Alternative Financial Credit Providers in Europe

By Caroline Corr, December 2007

When credit is unavailable from mainstream financial providers[1], low-income consumers and the credit impaired[2] often turn to alternative financial providers[3] to access credit. The overall aim of this paper is to examine the use of alternative financial credit providers in Europe, to explain the persistence and growth of these providers and to offer recommendations for more appropriate ways of meeting the credit needs of financially excluded and credit impaired consumers.

1. Credit exclusion

Consumers usually turn to alternative financial credit providers when they cannot gain access to mainstream credit (i.e. credit exclusion). Nieri (2006: 134) defines credit exclusion as 'the problem of obtaining credit at terms and conditions compatible with the financial and social characteristics of the applicant'. Similarly, Gloukoviezoff (2006) employs a wide definition of credit exclusion to include people encountering both access and use difficulties (e.g. problems repaying a loan; selling of inappropriate products etc.).

Credit exclusion can occur as a result of credit scoring, responsible lending strategies, regulation and consumer protection regimes. Other factors highlighted by Kempson and Whyley (1999) include a growing number of low-income households working in a more 'flexible' labour market, increasing numbers of lone parent households living on a low income and economic recessions leading to mortgage arrears and house repossessions.

In some countries (e.g. Ireland; UK) the debate focuses more on access to affordable credit, with people being considered credit excluded if they have to pay charges that are considerably in excess of those in the mainstream credit market (Kempson and Anderloni, 2007; Kempson *et al.,* 2000). High interest rates are a key feature of the alternative financial credit market due to the greater risk for the lender (i.e. borrowers are on a low income or have a poor credit history).

2. Alternative financial credit providers

This paper concentrates on alternative financial credit providers involved in sub-prime lending. This is a term used to describe high interest loans made to low-income consumers and the credit impaired. The paper does not cover non-

[1] Mainstream financial providers include institutions legally recognised as banks, savings banks, postal banks and publicly owned banks.
[2] The credit impaired are those who have run into problems with debt.
[3] Alternative financial credit providers charge higher costs and offer poorer terms and conditions than mainstream financial providers.

commercial loans which include state-funded loan schemes, credit unions, community-based or informal loans schemes and loans made by family and friends.

Not all, but some sub-prime loans are considered 'predatory' or extortionate'. Predatory lending is a term which is more commonly used in the US, where European commentators usually refer to 'extortionate' or 'usurious' lending. In April 2000, the National Predatory Lending Taskforce was established in the US. This Taskforce stated that a loan can be considered predatory when lenders or brokers:

- charge borrowers excessive, often hidden fees
- refinance loans at no benefit to the borrowers (i.e. loan flipping)
- grant loans without regard to a borrower's ability to repay
- engage in high-pressure sales tactics or outright-fraud and deception
- take unfair advantage of a borrowers' lack of understanding about loan terms

Whenever predatory practices occur, it is usually in the sub-prime mortgage market where most borrowers use collateral in their homes for debt consolidation or other consumer credit purposes (HUD-TTFPL, 2000). However, this paper will focus on consumer credit and not mortgages.[4]

In a study on *Extortionate Credit in the UK,* Kempson and Whyley summarised the main factors associated with extortionate credit, mirroring those highlighted by commentators in the US. These include:

- High cost of credit (e.g. high interest rates; dual interest rates; fees and charges; non-compulsory insurance policies; late settlement of superseded credit agreements)
- Terms and conditions of agreements (e.g. levels of security required; dual interest rates, with concessionary rates ending at an early stage of default; conversion from unsecured to secured loans following default; interest penalties for early settlement)
- Sales practices (e.g. high pressure sales; encouragement of a cycle of borrowing; roll-over loans; failure to check borrowers' ability to repay; falsification of income data on application forms; equity lending)
- Lack of transparency in agreements (e.g. lack of price transparency; mis-representation or concealment of terms conditions; irregular and incomplete documentation)
- The role of brokers and other third parties (e.g. encouragement of irresponsible lending; failure to disclose ties to lenders; charging fees even if no loan is arranged; deduction of fees from the loan; linking credit agreements to sales agreements so that rights of cancellation are curtailed; unlicensed brokers)

[4] This is because access to mortgages is excluded from the terms of reference of the European Commission Study on *Financial Services Provision and Prevention of Financial Exclusion* 'as it raises a much wider set of issues about access to home ownership' (Kempson and Anderloni, 2007).

- Debt recovery (immoral and illegal practices; allowing financial penalties to erode the equity for secured loans)

The range of alternative financial credit providers who make up the sub-prime credit market in Europe are summarised in Table 1.

Table 1: Alternative Financial Credit Providers in Europe

Alternative financial credit providers	Countries affected
Sub-prime market	
Sub-prime lenders (or non-deposit lending companies)	UK; Ireland; Lithuania; Slovakia; Bulgaria
Sub-prime credit card companies	UK
Pay day lenders	UK; Bulgaria
Mail-order catalogues and rental purchase outlets	UK; Ireland
Sub sub-prime market	
Legal moneylenders (or doorstep lenders/home credit companies)	UK; Ireland; Poland*
Pawnbrokers	UK; Germany; Norway; France; Ireland; Austria; Holland; Belgium
Illegal sub-prime market	
Unlicensed moneylenders (or loan sharks)	Likely to be occurring in most EU States

* Not regulated by financial authority or commercial law

2.1 Sub-prime market

Sub-prime lenders: These lenders are often subsidiaries of mainstream banks and offer secured and unsecured loans to people with a history of bad debts, poor credit records, over-stretched mortgages and defaulted loans. These companies largely resemble lenders in the prime credit market except that their charges are significantly higher to reflect the higher-risk borrowers they serve. Several countries have well-established sub-prime lenders (e.g. UK) with the sector in other countries (e.g. Ireland) rapidly increasing. In Lithuania, there are currently 2 offices of AM Credit providing mortgages at higher interest rates than mainstream providers. Similar companies exist in Slovakia and Bulgaria. A distinguishing feature is their use of credit-rating practices which allows them to ensure that they make a profit regardless of the risk and a hierarchy of price banding means that a client will be charged automatically in accordance with the stability of their repayment history (Burton *et al.,* 2004). In Ireland and the UK fees and charges can make the cost of credit higher than borrowers originally anticipate and borrowers are also sometimes led to believe, that protection insurance is a condition of their loan (Kempson and Whyley, 1999).

Sub-prime credit cards: Sub-prime credit cards are a relatively new sub-prime product in the UK. In 2004, it was estimated that approximately 0.5 million low income households had used a sub-prime credit card in the UK in the previous 12 months (Policis, 2004). APRs in the UK are much higher than the mainstream, ranging from 20 to 60%. Sub-prime credit card companies which are often subsidiaries of mainstream credit card providers usually charge high late fees, high over limit fees, annual fees or up-front fees for the card. Conversely, Collard and Kempson (2005) found that sub-prime credit cards developed by moneylenders did not have any additional charges but these were included in the overall charge for credit which was reflected in a higher APR.

Pay-day lenders: Customers write one or more cheques to a pay-day lender, which, in return for a fee, agrees not to present the cheque for up to 30 days. The customers receive the amount of the cheque less a fee (Collard and Kempson, 2005). Research in the UK found that payday loans offered easy access to credit for people with a cheque guarantee card and a regular income and these loans were perceived as cheaper than exceeding credit limits on credit cards or overdrafts without authorisation although costs were still perceived as high (Collard and Kempson, 2005).

Mail order catalogues and rental purchase outlets: Credit can also be tied to the purchase of goods. In Ireland and the UK customers can buy goods through catalogues which are technically interest-free but if repayments are extended research in the UK has found interest can be as high as 28.8% APR. In Ireland, mail order catalogue shopping can be offered by moneylenders with a charge of 32.77% APR plus a collection fee (Conroy and O'Leary, 2005). In the UK in 2002, around 14 million people, used agency mail order, down from just under 21 million in 1996 (Competition Commission, 2004). In recent years, rental purchase outlets have opened in the UK (e.g. Brighthouse which was formerly Crazy Georges and was banned in France for charging usurious interest rates). Interest rates can be as high as 29.9% APR although 'optional' insurance and service cover can significantly increase the costs of borrowing.

2.2 Sub sub-prime market

Moneylenders: Moneylenders make door-to-door calls offering retail credit usually for small cash loans. These are commonly used by people on low or insecure incomes. The agent collects set weekly repayments. Usually, no additional charges are made for default or rescheduling the loan. Moneylenders are well established in England and Ireland and work within the regulatory framework. The market in Poland is developing rapidly, in comparison to the UK where it is at best stagnating and at worst declining. What distinguishes them from the sub-prime market is the 'cross-subsidisation from the poor to the even poorer through standard charging rather than risk-based pricing' (Burton *et al.,* 2004: 19). Research in the UK has estimated that approximately 5% of consumers in Britain (approximately 2 to 2.5 million people) have taken out a home credit loan in the past 12 months (Policis, 2004; Whyley and Brooker, 2004). In 2005, it was estimated that there were 300,000 customers of moneylenders in Ireland, representing approximately 10% of the population over the age of 20 years (Financial Regulator, 2007). APRs can be as high as 400% in the UK and 200% in Ireland. However, these costs include the cost of home collection as well as the costs of late payment (Kempson and Whyley, 1999). Therefore research in the UK and Ireland have highlighted that the main downside of using home credit is its high cost (Collard and Kempson, 2005; Corr, 2006; Whyley and Brooker, 2004). An investigation into the home credit market in the UK also found that there was little evidence of switching, there were significant switching costs, information asymmetries were common (i.e. when the seller has more information than the buyer), and the market is concentrated by a small number of major suppliers with barriers to entry for new suppliers[5] (Whyley and Brooker, 2004).

Pawnbrokers: Pawnbrokers are one of the oldest traditional sub-prime markets in Europe and still exist in Ireland, UK, France, Germany, Austria and Norway. Pawnbrokers offer small cash loans secured on collateral (usually property or jewellery). In some countries (e.g. Ireland) their presence has been diminishing. Likewise, in the UK, usage has decreased although it has been estimated that there are still approximately 3 quarters of a million users in the UK (Collard and Kempson, 2005). In 2006 in Germany, it was estimated that there were about 1.1 million customers who were paid loans amounting to 500 million euro. Conversely the market is growing in Norway, through the main pawnbroker, Lånekontoret, which is owned by the second largest commercial bank Nordea. Unlike other traditional sub-prime lenders, its service is accessible on the Internet and the profile of its customer base has changed from solely lower income customers to customers from all strata of society. APRs in Ireland in the UK can be extremely high with research in the UK finding that APRs can range from 70 to 200% (Collard and Kempson, 2005). However, pawnshops in continental Europe (e.g. France, Belgium, Germany, Holland, Italy, Spain) differ substantially to the Irish and British ones as they are either run by the state or municipality (e.g. Mont de Piété). For instance, in Belgium, Mont de Piété makes approximately 120,000 loans every year. Potential borrowers must provide proof of identity, irrespective of nationality. Applications must be a national or a European Member State. In different countries, interest rates can be as low as 4%. However, in Germany, Italy and Spain, pawnbrokers are also provided by private companies as well as the state and municipalities and therefore charge much higher interest rates.

2.3 Illegal sub-prime market

Illegal sub-prime market: The illegal sub-prime market consists of unlicensed moneylenders or lone sharks who charge much higher interest rates than those working within the regulatory framework. Such lenders do not issue credit agreements and apply default charges that can be extortionate and arbitrary. Intimidation and violence are frequently used to ensure repayments are prioritised and to protect lenders from being reported. Illegal lending is a problem in some countries (e.g. UK; Lithuania), although it is limited to specific

[5] These include regulatory barriers, costs involved in setting up a new business and switching costs for customers.

cases/areas in other countries (e.g. Poland; Ireland; Germany; Norway; Slovakia; Italy). Research in the UK has estimated that up to 3% of low-income households could be using illegal moneylenders (Policis, 2004). The incidence of illegal lending is even higher in Germany and in France with 8% of those on low incomes who are credit impaired in Germany and 7% in France admitting that either they or someone living in their household have used an unlicensed lender (Policis, 2004). Some commentators argue that the incidence of illegal lending is lower in the UK as consumers have more legal options through the sub-prime market (Ellison *et al.,* 2006; Policis, 2004). In Ireland, a study carried out in a region in the south of Ireland found that 1% of low-income consumers were using illegal moneylending (Byrne *et al.,* 2005). There are also reports in Norway of people using private 'friendly' loan services, while in Slovakia the problem is mainly concentrated within the Travelling community.

2.4 Credit brokers

Sub-prime loans are often arranged via a third party who has a relationship with the lender and can apply for credit on behalf of the customer (Kempson and Whyley, 1999). With secured loans this is usually a credit broker. Kempson and Whyley (1999) stress that borrowers who use credit brokers are more likely to become involved in an extortionate credit agreement as given their commission structure, brokers are more likely to encourage irresponsible lending, to fail to disclose ties to lenders, to charge fees even if no loan is arranged, to falsify information and to misrepresent the terms and conditions of agreements. Fees may also be deducted from an advance, leaving borrowers with less than they thought they had borrowed, while still paying interest on the total amount.

Unsecured loans may also be arranged via a third party but this is usually arranged by the organisation that provides the goods or services being supplied on credit such as a home improvement company or motor trader (Kempson and Whyley, 1999). According to Kempson and Whyley (1999), this type of lending can raise consumer protection issues. For instance, some companies might not inform borrowers that agreements are cancellable.

Kempson and Whyley (1999) also highlight the case in the UK where Asian communities have people known as 'go-betweens'. They state that at the 'less reputable end, there are strong indications that the go-between is selling on a loan taken out in his own name' (Kempson and Whyley, 1999: 12).

3. Socio-demographic profile of customers

Burton *et al.* (2004) note that the sub-prime market fulfils the needs of consumers who fall outside mainstream lending criteria because their needs and circumstances are slightly unusual and whose credit histories may or may not be impaired. They state that while the number of borrowers of sub-prime lenders in the UK with poor credit histories is falling, the number of self-employed and temporary workers is increasing. Research has found that in the UK the sub-prime credit card market is attracting the more affluent end of the home credit spectrum (i.e. those on low income, non status and credit impaired workers) (Policis, 2004). The sub-prime lenders are more likely to lend to those with higher incomes than the sub sub-prime market because as Collard and Kempson (2005) point out, they often have a minimum loan size that exceeds the amount that people on low incomes generally want to borrow. Customers are more likely to be banked in order to make repayments by direct debit. For instance, payday lenders in the UK are generally only available to full-time workers with a bank account and usually a cheque guarantee card as well (Collard and Kempson, 2005). The exception is mail order catalogues and rental purchase outlets where it is not necessary to have a bank account and customers are more likely to on a low income, economically inactive due to long-term ill health or disability, a pensioner or from a minority ethnic group (Collard and Kempson, 2005).

According to Burton *et al.* (2004) the sub sub-prime market caters for those individuals with adverse credit histories, which because of their credit rating fall outside mainstream lending criteria. Kempson and Whyley (1999) point out that these are usually low-income households' whose needs are not adequately met by mainstream providers and they therefore turn to sub sup-prime providers to access small sums of money for relatively short periods of time. Whyley and Brooker (2004: 8) state that these customers are more likely to be on long-term low and/or unstable incomes and/or have a history of bad debt. These customers are more likely to be at the sharp-end of financial exclusion as they do not need a bank account to access sub sub-prime products.

Research carried out in France and Germany has found that illegal lending is concentrated among those who have been refused credit and/or shut out of the legitimate credit market (Policis, 2004; Babeau, 2006). The profile of users of illegal lenders in France and Germany are more up-market than in other countries (e.g. UK; Ireland) and are 'more likely to be male, to be in work or to be short-term unemployed' (Ellison *et al.,* 2006: 25). Conversely, borrowers in the UK are 'more likely to live in conditions of entrenched poverty and are overwhelmingly long-term unemployed, with the profile of illegal lender users having a strong female bias, being often single mothers living in social housing' (Ellison *et al.,* 2006: 25). Research in the UK has also found that inhabitants of high-rise council flats are usually unable to obtain loans from licensed moneylenders (as agents are either prevented from, or reluctant to, work in such environments) and have to depend on unlicensed moneylenders (Leyshon *et al.,* 2004). Similarly, research carried out in Ireland indicated that borrowers of illegal lenders are concentrated in the most deprived areas (Corr, 2006).

4. The persistence and growth of alternative financial credit providers

As Table 1 reveals, the sub-prime market has varying degrees of penetration in different European countries. Countries such as Ireland and the UK have a highly developed sub-prime market, while in countries such as Belgium, Norway, and the Netherlands it is non-existent. The reasons for this are complex. The section below will discuss the factors which impede or facilitate the growth of alternative financial credit providers in Europe.

Table 2: Factors influencing the growth of alternative credit providers in Europe

Societal	Supply	Demand
• Financial markets • Banking exclusion • Regulation • Interest rate caps	• Credit scoring • Inappropriate terms and conditions of mainstream credit providers • Geographical access • Appealing terms and conditions of sub sub-prime providers	• Preference for alternatives • Belief that mainstream is not for poor • Familiarity and tradition of using alternative financial credit providers

4.1 Societal explanations

Financial markets: Market-orientated financial sectors have facilitated the growth of alternative financial credit providers in different countries by leaving a gap in the market. According to Carbo *et al.* (2005: 113) the economic model pursued in Europe via liberalisation and globalisation has resulted in 'products tailored more closely to demand, higher rates of innovation, greater bank efficiency, lower prices and improved service quality'. There is no doubt that these developments have benefited the majority of consumers. However, this has resulted in a lack of appropriate products designed for low-income consumers due to the financial industry's 'flight to quality strategy'. In relation to access to credit, Nieri (2006:112) points out that 'comparatively low credit requests made by poorer citizens with limited openings for cross-selling make such customers unattractive, which can, from this point of view, lead the intermediary to reject the credit'.

The free market model has led to the exclusion of vulnerable consumers through more sophisticated credit scoring (Carbo *et al.,* 2005). While the use of credit scoring has increased access for many people, Collard and Kempson (2005: 22) point out that 'there is a real risk, however, that the increased use of application credit scoring and credit reference agency data in the low-income credit market will exacerbate credit exclusion among the poorest households. As companies become better able to ascertain relative customer profitability, they will increasingly move away from lending to less profitable customers – the poorest, the highest risk and the most vulnerable'. Exclusion as a result of credit scoring and a poor credit history are a problem in many European countries (e.g. Ireland; Poland; Belgium; UK; Germany; Italy).

Free market forces have also led to more concentrated banking systems, staff cuts and branch closures. This has resulted in the 'desertification' of some areas by banks (Carbo *et al.,* 2005). Leyshon *et al.* (2004) have coined the phrase 'relic financial ecology' to describe these areas which have been largely abandoned by mainstream financial services or that have never constituted markets for such firms. These areas are more likely to be poorer inner-city areas and peripheral local authority housing estates. In many of these deprived areas the only financial services are offered by alternative financial credit providers (Collard and Kempson, 2005; Leyshon *et al.,* 2004).

Banking exclusion: A bank account does not guarantee access to credit, but lack of a bank account can represent a barrier to mainstream, 'low-cost' credit. As Nieri (2006: 110) pointed out 'it is highly probable that those people who have no access to basic financial services, such as a current account, and are therefore considered unbanked, are also excluded from mainstream credit'.

Regulatory regime: Whyley and Brooker (2004) argue that effective consumer protection regimes can deter companies entering the sub-prime market. Consumers in Europe have increasingly more rights when it comes to lending. In different European countries responsible lending is ensured by law (e.g. Norway; France; Belgium; UK; Poland; Slovakia; Bulgaria), codes of conduct (e.g. Germany; UK; Ireland; Italy), individually within some prime credit lenders (e.g. UK; Lithuania; Slovakia; Spain) and by alternative financial credit providers themselves (e.g. UK; Slovakia; Spain). Some countries (e.g. Italy) have also included credit brokers within the regulatory framework.

Interest rate cap: One of the main initiatives that have been introduced by different European countries to ensure responsible lending is interest rate caps (e.g. Germany; Norway; France; Belgium; Poland; Slovakia; Spain; Italy; the Netherlands; Austria).[6] Some countries (e.g. Germany; Norway; Spain, Slovakia) do not specify an exact interest rate cap which means that the effectiveness of this legislation can be limited in practice. However, in Germany, the courts have defined a usury interest rate ceiling of approximately twice the average rate for consumer credit. They have also established that interest rate charges in excess of this ceiling are 'extortionate' and subject to prosecution. The French system is tightly controlled by the Banque de France who set both the usury and consumer protection regime. The interest rate cap is usually set at 33% above the average rate set quarterly by Banque de France and the rates vary depending on the type of credit sought. All compulsory charges are included within the APR. A similar regime exists in Belgium. In Italy, there is an interest rate cap set for 15 different types of transactions which are assessed quarterly by the Italian Treasury, taking into account assessments by the Bank of Italy and the Italian Bureau of Foreign Exchange. The most recent interest rate cap was introduced in Poland in 2006 which was set at four times the Central Bank's Lombard rate.

[6] Ireland, UK, Bulgaria and Lithuania have not introduced interest rate caps.

Consumer representatives who advocate interest rate caps argue that they are 'an effective means of addressing exploitative lending, enhancing consumer protection and tackling poverty' (Policis, 2004: 3). Reifner (2004: 3) argues that 'high interest rates are detrimental to poor people and destroy their household finance and behaviour'. Debt on Our Doorstep (DOOD, 2005: 3) contend that interest rate caps are only effective if a ceiling is set at an appropriate level as 'caps below 36% provide some evidence of credit rationing by lenders'. They also stress that interest rate caps are most effective when affordable credit is available to low income households through other intermediaries including mainstream financial institutions. Government interventions may also be necessary, especially for those whose 'productivity is so low that no interest at all can be paid and credit will only do harm to their families' (Reifner, 2004: 2).

Tighter regulatory regimes (e.g. France; Germany) have certainly prevented the sub-prime market developing. Policis (2004) found that sub-prime markets are unable to develop or are forced out of the market where interest rate ceilings exist. However, one of the main concerns of interest rate caps is that they could cause credit exclusion and restrict the amount of credit available to low income households. Policies (2004) found that the consumers most likely to be affected by rate ceilings in France and Germany are those operating outside the financial mainstream (e.g. unbanked or credit impaired). In France, some mainstream service providers claim that an interest rate cap prevents them from providing credit to financially excluded customers as they are unable to charge higher interest rates to cover the risks. Similar arguments have been put forward recently by Polish banks. Likewise, in Belgium, the Professional Union of Credit (representing 90% of Belgian consumer credit providers) advocates deregulation, mainly because they believe it is uncompetitive in comparison to other European countries.

Other commentators have stressed that there is a danger that the introduction of interest rate caps would result in lenders moving out of the sub-prime market altogether, leaving poor people even more prey to unlicensed moneylenders (Collard and Kempson, 2005: Burton *et al.,* 2004). For example, in Italy, Porto and Masciandaro (2006) argue that the interest rate cap has resulted in high risk consumers being refused credit by banks and finance companies which could lead them to rely on illegal providers. This is precisely why some countries (e.g. UK, Ireland) have been reluctant to introduce interest rate caps.

Another concern is that putting a ceiling on interest rates could result in every provider setting rates near the maximum when they could be lower (Rowlingson, 1994). Burton *et al.* (2004) are concerned that this could be even more the case in relation to the sub-prime market given that rates are more directly related to risk. There are also fears that interest rate ceilings can be ineffective as lenders circumvent the ceiling by adding fees and charges that are not covered by the cap. Collard and Kempson (2005: 30) argue that this would result in the total costs of borrowing being less transparent.

4.2 Supply factors

Low-income consumers often turn to alternative financial credit providers when credit is unavailable from mainstream institutions. A survey carried out among 700 respondents France, Spain and Italy found that 16% of credit applications were rejected and this was most common among migrants (26%) (Nieri, 2006). However, the incidence of credit refusal carried among countries: it was 2.5 times higher in Italy than Spain. The main reasons for consumers being refused credit in different European countries are poor credit history (e.g. Poland; Ireland; Belgium; UK; Germany; Lithuania; Spain; Italy; Austria) and low income/unstable employment (e.g. Lithuania; Ireland; UK; Germany; Belgium; Norway; Spain; Italy; Austria). Other reasons highlighted by Nieri (2006) include the lack of guarantees and collateral and the negative evaluation of an application to finance a business or a micro-enterprise.

Moreover, mainstream institutions do not provide small loans which suit the needs of those on low incomes. For instance, in the UK the smallest loan provided by banks is €1,500 compared to the average home credit loan of €400. Other terms and conditions attached to credit provided by mainstream institutions do not suit the needs of those on low incomes (e.g. higher interest rates for smaller loans; monthly repayments; little flexibility for occasional missed payments) (Corr, 2006; Kempson *et al.,* 2004).

Research in the UK also indicates that alternative financial credit providers are often located in areas where there are no mainstream financial services and are therefore the only source of credit low income consumers can access (Leyshon *et al.,* 2004). In relation to illegal lending, in countries such as Germany, customers turn to these providers when they have been refused mainstream credit and no other alternatives exist (Policis, 2007). Similarly, in the UK, Ellison *et al.* (2006: 6) found that 'illegal lending arises in a supply vacuum, with illegal lenders unequivocally the lenders of last resort'. This study found that around one in five users of illegal lenders live in areas not served by licensed moneylenders (Ellison *et al.,* 2006).

The terms and conditions associated with many sub sub-prime products are often more suited to the needs of low-income consumers. Moneylenders, in particular, suit the needs of low-income consumers in Ireland and the UK as payments are usually collected from customers' homes, which is not only convenient but reduces the chances of default. Weekly repayments also suit the budgeting needs of low-income consumers. The total cost of credit to moneylenders usually allows for a certain level of missed payments. Similarly, low income consumers in the UK are likely to use agency mail order as they are convenient and customers can spread the cost of goods over a fixed time period with set amounts (Byrne *et al.,* 2005; Collard and Kempson, 2005; Conroy and O'Leary, 2005; Corr, 2006 Financial Regulator, 2007; Kempson *et al.,* 2000; Kempson and Whyley, 1999; Leyshon *et al.,* 2004; Whyley and Brooker, 2004).

Dedicated sub sub-prime models can sometimes be cheaper than the mainstream alternatives. Policis (2004) use the example of high risk borrowers using credit products designed for low risk credit users in France. They highlight that 'use of such mainstream credit vehicles does not necessarily lower the cost of credit for high risk borrowers […but…] the cost of credit will be contained only if higher risk borrowers are able to maintain the perfect payment record typical of the lower risk borrower' (Policis, 2004: 24). For example, a French borrower who makes three late payments over the course of five years on a single purchase of €1,400 on a revolving credit card will pay a higher cost of credit than home credit in the UK (Policis, 2004). Similarly, customers in the UK who make irregular repayments on sub-prime credit cards will pay more than they would on a home credit loan (Policis, 2004).

4.3 Demand factors

Customers of alternative financial credit providers sometimes self-exclude from mainstream providers as they have a preference for non-mainstream providers or they believe that they would be refused by mainstream financial services (Whyley and Brooker, 2004). In a survey carried out among 700 people in France, Spain and Italy, 21% of respondents stated that they did not ask for credit for fear that the application would be rejected and this was particularly common among migrants (30%) (Nieri, 2006). Despite the high cost of borrowing, people may continue to use alternative financial credit providers because of familiarity and because they have a good relationship with the lender. There is also a long tradition of the use of sub sub-prime providers in the UK and Ireland and customers often feel that the lenders understand the difficulties of managing on a low income. Nieri (2006) also points out that some individuals who manage to find an intermediary who is willing to grant them credit, may not want or use this possibility due to the excessive cost of the loan or contractual terms that are ill-suited to the applicant.

5. Consequences of using alternative financial credit providers

Customers of alternative financial credit providers can face a number of negative consequences. By using alternative financial credit providers as opposed to mainstream providers, customers are unable to build up a good relationship and good credit history with a mainstream provider. Even if they successfully repay an alternative credit provider without falling into arrears, they will not be able to use this good credit history with potential dealings with mainstream providers.

As already stated, the main disadvantage of sub-prime lending is the high costs involved. In research carried out in the south of Ireland, Byrne *et al.* (2005) found that people on low incomes who rely on moneylenders as a source of credit pay out a higher percentage of their income on loan repayments compared to those who use mainstream providers. They concluded that moneylending was not only a 'serious drain on the household economy' but also 'on the local economy of poorer communities across Ireland' as a 'significant percentage of state transfers into communities is quickly drained out in high interest payments to moneylending companies' (Byrne *et al.,* 2005: 23). Similarly, British research has found that the high interest rates of moneylenders can cause further financial strain and unmanageable levels of debt for low-income households (Herbert and Hopwood-Road, 2006).

Kempson and Whyley (1999: 2) argue that vulnerable consumers are 'at greater risk of default and likely to face more server consequences should default occur'. Defaulting on a payment with sub-prime lenders can generate a penalty in the form of increasing the interest rate (Burton *et al.,* 2004). This can lead customers into greater financial difficulties. The Money Advice and Budgeting Service (MABS, 2007) in Ireland is concerned that those borrowing from sub-prime lenders can become overindebted because of 3 main reasons:

- Many of the products are heavily advertised and may cause people to borrow more than they can really afford
- Proof of income is not always required which could lead to borrowers overstating their capacity to repay
- Equity lending may be the prime motivation of the lender rather than the consumer's income or ability to repay

Similarly, in the UK, Kempson and Whyley (1999) found that sub-prime lenders target vulnerable consumers and encourage them to take out loans that they are unlikely to be able to repay.

Evidently, the most negative consequences are experienced by those lending from illegal financial credit providers given that they are covered by no consumer credit protection. Research in the UK found that penalty charges are often disproportionate and arbitrary, paperwork is rarely provided and the cost of credit could be as high as three times the cost of credit from the highest cost legal lender (Ellison *et al.,* 2006). In Germany, Policis (2007) highlighted that one of the major risks associated with borrowing from illegal lenders arises when borrowers find themselves in financial difficulties with lenders likely to use violence and intimidation. In Slovakia, when customers do not fulfil their repayments, unlicensed lenders pass on the information to an outsourcing company who then use harsh methods to recoup payments. Research in the UK found that 'most relationships between illegal lenders and their customers are based on fear and intimidation with lenders seeking to control their customers with a range of coercive practices' (Ellison *et al.,* 2006). In the worst cases, failure to pay can result in customers being forced to deal drugs or into prostitution on behalf of the lender (Ellison *et al.,* 2006).

6. Meeting the credit needs of financially excluded consumers

The persistence and growth of alternative financial credit providers raises public policy issues, particularly in relation to social justice (Leyshon *et al.,* 2004). Is it just that one section of the population should have to pay much higher prices for products that, for the majority are not only cheaper, but also available from a much wider range of providers? Commentators generally agree that there is a need to create other sources of financial services and affordable credit for the financially excluded and credit impaired (Corr, 2006; Ellison *et al.,* 2006; Leyshon *et al.,* 2004; Policis/PFRC, 2007). Ellison *et al.* (2006) argue that once other appropriate sources are created which will address the supply vacuum the sub-prime market will gradually withdraw.

It is important to respond to the needs of financially excluded and credit impaired customers when designing and implementing policies. A study in the UK (Collard and Kempson, 2005) investigating what people on low incomes wanted from credit providers found that:

- People on low incomes want to be able to access credit quickly and easily, without lengthy or intrusive application procedures
- They need small fixed-term cash loans without the requirements of security in the form of savings and valuables
- Affordable repayments are more important than the total cost of credit usually over a weekly period
- Suitable repayment methods help minimise the risks of default (e.g. home collection suits some customers, while a minority prefer direct debit payments) and lenders are valued who make no additional charge for late or missed loan payments.

An overview of appropriate policies and services to meet the credit needs of financial excluded and credit impaired customers are summarised in table 3.

Table 3: Meeting the credit needs of financially excluded customers: appropriate polices and services

	Policies and Services
Societal factors	• Innovative and flexible regulation • Responsible lending legislation • Detection and enforcement of illegal lending
Supply factors	• Greater access to banking services through the provision of basic bank accounts • Increasing access to affordable credit (e.g. through credit unions and community-based initiatives) • Social funding provided through the state
Demand factors	• Financial education and advice

6.1 Societal factors

There is an onus on regulators to respond to both the emerging sub-prime market and the existing sub sub-prime market. Burton *et al.* (2004) warn that regulators should be wary not to increase the cost of borrowing in the sub-prime sector since the providers would most likely pass the costs to consumers. Ellison *et al.* (2006:11) also advise that 'regulatory strategies for both illegal and high cost lending carry significant social risks if developed in isolation from wider social policy considerations'. Therefore, they argue that regulatory strategies should be introduced to maximise the availability of regulated credit, while Leyshon *et al.* (2004) argue that regulators should encourage 'a more enriched and diversified financial ecology'. Similarly, Burton *et al.* (2004: 22-23) warn regulators against their 'preoccupation with transparency' but instead advise that they need to be 'innovative and flexible in their strategies if they are to meet the challenge that they face'.

The European Coalition for Responsible Credit (ECRC, 2007) argues that national and European legislation on consumer protection should incorporate seven general principles of responsible lending. These include:

- Responsible and affordable credit must be provided for all
- Credit relations have to be transparent and understandable
- Lending has at all times to be cautious, responsible and fair
- Adaptation should be preferred to credit cancellation and destruction
- Protection legislation has to be effective
- Overindebtedness should be a public concern
- Borrowers must have adequate means to defend their rights and be free to voice their concerns

Researchers in the UK have recommended that detection and enforcement of illegal lending is crucial (Ellison *et al.,* 2006). To this end, the Department of Trade and Industry in the UK have set up illegal money lending projects across Britain to tackle illegal lending on the ground. In Italy, the Anti-Usury Foundation has been set up to combat illegal lending. Ellison *et al.* (2006) also argue for the need to maintain 'a regulatory environment which encourages legal credit options'.

6.2 Supply factors

Greater access to banking services could help financially excluded and credit impaired customers to develop a relationship with mainstream institutions which in turn could act as a gateway to other financial products such as credit. Many European countries have introduced basic bank accounts to bring financially excluded people into the banking system and this has also been facilitated through universal banking services (e.g. basic banking products provided through other intermediaries e.g. post offices). However some countries have made no attempt to introduce basic bank accounts (e.g. Ireland) and some banks in other countries like the UK exclude those who are bankrupt, although the Banking Codes Standard Board are monitoring this.

Debates in several countries have concentrated on the role of locally based initiatives, particularly credit unions, in providing affordable credit to low income consumers. Recently in the UK, the interest rate ceiling for credit unions was increased from 12.68% to 26.8% (on not-for-profit basis) to encourage credit unions to target high risk borrowers. Ireland has one of the largest credit union movements with 70% of the population a member. However, research in Ireland has highlighted that there are numerous barriers for low income consumers in accessing credit union loans, most importantly building up a savings history (Byrne *et al.,* 2005; Corr, 2006). Therefore, Corr (2006) recommends that credit unions should develop a social finance policy which should be provided to those who need credit but do not have a savings history or who need money for an emergency or unexpected event. In the UK, similar developments by credit unions have been supported financially by the government's Financial Inclusion Growth Fund. Collard and Kempson (2005) also posit community-based lenders as a way of providing affordable credit and they recommend that these services could expand by developing effective partnerships (e.g. with banks, credit unions, housing associations etc.).

Despite the high rates of interest, moneylenders offer many benefits to low-income consumers (e.g. cash loans, convenience, door-to-door service etc.), In light of this, the Joseph Rowntree Foundation in the UK has commissioned a study to examine whether a not-for profit home credit service could be established and offer loans at a price that is substantially lower than those in the commercial sector. This is an initiative also supported by Leyshon *et al.* (2004: 643) as they feel it would crowd the home credit industry out of its current market which is 'a more effective route for public policy' rather than 'regulating the home credit industry out of existence'.

Ellison *et al.* (2006) have highlighted the need for the state to intervene and provide social lending. One example of this is the Social Fund in the UK. A survey carried out in the UK found that the Social Fund was the most popular source of credit among people living in the poorest fifth of UK households with 20% using it in the 12 months prior to interview (Collard and Kempson, 2005). However, the main criticism of it is that the repayment levels tend to be high. Therefore, Collard and Kempson (2005) recommend that it should be reduced from 12% to 5% or 10% of income. They also propose that it is expanded (either through taxation or using capital provided by the banks). Similarly, in France Article 80-III of the Borloo Law established the "Social Cohesion Fund" (Fond de Cohésion Sociale) which grants loans to unemployed people and people receiving minimum unemployment benefits through accompanying organisations and French banks. Likewise, in 2005 the Italian Industry Ministry together with the Italian Bankers' Association (ABI) and the Italian Association of Consumer

Credit and Mortgage Intermediarieis (Assofin) created a guarantee fund "Fondo di garanzia per il credito al consume " (FDGCC) to support access to credit for low income households.

6.3 Demand factors

Vulnerable consumers are less well-informed about credit generally (Kempson and Whyley, 1999). In a survey of 700 consumers in France, Italy and Spain, Nieri (2006) found that difficulties in credit access are often due to an inadequate financial literacy. Burton *et al.* (2004) argue that financial education which addresses low levels of financial numeracy and literacy is crucial to enable customers of alternative financial credit providers to make rational choices. They stress that financial educational programmes should be specifically targeted at lower socio-economic groups residing in deprived areas. Nieri (2006) also emphasises the need for financial advice and education to increase the financial capability of people on low incomes. She argues that this will result in people being 'better equipped to learn about and assess which financial products will be of benefit to them. They will also be less likely to use unsuitable financial products and be less likely to end up in financial difficulty or to be over-indebted' (Nieri, 2006: 131). She also highlights that this would benefit banks and mainstream financial institutions as well 'due to the lowering of costs associated with the risk assessment and choice of the credit product, and/or because of the reduced risk of default'.

In relation to illegal lending, Ellison *et al.* (2006: 10) recommended that 'advice and financial education will be important as a component of a long-term strategy to create awareness of the dangers of illegal lending but are unlikely to have an immediate impact on the incidence of illegal lending'. Such an educational campaign has been launched by credit unions in Ireland on a pilot basis (*Keep the Wolves from the Doors)* and is gradually being rolled out to other credit unions nationally.

7. Summary

There are a range of alternative financial credit providers which make up the sub-prime market in Europe. These include sub-prime providers (sub-prime lending companies; sub-prime credit cards); sub sub-prime market (licensed moneylenders and pawnbrokers) and the illegal sub-prime market (unlicensed moneylenders). These providers cater for those with poor credit histories and low incomes although customers of the sub-prime market may or may not be credit impaired. The sub-prime market has varying degrees of penetration in European countries due to differences in economic models, the market-orientation of financial services, credit scoring, bank closures, regulation and interest rate caps. The use of alternative financial credit providers raises public policy issues, particularly in relation to social justice. Different commentators have recommended that services and policies need to be introduced to provide appropriate and affordable options for low-income consumers. This will require action at a national and European level (e.g. through legislation and regulation); at an industry level (through mainstream service providers); as well as at a local level (e.g. through credit unions and community-based lenders and dedicated financial educational campaigns).

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