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# Borrowing your way out of debt: lessons from a North East debt consolidation programme

Financial exclusion is concentrated in areas with few or no mainstream banking or credit services. Without the financial services taken for granted by most consumers, people living on low incomes have little choice but to pay high charges to cash cheques and pay bills. They are also vulnerable to high-cost lenders and may make poor money management decisions. High-cost loan repayments eat into already limited incomes, meaning people's ability to pay for basic necessities is put under severe strain.

Providing lower-interest consolidation loans through community finance institutions is one way of tackling this problem. The theory is that once freed from high interest rates, people can repay a consolidated loan more easily and improve their financial stability – in other words, they can borrow their way out of debt. Previous research has found, however, that in such schemes default rates can be high with few borrowers moving into financial stability. Evidence has suggested that more comprehensive support – including money and debt advice and access to savings and budgeting accounts – is needed to make debt consolidation effective.

In 2005, Northern Rock Foundation awarded a grant to Money Answers South Tyneside (MAST), to test a more comprehensive approach to tackling over-indebtedness. MAST sought to provide not just accessible and affordable loans, but also flexible savings schemes and money and debt advice, in partnership with South Tyneside Credit Union and South Tyneside Citizens Advice Bureau. As part of the Foundation's contribution to establishing the programme, MAST commissioned Paul A Jones, at the Research Unit for Financial Inclusion, Liverpool John Moores University, to assess its impact and effectiveness. This edition of *Insight* summarises the key findings from the research

## In brief

- Northern Rock Foundation funded a debt consolidation scheme, Money Answers South Tyneside (MAST) which included money and debt advice and access to financial services.
- 57% of loan applicants were turned down because a MAST loan was unsuitable. They were offered support and advised on alternative options.
- In particular and limited circumstances, consolidation loans did work. 20 people with MAST loans made regular repayments and improved their financial stability.
- Those with poor financial literacy, low motivation to repay and with a history of making payments in cash to home collectors were most likely to default on loans.
- Even with rigorous procedures, default will inevitably be high given the part of the market in which community finance services work.
- MAST operated as much as a money advice service as it did a lender. Financial education should be part of similar programmes attempting to help financially excluded people.

## The MAST debt consolidation programme

MAST is a community development finance institution (CDFI) set up in 2005 to help people on low incomes. As a CDFI, it can receive financial donations or loans from charities or other bodies for on lending to excluded groups. Unlike credit unions, it can make loans at higher interest rates to support a higher risk portfolio. Importantly, a CDFI can also serve people who are not credit union members.

In partnership with South Tyneside Citizens Advice Bureau (STCAB) and South Tyneside Credit Union (STCU), MAST provides loans at affordable rates so people can consolidate and repay high-cost debts. Northern Rock Foundation made a grant of £200,000 in October 2005 to establish the debt consolidation fund, and to evaluate its effectiveness. The MAST scheme developed following a previous programme run by STCU and STCAB.

At MAST, loan offers are directly linked to the CAB's money and debt advice, and to membership of the credit union. Referrals come from STCU, STCAB and the local authority. The borrower must attend an interview with a CAB adviser, and open a credit union savings account. The loan is a one-off intervention, designed to provide the individual with a new start. If they need further credit, they are encouraged to use the credit union rather than return to high-cost lenders. MAST is based in STCU's offices, and run by STCU employees.

At an initial interview, the MAST loans officer discusses the applicant's over-indebtedness, financial status and credit history. The applicant then sees the CAB advisor, who works out what they can afford to repay. The advisor also explores alternative options with the applicants. In many cases, a MAST loan is not the best way forward. If a loan is recommended and approved, the MAST loan officer then agrees a payment plan, alongside a recommendation to set up a savings account with STCU. Loan repayments are made either electronically (the preferred method) or with a cash repayment book at STCU's offices for those who had no other means to pay.

## MAST statistics from March 2006 to December 2007

- 97 loan applications were made; 42 were approved and 55 refused.
- £95,064 was lent; loans ranged from £638 to £5,240; the average loan was £2,382.
- 83% of loan recipients were women, most of them young lone parents.
- All loan recipients were on welfare benefits or low waged.
- 48% of loans were to consolidate debt to doorstep lenders; 29% to high-cost credit cards or overdrafts; 19% to high-cost retailers; 19% to catalogues; 17% to store cards; 10% to illegal money lenders and 7% to slot television loan companies.
- Of the 38 borrowers taking loans to September 2007, 20 were able to repay regularly and move into greater financial stability. This represents a 52% success rate.
- At the end of December 2007, 11 of the 38 loans (29%) were in serious default, representing a potential 29% write-off of MAST's loan book. By September 2008, however, the potential write-off had reduced to 19.45%.
- All those defaulting were making cash repayments.

# Lessons learned

## Low take up of the programme

The take up of loans was not as high as might have been expected. This was in large part due to the careful assessment of applicants' ability to pay loans, meaning more than half were refused and offered alternative help. MAST did not provide consolidation for home credit loans (although it did so as part of a consolidation package), utility bills or rent arrears. MAST also refused applications where the maximum loan available (£5,000) would have been insufficient to make a difference, where the applicants lacked the financial capacity to make regular payments or where there were other more appropriate solutions.

The MAST scheme was not openly marketed, and staff had very limited time to see applicants. Although some involved thought direct marketing might attract applicants who lacked the capacity to make repayments, the research concluded that there was scope for increased marketing of the programme through a wider group of potential referral agencies e.g. housing associations and community groups.

## Successful borrowing

MAST's debt consolidation programme demonstrated that it could significantly reduce clients' overall debt in particular circumstances. Collectively the 20 people who successfully managed their MAST loans saved £38,000, and most benefited from reduced payments of up to £50 a week. The evidence also suggested that the programme helped these people to improve their overall financial stability. Settling debts could help clients break the habit of using high-cost lenders, and encourage them to save. Of the 20, half began regularly saving with STCU during the period to December 2007.

## Why some people failed to keep up repayments

The high level of default shows the risks of moving people from high cost credit, particularly when their previous experience of loan repayment had been through home collection of cash payments. Customers of home credit companies are used to the lender taking responsibility for collecting payments from them. It may be the case that some people do require home collection to avoid defaulting on loans, particularly if they know missed payments do not incur penalties. It is not unexpected that a significant number of people, when under household financial pressure, defaulted when obliged to visit STCU's office to pay in person and in cash.

The level of default was not unusual when compared to similar schemes including government programmes. MAST pursued loan defaulters using standard recovery procedures and there was evidence that this worked, with half of those concerned starting to repay when cash collections were made at their home.

Almost all the serious defaulters were referred to MAST by STCAB after an interview. There was some evidence to suggest applicants interpreted the referral as a guarantee of a loan. This led to a re-emphasis of the role of the STCAB as being to assess applicants' income and expenditure, and to advise on budgeting, dealing with creditors and future financial options, and not to make loan offers.

## Recognising borrower types

MAST staff and directors stressed the limited financial capability of many loan applicants. The successful borrowers had a good grasp of the benefits and demands of taking a consolidation loan. Financial education was identified as a necessary element, but was not part of the original MAST programme. Further direct contact from the CAB, or home support from MAST, might have increased the numbers of borrowers making regular payments. The evidence suggested that at the loan assessment stage, staff needed to look at not only the applicants' capacity to repay, but whether they were likely to do so. Application of techniques to assess behavioural characteristics might help with such judgements.

## Lessons learned

### Assessing overall impact

The MAST debt consolidation scheme was an ambitious undertaking: it tried to provide a way for a group of deeply over-indebted people to move into financial inclusion and stability. The programme demanded behavioural change on the part of borrowers and not all had the commitment and motivation needed.

The programme drew on established good practice, with a straightforward application process, rigorous financial analysis, access to advice and loan repayments set at affordable levels. The need for a personal relationship with the borrower and the organisation was also stressed.

The fact that 57% of applicants were refused a loan can be seen as a strength of the programme. MAST staff often spent as much time with refused applicants as those offered loans. People were referred to the CAB or elsewhere for debt advice and other support. MAST therefore operated as much as a money advice and signposting service as it did a lender.

### Research methodology

The research took place over 21 months to December 2007. The researcher interviewed directors and staff of the three organisations, and gathered statistical data on beneficiaries, loans and repayments, and progression to credit union saving and borrowing. The researcher also conducted interviews with a sample of beneficiaries.

### More information

**Full report**

*Borrowing your way out of debt – a research report into the operation of the Money Answers South Tyneside debt consolidation programme*
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