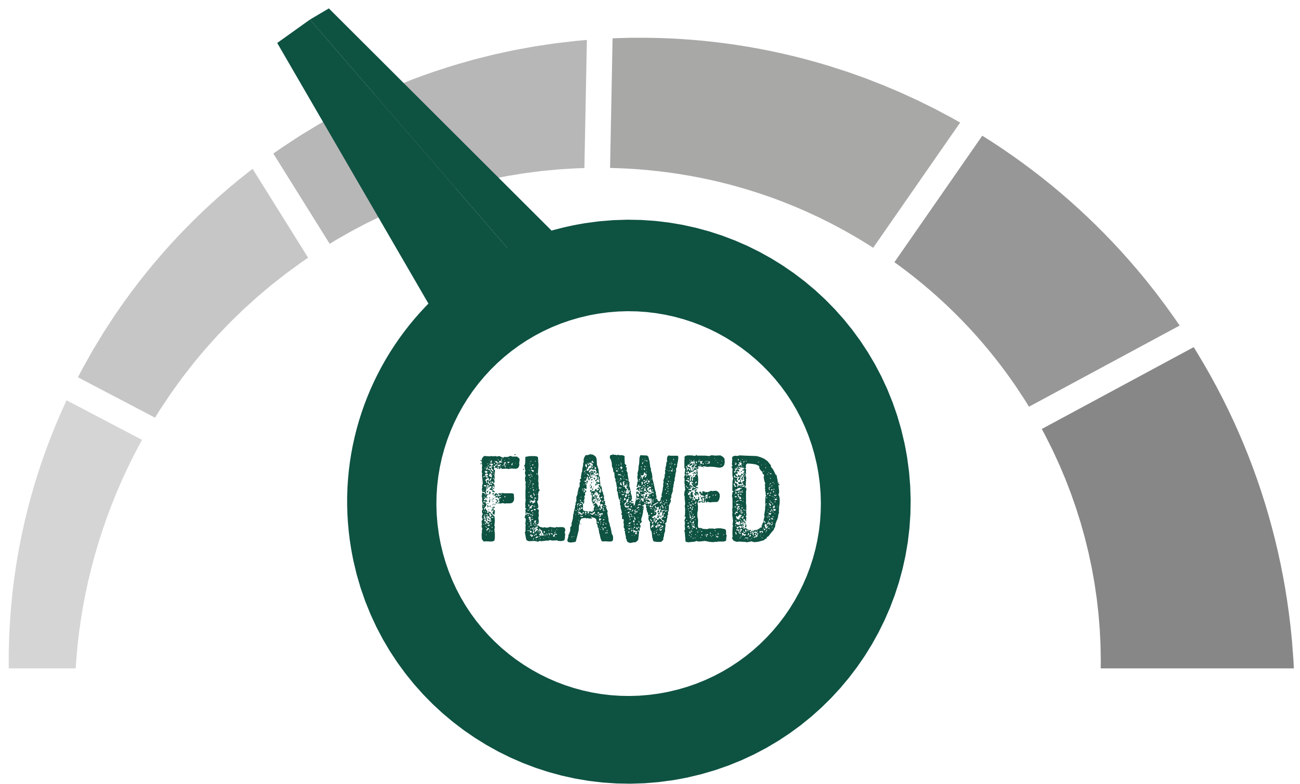
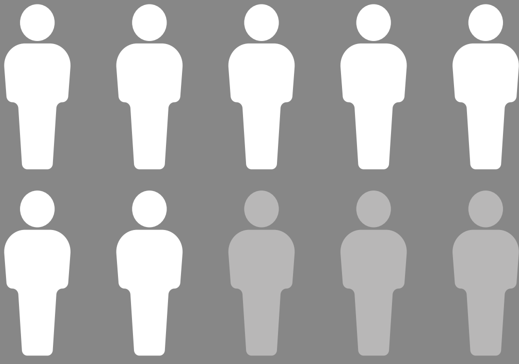
SALAD PROJECTS

Responsible Finance

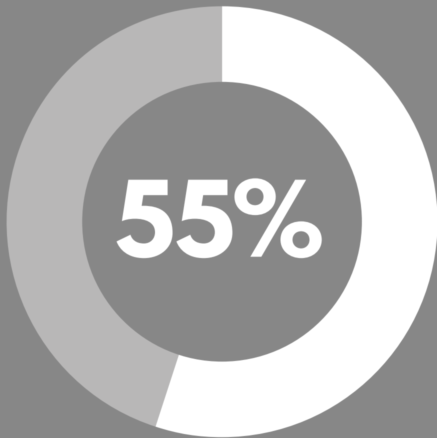


BUILDING FINANCIAL INCLUSION WITH A BETTER APPROACH TO CREDIT SCORES

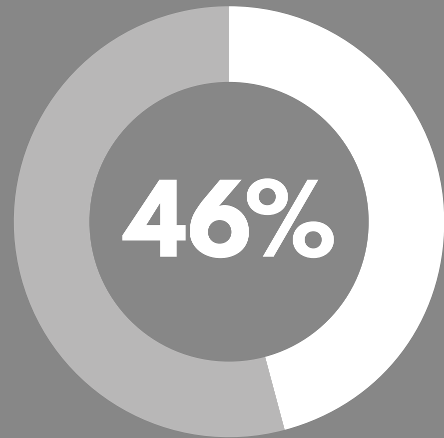


7 OUT OF 10

ADULTS THINK IT'S UNFAIR FOR POSTCODE OR LOCATION TO HAVE A NEGATIVE IMPACT ON A CREDIT SCORE



MORE THAN HALF (55%) OF ADULTS THINK IT'S UNFAIR IF NOT HAVING AN EXISTING CREDIT HISTORY HAS A NEGATIVE IMPACT ON A CREDIT SCORE



AROUND HALF (46%) OF ADULTS THINK THE FAIREST IMPACT OF A LOWER CREDIT SCORE ON BORROWING IS FOR THE BORROWER TO NEED TO PROVIDE MORE INFORMATION

LESS THAN 1 IN 6 ADULTS THINK IT'S FAIR FOR A LOWER CREDIT SCORE TO RESULT IN HIGHER INTEREST PAYMENTS FOR CREDIT

JUST 4% OF UK ADULTS BELIEVE AN APPLICANT'S LOCATION SHOULD BE CONSIDERED BY LENDERS WHEN MAKING A DECISION ABOUT A LOAN OR CREDIT FOR SOMEONE WHO DOES NOT HAVE AN EXISTING CREDIT HISTORY

Source: Opinium Research polling of 2,000 UK adults, weighted to be nationally representative. Fieldwork: 14-18 April 2023.

"The Credit Information Market in its current form harms access to affordable credit, contributes to the poverty premium and results in poor consumer outcomes. We must not miss the opportunity to transform the credit information sector to a more inclusive system which better reflects the realities of people's lives. A social score could give more people access to a fair assessment of their ability to afford credit so would benefit many currently excluded consumers."

Theodora Hadjimichael
Chief Executive, Responsible Finance

IN 2022, RESPONSIBLE FINANCE MEMBERS HELPED HOUSEHOLDS HOLD ON TO £28M IN INTEREST THEY WOULD HAVE PAID TO A HIGH COST LENDER.

INTRODUCTION: FLAWED CREDIT SCORING IS HARMFUL

The Financial Conduct Authority's Credit Information Market Study interim report acknowledged that the traditional approach to credit information fails many consumers. The FCA invited responses to its report, discussion paper and proposed remedies and Responsible Finance and members welcomed the opportunity to respond.

This report builds on submissions made to the FCA's market study by:

- Responsible Finance on behalf of CDFIs
- and Baroness Evans and Lord McNicol, co-chairs of the Salad Projects Oversight Body[1] on behalf of millions of UK consumers under-served by the "one size fits all" approach of the credit information market.

Responsible Finance believes the Credit Information Market in its current form harms access to affordable credit, contributes to the poverty premium and results in poor consumer outcomes.

FINANCIAL EXCLUSION IN NUMBERS

- More than 20 million UK adults are financially under-served and at least 1 in 3 adults may have difficulty accessing credit from mainstream lenders, a 50 % increase since 2016[2].
- The number of financially vulnerable people has increased to 17.6 million[3].
- 14.2 million people – more than a quarter of all UK adults – have low financial resilience[4].
- Between 7 and 9 million people risk being excluded from accessing affordable financial services because of flaws in credit scoring[5].
- At least 1.1 million people are borrowing from loan sharks[6].
- A quarter of UK adults have less than £100 in savings and one in six people have no money put away.
- Often low-income households don't have access to an arranged overdraft or a credit card; in the absence of savings this leaves them highly vulnerable to a financial shock.

CDFIs ADDRESS EXCLUSION AND BUILD RESILIENCE

Eight of the UK's Community Development Finance Institutions (CDFIs) make personal loans to households across the UK who increasingly find themselves unable to access credit from anywhere else.

They serve some of the most disadvantaged and excluded customers in the UK.

While they are only able to lend to 5 to 7 % of their applicants (because for many people their circumstances mean they could not afford to borrow or they do not have a credit score) they support both their customers and those they are unable to lend to in many other ways. They give income-boosting, tailored financial support to hundreds of thousands of applicants every year.

In 2022, UK personal-lending CDFIS made

90,630

loans

Value of loans made:

£45,694,020

Average loan size:

£500

Interest saved for customers compared with high-cost credit:

£27,934,270

(£308 per average loan)

They helped 68,470 people –many the "working poor" – who thought they needed a loan to identify £410 per person per month in benefits they were rightfully due, but not claiming (£4,920 each per year) amounting to some £337 million annually.

SCALING SOCIAL PURPOSE LENDERS ALONE WON'T WORK

The Financial Conduct Authority, the Centre for Social Justice and the Joseph Rowntree Foundation have all called[7] for an expansion in CDFIs so people excluded from mainstream credit have better and fairer options available.

While we welcome the ambition to scale up the community lending sector and the work already underway to support CDFIs, doing so without reforming the credit information market (and credit scores) will not address the full extent of financial exclusion in the UK.

The traditional approach to credit information fails many consumers. "Credit invisibles" and the financially vulnerable and excluded are harmed the most, as demonstrated by decline loan rates and the rapid growth in use of illegal lenders. The risk is that remedies only based on legacy thinking will not address the needs of under-served and financially excluded consumers and may even cause them further harm. This is a significant issue: many millions are "credit invisible" and financial vulnerability is growing (see p4).

We propose a powerful new instrument, the social credit score (or "social score") to be given to all new entrants to credit and the credit invisibles. If adopted, the social score would enable millions of people currently unable to access credit to be assessed fairly about their ability to take on and repay an affordable loan.

The current system means that most lenders automatically reject an application where there is no credit score and therefore, the borrower does not get the opportunity for the lender to assess if the loan would be affordable. This automatically, and unfairly, bars many from a fair affordability assessment for loans which they may be able to afford. Consider a pensioner whose mortgage has been repaid and is in receipt of a pension but may have been credit free for decades, who may be credit invisible and unable to borrow affordably for an emergency.

Our proposal would benefit all consumers and create a level playing field for lenders allowing them to serve a massive, nascent, under-served market by giving the opportunity of an affordability assessment. It would enable real competition in all parts of the market, not only the attractive and easy to serve "prime" and "near prime" categories. And it would address the poverty premium through which those with the lowest incomes often pay the most for access to credit.

Credit does not have to be harmful. If it is used appropriately and is sustainable and affordable, it is a tool which people need, value and use to spread the cost of larger expenses. These may be discretionary, like an annual holiday, or cover larger household bills like a car repair to enable someone to get to work. Credit can smooth costs and help people budget.

Credit is never a sustainable solution if a household's expenses exceed its income but it is a tool which 9 out of 10 people want or need to use from time to time. If they can afford to and wish to use credit, they deserve a fair lending market underpinned by a fair credit information market.

Social purpose lenders make an undeniable impact, saving households many millions of pounds in interest and signposting them to hundreds of millions of pounds of financial support. But they are barely scratching the surface of the need for affordable and fair credit.

A fit-for-purpose credit information market should represent all consumers, including those financially under-served, vulnerable or with low financial resilience.

> ***"A fit-for-purpose credit information market should represent all consumers, including those financially under-served, vulnerable or with low financial resilience."***

SYSTEM FAILURE

FAILING SOCIAL PURPOSE LENDERS AND PERPETUATING THE POVERTY PREMIUM

Credit scores serve some (prime and near prime) consumers well, enabling competition and choice in consumer credit markets. But they do not improve the ability for firms to provide affordable loans to under-served customers.

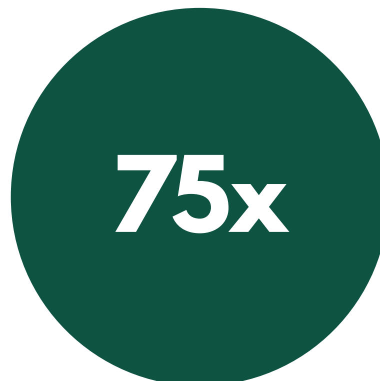
For example, more than 10% of customers which one Responsible Finance member has successfully lent to have no credit record or score (yet are successfully repaying their loans).

Payment data shows that customers with no score perform no worse than other customers and are therefore being excluded unnecessarily by other lenders where the absence of a score leads to an automatic rejection.

Furthermore traditional credit information is poor at identifying and mitigating potential vulnerability.

In many cases, the funders to the lenders demand that a credit score is used in the assessment of the applicant.

A social score would meet this requirement allowing the application to then progress to an affordability assessment.



Social purpose lenders like not-for-profit and asset-locked CDFIs, which serve some of the poorest or most vulnerable households, can be paying 75 times more to Credit Reference Agencies per loan they write than banks which serve 'prime' customers.

Some social purpose lenders use Open Banking data solely to make affordability decisions. But other social purpose lenders seeking to offer fair and affordable products to under-served people use traditional credit information, and pay a premium to do so.

Lenders using traditional credit information pay CRAs for information about an applicant irrespective of whether they lend or not. That may be fine for lenders which only serve (and attract) prime and near-prime applicants, but lenders seeking to serve people with lower financial resilience, if they can afford a loan, decline most applicants, which drives up lenders' unit search costs.

High costs harm the sustainability of the CDFI sector and its ability to scale up in line with the recommendations in the FCA's Woolard Review.

Credit Reference Agencies (CRAs) serve large, prime, high-volume markets well because both scale and high acceptance rates drive down the unit cost of their service. But smaller, niche lenders experience higher unit search costs which combined with low approval rates result in a significant cost of doing business. This feeds into higher pricing that must be borne by borrowers. **Thus the "poverty premium" is perpetuated and contributes to financial vulnerability.**

> ***The assumption that people must "earn" a credit score automatically imposes the highest interest rates on the most vulnerable.***

FAILING CONSUMERS AND MAKING JUDGEMENTS BASED ON POSTCODES

Most lenders rely on a credit score, so someone without one (like 5.8 million "credit invisible" people in the UK) or with a "thin file" is either:

- not even assessed as to whether or not they can afford to repay a loan by many lenders.
  NOT FAIR
- given an estimated score (based on their post code, among other factors) – so they are judged based on where they live.
  NOT FAIR

The assumption that people must "earn" a credit score automatically imposes the highest interest rates on the most vulnerable by forcing a low initial credit score on them. This results in additional expense through higher interest charges which is unfair and can lead to financial difficulty, long-lasting financial vulnerability and dependency on high-interest lenders. The most vulnerable either remain credit invisible, or the credit score they have denies them access to affordable credit and the ability to build financial resilience. It places the highest financial burden on the most vulnerable.

The use of traditional credit information can even accelerate financial vulnerability. Some high-cost lenders which promote their products to financially vulnerable consumers do not inform them that an application can be detrimental to the applicant's credit score, whether or not they are successful in applying and repaying the loan. This creates a trap which ensnares people with low financial resilience and turns them into financially vulnerable people. It cannot be right that any lender with no relationship with an applicant can damage their credit score, simply because that applicant has applied to them.

Why should a declined loan application affect someone's score? Lenders may decline loans for reasons which have nothing to do with the individual applicant, yet the declined application is reflected to their detriment in their score.

Declined applicants should not be reported, particularly in light of the high decline rates among financially vulnerable customers. The vast majority of applicants give their data to CRAs which monetise it while damaging each applicant's credit score. Applicants have little prospect of accessing an affordable loan and get nothing in return for their data. This can't be in keeping with the consumer duty or any standards of fairness.

As it currently operates the CRA industry penalises those with the lowest incomes, penalises the for-purpose lenders and creates the opposite of a "level playing field."

Seven in ten UK adults think that location having an impact on credit score is unfair.

Another factor which was considered unfair by a majority of UK adults was not having an existing credit history (**55%**), while just under a half consider an unsuccessful application for a loan (**47%**) or not being on a credit reference agency's records (**49%**) unfair.

Source: Opinium research, April 2023, see p2.

THE PRINCIPLE OF INNOCENCE UNLESS PROVEN GUILTY

The presumption of innocence until proven guilty is a basic and fundamental principle which underpins law and justice in the UK. But not many people are aware that our credit industry operates on the reverse assumption, forcing people with no or thin credit files to endure the punishment of limited access to credit to "build" their credit score and prove themselves worthy of more affordable rates.

This is as unfair and unjust as it would be to assume guilt in a court of law unless someone could prove their innocence. For many consumers it is a root cause of financial vulnerability, resulting in never-ending cycles of high-cost credit and at its worst the destruction of health, homes, relationships, opportunities and human and economic potential.

Most lenders will not even consider affordability for an applicant with no credit record or score. It is difficult and expensive to serve them. But this approach is unfair, discriminatory and not in keeping with the consumer duty. It is a binary, negative pre-screening which means many people with the means to repay a loan are never assessed for affordability.

Yet not having any credit score or record is not necessarily a barrier to being granted an appropriate amount of credit and successfully repaying it, as CDFIs using Open Banking have demonstrated.

Over
12 million
people are now borrowing money for food or essential bills[8].

Nearly
1 in 4
adults (23 %) relied on credit or money from family and friends to buy food in the three months to November 2022[9].

There has been an
86 % drop in high-cost short-term credit and home credit loans since 2013[10].

Between
7 and 9 million
people risk being excluded from accessing affordable financial services because of flaws in credit scoring[11].

THE SOCIAL SCORE: BUILDING OPPORTUNITIES FOR PEOPLE AND A COMPETITIVE, FIT-FOR-PURPOSE INDUSTRY

We propose the introduction of an automatic "social credit score" to address the chicken and egg situation whereby a "credit invisible" person can't get credit at an affordable rate until they have suffered the expense of borrowing from a lender for people with poor scores, all while attempting to manage the unnecessarily high burden on their finances.

The concept of the social score would mean lenders would assess all applicants on the basis of their actual financial circumstances and whether or not they can afford a loan. It would expand access to affordable credit for the 5.8 million credit invisibles and open the credit market for lenders. It has the potential to be a "win-win" for consumers and the credit industry serving the financially vulnerable.

The score would be mandated by the FCA at a level enabling people access to affordable credit. FCA, industry and consumer (and excluded-consumer) representatives should work together to determine what an appropriate score would be. Then if an applicant applied to a lender using traditional credit industry data, the lender made a search against the applicant to a CRA, and found there was no record or score for the applicant, the applicant would automatically be assigned the social score across the CRAs.

The applicant's data could then be added to the CRA record, starting the process of creating a score based on their repayment behaviour and performance. The 5.8 million credit invisibles would start to become visible. Lenders and CRAs should welcome this intervention.

The social score would not guarantee automatic acceptance to credit but would mean people automatically progressed to an affordability assessment (which a lender would be obliged to conduct) rather than being rejected simply for having no score.

It would present a major opportunity for lenders to serve a massive nascent market which would otherwise usually be denied access to affordable credit just because CRAs do not provide an opening credit score. The social score is beneficial for society, borrowers, lenders and CRAs.

Lenders would conduct KYC (Know Your Customer) checks for any applicants with a social score and would report these back to the CRA thus creating the credit footprint that the CRAs require. A virtuous circle enabling more potential choice at better rates for the applicant and more potential customers for the entire industry where the consumer's actual credit performance moves the scores up or down; rather than starting at the bottom and – for many – staying at the bottom.

CATALYSING ACCESS TO FAIR CREDIT AND BETTER OUTCOMES

The social score addresses the unfairness of the current system which assumes potential borrowers are guilty until they prove otherwise. This places the highest burden on the most vulnerable and leads to financial vulnerability and exclusion.

It is a false premise that would not be accepted in any other arena of civil society. Citizens have the right to be judged after the event of their action and not have the underlying assumption that they do not have a propensity to meet their credit obligations along with their other civic obligations.

The drivers of financial difficulty (and, therefore, non-repayment of consumer credit) are external, not deliberate. They include, as the Treasury Committee's evidence report of 18 July 2018 noted "a life shock of some kind–they fall ill, lose their jobs or have a quiet month on a zero-hours contract." So it is not appropriate for the CRAs to continue with a working premise of "guilty until proven innocent."

We believe the social score will catalyse the lending industry to look at applicants' actual circumstances and see the "wider picture" of affordability, rather than the narrow lens of a credit reference agency dataset which screens for the most desirable (to a lender) customers.

It will enable the entire industry to address the market which CDFIs serve, opening options for millions of adults, many of whom currently have no or a poor credit score, but do have a propensity to pay and are creditworthy.

A social score accords with consumer duty, stops the immediate triage of the millions of credit applicants currently consigned to few and poor options, addresses financial exclusion and creates better outcomes for consumers. It provides opportunity for people and for a fit-for-purpose, technologically innovative industry.

WHAT NEXT?

CDFIs have been around for over two decades. They are proven to build financial resilience and address financial exclusion. They already partners with many banks, financial inclusion champions, charities, local authorities and housing associations. But to magnify CDFIs' impact, policymakers and stakeholders should:

- **Support the concept of a Social Score as outlined in this document, and:**
- **Back the Fair Banking Act**
- **Expand Community Investment Tax Relief to personal lending CDFIs**
- **Extend the credit broking exemption for registered social landlords (RSLs) to all organisations when making fee free referrals for individuals to CDFIs, to reroute more people away from high-cost and illegal lenders**
- **Target portions of the expanded Dormant Assets for Social Investment and Financial Inclusion to scaling up CDFIs**
- **Exempt all Community Finance Organisations from payment of Financial Ombudsman Service Case Fees**

Please contact Responsible Finance for more about CDFIs' impact and our policy asks.

REFERENCES

[1] Responsible Finance member Salad Money is the largest personal-lending CDFI

[2] PwC and TotallyMoney (2021)

[3] Fair4All Finance, Trajectory and CACI (2022) 6

[4] Fair4All Finance

[5] Financial Times citing Lexis Nexis data

[6] Centre for Social Justice (2022) Swimming with Sharks: Tackling illegal money lending in England.

[7] Financial Conduct Authority: Woolard Review (2020); Centre for Social Justice: Swimming with Sharks (2022); Joseph Rowntree Foundation: Dragged down by debt: Millions of low-income households pulled under by arrears as living costs rise (2021)

[8] Analysis by The Money and Pensions Service, published January 2023

[9] Ibid

[10] Fair4All Finance

[11] Financial Times citing Lexis Nexis data

This report builds on submissions made to the FCA's market study (see page 3). It was edited by Jamie Veitch and designed by David Palmer (www.dp-creative.co.uk)

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