



Making financial services more inclusive: What can be done about the ‘poverty premium’?

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Introduction

Poor people pay more for some everyday goods and services than other people. They often pay more for utilities such as energy, telecoms and water. They may pay more for goods they buy by mail order - for example for Christmas - and for household goods. They have to use more expensive pay-as-you-go mobile phones because they cannot get contracts. And they may find some services, such as insurance, difficult to buy at all so that they are unable to protect themselves against the risk of losing possessions through fire, theft or floods. The Financial Inclusion Taskforce’s forthcoming evidence review identifies a number of studies that document and quantify these costs, which can be substantial. For example, a study which sought to aggregate them has estimated that, for an average-size family, the poverty premium could amount to as much as £1,000 a year in total¹.

This paper focuses on how *financial exclusion*, that is lack of access to mainstream financial services, contributes towards the poverty premium and what can be done about it.

Access to banking

Not having a bank account has many disadvantages. Without one, you often cannot get a job since employers do not have to pay their staff in any other way; and unbanked people who receive cheques from their employers can pay substantial additional fees to have them cashed. Not having a bank account means your money is less safe and more vulnerable to theft or loss. A bank account also makes it possible to get discounts on everyday necessities by using efficient payment methods. Suppliers of gas, electricity, water and telecommunications, who receive money electronically - for example by direct debit – have considerably lower costs than if they have to handle cheques or cash. Not only does it lower their administration costs, it also reduces the likelihood of missed payments and default, so utilities offer discounts to people who pay in this way. But only if you have a bank account can you take advantage of them. As we shall see below, direct debits are not suitable for everyone to use but, where they are suitable, not having a bank account means significant

¹ *The Poverty Premium*, Save the Children UK and the Family Welfare Association, 2007.



extra costs. In some cases, poor people do not just miss out on discounts, they actually pay higher tariffs than the better-off – for example if they have to use prepayment meters to pay for their energy.

Giving people an opportunity to benefit from a bank account is an important part of the remedy for the poverty premium. Historically there have been strong barriers to people on low incomes opening bank accounts. Banks did not welcome this particular customer group which they did not see as profitable. Formal barriers included the need to show types of ID, such as a passport and driving licence, that many poor people simply did not possess. Staff in bank branches were sometimes far from welcoming. Information about suitable products, notably the basic bank account², was not readily available. And, in addition to these “supply side” constraints, many financially excluded people themselves saw no benefit in having a bank account, sometimes through lack of knowledge about banking, sometimes through fear of losing control over their finances if they moved away from managing their money in cash; and, in the case of direct debits, through fear of suffering large penalty charges which some banks apply to customers who find that they do not have enough money in their account to meet payments when they are due. Mistrust of banks and other financial institutions has also been endemic among low income consumers (well pre-dating the recent crisis) and represents a significant deterrent to engagement with the mainstream commercial banking sector.

Whilst bringing people into banking is a first line of defence against the poverty premium, this does not mean that everyone must have a bank account. But it does mean that anyone who wants to take the advantages of being banked should have the opportunity to do so. Along with this goes the need to have sufficient knowledge (financial capability) to decide whether opening a bank account is right for them.

In 2004, the Government agreed with the banks on a “shared goal” to halve the number of adults in households without a bank account, principally by means of the basic bank account. Since then, many of the barriers to becoming banked have been lowered and in 2009 the goal was met. However, in spite of this good progress, for which credit goes to banks, government and many other agencies, there are still some 1.75m adults in households without access to a transactional bank account. And recent research shows that the ability of banks to open new accounts for low-income customers may be reaching its limit because of the “demand side” factors already mentioned.

This all indicates that further progress depends upon a multi-pronged approach. We must encourage banks to continue to open basic bank accounts when customers ask for them and to keep up their efforts to reduce barriers further. At the same time, we must recognise that there is a limit to what the banks alone can do in this field because there is a substantial

² Similar to a normal current account, but without a chequebook or overdraft facility.



minority to whom the mainstream commercial banks will always be unattractive and who will prefer “friendlier”, trusted outlets such as third sector financial institutions³ and, notably, the Post Office. This means stimulating additional sources of banking services and working through trusted intermediaries such as local authorities, housing associations, advice services and third sector organisations to inform and support people who want to open bank accounts. It also means designing suitable products for low income consumers, for example accounts with low (or no) penalty charges and “buffer zones” to cushion them if they go slightly overdrawn. It means looking for ways to use new technology (for example, based on mobile phones) to design products that are cheaper to provide and therefore give banks a stronger commercial incentive to serve low-income consumers. And we must look hard to see if there is scope for new forms of social enterprise to emerge to provide community banking services.

Some alternative providers of banking services do already exist. A number of credit unions now offer a bank account. Many accounts offered by the major banks, including all basic bank accounts, can be operated at Post Office counters but opening one means a visit to a bank branch which can be a significant deterrent; and as already noted, many financially excluded people will simply not want such an account. Although the Post Office does offer a form of account – the Post Office Card Account (POCA) – this was designed as means of paying welfare benefits electronically and does not have sufficient functionality to be counted as a transactional bank account. However, it could be made to do so. Many holders of a POCA do not have a bank account, so adding more functions to the POCA (such as the ability to pay money into the account, to make payments by direct debit when needed and to withdraw cash from the national network of cash machines) could provide them with a basic set of transactional banking services. This would be consistent with the commitment made by the government last year to put the Post Office at the heart of community banking. Upgrading the POCA in this way is the single step that could do most to bring banking within reach of a significant proportion of the currently unbanked population.

Of course, just possessing a bank account does not amount to financial inclusion and does not in itself attack the poverty premium. An account that is unused or becomes dormant does not represent financial inclusion. Someone who withdraws their weekly or monthly income all at once and then continues to manage their money in cash cannot truly be considered to be banked. Although we should want bank account holders to make the best use of their account, it is important to acknowledge that many people who have been used to using cash have a very reasonable fear that they will find it difficult to control their finances with a bank account. For this reason, we must recognise that direct debits, the feature which has the potential to save money from utility bills for many consumers, are not suitable for all; for some it would invite loss of control and a significant risk of incurring penalty charges. It

³ Credit Unions and Community Development Finance Institutions.



follows that financial capability, and measures to increase confidence in managing an account, are also vital elements of financial inclusion policy.

As well as financial institutions, firms that receive payments on a large scale from consumers, such as utility companies, have an important – and as yet relatively undeveloped – role to play. Many financially excluded people manage their money on a weekly rather than a monthly cycle and utilities could do more to facilitate weekly collection of payment. They could also provide information about payments that are imminently due (for example by text messages), helping to make direct debits safer and more manageable by their customers.

High cost credit

A major component of the poverty premium is the high cost that some borrowers have to pay for credit. Poor people often need to borrow money to smooth out peaks and troughs in income and expenditure. These are typically small loans, unsecured, for periods of up to a year which are needed to fund necessities such (e.g. school uniforms, white goods, etc.) Being financially excluded often means paying high charges for this kind of credit, whether to home credit lenders, retailers and mail order companies selling household goods on credit or, in some cases, illegal money lenders. Interest rates (APR) of several hundred percent and higher are not uncommon, with consumers sometimes paying back double the amount borrowed. There are two reasons why such credit can be expensive. First, the inherent cost of providing it can be high, either because of high default rates among some groups of borrowers or because of high distribution costs (as in the case of a home service). The administration costs of small loans will inevitably be large in relation to the loan itself and add a significant amount, proportionately, to charges. The second reason is that lack of competition in this segment of the market may permit providers to overcharge. Both causes may be present together, of course. We do not have as much information as we ought to have about how much of the high cost of credit is inherent in the product and how much is the result of inadequate competition. The Office of Fair Trading is examining the market for high-cost consumer credit at present. Where consumers are being overcharged because of lack of competition, the competition authorities need to take action.

The major commercial banks have made it clear that they are not interested in serving this market. They do not see it as profitable and are concerned at the reputational risk they would suffer if they were to charge interest rates necessary to make the business viable for them. Third sector lenders, such as credit unions and community development finance institutions, are willing, trusted, effective and affordable providers of such loans. The DWP's Growth Fund has added significantly to the third sector's lending capacity, enabling some 225,000 additional loans totalling £98m to be made. However third sector lenders are still small in relation to the market as a whole and do not have full geographical coverage, and there remains a significant unmet need for low value affordable loans among low-income



households. We need, therefore, to continue efforts to scale up the third sector. The banks, while not being direct participants in this market, have said they see their role as supporting the third sector. With some exceptions, their contribution has so far been disappointing and we need them to deliver more support.

The state of the market for the sort of credit we are considering here appears to be changing rapidly as a result of the economic crisis. Evidence is emerging that lower income borrowers, who have traditionally made up the customer base of high cost lenders, are being crowded out by middle income groups, which could drive the former to rely on even higher cost sources and, possibly, illegal lenders. This development, and its adverse consequences for the most vulnerable groups, needs careful monitoring.

Saving

Building up a cushion of savings is an important way of avoiding getting into high cost debt. Many people on low incomes find saving difficult and, when they do save, use informal methods such as cash in tins and jam jars, as well as informal collective schemes. One reason why they avoid financial institutions is lack of trust, as already mentioned. Another is the absence of simple, clearly understandable, no-frills saving products. Many feel uncomfortable saving with mainstream financial institutions and can be embarrassed at the idea of depositing very small sums of money with them.

It is a fallacy that poor people cannot save. But it is true that financially excluded people find that in practice they have a narrower choice of savings products than the better off and are more likely to save if they can find products that meet their own preferences. For example, many low-income consumers, who generally find saving difficult, do save for Christmas by using schemes in which they prepay throughout the year for goods or shopping vouchers. Such schemes are attractive to customers because they involve home collection of savings by trusted agents and provide a means of locking in savings until Christmas so that it is hard to withdraw them for other purposes. The design of the product makes it easier for them to save because it is tailored to their needs (although the goods in Christmas saving catalogues are more expensive than they could buy in a supermarket – another example of the poverty premium).

There is therefore a need for more products which are designed for low-income savers and will encourage a saving habit. The Post Office and third sector organisations are examples of trusted, accessible providers that can lower barriers to saving. Savings products in which government matches an individual's savings for a period, such as the Saving Gateway which is due to be introduced soon, are good examples of how people who have not been used to saving can be incentivised to start. We need to think harder about how to develop products that are trusted, understood and accessible and that are delivered in a manner that suits the way in which people on low incomes find it easiest to save.



Insurance

Poor people find it hard to get insurance, particularly for home contents. Here, the need is for simple no-frills products with modest amounts of cover that match the value of low-income consumers' possessions. Such insurance can be cost-effectively provided via social landlords such as local authorities and housing associations, with premium being collected along with rent. A number of such schemes are in operation and being developed, but there is scope to provide them on a greater scale.

Conclusion

Financial services, the lack of access to which is a prime cause of the poverty premium, should be regarded as an essential service. The retail banking system (and, in particular, payment services) are part of society's basic infrastructure. Being connected to them – or at least having the opportunity to be connected - is no longer a luxury but a necessity. Progress has been made in reducing financial exclusion. The government's financial inclusion policy, including its Financial Inclusion Fund of £250m and the initiatives it has financed, have helped greatly, as have the efforts made by the banks, the third sector and many other agencies. But there is still plenty left to be done and we need to keep up the pressure to make access to financial services available to all and bring down the extra costs that financial exclusion unfairly imposes on vulnerable groups.