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Locating credit and debt within an anti-poverty strategy for the UK

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Abstract

This paper examines the evidence on the links between problem debt, consumer credit use and poverty to better understand how tackling problems in relation to debt and credit use can contribute to combatting poverty. Based on this evidence we recommend four policy and practice interventions for inclusion in an anti-poverty strategy for the UK that would help to increase disposable income and for those already in poverty, help to prevent their financial circumstances from worsening.

Introduction

This paper draws on a research review conducted for the Joseph Rowntree Foundation as part of its programme to produce an anti-poverty strategy for the UK (Hartfree and Collard, 2014). It examines the relationships between poverty, problem debt and consumer credit use to better understand how tackling problems in relation to debt and credit use can contribute to tackling poverty. We then draw on this evidence to recommend a number of policy measures for inclusion in an anti-poverty strategy for the UK.

With around half of British households using consumer credit (BIS, 2013; ONS, 2012) it is part of everyday life for many people, helping to smooth the ebbs and flows of income and expenditure. While UK consumer credit contracted significantly in response to the 2008 financial crisis, since 2013 the picture has been one of strong growth as the economy starts to recover (Bank of England, 2015). As of March 2015, outstanding consumer credit lending was £170.2 billion, up from £160 billion in March 2014, with an average consumer credit debt of £6,376 (The Money Charity, 2015).

On the issue of debt, it is estimated that between 10 and 12 per cent of British households has problem debt (BIS 2013; Bryan et al., 2010); equivalent to between 2.6 million and 3.1 million households. Low-income households are more likely to be in arrears on household bills than consumer credit, which partly reflects that not all low-income households use credit (Bridges and Disney, 2004; Dearden et al., 2010; Kempson et al., 2004). Citizens Advice Bureau (CAB), a main provider of free debt advice services report a significant shift in the type of debt problems they are seeing, with more household bill debts and fewer consumer credit problems (Citizens Advice 2015a). This is attributed to the constraints in consumer credit and incomes not keeping pace with rising household bills (Citizens Advice, 2015b).

Policies to address issues around credit use and problem debt were included in the Child Poverty Strategy 2014-17 (HM Government, 2014a) under a group of measures focused on reducing living costs for low-income families. On credit, the strategy aimed to improve access to affordable credit through investing in credit union expansion and toughening up the regulations on payday lending through the work of the Financial Conduct Authority. On problem debt the strategy focused on providing money management support and debt advice via the Money Advice Service, budgeting support for those moving onto Universal Credit, and improving financial capability. More recently, the Conservative Government announced, as part of its plans to replace the Child Poverty Act 2010 with new legislation in the Welfare Reform and Work Act 2015, that debt is one of the root causes of poverty on which they will develop new measures and indicators (DWP, 2015).

This paper first considers in detail the evidence on the relationship between problem debt and poverty, where problem debt is defined as an inability to meet contractual payments on credit commitments or household bills (or both), resulting in arrears. We then consider the evidence on the links between consumer credit and poverty, with consumer credit defined as non-mortgage borrowing. Our focus is evidence from research studies published in the last 15 years, mainly from the UK. While we sought to understand the relationship between debt, credit and poverty, in fact the majority of the evidence on debt and credit has not been conducted from a poverty perspective. Most commonly, studies of consumer credit and problem debt have focused on people on '*low incomes'*, defined in a range of ways, for example: below 60 per cent of median income; below a set household income; or those in the lowest income quintile. In the absence of any other poverty measure, we have used low income (and circumstances associated with low income such as unemployment) as a proxy for poverty.

In particular this paper seeks to understand the extent to which consumer credit use and problem debt are a *cause* or a *consequence* of poverty. The hypothesis that poverty causes problem debt and problem credit use is that without sufficient income households fall into arrears on bills and other payments and in order to meet their needs may resort to using credit. The hypothesis that problem debt and credit use cause poverty is that use of consumer credit, particularly high-cost credit, over-stretches households causing financial difficulty and over-indebtedness; the cost of servicing these debts reduces households' disposable income to the extent that they experience material deprivation.

The relationship between problem debt and poverty

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). 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 al., 2010).

Some of the characteristics of households with problem debt are the same characteristics associated with households in poverty. These include: being a tenant, not being in work, working only part-time, or working in low status occupations. Studies show that debt problems were two to three times as prevalent among tenants as compared to homeowners (Disney et al., 2008; ONS, 2009) and being a tenant had the largest impact on predicting over-indebtedness (Collard and Finney, 2013). Not being in work is also associated with an increased likelihood of over-indebtedness: households headed by someone 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 is also 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).

While low-income households are more likely to experience problem debt than higher-income households and some of the characteristics of households with problem debt and households in poverty are shared, this does not necessarily indicate a direct causal relationship. A lack of longitudinal quantitative data on problem debt amongst low-income households (or on any other measure of poverty) means that it is not possible to definitively ascertain a causal relationship between poverty and problem debt. Below we consider the evidence that does exist and what it suggests about causality.

Is poverty a cause of problem debt?

Cross-sectional quantitative studies identify drops in income as the major self-reported 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, for example due to redundancy; giving up work due to ill health; or relationship breakdown (Kempson et al., 2004; Kempson, 2002). Low income was given as a reason for falling into arrears by between 14 and 15 per cent of households and 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 (ibid).

The interaction between income drops, expenditure increases and low income is perhaps best illustrated by Dearden et al.'s (2010) longitudinal qualitative study of credit and debt in 60 low-income households (defined as having a household income below £20,000, although most participants had a household income below £15,000). Whilst for some participants problem debt was the result of a single specific event, such as losing a job or starting a family, for others use of credit and the accumulation of debt were because of persistent low levels of income, whereby any shocks to their income or expenditure easily tipped them into problematic debt.

Similarly, qualitative evidence from advice agencies showed that very low income households were susceptible to small changes in income or expenditure, where 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).

Is problem debt a cause of poverty?

In the studies reviewed, we were unable to find any robust evidence to show that problem debt directly causes poverty. The same conclusion was drawn by a government review of the drivers of child poverty (HM Government, 2014b) - in direct contrast to recent claims made by the Secretary of State for Work and Pensions that debt is a root cause of poverty (DWP, 2015).

What the evidence does show, though, is that the consequences of problem debt can adversely impact on standards of living and well-being, because servicing debts reduces disposable income (Harris et al., 2009; Civic Consulting, 2013). This can deepen people’s poverty, even if it is not a direct cause of poverty. It can also increase the risk of remaining in poverty through psychological impacts whereby people feel too overwhelmed to address their financial difficulties, or it undermines their ability to improve their financial situation (Civic Consulting, 2013; Dearden et al., 2010; Disney et al., 2008).

The relationship between consumer credit and poverty

Even though consumer credit has been well researched in the UK, we did not find any studies that specifically explored the extent and characteristics of credit use amongst households in poverty, or that examined the relationship between credit use and poverty using longitudinal quantitative data.

Consumer credit use is by no means an inevitable outcome of living in poverty. Low-income households are less likely than those on higher incomes to use consumer credit. In one study 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 (Finney et al., 2007). Another study of lower-income households also showed that fewer households in the bottom income quintile 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 (Ellison et al., 2011).

Taking housing tenure and work status as indicators of household income, among households that did borrow, low-income households borrowed less. The average amounts borrowed by social housing tenants, those who had never worked or were long-term unemployed, and those looking after the family home were much lower (£3,200 - £3,900) compared to households that owned their home (£8,600) or were headed by someone who was an employee (£8,100) (ONS, 2009). While households with higher incomes have higher levels of borrowing in absolute terms, 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).

Credit cards, personal loans and overdrafts are the most common sources of credit used by lower income households (as they are among the general population), however, their use of these products is lower compared to better-off households (BIS, 2013; Ellison et al., 2011). Lower-income households are more likely to use the discretionary Social Fund (replaced in 2013[1]), mail order catalogues, home credit, pawnbroker loans, payday loans and to borrow from friends and family (BIS, 2013; Collard et al., 2013; Ellison et al., 2011; Kempson, 2002). Use of credit unions is low compared with other types of credit, estimated to be used by just two per cent of households in the bottom half of household incomes (Ellison et al., 2011) – a picture replicated in the general population.

High-cost credit (home credit, pawnbroker loans, payday loans) represents a minority of overall credit use, used by just 2.5 per cent of all households in Britain (BIS, 2013), but users of high-cost credit are most likely to be households in the lowest income quintile (Collard et al., 2013; Ellison et al., 2011). The literature identifies three main reasons why people use high-cost credit (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 poor credit history, or low income; another is because they have reached or exceeded the credit limit on their mainstream credit commitments; the third reason is choice, whereby high-cost credit better meets households' needs for borrowing small sums of money over a short time period, that is quick and easy to obtain; where repayments can be more flexible, and provides better control over debts as compared to open-ended revolving credit (such as overdrafts and credit cards).

Is consumer credit a cause of poverty?

Quantitative evidence shows a strong link between the use of consumer credit (in general) and being in financial difficulty, with the risk of financial difficulty increasing the more credit commitments people have (Kempson et al., 2004; Kempson, 2002). However, as with poverty and problem debt, a lack of evidence focusing on poor or low-income households and a lack of longitudinal quantitative evidence means it is not possible to confirm a causal relationship between consumer credit and poverty.

Nevertheless, buying goods and services on credit is more expensive than buying them outright (although with the advantage of allowing people to spread the costs over time). Gibbons et al. (2011) estimate that buying some of the items in the Minimum Income Standard[2] on credit 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.

It is perhaps surprising then that the majority of high-cost credit users questioned in surveys report a positive impact of using high-cost credit (at least in the short term). The benefits of using credit, in terms of the items or services it enables them to buy, outweighs the impact of making loan repayments, provided that repayment amounts are affordable (Collard et al., 2013; Ellison et al., 2011). However, for a significant minority of high-cost credit users, credit use makes their financial situation worse so that they find it difficult to meet everyday needs whilst also repaying what they owe. In a survey of high-cost credit users (not all of whom would be poor) between 11 and 24 per cent felt worse off financially as a result of their borrowing (Collard et al., 2013). 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). Similarly, making minimum repayments on mainstream credit (credit cards and overdrafts) over a prolonged period of time can also trap low-income households in a cycle of servicing debt that they cannot reduce or pay off (Ellison et al., 2011).

Summary of evidence

Although the review was hampered by a lack of longitudinal quantitative evidence, other evidence suggests that problem debt is likely to be a consequence of poverty. Low income, as an underlying factor, means that household finances are very vulnerable to drops in income or peaks in expenditure that, in the absence of savings or other resources, put them at risk of financial difficulties and problem debt.

There is no evidence to suggest that problem debt directly causes poverty, a conclusion also drawn by government research – but not necessarily reflected in current government thinking. The findings do though suggest that problem debt can exacerbate and deepen the experience of poverty.

There was no evidence to confirm a causal relationship between poverty and consumer credit use, with over half of low-income households not using credit. For many that do use credit, the benefits outweigh the costs of borrowing. However for others, use of (high-cost) credit is detrimental to their financial circumstances and can also trap low-income households in a cycle of credit dependency.

Informed by this evidence we turn now to consider a number of measures that we recommend be included in an anti-poverty strategy for the UK.

Recommendations for an anti-poverty strategy

The Joseph Rowntree Foundation’s programme to produce an anti-poverty strategy for the UK focuses on four key areas - the four ‘Ps’: pockets, prospects, prevention and place (JRF, 2014). The four ‘Ps’ are aimed at tackling the *causes* of poverty – something which we have limited evidence about in relation to consumer credit and problem debt. Even so, they provide a useful tool for framing policy responses to address consumer credit and problem debt within an anti-poverty strategy. Using this framework, we recommend four measures that span two of these areas:

> **pockets**: increasing households’ income and reducing the costs of meeting essential needs; and
>
> **prevention**: providing services that enables people to access advice and support to help stop them falling into poverty and protect against future poverty risk.

Based on the available evidence, these four recommendations offer the most potential to tackle issues related to credit use and problem debt.

Adequate incomes

Firstly, given that the evidence suggests problem debt is likely to be a consequence of low income, rather than the other way round, a key priority for an anti-poverty strategy for the UK is to ensure that people have adequate incomes, in and out of work. Furthermore, without sufficient income, low-income households are unlikely to be able to access affordable credit. Without spare disposable income, low-income households will not pass lenders' affordability checks – and for lenders to lend to them would be irresponsible. Similarly, without spare income low-income households are unable to build up savings. Both affordable credit and savings can provide a financial cushion at times of income loss or expenditure peaks that can help prevent financial difficulty turning into problem debt, at least in the short-term.

Income adequacy does not appear to be a central focus of the Conservative Government's policy to tackling poverty. The Welfare Reform and Work Bill 2015 proposes to remove income measures from the Child Poverty Act 2010 and introduce further welfare cuts including: extending the freeze on working-age benefits, lowering the benefit cap and cuts to tax credits (House of Commons, 2015). The introduction of a 'national living wage' announced in the Summer Budget 2015 (HM Treasury, 2015) will raise wages for the lowest paid workers, but as calculated by the Institute for Fiscal Studies (2015) will not fully compensate for the losses introduced by welfare cuts and will not benefit those not in employment. Whilst the Government's commitment to tackling the underlying causes of poverty, such as worklessness, is important for an anti-poverty strategy they will not be resolved overnight. Meanwhile, the incomes of the lowest income households will fall and, as suggested by this evidence review, problem debt will likely rise.

Affordable credit

Secondly, access to affordable credit and encouraging the expansion of affordable credit should also be part of an anti-poverty strategy for the UK. Whilst there was no evidence to confirm a causal relationship between poverty and credit use, for those who need to borrow, increasing the availability of affordable credit will reduce the cost of meeting essential needs, compared to using high-cost credit. Furthermore, not-for-profit lenders commonly encourage borrowers to save small sums of money as they repay their loans, helping them build financial resilience that may reduce or prevent their future need to borrow, or borrow as much.

The UK Child Poverty Strategies 2011 (HM Government, 2011) and 2014-17 (HM Government, 2014a) both included measures to tackle problem debt and support living standards through the expansion and modernisation of credit unions. In April 2013, the £38 million Credit Union Expansion Project was launched to increase access to affordable financial services (including affordable credit) for people on low incomes. However, there are two key issues that limit the effectiveness of this policy.

The first issue is cost: delivering small-sum loans to low-income households is not low-cost. Small, short-term loans are expensive to deliver because they attract a higher proportion of fixed costs to administer. Lending to low-income households is also more expensive because they are more likely to miss payments and providers incur a higher risk of 'bad debt' (Alexander et al., 2015). For credit unions who wish to broaden their member base to include a greater number of people on low incomes, this must be achieved within the three per cent cap on interest rates (equivalent to 42.6% APR[3]) that they can charge for loans. A review by the Financial Inclusion Commission (2015) recommended that the government lift the cap on credit unions to enable them to become financially sustainable and expand among financially excluded communities (not necessarily something that all credit unions agree with). Evidence from the DWP Growth Fund Evaluation suggested that not-for-profit lenders would have to charge an APR of at least 70 per cent to break-even (Alexander et al., 2015).

To improve access to affordable credit for low-income households, an anti-poverty strategy also needs to support the expansion of community development finance institutions (CDFIs[4]), not just credit unions. CDFIs are not restricted by interest rate caps and are, therefore, in a better position to lend to low-income households. Analysis shows that 70 per cent of CDFI customers had household incomes of less than £15,000 (CDFA, 2014) and that CDFI customers have lower incomes compared to credit union customers (Alexander et al., 2015). The average interest rate charged by CDFIs for personal loans in 2014 was 67% APR (CDFA, 2014); although more expensive than credit unions they are still affordable compared to high-cost credit.

The second issue is scale. The size of the not-for-profit community finance sector is still very small relative to the commercial credit sector. In 2013-14 credit union lending reached £687 million (ABCUL, 2015) and in 2014 CDFIs lent £19 million to individuals (CDFA, 2014). This is tiny compared to the estimated £5 billion of lending in the high-cost credit sector (Alexander et al., 2015). It is also less than the amount delivered by the discretionary Social Fund (comprising Community Care Grants, Budgeting Loans and Crisis Loans) of £815 million prior to its replacement in 2013 (DWP, 2011).

Credit unions and CDFIs are limited in their ability to expand by a shortage of loan and development capital (Alexander et al., 2015; Financial Inclusion Commission, 2015). To provide affordable credit to low-income households at a significantly larger scale will require further investment and support from government (or others) than has currently been offered. The Coalition government announced plans to pilot a new £2 million Peer-to-Peer Impact Fund to enable regulated social sector organisations (such as CDFIs and credit unions) to take on investment through the crowdfunding market (Cabinet Office, 2015), but it is not yet clear what impact, if any, this may have on the availability of affordable credit.

Emergency grant scheme

Thirdly, an emergency grant scheme is recommended for inclusion in an anti-poverty strategy, to enable poor households to meet essential needs without their financial circumstances worsening. The lowest income households may be unable to access affordable credit from a not-for-profit lender because their incomes are inadequate, or because they are using any spare disposable income to repay other debts. In these circumstances, an emergency grant scheme to meet essential needs would prevent people on low incomes from resorting to high-cost credit providers; or prevent those unwilling or unable to get high-cost credit from having to go without, with the associated risk of material deprivation.

An emergency grant scheme is not included within the existing Child Poverty Strategy 2014-17 (HM Government, 2014a). Whilst interest free Budgeting Loans are still available from DWP they do not resolve the issue of affordability for the very lowest income households because loan repayments are deducted from benefit payments reducing household income – and notably the rate of weekly or monthly repayments required by DWP can be higher than those of commercial lenders.

Following changes to the Discretionary Social Fund[1], a review of the new local welfare arrangements in England (Gibbons, 2015) found that while the majority of local authorities had moved away from providing crisis loans towards providing grants (provided by some local authorities as ‘in-kind’ support rather than a cash payment), most local authorities were failing to spend all of the money allocated to them, there were high levels of refusal rates and the value of awards was lower. The review concluded that there had been a significant fall in the amount of financial support available and that, with some exceptions, many local authorities needed to improve their delivery of local welfare schemes. In September 2015, the Work and Pensions Committee launched an inquiry into the operation of local welfare schemes.

As part of an anti-poverty strategy, there should be a government commitment to a grant-based emergency assistance scheme with increased funding and performance monitoring of its delivery. Without it, the alternatives for low-income households who cannot access affordable credit are likely to make their living standards worse and deepen their experience of poverty.

Debt advice

Finally, we recommend that an anti-poverty strategy includes a commitment to providing access to debt advice that is impartial and free at the point of use. While there is no evidence that debt advice helps lift people out of poverty (or prevents them falling into poverty), studies of free-to-user debt advice services show a range of positive outcomes that may help mitigate the impacts of poverty. Most notably, debt advice can increase disposable household income through the maximisation of benefit income that people are entitled to (Pleasence et al., 2007; Gillespie et al., 2007; Buck et al., 2009; Dayson, undated). A second benefit is a reduction in the amount that individuals have to repay to their creditors, either through repayment arrangements (where the repayment amount is reduced for a period of time) or debt write-off negotiated by advice services (Evans and McAteer, 2011; Buck et al., 2009; Orton, 2008; Pleasence et al., 2007). Debt advice users also report improved understanding of their finances and feeling better able to cope with their financial situation (even if their debt problems are not fully resolved) (Optimisa Research, 2013; Orton, 2008; Pleasence et al., 2007).

On debt advice, our recommendation concurs with existing government policy. Both Child Poverty Strategies (HM Government, 2011; HM Government, 2014a) included measures to tackle problem debt through the Money Advice Service[5] and the Universal Credit Local Support Services Framework[6] (to help people moving onto Universal Credit with money management). Set against this, however, are serious concerns about the withdrawal of funding for debt issues (as well as welfare benefits and most housing issues) brought about by the government's civil legal aid changes in the Legal Aid, Sentencing and Punishment of Offenders (LASPO) Act 2012. This involved a cut of £89 million per annum in legal aid and reduced access to specialist advice services; at the same time, there were reductions in local authority funding of advice and legal support, estimated to be at least £40 million per annum 2015 (Low Commission, 2014).

While adequate funding for the delivery of free-to-client debt advice services is important, making sure that services reach the people that need them, in as timely a fashion as possible, is also crucial. One study, for example, found that only 17 per cent of over-indebted people seek advice (Money Advice Service, 2013).

Conclusions

There is no evidence that problem debt or consumer credit use directly cause poverty. However, despite a focus on tackling the root causes of poverty this does not mean that measures to address credit and debt issues have no place in an anti-poverty strategy. Using Joseph Rowntree Foundation's framework we have recommended four policy and practice interventions.

Ensuring that households have adequate incomes is a cornerstone for preventing poverty and would also be likely to help low-income households avoid problem debt. Our recommendations for free debt advice, increased access to affordable credit, and an emergency grant scheme would help to increase households' disposable income through: maximising income, reducing income spent on debt repayments and reducing the cost of meeting essential needs that might otherwise be met through high-cost credit.

For households already in poverty, their financial circumstances could be prevented from worsening through the provision of debt advice. Furthermore, with adequate incomes households are more likely to be able to access affordable credit and be able to put aside savings, both of which can help to protect against future financial difficulty when faced with unexpected income drops and expenditure peaks.

Notes

[1] The discretionary Social Fund, providing Community Care Grants, Budgeting Loans and Crisis Loans, was replaced in April 2013: funding for Crisis Loans and Community Care Grants was passed onto local authorities in England and the devolved administrations to deliver new localised schemes: DWP retained responsibility for delivery Budgeting Loans and Social Fund Alignment Payments.

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

[3] The APR (Annual Percentage Rate), is the amount a loan costs over a year expressed as a percentage of the loan amount.

[4] CDFIs are private financial institutions that provide responsible credit to individuals and businesses.

[5] The Money Advice Service (MAS) established in 2010 is an independent statutory body with responsibility for providing impartial money advice, improving financial capability and are a major funder of debt advice services.

[6] The Local Support Services Framework is a partnership between local authorities, DWP and local organisations (e.g. housing associations, Citizens Advice Bureaux) to

provide support to those needing help with money management when they move onto Universal Credit.

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