Meaningful Choices
The Policy Options For Financial Exclusion

Nick Donovan and Guy Palmer

Contents

ACKNOWLEDGEMENTS

We are very grateful to those who kindly agreed to comment on an earlier draft of this report: Tina Barnes, Association of British Credit Unions Ltd; Anna Campopiano, ICL Pathway; John Earls, Banking, Insurance and Finance Union; Joel Feyerherm, Abbey National; Derek French, Campaign for Community Banking Services; Kevin Gilliland, Post Office Counters Ltd; Paul Jones, Liverpool John Moores University; Andy Love MP; Ed Mayo, New Economics Foundation; Claire Milne, Antelope Consulting; Martin Mosley and David Thomson, Barclays Bank; Richard Newcombe, Cambridge Housing Society; Susan Rice, Bank of Scotland; Steve Rowe, Girobank; and various civil servants.

We would also like to thank all those who agreed to be interviewed and participated in various seminars during the course of this research. In particular, we would like to thank Tony Baker, Association of British Insurers; Tania Burchardt, London School of Economics; John Caine, Alliance & Leicester; Tony Colman MP; James McCormick, Scottish Council Foundation; Richard Newcombe, Cambridge Housing Society; Carey Oppenheim, IPPR; Tim Roberson, Office of Fair Trading; Roy Sainsbury, University of York; and Claire Whyley for speaking at the seminars we held. Indeed a particular debt of gratitude is felt by all researchers working in this field for the work of Elaine Kempson and Claire Whyley and colleagues at the Policy Studies Institute and Personal Finance Research Centre.

Specific thanks are due to Girobank and Post Office Counters Ltd for supporting this work and making this report possible. In particular, Giles Deards and John Caine from Alliance & Leicester, Steve Rowe from Girobank, and Kevin Gilliland from Post Office Counters Ltd have been most helpful and generous with their time and energy. We are also grateful to the Office of Fair Trading and Office of National Statistics for releasing their 1998 surveys into financial services to us.

Many of the people above have commented on earlier drafts of the report. Whilst many of these have been incorporated to the great benefit of the document, limitations on space and a wish to keep the overall argument clear have inevitably meant that some of the more detailed points could not reasonably be included.

Responsibility for content and any errors, as ever, rests with the authors alone.

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Published by the New Policy Institute. First published 1999.

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ISBN 1-902080-08-4

SUMMARY

INTRODUCTION

The issues associated with financial services for low income consumers are usually divided into four broad categories: basic banking services, credit, insurance, and long term savings (including pensions). This report focuses on the first two of these categories, basic banking services and credit, and also discusses the subject of electronic methods of benefits delivery.

The material in the report is organised under three main sections:

- ***Basic banking services for money transmission***, focusing particularly on facilities for those without current accounts.
- ***Methods for delivering benefits***: the debate between current manual methods of payment via post offices and the government's stated long term aim of automated credit transfer.
- ***Access to affordable credit***, for low income consumers, both with and without bank accounts.

The argument is supported by a variety of appendices which discuss the problems faced by those outside the banking system and analyse the policy options open to a government wishing to tackle financial exclusion.

Although the report focuses on issues of supply rather than demand, this should not be taken to imply that we underestimate the issues relating to demand. For example, it is clear that government has an important role to play in encouraging the take up of financial services by lower income consumers through information, education and awareness programmes.

The main purpose of the report is to provide some overall direction to the debate amongst the financial industry and within government, in terms of both the strategic solutions to which all the interested parties should be aiming and the consequent agenda for government action. In that sense, the report aims to complement other recent research, such as that undertaken by the Office of Fair Trading and the Personal Finance Research Centre at the University of Bristol.

A key theme of recent research is that, on a practical day-to-day basis, low income consumers have much more limited choices than the rest of the population because the available options do not meet their needs.[1] The main principle underlying the proposals put forward in this report is that government should be looking to widen the practical choices available to low income customers. As the particular proposals demonstrate, this is a realistic aim for both basic banking services and access to affordable credit.

There are inevitably uncertainties about the extent to which people will, in practice, take up the new types of financial services discussed in this report. It is for this reason that our key principle is that of widening choice rather than compulsion, and we recognise that there is no single solution which will suit everyone. Furthermore, we would expect the financial industry to research the market before launching any new services, and to shape their offerings accordingly.

OUR PROPOSALS

Basic Banking Services For Money Transmission

The main problems of money transmission centre on the numbers of low income consumers who do not have current bank accounts and who conduct all their transactions on a strictly cash only basis. This restricts the choices available to them on a day-to-day basis: they cannot pay bills by using direct debit, cash cheques or buy goods using the telephone or computer.

The overall challenge for Government policy is to ensure that options exist that meet a clear need, currently unmet, for basic banking services for people who are currently outside the banking system. We suggest that the government should take the lead on this policy issue with a clear statement of the goal of universal access to basic banking services.

We further suggest that the financial services industry itself should then be given the opportunity of achieving the goal of universality, with the emergence of simple bank accounts which have no overdraft facilities being an important part of the solution. Only if this 'voluntary' approach does not deliver should the government then legislate.

In this context, our suggested agenda for government action is:

1. Set a clear, timetabled objective for the universal provision of money transmission facilities.
2. Consider the need for some rules for the provision of simple accounts.
3. Set a checkpoint at which rate of progress towards this objective is reviewed.
4. Outline a credible 'threat'if adequate progress is not being made, perhaps via the imposition of an universal service obligation.

Methods For Delivering Benefits

A major problem of benefits delivery is the potential conflict between initiatives to lower the high costs of current manual methods of delivering benefits and the adverse social consequences of any wholesale move to cheaper electronic methods of electronic transfer via banks (in particular, the possible closure of many sub-post offices).

We suggest that one attractive way forward of resolving this conflict is for banks and post offices to work in partnership to deliver benefits, with benefits being paid into accounts operated by banks but with customers being able to access these accounts via post offices.

Such an initiative is potentially in the interests of all parties, and most of those that we have interviewed have been enthusiastic about the idea. But it will necessarily take some time, and maybe some encouragement, to develop.

In terms of a consequent agenda for government action, we suggest:

1. Ensure policy on this subject is adequately coordinated between DSS, DTI and Treasury.
2. Avoid precipitate action to impose compulsory automated credit transfer via banks.
3. Encourage partnerships between the Post Office and the banks.
4. Regulate the end result so that there are no dis-benefits to the consumer (e.g. no charges).
5. Ensure that the necessary automation of post offices is successfully implemented.

Access To Affordable Credit

The main problems of access to affordable credit centre on the lack of institutional options available to low income consumers. They have fewer choices and credit is often more expensive. Again, the aim is to increase the choices available to those on a low income.

Unlike both basic banking services and benefits delivery, we do not see this as a subject which is likely to be fully resolved by the financial services industry itself, even if a clear direction is set by government.

Our particular proposal is for government to re-position and further expand the Social Fund:

1. Re-position to be a source of affordable credit to low income consumers.
2. Extend the possible applicants from those on Income Support to other benefit and tax-credit recipients.
3. Increase the funds available to make loans accordingly.

These reforms would build on the important changes that came into force on 1 April 1999, whereby the Fund has been expanded in size and less discretionary assessment criteria have been introduced focusing on ‘who you are’ rather than ‘what you want to spend the money on’.

1. BASIC BANKING SERVICES FOR MONEY TRANSMISSION

PROBLEMS: LIMITED CHOICES FOR PEOPLE WITHOUT BANK ACCOUNTS

Whilst their detailed statistics may differ, the available UK research concludes that there are many people in the country who do not have a current bank account but who say that they need the services that it offers:

- To pay income into.
- To hold that income until it is needed.
- To cash cheques.
- To pay bills easily and economically.
- To make other purchases.

Some commentators do not view this as a matter of concern: they point to statistics suggesting that relatively few people are actually refused a bank account and conclude that the matter is simply one of 'self-exclusion'.

But this argument assumes that the options currently available in the marketplace actually meet the needs of all low income consumers. In practice, what research is available suggests that some people worry about overdrawing, some worry about losing control over their financial situation, and some are not fully aware of the advantages of having a bank account. For these reasons, 'need' for a bank account does not always translate into actual 'demand' in the marketplace.

Furthermore, life is has become more difficult and relatively more expensive without a bank account: employers now overwhelmingly pay their salaries and wages into bank accounts, cheques can no longer be easily and cheaply be cashed except into a bank account, utility companies increasingly want to be paid by direct debit and offer discounts for such payments, and new forms of shopping (such as the Internet) simply do not accept cash.

Finally, life is becoming more expensive for those outside the banking system, as companies in competitive markets cease to cross subsidise customers using more expensive methods of money transmission. Can it be right that over 4 million people, of whom about half are on low incomes, now pay 20-40% more for their gas and electricity because they feel that the methods of payment used by the rest of society do not offer them the control over their finances that pre-payment meters offer?[2]

To summarise, most of the population take basic banking services for granted. They could just use cash but they choose not to because it is inconvenient. People who do not have bank accounts have, on a day-to-day basis, no such choice. Increasing the choices available to all is the key reason for wishing to tackle financial exclusion.

In this context, we suggest that the challenge for Government policy is ***to ensure that options exist that meet a clear need, currently unmet, for basic banking services for people who are currently outside the banking system.*** In other words, the issue is not just whether people have bank accounts or not but the characteristics of the accounts on offer and how these relate to the needs of people with low incomes.

SOLUTIONS: SIMPLE MONEY TRANSMISSION ACCOUNTS?

Drawing on research by the Personal Finance Research Centre, the British Banker's Association have characterised the 'ideal service features' of new types of bank accounts for those currently without as being:

- Easy cheque deposit and cash transmission.
- Transparency, with available funds made clear.
- Bill payment via simple, automatic systems, paying in regular, small amounts.
- Ability to avoid going overdrawn.

In other words, they suggest that a key element of the solution lies with the provision of simple bank accounts, which combine the advantages of cash with modern methods of money transmission. Other research, and most bankers that we have interviewed during our study, support this general conclusion: the closer an account resembles cash, the more likely it is to attract consumers currently outside the banking system.

Furthermore, developments in technology are making such simple bank accounts an ever more practical possibility. 'Online banking' theoretically checks current balances before processing transactions and this can potentially be achieved at ATMs, telephone banking, over the counter transactions and with some debit cards, such as Solo or Electron. If real time checking of balances were undertaken, accounts could be offered without an overdraft facility; thus avoiding the need for a credit check when opening an account, and also removing one of peoples' key fears about banking - high charges for unauthorised overdrafts.

Clearly, this would require the computerised bank accounts to be updated as soon as any electronic transaction was undertaken. Whilst this does not happen currently (e.g. many transactions are currently processed overnight), the technology for so doing is increasingly available and the balance of opinion is that the question is more 'when' rather than 'whether'.Whilst not disagreeing with the drift of this argument, the Office of Fair Trading have pointed out that 40% of people without a bank account also have no telephone and over 90% do not have a computer. Furthermore, research suggests that those in lower socio-economic groups are often reluctant to use high technology distribution channels.[3] They conclude that bank branches will continue to be important as a way of conducting basic financial transactions, and contrast this with the 22% reduction in the number of bank branches over the last seven years, often concentrated in more deprived areas. They then contrast this with the network of post offices, which are now both twice as numerous and much more geographically spread.

So, whilst the use of sophisticated technology is key to the practical provision of simple bank accounts, there is still likely to be a continuing need for face-to-face methods of accessing such accounts which would complement more technological methods of access. There is an obvious potential role for post offices in providing a convenient and trusted point of access for such accounts.

Drawing all this together, we suggest that ***the emergence of simple bank accounts is likely to be an important element in meeting the money transmission needs of those currently outside of the banking system. The focus of policy is then to make universal access to these accounts a practical reality.***

ISSUES: WILL CURRENT MARKET PROCESSES LEAD TO UNIVERSAL ACCESS OVER TIME?

This is a key question: if the operation of the financial markets is such that the problems of financial exclusion will automatically disappear over a reasonable period of time, then no major government action is required; if, however, the problems are set to continue then the argument for government intervention is consequently much stronger.

Unfortunately, however, there is no clear answer to the question, and it is more a matter of judgement than anything else. Looking at the issue from a variety of perspectives:

- ***Statistical trends***: Over the past 6 years, ownership of a current bank account amongst social class E has risen from about 43% in 1991 to about 50% in 1997.[4] This level of participation compares with over 80% for the rest of the population. Whilst such statistics must clearly be treated with caution, they certainly provide no guarantee that the problems of non-participation will automatically disappear of their own accord within any sort of reasonable time frame.

- ***Demand***: it is clear that cash will never again become the sole method of money transmission. Companies operating in competitive markets tend towards cost reflective pricing and will simply not cross subsidise customers using more expensive methods of money transmission over the long term. There are increasing incentives for services which support money transmission.

- ***Supply***: When bankers that we interviewed during this study were asked whether the problems will go away automatically, they generally translated the question into a profit argument: if it is profitable, then it will happen; if it is not then it will not. When asked whether or not providing bank accounts for poor people was profitable or not, they said that they simply did not yet know – relevant research was underway but has not yet reached a firm conclusion. Based on its practical experience, one bank suggested that, whilst it was not the most profitable market, there was clearly some potential profit to be made; what was required was a mindset which asked ‘is there any profit’ rather than ‘does it meet our target rate of return’?

  Such a mindset requires accounting methods that take all the relevant revenue factors into account, with the basic equation then becoming:

Major Revenue Factors	Major Cost Factors
Interest from float income	Processing of cash withdrawals
Charges for bill payments	Costs of opening the bank account
Potential future revenues[5]	Costs of maintaining the bank account

  Some bankers also pointed out that banking costs, particularly at the margin, come down over time as new technology is employed. So, even if not profitable now, bank accounts for those currently without should become an increasingly viable proposition over time.

The issue of banking motivation appears to be crucial – the market will only solve the problem of financial exclusion if banks make a conscious and sustained effort to supply these accounts. At one bank, the appointment of a senior person with explicit responsibility to try and build up a practice focussed on the less well off is resulting in a number of interesting initiatives, such as the targeting of housing estates with mailshots detailing both conventional and simple bank accounts, together with their attractions for less well off people. Banks without such commitment and personnel would seem much less likely to be proactive in trying to attract such customers, given the uncertainty about their profitability.

In summary, we conclude that ***there is no obvious, strong evidence that current market processes will solve the problems of financial exclusion over time and that progress will depend in part on how actively the financial institutions decide to seek such business***.

CONCLUSIONS: A CLEAR CASE FOR GOVERNMENT LEADERSHIP

Given the widespread agreement that there are problems, and the lack of positive evidence that these problems will automatically disappear over time, we suggest that there is clear argument for active leadership from any government which is committed to tackling the problems of social exclusion. In other words, the government should not just leave it up to the market.

The starting point for any leadership programme must be to clarify the overall objective. We suggest that this should focus on universality; for example: ***everyone should be able to access accounts which support electronic methods of money transmission without worrying about losing control over their finances or paying unexpected charges***.

It also requires some way of measuring the extent to which the objective is being achieved. We suggest that this focuses on takeup by lower income consumers; for example: ***80% of households in the bottom fifth of the income spectrum to have access to banking facilities which support money transmission***:

- The focus on takeup recognises that it is the consumers' view on suitability that matters rather than the suppliers'.
- The focus on lower income consumers reflects the fact they are disproportionately represented in those without current bank accounts.
- The figure of 80% is the current average participation rate for all households.

OUR PROPOSAL: TARGETS, CHECKPOINTS AND A 'THREAT'

Given the variety of options for making simple bank accounts a practical reality, plus the fact that at least some banks are actively exploring the subject, we suggest that government action should initially focus on the ends (timetabled objectives for achieving universality) rather than the means (what types of accounts). Thus, it should first allow some time to see if the financial industry itself can successfully introduce and market suitable new types of account which are taken up in practice and which thus meet the objective of universal access to money transmission services. Only if this approach does not deliver should the government legislate.

In this context, our specific proposals are:

1. ***Set a clear timetable for the achieving the stated objectives.*** This would focus the minds of all interested parties, and would provide the basis for evaluating developments and progress more generally. It could also provide the foundation for an information and awareness campaign of the benefits of such facilities to those currently without.
2. ***Consider the need for some rules for the provision of simple accounts***. There may be a role for government in ensuring that these accounts have the desired attributes, for example concerning charges and access. There are analogies here with the US government's specification of the attributes of an Electronic Transfer Account.
3. ***Set a formal checkpoint at which rate of progress towards the objective is reviewed.*** We suggest 2003 (midway through the next government's term of office) might an appropriate time to compare participation rates amongst lower income consumers with the 80% target, with a further checkpoint in 2006 (start of the following term of office). Annual reporting of progress could also help to concentrate minds on reaching the target.
4. ***Outline a credible 'threat', if adequate progress is not being made***. If market forces alone prove insufficient to achieve the desired aim of universal access to suitable money transmission accounts, then it will be necessary for the government to have a fallback plan. Stating this plan in advance would both clarify matters and focus minds.

   Compulsory bank accounts would be one possibility, but, in keeping with our preference for choice, we see attractions in a less draconian approach – an universal service obligation (USO) – which would place an obligation upon banks and others to provide simple money transmission accounts to all those who requested one. Clearly, the government would need to undertake research into costs and mechanisms in the run up to 2003 – ready for swift introduction if the industry fails to achieve the stated objective through its own efforts. But there are precedents; for example, in Sweden there is a statutory right to a bank account and in this country there is already a universal service obligation in telecommunications, whose market structure is arguably becoming more like that of the banking industry.

To help maximise the chances of meeting the desired objective, the government may wish to consider what incentives it could offer banks and what disincentives it could introduce to discourage non-participation. Such initiatives would, however, risk moving the responsibility for progress from the financial industry to the government itself, and should therefore be viewed with caution. A more productive approach might be to ask the financial industry what barriers there are to progress (e.g. money laundering regulations) and then to react accordingly.

One specific lever potentially available to the government to stimulate the use of bank accounts by lower income consumers would be to channel social security benefits through such accounts as a matter of course. As discussed in the next section, however, this is a much wider issue which raises important concerns about social exclusion in its own right.

2. BENEFITS DELIVERY

PROBLEMS: MODERNISING BENEFITS DELIVERY

Running alongside the discussion about social exclusion and financial services is a debate with separate origins – how social security benefits should be delivered to recipients. Currently, most benefits are delivered via a Girocheque or an order book which are then cashed at a post office. Increasingly, however, benefits are delivered directly into recipient's bank account via automated credit transfer (ACT): 33% of recipients received their benefits in this way in 1998, up from 16% in 1993. It is the stated long term aim of the Department of Social Security to move to paying all benefits via ACT into accounts. Active measures to achieve this aim have, however, been deferred for the time being, in part because of those benefit recipients who do not yet have bank accounts, plus a recognition that some of those with a bank account still prefer to receive their benefits at the post office in cash.

The reason for the DSS' desire to move to ACT is because they estimate that the unit cost to the DSS of paying a benefit into a recipient's account via ACT is substantially lower than the cost of paying a benefit by Giro cheque or order book at the Post Office (anecdotally around 4-10 pence compared to around 50 pence). In other words, delivering benefits directly into recipients' bank accounts would save money for the government.

It is also consistent with a broader trend: the introduction of new tax credits (e.g. Working Families Tax Credit, Disabled Person's Tax Credit and Children's Tax Credit) is likely to mean that in-work benefits will increasingly be delivered via an employer rather than post offices, and via electronic rather than paper-based methods.

However, if all benefit recipients were forced to collect their benefits from banks, or if all in-work benefits were converted to tax credits, then many sub-post offices, which depend on the custom brought in by those collecting benefits, could cease to remain viable and therefore close. This would have wider social consequences for those communities which rely on these post offices for a variety of services. Given that the Post Office network is substantially larger than that of the bank and building societies (19,000 compared to 15,000), and that they have a much wider geographic spread, these adverse social consequences could well be major.

Set against this, compulsory ACT could encourage banks to focus more on low income customers, and either encourage or compel people to open bank accounts, thus potentially helping to tackle the issues of financial exclusion discussed earlier.

So, whilst it has been the institutional concerns of the Benefits Agency and the Post Office which have largely driven the debate to date, there are also important concerns relating to social exclusion. In developing its future policies, it is clearly important that the government takes these concerns, as well as the direct impact on its finances, into account. The issue affects at least three separate government departments: the DSS is responsible for benefits, the DTI is responsible for the Post Office, and the Treasury is responsible for issues relating to the financial services industry in general and financial exclusion in particular.

We conclude ***that there is a clear need for government to think about benefits delivery in the round and to ensure these discussions take place in the public and political arena. This seemingly technical issue is actually very political – it relates to how people receive their benefits, possible post office closures and the overall impact on banks' customers.***

SOLUTIONS: ELECTRONIC TRANSFER BUT NOT NECESSARILY VIA BANKS?

In developing solutions for the future, we suggest that the prime focus of concern, in addition to the direct impact on government finances, should be the impact on benefit recipients and the wider community more generally.

The Government's Perspective

To date the options have usually been characterised as 'ACT and banks' versus 'manual methods and post offices', in part because the post offices cannot currently support ACT. This is, however, essentially a matter of timing. In our view, a more productive way of analysing the problem is:

1. ***ACT versus manual methods***: although the precise figures may be in dispute, it is generally accepted that electronic methods of money transmission are substantially cheaper than manual methods. Furthermore, fraud is potentially reduced. Hence, from the government perspective at least, the obvious strategic way forward would seem to lie with some form of electronic transfer of benefits.

2. ***Banks versus post offices***: in terms of banks and post offices being competing providers, the government has no role in favouring one or the other. However, as the choices do have differing implications from a social exclusion perspective, this is rightly a matter on which the government should have a view.

The Consumers' Perspective

Preferences between banks and post offices will differ from individual to individual, and the obvious ideal would be to have both choices available; it is, however, clear that, because of their wider geographic spread and different ambience, a significant proportion of benefit recipients could well favour post offices.

Rural and certain urban communities would also clearly view any risk to the continued viability of their local post office with potential concern.

Benefit recipients currently collect their benefits free of charge, the costs being picked up by the taxpayer. Whatever their views on electronic transfer itself, benefit recipients would clearly not welcome any accompanying imposition of charges on cash withdrawals. Given that cash acquisition is one of banks' major costs, there is a real risk that they will seek to recoup these costs through charging for withdrawals. This is not just a theoretical possibility: free banking ended in Australia with the introduction of ACT and, more recently, the US government, in designing its electronic transfer account, had to ensure that the accounts have a minimum of four free withdrawals a month.

We conclude that, ***whilst electronic means of benefits transfer are the likely strategic way forward over the long term, any precipitate move from post offices to banks for the delivery of benefits is a subject of potential concern to both benefit recipients and to communities more generally. The challenge for government therefore becomes how best to move to electronic means of transfer whilst ensuring that recipients have maximum choice over where to collect their benefit and continuing assurance that they will not be charged for doing so.***

OUR PROPOSAL: BANKS AS 'BACK OFFICE'; POST OFFICES AS 'FRONT OFFICE'

As discussed above, the risk of moving towards electronic transfer of benefits is that recipients are deprived of a major option – post offices – for collecting their benefit. In contrast, we suggest that the government's aspiration should actually be that that benefit recipients have an *increased* choice of places from which to collect their benefit – both banks and post offices.

In such a scenario, post offices would act as the 'front office' for any major banks or building societies that wished to participate. The potential for such a scenario is illustrated by the links that already exist between the Post Office and various banks such as the Co-operative Bank, Alliance & Leicester, Girobank and Lloyds TSB. Benefits would be delivered via ACT into bank accounts, and recipients could choose between a bank branch or the Post Office when acquiring cash.

Furthermore, customers could make deposits and withdrawals from their local post office if they so wished, and could also withdraw funds that had been paid into accounts by an employer as a tax credit. This would increase the geographical choice for banking consumers in general and would represent a step change in the range of financial services offered to rural villages and certain urban areas.

It is clear from our interviews that both the Post Office and banks would be interested in progressing in such a direction. From the perspective of the Post Office, it would mitigate their major concern, which centres on potential closure of many sub-post offices. The Post Office would then also benefit from the "footfall" of customers withdrawing funds which had been paid into accounts by an employer as a tax credit. From the banks' perspective, it would provide another business opportunity.

It is, however, also clear that implementation of such a scenario would require careful handling. First, post offices cannot currently support ACT because of their general lack of automation. The current project to automate Post Offices and benefits, if successfully delivered, should provide such automation and, over time, post offices should therefore be able to support the electronic transfer of benefits.

In this context, it is worth noting that post offices are currently being automated for more than just electronic transfer payments. If partnerships between Post Office and banks to deliver benefits were pursued, this at least raises issues of implementation priority and phasing.

Second, the development of partnerships between the banks and the Post Office will itself take time to develop and there may be a role for government in persuading major banks and building societies and the Post Office to co-operate and then in facilitating these agreements.

Drawing all this together, we conclude that, there are real attractions in the banks, the Post Office and government working together to provide benefits via electronic transfer. But implementation will require careful handling, with the timing issues being key and with a need to ensure that any new methods do not increase overall costs.

Note that, clearly, this idea of bank / post office cooperation with respect to benefits is only one specific of the wider subject of possible bank / post office cooperation, or community banking more generally.

CONCLUSIONS: MANAGING THE PACE OF CHANGE

If the Department of Social Security were to make any precipitate moves towards compulsory ACT, then the time required to automate post offices and for further partnerships between the banks and the Post Office to develop, might not be available. We therefore suggest that the government exercise caution on this agenda, perhaps setting out a timeframe within which it wishes to see widespread electronic transfer of benefits. This would then provide a timetable for the partnerships to be developed and for the technology to be implemented.

It could also be that the development of new partnerships between the banks and government would be substantially aided if the government took an active role in facilitating agreements between banks and the Post Office as part of its drive to tackle financial exclusion and increase the range of services offered to rural communities. An obvious starting point would be to articulate the attractions of such an approach from the consumers' perspective.

Finally, experience from other countries and analysis of the major cost centres of maintaining bank accounts suggests that there is a real risk that banks would want to charge consumers for cash withdrawals. We suggest that the government make it clear that this would not be appropriate, as the consumer would be losing out in comparison with current arrangements. There is a already a precedent for such an approach: under the EFT 99 reforms the US government recently stipulated that any electronic transfer accounts had to include a minimum of four free withdrawals each month.

Drawing all these points together, ***there is a clear need for careful handling of this policy issue by the government in terms of both managing the pace of change and regulating the end result. This will only be achievable if all the relevant departments (DSS, DTI and the Treasury) are working to the same policy agenda and are adequately co-ordinated.***

3. ACCESS TO AFFORDABLE CREDIT

PROBLEMS: LIMITED CHOICES AGAIN

In many ways, the issues relating to access to affordable credit are similar to those relating to money transmission: they centre on the lack of choice available for those on low incomes and outside the banking system. Most of the population use credit cards, overdrafts and other facilities from banks and building societies for credit purposes. There is, however, a significant proportion of the population who cannot use such methods and instead rely on money lenders and, where eligible, the Social Fund. Those without a current account in the household are more than four times as likely to use sources such as the Social Fund, money lenders, family and friends, and pawnbrokers than those households who have access to a current account.[6] The Office of Fair Trading concluded that "*The use of high street credit was found to be strongly related to household income and to whether or not the household had a current account.*"[7]

There is a demand for credit from those on low incomes: half of those low or very low income use credit of one type or another[8] and there were 2½ million applications for Social Fund loans in 1996/7,[9] mostly small loans (average Social Fund loan: £300).

This need is not currently being fully met by mainstream financial institutions: "*the banks and other high-street sources of credit are moving away from serving the credit needs of low-income consumers. The shrinking branch network, a more systematic assessment of credit risks, and the imposition of relatively high minimum loan values have further reinforced this tendency*".[10]

So, the issues centre on supply rather than demand and the question is again one of choice: most of the population could use money lenders but choose to use banks and building societies; low income consumers have less choice. And the conclusion is again the same: access to affordable credit must be of concern to a government committed to tackling the problems of social exclusion.

In this context, we suggest that the challenge for Government policy is ***how to ensure that options exist to meet the needs for accessible and affordable credit for people who want to borrow small amounts of money and for whom the current offerings in the market, for one reason or another, do not meet this need.***

SOLUTIONS: NEED FOR A GOVERNMENTAL NEW INITIATIVE?

Research into the 'ideal service features' of credit for low income consumers suggests that they include:

1. Small, one-off fixed term loans.
2. Regular, fixed repayments.
3. Low or no rates of interest.
4. Not conditional on the purpose for which the money is to be used.
5. Widely available to those on low income.

The ***Social Fund*** meets the first three of these characteristics, but historically not the fourth (assessment has depended on purpose) and often not the fifth (only eligible to those on Income Support and strictly cash limited, with substantial refusal rates). With imminent changes to the rules, whereby assessment will be based more on who the person is than on what they need the money for, the fourth characteristic may be eased but only at the expense of a worsening of the fifth, with certain types of people institutionally out-of-favour.

Moneylenders may have advantages in terms of their flexibility of repayments, but they certainly do not meet the low-cost criterion (APRs are commonly more than 200%).

As discussed earlier, the ***mainstream financial institutions*** do not appear to be a complete solution. None of those we interviewed felt that small loans targeted on low income consumers were an attractive business proposition for such institutions: the costs involved in the decision-making and the credit risks both make them unattractive. So, if the aim is to improve access to affordable credit, the government must look either to change the environment in which existing lenders make their decisions or to alternative lending institutions.

One way of changing the environment would be to introduce legislation analogous to the United State's ***Community Reinvestment Act*** (CRA), whereby financial institutions are obliged to meet the credit needs of their communities (within overall prudential lending rules). But the banking system is different in this country and, anyway, the emphasis of the CRA is slightly more towards businesses in low income areas than at households with low income. Similarly, variants on the CRA, such as the Community Reinvestment Disclosure Bill, in which lending institutions have to reveal their lending activities on a postcode by postcode basis, do not necessarily help individuals' access to credit.

Credit Union are alternative lending institutions, currently the subject of much debate. Whilst they are a potential solution, and clearly have a role to play, their current scale and historic rates of growth suggest that, at best, it will take some considerable time for them to become **the** solution. As a recent report concluded "*credit union development as typically undertaken has not created sustainable financial institutions that are able to serve large number of people, particularly in more disadvantaged areas*."[11] Furthermore, the necessity of the existence of savings before a loan can be taken out means Credit Unions can be problematic for those on low incomes who find it difficult to save, or those who need credit at short notice.

A related, more recent, idea is that of ***gateway institutions***, which are membership organisations which act as intermediaries between the customer and mainstream financial institutions. They are an interesting idea with potential but again, at best, they offer a potential solution of sufficient scale in the longer term only.

Drawing all this together, we suggest that ***there are a variety of interesting ideas for promoting affordable credit to the more disadvantaged, which may well become major solutions over time. However, none offers an obvious short term solution on a large scale and other new initiatives are therefore worth considering.***

OUR PROPOSAL: A NEW PHILOSOPHY FOR THE SOCIAL FUND

"*The makings of a banking service are emerging within the benefit system in the operations of the Social Fund which offers loans, and in the system of direct payments which offer a direct debit system for some people on income support.*"[12]

The Social Fund was introduced by the previous government as a means of saving money, replacing grants made under the previous Supplementary Benefit scheme with a mixture of non-discretionary payments and discretionary grants and loans. The Budgeting loans section of the Fund consists of interest free loans for important 'lumpy' expenses which are difficult to budget for from within a weekly income. It is restricted to those on Income Support, partly because the previous grants system had been, and partly because repayment was easy to achieve (direct deductions from future Income Support payments). Any underlying philosophy has been lost in the mists of time. Whatever its past, it is surely time to re-visit and re-formulate its purpose.

We suggest that one of the future purposes of the Social Fund should be as a source of credit for those on low incomes, and that this represents a practical medium term option for a government wishing to increase access to affordable credit for those on low incomes.

This suggestion is made for pragmatic reasons: the Fund is an efficient and sustainable loans scheme. Whereas lending schemes which rely upon door-to-door collection tend be very expensive - witness the high APRs of traditional moneylenders - the Social Fund collects repayments relatively cheaply and effectively through direct deductions from Income Support. Gross lending in 1996/7 was £284 million, of which £250 million was later recovered - a recovery rate of 88%. Whilst the administration costs are substantial (about £160 million in 1997/8), these cover the whole of the Social Fund, not just budgeting loans; furthermore, many of these costs are fixed, and do not therefore rise in proportion to the amount of money lent. That the government considers it 'good value' is illustrated by its plans to expand the gross expenditure on budgeting and crisis loans to £437 million in 1999/2000.

From the consumer perspective, the size of the loans made by the Fund, its affordability, and the shape of its repayments all fit with the objective proposed earlier of providing affordable credit for people who want to borrow small amounts of money.

The assessment process for Social Fund applications is currently being changed in two major respects. First, more rigorous national guidelines are being introduced, with less local discretion. Second, the criteria are moving away from 'what is the money being loaned for' and towards 'who is it being loaned to'. These changes should make the Fund more attractive to those who successfully apply: by reducing the rules on what the money can be spent on, they should make the Fund more flexible in meeting people's various needs and should lessen the questioning of need which is sometimes viewed as somewhat paternalistic. They should also make the operation of the Fund cheaper, as less detailed personal assessments will be required.

Combined with the significant expansion of the Fund, these changes represent a major shift of direction by the government, with this shift being in line with the idea of the Social Fund being a source of credit for those on low incomes.

Building on this foundation, we suggest ***that the government widen the potential scope of the recipients beyond those on Income Support to those on other benefits and, potentially, to those in receipt of the new in-work tax credits***. There are no technical reasons why the Fund should not be extended to, for instance, recipients of the Working Families Tax Credit. Repayments of such loans could still be via direct deduction – albeit involving the Inland Revenue in the case of tax credits. It would allow the Fund to be extended to those in work (but on low wages), whilst still being collected efficiently.

Any extension of the population who are considered eligible for Social Fund loans implies an expansion of the Fund itself, if reduced access to those already eligible is to be avoided. But, as discussed earlier, the net cost of so doing would be relatively small, so long as the system of direct deductions is maintained.

4. A FRAMEWORK FOR EVALUATING OTHER PROPOSALS

In this report, we have provided an analysis of the issues and our proposals for addressing them. Implicit in this analysis is a framework for evaluating proposals from other sources to address the same problems. In undertaking any such evaluation, we suggest that the following checklist is used:

Basic Banking Services For Money Transmission
Is the objective clear?
Does the objective include universal access to electronic methods of money transmission?
Does the objective include an overall timeframe for its achievement?
Are there clear means for achieving the objective?
Will consumer choice be increased as a result?
Is there a fallback plan?
Benefits Delivery
Does it address the risks of the closure of many post offices?
Does it achieve the objective of reduced government costs for benefits delivery?
Will consumer choice between banks and post offices be maintained?
Does it avoid the risk of unilateral action by individual government departments?
Access To Affordable Credit
Does it address the issues of accessible and affordable credit to low income consumers?
Are there clear means for achieving the objective?
Will consumer choice be increased as a result?

APPENDIX 1 - THE POLITICAL CONTEXT

POLITICAL SALIENCE

The issues of 'financial exclusion' and access to financial services have risen high up the political agenda. From being the subject of concern of a few academics, the matter is now being investigated by two HM Treasury action teams and one taskforce and has been the subject of an Office of Fair Trading investigation.

In 1998, the Social Exclusion Unit published *Bringing Britain Together, A National Strategy for Neighbourhood Renewal*. This set up an action team with a remit to examine:

- "*the scope for development of credit unions, building on planned legislative change*;
- *"increasing the availability of insurance services to deprived communities*;
- "*the role of the retail banks, Post Offices and other organisations in providing access to and delivery of financial services in deprived neighbourhoods*."

The stated goal of the Action Team is "*to develop a strategy to increase access to financial services for people living in poor neighbourhoods*."[13] A further Action Team was set up to look at how entrepreneurship could be encouraged. It has been given a remit which includes the request to investigate "*how access to capital for small firms can be improved, especially for small firms, including innovative approaches such as 'microcredit'*."[14]

Also in 1998, the Government announced the formation of a taskforce, led by Fred Goodwin of the Royal Bank of Scotland, with a remit to *"explore ways in which banks and building societies can work more closely with credit unions to increase their effectiveness; look at ways to widen the range of services that are provided to credit union customers; and encourage the continued expansion of the movement."*[15]

In 1999, the Office of Fair Trading produced its report into financial services for vulnerable consumers. The investigation covers "*banking, credit, insurance and saving and will consider the experiences of groups such as the elderly, the disabled, those with learning difficulties or low educational attainment, those for whom English is not their first language and those with a low or uncertain income."*

Finally, there is a wider investigation into the competitiveness of the banking industry in a review led by Don Cruickshank which is examining payment systems, finance for small and medium size enterprises, credit cards, electronic commerce, and the bundling of banking services.

WHY NOW?

The movement of financial exclusion up the political agenda is due to the convergence of at least four factors:

- A focus on access to services (including access to financial services) as an integral part of social exclusion.
- A focus on entrepreneurship as a route out of poverty, as well as vital for job creation, has led to concern about access to finance for entrepreneurs.
- Recognition by the Labour government of the importance of stimulating competition as a tool for improving the delivery of all services has led to scrutiny of the degree of competition in financial services – particularly at the low end of the retail market.
- The welfare reform programme, and in particular the desire to cut the benefit delivery budget, perhaps through increased use of ACT, and reform of the Social Fund.

RELATIONSHIP WITH SOCIAL EXCLUSION

This government has stated its commitment to tackling social exclusion. Early in the government's first year, the high profile Social Exclusion Unit was established, reporting directly to the Prime Minister. So how does 'financial exclusion' fit in with the wider themes and definitions of social exclusion? It does so in four ways:

Access to services

One of the common themes of social exclusion, as opposed to narrower definitions of poverty or low income, is that individuals are deprived of the goods and services that most people in the country accept as the norm. Often the use of such services varies considerably by income or social class and bank accounts are no exception.

As will become clear later, banking services can affect the real price of fuel, while use of other financial services such as home contents insurance have been found to be linked with ownership of a bank account.[16] A bank account is a gateway to many other goods and services.

Dynamics

Other elements of the social exclusion debate are also shared with financial exclusion. There is a great deal of interest in the dynamics of social exclusion – the movement of people in and out of employment, benefit and poverty. Such churning also occurs with financial exclusion.

Economic opportunity

As part of this concern with the processes of social exclusion, there is a focus on the processes towards social *in*clusion. It is sometimes claimed that entrepreneurship is an important route out of poverty and social exclusion.[17] One of the HM Treasury policy action teams is specifically mandated to examine how access to finance for entrepreneurs can be improved.

Geography

Finally there has been a great deal of interest in the geography of social exclusion. In particular it is perceived that polarisation has increased – that certain areas suffer from concentrations of unemployment, low income, poor health and contracting private services. Accusations of 'redlining' and financial 'desertification' form part of this concern.

APPENDIX 2: CURRENT PROBLEMS

It is axiomatic that any policy solutions that are developed should respond to the actual problems being faced. This section summarises those problems, largely drawing on research by the Policy Studies Institute and Personal Finance Research Centre at the University of Bristol[18], the Office of Fair Trading[19], Pratt *et al*[20] and the National Consumer Council and supplemented where necessary by our own analysis of two surveys – the Family Resources Survey and the ONS Omnibus survey used by the OFT.[21]

The various types of problems and the people to whom they mainly apply are summarised in the table below.

Types of problem	Because you haven't got a bank account	Because your income is low	Because of where you live	For all people / for average person
Money Transmission	**Cannot pay using cheques.** **Cannot pay bills via direct debit.**			
Credit	**Overdrafts and bank loans are not available.** **Current account ownership is used as a positive indicator in credit scoring**	**Small amounts of money are costly for institutions to lend.**		
Savings	**Those without accounts cannot store and save money safely.**			
High Charges	**One third of those without bank accounts closed them down in the past – some due to a bad experience with the account**	**Flat rate charges impact more on low income bank users**		**Charges exist for some banking services and to deter unauthorised overdrafts**
Communities		**Low income communities have fewer bank branches per head of population than others.**	**It is claimed that rural communities have a high rate of bank branch closure.** **Lower income areas have a high rate of bank branch closure and fewer branches per head of population**	

PEOPLE WITHOUT BANK ACCOUNTS

Numbers

The number of people without a bank account is often used as an indicator of the extent of financial exclusion. The most widely used data source is the Family Resources Survey – which indicates that 20% of households and 23% of individuals aged 20 or over – 9.6 million people – do not have a current account. Furthermore 9% of households and 11% of individuals aged 20 or over – 4.8 million people – have no account at all.[22]

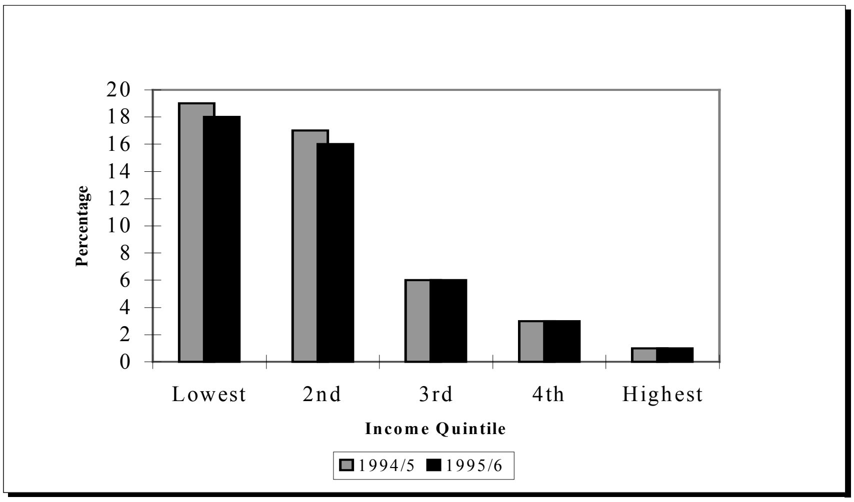
It may be that the Family Resources Survey overestimates the extent of financial exclusion. Other sources such as the ONS Omnibus survey carried out for the Office of Fair Trading (OFT) in 1998 indicated that 11% of households did not possess a current account. Similarly, the OFT states that this survey underestimates the numbers of households without a current account.[23]

Socio-economic characteristics

Despite the disparities in the overall numbers, it is clear that both the income distribution of account possession and the trend over time are vital in understanding why access to financial services is an aspect of social exclusion.

One of the common themes of social exclusion, as opposed to narrower definitions of poverty or low income, is that individuals are deprived of the goods and services that most people in the country accept as the norm. Like some other services, the use of bank accounts varies considerably by income or social class.

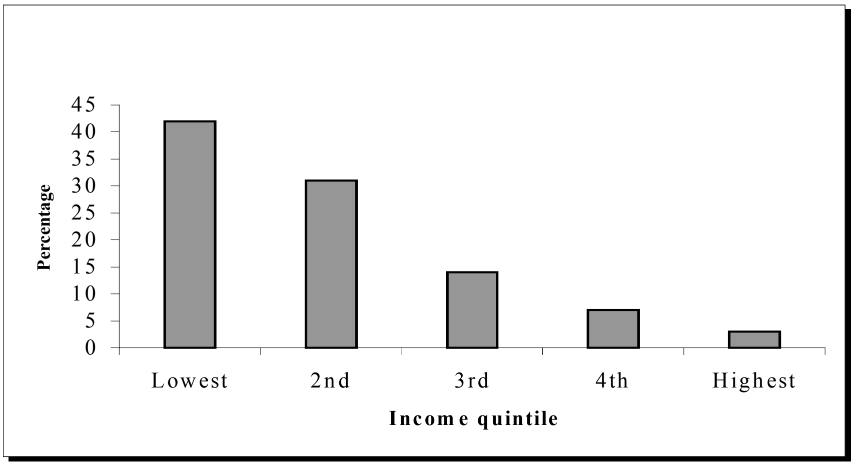
Chart 1: Households Without Any Bank Account By Income



Source: New Policy Institute, FRS/HBAI, DSS Analysis[24]

These differentials are even more pronounced with figures showing possession of current accounts:

Chart 2: Benefit Units Without A Current Account By Income



Source: HBAI 1996/7 Table 2.11, FRS, DSS analysis.[25]

As might be expected, these differentials can be found not just according to income but also according to other household characteristics:

Table 1: Percentage of bank accounts in households with selected characteristics

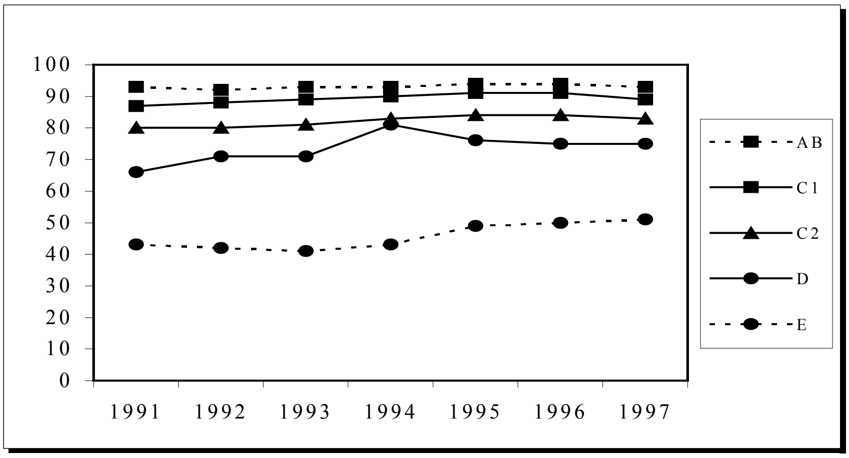
Type of household	% without any account	% without current account
Lone parents:	27	47
Bangladeshi & Pakistani households:	27	39
Local authority tenants:	n/a	50
Low incomes (income < £100 p.w.)	20	41
One or more unemployed adults under pension age	18	30
One or more sick or disabled adults under pension age	14	25
All households	9	20

Source: Family Resources Survey, 1995/6

Trends

The proportion of the population with some form of current account has been rising over time. In 1975, only 45% of adults in the UK had a current account. By 1985, this proportion had risen to 70%. In 1995/6, 77% of individuals in Great Britain held a current account.[26] However, it is equally clear that this progress has not been shared by all the population. As the following chart demonstrates, those in the lowest socio-economic group have not yet seen a dramatic rise in current account ownership in the last 6 years.

Chart 3: Current Account Ownership By Social Class



Source: Office of Fair Trading[27]

Choice

Choices about whether to have a current account have been at the centre of the debate over financial exclusion so far. The British Bankers' Association survey suggests that only 2% of individuals without an account do so because they have been refused – this has led to statements saying that the problem is largely self-exclusion. The British Bankers' Association have used their research to classify four key types of 'unbanked' adults:

- *Opted Out* (30%) "I used to have an account, but I closed it",
- *Not yet in* (8%) "I haven't yet opened an account but I will",
- *Always out* (60%) "I've never had an account and I never will",
- *Refused* (2%) "The bank refused/closed an account in my name".

The OFT research supports the finding that very few are actively refused access to, or ejected from, a current account. However they also state that "*it would be unwise to underestimate the problem. The banks that responded to our question on the matter revealed that between 13% and 41% of applications for conventional current accounts were turned down in the most recent 12 month period. In total, of 2.5 million applicants received, 650,000 were refused – or just under a quarter*."[28]

More importantly, the OFT reject as simplistic the claim that "*those who fail to take up even the most basic of financial services have done so out of choice*." The Director General of Fair Trading goes on to argue, "*The take up of bank current accounts, household insurance and short term credit is inconsistent with the exercise of any meaningful choice*." The OFT argues that financial products currently on the market are inappropriate for those on low incomes and, furthermore, that financial institutions simply do not approach low income customers. By and large, the custom of those who do not have a current account is not sought after by banks and building societies. Junk mail is one indicator of the lengths to which banks compete for target groups. "*Nearly one half of those consumers without a current account in the household had not received any approaches advertising financial services in the previous fourteen months, compared to less than one fifth of those who had active current accounts*."[29]

BASIC BANKING SERVICES – MONEY TRANSMISSION

Bank accounts provide convenient money transmission services. They allow bills to be paid conveniently, they allow income (whether from wages or benefits) to be received simply, and they are the main method for receiving cheque payments. People without bank accounts have to follow different approaches, which are generally less convenient and are increasingly more expensive.

Needs

Some research has been carried out into the money transmission needs of those without a current account. About 70% of individuals without a bank account say that they have no need for banking services, perhaps because their partner has a bank account.[30] That still leaves at least two million people who do not have a bank account who say that they need at least one of the basic banking services that it offers:

Table 2: Facilities regularly needed by people without a current account

	% needing
Somewhere to have earnings or social security benefits paid into	19
Somewhere to keep earnings or social security benefits until needed	16
A way of cashing cheques	11
A way of paying bills	13
A way of paying for things bought	9
None of these	71

Source: *ONS Omnibus module, base n = 224*[31]

Bill payment

The vast majority of people with a bank account pay their bills using it, whether by cheque, direct debit or debit/credit card. Those without bank accounts cannot use any of these options and rely on cash.

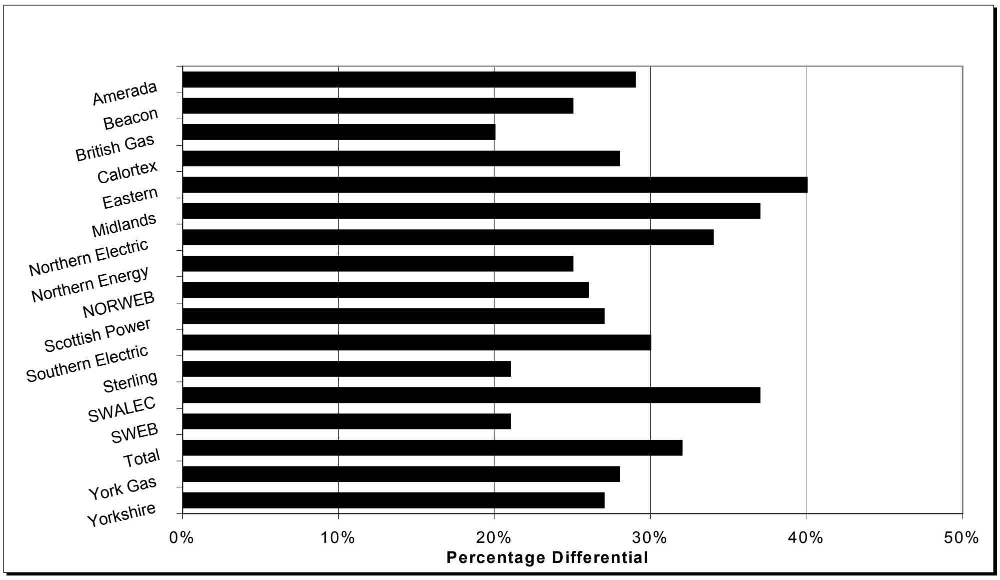
Table 3: How household bills are paid

	Has no account in the household	Has an account in the household
Base	*144*	*1634*
	Column percentages	
Cheque from current account	*	67
Cheque from savings account	1	6
Direct debit/standing order/other transfer	4	74
Debit or credit card	*	50
Cash at PO, bank or building society	86	27
Cash direct to person billing	41	25
Paypoint or other third party	4	1
Direct deductions from benefit	7	*
Pre-payment meter/stamps/other pay as you go	23	5
Someone else responsible for paying bills	3	4
Someone else pays through their account	2	-
Other	-	*

Source: ONS Omnibus module[32]

In addition to being far more convenient, paying bills using basic banking services is often cheaper, particularly for utility bills. For example, the Department of Trade and Industry have calculated that gas consumers who pay by direct debit on average paid 7% less than those who paid on receipt of a quarterly bill.[33] As can be seen in the chart below, these differentials are even larger between those paying by pre payment meters, who are often on low incomes, and those paying by direct debit.

Chart 4: Percentage Differential Between Prepayment Meter And Direct Debit Tariffs For Companies Supplying Gas



Source: Centrica and Consumers' Association[34]

Cheque cashing

The Cheque Act (1992) was designed to counteract fraud. It prevented fraudulent encashment by people who have intercepted a cheque – a problem which had reached the scale of £34 million in 1990. Since the Act, cheques have been automatically crossed as 'account payee only'. Obviously, those without an account have difficulties receiving cheques.

One option open to those receiving a cheque is to open an account. Another option would be to go to a cheque casher. These require proof of signature, a photograph, and proof of address. A cheque cashing service typically charges seven or eight per cent of the value of the cheque and a handling charge of around £2. The first use of a cheque cashing service also incurs an additional £2 charge.[35]

ACCESS TO AFFORDABLE CREDIT

Choice

Access to affordable credit is important for helping to smooth out the purchase of one-off bulky items and for coping with other cash flow problems. The PSI survey on credit and debt, carried out in 1989 found that those on low incomes have fewer choices over the source of their credit than the rest of society.

Table 4: Use of credit, by household income[36]

	Up to £100	£100-£150	£150-£200	£200-£250	£250-£300	£300-£400	Over £400
Total =100%	255	176	255	201	177	284	206
Percentage using any source	67%	69%	75%	77%	77%	78%	76%
Average number of sources among users	2.14	2.25	2.45	2.71	2.77	2.84	2.96
Average number of sources overall	1.43	1.55	1.85	2.08	2.13	2.21	2.25

This curtailment of choice may be due to lack of access to the banking system. This can be seen in the following analysis of the types of credit used by those without a current account.

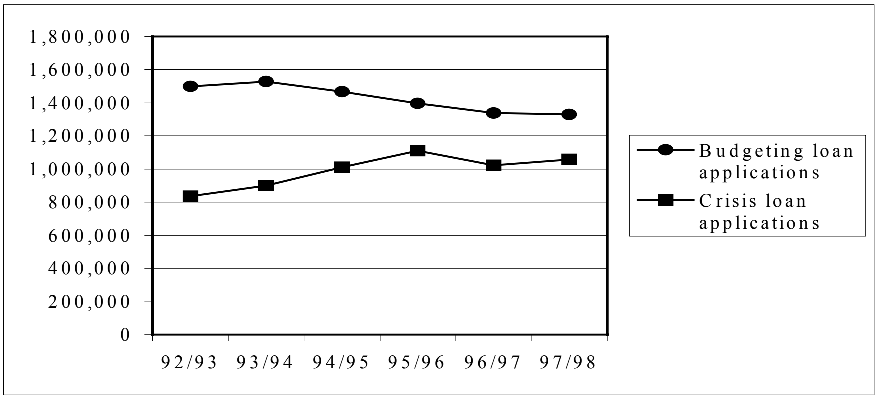
Table 5: Use of credit, by current account ownership[37]

	No account (n=418)	Has account (n=1807)
Credit facilities	*Row percentages*	
Overdraft	-	100%
Credit/charge card	3%	97%
Store card	4%	96%
Mail order catalogue	17%	83%
Hire Purchase	12%	88%
Informal loan	27%	73%
Cash loan	8%	92%
Source of cash loan	*Row percentages*	
Bank	3%	97%
Building Society	2%	98%
Check Trader/ Money Lender/ Pawnbroker	63%	37%
Social Fund	85%	15%
Credit Union (Northern Ireland only)	30%	70%

Table 5 shows clearly how those who are outside the banking system use very different sources of credit than their account owning peers – often turning to moneylenders and the Social Fund for their credit needs.

One indicator, albeit with heavy limitations, of the scale of the problems that people have gaining access to affordable credit from mainstream sources, are the numbers who apply for budgeting or crisis loans from the Social Fund. Over one million applications for budgeting loans were received in 1996/7 and, separately, there were over one million applications for crisis loans. While these figures may include people who make more than one application in a year, it is important to note that only those who have been on income support for 26 weeks are eligible to apply to the Social Fund - recipients of other benefits and the 'working poor' are excluded.[38]

Chart 5: Social Fund Loan Applications



Source: DSS, Social Security Statistics 1996/7

Those who are ineligible for the Social Fund (and indeed large numbers of those who are eligible) use other sources to meet their credit needs.

Price

In practice, very few are refused access to credit of any kind, from any source. Those who are refused credit by, or do not apply to, the mainstream financial institutions, can often turn to moneylenders or non-market sources such as the Social Fund or friends and family. Analysis of data collected by the OFT in 1998 reveals that only 3% of households who had not used credit since 1993 had not done so because of refusal by lenders.[39] Rather than access *per se*, it is often the prices and conditions on which credit is offered that is the issue.

This concern with price and source is shared by the government: the Social Exclusion Unit state that once banks have closed many branches within one area *"the net result is that people living in poor neighbourhoods often have to depend on very expensive forms of credit, including 'loan sharks'."*[40] The table below shows the interest rates charged by several of the main types of institutions offering loans.

Table 6: Prices of £500 loan from various institutions

	Bank overdraft (authorised)	**Bank overdraft (unauthorised)**	**Building society overdraft (authorised)**	**Building society overdraft (unauthorised)**	**Credit Union**	**Registered Money Lender**
APR	18.8 %[41]	29.8 %	12.2 %[42]	28.3 %	12.68%	233%[43]

PLACE TO STORE AND SAVE MONEY

A bank account also provides the individual with a safe place to store and save money. Table 2 showed that nearly one in five of those without a current account needed somewhere to pay earnings or social security payments into.

The abolition of the Truck Act in 1987, which required those who were paid weekly to be paid in cash, has led to an increase in the numbers having their wages paid by cheque or automatic credit transfer. Since 1978, the proportion of those paid in cash has dropped from around 58% in 1978 to 12% in 1998.[44]

Of course, money can be stored and saved in savings accounts and many people without current accounts use savings accounts in this way. There is little evidence that access to savings accounts are a pressing problem for most of the population. The percentage of those with any kind of account, including savings accounts, is much higher than that of those having a current account: only 9% of households do not have any account – compared with 20% of those without a current account.

However, chart 1 shows that nearly 20% of those in the bottom quartile of the income distribution do not even own a savings account.

TREATMENT OF LOW INCOME CUSTOMERS

Both the Banking and Building Societies Ombudsmen record a large number of complaints each year about the treatment of customers who are inside the banking system. The Banking Ombudsman received 11,874 written complaints, 19,778 'concern calls' and 10,263 enquiry calls in 1997/8.[45]

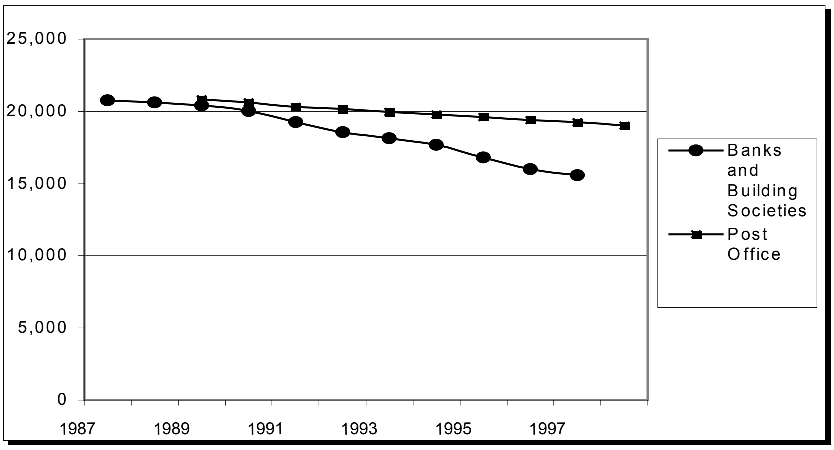
Research in this area has indicated that, although the Banking Code of Practice is an important and useful tool, it is sometimes not put in practice at branch level. Examples exist of banking practice towards those who are in debt or overdrawn which is contrary to the both the letter and spirit of the Code of Practice.[46]

Evidence from the ONS omnibus survey demonstrates the existence of 'churning' – the movement in and out of the banking system. One third of those currently without a current account previously had one but either they or the bank had closed it down. Very few – only 5% - of those who have had an account in the past have it closed by the bank or building society. Many of those who have closed their accounts have done so because of a change in personal circumstances, such as unemployment, illness or disability and retirement. However, a "*small but significant*" group within the Omnibus survey had closed their current account following what they considered maltreatment by their bank.[47]

COMMUNITIES AND FINANCE

So far the analysis has focused on personal finance for individuals and families. However, financial exclusion is also thought to have a geographical dimension. It is alleged by some that many areas of Britain are undergoing a process of 'financial desertification'.[48] As chart 6 demonstrates, many banks and building societies have closed during the last decade.

Chart 6. Banking And Post Office Branch Networks, 1987-98



Source: Annual Abstract of Banking Statistics and Post Office Users' National Council[49]

Furthermore, many of these closures have taken place in lower income communities.[50] In London, the wealthiest wards have on average five bank branches for every one branch in the most deprived wards.[51] A detailed study of the geography of banking services in Tower Hamlets, Barnstaple in North Devon, and Richmond upon Thames concluded that "*there are grounds for arguing that there is a negative correlation between a need for financial services infrastructure and its actual geography. Of the three case study areas Richmond-upon-Thames was revealed to have the highest concentration of financial service infrastructure, as measured in terms of the distance which had to be travelled by the sample in order to use various financial services facilities*."[52]

The same research found that the "*number of respondents with a Post Office giro account in North Devon (22 per cent) was almost double that in Richmond-upon-Thames (12 per cent) and more than twice that in Tower Hamlets (nine per cent).*"[53] This underlines the importance of the Post Office network as a physical point of access to financial services, particularly in rural areas. Around 96 % of the population live within one mile of a Post Office. As can be seen above, the Post Office network has declined less rapidly then the Bank and Building Society branch network during the past decade.

In addition to the geographical distribution of branch networks, it is sometimes alleged that both insurance and banking sectors redline certain neighbourhoods and neither lend to nor insure these areas. There is nothing more substantial than anecdotal evidence claiming that redlining exists in the personal credit market. In any case, credit scoring technologies are now so sophisticated make it less likely that a potential borrower would be refused or offered different terms on the basis of their area or postcode.

APPENDIX 3: FUTURE TRENDS

The situation in relation to financial services is not static. Indeed, certain developments are moving rather rapidly. Whilst there is inevitably some uncertainty about which developments will settle and become embedded within our everyday use of financial services, it is unlikely that the status quo will remain, and it is unlikely that changes will not impact, perhaps adversely, on those on low incomes and those outside the banking system.

This appendix discusses future trends in financial services and how these might impact on the issues associated with low income consumers. The material is organised under the following headings:

- New technologies.
- Electronic transfers.

New technologies have, only in the last few years, allowed most goods and services to be paid for electronically: for example, using credit and debit cards or electronic money transfers such as direct debit. These trends will probably continue - allowing payment over the Internet, the development of electronic purses, improvements in barcode scanning technology, etc.

As the unit costs of these new methods of payment are generally cheaper than the traditional methods of payment, there is pressure to differentiate the prices of goods according to the method of payment. Competitive pressures force providers of goods and services to unravel any cross subsidies - including those relating to method of payment. These developments can already be seen in payment of fuel - where tariffs are higher for prepayment meters and lower for direct debit. Living on cash has become relatively more expensive - and will continue to do so.

The tentative conclusions emerging are:

- Living in the physical cash economy will become relatively more expensive as new technologies co-exist and grow alongside traditional methods of payment. Being within mainstream information technology and banking systems will become more important.

- Inclusion now does not necessarily mean inclusion for all time. As new technologies develop and become essential to everyday life then new exclusionary problems can emerge. One implication of this, for example, is that while a Universal Service Obligation might not be appropriate now, there may be an occasion in the future where it does become necessary.

- New technologies can work in two ways: they can be forces for inclusion or exclusion. In this context, it is possible that unit costs of maintaining and operating bank accounts will fall – allowing more people to be brought into the banking system.

NEW TECHNOLOGIES

Developments such as the introduction of computers, the use of databases, the growth of networks, and the use of telephone call centres have already transformed the traditional labour intensive, paper based branch banking network. Newer technologies such as the Internet and mobile telephony are changing the way that many services are used and paid for, banking is no exception.

- ***Network technology*** is evolving so that different proprietary systems can communicate with each other with increasing ease. This allows electronic transfers of funds across geography and between organisations.

- ***Internet***. One particular network, the Internet, has larger implications for retail banking and commerce. Many banks already have a presence on the Internet and this presence has now developed from passive websites solely offering information to those offering online banking services. The number of households with access to the Internet is also continuing to increase rapidly. Although, many people still have concerns about electronic commerce, technologies which ensure the security of online transactions are developing, as is software which acts as an electronic wallet on the internet – simplifying the purchasing process.

- ***Smart card*** technologies have improved so that money can be stored and communicated easily. There have been several trials worldwide of smart cards. These have had mixed results: failures in Manhattan and Swindon must be balanced with relative success in Exeter University.

  These trials could be interpreted to suggest that customers and merchants will only adopt smart cards (e-purses) when there are compelling economic incentives to do so: merchants will accept the cards when they lower their costs and consumers will do so likewise if they have a higher value or lower cost to them than notes and coins. At present, smart cards do little which ordinary currency does not.[54]

  This situation might eventually change – and once the smart card system reaches critical mass the incentives to use smart cards might change rapidly – possibly leaving those outside the technology system in ‘ghettos’ of relatively expensive physical cash: “*The reduction in cash handling overheads that allow banks and retailers to incentivise consumer use of e-purses does not become dramatic until e-purse penetration rates are high. This cost reduction is highly non-linear: banks can’t, for example, reduce the number of ATMs, night safes and counters out there until a high proportion of customers are using their e-purses and telephones instead.*”[55]

- ***Mobile phone banking*** is a possibility. A trial scheme run by Barclaycard and Cellnet is taking place in Leeds where customers can download money from their account on to a smart card which slots into a mobile phone.[56]

All of the technologies discussed above, if they continue to grow in importance, will lessen the need for a physical bank branch network.

ELECTRONIC TRANSFERS

Electronic transfers of funds (both between banks and between customers and retailers) have increased in use over recent years and this seems set to continue. For example, direct debit is increasing in popularity: 73 % of households already pay one bill by direct debit and the direct debit scheme has grown by a factor of four over the last decade.[57]

Electronic transfers are cheaper than paper based transactions. One survey of banking in the US compared the average costs of transactions for suppliers using different mechanisms. The results are striking: $1.08 for a bank branch transaction, 54 cents for telephone banking and 13 cents for internet banking.[58] It has been estimated that First Direct, the UK telephone banking service, has a cost-income ratio of 40% - compared with 60-70% for a typical European clearing bank.[59]

POSSIBLE IMPACT ON LOW INCOME AND VULNERABLE CONSUMERS

The end of cross subsidies

The differences in costs above are, in an unfettered competitive market that demands cost-reflective pricing, beginning to unwind existing cross subsidies. This is occurring both in market as a whole and in individual retail payment systems such as direct debit.

Cash and paper based methods of money transmission are expensive compared to electronic cash. They require greater staff costs and higher storage costs. Some banks, especially in the US, charge some customers for all paper based transactions.[60] "*If the current landscape of pilots and trials evolves into an operational environment in which the (broadly) middle classes use e-cash to shop around for the cheapest banking services (and a lot of other things as well) on the Net, the (broadly) working classes will find themselves having to bear the cost of the physical cash infrastructure. Everything from the distribution of notes and coins to the upkeep of ATMs will have to be paid for by a smaller and smaller proportion of the population. This would mean a potentially unacceptable increase in transaction costs for the poorer sections of society.*"[61]

It is likely that cross subsidies will continue to unwind in payment methods. Differential tariffs for payment methods such as direct debit are well known; for example, British Gas Home Energy offers an average 15% discount on fuel bills.[62] It is reported that in Norway the National Consumer Affairs Board has complained that some organisations (including hospitals, utilities and some city governments) are refusing to accept cash or demanding fees to accept it.[63]

Possibly decreased access

As well as concerns about the effect on prices of the unwinding of cross subsidies, there are worries about access – both in terms of access to the infrastructure to reach banking services, and - vice versa - in terms of access to bank accounts to reach a new financial infrastructure.

Traditionally banks have borne the cost of building and maintaining the financial services infrastructure (bank branches, ATMs) and have recouped that cost through profits from a wide range of sources. In the future, if banking is conducted through an infrastructure consisting of personal computers, mobile telephony, and smart card readers, then the costs of installing this infrastructure are transferred to the individual consumer – at a relatively 'flat rate'. It is possible that individuals and households living on a low income will simply be unable to afford the cost of this infrastructure. This problem will be magnified if the existing infrastructure – in particular bank branches – withers away.

Under some possible and plausible scenarios, such as the growth of smart cards, access to this electronic cash may depend upon access to banking services. In the case of smart cards, access may depend upon the franchise holder. Smart card systems are dependent on private proprietary technology. "*It lies within the authority of the Mondex franchisees to decide to whom the card is issued…from a banking point of view there is little incentive to issue a card to someone without a bank account since the cards are relatively expensive and no revenue would be generated.*"[64] Moreover, the security of some smart card technologies partly depends upon each card coming into contact with the banking system regularly – which would not occur if the user did not possess a bank account.

Possibly increased access

Alternatively, banking could become more inclusive – even to the point where it is universal. The lower costs associated with electronic funds transfer may make it plausible to offer simple money transmission accounts which involve little or no marginal cost to the institution. Even if the accounts do not generate much revenue over the short term for the banks, they may be cross subsidised for reasons of corporate reputation, profit from the float from benefit receipt, and the chance that over the individual's life cycle they will become more profitable by buying other financial products.

APPENDIX 4: DELIVERY OPTIONS

This appendix discusses the various potential vehicles for delivering financial services to low income consumers. It covers the following topics:

Products	1. Money transmission accounts
Distribution channels	1. Post Offices.
	2. Credit Unions.
	3. Gateway institutions.
	4. The Social Fund.

In each case, the material is presented in a structured format, under the following headings:

Current situation	Summary
	Scale
	Reach
	Evidence of success
Relevance to the low income consumer	Money transmission
	Access to affordable credit
	Place to store and save money
	Treatment of low income consumers
	Communities and finance
Future potential	Theoretical
	Practical
Requirements for realising the potential	Role of central government
	The banking industry
	Other

The two tables overleaf summarise the discussion:

- The first table provides an evaluation of the potential of each of the delivery vehicles against each of the problems of low income consumers discussed in Appendix 1.
- The second table summarises the potential of each of the delivery vehicles and what would be required to achieve this potential.

Problem/Policy option	Scale and Reach	Money transmission	Credit	Store and save	Charges/treatment of customers	Communities
Simple money transmission accounts	N/A	Yes Account holders will be able to cash cheques, pay bills easily via a 'Solo' or 'Electron' card.	No Money transmission accounts will not provide overdraft facilities. However over time the account may help the holder gain credit.	Yes Accounts will provide a place to store and save money – albeit at little or no interest.	Maybe Minimum standards will need to be set, some relating to charges payable on these accounts. By definition there can be no charges on unauthorised overdrafts.	Yes. If money transmission accounts are provided by the Post Office they will be widely available in low income communities.
Post Office	96% of the population live within one mile of a post office.	Yes The Post Office provides a wide variety of money transmission facilities – some will be available through new money transmission accounts.	No Use of the Post Office network will not improve the availability of credit	Yes The Post Office already provides access to savings accounts.	N/A	Yes
Credit Unions	Currently there are 215,000 members of credit unions – less than 1% of the adult population.	Maybe Credit Unions can currently pay bills via a cheque drawn on a members account. However this is not a very convenient method and after forthcoming reforms there will usually be charges for this service.	Yes Only to those who can afford to save Only to those within common bond	Yes Credit Unions provide a place to store and save money.	Yes Credit Unions are owned by their members and have no charges for savings or loans.	Yes Only via community based Credit Unions – these do not have a good growth record and have problems if specifically targeted at low income communities.
Gateways	The only gateway in the UK providing savings and credit facilities is the New Horizons scheme with 40 members in Cambridge. However 46% of local authorities and 18% of housing associations run gateway schemes providing home contents insurance.	No The New Horizons scheme only provides savings and loans schemes.	Yes. Only to those with a regular savings record.	Yes The New Horizons pay an enhanced rate of interest on savings.	Yes The New Horizons scheme has no charges	Yes Areas with many local authority and HA estates are under represented by banks and building society branches.
Social Fund	There were approximately 1 million budgeting loan applications in 1996/7. Income Support recipients form 45% of those without current accounts.	No The Social Fund does not help with bill payment or cheque cashing.	Yes Only to Income Support recipients. Budget limited and discretionary. With reform could reach other benefit recipients.	No The SF does not help users store and save money	N/A	N/A

	Theoretical potential	Barriers to achieving potential	Can government remove barriers?	Can mainstream financial institutions help remove barriers?
Simple money transmission accounts	If new simple accounts were widely or universally possessed then this would solve many of the problems relating to money transmission.	1. Money laundering and fraud regulations 2. Need broad delivery network e.g. PO. 3. Need minimum standards 4. Need to be made available to those currently without accounts. (through marketing or universal access).	1. Yes 2. Yes 3. Yes 4. Yes	1. No 2. Yes 3. Yes 4. Yes
Post Office	The Post Office could make banking services physically accessible to almost the entire adult population.	1. Needs to sign contracts with banks and building societies. 2. Needs automation of Post Office network.	1. ? 2. Yes	1. Yes 2. No
Credit Unions	If Credit Unions were far more widespread then they could provide a viable alternative source of savings and loans facilities.	1. Current regulations 2. Lack of driven volunteers 3. Time 4. Financial Resources 5. Lack of professional expertise 6. Lack of public awareness 7. Low growth of community based credit unions	1. Yes. 2. No. 3. No. 4. Yes. 5. No. 6. Yes 7. No	1. No 2. ? 3. ? 4. Yes. 5. Yes. 6. ? 7. No
Gateways	If Gateways were available from all social housing providers then they could reach 60% of those currently without a current account	1. Current regulations 2. Lack of driven individuals 3. Financial Resources 4. Lack of incentives for institutions to take up Gateway role	1. Yes 2. No 3. No 4. Yes	1. No 2. ? 3. No 4. Yes
Social Fund	If the Social Fund was extended to other recipients of benefits it could become a source of cheap for most of those in need.	1. Current regulations 2. Financial Resources 3. Stigma 4. Political will 5. Lack of computerisation	1. Yes 2. Yes 3. ? 4. Yes 5. Yes.	N/A

MONEY TRANSMISSION ACCOUNTS

Current situation

Summary

Historically, current accounts, which combine credit and money transfer functions, have been the main banking vehicle for money transmission facilities. However, other types of accounts that allow electronic money transmission have begun to emerge due to the development of on-line banking – where transactions are made almost in real time, preventing unauthorised overdrafts. While the available technology does not yet support real time checking of balances – instead checking the overnight balance – it is thought that this will develop in time.

Such developments have been supported by the Office of Fair Trading, which has called for the 'unbundling' of financial products. It argues that the removal of credit facilities from some accounts would make money transmission facilities more accessible as it would remove the need for a credit check.[65]

These Money Transmission Accounts (MTAs) often have the following attributes: no overdraft facility, no or low fees and charges, low interest rates, an on-line debit 'Solo' or 'Electron' card (which prevent the account going overdrawn) and no chequebook. A buffer zone of £9.99 has been proposed - to allow the withdrawal of a person's last penny from an ATM giving out £10 notes. Such buffer zones would, however, still count as an overdraft and would be regulated by the Consumer Credit Act – adding to the cost of providing the account.

Relevance to the low income consumer

Money transmission

Bills can be paid over the phone using the on-line debit cards and cheques can be paid in easily. The prohibition against going overdrawn should make the accounts more attractive to those low income users who currently have concerns about control over their finances. Direct debits and standing orders can also be used, though some re-engineering of these services may be required. There are also concerns about the acceptance of on-line debit cards at retail outlets.

Access to affordable credit

These accounts do little to help the account holder gain access to affordable credit. However, the accounts can provide information to banks and building societies regarding the account holder's credit worthiness and may therefore help build a relationship between the lending institution and customer.

Potential

Money transmission accounts could provide a useful delivery vehicle for meeting the money transmission needs of low income customers. The practical question, explored elsewhere, is whether natural market processes will lead to universal, or near-universal take up of these products.

What would have to happen for the policy solution to work

Role of central government

Deregulation. Government could help in small ways by relaxing certain elements of money laundering and anti-fraud legislation (the relevant European law is Directive 308/91). Some have difficulties meeting all the identification requirements presently required to open account. These can be difficult for those living in temporary accommodation or those without a passport or driving licence.[66] One banker has posed the question: "*What if the rules were changed or simply relaxed so that the requirement for an address ceased to be an issue so long as the amount of money going in and out of the account was below a certain threshold?*"[67].

CATmarking. There may be a role for government in certificating those accounts which have the desired attributes, for example concerning charges and access. This could perhaps be through a CATmark, similar in concept to those the Government is committed to providing for stakeholder pensions and ISAs. There are also analogies here with the US government's specification of the attributes of an Electronic Transfer Account during its moves to deliver benefits by electronic funds transfer.

Aiming for universality. The most important role that the government should play is to set out a goal of universal access to accounts that allow money transmission. There are then issues of what means are used to reach this goal: if it were thought that natural market processes would not reach this goal then the government could set a target for industry to meet; alternatively, the government could impose an Universal Service Obligation.

Banking industry

Reaching a goal of universal access relies in part upon the efforts of the banks and building societies in targeting money transmission accounts at those currently outside the banking system. It is unclear whether banks regard such accounts as sufficiently profitable, or whether, like many other types of accounts they are run at a small profit/loss. What is clear is that simply placing these accounts 'on the shelf' is not enough to make money transmission accounts the answer to meeting the money transmission needs of those outside the banking system.

If the banks and building societies were set a target by government for increasing the take up of accounts which allowed money transmission then they would have to divide this task between them so that the effort was shared fairly between different companies and societies.

POST OFFICE

Current situation

Summary

The Post Office already provides many banking functions either acting by itself or as an agent for other institutions. It already provides paper based money transmission services such as bill payment, money transfers, and access to National Savings products.

It currently has a long standing arrangement with Girobank and newer contracts with Alliance & Leicester, Lloyds TSB and the Co-operative Bank. It acts as a front office for these banks, accepting deposits and handling withdrawals.

There is currently a major Private Finance Initiative project to automate the Post Office. The project should replace most paper based procedures with electronic transactions through the introduction of computer terminals at all post offices. The project is designed to automate benefit delivery and to computerise post offices, building on banking technology.

Post offices could potentially act as a front office for all or most banks and building societies, solving most problems of geographical access to financial services. Automation would allow money transmission accounts to be operated by the Post Office on behalf of mainstream financial institutions. This would permit benefit payments to be paid via ACT into accounts but withdrawn at either post offices or the banks.

Scale

The Post Office currently has a network of around 19,000 offices.

Relevance to the low income consumer

Money transmission

If money transmission accounts were available at post offices this would help meet the money transmission needs of low income consumers.

Place to store and save money

Money transmission accounts available through post offices would provide a place to store money. The Post Office also currently provides access to National Savings accounts which can be a place to save money, albeit with restrictions on accessing deposits and unattractive interest rates.

Communities and finance

Around 96 % of the population live within one mile of a post office. Use of the Post Office network to provide access to simple money transmission accounts would make a big impact upon the problems of money transmission associated with geographical access to banking services.

Potential

If money transmission accounts were to be widely available then, if offered via post offices, these could effectively solve problems of money transmission associated with geographical financial exclusion.

What would have to happen for the policy solution to work

Role of central government

Co-ordinating financial exclusion and benefit delivery reforms. As discussed elsewhere, the government departments would have to co-ordinate planned or mooted changes to the methods of delivering benefits with plans to tackle financial exclusion.

In relation to the Post Office, this implies government encouragement for the creation of partnerships between the mainstream financial institutions and the Post Office. There have been previous occasions where the government has sought to give the lead to private companies in policy issues where the government has few direct levers of control. Notable examples include the water summit in 1997 which arranged leakage targets for the water industry.

SOCIAL FUND

Current situation

Summary

The Social Fund forms part of the Department of Social Security's benefit system. It replaced single payments under the Supplementary Benefit scheme in 1988 with a mixture of non discretionary payments and discretionary grants and loans. The fund comprises:

- *Grants* (which do not particularly concern us here) are available for maternity, funeral, cold weather, and community care expenses.
- *Budgeting loans* are interest free loans for important intermittent expenses which are difficult to budget for from a weekly income. The average size of loan made in 1996/7 was around £300. Maximum loan size is £1000 (minimum £30).
- *Crisis loans* are also interest free and are available in an emergency to people with no alternative means of avoiding risk to their health or safety. They are available to all, whether in receipt of a benefit, or not. The average size of the loan in 1996/7 was £67.

Whilst the fixed administration costs of the overall fund are substantial (£161 million in 1997/8), there is considerable scope for expanding the scope and size of the Fund – building upon the existing structure. The budgeting loans section is a cheap and efficient method of recovering loans to those on low incomes. Gross expenditure in 1996/7 was £284 million, of which £250 million was later recovered - a recovery rate of 88%.[68]

Recent reforms have removed the element of discretion from the budgeting loans, replacing the rather paternalistic questioning of need for the loan with a set of criteria such as length of time on benefit or family size.

Scale

Table 7: Scale of Budgeting Loan scheme

	Budgeting Loans expenditure	No. of Budgeting Loans
1995-96	£250m	921,000
1996-97	£284m	923,000
1997-98	£311m	916,000
1998-99	£403m (budgeted, includes crisis loan)	N/A
1999-2000	£437m (budgeted, includes crisis loan)	N/A

Reach

The Social Fund is only accessible by those who have been in receipt of Income Support for 26 weeks. Analysis of the Family Resources Survey reveals that 45% of those without a current account are in receipt of Income Support.[69]

Evidence of success

The Social Fund is not always successful in its primary aim – which is not providing credit, but targeting help for exceptional problems at those most in need. Research has found that the "*circumstances and many of the needs of eligible non-applicants and those people not eligible to receive awards are similar to those of other people who receive help from the Fund*."[70] In other words, there are those with needs equally as great as those who do benefit from the fund who are not valid applicants or who are eligible but do not apply.

However, as a source of credit for those on Income Support, the Social Fund appears to be popular with users. It is also successful from the DSS perspective, in as much of the money it distributes is recycled. That the government considers it 'good value' is illustrated by its plans to expand gross expenditure on budgeting loans by over a third to £437 million in 1999/2000.

Relevance to the low income consumer

Access to affordable credit

The Social Fund offers a source of cheap credit for those in receipt of income support. It does not offer credit to those in receipt of other benefits, nor to the working poor.

Potential

Theoretical

Many micro-credit schemes in developing countries rely upon labour intensive forms of repayment collection to ensure the loan schemes sustainability. Lending schemes which rely upon door-to-door collection tend be very expensive in Britain where labour costs are high – witness the high APRs of traditional moneylenders. By contrast, the Social Fund collects repayments relatively cheaply and effectively through direct deductions from Income Support.

The Social Fund is, presently, more suitable as a source of credit than credit unions and gateways for those on very low incomes who are not able to save. A review of the Fund found that only 3.3 % of respondents had any savings when they were interviewed.[71] Furthermore, unlike other sources of credit such as credit unions, the Fund is geographically universal.

There is great potential for an extension of the scope and size of the Fund to recipients of other benefits and tax credits such as the Working Families Tax Credit.

Practical

There may be an element of stigma attached to taking out a Social Fund loan: 'take up' is low for certain groups e.g. pensioners who are traditionally reluctant to claim certain benefits.

The Fund is budget capped, both overall and subsequently at local level. This creates inequities: when the budget runs out, valid claims can be rejected. Equally it creates local disparities – with an application more likely to be approved in an area with few applicants.

What would have to happen for the policy solution to work

Eligibility. Crisis and budgeting loans are currently only available to those who have been receiving income support for more than 26 weeks. There is no technical reason why eligibility could not be extended to those in receipt of other benefits – including tax credits. The direct payments system would also have to be extended from Income Support to other benefits and tax credits.[72]

Budget. Many of the costs of the Social Fund budgeting loans scheme are fixed, that is they do not rise in proportion to the amount of money lent. There is scope for the Fund to be expanded in size; indeed this is happening already with a one-third increase in gross expenditure (before recoveries) next year. As long as the high level of repayments is maintained, the 'top up' net payment provided by the government will remain low.

CREDIT UNIONS

Current situation

Summary

Credit Unions are co-operative financial institutions which are owned by their members. Membership is restricted to those sharing a 'common bond'. A common bond is needed to reduce the risks of non-repayment of loans. In economist's terms, the common bond assists credit unions by reducing the risks associated with information asymmetries. There are currently four types of common bond:

- Community based common bonds centre around a specified neighbourhood.
- Occupational bonds cover those working in the same industry or profession.
- Those who work for a common employer.
- Associational bonds centre around existing associations – including religious organisations.

Recent reforms have allowed the creation of common bonds based around those who live or work in the same area.[73] It is also proposed that associational bonds can be combined with others: for example, a residential credit union could join with one based on a place of worship[74].

Scale

Credit Unions are growing fast, but from a very low base: from 1992 to 1997 the number of credit unions has increased from 383 to 584, members have increased from 88,007 to 214, 660, savings deposits from £28.5 million to £105.8 million, funds out on loan from £26.8 million, and total assets from £32.4 million to £122.3 million.[75]

Compared to other countries, few of the adult population are members of credit unions. "*In Canada, Ireland, Australia, and the United States between one-third and one-half of adults are members of a credit union. The Registry estimates the figure for Great Britain to be 0.2%.*"[76]

Furthermore, the movement is dominated by workplace based credit unions: they currently have 16% of the total number of credit unions, 50% of the membership, and 71% of the movement's total assets. Most of the growth of the credit union movement derives from those with a work based common bond.

Reach

There is little evidence that many credit unions on mainland Britain have yet been successful at reaching those on very low incomes – the median income of those borrowing from credit unions in 1989 was £200 per week.[77] However they may play a role in reaching those outside the banking system: in Northern Ireland, where they are far more common, 30% of those borrowing from credit unions in 1989 did not have a current account.[78]

Evidence of success

There appears to be little evidence that credit unions have yet been successful in tackling financial exclusion. Indeed, a recent report found that Credit Unions are often "*seen as a panacea for local economic development and are linked directly to anti-poverty initiatives. This latter point is maintained even though there is little evidence of these credit unions ever being able to reach a significant proportion of the local population.*"[79]

Relevance to the low income consumer

Access to affordable credit

"*In order to qualify for a loan, the borrower must be a member of the credit union, and therefore with in the common bond, must have saved for a certain period of time … and must retain savings in a particular ratio to the amount borrowed.'*"[80] The interest rate which can be charged for a loan is limited by the Credit Union Act to 1% each month (12.68 % APR).

Credit Unions offer cheap credit without too many restrictions. However, the requirement to save beforehand makes this form of credit inappropriate for those whose low incomes make saving somewhat problematic. It also makes getting access to short term credit very difficult. Analysis of OFT data demonstrates that two thirds of those without current accounts had no savings at all.[81]

In 1989, researchers wrote that, "*There is little sign that credit union members lack access to the mainstream credit market, or that the union substitutes for other kinds of credit. The union is nevertheless members' preferred method of borrowing.*"[82]

Place to store and save money

Interest is paid in the form of dividends – it may not exceed 8 % and dividends may only be issued once all taxes and other expenses have been paid. Often no dividend is issued by small credit unions. The normal range of dividend payments is between 3 and 5 %.[83] If current deregulation goes ahead then Credit Unions can offer interest bearing accounts.

Communities and finance

There is no direct evidence to suggest that Credit Unions are currently concentrated in areas which have been deserted by mainstream financial institutions. In theory, area based credit unions could be established in areas where banks have withdrawn. However, recent research suggests that credit unions with common bonds drawn around poor neighbourhoods are less successful than those based around mixed neighbourhoods (and than those based on associational or occupational common bonds).[84]

Potential

Theoretical

There is great potential for credit unions to offer cheap and affordable credit- *to those who can afford to save*. Furthermore these loans can be obtained without collateral.

Community Development Credit Unions may have the potential to serve certain geographical areas which have been deserted by mainstream financial services – although they will still need a mixed income common bond. Although the long term objective must be sustainability it should be recognised that these will need subsidy for a considerable amount of time, especially if their common bond is drawn tightly around a deprived neighbourhood.

Practical

There are three reasons why Credit Unions may not be the complete answer to financial exclusion: the need for an existing level of savings before a loan can be obtained, the small scale of the credit union movement, and the pattern of growth of credit unions with different common bonds.

- Loans are available only after a certain amount of time and require a certain level of savings. The maximum level of loan available is also dependent upon the amount the borrower holds in savings. The problems of access to credit for those who cannot save because of persistent low income will not be solved by credit unions.

- As the credit union movement is growing from a small base, it will take very many years for the UK to match, say, the one-third of the adult population in Eire who are members. This lack of growth may, however, reflect the development models which have hitherto been used.

- Research suggests that credit unions based upon associational or employer based common bonds are more successful and sustainable than area based common bonds. Indeed, most of the current growth in the movement is powered by employer based credit unions: those credit unions which are based in low income areas tend to be unsustainable because successful credit unions need a membership which socially and economically diverse: high levels of savings are needed to build up reserves, and loans need to be made to generate surpluses which pay for overheads and dividends – which attract further members.[85] To be a potential member of a successful credit union therefore depends upon belonging to an associational or work based common bond. However, many of those without a current account are neither in employment nor a member of a religious or civic organisation.[86] This situation may change as more credit unions adopt a "live and work" common bond.

What would have to happen for the policy solution to work?

Role of central government

The establishment of credit unions is essentially a voluntary activity. If there is no impetus from volunteers then there is little the government can do to stimulate the growth of credit unions. However, if it is thought that the removal of existing regulations and financial support would assist the growth of the credit union movement, then there are certain proposals which are currently being explored. These include: allowing non-member deposits, establishing a share protection scheme, relaxing common bond requirements, allowing other services to be offered, allowing interest bearing deposit accounts to be offered, and ensuring a light burden of regulation under the new FSA regulatory regime.

If the government wished to increase the rate of growth, one option could be to subsidise credit unions in some way. The key needs of credit unions include the provision of credible premises and paid staff. As long as it is recognised that good business plans are necessary and that local people actually want a credit union, then subsidy could be a valid tool to encourage their development. However, lessons should be learnt from the United States under President Johnson's "war on poverty" – which failed to develop sustainable credit unions. One method of providing funding might be the establishment of a National Development Fund.[87] This could, for example, operate a revolving loan fund for the financing the acquisition of credit union premises.

Banking industry

A taskforce has been set up to examine the scope for mainstream financial institutions to assist credit unions through the provision of training, staff, technology and premises. While undoubtedly welcome, it seems unlikely that voluntary non-financial assistance from banks will prove crucial for the success of credit unions.

It has been proposed that a partnership between Credit Unions and the Post Office would greatly assist the growth of the credit union movement. Research has highlighted that the lack of paid staff and visible and accessible premises is hampering credit union growth. Sub-post offices could provide the ideal 'front office' for many credit unions.[88]

Box 1: Community Development Credit Unions[89]

In the United States, there exist credit unions with special status: Community Development Credit Unions (CDCUs). Unlike other credit unions they have a dual purpose – to provide financial services to their members, and secondly to promote local community development. Furthermore, CDCUs can join a 'low income designation' register if more than half of their membership is below the US poverty line. This designation assists CDCUs on obtaining access to non member deposits, government and bank deposits, and grants for running costs.

Some have argued for the establishment of CDCUs in the UK. British CDCUs could be based solely around a geographical or associational common bond. They could be allowed to register as a CDCU if the common bond covered areas which are ranked below average in the Index of Living Conditions and if they specifically stated that they had a wider social purpose than normal credit unions.

The special privileges for CDCUs could include:
- Up to 20% non-member shares.
- Reduced council tax.
- Access to grant funding.
- New products and services.
- Access to grants through an explicit social purpose.
- Preferential access to a new Credit Union National Development Fund.

GATEWAYS

Current situation

Summary

A gateway institution is a membership organisation which acts as an intermediary between the customer and a mainstream financial institution. They can be seen as analogous to intermediate labour markets – which are also not-for-profit schemes designed to re-connect those excluded from a mainstream market.

There is currently only one gateway operating providing savings and loans schemes for its members in the UK (although there are many more offering home contents insurance).[90] The New Horizons scheme in Cambridge is a joint venture between the Cambridge Housing Society (CHS) and the Cambridge Building Society (CBS).[91]

The scheme is similar to a sophisticated joint account: the CHS is one of the partners and its tenants is the other. The CHS has deposited a lump sum with the CBS. Its tenants are then permitted to open a savings account within the New Horizons scheme. Once the tenant has established a regular savings record, he or she is then allowed to borrow without any need for collateral to secure the loan. Deposits and withdrawals are made directly into CBS branches.

CHS tenants have gained access to affordable credit and a bank account. The necessity of a screening process which commercial banks use to tackle the problem of adverse selection has been removed. In the absence of perfect information, collateral is used as a signal that the loan will be repaid. With the New Horizons scheme, the need for collateral is replaced by the lump sum guarantee and better information about the borrower's savings record.

Scale

The New Horizon scheme, which began in 1997, is extremely small: 44 tenants out of Cambridge Housing Society's approximate 3,300 members have opened accounts.

Reach

There is no data on the socio-economic profile of CHS tenants participating in the New Horizons scheme. A very small interview based survey of ten of the members revealed that eight had a current account - i.e. the same proportion as the general population. The majority of members (34) have saved less than £100. Six members have saved between £100 and £1,000 and four members have saved between £1,000 and £6,000.

The socio-economic profile of CHS tenants is that 25 % of tenants have weekly incomes under £80 per week, 31 % £81-£140 and 28% £141-£220 and 16 % over £221 per week. 32% of tenants are in receipt of Income Support and 4.2% are in receipt of Job Seeker's Allowance. Almost all (98%) of the tenants have some kind of bank account and 79% have a current account.[92] This is a higher level of ownership of current accounts than most Housing Association tenants (59%).

Evidence of success

So far is there is little evidence of a large take up of this scheme – few tenants have opened savings accounts and as yet no-one has taken out a loan.

Relevance to the low income consumer

Access to affordable credit

Gateways provide access to affordable loans once a regular savings record has been established. CHS is considering whether to remove the requirement to have a regular savings record and rely upon the lump sum to guarantee loans. The loans interest rate is 12.68 % - the same as the credit union rate.

Place to store and save money

As an individual's savings are assessed together with the lump sum deposited by the CHS a preferential interest rate is received by scheme members. Currently, the CBS's savings rate is 1.51% AER (Annual Equivalent Rate) for a balance of less than £500, New Horizons scheme members would receive 4.19% on the same balance.[93]

Communities and finance

The New Horizons scheme relies upon the ready availability of CBS branches and so would not improve geographical access to banking services. This would cease to be so important if the housing association or local authority were permitted to collect deposits themselves and pass them on to a bank or building society.

Potential

Theoretical

The theoretical potential for gateways to make a difference is large: 60% of those without current accounts live in rented social housing (9% in housing associations and 50% in local authority housing).[94] For gateways to succeed, local authorities will need to adopt this scheme – over half of all those without current accounts live in local authority rented housing. That local authorities could play a role in tackling financial exclusion is demonstrated by their existing role in providing a gateway to home contents insurers.

Importantly, like credit unions, they offer loans without requiring collateral. They also have several potential advantages over credit unions: they are immediately viable – they do not have to build up reserves over a number of years, they do not rely on volunteers, they have an immediate shop front presence in the form of high street banks and building societies, the scheme does not require the existence of a common bond, and they can pay an enhanced interest rate.

Practical

Setting up a gateway is essentially a voluntary operation for the organisation. Success depends upon commitment and goodwill from an organisation which is essentially focused upon their central task of providing and managing affordable housing. Voluntary schemes, while laudable in themselves, will not 'solve' the problem of financial exclusion because their coverage will inevitably be patchy and their growth will be slow.

What would have to happen for the policy solution to work

Role of central government

There are certain laws whose relaxation would assist the growth of gateway organisations. First, it would be helpful to clarify the position of housing associations with regard to Section 2 of the 1996 Housing Act - which defines the permissible activities which may be carried out by a Registered Social Landlord. Likewise it would have to be clear to local authorities that their participation in this scheme was not *ultra vires*.

Second, the laws governing deposit taking institutions could be amended. If the gateway wished to absorb administration costs and provide a convenient service for their tenants, they could take in deposits and pass them on to the building society or bank. At present, the Banking Act (1987) prohibits institutions from taking deposits unless they are regulated as banks. This prevents housing associations and local authorities from collecting deposits in a deposit-with-rent scheme. This is analogous to insure with rent scheme, as discussed in the box below.

Box 2: Home Contents Insurance

Social housing providers, together with credit unions, play a role in the provision of home contents insurance. Home contents insurance schemes are run by 46% of local authorities and 18% of housing associations. In addition, all credit unions affiliated to the Association of British Credit Unions Ltd (ABCUL) or the National Federation of Credit Unions (NFCU) have access to home contents insurance.[95] Local authorities play an active part in collecting premiums along with rent payments while housing association schemes tend to negotiate preferential insurance rates for their tenants rather than collect premiums themselves. Both housing associations and local authorities run schemes solely for their tenants, not for owner occupiers or private rented tenants. By contrast, credit union schemes are national in their scope: they are arranged on a national basis by ABCUL and NFCU and are available to members of any local credit union.

The common theme of these schemes is that they pool risks: they are an attempt to reverse the trend towards the demutualisation of risk: "*within each local authority scheme, tenants pay the same for a standard level of cover regardless of their postcode. 'One rate risk pools' are the key condition set by social landlords as gatekeepers if insurers wish to gain access to potentially large blocks of business. This effectively means that lower risk households cross subsidise higher risk households*."[96] Although the national credit union schemes divide households into several risk bands, the differential between the high and low risk premiums is much smaller than in commercial schemes.

Whyley *et al* also note that one "*insurer writing cover for one of the credit union associations also factors into the premium calculation a measure for the strength of the common bond, taking into account how long the credit union has been working, its size and rate of growth and its loan default record*."[97] Here is an example of a gateway institution overcoming an information problem through the provision of more appropriate information rather than the imposition of exclusions and higher premiums.

APPENDIX 5: LEGISLATIVE OPTIONS

This appendix discusses potential changes to the environment within which financial institutions deliver their services. It covers the following topics:

1. Community Reinvestment Act.
2. Universal Service Obligation.
3. Compulsory Automated Credit Transfer.
4. Challenge Fund.

In each case, the material is presented in a structured format, under the following headings:

<table>
<tr><td colspan="2">Summary of legislative option</td></tr>
<tr><td rowspan="5">Relevance to the low income consumer</td><td>Money transmission</td></tr>
<tr><td>Access to affordable credit</td></tr>
<tr><td>Place to store and save money</td></tr>
<tr><td>Treatment of low income consumers</td></tr>
<tr><td>Communities and finance</td></tr>
<tr><td colspan="2">Evidence from other countries or industries</td></tr>
<tr><td rowspan="2">Analysis</td><td>Justification</td></tr>
<tr><td>Assessment of chances of success</td></tr>
</table>

The two tables overleaf summarise the discussion:

- The first table provides an evaluation of the potential of each of the legislative options against each of the problems of low income consumers discussed in Appendix 1.
- The second table summarises the potential of each of the legislative options and what would be required to achieve this potential.

Legislative option	Scale and Reach	Money transmission	Credit	Store and save	High charges/treatment of customers	Communities
Community Reinvestment Act (CRA)	N/A	No There is no suggestion that financial institutions refuse money transmission facilities on a geographical basis.	Maybe A CRA would place a positive obligation on lenders to meet the credit needs of their community. However there is no obligation to meet the credit needs of individual households within those communities.	No There is no suggestion that banks refuse to accept deposits on a geographical basis.	No	Yes The disclosure aspect of the CRA might be a deterrent to redlining.
Universal Service Obligation (USO)	100% of those who wanted an account would be entitled to one. It is claimed that only 60% of those without an account actively choose not to have one.	Yes If there was a statutory right to a money transmission account then this would help ease basic money transmission problems.	No Banks would be under no obligation to lend nor to offer overdraft facilities.	Yes Accounts will provide a place to store and save money – albeit at little or no interest.	No Charges may be more likely if accounts are made compulsory. However charges on unauthorised overdrafts would not occur	N/A
Compulsory ACT	N/A	Yes If benefits were paid into a money transmission account then this may help to ease basic money transaction problems	No	N/A	N/A	N/A
Challenge Fund	N/A	N/A	Yes A Challenge Fund may facilitate the leverage of funds from mainstream into alternative lending institutions.	N/A	N/A	Yes A Challenge Fund could be designed to reward work in low income communities

	Theoretical potential	Barriers to achieving potential	Can government remove barriers?	Can mainstream financial institutions help remove barriers?
Community Reinvestment Act	If a CRA were to be introduced in the UK it may a) create an incentive (through disclosure or obligation) to meet credit needs in low income areas and b) stimulate financial support for alternative lending institutions.	1. CRA would need primary legislation.	1. Yes	1. No
Universal Service Obligation	If there were a statutory right to a bank account then everyone who wanted an account would theoretically be entitled to one.	1. Would need primary legislation.	1. Yes	N/A
Compulsory ACT	If benefits were compulsorily paid via ACT directly into bank accounts there would be a large new group of customers needing bank accounts.	1. Would need legislation. 2. Post Office network would need support. 3. Banks would need to be forced to accept new clients	1. Yes 2. Yes 3. Yes	1. No 2. No 3. Yes
Challenge Fund	If a Challenge Fund were introduced then it may stimulate support for the alternative lending sector by mainstream banks and building societies.	1. A tax credits system would need primary legislation. 2. As the system is voluntary it would need participation of mainstream financial institutions.	1. Yes. 2. No.	1. No. 2. Yes.

COMMUNITY REINVESTMENT ACT

Summary of legislative option

A Community Reinvestment Act (CRA) places an obligation upon financial institutions to meet their credit needs of their community – as judged by banking regulators. In effect, it works in two ways:

- It acts an incentive for financial institutions to act in a socially responsible fashion. Poor performers are brought into the public spotlight and their reputations are affected. Proposals for a Community Reinvestment Disclosure Act (CRD) in the UK, in which financial institutions would be forced to reveal lending data on a postcode by postcode basis, would perform a similar role as this section of the CRA.[98]

- The CRA acts as a spur to the creation of partnerships, which include the donation of financial resources, between financial institutions and community lending organisations - a process which is partly motivated by the existence of tax incentives. This leverage of money from mainstream banks has accelerated during the mergers and acquisitions activity in the banking sector. The regulators are obliged to consider an institution's CRA record before approving a bank's application to open a branch or to merge with a competitor (no such obligation exists when a bank wishes to close a branch).

Relevance to the low income consumer

Access to affordable credit

The CRA is relevant to the problem of access to affordable credit only in so far as it increases lending activity in low and moderate income communities. There is no obligation to meet the credit needs of individuals or households within those communities.

Communities and finance

As presently defined, the CRA does not impact on bank closures – the regulation only really bites when a new branch or a merger is proposed by the bank and then the CRA record of the bank is considered by the regulators when deciding whether or not to permit the merger or branch opening. The CRA does not stop bank closures. However, the obligation to meet the credit needs of the bank's community would lessen any 'redlining' of lower income areas - if this were a significant problem.

Evidence from other countries or industries

The aim of the United State's Community Reinvestment Act (1977 and 1989) is to ensure that financial institutions meet the credit needs of their communities. Banking regulators are obliged by law to carefully evaluate each *"institution's record of meeting the credit needs of its entire community, including low and moderate income neighbourhoods, consistent within the safe and sound operation of the institution."*[99]

Lending institutions are obliged to put forward their record of meeting these credit needs in a mandatory public report. These records are then assessed by the regulators and graded (excellent, sufficient, needs improvement and unsatisfactory). Both the records and the assessment are then placed in the public domain. If a bank applies to open a new branch or merge or acquire another bank then regulators are required to take into account the institution's CRA record before approving or denying the application.

Factors which are considered when assessing a CRA record include: the total number and the total dollar amount of loans, the geographic location of loans, the characteristics of borrowers, banks activities in community development, how branches are distributed throughout the community, and the bank's history of opening and closing branches – particularly those serving low or moderate income consumers or neighbourhoods.[100]

It is claimed that $353 billion has been committed over 20 years to low and moderate income neighbourhoods in the US under the influence of the CRA.[101] There has, as yet, been no independent evaluation of the success of the CRA.

Analysis

Justification

Imperfections in capital markets which lead to decision making that has a social cost or benefit are usually cited as the economic justification for intervention. Market imperfections can stem from such factors as information asymmetries, lender's risk aversion, racial or gender prejudice, and high, fixed, transaction costs.

Assessment

While access to financial services does differ according to area, it is not proven that problems of access to affordable credit for individuals are mainly area-based.[102] There is no evidence in the UK of redlining in credit markets– of individuals being discriminated against according to their geographic location. Credit scoring techniques rely on many different indicators of credit risk – it is not be necessary to discriminate according to a crude measure such as postcode. Thus, for individuals at least, legislation which relies upon an area based analysis of the problem may be unsuitable. While the potential for community enterprises and small businesses to benefit from the introduction of a CRA in the UK is theoretically large, the CRA does not impose an obligation to meet the needs of individuals or households *within* low income neighbourhoods. A CRA would therefore seem, at most, only a partial solution to the problems of access to credit.

If the aim of government policy is to lever money out of mainstream financial institutions into alternative lending organisations then a CRA may be the right policy tool. The anecdotal evidence is that the CRA has been successful in the USA as a means of creating partnerships between banks and credit unions.

However, there are practical issues which would make the introduction of a CRA in the UK problematic. It is based upon the American system of banking and banking regulation which is far more local and regional in nature: banks are based in defined communities whose credit needs are to be met. In the UK, by contrast, most banks are national, and do not serve specific communities.

The Community Reinvestment Disclosure Act could be a suitable alternative for the UK. It has the aim of 'naming and shaming' banks and building societies into retaining a presence in low income areas. As argued earlier, there is little evidence that access to affordable credit is determined geographically. If the government were to introduce disclosure then it must consider carefully whether, in relation to lending households and individuals, data should focus on income percentiles and other socio-economic indicators such as household status, ethnicity and housing tenure type, rather than geographically.

UNIVERSAL SERVICE OBLIGATION

Summary of Legislative Option

Government could legislate and impose a universal service obligation (USO) on the banking industry. Such a USO could consist of a statutory right of access to a simple money transmission account – a lifeline account. All those who wished to possess a bank account would be entitled to a simple money transmission account. This would have no overdraft facility nor chequebook, but would be allow benefits and wages to be received, allow cheques to be cashed, money to be withdrawn via ATMs and would provide an online debit card.

Relevance to the Low Income Consumer

Money transmission

A USO could solve most of the problems associated with money transmission. If a simple account were available where cheques could be cashed, an online debit card were offered, and benefit payments and wages could be paid into (including by ACT) then many of the money transmission problems currently faced by those without current accounts would be solved.

Treatment of low income customers

If banks and building society members were forced to accept customers whom they did not welcome then there is a serious possibility of poor treatment. At present, the most serious problems are caused by charges due to unauthorised overdrafts. This would not be a problem under a USO as overdrafts would not be available in these on-line accounts.

However, the re-introduction of banking charges is a serious possibility. It is possible that banking fees would be introduced if banks and building societies are forced to accept customers with accounts which are perceived as even less profitable than present day current accounts. Account management fees are common in both Australia and the US.

Evidence from other countries or industries

A statutory right to a bank account exists in other countries. In France, if you are rejected twice you can appeal to the *Banque de France* and a bank will be nominated for you. In practice, those appealing receive a very simple account based at the Post Office which allows deposits and withdrawals but little else. In Sweden, it is a condition of a bank's licence that they are obliged to accept deposits.

In other industries, particularly those which historically have been dominated by a monopoly utility service provider, USOs have been imposed.[103] The situation of most relevance is telecommunications (see box 3). There are, of course, differences between the banking and telecommunication sectors. Most importantly, the market structure is different. While competition is increasing, the market is still dominated by BT which has a special position as the Universal Service Provider, while banking is more competitive. On the other hand, the number of customers without a home phone (7%) is similar to that of banking – implying that any cross subsidy that takes place involves a transfer from a large group to a very small group of customers. Furthermore, there are important network externalities present in both markets - which provide an economic justification for imposing a USO.

Box 3: USO in telecommunications

Oftel has established the service level of the USO as consisting of "*a connection to the fixed network able to support voice telephony and low speed data and fax transmission; the option of a more restricted service package at low cost, and reasonable geographic access to public call boxes across the UK at affordable prices*."[104]

BT is the Universal Service Provider (USP). Oftel has rejected for the moment the idea of a USO fund to share the cost of the USO because they estimate that the benefits of the USO are comparable to the costs. Their cost benefit analysis (disputed by BT) is as follows:

Cost	£M	Benefit	£M
Uneconomic areas	10-15	Life cycle effects	1-10
Uneconomic customers	45-55	Ubiquity	40-80
Uneconomic call boxes	10-15	Brand enhancement/Corporate reputation	50
		Advertisements on uneconomic call boxes	11
Total	**65-85**	**Total**	**102-151**

Oftel recognises that the competitive position of BT will change and that provision should be made for a method of sharing the costs and benefits of USO. The two options which have been discussed are an actual and a virtual fund. The actual fund would be an independent institution which calculates net costs and charges operators accordingly. The virtual fund would operate through BT as the USP billing other operators on the basis of a costing formula determined by Oftel. Oftel would act as an arbitrator in the case of dispute.[105]

Analysis

Justification

The social case for imposing a USO is that life is becoming more difficult and relatively more expensive without a bank account: cheques can no longer be easily and cheaply be cashed except into a bank account, utility companies increasingly want to be paid by direct debit and offer discounts for such payments, and new forms of shopping (such as the Internet) simply do not accept cash. These trends will continue as companies in competitive markets cease to cross-subsidise customers using more expensive methods of money transmission.

The economic case made for establishing a USO in telecommunications also has some applicability to banking services and is worth setting out in full. Oftel state that "*The provision of universal service in telecommunications has important economic externality benefits which are not captured in the prices charged for telecommunications services. These externalities arise from the two-way nature of communications between telecom network users…. As new customers join the network, the value to all customers of being on the network increases because they can – either actually or potentially – access a larger number of other users. Operators may have no incentive to offer service to customers who are unwilling or unable to pay for the standard costs of provision, and may have no reason to take into account the additional benefits to existing users. Overall economic welfare, however, is higher if service is provided to these additional customers. There are, therefore, circumstances in which it is appropriate to provide support to some customers whose costs of service provision exceed the cash revenues that they generate*."[106]

There are parallels with banking – certain users of the banking network, especially large customers like the utility companies, the DSS and retailers, benefit from reduced transaction costs associated from their customers having a bank account. These benefits increase as more customers enter the banking system. There are network externalities in the banking sector. The DSS case for using ACT to deliver benefits is simply the most prominent example of this.

Assessment

If current trends towards greater price differentials between electronic payment methods (which require a bank account) and paper based methods continues, and these differentials continue to be passed on to consumers, then the case for a USO in banking is increasingly strengthened.

However, the above analysis holds good if universality is achieved even if a USO is not imposed. In other words, the means (the USO) are not as important as the end (universal access to accounts which allow money transmission). Serious consideration should therefore be given to whether a USO is necessary or whether existing market trends will lead to universal access. If it is concluded that these trends will not lead to the desired end, then consideration should be given to the introduction of a USO.

Note: Preparing for a USO

There are three main areas where preparations would be needed:

1. Definition of the minimum service requirements of the USO e.g. the attributes of the money transmission account.
2. Assessment of the costs and benefits of imposing a USO – to decide whether compensation need be paid.
3. Design of a funding formula to ensure that no one institution faces an undue burden or benefit.

Attributes of universal service

The government and regulators would have to become involved in designing the financial product which deposit taking institutions would be required to offer if applied for. Features could include: no minimum balance, no overdraft facility or chequebook, low or no fees, issue of an online debit card (e.g. Solo or Electron) and free withdrawals.

Cost benefit analysis

Using and extending the model used by Oftel to justify a USO in the Telecommunications market, the table below provides an initial rough working framework in which the social and economic costs and benefits of a USO in banking could be discussed.[107]

Table 8: The costs and benefits of a USO in banking

BANKING INDUSTRY			
	Cost	**Benefit**	**Variables**
Changes in cash acquisition	£113- 140m		1. Depends how many different benefit recipient groups use ATMs or cheque encashments to withdraw money.
Cost of opening accounts for unbanked	£50m		1. Depends upon government subsidy 2. Depends upon whether existing account holders open new “benefit” accounts.
Cost of maintaining accounts for unbanked	£60-80m (p.a.)		1. Depends upon unit operating cost of account (and features of that account).
Float income		£88- 16m	1. Interest rate 2. Draw – down rate 3. Frequency of benefit payments
Other net income		£7m	
Life cycle effects		?	1. Depends upon movements in and out of low income and on and off benefits.[108]
Cross selling to new account holders over life-time		?	1. Depends upon movements in and out of low income and on and off benefits. 2. Depends on future welfare reforms.
Corporate reputation/ Brand enhancement	?	?	
GOVERNMENT – SOCIETY			
Benefit delivery costs		£400m	1. Assumes no direct subsidy to support PO network. 2. Assumes no subsidy for setting up accounts or cash acquisition.
Financial inclusion		Yes	1. Depends upon ability to access cheaper methods of payment.
Post Office closures	Yes		1. Depends upon how benefits are withdrawn from accounts in future.

If the government concluded that the costs to the banking industry outweighed the benefits then it may wish to subsidise the operation of the USO – perhaps to reflect the benefits accruing to it from cheaper benefit delivery. This has occurred in the USA, where financial institutions offering the Electronic Transfer Account (ETA) are reimbursed with a set up cost of $12.60 per account.

Oftel has speculated that if they are correct about their analysis then it might be possible to put sections of the USO telecommunications business out to competitive tender. This idea has also been floated for the banking industry.[109]

Fair funding formula

It is probable that the costs (and the benefits) would fall on certain institutions to a greater extent than others. There would need to be a mechanism for sharing these costs and benefits equitably. There are three options for allocating the costs (or benefits) of imposing a USO – a virtual fund, an actual fund or rough justice.

- **Rough justice**. In telecommunications, as Oftel judges that the benefits to the USP (BT) outweigh the costs, no mechanisms are used to share the costs of the USO. The banking industry is more competitive than telecommunications and there would be no USP so this approach is unlikely. However, it is possible that the overall costs of setting up a fair funding mechanism are so high that it is deemed uneconomic – in this case the burden would simply lie where it falls.

- **Virtual fund**. This would take the form of net transfers between financial institutions under the supervision of the Financial Services Authority and in a framework decided by the FSA.

- **Actual fund**. Alternatively, a separate organisation could be established which calculated the net costs and benefits to each firm and charged or paid out to different financial institutions accordingly.

COMPULSORY AUTOMATED CREDIT TRANSFER (ACT)

Summary of legislative option

One of the tools a government could use to bring those on low incomes within the banking system would be to only pay their benefits via ACT direct into a bank account. There are two reasons for paying benefits using ACT rather than by Girocheque or Order book.

- First, electronic delivery of benefits into an account is cheaper than paper based methods (anecdotally, around 4-10 pence compared to 50 pence). Paying benefits solely by ACT into bank accounts is the stated long term aim of the Department of Social Security.[110]

- Second, it is argued that it would provide an obvious motive for benefit recipients to open accounts and also a steady stream of income which will provide a motive for banks and building societies to accept them as customers.

At present, many of those without a current account are in receipt of a benefit. This means that using compulsory ACT has the potential to bring many of the unbanked within the banking system. It is estimated that around 80% of those in receipt of a benefit do not currently have an account or do not have an account which can support ACT.[111] This implies that, before payment by ACT can be made compulsory, either there needs to be universal access to money transmission accounts, or provision would have to be made for alternative methods of payment to those whom the banks refuse to offer an account.

Universal access could be achieved by imposing a universal service obligation on banks and building societies, or, as discussed elsewhere, by using more voluntary methods of achieving universality. Financial incentives could also be introduced for banks – subsidising the set-up and account maintenance costs of new customers receiving their benefits via ACT.

Relevance to the low income consumer

Money transmission

If compulsory ACT were combined with policies which increased access to money transmission accounts, then this could help meet the money transmission needs of those without accounts.

Treatment of low income consumers

There would need to be careful regulation of the treatment of new customers by the banking industry. In particular, it is possible that banks will seek to recoup the cost of cash withdrawals by introducing charges for over-the-counter or ATM withdrawals. Benefit integrity would need to be maintained – perhaps by regulating to allow a number of free withdrawals per month.

Evidence from other countries or industries

Under the EFT '99 (Electronic Funds Transfer) programme, the US Federal government is attempting to pay all monies, including federal benefits, electronically. The 1996 Debt Collection Improvement Act committed the government to conduct all its financial transactions using EFT by 2nd January 1999.

The problems of the estimated 18% of Federal benefit recipients without a bank account quickly emerged.[112] It also became clear that the financial services industry would accept these low income individuals as account holders. The Federal government's response was twofold. First it set about designing an Electronic Transfer Account (ETA) into which benefits could be paid. Second, it introduced a wide ranging series of exemptions so that recipients could still be paid without a bank account.

Attributes of the ETA. A series of surveys and focus groups were held to discover what those people outside the banking system needed from an account.[113] It was decided that the ETA would: be available to any individual who receives Federal funds, would accept only federal payments, be subject to a maximum price of $3 per month, have a minimum of four cash withdrawals per month, provide the same consumer protections available to other bank customers, allow access to point-of sale networks if available, require no minimum balance, and would provide a monthly balance.

Furthermore, the government conducted a Float Earnings Valuation trial in Texas to investigate the potential for undrawn balances in accounts to generate earnings for the serving financial institution.[114] It was decided to offer a one off reimbursement to financial institutions of $12.60 for the set up costs of the ETA account.

Exemptions. The Federal government did not make EFT compulsory. A recipient can still receive a paper cheque if receiving payment by EFT will cost them more than receiving a cheque, or if the recipient has a disability, or a geographic, language or literacy barrier. Furthermore, the waivers are self certifying – i.e. payment recipients can make their own decisions as to whether they continue receiving paper cheques.[115]

Analysis

Justification

As a policy tool for tackling financial exclusion, compulsory ACT would work in two ways. First, it could encourage those outside the banking system who are 'self-excluded' to enter the banking system. Second, the float income from these new accounts may provide an incentive for banks to accept these customers.

Assessment

Would the introduction of compulsory ACT help tackle financial exclusion? It would clearly encourage them to apply for an account, as most of those without a bank account are in this position because they do not think that an account is relevant to them. However, it is less clear that banks would accept these new customers, although it would provide a regular income stream for the account which may provide an incentive for the banks to accept them. Evidence from the trial conducted into float income from ETAs in the USA above provides little hope that these accounts will be immediately profitable. Banks will probably need more persuasion, incentives or even regulation if universal access to accounts which allow money transmission.

Furthermore, the risk of closure of rural sub post offices would mean that compulsory ACT has detrimental effects upon these communities which may even intensify social exclusion in these areas.

CHALLENGE FUNDS

Summary of legislative option

One of the keys to the success of the Community Reinvestment Act in the United States is that it has acted as a spur to levering resources out of mainstream financial services and into community finance institutions. If the Community Reinvestment Act is not adopted in the UK (or a version is introduced which concentrates upon disclosure rather than an affirmative obligation to meet a community's credit needs) then there will be little obvious incentive for banks to donate resources, financial or otherwise, to alternative financial institutions such as credit unions and gateway institutions. An alternative could be the introduction of a challenge fund.

The challenge fund would reward banks financially who invest, lend to, and assist alternative lending institutions, including credit unions. The challenge fund would reward the banks and building societies which had the best record through an annual competition. The fund would thus lever out extra private money, over and above the public funds committed to the competition rewards.

Relevance to the low income consumer

Access to affordable credit

Through subsidising the operation of alternative lending organisations a challenge fund would assist in the process of widening access to affordable credit.

Communities and finance

Challenge fund rules could be structured so that alternative financial institutions operating in areas with few banks and building societies were given priority.

Evidence from other countries or industries

The Community Development Financial Institutions (CDFI) Fund is a US government corporation which stimulates investment in alternative financial institutions through two main programs: the CDFI program and the Bank Enterprise Award program. It was set up with the Community Development Banking and Financial Institutions Act (1994).

The CDFI program invests in CDFIs through a mixture of loans, grants, equity investments and deposits. It is a requirement that Federal funds are matched dollar for dollar with private funds raised by the CDFI. In 1996 and 1997 the Fund awarded $77.6 million to 81 CDFIs.

The Bank Enterprises Award program (BEA) in the USA is substantially based upon the Bank Enterprise Act (1991), but has been modified to ensure co-ordination with the CDFI Fund. The BEA program encourages mainstream financial institutions to lend and invest in CDFIs by levering in private sector funds. It provides money prizes to banks which lend and invest directly in low income communities and which support CDFIs operating in these communities. In 1996 and 1997, 79 banks were awarded a total of $30 million. These banks provided $133 million of support to CDFIs and $143 million in direct lending and financial services.[116]

Analysis

Justification

Credit Unions usually require subsidy in the early years of their operation, particularly to pay for professional staff. It has been estimated that with savings accumulation of about £10,000 per year it would require a hundred years to raise £1 million in order to employ just one full time worker, paid for from asset income.[117]

There is a case, in economic theory, for mainstream financial institutions to subsidise the work of alternative financial institutions as 'pioneer creditors'. Where credit unions or gateways lend to those who have no credit record they effectively screen out high credit risks, and give those who are outside the banking system, but who are good risks, a credit history. In this way, they reduce the risks confronted by subsequent borrowers. *"An implication of the existence of hidden information (about borrowers' motivation and competence) is that those who cause such information to be revealed confer an external benefit on those who subsequently trade in the market."*[118]

A good example of this working in practice is provided by a description of a Community Development Credit Union sharing premises, and working in partnership with, a bank. "*This unique one-stop-shopping provides consumers with a continuum of financial services, which underscores how the services of traditional banks and CDCUs can complement each other. [The CDCU] works with customers who have limited or no credit, helping them take their first steps towards accessing capital. Once they've developed reliable credit histories, Wells Fargo offers these customers the more traditional financial services of a bank.*"[119]

Assessment

A Challenge Fund would probably not, on its own, make more than a marginal difference, over the long term, to low income consumer's access to credit. As argued elsewhere, alternative lending institutions such as credit unions can only ever be a partial response to financial exclusion.

When deciding whether to use a Challenge Fund the assessment must also take into account whether the public funds spent on achieving the policy aim – increasing access to affordable credit – would be more effective if spent on enlarging the Social Fund.

It seems probable that money spent enlarging the scope and size of the Social Fund would have a more direct impact in terms of increasing access to credit. There may, of course, be subsidiary policy aims – such as the fostering of alternative lending institutions – which lead to the conclusion that a Challenge Fund could be a good use of public funds.

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[3] Office of Fair Trading, pp. 23-6.

[4] Office of Fair Trading, p. 25.

[5] Because some people currently on low income will be on higher income in later life.

[6] Office of Fair Trading, *The Consumer Survey*, Appendix 4, table 2.1.

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