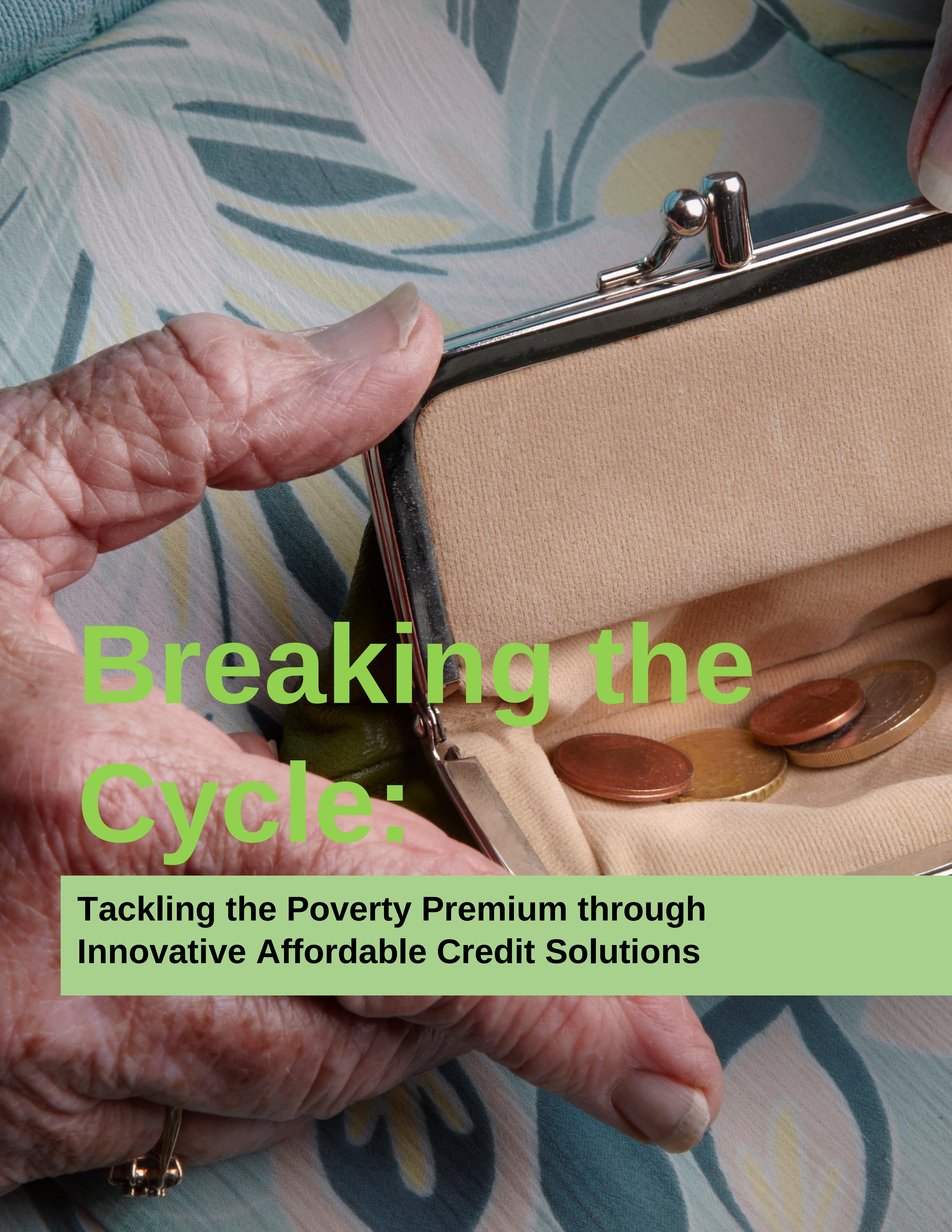

Breaking the Cycle:

Tackling the Poverty Premium through Innovative Affordable Credit Solutions

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Report on the Actions Taken to Address Affordable Credit and the Poverty Premium

This report explores the actions taken by LendFair to address the poverty premium through affordable credit solutions, supported by social investment and local partnerships. Despite successes, challenges remain, including regulatory burdens, financial sustainability, and operational costs. The report emphasizes the need for government support, regulatory reform, and the expansion of financial education to sustain the impact of affordable credit initiatives.

Introduction

The poverty premium remains a persistent issue affecting low-income households across the UK, including in South West England and South Wales. This premium results in those on lower incomes paying more for essential goods and services, including credit, due to their limited access to affordable financial products. Over the past year, the Oblige Institute, in collaboration with local social investment initiatives and credit unions, has undertaken a series of actions aimed at assessing the scale and particulars of this problem – this initiative was called LendFair. This report outlines the steps taken, the ongoing challenges, and evaluates how LendFair's model offer meaning insight for tackling the poverty premium.

The Poverty Premium: A Persistent Challenge

The poverty premium refers to the additional costs faced by low-income individuals when accessing financial services, including credit. Those living in poverty are often excluded from mainstream financial products due to poor credit history, lack of collateral, or low financial literacy. As a result, they turn to high-cost lenders such as payday loan companies or unregulated loan sharks. These lenders charge exorbitant interest rates, which can exceed 1000% APR, trapping borrowers in cycles of debt that are difficult to escape.

1. **Regulatory Reform**: Easing compliance burdens for innovative social lenders.
2. **Government Support**: Increase engagement with CDFIs and social investors.
3. **KYC Streamlining**: Reduce costs for onboarding new customers.
4. **Back-office Efficiency**: Develop affordable loan management systems.
5. **Support CSOs**: Government should fund financial education via the voluntary sector.

The Current Landscape

Research from the Joseph Rowntree Foundation and StepChange Debt Charity has highlighted the extent of the poverty premium. In the UK, around 20% of the population lives in poverty, with low-income households more likely to experience financial insecurity and debt; (this equates to 13.4 million people in poverty. Of these: 7.9 million were working-age adults. 3.9 million were children).

The cost of borrowing for essential purchases or to cover emergencies, such as car repairs or household appliances, is disproportionately higher for those in poverty. For example:

- Payday loans charge up to 0.8% daily interest, equating to an APR of over 1250%.
- Credit cards for individuals with low credit scores can charge up to 34.9% APR.
- Even credit unions, which aim to offer affordable loans, typically charge interest rates between 30-46% APR.

These high costs perpetuate a cycle of financial exclusion and instability for the poorest individuals, preventing them from escaping poverty and leading to broader social issues such as poor mental health, housing insecurity, and family stress.

Previous Approaches to Address the Poverty Premium

Various strategies have been developed over the years to address the poverty premium, with varying degrees of success:

- **Credit Unions**: Credit unions have long been seen as a solution for low-income individuals, offering loans at lower interest rates compared to traditional payday lenders. However, even these institutions often charge interest rates of up to 46% APR for small loans, and their reach remains limited due to low financial literacy and lack of awareness among potential borrowers.
- **Non-profit Loan Schemes**: Charities and non-profit organizations have attempted to fill the gap by providing low-interest loans to vulnerable groups. While these initiatives have had some success, they often rely heavily on external funding and grants, making them unsustainable in the long term. Additionally, they tend to focus on emergency or one-off loans, rather than providing a sustainable financial infrastructure for borrowers to access affordable credit on a regular basis.
- **Government Programs**: Government-backed schemes such as interest-free loans or loan guarantees have also been introduced, but these programs are typically difficult to scale and are often bureaucratic, limiting access for those who need it most.

Persistent Issues with Existing Models

Despite these efforts, the poverty premium remains a significant barrier for low-income households. The challenges with existing approaches include:

- **High interest rates**: Even credit unions, which offer more affordable loans than payday lenders, charge interest rates that are still unaffordable for many borrowers.
- **Limited reach**: Many non-profit schemes have limited geographic reach and depend heavily on external funding, making them unsustainable.
- **Financial exclusion**: A lack of financial education and awareness continues to exclude many individuals from accessing even the more affordable financial services that are available.

These persistent challenges underscored the need for a more robust, scalable, and sustainable approach to affordable credit—one that LendFair sought to provide.

LendFair's Approach

The LendFair Model

LendFair, spearheaded by the Oblige Institute, adopted an approach to tackling the poverty premium that focused on ultra-low and no-interest loans, funded through blende finance, and designed to be both sustainable and scalable. During 2023/24, LendFair rolled out its initiative across South West England, providing loans to individuals who are typically excluded from mainstream financial products.

Key elements of the LendFair model include:

- **Ultra-low Interest Loans**: Unlike traditional payday lenders and even credit unions, LendFair offered loans with interest rates as low as 0-3% APR. This is possible due to the blended capital approach, where the pressure for high returns on loans is removed, allowing for more social and concessionary returns to investors
- **Blended Capital**: The project utilized a mix of philanthropic funding, social investment, and partnerships with local financial institutions to create a sustainable lending pool. This reduces reliance on external grants and enables the initiative to scale without compromising the affordability of the loans
- **Financial Education and Support**: LendFair went beyond just providing loans; it also offered financial education and debt management services to its borrowers. This helps individuals not only access affordable credit but also build their financial literacy and improve their long-term financial stability.
- **Small, High-Impact Loans**: The majority of LendFair loans were small, typically around £500-£1000, designed to meet immediate needs such as paying for car repairs or unexpected medical expenses. This approach helps borrowers avoid spiralling into debt while covering essential costs

Successes of the LendFair Initiative

During the test period, LendFair issued more than 100 loans to individuals across the South West region. Key outcomes from the first year include:

- **Reduction in Poverty Premium**: Borrowers who used LendFair loans reported significant savings compared to what they would have paid through payday lenders or other high-cost credit options. On average, borrowers saved hundreds of pounds in interest payments by using LendFair's ultra-low interest loans.
- **Financial Inclusion**: By partnering with local credit unions and financial institutions, LendFair was able to reach individuals who were previously excluded from accessing affordable credit. Many borrowers had never previously engaged with formal financial services.
- **Positive Social Impact**: Beyond financial savings, LendFair's borrowers reported improved mental well-being and reduced financial stress. Many of the borrowers also took advantage of LendFair's financial education services, which further empowered them to manage their finances more effectively and avoid future debt problems.

LendFair's model offers several advantages over traditional credit unions and non-profit loan schemes:

- **Sustainability**: By leveraging a blended capital model, LendFair is less reliant on external grants and can offer loans at near-zero interest rates without jeopardizing the sustainability of the fund. This ensures that the model can scale effectively and continue providing affordable credit to low-income individuals.
- **Comprehensive Support**: In addition to loans, LendFair provides financial education and debt management support, helping borrowers improve their long-term financial health and avoid future poverty traps. This holistic approach sets it apart from other initiatives that only focus on lending.

- **Accessibility and Inclusion**: By partnering with local financial institutions and social investment vehicles, LendFair ensured that even the most vulnerable populations can access affordable credit. This inclusivity is crucial for breaking the cycle of financial exclusion.

Challenges and recommendations

Despite the successes of LendFair and similar initiatives in addressing the poverty premium, several significant challenges remain. These challenges relate to financial sustainability, regulatory burdens, technological infrastructure, and the role of government and civil society in supporting the sector. This section outlines the most pressing issues that need to be addressed to ensure the long-term viability and impact of affordable credit initiatives.

1. **Financial Sustainability and Regulatory Burdens**

While LendFair's blended philanthropic and concessionary funding structure proved effective in offering ultra-low-interest loans, ensuring financial sustainability remains a challenge. One of the key hurdles is the regulatory and compliance burden facing financial services providers, particularly smaller, innovative initiatives like LendFair. The current financial regulatory environment places heavy compliance demands on lenders. While these regulations are crucial for maintaining the integrity of financial systems, they can stifle innovation and limit the capacity of social enterprises to operate sustainably.

To address this, there is a need for a re-imagination of the compliance burden in a way that accommodates innovative, mission-driven lenders like LendFair without compromising the safeguards intended to protect the broader financial system. By easing certain compliance requirements or creating tailored regulatory frameworks for social investment and community development financial institutions (CDFIs), the burden on these organizations can be reduced, thereby allowing them to focus more on delivering impact.

2. **The Need for Greater State Support and Engagement with CDFIs and Social Investors**

The role of the state is critical in fostering the growth and sustainability of social lenders and CDFIs. Further state support and active engagement with CDFIs and social investors are essential to improve the lending infrastructure for affordable credit. While LendFair and similar organizations have benefitted from philanthropic capital and social investment, a more structured and robust support system from the government could provide the stability needed for long-term success. This could include direct financial support, such as grants or subsidized funding, as well as facilitating partnerships between CDFIs, social investors, and mainstream financial institutions to expand access to capital.

By creating a conducive policy environment and offering technical and financial support, the government can play a pivotal role in scaling initiatives like LendFair. These efforts would not only support the provision of affordable credit but also bolster financial inclusion and economic development in low-income communities.

3. **Open Banking and KYC Challenges**

The advent of open banking and data services has been a positive development for lenders such as LendFair. By leveraging data sharing, lenders can better assess creditworthiness and tailor products to meet the needs of their customers. However, Know Your Customer (KYC) and onboarding processes remain prohibitively expensive, particularly for small, socially driven lenders. The cost of compliance with KYC regulations, combined with the complexity of onboarding new customers, creates significant operational challenges.

Efforts to streamline KYC processes and reduce costs—possibly through technological innovations or partnerships with mainstream financial institutions—would be beneficial. By making it easier and more affordable for social lenders to onboard new customers, the sector can expand its reach and provide affordable credit to more individuals in need.

4. **Back Office Loan Management Systems**

Managing high-volume, low-value loans requires sophisticated back-office systems, which can be disproportionately expensive for small lenders like LendFair. The costs associated with loan management software, payment processing, and customer service infrastructure can undermine the business case for providing small loans at ultra-low interest rates.

To address this, there is a need for affordable and scalable technological solutions tailored to the needs of social lenders. These solutions should focus on streamlining operations and reducing costs while maintaining the flexibility to manage a diverse portfolio of loans. Additionally, collaborative platforms that allow multiple social lenders to share back-office resources could help to reduce costs and increase operational efficiency across the sector.

5. **The Role of Civil Society and the Voluntary Sector**

Civil society organizations (CSOs) and the voluntary sector are essential partners in the delivery of affordable credit services. Their role in providing financial education, outreach, and support services to vulnerable populations cannot be overstated. The government should recognize the vital role that the voluntary sector plays in enabling financial inclusion and should offer greater support to these organizations. This could take the form of increased funding for financial education programs, capacity-building initiatives for CSOs, and the creation of public-private partnerships to enhance service delivery. Supporting the voluntary sector would not only strengthen the provision of affordable credit but also help ensure that borrowers receive the comprehensive support they need to manage their finances effectively and avoid falling into debt traps.

6. **Mandatory Financial Education in the National Curriculum**

One of the key challenges is a lack of financial literacy, which exacerbates issues related to debt, poor credit decisions, and financial exclusion. A long-term solution to this issue is the integration of financial education into the national curriculum. The Conservative government's extension of mandatory maths education from 16 to 18 years old is a step in the right direction. However, these additional two years should focus on 'functional' maths, where students are taught essential life skills such as financial management, understanding interest rates, debt, investments, and credit.

Embedding practical financial education into the curriculum would equip young people with the skills they need to make informed financial decisions as adults. This would address the root causes of financial exclusion and reduce reliance on high-cost credit, which many low-income individuals currently face.

Conclusion

The poverty premium remains a significant challenge for low-income households in the UK, despite the efforts of various credit unions, non-profit organizations, and government schemes. The LendFair initiative, however, has demonstrated that a new approach—one that combines ultra-low interest loans with blended capital and financial education—can provide a sustainable solution to this issue. By reducing the cost of credit, increasing financial inclusion, and empowering borrowers through education, LendFair has created a model that not only addresses the immediate financial needs of low-income individuals but also promotes long-term financial stability.

While LendFair's innovative approach to affordable credit has made significant strides in addressing the poverty premium, several ongoing challenges must be addressed to ensure long-term success. Regulatory and compliance burdens, high operational costs, and the need for greater government support all pose significant barriers to the financial sustainability of social lenders. Additionally, expanding financial education and leveraging technology to reduce onboarding costs will be crucial in enabling the sector to scale and deliver impact.

The role of the state, civil society, and education systems is critical in creating an ecosystem that supports affordable credit and financial inclusion. By addressing these continued issues, LendFair and similar initiatives can play a transformative role in reducing poverty, promoting financial stability, and fostering economic development in low-income communities.

Further reading:

1. Joseph Rowntree Foundation. (2021). Poverty in the UK: Statistics and Insights.
2. StepChange Debt Charity. (2022). Financial Vulnerability in the UK: Report on Debt and Wellbeing.
3. Centre for Social Justice. (2020). The Financial Inclusion Report: Tackling Poverty through Affordable Credit.
4. LendFair Concept Note on Affordable Loan Fund.