Profiting from Poverty

Why debt is big business in Britain

Henry Palmer
with Pat Conaty

A NEF Pocketbook

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New Economics Foundation
Cinnamon House, 6–8 Cole Street
London SE1 4YH, United Kingdom

Registered charity number 1055254

Tel: +44 (0)20 7089 2800
Fax: +44 (0)20 7407 6473
Email: info@neweconomics.org
Web: www.neweconomics.org

Executive Director: Ed Mayo

NEF Pocketbooks
Editor: David Nicholson-Lord
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Introduction

Few figures in British life inspire as much fear and loathing as the loan shark. Contemporary urban mythology depicts an inner-city housing estate where a thug wielding a baseball bat climbs a urine-streaked stairwell to mete out summary punishment to a punter who has defaulted on a loan. Once the beating is deemed sufficient, the loan shark doubles the interest owed and warns of more beatings if his demands – invariably extortionate – are not met.

As the testimony of one former illegal loan shark interviewed in the research for this book confirmed, such images may be an urban myth but they are not too far from the truth. But if there is one flaw in this perception, it is that it misses a far more pervasive, yet insidious, phenomenon. Unlicensed moneylenders are not the only people reaping huge profits from loaning money at exorbitant rates of interest to those unable to access "normal" sources of credit – the kind of credit that the rest of the population takes for granted.

Big business, including some of the world's leading financial service companies, is involved in a highly lucrative – and, in the UK at least, completely legal – industry that feeds off poverty and financial exclusion. The result is that those least able to afford credit end up paying the most for it.

"Sub-prime lending", as it is known in the financial services industry, is targeted at the millions of people who fail to notch up the necessary credit scores to secure entry into the world of modern consumerism. Just as the availability of “mainstream” credit – through overdrafts, credit cards, personal loans and store cards – has risen to unprecedented levels since the 1970s, so too has the availability of credit to the financially excluded. Unsecured credit from doorstep lenders, high street retail chains and catalogue companies is now readily available to many who fall foul of the computerised credit check. Secured loans, which require borrowers to put up their possessions as security, are offered against assets of just about any size. Whether it’s a television set, family heirloom, car, social security book or house, a swarm of companies will be queuing up with promises of instant cash.

But borrowing from such sources doesn’t come cheap. Where junk mail advertising a credit card or personal loan may offer £1,000 at between 5 and 17 per cent APR (annual percentage rate), loans offered on the doorstep of a council flat can easily amass interest and charges in excess of 1,000 per cent. Even where interest rates appear competitive, borrowers may be tied into agreements that contain hidden charges; or they may be forced to put up unreasonable levels of security, threatening their livelihoods.

For many, the rising availability of consumer credit, combined with society’s growing moral acceptance of debt, has been empowering. The trappings of consumerism – cars, holidays, washing machines – are within the reach of

more people than ever before. But for those left behind, whose lives involve more basic needs such as food, school uniforms or a Christmas present, credit can lead to an inescapable cycle of indebtedness.

Predatory lending not only devastates individual families and households. It is systematically stripping the wealth and assets of some of the country's poorest neighbourhoods. While it is allowed to operate unchecked, attempts to revive the fortunes of impoverished communities will face an uphill struggle. Too often, what the taxpayer is providing, through welfare and regeneration budgets, the lender is taking away – with interest.

But by far the least palatable feature of such practices is that successive British governments have failed to control them. This pocketbook argues that predatory lending is one of the worst excesses of the free market economy – and we lag far behind other countries, notably the US and our European neighbours, in our attempts to curb it. Since the 1970s the UK has had no statutory ceiling on the amount of interest that can be charged on a loan. The usury laws that do exist are neither effective nor accessible to consumers. Indeed, the victims of predatory lending must be prepared to incur heavy legal costs if they attempt to seek recompense through the courts.

Today, almost anyone can register themselves as a moneylender. It is far easier to get a licence to trade as a moneylender than it is to get a driving licence or to set up a credit union – one of the institutions that could, with the

right support, help drive high-interest lenders out of the market. In the rare cases that moneylenders are threatened with revocation of their licence, past experience shows there is little to stop them reapplying under a different name.

But it is not just the laws that need an overhaul. For market intervention to be successful, the government needs to combine stringent regulation with support for projects that widen access to affordable credit. The only way to drive loan sharks out of the market is to play them at their own game. If the high-interest lenders are undercut, only those willing to reduce their profit margins will stay in the UK. It will be good riddance to the rest.

In the absence of any effective regulation or market intervention, Britain is fast becoming a safe haven for high-cost lenders. One would have thought the current government, with its pledges to tackle poverty and financial exclusion, would find such a reputation deeply embarrassing. Indeed in 1987 Tony Blair, then shadow city spokesman, told the BBC's *Panorama* programme: "You need some measure of control and regulation to ensure that the unscrupulous aren't lending to the desperate when there's no possibility of repayment". But Mr Blair's government has failed to act on these good intentions. Despite a review of the consumer credit laws, a recommendation of the government's own social exclusion unit to widen access to affordable credit, and a wide array of reports and consultation papers, predatory lending retains its stranglehold on the poor.

1 The Debt Boom

For most businesses, rising levels of poverty set alarm bells ringing. For predatory lending, a country hit by recession, or a society marked by a growing polarisation between the rich and the poor, is a fertile feeding ground.

The debt business in the UK is booming. According to industry analyst Datamonitor, 8.3 million people (one in five adults) are systematically denied access to mainstream credit from banks, building societies and finance houses. This sub-prime market was estimated to be worth £16 billion a year to "non-standard lenders".

Research by the Bristol University-based academic Elaine Kempson suggests that the number of consumers exposed to predatory lending has been rising for the last 10 years. Kempson, who was commissioned by the Department of Trade and Industry to determine levels of extortion in the consumer credit industry in 1999, believes this is directly related to a rise in financial exclusion.

Kempson attributes this increase to three key trends: the higher number of low-income households facing "flexible" and less secure employment; the upward trend in relationship breakdown and lone-parent households living on low-incomes; and the economic recession of the 1990s. The latter resulted in a massive increase in mortgage

arrears, repossession actions and consumer credit debts that left hundreds of thousands of people facing county court judgements.

According to the National Association of Citizens' Advice Bureaux, extortionate credit is that which "arises from either unduly high interest rates or from loans that put the borrower at a significant and unfair disadvantage against the lender". NACAB, which describes many of the financial products on offer as "daylight robbery", deals with more than half a million consumer credit cases each year.

While predatory lending comes in many different guises, shaping itself to the different niches within the increasingly lucrative market of the financially excluded, it is possible to divide it into two distinct parts.

First there is the long-standing "alternative credit industry" selling to the poor and dispossessed, those who stand no chance of getting credit from banks or building societies. The products are usually small loans, ranging between £25 and £1,000, offered over short periods of time to cover basic needs.

The vulnerable nature of the industry's client base has made it particularly hard to stamp out bad practice. In one case cited by debt advisers at a citizens' advice bureau in the West Midlands a disabled client took out two loans with a local company. The first loan was for £50, of which the client received £30. The second loan was for £25, of which

the client received £15. The money retained by the lender was described as "interest up front". The client repaid £20 and was told that she still owed £67. The loan company took her wedding ring, watch, kettle and radio as security for the loan.

Second, there are the "non-status lenders" whose speciality since the 1980s has been to offer credit to consumers with impaired or low credit ratings. Many of the products offered take on the guise of the mortgages and personal loans offered by mainstream banks and building societies.

A particularly disturbing trend among some non-status lenders and their brokers has been to target low-income home owners, who will struggle to repay. By allowing the debts to spiral out of control, often incurring exorbitant charges along the way, the lender will be able to take possession of their client's home. In the case of former council houses, lenders have been known to wait for three years, leaving their client in residence, before finally taking possession. This strategy enables them to claim the right-to-buy discount, which is available only after three years' ownership. Public funds intended to boost levels of home ownership are thus going straight into corporate pockets.

2 Doorsteps and Pawnshops

Alternative credit providers have been a fixture in deprived neighbourhoods for centuries. The oldest players in the industry include the notorious, and illegal, loan sharks on the one hand; and licensed doorstep credit companies and pawnbrokers on the other.

Doorstep lending, or weekly collected credit, is one of the oldest forms of money lending in the UK. Indeed, the market leader, Provident Financial, was set up in the mid-19th century to offer credit to the vast majority of the population, then excluded by the banks. And despite operating, in effect, at a subterranean level, out of sight of today's empowered consumer, it's a booming industry. In 2001 Provident Financial bucked the stock market trend by announcing its fifth consecutive year of growth.

With a 40 per cent share of the market, the company posted pre-tax profits from its weekly collected credit operations of £150 million. If this is divided by the company's 1.6-million customer base, a simple calculation shows that each customer contributed more than £93 to the profits total. Its success in the UK has led the Provident to tap new markets in Eastern Europe and South Africa.

In addition to Provident Financial – "the Provy", as it is known on the doorstep – four national companies offer credit on the doorstep: London Scottish Bank, Shopacheck, Morses and S & U. Another 1,000 small operations cover particular regions, cities or neighbourhoods. Overall, the doorstep lending market is worth around £3.3 billion.

In 1999 Datamonitor estimated that customers of doorstep lenders borrowed an average of £940 a year. Considerably more is paid back. Charges on doorstep credit are among the highest in the consumer credit industry. A typical APR charged on a loan of £60 repayable over six weeks is 500 per cent; loans that amass APRs of 1,000 per cent and even 2,000 per cent are not unusual. The files of two debt advisory services in northern England provide a taste of the sort of terms clients face:

- London Scottish. A client borrowed £485.18 over 75 weeks with a total amount repayable of £900 – an APR of 160 per cent.
- Provident. A client borrowed £400 over 53 weeks, repaying £636. APR – 164 per cent.
- Morses. A customer borrowed £150 loan over 31 weeks, repaying £232. APR – 365 per cent.
- CLC, a Liverpool-based financial company. A client borrowed £50 over 15 weeks and repaid £75. APR – a remarkable 1,564 per cent.

The Consumer Credit Association, the trade association for doorstep lenders, says that because loans include the cost of home collection and there are no additional charges for missed payments, APRs do not reflect the true cost of the debt sold by its members. Anti-debt campaigners argue that even when the cost of home collection is taken into account, interest is still massively higher than that charged by mainstream lenders.

According to the CCA's own estimates, 15 per cent of the total sum collected covers the cost of collection. This means that for a loan of £100 repayable over 30 weeks, which incurs interest and charges totalling £40 (292.4 per cent APR), £21 would cover the cost of collection. But even after deducting this additional cost, the APR charged on the loan is still a staggering 82.8 per cent.

The worst problems with debt arise when borrowers run into difficulties with repayments and are offered roll-over loans to cover the debts built up on their first.

Mary, a lone mother living off income support worth £101.50 a week on a council estate in south-east London, was offered a £200 loan from an agent of the Provident.

Under the terms of the agreement she was required to pay back £300 over the course of 30 weeks (330 per cent APR). One month later, despite being in no position to afford it, Mary was offered a second loan of £500 to settle her debt and give her some cash to cover essentials.

Interest on the second loan was to be £310 to be repaid over 54 weeks (170 per cent APR) but again she ran into difficulties with repayments. Mary was then offered a loan of £1,000 to pay off the balance owed on the second loan. This time she was required to pay back the £1,000 with interest amounting to £620 over 54 weeks, which again amounted to 170 per cent APR.

In just six months, Mary's loan of £200 had turned into a debt of £2,227. Forced to repay the loan, she was unable to pay her rent and repay debts to two catalogue companies she owed. At the beginning of 2002, Mary was in debt to the tune of £7,203, a figure she will be unlikely ever to have the means to repay. (Mary is not her real name.)

The high take-up of doorstep credit can be put down to its convenience. Company agents are paid on commission and ply their trade by visiting the homes of their clients each week to pick up repayments or arrange new loans. Borrowers, often living in areas long deserted by the banks, can get instant cash without having to face questioning from bank staff, fill out complicated forms or undergo a credit check.

The law currently prohibits companies from canvassing new customers on the doorstep. However, many companies, such as Shopacheck, offer vouchers that can be redeemed in high street shops. Once the customer accepts the vouchers, the agent is free to offer them cash loans.

To the dismay of anti-debt campaigners, home credit companies appear to have gained legitimacy in some surprising quarters. Both the Church of England and Co-operative Insurance Services have been tied to the Provident through institutional shareholdings. Protests by the campaigning group Church Action on Poverty led to a disinvestment by the Church of England, but CIS continues to hold shares in the Provident with investments in 2002 worth £4 million.

Pawnbrokers

Pawnbrokers have been intrinsic to working class communities for as long as the moneylender. They offer credit secured against assets of just about any size: a family heirloom, television set, a piece of jewellery. Loans are usually offered up to half the value of the borrower's asset, which typically is repayable over six to seven months. A borrower can extend the period of the loan indefinitely by paying the interest built up over the time of the credit agreement.

While APR on loans is lower than that offered by the home credit industry – typical pawnbroking rates are between 40 and 85 per cent – critics point out that it is still extremely high, since there is absolutely no risk to the lender. Loans are secured against the borrower's property. In the event of a failure to repay, the pawnbroker can simply sell on the possessions to cover the loss.

Even pawnbroking has found new ways of doing business, however. Recent years have seen the emergence of companies that offer to buy possessions from customers, who retain the right to buy back the products at a higher price within a given period. The deal is not subject to consumer credit regulations because credit, in effect, is replaced by purchase – the loan is received by handing over ownership.

In NACAB's *Daylight Robbery* report, published in 2000, a CAB in West Sussex gave the example of a client who borrowed £150 by providing his stereos – valued at £500 – as security. The amount had to be repaid within 28 days with an interest charge of £42. This equates to an APR of 1,834 per cent.

The largest company in this market is Cash Converters. Founded in Australia in 1984, Cash Converters currently has a network of 90 franchised stores in mainly low-income neighbourhoods across the UK. It presents itself as something of a one-stop-shop to meet the credit needs of the financially excluded. Many of the franchises also offer payday loans and cheque-cashing facilities.

3 Foreign Imports

Britain's debt boom has attracted new entrants to the alternative credit industry, their techniques and tactics often imported from abroad. Cheque cashing is the fastest growing. An import from the US, where the industry has thrived since the 1930s, cheque cashers lend money to bridge the gap from one payday to the next. Another development is the spread of high street chains such as BrightHouse, formerly known as Crazy George's. Setting up shop in low-income neighbourhoods, these sell household goods and appliances on what, at first glance, appear to be competitive terms of credit.

Cheque cashers offer consumer credit in the form of payday loans and, for those without access to a bank account, cheque-cashing facilities. Payday loans are targeted at low-income consumers who need to bridge a shortfall from one payday to the next. Loans are made against the security of a post-dated cheque made out to the lender by the borrower.

Not surprisingly, the cost of being marginalised from mainstream financial services is high. Charges for the service vary according to the length of time before a borrower's cheque is cashed. A typical charge for a £40 cheque held for between one and seven days is around £4. To hold a cheque of the same amount for one month would cost around £5, which would amount to an APR of 396 per cent.

The cost of credit rises further when customers do not have the necessary funds in their bank account when the cheque is due to be cashed. Borrowers can opt to "roll over" their loan, which involves writing another cheque to cover the interest accrued on the first. This means that a loan of £40 over two months would cost the borrower a total of £10. While the British Cheque Cashers' Association's (BCCA) guidelines outlaw such procedures, non-members have been known to adopt them.

The practices of payday lenders in the US have been the focus of high-profile anti-predatory lending campaigns, which have resulted in a number of states, such as North Carolina, passing legislation to outlaw the industry. But the cheque cashers' core market in the UK is the facility known as third-party encashment under which a company will cash a cheque for a customer. The service is targeted at the 1.5 million households without access to a bank account and also those who cannot afford the delay of the banking industry's clearing system.

While the service is not legally considered to be a credit agreement – which means it is not subject to the regulation governing payday loans – charges are high. According to the BCCA, the fee for cashing a cheque in an area where a company has little competition will be around 10 per cent of the cheque's value. The practice is only made possible by agreements between a cheque casher and the clearing banks. Without the complicity of the latter, the "service" would grind to a halt.

In April 1994 a high street retail company with origins in Australia and the US opened its first UK-based shop in Chelmsey Wood, Birmingham. The company, then known as Crazy George's but since rebranded BrightHouse, advertises credit agreements that appear to be only marginally more expensive than those offered by mainstream providers. Better still, the credit is offered to anyone, regardless of credit history or employment status. To get credit, customers only need to provide the name, address and telephone number of five people able to confirm where the customer lives.

On paper BrightHouse looks like a company with a strong social mission. Its website proudly states: "We aim to provide anyone, regardless of their household income, employment or credit status, with a wide choice of high-quality products for their home at affordable prices. We do this by providing you with the benefits of credit without the traditional strings attached."

There is a catch, however. While the advertised cost of credit (29.9 per cent APR) seems competitive compared to the home credit industry, customers are encouraged to take out "optional cover", which includes both insurance and a clause that allows the customer to return the goods at any time.

Interest on a gas cooker sold for £386.86 would thus amount to £3.57 a week for 156 weeks. The optional cover, which legally does not have to be included in the advertised APR, would cost a further £1.92 a week. If it was included in the advertised cost of credit the "optional cover" would

mean an APR of 86.2 per cent, pushing the total cost of the cooker up to £856.44 rather than the £556.92 it would cost at 29.9 per cent APR.

While BrightHouse insists that this cover is optional, one company director says it is taken out by more than 90 per cent of customers. He adds that the high take-up rate is largely the result of previous problems its customers have experienced with credit agreements.

But this is only half the story. BrightHouse increases its profits further by selling products at inflated cash prices. For example, a Philips 28” widescreen television that can be bought in a high street retailer for £379.99 is sold in BrightHouse for £562.42. The law requiers a lender to advertise the true cost of the debt it sells in its APR. If the inflated cost of the television was taken into account, along with the interest and optional cover (£7.99 a week for 156 weeks), the APR would be 182.2 per cent.

Like the Provident, BrightHouse has excellent corporate connections. It is owned by the Thorn Group Plc, which is in turn owned by Nomura, the Japanese investment bank which once put in a bid for the Millennium Dome. Its practices do not command universal tolerance, however. In 1996 the company was the subject of a successful anti-predatory lending campaign in France. The campaign, led by Lionel Jospin before he became French Prime Minister, forced the company to shut up shop and scrap its plans to become a major player in France’s retail market.

4 Asset Stripping

A quick flick through the middle pages of any tabloid newspaper illustrates the high penetration that so-called "non-status" lenders have achieved in the UK's consumer credit market in recent years. Advertisements promise instant cash, regardless of credit history or county court judgements, to anyone looking for the house, car or holiday of their dreams. Worse, loans are offered to repay other debts. Indeed, to the exasperation of the UK's debt advisers, the industry has marketed its products so convincingly that it has even found a market selling debt to pay off other debt, under so-called "consolidation loans".

Non-status lenders specialise in offering finance to people with impaired credit records. Loans and mortgages are made available to the increasing number of people viewed by mainstream financial service companies as "non-standard". The industry hit the UK in the 1980s. Backed by parent companies in the US, these businesses exploited a growing niche created by the tightening of credit criteria among mainstream lenders.

Among the most socially destructive non-status lending practices are those that involve mortgages and loans known as secondary mortgages: these are secured on the properties of low-income customers. The right-to-buy option introduced for council tenants in the 1980s, combined with the high number

of county court judgements recorded during the recession of the 1990s, has turned such lending into a boom industry, according to Datamonitor's research. Indeed, the profits to be made from people with low scores on credit ratings has attracted some of the world's largest corporations.

Under the terms of a secondary mortgage, the borrower is offered credit. In exchange the lender receives a claim to the equity in the borrower's property. There is very little risk to the lender, who has his customer's house as security. Borrowers, by contrast, risk the roof over their heads. The National Consumer Council found that interest rates offered by non-status lenders were nevertheless as high as 32 per cent.

Similar products, with similarly high charges, are increasingly targeted at car-owners under agreements known as "log-book loans". Loans are made according to the value of the borrower's car in exchange for temporary ownership of the vehicle. The car is signed back over to the borrower on receipt of repayment. Again, according to NACAB, high charges are a cause for concern

One of the most disturbing practices in some non-status lending is to target products at people who will struggle to repay. As the debt spirals out of control, often incurring heavy default penalties along the way, the lender moves in, taking possession of the victim's home.

The impact of this practice is devastating for both households and neighbourhoods. According to research in

the US, low-income home-owners are stripped of approximately $9.1 billion a year through the predatory tactics of non-status lenders.

In the UK, where the industry is still in its infancy, a similar pattern appears to be emerging. Research by credit union trade association ACE Credit Union Services found that in three streets with a total of 40 households on the Meadow Well estate in Newcastle £240,000 was being paid each year to high-cost lenders. Of this, at least £120,000 was paid in interest charges alone. The average weekly income of the households surveyed was just £230. Nationally, this adds up to a huge transfer of resources and potential assets from poor communities to the directors and shareholders of loan companies

A look at county court lists shows that the number of non-status lenders applying for possession of a borrower's home is disproportionately high, in relation to their two per cent share of the overall mortgage market. On a Wednesday, which is the day put aside for mortgage possessions in Bow County Court in east London, it would not be unusual to find 55–65 per cent of court actions being taken by non-status lenders. In Lambeth, south London, this figure has sometimes reached 80 per cent.

High APRs are not the only obstacle to keeping up repayments, however. Credit agreements often carry complex clauses that allow the lender to hike up the cost if a repayment is missed. An investigation by the Office of

Fair Trading in 1998 found one of the UK's largest non-status lenders in breach of laws that prohibit raising interest rates as a penalty for defaulting on a loan. City Mortgage Corporation, offered a "concessionary" interest rate of 9.9 per cent to customers who kept repayments up to date. For borrowers who fell foul of the repayment schedule, interest was almost doubled to the so-called "standard rate" of 18 per cent. The OFT described the practice as "unacceptable" and said it operated to the "considerable detriment" of customers.

Losing a home

A case involving First National, a finance company currently owned by high street bank Abbey National, highlights the practices which often result in non-status lenders gaining possession of a customer's home. Dave McNevin, who took out an unsecured loan for £1,100 from First National in 1991, struggled to keep up repayments when he lost his job through illness. First National took Mr McNevin to court where a judgement was issued against him and he was ordered to pay back £10 a month.

Unknown to Mr. McNevin, however, First National continued to charge interest on his outstanding debt. Despite the court's intervention, the interest and charges on the loan were not frozen. By 2001 a loan of £1,100 had turned into a debt of nearly £8,500.

It was a debt that Mr McNevin had no means of paying. First National already had contingency plans in place. When the initial county court judgement was taken out against the borrower, First National – quite legally – took out a “charging order” against their client. Such orders effectively turn an unsecured loan into a debt secured against the borrower’s home. This meant First National would have been able to take possession of Mr McNevinÌs house to recover the debt.

The courts were powerless to act. Despite an attempt by the OFT to take First National to task, claiming its practices were sucking borrowers into a “vortex of debt”, the case ended in the House of Lords where the Law Lords reluctantly ruled the practice lawful. “I think the consequences of this term must come as a nasty shock to many borrowers. I think they have a legitimate grievance”, one of the Law Lords said.

5 The UK – A Soft Touch?

When Crazy George's, the company now trading as BrightHouse, decided to shut up shop in France following the success of Lionel Jospin's anti-predatory lending campaign, one of the company's directors was reported protesting to the French newspaper *Humanité*: "In Great Britain there has been absolutely no reaction to the stores."

It is not hard to see how Britain has picked up its reputation as a soft touch for sub-prime lenders. Professor Udo Reifner, a German lawyer who was a leading force in stamping out predatory lending in both his own country and many others in the EU, says: "The UK's argument that social consumer protection would exclude poor people from access to credit is false. The UK has by far the highest exclusion rate in financial services for poor people in northern Europe and by far the lowest standard of social consumer protection."

Since the introduction of the Consumer Credit Act of 1974, the UK has had no statutory ceiling on interest rates. Regulation through the OFT and the courts has been almost completely ineffectual. And in the absence of any serious attempt to widen access to affordable credit or provide sufficient state grants to meet basic needs, Britain's consumer credit industry is positioned at the far extreme of *laissez-faire* economics. In effect, the state has subsidised

sub-prime lenders because regulations are enforced by trading standard officers, who are council employees; other sectors – banks, for example – typically pay for their own regulation. It is fair to say the UK provides one of the safest environments for predatory lending in Europe, if not the industrialised world.

One of the biggest barriers has been the lack of joined-up government. The various tools required to control the industry are held in different boxes across Whitehall.

The review of consumer credit laws currently taking place at the Department of Trade and Industry can only address part of the problem. In fact, without action across government, tighter regulation alone could make matters worse. The Consumer Credit Association, the moneylending industry's trade association, rightly points out that tighter regulation, such as the introduction of an interest-rate ceiling, would risk squeezing out its members, leaving low-income consumers prone to the underworld tactics of the illegal loan sharks.

To be effective, tougher legislation needs to be combined with support for initiatives that simultaneously widen access to both affordable credit and money advice. The Treasury, the Office of the Deputy Prime Minister, the Department for Work and Pensions and the Department for Education and Skills, are just some of the government departments and agencies that need to give priority to developing a joint approach.

British laws regulating the consumer credit industry leave a lot to be desired. Despite hundreds of thousands of complaints lodged with debt advisory services every year, the Consumer Credit Act of 1974 has succeeded in bringing only 29 cases to the courts. Of these, only two companies have been found guilty of charging extortionate credit. Perhaps most disturbingly, given the vulnerable nature of its client base, no reported cases during this period have involved the weekly collected credit industry.

Legal barriers

Several factors have made it virtually impossible to secure victory against predatory lending through the courts. Legal action is both complex and, in the absence of legal aid, expensive. What's more, court actions can only be taken by borrowers themselves: third parties, such as debt advisory charities, may not take action on a debtor's behalf. Action by a third party has been key to the many court successes against predatory lending in the US.

Existing legislation also prohibits groups of borrowers from lodging joint actions against the practices of any one company. This means that even if a credit agreement was ruled to be extortionate against one borrower, the lender would remain free to sell products based on the same credit agreement to others. It was the use of "super complaints" in Germany that succeeded in driving many high-cost lenders out of the markets in the late 1970s.

But perhaps the biggest obstacle to seeking recompense through the courts is the confusion surrounding the legal definition of "extortionate credit". Up to 1974 the consumer credit industry was regulated by the 1948 Moneylenders Act, which capped interest rates at 48 per cent. But its successor legislation, the Consumer Credit Act, abandoned the interest-rate ceiling, leaving the onus on the courts to decide whether a credit agreement was "grossly exorbitant" and the result of "fair dealing". In practice – and in contrast to the previous hard-and-fast maximum figure for interest rates – the courts have found such wording almost impossible to decipher.

In this respect, the UK is relatively isolated. France, Belgium, Switzerland, the Netherlands, Germany, Austria and Greece are among the EU member states that seek to control the excesses of consumer credit companies through a cap on interest rates. Several states in the US also operate caps.

In Germany growing public concern at tactics imported by US companies during the 1970s prompted the courts to tilt the balance of power in favour of borrowers. It has been estimated that as many as 100,000 credit agreements each year are judged unfair by the courts in Germany. During the early 1980s special courts had to be set up to deal with the backlog of legitimate cases against predatory lenders. Unlike the UK, debtors in Germany are given easy access to legal aid to take their grievances to court.

In Germany credit is deemed to be extortionate where interest is found to be "double the market average". In periods of high interest rates, this "floating ceiling" is reduced so that interest rates 12 per cent above the average have been high enough to be judged usury. The German Bundesbank publishes market averages for different forms of credit each month.

The drive to oust predatory lending through the courts in Germany appears to be working. Today, the companies that provoked public outcry in the 1970s have either left or altered their practices to those tolerated under German law. Thanks to a strong tradition of community banking, there has been no reported rise in the number of illegal loan sharks taking the place of these companies.

A combination of bank branch closure programmes and the rapid disappearance of face-to-face banking in favour of automated credit scoring has left a growing proportion of the British population without access to mainstream financial services. This is not merely the conclusion drawn by critics of predatory lending: the Government thinks the same. In 1999 the social exclusion unit's policy action team 14 published a report confirming that banks and other mainstream lenders were reluctant to serve low-income groups.

So far, however, the Government's only major response has been to enter into prolonged discussions with a reluctant banking industry to urge it to finance the creation of the Universal Bank. While the negotiations gave low-income

groups access to basic bank accounts, which should eventually be accessible through local post offices, no provision was made to widen access to credit. Many anti-debt campaigners view this as a missed opportunity. And although it's true that basic bank accounts could help drive out the cheque cashers, there is widespread concern that the banks are doing little to promote them to the financially excluded. An investigation by the Financial Services Authority in 2002 found there was little awareness of the products among frontline banking staff.

The only available alternatives to predatory lending for poorer households are credit unions or the government's Social Fund. As they stand, both sources are woefully ill-equipped to provide robust competition to sub-prime lenders. According to research published by the National Association of Citizens' Advice Bureaux in 2002, the failings of the Social Fund were driving the socially excluded into the clutches of high-cost lenders. The fund is supposed to operate as a safety net by providing a mixture of grants and interest-free loans to meet the basic needs for the very poor. But lack of resources and overly stringent criteria for eligibility has led many anti-debt campaigners to call for a complete overhaul of the fund. Rather than tackle financial exclusion, the Social Fund can be seen to be directly fuelling the high-cost lenders' customer base.

In one case cited by NACAB, a woman walked five miles to ask for a crisis loan of £40 after using her giro payment to cover mortgage arrears. She was given a loan of £11, the

equivalent of just one day's benefit, even though her next giro was not due for another seven days. In another case a woman was forced to take out a £500 loan charged at 106 per cent APR from a doorstep lender after being refused a budgeting loan for a bed and a fridge.

The government's provision of state-sponsored credit to meet the needs of the financially excluded is a far cry from that offered by other EU member states. The Netherlands, for example, protects low-income consumers by operating an interest-rate ceiling and also by providing affordable credit through a network of "municipal banks".The first municipal banks were set up at the beginning of the 20th century to serve working-class communities that had become the victims of predatory lenders and illegal loan sharks. Today the Netherlands has 50 such banks; by 1995 official statistics suggested the sector had a four per cent share of the country's consumer credit market.

Municipal banks

Municipal banks in the Netherlands offer credit at the market rates – the same as those offered by mainstream banks. They offer loans to low-income groups to cover anything from basic needs to home improvements and cars. Although they generate lower surpluses than commercial banks, they are self-financing social enterprises, which reinvest profits into providing other services such as debt mediation and budgeting advice.

Other than the Social Fund, credit unions are usually the only source of affordable credit available to the financially excluded. By law credit unions can only charge a maximum of 12.68 per cent APR, a figure which must also cover administration fees.

On the face of it, there is huge potential for credit unions to play a key role in offering affordable credit to those most vulnerable to predatory lending. But in comparison to many other countries, the UK's credit union movement remains perilously weak. With 697 organisations catering for just 325,000 members, the movement is in no position to make serious market inroads. Many existing credit unions are not equipped to meet the needs of the financially excluded. The largest and strongest are employee-based organisations drawing their memberships from a particular workplace, such as a local authority or police force. Their members are in employment; they are also often required to pay into their savings through their payroll or a direct debit from a bank account. The scope for such organisations to serve people marginalised from mainstream financial services is severely limited.

According to the Association of British Credit Unions, credit unions that draw their members exclusively from poor neighbourhoods are those that will find it hardest to grow. And although credit unions, after a long campaign by the movement itself, are now regulated by the Financial Services Authority, it is widely accepted that this has brought with it added costs – to the extent that many

under-resourced community credit unions are struggling to survive. The challenge for the UK's credit union movement is to find a model that makes serving those most vulnerable to predatory lending compatible with financial viability and membership growth.

In the US, which has three quarters of the world's 90 million credit union members, such a model seems to exist. Community development credit unions emerged in response to concerns that the larger institutions were being operated more like mainstream banks. As credit unions grew in size, there was a tendency to vacate poor neighbourhoods in pursuit of middle-class members.

But a large number of institutions remained committed to serving the needs of impoverished neighbourhoods, often black or Hispanic. In 1974 the National Federation of Community Development Credit Unions was set up to represent the interests of these institutions. Today, the trade association has 215 institutions on its books with a combined membership of around 700,000 people. In 2000, according to the NFCDCU, its members prevented up to $300 million from being paid in interest to moneylenders, pawnbrokers and payday lenders. In total, 204,000 loans worth a combined $660 million were made to low-income groups in the same year.

The ASI Federal Credit Union in New Orleans is one that has successfully taken on the high-cost lenders. It offers small, short-term payday loans at one fifth of the cost of those

offered by the cheque cashers. A $200 loan repayable over six weeks costs just $212.15 in total, compared with the $320 that would have been repaid to a typical payday lender. Out of $700,000 advanced in loans over two years, only 27 loans have been written off, with a net loss of just $4,000.

The creation of credit unions based on this model has been restricted in the UK by a lack of access to funds, especially to start-up capital. Under President Carter a $6 million fund was set up to aid the development of CDCUs. CDCUs in the US are also entitled to investment from the Government and banks under legislation first introduced in the late 1970s to tackle red-lining – the refusal of banks to serve poor neighbourhoods on the ground that they were too much of a risk. The Community Reinvestment Act of 1977 compelled banks to offer credit facilities to people living in deprived areas. An amendment to the CRA during Bill Clinton's presidency allowed banks to meet their obligations to low-income neighbourhoods by investing in community development credit unions or banking intermediaries known as community development finance institutions. Since the legislation was enforced it is estimated that $1 trillion has been made available under CRA agreements.

Generally, for a member to borrow from a credit union, they must first save – a significant problem for poorer households. Ireland is one of the few countries where victims of predatory lending receive both money advice and access to affordable credit. The Money Advice and Budgeting Service (MABS), set up with funding from the Irish Government in the early

1990s after a successful anti-predatory lending campaign led by the Combat Poverty Agency, operates a loan fund that can be called upon by debt advisers to pay off debts built up with high-cost lenders.

The service not only undermines dependency on high-cost credit; it provides a steady stream of new members to credit unions. Half Ireland's population are now members of its 600 credit unions. Assets in savings capital is more than IR£3 billion (£2.4 billion)

The loan, or redemption, fund operated by MABS is used to underwrite loans made by credit unions to the victims of predatory lending. It is only called upon in the event that a debtor defaults on a payment. To prevent abuse of the fund, clients are not told their debt has been underwritten. Customers are offered a loan by a credit union on the same terms and conditions as any other member. The decision to underwrite a loan is made by MABS staff who first work closely with each debtor to improve budgeting skills and levels of financial literacy. The debtor will then be referred to a credit union to sign the credit agreement and collect the money.

After a decade in operation, MABS assists 40,000 households, with a combined repayment "turnover" of over of IR £14 million (£11.3 million). The service has a network of 50 branches, each employing three advisers.

6 Tackling Predatory Lending

The UK has much to learn from around the world if it is serious about stamping out the consumer credit practices outlined in the last four chapters. Unchecked, predatory lending will seriously undermine attempts to combat financial exclusion and revive the fortunes of the country's poorest neighbourhoods.

This pocketbook suggests four fundamental principles that could help the UK shed its reputation as a safe haven for high-cost lenders.

Prevention rather than cure. A levy on the consumer credit industry should be introduced to help fund a national network of 250 new consumer advice centres. In Germany, such centres give the public the expert legal advice and information they need before signing up to a credit agreement. The centres would collate information on good and bad practice in the industry, refer cases of bad practice to local trading standards officers and boost levels of financial inclusion. Usury should once again be regarded as socially and morally unacceptable; banks, building societies and ethical investment funds should not supply credit or investment to high-cost lenders. In socially responsible investment (SRI) terms, predatory lending should constitute a

"negative screen": like tobacco, the arms trade, pornography and brutal regimes, it should be a bar to investment.

Tighter regulation. The courts' task of deciding whether a credit agreement is "extortionate" needs to be simplified. The DTI's review of the 1974 Consumer Credit Act must include a recommendation for a form of interest-rate ceiling to achieve this. A "floating ceiling", as used in Germany (see Chapter 5), would mirror existing market rates and prevent changes in the wider economy rendering a cap obsolete.

The county court system must be made accessible to consumers by allowing third parties, such as debt advisory charities or local authorities, to take action on behalf of borrowers. "Super-complaints", taken on behalf of groups of borrowers against the loan agreements of any one company, must also be permitted.

Local authorities vary widely in their funding of trading standards officers with a credit enforcement remit. As a result, regulation of the consumer credit industry, nationally the responsibility of the Office of Fair Trading, has become something of a postcode lottery. Councils must be given a legal duty to fund a "dedicated" trading standards service – officers part or all of whose job is to investigate malpractice in the consumer credit industry.

While the rest of the financial services industry pays for its own regulation through fees paid to the Financial Services Authority, money lenders and the home credit industry are

supervised at the expense of the taxpayer – through the council trading standards service by the OFT. This subsidy must be brought to an end. Companies must cover the cost of their regulation through a more robust licensing regime.

Lenders should be legally required to break down the cost of credit agreements into their constituent parts, as is the case with a restaurant bill or a shop receipt. By having the component elements of an agreement itemised – interest, collection costs, arrangement fees and so on – vulnerable borrowers will be able to make better judgements. Such "truth in lending" should highlight the difference in costs between home credit companies and credit unions, for example. The Treasury's CAT standard, developed to increase the transparency of charges on financial products such as individual savings accounts (ISAs), is a useful model for credit agreements.

Doorstep lenders should be legally obliged to inform borrowers of their payment choices and give them the option of declining the home collection service and its associated charges. The aim should ultimately be to make home collection charges redundant – funnelling repayments either through one of the new basic bank accounts, or via the Universal Banking service due to start operating in 2003 at sub-post offices.

Social security reforms. The Government's Social Fund, which provides grants and interest-free loans for people in basic need, needs to be radically reformed. The evidence suggests it is not doing the job it was supposed to do.

The fund, currently with an annual budget of £600 million, was set up in 1988 to replace the single payments system which gave low-income groups access to grants to purchase essential items. Four fifths of it is allocated through so-called budgeting and crisis loans. Debts are repaid via deductions in benefit payments. Just £100 million a year is put aside for grants – much less than the £335 million that was made available in 1985.

By 1999, more than eight million people had been turned down for loans from the Social Fund, leaving them at the mercy of the high-cost lenders. According to research by the Child Poverty Action Group, applicants are turned down either because they are considered too high a risk or simply because a benefit office's annual budget has dried up.

The Government must recognise that loan finance is inappropriate for many households. Essential items such as furniture, clothes and food must be met through extending the provision of grants. A return to a single-payments system would allow the socially and financially excluded to buy the items without which everyday life is virtually impossible. At least £500 million – in effect, a five-fold increase – should be put aside for single payments. Interest-free loans should be more flexible and locally managed, following the example of the highly successful municipal banks in the Netherlands (see Chapter 5). The fund represents a substantial asset that should be used to compete directly with high-cost lenders.

Social housing landlords have an important role in helping low-income households meet basic needs. They should give tenants the right to choose furnished dwellings; the latter would then have less need to borrow. To meet the extra cost, a small charge would be added to the rent and paid to social enterprises for furnishing and equipping dwellings. The charge should be covered by housing benefit.

Access to affordable credit. The Government must do more to ensure that the personal banking needs of low-income consumers are met. A first step would be to launch a community reinvestment scheme (CRS) – a fund to support credit unions and get other community development finance institutions off the ground. This would require start-up capital – an endowment of £20 million would be in line with similar initiatives, such as the Phoenix Fund for community finance.

Ministers should also consider new legislation, along the lines of the US Community Reinvestment Act of 1977, which compelled banks to offer credit facilities to people in deprived areas but allows them to meet this obligation by investing in community finance institutions. In default of legislation, the banking industry should be encouraged to invest in the CRS through a voluntary levy. There is both precedent and logic for such a levy: politically, it would be recompense for branch closure programmes and the tightening of credit criteria.

Tax incentives should be offered for investment in community development credit unions. These would be

similar to those operating under Gift Aid and would allow CDCUs to build up reserves from non-member deposits. This could appeal particularly to the growing ethical investment movement.

The Government should set up a UK version of Ireland's Money Advice and Budgeting Service (MABS) (see Chapter 5). Its job would be to refer low-income consumers to credit unions; provide debt and energy advice; and operate a loan guarantee scheme, underwriting loans taken out with credit unions.

The aim of a UK MABS would be to demonstrate the alternatives to high-cost borrowing. It could be financed through an "ethical tithe" on the savings from the universal banking service, due to start operating in 2003. The electronic payment of benefits and pension from April 2003 will save the Treasury over £300 million a year. At least 10 per cent of this sum should be earmarked for the establishment of a MABS-style network and the provision of a national redemption fund for the victims of predatory lending. Nationally, £30 million could fund 120 MABS centres.

Which bit of government should take the initiative in developing these new institutions and services? The Department of Trade and Industry already runs the small business service; this, in turn, manages the Phoenix Fund for community finance solutions for business credit. The DTI, working with the Office of Fair Trading, is thus best placed for the lead role.

7 Profits and Poverty – A Summary

To sum up…

The UK's credit underground is flourishing. According to industry analyst Datamonitor, 8.3 million people (one in five adults) are systematically denied access to mainstream credit from banks, building societies and finance houses in 1999. This "sub-prime" market was estimated to be worth £16 billion a year to companies that specialise in it – so-called "non-standard" lenders.

Research suggests that the number of consumers exposed to predatory lending has been rising for the last 10 years and is linked to the growth in financial exclusion. Factors responsible include: the growth in less secure employment; the upward trend in relationship breakdown and lone-parent households; and the economic recession of the 1990s, which produced an increase in mortgage arrears, repossession actions and consumer credit debts that left hundreds of thousands facing county court judgements.

Lack of access to mainstream credit condemns millions of people to a financial "twilight zone", where interest rates can run into four figures. Typical mainstream interest on credit cards or personal loans ranges between 5 and 17

per cent APR (annual percentage rate). Loans offered on the doorstep of a council flat can amass an inclusive APR of more than 1,000 per cent. Research for this pocketbook has disclosed effective interest rates of up to 1,834 per cent.

Many well-known businesses and organisations have been linked with high-cost lenders. These include Co-operative Insurance Services, the Thorn Group, Nomura Bank and Abbey National.

The last two decades has seen the arrival of sophisticated hard-sell techniques from abroad. These include cheque cashing, secondary mortgages, "log-book loans" on cars and new high-street discount chains. Evidence suggests that so-called "non-status" lenders figure disproportionately in home repossession cases. The Office of Fair Trading claimed one institution was sucking clients into a "vortex of debt".

While many high-lending practices have been outlawed abroad, they are flourishing in the UK. Legislation and regulation are ineffective; poorer households needing affordable credit have few alternatives.

Despite awareness of the problem, the Government has failed to act. Hundreds of thousands of complaints are lodged with debt advisory services every year yet only 29 cases have been brought to court under the Consumer Credit Act of 1974, and only two companies have been found guilty of charging extortionate credit. The UK is said to have the lowest standard of consumer protection for

poor people in northern Europe: its *laissez-faire* economic policies have made it a soft touch for high-cost lenders.

Changes should include:

- A levy on the consumer credit industry to help fund a national network of 250 new consumer advice centres.

- A cap on interest rates that can be charged to borrowers. This could take the form of a "floating ceiling" that reflects market rates. Such a ceiling currently operates in Germany.

- Shared legal actions against companies. These are currently not permitted in the UK. They include action by third parties, such as debt advisory charities or local authorities, and "super-complaints" by groups of borrowers.

- Ending the state subsidy of consumer credit enforcement. Unlike the rest of the financial services industry, which funds its own regulation through fees to the Financial Services Authority, money lenders and the home credit industry are supervised through local authorities by the Office of Fair Trading. Companies must pay for their own regulation through a robust licensing regime.

- New "truth in lending" requirements. Lenders must be legally obliged to break down the cost of credit agreements into the constituent parts, like a restaurant bill or a shop receipt.

- Radical reform of the Government's £600 million Social Fund to include a bigger emphasis on grants and more flexible interest-free loans. At least £500 million – five times more than at present - should be spent on grants (single payments). By 1999, 11 years after the fund was set up, more than eight million people had been turned down for loans, leaving them at the mercy of high-cost lenders.

- A £20 million community reinvestment scheme (CRS) to support and promote credit unions and similar institutions serving the banking needs of low-income consumers. The CRS could be partly financed by a voluntary levy on the banking industry.

- A UK version of Ireland's highly successful Money Advice and Budgeting Service (MABS) (see Chapter 5). This refers low-income consumers to credit unions, provides debt and energy advice and underwrites loans taken out with credit unions. It could be financed through a 10 per cent "ethical tithe" on the savings from the universal banking service, due to start in 2003, which through the electronic payment of benefits and pension will cut Government costs by over £300 million a year. Nationally this could fund 120 MABS centres.

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The credit underground is thriving in Britain today. Recession, social exclusion and the widening gap between rich and poor have pushed increasing numbers of people into a financial twilight zone where borrowing, even for necessities, carries an extravagant price tag. Estimates suggest that one in five adults are denied the loans and cheap interest rates most of us take for granted. For over eight million people, the only credit available is that offered by high-cost lenders – a market worth £16 billion a year.

In this new NEF pocketbook, Henry Palmer looks at how sophisticated marketing techniques, involving some of the best-known names in business, are being employed to sell expensive credit to those who can least afford it. For people on the receiving end, the result can be financial disaster – debts, court judgements, the loss of a home. Yet while many of the techniques have been outlawed abroad, in the UK they remain perfectly legal. Britain needs to shed its reputation as a safe haven for predatory lending. This pocketbook shows how it could be done.

Henry Palmer is a freelance journalist specialising in regeneration and social issues. He is a a special correspondent for *New Start* magazine and was named community development finance journalist of the year in 2001.

Pat Conaty is senior research associate at NEF and was formerly director of money advice services at Birmingham Settlement and co-founder of Business Debtline and National Debtline

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