum waged based on a 40 hour working week), with no property and total assets worth no more than £10,000 (Accountant in Bankruptcy, 2009). Debtors must have a minimum of £1,500 total debt to apply, but there is no upper debt limit. The application fee is £100.

Analysis of both DRO and LILA applicant data and the high number of applications indicates that they provide low-income households with a route into debt relief that was not previously available to them (Accountant in Bankruptcy, 2009; The Insolvency Service, 2010). Of those entering LILA, 99 per cent were unemployed, as were over half of people granted a DRO. Refusal rates are also low: in their first year of operation less than one per cent of DRO applications and only 3.5 per cent of LILA applications were refused. However, in Scotland stakeholders have raised concerns that the LILA criteria deny debt relief to people with incomes just above the low income threshold (Accountant in Bankruptcy, 2009).

There is very little published research on the impacts of debt solutions on individuals in terms of their finances, well-being and access to financial services. A small survey of bankrupts (Tribe, 2006) indicated mixed effects of bankruptcy on individuals. Respondents reported negative effects on family relationships, feelings of shame and failure, and difficulties in accessing bank accounts and credit, but positive effects on family relationships were also reported with bankruptcy alleviating stress. The findings also suggested that the experience of bankruptcy can change attitudes towards borrowing with many not wanting to use credit again.

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5 Summary, Conclusions and Policy Implications

The basic definition of poverty used by JRF in its anti-poverty strategy is 'When a person's resources (mainly their material resources) are not sufficient to meet their minimum needs (including social participation)'. The research described in this review was not necessarily carried out from a poverty perspective. This review therefore includes research evidence that either defined poverty in different ways to JRF (typically on the basis of low income, itself defined in different ways) or did not include a specific definition of poverty.

5.1 Debt and poverty

For the purpose of this review, 'debt' was defined as problem debt, which describes a situation where individuals are unable to make contractual payments on consumer credit or household bills. Although the review did not find any studies that explored the extent and characteristics of debt amongst households in poverty, key findings from the review show that:

- Low-income households are more likely to experience financial difficulties and problem debt than higher-income households.
- The characteristics of households with problem debt reflect those associated with low income and poverty, namely being a tenant (particularly a social housing tenant), not being in work (excluding retirement), working only part-time or in low status occupations.
- Low-income households are more likely to be in arrears on household bills than in arrears on consumer credit.

A lack of longitudinal quantitative data on debt amongst low income households (or on any other measure of poverty) means that it is not possible to definitively ascertain the extent of, or the direction of, a causal relationship between poverty and problem debt. The evidence that is available shows that low income and problem debt are correlated with each other, but there is no evidence that problem debt causes poverty. Therefore, this leads us to view problem debt as a consequence of poverty. Low income, as underlying factor, means that household finances are precarious whereby drops in income or increases in expenditure, often as a result of life events (such as having children, relationship breakdown) or unforeseen events (such as job loss, emergency expenditure) can lead to financial difficulties and problem debt. Once in problem debt, making repayments can further reduce living standards and low-income households can find it very difficult to get back to a more stable financial situation.

5.2 Credit and poverty

For the purpose of this review, 'credit' was defined as non-mortgage consumer credit. High-cost credit includes home credit, pawnbroker loans and payday loans. Again, although the review did not find any studies that explored the extent and characteristics of credit use amongst households in poverty, key findings from the review show that:

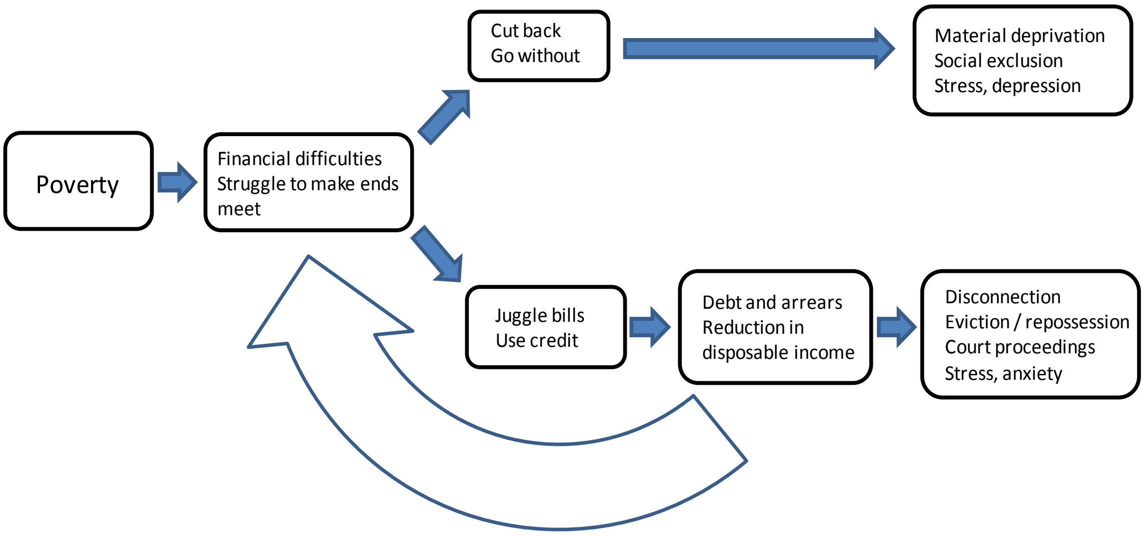
- Low-income households are less likely to use consumer credit than higher-income households and those who do not use credit largely do so out of choice.
- High-cost credit represents a minority of overall credit use, but users of high-cost credit are most likely to be households with the lowest incomes.

- High-cost credit is used when households are unable to access mainstream credit, but also out of choice because it better meets low-income households needs for small-sum short-term loans.

Whilst buying goods and services on credit is more costly overall than buying them outright, for the majority of low-income credit users the impact of using credit is generally a positive one. Credit enables households to afford things that they would not otherwise be able to buy. This is not to ignore, however, the evidence that for some households using credit is detrimental to their financial circumstances and living standards and can make difficult situations even worse. However, for low-income households who do not use credit, managing money carefully and avoiding arrears can also be detrimental to their living standards.

The diagram below illustrates the relationship between poverty, debt and credit and the impacts on low-income households.

Figure 1 The relationship between poverty, debt and credit



5.3 Implications for a UK-wide anti-poverty strategy

The evidence highlights two key issues for low-income households: their vulnerability to drops in income and to peaks in expenditure, both of which put them at greater risk of problem debt. Overall there is a lack of robust evidence about the effectiveness of interventions and cost-benefit analyses which makes it difficult to set priorities for an anti-poverty strategy, but, based on the evidence that is available, we suggest a number of policy and practice interventions to be included in an anti-poverty strategy. These recommendations may change over time if more evidence of impact and cost-benefit analyses becomes available.

Debt Advice: To address the issue of problem debt the empirical evidence indicates a strong case for an anti-poverty strategy to include access to debt advice that is impartial and free at the point of use. What cost-benefit analyses exist suggest that the benefits of debt advice outweigh the costs. While there is no evidence that debt advice helps lift people out of poverty (or prevents them falling into poverty), nonetheless the positive financial outcomes include increased income through income maximisation and a reduction in the amount owed to creditors.

Affordable small-sum loans: Greater access to affordable small-sum loans could help low-income households to cope with both peaks in expenditure and to cover everyday expenses following an unexpected fall in income. Cash loans also provide more flexibility in purchasing household items than a low-cost rent-to-own scheme.

There is evidence (in particular from the DWP Growth Fund) of the positive financial impacts of small-sum loan schemes delivered by not-for-profit lenders such as credit unions, in the form of reduced interest payments (compared to for-profit lenders) and access to other financial services. Not-for-profit lenders may also help mitigate the reduced access to credit caused by a cap on the total cost of credit (see below). For these reasons, there is a case for recommending increased access to affordable loans through not-for-profit lenders in an anti-poverty strategy.

That said, the evidence raises two main concerns about the delivery of small-sum loans by not-for-profit lenders. Even on a not-for-profit basis, to be financially viable loan interest rates would need to be higher than the current interest rate cap on credit unions. They would also need to be accessible to people not in employment and with poor credit histories which would increase the likely level of loan defaults, raising further the level of interest rates that would need to be charged. The credit union expansion and modernisation programme and the increase in the credit union interest rate cap to three per cent per month from April 2014 should place credit unions in a better position to offer affordable loans to more people on low incomes, but to protect their financial sustainability there remains a potential risk that low-cost loans may not be made available to those with poor credit histories. The other concern is the extent to which credit unions can expand sufficiently in the short to medium term to match the volume of loans provided by the discretionary Social Fund and for-profit lenders.

The alternative delivery model is a national scheme such as the former discretionary Social Fund and the Australian No Interest Loan Scheme (NILS) which provide small sum loans to low-income households with no interest charged. A main barrier to extending such a scheme in the UK is cost. In Australia NILS receives significant funding from the National Bank of Australia as well as government support. Due to demand far exceeding the available resources, many people who applied for a Social Fund Budgeting Loan were unsuccessful and qualifying restrictions meant they were not accessible to people who had been in receipt of benefits for less than 26 weeks. Both Social Fund Budgeting Loans and NILS have restrictions on what loans can be used for. Given the recent withdrawal of the discretionary Social Fund, a nationally provided no interest loan scheme that is widely accessible seems an unrealistic proposition.

Credit regulation, and more importantly better enforcement of credit regulation, can help prevent people getting into financial difficulty. This applies especially to tighter affordability assessments and the enforcement of responsible lending, where better lender practice could make sure that people on low incomes only borrow what they can afford to repay. Although the costs and benefits of credit regulation have not been quantified, it may nonetheless be appropriate to include this fundamental issue in an anti-poverty strategy.

Debt Solutions: While we lack evidence about the wider impacts of Debt Relief Orders and Low Income Low Asset Bankruptcy, these debt solutions provide low-income households with a route into debt relief that was previously not available to them. The inclusion of appropriate debt solutions for people on low incomes therefore seems warranted in an anti-poverty strategy.

The vulnerability of households to income shocks also suggests a role for the promotion of **savings** (covered by another evidence review) to provide a financial cushion for households whilst they adjust to their new circumstances. It also suggests a need for people to be able to access information and support at the point of experiencing (or anticipating) an income drop that might help them to cope better and prevent arrears and unsustainable credit use. This type of **preventative money guidance** is provided in the UK through the Money Advice Service, although its target audience is the general population rather than specifically people in poverty. Preventative money advice and guidance was not an intervention covered by this review and evidence as to its effectiveness would need to assessed before recommending its inclusion.

For-profit lenders such as pawnbrokers, home credit firms and payday lenders provide low-income households with access to small-sum loans - but at a high cost. The planned cap on the total cost of payday loans is intended to prevent excessive charges and so should make payday loans cheaper for those still able to borrow. However, as the impact of the FCA's cap on payday loans will not be known for some time and evidence from other countries that have introduced a cap is equivocal, we do not recommend including price restrictions in an anti-poverty strategy at the present time.