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Financial Inclusion, Financial Education, and Financial Regulation in the United Kingdom

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Abstract

The United Kingdom (UK) has one of the largest financial services sectors in the world, and strong consumer protection regulation. Yet, despite nearly 2 decades of financial inclusion policymaking, persistent problems remain. Many individuals, often the most vulnerable, are unable to get financial products and services that meet their needs at affordable prices. New forms of exclusion are emerging as digital technology advances and risk profiling becomes increasingly sophisticated. The self-employed face particular problems, having high levels of unsecured debt and being less likely to have pension savings than employees. There are long-standing competition and conduct problems in the market for small business finance, and lending to small firms has both decreased and become more expensive since the financial crisis of 2007–2008. Despite many small businesses having similar levels of financial sophistication as retail consumers, the regulatory system does not protect them to the same degree. Financial capability is low among the UK population. Often, the groups with the lowest capability are also those at most risk of financial exclusion. Policy recommendations include: better coordination for financial inclusion policies; support for teaching financial education in schools; more progressive savings incentives; basic banking to meet the needs of the most vulnerable; streamlining government support for small businesses; and specialized advice and financial education for small businesses and the self-employed.

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1. INTRODUCTION

The United Kingdom (UK) has a large and open retail financial services sector. It has a strong financial conduct regulator, with a specific consumer protection mandate. It should work well for retail and small business consumers, but it does not.

In recent years, UK consumers have faced increased complexity and choice in financial markets. Product innovation has been rapid, and rarely in consumers' interests. Despite the apparent abundance of choice, many consumers cannot find financial products that meet their needs; some are excluded altogether. By contrast, credit has been more readily available, although often at a very high prices, and a significant minority of the population has debt problems.

Levels of financial literacy are low, particularly among the youngest, oldest, and most vulnerable groups in society.

These factors have led to a dysfunctional marketplace, with widespread consumer detriment, lack of trust in financial institutions, and weak competition between firms in most product markets. This is characterized by opaque terms and conditions, products that do not perform as expected, and pressure selling or even misselling of products.

Financial inclusion is essential for individuals to participate in a modern economy. People without a bank account usually pay more for utilities and other services. It is also more difficult for them to smooth income and expenditure without the ability to save or borrow at a reasonable cost; and to manage risks without insurance. All financial services markets exhibit a degree of exclusion. In this paper, we concentrate on "everyday" product markets: transactional banking, savings, loans, and general insurance. We also touch on pensions, as these are undergoing significant reform in the UK.

Financial exclusion is usually defined as the inability of individuals or firms to access financial products and services appropriate to their needs. There is growing recognition that access is not enough. Products and services should be fair and affordable, and consumers should be able to use them effectively (Financial Inclusion Centre and Community Development Finance Association 2009).

Small firms need financial services to manage and grow their businesses, yet they often have problems gaining access to finance.[1] Banks treat them like business customers, but they lack the financial expertise of larger firms. Although regulation protects small firms in some cases, they do not enjoy the same level of protection as retail consumers, even though their level of financial sophistication may be similar.

This paper sets out an overview of the UK financial system (Section 2) and the extent of financial inclusion for both households and small businesses (Section 3).[2] It also

[1] In the UK, firm size is defined by the number of employees. The European Union definition also takes account of turnover, as below.

Company Category	Employees	Turnover (European Union definition)
Medium	< 250	£41 million
Small	< 50	£8.2 million
Micro	< 10	£1.7 million
Sole trader/self-employed	0	Not defined

[2] Unless there is a need to differentiate, we generally use the term MSMEs to cover the self-employed, microbusinesses, and small and medium-sized enterprises.

covers the regulation of financial services, including government policy (Section 4); initiatives to improve financial capability (Section 5); and policy conclusions and recommendations (Section 6).

2. OVERVIEW OF THE UK FINANCIAL SYSTEM

The UK banking system is large in relation to the size of the economy, with total assets of around 450% of gross domestic product (GDP). Much of the system is international, with the UK hosting a large number of foreign banks and UK-owned banks having large operations abroad. Only around half of UK-owned banks' assets represent loans to non-bank customers (Bank of England 2014).

The "Big 5" banks dominate the UK banking system and retail financial services markets.[3] They account for 85% of the personal current account (PCA) market (OFT 2013a), 61% of outstanding mortgage lending (The Data 2014), 93% of business loans in England and Wales, and 82% in Scotland (FCA and CMA 2014). The market shares of the Big 5 have been built up through a series of mergers and acquisitions, particularly as a result of the financial crisis in 2008, which also resulted in the UK government acquiring stakes in Lloyds Banking Group (43%) and the Royal Bank of Scotland Group (RBS) (84%).

There are also a number of smaller banks and mutually owned institutions: cooperatives, building societies, and credit unions. Small "challenger" banks are a recent phenomenon; in 2010, Metro Bank was the first UK financial institution to be granted a full banking license in over 100 years. At the end of 2013, the British Bankers' Association (BBA) estimated that challenger banks had £40 billion of loans outstanding, accounting for 2% of the UK market. Lloyds Banking Group and RBS will be required to divest a proportion of their retail banking assets as a condition for receiving state aid in the financial crisis. The resulting new banks, TSB and Williams & Glyn, will account for 6% of the PCA market (CMA 2014a). There is only one state-owned deposit taker, National Savings and Investments (NS&I), which uses retail savings to help finance the government's borrowing requirement.

The mutually owned sector consists of one large building society (Nationwide), one medium-sized bank (the Co-operative Bank[4]), around 50 smaller societies, and 375 credit unions.[5] Mutual lenders and deposit takers have total assets of over £375 billion and have £245 billion of mortgages outstanding, 20% of the UK total. The £250 billion of deposits they hold is 22% of the UK total (Building Societies Association 2013). Alongside their core activities of savings and mortgage lending, most building societies now offer a range of banking services, and mainly differ from banks in ownership structure. Building societies are restricted in their use of wholesale funding and find it more difficult to raise additional capital than publicly quoted banks.

Credit unions are financial cooperatives, owned and controlled by their members. They aim to promote thrift, provide credit and loans at competitive rates, use members' savings for their mutual benefit, and educate members in money management. The rate of interest credit unions can charge for their loans is capped at 3% per month.

[3] Retail banks Santander UK and Lloyds Banking Group; and international, universal banks, Royal Bank of Scotland Group (RBS), HSBC, and Barclays.

[4] Following financial difficulties in 2013–2014, the Cooperative Bank is now mainly owned by hedge funds, with the parent Cooperative Group retaining only around a 30% share.

[5] Figure for Great Britain. There are over 100 credit unions in Northern Ireland, which has a much higher number of credit unions per head of population than the rest of the UK.

According to HM Treasury (2014), there are around 1 million members of credit unions in the UK and total assets are just over £1 billion.

Community development finance institutions (CDFIs) are small-scale social enterprises that lend money to businesses and individuals who cannot get finance from major banks. The Community Development Finance Association (CDFA), the membership body for CDFIs, reported that, in 2014, CDFIs lent £173 million to 50,000 businesses, social ventures, individuals, and homeowners in the UK. CDFIs are primarily a channel for distributing government funding for small businesses. They can also borrow.

There has been a rapid increase in recent years in "crowdfunding." Investment crowdfunding is the provision of equity finance to businesses through an online platform. Peer-to-peer (P2P) lending connects borrowers with lenders online. The P2P lending market has grown strongly over the past few years, with total gross lending at the end of Q3 2014 reaching £1.89 billion (P2P Finance Association). The UK alternative finance market is the largest in Europe, with around 75% of the total (Wardrop et al. 2015).

3. FINANCIAL INCLUSION

The causes of financial exclusion are many and varied (Atkinson and Messy 2013). Some people are not excluded altogether, but have access only to a limited range of products, often at a high price or with onerous terms and conditions. On the supply side, for example, firms might take a risk-averse interpretation of money laundering regulations or the likelihood that a consumer or small firm will be able repay a loan. They may exclude through charging a higher price for extending credit to individuals with a poor or non-existent credit record; or charging higher insurance premia to people living in areas with high burglary rates or in areas prone to flooding. As insurance underwriting becomes more sophisticated, there is a risk that many people who are currently insured will become excluded. Independent financial advisers may exclude less profitable consumers with relatively small amounts of money to invest. Exclusion may also be more subtle: high charges for "basic" accounts; barriers to opening accounts; onerous terms and conditions; or marketing activities that are restricted to profitable groups.

On the demand side, people may 'self-exclude' from financial services because they have a low or irregular income; problems with physical access to branches or ATMs; religious or cultural beliefs that mean mainstream products are not appropriate for them; or an inability to understand marketing or product information, because of low financial capability or general education levels, language barriers or the lack of transparency of the information.

3.1 Transactional Bank Accounts

According to the BBA (2014), there are 9,700 bank branches and 1,600 building society branches in the UK. Some limited services are also available through the 11,500 local post offices, through agency agreements with the major banks.[6] The Big 5 own 9,000 (92%) of bank branches in the UK (Campaign for Community Banking Services 2013).

[6] A list of the agreements between the Post Office and UK banks and building societies can be found at http://www.postoffice.co.uk/banking-services (accessed 17 December 2014).

Using Office for National Statistics (ONS) population statistics and the BBA estimates suggests there are about 0.19 bank branches per 1,000 adults in the UK, or 0.22 if building societies are included. However, this is not a good indicator of inclusion, as it does not take account of geographical distribution. Around 1,800 bank and building society branches closed between 2003 and 2012, disproportionately in poorer and rural areas (French, Leyshon, and Meek 2013). This has increased exclusion for those who prefer or need to use a branch, for example, the elderly and small "cash" businesses wanting to bank their takings.

Around half of all adults in Great Britain now bank online, up from 30% in 2007 (ONS 2013). In 2013, there were 534 million online banking transactions, up by 64% since 2011, and mobile banking is now used by 37% of PCA customers (Mintel 2013). These changes have led to reduced use of branches for transactions. RBS, for example, has reported a 30% drop in footfall in the past 3 years (BBA 2014).

The number of bank accounts is also a poor indicator of the extent of inclusion. There are 65 million "active" PCAs in the UK (CMA 2014b) or 1.28 per 1,000 adults. However, many people have more than one account: the UK's predominant "free if in credit" model means that there is often no cost to holding multiple accounts.

Table 1 shows household holdings by type of account. Excluding Post Office card accounts (POCAs), 4% of households have no access to any type of transactional or savings account. However, this figure needs to be treated with some caution due to the high number of "don't know"/refusals in answering the question (Rowlingson and McKay 2014).

Table 1: Households with Access to Transactional and Savings Accounts

Type of Account	% of Households
No transactional account (unbanked)	4
Personal current account	93
NS&I savings account	5
Premium bonds (zero interest savings with monthly prizes)	20
Basic bank account	6
Post Office card account (POCA)	6
Individual Savings Account (ISA—includes "stocks and shares" as well as cash)	39
Other bank or building society account	45
Credit union account	1

NS&I = National Savings and Investments.

Source: Family Resources Survey (FRS) July 2014, Table 2.

Households living in accommodation rented from a local council or housing association are more than three times more likely to be unbanked than average, and lone parents and single pensioners more than twice as likely (HMT 2010), as are households in the lowest three income deciles (FRS 2014: Table 2.7). Lawton and Platt (2010) also reported that certain ethnic groups and people with a disability (particularly those with mental health problems) were more likely to be unbanked, although they noted that housing tenure and income were stronger predictors.

Access is less of an issue for small businesses and the self-employed, but there are persistent problems in the banking market for SMEs, which has been subject to a

number of competition and regulatory inquiries over the past 15 years.[7] The most recent (CMA, 2013) found that the sector is as concentrated as it was in 1999, with provision of Business Current Accounts (BCAs) and business loans concentrated among the largest four banks. In the same study, SME customers reported that they believed there to be little differentiation between providers**.** They also experienced difficulty in comparing offers across providers and did not shop around. This has inhibited competition between existing providers and new entry.

3.2 Savings and Pensions

Over one third of households in the UK have no savings, and a further 13% of households have less than £1,500 put by. In general, the level of savings increases with income. However, some households on high incomes do not save at all, while others in the lowest decile do (FRS 2014, Table 2.8).

In 2012/13, 26% of UK adults (12.9 million) were contributing to a pension. Employees have the highest pension participation rate (48%); with significantly lower levels of participation amongst the self-employed (17%). There is little difference between participation rates by gender for employees (men 47%, women 48%), but self-employed women have much lower participation rates (12%) than self-employed men (21%) (FRS 2014, Table 6.1). Self-employed contribution rates tend to be lower as well, so only 33% of the self-employed are providing "adequately" for retirement compared to 59% in the public sector and 41% in the private sector (Scottish Widows 2014).

3.3 Insurance

In 2012, the Association of British Insurers (ABI 2013) estimated that 76% of households had home contents insurance, 74% had motor insurance, 64% had buildings insurance, 20% had whole of life assurance, and 2% had fixed-term life assurance.

The likelihood of having home contents insurance increases with income (Rowlingson and McKay 2014). In general, older age groups are more likely to have general insurance. The groups least likely to have general insurance include adults with disabilities, particularly mental health problems, for whom affordability is the main barrier (Lawton and Platt 2010).

The self-employed are less likely to have some form of insurance than those in employment. For example, 79% of the self-employed have contents insurance, 11% have medical insurance, and 19% have life insurance. These figures compare with 87%, 14%, and 28% for lower managerial and professional workers (ABI 2012).

3.4 Unsecured Credit

Total UK outstanding consumer credit debt is currently £169.5 billion, of which £61.2 billion is credit card debt.[8] According to the consumer organization Which?, 79% of consumers used at least one unsecured credit product during 2013. The fastest growing sector of the market is high-cost, short-term credit (HCSTC, or "payday" lending). In 2012, 1.8 million consumers took out payday loans worth £2.8 billion, up

[7] See Cruickshank (2000); Competition Commission (2002); TSC (2002); OFT (2007); OFT (2010); Independent Commission on Banking (2011); TSC (2011); and FCA and CMA (2014).

[8] January 2015 figures from themoneycharity.org.uk, downloaded 12 March 2015.

from £900 million in 2008 (CMA 2015). This type of lending has proved attractive because it allows people to borrow small amounts for a short time, and the charges are transparent. It is even preferred by some people who could get access to bank lending. However, it is very expensive. Moreover, supplier profitability relies on the debt being rolled over and incurring additional charges, leading many into a debt spiral (Beddows and McAteer 2014).

Bank overdrafts are also an expensive way of borrowing, especially if not authorized in advance. Unlike payday loans, unauthorized overdrafts are complex and non-transparent. Which? used volunteers to calculate the overdraft costs and charges of 12 UK banks. The volunteers took 10 minutes on average to find the relevant information on the banks' websites and only got 10 out of 72 calculations correct (Which? 2014b). Even for the cheapest accounts, dipping into an overdraft for just 2 days a month would cost £10–£20.

Table 2: Use of Unsecured Credit in the UK, 2013

Type of Unsecured Credit	% of People Who Used this Type of Credit in 2013
Credit card	56
Authorized overdraft	28
Store card	12
Personal loan	9
Catalog finance	10
Car finance/hire purchase	7
Payday loan	5
Unauthorized overdraft	5
Home credit/doorstep loan	2
Credit union loan	1
Other	1
No credit products	21

Source: Which? (2014a).

The use of unsecured credit is closely linked to low income, low levels of savings, and having children at home. Lone parents are particularly likely to use payday loans. Younger and middle-aged households are more exposed to relatively high levels of unsecured debt than older households, contributing to a higher concentration of over-indebtedness and financial difficulties in these age groups (Department for Business, Innovation and Skills 2013).

The self-employed have similar levels of over-indebtedness as employees, with around 6.4% of both groups finding unsecured debt a heavy burden. However, overall levels of total (secured and unsecured) debt are higher for the self-employed, as is the burden of debt repayment: more than twice as many self-employed households spend 25% or more of their income on repaying unsecured debt as employee households; and nearly three times as many spend over half of their household income on servicing debt (Bryan, Taylor, and Veliziotis 2010).

3.5 Lending to SMEs

Bank business loans account for 70% of funding for SMEs in the UK (FCA and CMA 2014). Overall bank lending to MSMEs declined by a quarter from the financial crisis to the end of 2013. Over the same period, lending margins increased, from 2.5% to 4% (FCA and CMA 2014).[9] Despite the government's "Funding for Lending" scheme being re-focused towards encouraging lending to MSMEs, lending contracted by £0.5 billion per quarter in 2014 (Bank of England 2015). While some of this decline was due to decreased demand (BDRC 2014), there is also evidence the banks withdrew from what they saw as riskier lending: in 2011–2012, 23% of MSMEs had a loan application rejected and 19% were refused an overdraft. Over the period 2005–2007, rejection rates were 6% for loans and 8% for overdrafts (BIS 2013b).

Lack of access to finance can be a particular problem for microbusinesses due to information asymmetries and the additional cost of providing small loans.[10] Three-quarters of microbusinesses reported problems in obtaining finance as an obstacle to business growth (BIS 2013c). The main problem reported was that banks were "not lending," followed by concerns about the cost of finance. Over one-third of microbusinesses reported that they were "not sure where to obtain finance."

MSMEs have also suffered from poor conduct by the major banks. One example is the widespread misselling of interest rate hedging products (IRHPs), which were sold to MSME customers alongside loans. The Financial Services Authority (FSA) found banks had failed to ascertain MSMEs' attitudes to risk; failed to disclose exit costs; and even sold IRHPs larger than the size of the loan (FSA 2012c). It was also reported that some banks told MSMEs that they risked being refused credit unless they bought IRHPs (BBC 2012).

Tomlinson (2013) found evidence of poor treatment of MSMEs in financial difficulty, including increasing the pricing of business loans for struggling firms and the application of opaque and arbitrary fees. A review of Tomlinson's findings commissioned by RBS concluded that there was "no systematic defrauding of business customers" but did find evidence of incomprehensible fees, and that banks used the threat of withdrawing an overdraft to gain leverage in negotiations with MSMEs (Clifford Chance 2014). The FCA is still investigating the Global Restructuring Group, the division of RBS that was supposed to help small businesses in financial difficulty.

4. FINANCIAL REGULATION AND SUPERVISION

The first priority of national authorities following the financial crisis was to stabilize financial systems. More recently, financial services regulators in developed economies have turned their attention to conduct regulation—looking at the way firms do business, and how this affects consumer outcomes. The UK has been at the forefront of these developments.

4.1 Regulatory and Supervisory Authorities

The UK has had a "twin peaks" model of financial services regulation since the single regulator, the FSA, was disbanded in 2013. The Prudential Regulatory Authority (PRA) is responsible for the safety and soundness of the financial system, and the Financial

[9] As measured by the spread between the Bank of England base rate and the cost of the loan.

[10] The EU defines microcredit as loans of less than €25,000 to new or existing micro-enterprises.

Conduct Authority (FCA) for ensuring financial services markets work well for consumers. The FCA has three statutory objectives: to secure an appropriate degree of protection for consumers; to protect and enhance the integrity of the UK financial system; and to promote effective competition in the interests of consumers (Financial Services Act 2012).[11]

The FCA supervises the conduct of larger financial services firms on a relationship basis; for smaller firms (for example, independent financial advisers and consumer credit firms) it carries out thematic reviews, intended to identify and remedy systematic issues causing consumer detriment. CDFIs are only authorized and regulated by the FCA, where they carry out regulated activities such as lending.

In respect of its competition objective, the FCA conducts market studies, sometimes jointly with the Competition and Markets Authority (CMA). In 2013, The Bank of England and FSA announced they would reduce entry barriers for new banks, through a combination of reduced capital requirements and streamlined authorization.

The FCA has no statutory remit in respect of financial inclusion, although, in carrying out its competition objective, it has a duty to "have regard" to how easy it is for consumers to access financial services, including those in areas affected by social or economic deprivation. In general, implementation of financial inclusion policies has been the subject of voluntary agreements between government and industry rather than a matter of law or of specific rules set and enforced by the regulator.

The Financial Services (Banking Reform) Act 2013 created a new competition-focused, economic regulator for payment systems in the UK: the Payment Systems Regulator (PSR), which is a subsidiary of the FCA.

In addition, the Money Advice Service (MAS) has a statutory objective to enhance people's ability to manage their own financial affairs. The regulatory system also has a binding alternative dispute resolution procedure (the Financial Ombudsman Service) and a redress mechanism (the Financial Services Compensation Scheme). All of these institutions are funded by a levy on regulated firms.

4.2 Increasing Access to Banking Services

The problems of financial exclusion are persistent. A report published by HM Treasury in 1999 (HM Treasury 1999) estimated that between 2.5 million and 3.5 million adults did not have access to a transactional bank account. Most of the unbanked were unemployed, dependent on state benefits, and living in social housing.

In 2004 the government allocated £120 million to spend on projects to promote financial inclusion (HM Treasury 2004a and 2004b), in line with its priorities for increasing the numbers of households with access to a bank account, developing models for affordable credit, and increasing the availability of free face-to-face money advice.[12] It set up a Financial Inclusion Taskforce to monitor progress.

The government negotiated a "shared goal" with the banks to halve the number of unbanked, and persuaded the major banks to introduce a "basic" bank account, which would allow people to make and receive payments, and withdraw cash, but with no

[11] The definition of consumers includes the self-employed and other business customers purchasing regulated financial products.

[12] Advice about personal debt was called "money advice" until around 2008. It is now more generally called "debt advice" and that is the term used throughout this paper.

overdraft facility. At the same time, the government introduced a Post Office card account (POCA) for recipients of welfare benefits. The POCA could only be accessed at local post offices, and benefits were the only deposits accepted. Despite the limited functionality, the account proved popular, with over 5 million consumers requesting a POCA.

Although the number of unbanked households halved in line with the shared goal, progress has stalled, and the proportion has stayed at around 4% for over 5 years. There are over 9 million live basic bank accounts, but they do not always meet consumers' needs. A number only allow free access to ATMs from their own cash machines, or do not allow money to be withdrawn at a branch. Only one provider offers accounts to undischarged bankrupts. None pay interest on credit balances.

Basic bank accounts do not provide an overdraft facility, but customers are still charged if they do not have sufficient funds to cover a direct debit that falls due. A 2010 study of the "newly banked" (Ellison, Whyley, and Forster 2010) found that half had previous experience of banking but had fallen out of the system due to problems with their accounts, particularly with unpaid direct debits. Many still showed a preference for using cash. The newly banked had a different profile to the remaining unbanked. They were better off and generally more financially secure. They were motivated to open an account because third parties required it (e.g., an employer), rather than because they wanted one. This suggests basic accounts are not meeting the needs of those on the lowest incomes.

New EU legislation, the Payments Account Directive, will give every EU citizen the right to a basic bank account for free or "at reasonable cost".[13] In December 2014, the Government announced that it had reached a voluntary agreement with the banks in advance of implementation of the Directive for the provision of free basic accounts to eligible consumers.[14] This agreement includes the removal of charges for unpaid items, which should give basic account holders more confidence they will not encounter unexpected charges.

The government is phasing in universal credit, which will bring together a number of existing welfare benefits into a single monthly payment. While people on low incomes are generally capable at managing day-to-day spending (FSA 2006a), the change to monthly payments, and the need to pay housing costs directly rather than have them deducted at source, are likely to lead to budgeting challenges for many. Mainstream banks have failed to innovate to meet these challenges, for example by providing so-called "jam-jar" accounts, which enable essential spending to be ring-fenced within the account; or by providing budgeting tools that anticipate upcoming spending and help consumers budget by providing them with a "safe to spend" limit (Lindley 2014). The presumption that universal credit will be managed online will be problematic for the digitally excluded. According to a BBC media literacy study, 21% of adults in the UK cannot use the internet, and 14% do not have access to it at all.[15] This proportion rises for people on low incomes, those with disabilities, and older people.

[13] Directive 2014/92/EU. eur-lex.europa.eu, accessed 13 March 2015.

[14] Revised basic bank account agreement. www.gov.uk, accessed 18 December 2014.

[15] http://www.bbc.co.uk/learning/overview/assets/bbcmedialiteracy_20130930.pdf, accessed 13 March 2015.

4.3 Savings and Pensions

In the early 2000s, asset-building initiatives were widely seen as a policy tool for increasing financial and social inclusion. In 2005, the government introduced a Child Trust Fund (CTF), intended to: create an asset for every eligible child to access when they turned 18; build a savings habit; and promote financial education. Every parent or guardian received a £250 voucher that could be used to open an account for the child. Low-income families received an additional £250. The government added the same amounts on the child's seventh birthday. Parents, friends, or family could add up to £1,200 a year to the account. All interest or capital gains on the accounts were tax-free. The child could manage their account from the age of 16, but only withdraw the money at 18.

Evaluation of the CTF found little impact on savings for children generally. However, total amounts saved increased by an estimated £618 for children living in homes that were not owner-occupied (Kempson, Finney, and Davies 2011), suggesting the scheme was effective in reaching children in poorer households.

At around the same time, the government piloted a matched funding "Saving Gateway" scheme for people on low income. In the pilot, the average amount of monthly saving by participants almost doubled from £8.85 to £16.14, and the average balance by the end of the scheme was £282—just over three quarters of the possible maximum of £375. Eight out of ten described themselves as saving regularly at the end of the scheme, compared with only 17% at the start (Kempson, McKay, and Collard 2005).

The government established a second pilot in 2005. In parallel, the Department for Education and Skills set up a Community and Finance Learning Initiative intended to: increase access to free education and training and take-up of financial incentives for learning, build financial literacy skills, and support access to financial services, including finance for the development of microenterprises (Ecotec Research and Consulting 2005).

The second Saving Gateway pilot also found a positive impact on saving (IPSOS MORI/IFS 2007). Participants became more familiar with financial products and information, and some came into contact with a bank for the first time in their lives.

Although it was demonstrably successful, the incoming government in 2010 decided not to go ahead with the Saving Gateway. It also reduced Child Trust Fund payments, and stopped them altogether for children born after 3 January 2011.

The proportion of household spending on essentials such as energy increased from 19.9% in 2003 to 27.3% in 2013 (ONS 2013b). This has had a disproportionate impact on low-income households, but savings incentives favor those on higher incomes. Individual Savings Accounts (ISAs), allow tax-advantaged savings or investments of up to £15,000 a year.[16] Although households at all income levels hold ISAs, the proportion, and value of holdings increase with income. To compound the problem of regressive incentives, the government replaced the CTF with a Junior ISA, with tax-free savings but no government contribution.

To increase the number of individuals saving into a pension, the government introduced automatic enrolment. This places a legal duty on employers to designate a pension scheme for their staff and to automatically enroll those aged between 22 and state pension age who earn above a trigger threshold. Schemes must meet set quality standards, and there is a charge cap of 0.75% a year for those in a default fund.

[16] In 2014/15.

Larger employers are already auto-enrolling their workforces; the smallest will do so by 2016. The minimum default level of contributions will also be increased until it reaches 8% of earnings (4% from the individual, 3% from the employer, and 1% from the government in the form of tax relief). Opt-out rates are low so far, and the proportion of employees contributing to a pension has increased for the first time for 10 years (DWP 2014). The current default level of contributions will give those on median incomes an income in retirement of a maximum 45% of their working age income, a replacement rate which is unlikely to be adequate for many.

The self-employed are excluded from automatic enrolment and this could widen the existing gap in pension provision between employees and the self-employed (D'Arcy and Gardiner 2014).

4.4 Insurance

Insurance has not had the same focus as other aspects of inclusion. In the early 2000s, the government and the insurance industry worked together to promote the take-up of "insurance with rent" schemes. These gave tenants in social housing the opportunity to access low-cost home contents insurance and to pay for it alongside their rent. By 2006, insurance with rent schemes were available within 75% of local authorities. However, the government did not set targets to promote the take-up of the schemes (Treasury Select Committee 2006a). In 2009 the Association of British Insurers (ABI 2009) noted that a third of the 4.8 million people in social housing did not have contents insurance, despite the fact that: people in social housing were twice as likely to be burgled as those who owned their home; arson attacks were 30 times higher in lower income communities; and low-income families were 8 times more likely to be living in areas at higher risk of flooding. It issued guidance to local authorities and housing associations on low-cost tenants' contents insurance schemes. As Rowlingson and McKay (2014) note, there has been almost no increase in the take-up of contents insurance.

4.5 Unsecured Credit

In a 2004 report, the UK Treasury found that people excluded from mainstream credit experienced excessive interest rates, poor price transparency, and pressure to take on more debt. Some resorted to illegal lenders. In response, the government encouraged banks to work with credit unions to expand their coverage and improve sustainability. It introduced a bespoke "light-touch" regulatory regime for credit unions and increased the maximum interest rate they could charge, from 1% to 2% per month, to reflect the riskiness of borrowers excluded from the mainstream (HM Treasury 2007a).

The government also expanded the scope of the Social Fund, which provided interest-free loans with repayments deducted from state benefits, and established a Growth Fund to support third-sector lenders. This provided funding of £42 million to CDFIs and credit unions during 2006–2011 for lending to individuals and microbusinesses. The government also instigated local projects to bring enforcement action against illegal lenders and help victims find local sources of affordable credit (HM Treasury 2007a).

In April 2014, the FCA took over responsibility for regulating consumer credit from the Office of Fair Trading. There is now a requirement for strict affordability checks to ensure that consumers can afford repayments, protection from misleading adverts and a robust authorization regime. The FCA introduced strict rules for HCSTC, limiting the number of times a loan could be rolled over, controlling collection practices and including risk warnings and information on debt advice in financial promotions (FCA

2014b). The definition of HCSTC is narrow, it excludes unauthorized overdrafts, for example, and CDFIs are exempt from the provisions.

The Financial Services (Banking Reform) Act 2013 requires the FCA to implement a price cap for payday loans. The FCA set the price cap at 0.8% per day of the amount borrowed, a cap on default charges of £15 and a total cap on the cost of a loan of 100% of the amount borrowed (FCA 2014c). The FCA expects that 7% of borrowers—70,000 consumers—will no longer have access to payday loans following the introduction of the cap. It acknowledges that a small percentage of these may seek loans from illegal lenders.

4.6 Crowdfunding

The FCA regulates P2P platforms that lend to consumers, sole traders, and small partnerships in respect of disclosure and promotions; capital requirements, safeguarding client money, dispute resolution, and business continuity in the event of platform failure.

Firms offering certain unlisted investments can only promote them to: professional clients; retail clients who are advised, or certified as sophisticated or high net worth; or retail clients who confirm that they will not invest more than 10% of their net investible assets in these products. For "non-advised" offers, firms must apply an "appropriateness" test, that is, to check that clients have the knowledge or experience to understand the risks involved (FCA 2014a).

4.7 MSMEs and Consumer Protection

In general, MSMEs do not have the same level of consumer protection as do retail consumers (Fletcher, Karatzas, and Kreutzmann-Gallasch 2014). Broadly, FCA rules apply to firms selling to MSME customers only for:

- Unsecured loans of less than £25,000, but some rules do not apply, for example, the requirement to assess creditworthiness;
- Loans secured on residential property;
- Banking services to microbusinesses (EU definition), except that the rules on distance marketing apply only to retail consumers.

Microbusinesses also have access to the Financial Ombudsman Service in the same way as retail consumers. Eligibility for redress depends on the product.

In the case of IRHPs, the FCA did not just include larger businesses, but also allowed for financial sophistication and experience. This meant that businesses that would not usually be eligible for redress were awarded compensation.

4.8 Access to Finance

Intervention in financial services markets for MSME consumers has for many years focused on access to finance, with the rationale of encouraging growth and sustainability. One in seven of the UK workforce is now self-employed, an increase of 650,000 since the 2008 financial crisis (D'Arcy and Gardiner 2014). At the start of 2012, SMEs employed over 14 million people. Three quarters of all new jobs in the UK are created by MSMEs (National Audit Office 2013). High-growth microbusinesses contribute disproportionately to the economy in terms of growth and productivity (BIS 2010).

Policy has generally focused on small-scale community finance, and a range of government programs aimed at MSMEs in general, or sectors such as technology.

The Legislative Reform (Industrial and Provident Societies and Credit Unions) Order 2011 enabled credit unions to provide services to businesses, social enterprises, and community groups. In practice, few credit unions have chosen to exercise these new freedoms. Some provide small-value loans to self-employed individuals for business purposes, but very few credit unions have the reserves to make bigger loans to businesses, and those that do are concerned about the risks of making larger loans (Civitas 2013).

The government has encouraged the development of CDFIs through tax relief and direct funding. Community Investment Tax Relief (CITR) was introduced in 2002 to provide tax relief for investments in accredited CDFIs that are held for at least 5 years. The relief is worth a total of 25% of the investment. Since CDFIs became the delivery channel for Start-Up Loans and New Enterprise Allowance schemes, the volume of loans to businesses increased from £30 million in 2012 to £52 million in 2013. There is evidence that CDFIs are lending to businesses that cannot get mainstream funding. In 2013, 93% of CDFI business loan recipients had previously been turned down for finance by a bank; and 57% had previously been unemployed (Community Development Finance Association 2013).

However, CDFIs are a long way from being sustainable. In 2013, the UK central and local government and the European Union accounted for 60% of the capital raised by CDFIs. A further 29% was raised through the Regional Growth Fund, which matched bank loans with central government grant funding.

In response to the declining availability of bank finance for MSMEs, the government has introduced a number of additional schemes in recent years. In 2013, there were 14 separate schemes with a variety of targets and delivery mechanisms in addition to the broader Funding for Lending scheme. These are summarized in the table below.

Table 3: Government Schemes to Promote Access to Finance

Name of Scheme	Details	Target Groups	Delivery Mechanism	Total Funding for Main BIS Schemes
Start Up Loans	Advice, small start-up loans (averaging £6,000) and mentoring.	Self-employed and microbusinesses	CDFIs	£120 million
Regional Growth Fund	Grants and loans to businesses and SME finance providers alongside private investment	All businesses	CDFIs for SMEs	
New Enterprise Allowance	Weekly allowances, start-up loans, and mentoring for those on certain welfare benefits.	Unemployed people establishing new businesses	Jobcentre Plus	
Technology-based SMEs	Grants, finance, networking, and monitoring for science, engineering, technology R&D projects	Tech-based SMEs	Technology Strategy Boards	
Business finance partnerships	Invests in lenders who provide financing to businesses—leveraging public money with private money.	SMEs	Fund managers, Non-traditional lenders, Venture capitalists	£100 million
Seed Enterprise Investment Scheme	Tax incentives for investing in a small business (to a maximum £150,000).	Small businesses with fewer than 25 employees	HMRC	
Enterprise Investment Scheme	Tax incentives for investing in qualifying companies or Enterprise Investment Funds, to a maximum of £1 million.	SMEs with less than £15 million in assets	HMRC/Fund managers	
Venture Capital Trusts	Tax incentives for investing in funds that invest in unquoted companies, to a maximum of £200,000 a year.	Unquoted companies with less than £15 million in assets	HMRC/Venture capital fund managers	
Business Angel Co-Investment Funds	Invests in business angel funds, which are making investments into SMEs in certain areas of the country	SMEs in qualifying areas	Individual Angel funds	£80 million
Enterprise Capital Funds	Invests in funds which invest in SMEs.	SMEs	Fund managers	£200 million
UK Innovation Investment Fund	Invests in UK high-growth technology based businesses.	Technology-based SMEs	Fund of funds managers	£150 million government + £180 million private investors
UK Export Finance Products	Export credit and finance to exporting businesses.	Exporters, especially SMEs	UK Export Finance	
Enterprise Finance Guarantee	Guarantees for banks/lenders making loans to eligible SMEs lacking security or track records.	Businesses with a turnover of less than £41 million a year	Banks	Up to £2 billion
Growth Accelerator	Access to finance, mentoring, business development, and leadership training.	SMEs	Growth Accelerator website	

BIS = Department for Business, Innovation, and Skills; CDFI = community development finance institutions; HMRC = Her Majesty's Revenue and Customs; SMEs = small and medium-sized enterprises.

Source: BIS, SME Access To Finance Schemes, April 2013.

In examining the value for money of the main access to finance schemes, the National Audit Office (2013) concluded that many delivered against their individual targets, but that the initiatives were not managed as a unified program. It recommended a number of measures for defining success measures more precisely and for using evaluation to increase the effectiveness of schemes. It also noted the need to make MSMEs more aware of what was on offer: only 52% of MSMEs were aware of the main government and bank initiatives designed to improve access to finance. The government subsequently set up the Business Bank to coordinate access to finance for MSMEs.[17]

5. FINANCIAL EDUCATION

The OECD defines financial literacy as "a combination of awareness, knowledge, skills, attitudes and behaviors necessary to make sound financial decisions and ultimately achieve individual financial wellbeing." (Atkinson and Messy 2012).

In 2006, the FSA published a five-year national strategy for improving the financial capability of UK citizens (FSA 2006a), based on the findings from a baseline survey, which measured the financial capability of adults across the country (FSA 2006b). The survey defined five elements of financial capability: making ends meet, keeping track of personal money, planning ahead, choosing financial products and staying informed about financial matters. It showed low levels of financial capability, for example:

- 81% thought that the state pension would not give them the standard of living they hoped for, but 37% of these had made no plans to provide additional pension.
- 70% of people had made no provision to cover a sudden drop in income.
- 33% bought everyday products, like insurance, without shopping around.
- 40% of people who had an equity ISA did not realize they were exposed to investment risk; 15% with a cash ISA thought they were.
- 9% of people who rented had bought (unnecessary) buildings insurance.

Younger people (20s–30s) were generally less capable than older age groups. Those on low incomes were good at making ends meet, but poor at planning ahead.

In 2012, the UK took part in an OECD pilot study (Atkinson and Messy 2012), aimed at comparing financial literacy across developed and developing countries. The OECD developed scores on three factors: knowledge, attitudes and behaviors. Of the eight most developed countries, the UK scored 6th on number of high scores for knowledge and attitudes, and 4th on behavior. The Money Advice Service undertook another financial capability survey in 2013, enabling some comparison with the original baseline survey. This found knowledge gaps—for example, 16% of people were unable to identify the balance on a bank statement and 12% thought the Bank of England base rate was over 10% (it was 0.5%). Compared with 2006, 9 million more people were struggling to keep up with commitments; 5 million fewer were saving for a rainy day, but more were keeping track of their bank statements. As in 2006, young people were less financially capable—for example, 43% of under-35s did not understand the impact of inflation on savings, and 14% thought it was best to start paying into a pension when they were in their 50s.

[17] http://www.british-business-bank.co.uk

As well as putting consumers at a disadvantage in dealing with financial services firms, poor money management can also have an adverse effect on health. A 2009 study (Taylor, Jenkins, and Sacker 2009) found that greater financial capability had a bigger effect on mental wellbeing than increases in household income. The researchers also found that having low financial capability exacerbated the psychological costs associated with unemployment and divorce.

5.1 Creation of the Money Advice Service

Following two reports on its approach to financial capability (HM Treasury 2007a; HM Treasury and FSA 2008), the government commissioned an independent review by Otto Thoresen to look at the feasibility of providing generic (unregulated) financial advice (Thoresen 2008). Thoresen concluded that up to 19 million people would benefit from general guidance: those who lacked access to advice, had poor planning skills, low or no savings or protection products, difficulty in making ends meet, and were over-indebted.

The effectiveness of the approach was tested in a pathfinder (Kempson et al. 2010), and the government brought forward legislation (included in the 2010 Financial Services Act) to set up an independent body to take over the financial capability role from the FSA (originally the Consumer Financial Education Body, now MAS). MAS's statutory objectives are: to enhance the understanding and knowledge of members of the public about financial matters (including the UK financial system); and to enhance the ability of members of the public to manage their own financial affairs.

The 2012 Financial Services Act gave MAS additional responsibility for funding and improving the quality, consistency, and availability of debt advice.

Since its inception, MAS has focused on providing a comprehensive website, which includes a financial health check, budgeting and product comparison tools, and information about the financial implications of different life stages and events. It also provides a web chat line, telephone helpline and, through partners, face-to-face guidance. MAS has also concentrated mostly on serving the adult population, with financial education in schools being supported by pfeg [18] and other third-sector organizations.

MAS has been reviewed many times in its short existence, most recently by independent reviewer Christine Farnish (HM Treasury 2015). Farnish recommended a tighter role for MAS, filling gaps in provision and driving better consumer information.

5.2 Financial Education in Schools

There are compelling reasons for teaching personal finance education to all schoolchildren (APPG 2011). Children are exposed to money issues at a very young age. A study by UK charity pfeg found that 98% of 11–17 year olds had money of their own. There are a number of prepaid debit cards on the market, some for children as young as eight (pfeg 2010).[19]

In money matters, parents are not always the best educators. Children learn both good and bad money habits from their parents (Centiq 2008). Parents who are financially illiterate often have low incomes. If their children do not learn to manage money well, this can reinforce cycles of deprivation.

[18] Personal Finance Education Group, which merged with Young Enterprise in September 2014.

[19] For example, the family card goHenry.

Responsibility for education in the UK is devolved to the four home countries: England, Scotland, Wales, and Northern Ireland. Personal finance education in schools was first introduced in Scotland, and is also embedded in the curriculum in Wales and Northern Ireland. The National Curriculum in England was revised in 2014, making financial education a statutory subject for the first time. The subject is covered in both citizenship and mathematics. For children aged 11–14 years the citizenship curriculum covers the functions and uses of money; the importance and practice of budgeting; and managing risk. For older children (14–16 years) topics include income and expenditure, credit and debt, insurance, savings and pensions, financial products and services, and how public money is raised and spent. In addition, the new mathematics curriculum is intended to ensure that "all young people leave school with an understanding of the mathematics skills needed for personal finance."

Schools across the UK make use of local credit unions or banks to support personal finance teaching. This support may take the form of assisting the classroom teacher, or developing teaching resources.[20]

A 2008 Office for Standards in Education (Ofsted 2008) study found that in schools where personal finance education was being delivered effectively, "students had a good grasp of key concepts and could demonstrate the ability to make sound financial decisions." They could, for example, identify what factors were relevant to investing a sum of money, balancing risk and return. Some older pupils used their skills to help their parents, e.g., by setting up direct debits for them to pay bills, helping with family budgeting, or recouping bank charges.

An independent study of the pfeg Learning Money Matters program (Spielhofer, Kerr, and Gardiner 2009) found that personal finance education lessons had a noticeable impact on students' attitudes to saving and borrowing and their confidence in dealing with money. A similar study (RBS 2010) found that young people who had been exposed to a Money Sense program in school were more knowledgeable about financial products and services; more likely to keep track of their spending through formal methods; more likely to believe in the importance of saving; and more likely to have more realistic expectations.

Despite encouraging evidence, some have argued that financial education will never work: people behave irrationally, do not remember what they have learned, and in any case the financial services industry will always outsmart them. Policymakers are therefore increasingly designing normative interventions that "nudge" people into making the "right" decisions (Thaler and Sunstein 2008).

The distinction between "financial capability" and "financial wellbeing" is important in policy terms. Other things being equal, increasing financial capability will increase financial wellbeing, although some people will always take decisions that are not in their own best interests, as they are free to do in many aspects of life. Nudge initiatives, for example, pensions auto-enrolment, may increase wellbeing, but will not increase financial capability, and may even have the reverse effect by taking away decision-making responsibility. The lessons from behavioral economics can be used to good effect by, for example, reducing choices to a manageable number, or designing communications in a way they are most likely to be acted upon. However, such interventions should not be used as a substitute for financial education, which has benefits beyond simply optimizing personal finance decision-making.

[20] Examples can be found at http://www.pfeg.org; pfeg also developed a quality mark for classroom resources.

5.3 Financial Education and MSMEs

Most policy interventions have focused on increasing access to finance for MSMEs, but not considered whether they have the awareness and skills to take advantage of these opportunities. Financial literacy is as important for MSMEs as for individual and households, both in accessing appropriate start-up finance and in empowering them to use financial products and services to manage risk and other business needs. The Association for Chartered Certified Accountants (ACCA 2014) discusses the need for MSMEs to demonstrate creditworthiness and "investability" through high-quality financial information. The ACCA also notes that the UK SME Finance Monitor has demonstrated that credit providers are more likely to lend to SMEs that produce regular management reports, and this advantage seems to be greater for SMEs that have not previously borrowed, and would otherwise be at a disadvantage.

There are a number of online advisory services for MSMEs in the UK, but no specific programs to build financial capability.

6. CONCLUSIONS AND RECOMMENDATIONS

While there is a high degree of access to financial products and services in the UK, the needs of a small but significant proportion of people are not met by mainstream providers. The most vulnerable groups are still excluded, and many rely on expensive credit to manage their day-to-day living expenses. Attempts to generate sources of affordable credit have foundered because policymakers have failed to take account of the different profiles and needs of high-cost borrowers. These problems persist despite nearly 2 decades of financial inclusion policy interventions, and may possibly be explained by the dominance of the "Big 5" banks, which have been reluctant to serve low-income consumers. They have only done so in a series of deals with the government. These deals do not work because they are not transparent, and the banks are not accountable for delivering their side of the bargain.

At the same time, more risk has been transferred to consumers, particularly through changes to the pensions landscape, and financial products have become more numerous and complex. Technological advances have not been matched by product innovation. There is a risk that technological advance will lead to more people being excluded or underserved by virtue of being unable or unwilling to do business on the internet. Similarly, more sophisticated risk assessment and the use of "big data" will narrow risk pools for insurance and credit, leading to many being excluded from products which they currently have access to.

Decades of interventions intended to help MSMEs access finance have also yielded little in the way of concrete results, a situation which has worsened since the financial crisis. The large number of government-supported schemes can cause complexity and bureaucracy for business. CDFIs are not yet sustainable, with public funding (central and local government, and European) accounting for 60% of their new capital in 2013. Credit unions have shown little appetite to diversify into business lending. Tax relief has so far been unsuccessful in attracting significant amounts of private capital from banks or external sources into microfinance institutions.

Strong consumer protection regulation has curbed some of the worst practices in financial services markets, but widespread problems remain. Financial education has a part to play, particularly in teaching children and young people how to manage money, but even the most financially literate consumer cannot keep up with a rapidly changing environment, product innovation, poor disclosure, and impenetrable jargon. Equally,

better transparency by firms requires a degree of consumer understanding, interest, and motivation to engage.

To improve financial inclusion and education the following are recommended:

(a) The financial inclusion agenda should be coordinated across the different government departments involved. Data on financial inclusion, in particular, access to products and services by individuals and MSMEs, and how these are used in practice, should be analyzed centrally. Particular attention should be paid to emerging causes of exclusion: technology and narrower risk pools.

(b) The FCA should monitor progress toward promoting financial inclusion as part of its competition objective. It should encourage the development of products and services meeting the needs of vulnerable and underserved consumers.

(c) The FCA should set and enforce rigorous standards for basic bank accounts, to ensure they meet the needs of low income and vulnerable consumers. There should be an appeals process for people turned down for an account. The cross-subsidy for basic bank accounts should be transparent, so it is clear who is paying, and how.

(d) Banks should make budgeting tools available as part of their basic bank account offer.

(e) The FCA should examine the impact of more personalized insurance underwriting on the availability of general and protection insurance to different groups of consumers; and the government should consider the policy implications of demutualization of risk.

(f) The government and the FCA should monitor the market for high-cost, short-term credit carefully, in the wake of tightened regulation. They should take tough action against illegal lenders and be prepared to support the development of alternative, low-cost credit products if necessary. In looking at alternatives, it needs to be recognized explicitly that some consumers are high-risk borrowers and that they cannot be served commercially at an affordable interest rate. It should also be acknowledged that some people borrow to cover living expenses, and that they require tailored, sustainable solutions.

(g) The government should consider a more progressive approach to savings incentives, using proven approaches like matched funding to encourage saving among those on low incomes.

(h) The government should consider how to meet the retirement income needs of the self-employed, who are excluded from auto-enrolment.

(i) The Money Advice Service should focus on the needs of the most vulnerable, rather than provide predominantly a universal online service. It should examine "what works," nationally and internationally, and design programs to increase financial capability across the UK.

(j) The Money Advice Service should consider with the Department for Business, Innovation and Skills how to meet the financial education needs of the self-employed and smaller businesses. It should also ensure that specialized debt advice is available for the self-employed and actively promoted to them.

(k) The Money Advice Service should fund support for financial education in schools, to help embed the new compulsory financial education curriculum in England; and ensure all young people come out of school able to manage their finances effectively.

(l) The FCA should examine online firms lending to MSMEs to ensure that their business models are not based on making profits through default. Online lenders should be subject to caps on default charges and restrictions on the use of Continuous Payment Authorities, in line with the rules for retail HCSTC.

(m) Investments by banks in microfinance institutions should count toward their total SME lending, which is used to determine the amount of funding they are able to access under the funding for lending scheme.

(n) The government should evaluate current access to finance schemes and redirect money to those that are most successful. It should also promote schemes more effectively to MSMEs. There should be greater coordination between government departments responsible for business, financial policy, and the labor market.

(o) The FCA should promote competition and market entry from alternative sources of finance while maintaining standards of consumer protection and stable access to finance. In particular, it should supervise the adequacy of provision funds in P2P lenders.

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