Impact of the cost-of-living crisis on the UK affordable credit sector

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September 2022

1. The cost-of-living crisis

UK households are facing a cost-of-living crisis. In July 2022, the annual rate of inflation reached 10.1%, the highest since 1982, and it is expected to peak at 13% in early 2023. In March 2022, the Office for Budget Responsibility projected that UK post-tax real incomes would start falling in quarter two of 2022 and not recover until the third quarter of 2024.[1] Since then, inflation forecasts and the economic outlook has worsened significantly.

This report draws on interviews with managers from 25 credit unions and Community Development Finance Institutions (CDFIs) to identify and analyse the current and projected impacts of the cost-of-living crisis on the UK affordable credit sector and its customers. The research was conducted May - August 2022 and was funded by Fair4All Finance.[2]

The perspective of and impact on affordable credit providers is important in three respects:

- Affordable credit providers have a unique insight into the real time effects of rising living costs because they analyse income and expenditure data of applicants and monitor loans of existing borrowers.
- The cost-of-living crisis is an important issue because low-income consumers are expected to be among the worst affected by the crisis and affordable credit providers are an important part of these consumers' strategies for coping with economic shocks and uncertainty.
- Affordable credit providers themselves may be negatively affected by the crisis, which in turn may affect low-income consumers' access to credit. To start with, the provision of loans and ancillary services to financially excluded consumers is a marginal activity due to small loan amounts, greater risk, and the need for flexibility in repayment. Moreover, there is evidence suggesting that those serving the most vulnerable customers were worse affected by Covid-19 than providers serving better off consumers.[3]

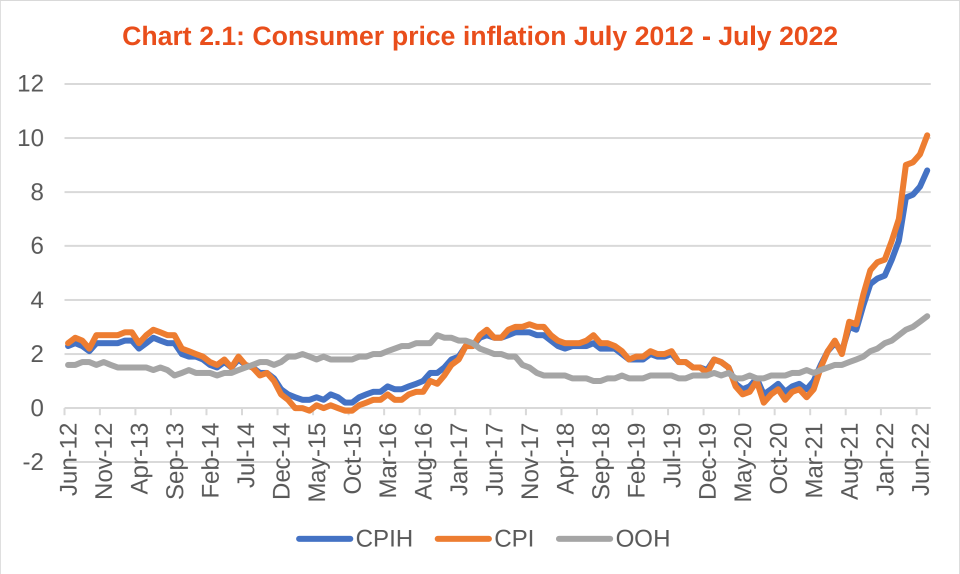
The remainder of the report is organised into four sections:

- Section 2: The cost-of-living crisis –summarises the key developments, and determinants and impacts of the cost-of-living crisis
- Section 3 – Methods and data – describes the methods and data used
- Section 4 – Findings – presents and discusses the findings from the research
- Section 5 – Conclusions and recommendations –concludes and makes some recommendations

[1] *Rising costs of living in the UK – research briefing*, House of Commons Library, 14 April 2022, https://researchbriefings.files.parliament.uk/documents/CBP-9428/CBP-9428.pdf
[2] https://fair4allfinance.org.uk/
[3] *Fear and loaning – Impact of Covid-19 on affordable credit providers serving financially vulnerable customers*, Carnegie UK Trust and Community Finance Solutions, University of Salford, July 2020, https://hub.salford.ac.uk/cfs/wp-content/uploads/sites/107/2021/09/Fear-and-Loaning-Impact-of-Covid-19-2.pdf

2. The cost-of-living crisis

UK households are facing a cost-of-living crisis due to sharp price rises and falling real household incomes. The consumer price index increased by 10.1% in July 2022 up from 1.6% the year before (Chart 2.1).[4]



The key drivers of the increase in the UK inflation rate were:[5]

- Increased energy prices: There was a 46% increase in energy prices between March and April 2022, as Ofgem increased the cap on energy prices by 54% in April 2022.
- Increased petrol and diesel prices: These prices increased by nearly 33% in the 12 months to May 2022.
- Increased food prices: The price for food and non-alcoholic beverages saw an 8.7% increase in the 12 months to May 2022.

The reasons for these increases are a mixture of the UK and other major economies emerging from the lockdown restrictions and global demand for resources increasing and outstripping global supply chains.[6] This coupled with the disruption to wheat and gas supplies to European countries from Russia due to the war in Ukraine has increased the wholesale price of both further. There is great uncertainty concerning the magnitude and duration of future price rises partly due the war in Ukraine. Nevertheless, the rate of inflation is expected to continue to rise, peaking at around 13%[7] or possibly as high as 15%[8] later this year, early next year. The Bank of England expects inflation to slow down in

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[4] Office for National Statistics (2022). *Consumer price inflation, UK: June 2022*, 20th July, https://www.ons.gov.uk/economy/inflationandpriceindices/bulletins/consumerpriceinflation/june2022

[5] Office for National Statistics (2022). *Inflation and the cost of living for UK households*, 22nd June, https://www.ons.gov.uk/economy/inflationandpriceindices/articles/overviewofinflationandthecostoflivingforukconsumers/june2022

[6] Institute for Government (2022). *Cost of living crisis*, 6th May, https://www.instituteforgovernment.org.uk/explainers/cost-living-crisis?msclkid=4e6bdb73cfb011eca53ad1f438a33f61

[7] Bank of England (2022). *When will inflation start to come down?* 4th of August, https://www.bankofengland.co.uk/knowledgebank/will-inflation-in-the-uk-keep-rising

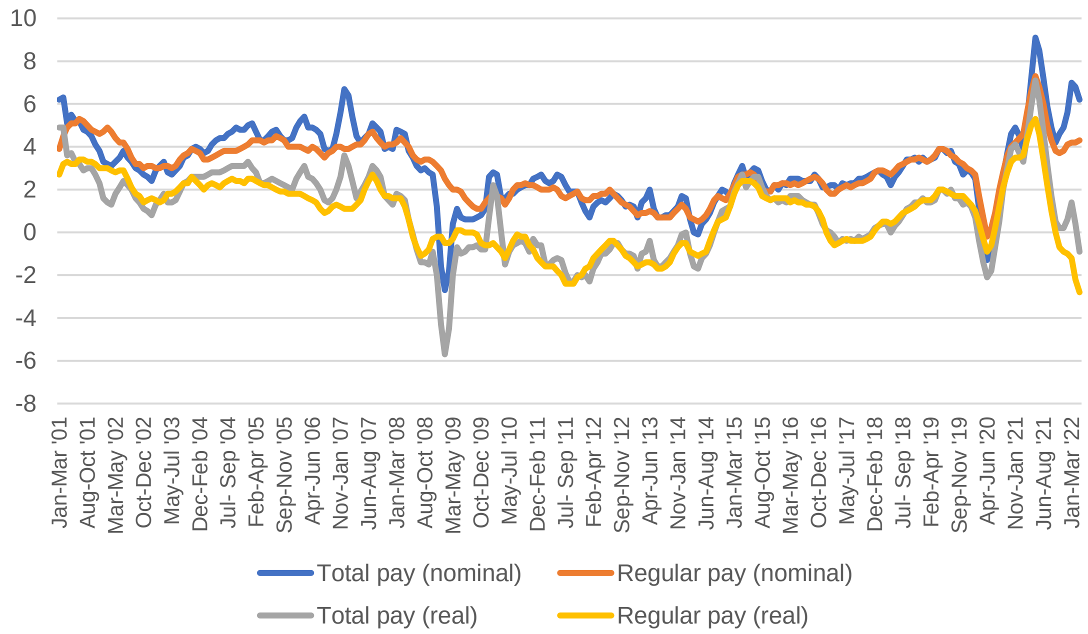
[8] Resolution Foundation (2022). *In the dread of winter – Prospects for inflation in the coming months ahead of the Bank of England's Monetary Policy Report*, 3rd of August, *https://www.resolutionfoundation.org/publications/in-the-dread-of-winter/*

2023 and fall close to 2% in around two years.[9] Energy prices are set to increase significantly in October and throughout 2023. It is difficult to predict the exact price increase, but energy prices for an average UK household are likely to be well in excess of 40% in October.[10]

In addition to rising prices, UK households are facing increasing interest rates. The Bank of England has gradually increased interest rates from 0.1% in December 2021. The base rate was increased by 50 basis points to 1.75% on the 3rd of August, with the Bank of England projecting the interest rate to rise further, peaking at 3% in March 2023.[11] Homeowners on tracker or standard variable rate mortgages will have seen significant increases in mortgage payments over the last 8-9 months. The 800,000 homeowners on tracker mortgages will have seen average monthly payments rise by £166 since December 2021. The average monthly payment for 1.1m homeowners on standard variable rate mortgages will have increased by around £105 since the end of 2021. Around 1.3m homeowners are on fixed interest rate mortgages ending 2022 and 1.8m are on fixed rate deals ending in 2023.[12]

Inflation is outstripping growth in nominal pay (Chart 2.2) resulting in real term falls in household income.

Chart 2.2: Average earnings annual growth rates Great Britain, January 2021-May 2022



Nominal total and regular pay increased by 6.2% and 4.3% in the 12-month period to March-May 2022, significantly less than inflation for the same period. Hence, real total pay fell by 0.9% in the year to March-May 2022, whilst real regular pay fell by 2.8% for the same period.[13] The Bank of England

[9] Bank of England (2022). *When will inflation start to come down?* 4th of August, https://www.bankofengland.co.uk/knowledgebank/will-inflation-in-the-uk-keep-rising
[10] https://www.bbc.co.uk/news/business-62123691
[11] Bank of England (2022). *Monetary Policy Summary – August 2022*, https://www.bankofengland.co.uk/monetary-policy-summary-and-minutes/2022/august-2022
[12] https://inews.co.uk/news/interest-rate-hike-millions-uk-mortgages-rise-1778044
[13] Office for National Statistics (2022). *Average weekly earnings in Great Britain: July 2022.* https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/bulletins/averageweeklyearningsingreatbritain/latest

expects pay to grow by around 5.5% in the near term, well below its projections for inflation.[14] Benefits and state pensions increased by 3.1% in April 2022 in line with the CPI inflation rate measured by the ONS last September, but substantially below inflation at the time. Overall, real post-tax household income is expected to fall by around 2% in the year to 2022 Q4.[15]

Low-income households have been especially affected by the cost-of-living crisis and are more vulnerable to its effects compared with better off households. Individuals on lower incomes are, compared to individuals in the top 10% of earners, likely to have the effects of the inflation rate compounded as they spend a greater amount of their income on essential items, such as heating and food.[16] A Resolution Foundation report finds that inflation is 1.5 percentage points higher for the lowest income decile than the richest 10%. Households in the lowest income decile spend 3 times as much on gas and electricity than households in the top income decile. In May 2022, the Institute for Fiscal Studies forecasted that the average inflation for the bottom income decile would be 14% in the year to October 2022 compared with a 10% average for all income groups.[17]

Furthermore, the fact that the cost-of-living crisis comes on the back of Covid-19 pandemic and lockdowns may exacerbate its effects on low-income households. A third of UK households experienced job loss or lower pay due to Covid-19, with people in precarious forms of employment (nonfixed hours, zero-hour contracts), self-employment, and sectors affected by the pandemic (hospitality, leisure) being the worst hit.[18] Low-income households were disproportionally affected because they came into the crisis with higher unsecured debt levels, less savings and lower or unchanged real income[19]

Perhaps in recognition of this, the government announced a package of measures worth £37bn in May 2022 to support low-income households, including higher winter fuel payments for pensioners, an enhanced energy discount, and an additional £650 for 8m households on means-tested benefits. These will result in an increase in real income for full-time workers on national living wage both for households receiving UC and those that do not. The Resolution Foundation estimates the gains in 2022 for lowest income quintile households will amount to around £1,200. Out of work lone parents with two children will experience a significantly lower fall in real income as a result of these measures.[20]

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[14] Bank of England (2022). *Monetary Policy Report – August 2022*. https://www.bankofengland.co.uk/monetary-policy-report/2022/august-2022
[15] Ibid
[16] House of Commons Library (2022). *Rising costs of living in the UK – research briefing*, 14 April, https://researchbriefings.files.parliament.uk/documents/CBP-9428/CBP-9428.pdf
[17] Institute for Fiscal Studies (2022). *Inflation for poorest households likely to increase even faster than for the richest, and could hit 14% in October.* 25th of May, https://ifs.org.uk/publications/16065
[18] Collard S, Collings D and Cross K (2021) *The financial impact of the pandemic - A review of the literature*, https://bristol.ac.uk/geography/research/pfrc/themes/financial-exclusion-poverty/pandemic-financial-impact/
[19] Collard S, Collings D and Cross K (2021) *The financial impact of the pandemic - A review of the literature*; https://bristol.ac.uk/geography/research/pfrc/themes/financial-exclusion-poverty/pandemic-financial-impact/
Franklin J, Green G, Rice-Jones L, et al. (2021) *Household debt and Covid* - Quarterly Bulletin 2021 Q2; Bank of England (2020). *Could Covid-19 lead to higher bank losses on unsecured debt?* Available at: https://www.bankofengland.co.uk/bank-overground/2020/could-covid-19-lead-to-higher-bank-losses-on-unsecured-debt
[20] Institute for Fiscal Studies (2022). IFS response to government cost of living support package. 26th of May, https://ifs.org.uk/publications/16066

3. Methods and data

We conducted semi-structured, qualitative interviews with managers of 25 credit unions and CDFIs between the 25th of May and 3rd of August 2022 (Table 3.1). We also conducted an online focus group with four loan officers from one CDFI and two credit unions on the 23rd of June 2022.

Table 3.1: Sample overview

	Community credit unions	Employee credit unions	CDFIs	Total
Small	2	-	3	**5**
Medium	8	2	4	**14**
Large	3	2	1	**6**
Total	**13**	**4**	**8**	**25**

Definition of size based on outstanding loan portfolio: <£2m (small); £2m-£9.9m (medium); ≥£10m

We interviewed 17 credit unions, mostly community credit unions, and 8 CDFIs, comprising traditional not-for-profit community lenders and newer Fintech entrants. Over half of the sample were medium-sized with loan books of between £2m and £10m. Three lenders were based in Scotland and the remainder in England.

The interviews were conducted remotely (using Teams) and focused on the impact of the cost-of-living crisis on customers, lending activity, and operational and financial effects. The interviews and the focus group discussions were recorded and transcribed. The analysis aimed to capture the range of trends that were relevant and material for how the cost-of-living crisis is affecting or may affect the affordable credit sector. The findings reported were widespread across a range of different organisations and/or material within organisations. Interviewees were asked to specify and quantify changes and developments within their organisation, which helped the researchers ascertain the significance of the developments.

4. Findings

In this section, we analyse and discuss six salient themes in the data:

- Cost-of-living crisis is reducing the access to affordable credit, as lenders decline more loan applications.
- It is harder to assess loan applications because applicant's circumstances and behaviour is more fluid and unpredictable.
- The nature of demand and lending is changing with a shift to smaller loans to cover living costs.
- Growth in savings is falling or is lower than projected, as members withdraw more savings and deposit less.
- The picture on portfolio quality is mixed, though mostly pointing to a deterioration in quality with more to come.
- Lenders are experiencing pressures on cost and income, which poses an existential threat for some lenders and is manageable for others.

We have included anonymised quotes to illustrate and substantiate the points made.

4.1. Reduced access to affordable credit, as lenders decline more applications

The interviews suggest that fewer people are able to access affordable credit as a result of the cost-of-living crisis. Most of the lenders interviewed – around 14-15 lenders – report declining a greater number and proportion of loan applicants. The **increases in decline rates** are material – 7-15 percentage points since the start of the crisis – and can be observed across a range of different community and employee-focused lenders:

> *"…the volumes of applications have increased considerably over the last few weeks, but unfortunately so have…declines. It used to be…quite stable around 30% of declines, but in April it was 35% and then in May it went up again to 37% and this month it's looking to rise again." (Loan officer, large employee credit union)*

> *"…so historically we would decline about 60% of our applicants…so just sorry you just cannot afford to take out any more credit, you are too impaired at the moment…That's now increased to about 75%" (Interviewee 8, CDFI)*

> *"[In] April the cap was lifted, and the energy bills…went up for lots of people, dramatically in some cases. …in April, we saw our decline rate on loans reach 60% whereas normally it's between…45 and 50%." (Interviewee 14, medium-sized employee credit union)*

The increasing propensity to decline loan applications was not limited to new customers but also in relation to existing customers with track records of paying off previous loans. This trend is, according to interviewees, driven by a **significant deterioration in the financial position of loan applicants**, with applicants spending a greater and increasing portion of their budget on essential bills:

> *"…there's obviously the cost-of-living stuff that we're calculating a lot more so that that cost of food has gone up 10%, that cost of electricity has gone up 8%...there's…the day-to-day cost of living." (Interviewee 8, CDFI)*

> *"…our decline rates are very, very high [partly] because of the financial distress we're seeing on bank statements and credit reference agency reports…So, customers that have never had financial distress that are actually now having financial distress for the first time." (Interviewee 22, CDFI)*

As a consequence, they are not able to service a loan. According to managers, **some customers emerged from Covid-19 in a much poorer financial position**. They or their partner may have been made redundant leading them to take out loans to bridge gaps between income and expenditure as well as payment holidays:

> *"I think this coming on the back of COVID hasn't helped either because...a lot of our members…have partners who [were] made redundant or reduced hours [or] not being able to work because they've got COVID and…not…getting sick pay… a lot of people got payment breaks as well during COVID for a lot of credit, and then realizing they have to catch up with, but now they're used to not paying it and then the cost of living has risen within this time. So, when they go back to having to pay it, they're in a really bad position." (Loan officer, medium-sized community credit union)*

> *"…COVID was [a] kind of magnifying glass…if their finances were fragile, then it's probably magnified that and bruised…their finances. [The cost-of-living crisis] just…continues that effect." (Interviewee 20, medium-sized community credit union)*

After government restrictions and regulator' requirements for lender forbearance ended, these consumers found themselves unable to resume payments, service loans or get new loans. Their financial difficulties have been further exacerbated by high levels of inflation.

Many lenders are seeing **greater levels of unsecured debt** and loans among loan applicants than before the start of the crisis, which contributes to greater decline rates. The number and value of unsecured credit commitments have increased:

> *"…people are more indebted. [The] average amount on a credit file…have gone up by that extra sort of few £100…as they're juggling and taking out more credit. [It's] not just the payday lenders or the high-cost short term credit that wasn't being repaid. There just seems to be more of it." (Interviewee 8, CDFI)*

Lenders reported seeing a significant increase in the use of Buy-Now-Pay-Later (BNPL) among loan applicants:

> *"…buy now pay later loans. There seems to be an increasing chunk of peoples expenses each month…it's quite common now that people have got…hundreds, 200 pounds going through a…buy now pay later provider." (Interviewee 18, large employee credit union)*

> *"…more and more customers wanting to spread the cost of quite small items probably on the buy now pay later…so quite a lot of change that we've had to do in that credit space and that means obviously customers that we would have been able to give a loan to before just can't afford credit anymore" (Interviewee 22, CDFI)*

Applicants' financial statements would often show many small BNPL payments with a significant cumulative effect on their financial situation making any additional loans unaffordable.

The increase in decline rates can also partly be explained by lenders **imposing tighter lending and affordability criteria**. Several lenders reported increasing their requirement for surplus income to make sure the customer would be able to repay the loan in light of rising inflation:

> *"we've left them with more of a cushion. Typically, we were looking at people having…at least £100 worth of disposable income [per month] that's now gone up to at least £300 worth of disposable income, so we are cushioning our borrowers" (Interviewee 25, CDFI)*

> *"One of the things we've introduced again just in the last couple of weeks is to change the level of disposable income will allow for a loan repayment as well." (Interviewee 7, medium-sized community credit union)*

These could involve material changes in the buffer required, illustrated by threefold increase (from £100 to £300) in the case of the CDFI above.

Lenders also introduced higher credit score requirements, additional checks, and made increased use of open banking data to verify spending:

> *"…we've tightened up the minimum credit score…for the smaller value loans. [Under] £1000…we would rely on a credit report alone for many…borrowers…but we've increased the frequency of doing an open banking affordability assessment for even for small value loans." (Interviewee 14, medium-sized employee credit union)*

> *"…we introduced creditworthiness checks alongside the affordability checks. And…that was a big change for us" (Interviewee 22, CDFI)*

As we will discuss in the next section, the increased use of open banking and the introduction of new tests reflects the increasing complexity of assessing applications in a context of rapid price increases and deterioration in customer finances.

4.2. Harder to assess loan applications due to more unpredictable circumstances and behaviour

Many lenders reported it was harder to assess loan applications. Living costs and customer behaviour are dynamic and fast-moving, especially among subprime borrowers, making it **more difficult to rely on traditional underwriting and assessment methods**:

> *"there's a lot of unknown quantities about a cost-of-living crisis…what's affordable on the 9th of June may not be affordable on the 9th of October or the 9th of January next year. So…how do you factor that in into your…affordability" (Interviewee 6, medium-sized employee credit union)*

> *"we're very focused on that data spec set of discretionary expenditure. God knows how you would use credit scores and ONS data to make lending decisions right now with these individuals, because the ONS data, as I'm sure you're aware, is pretty much out of date as soon as it's published." (Interviewee 25, CDFI)*

> *"…we…discard the numbers [stated by customers] with the fast evolving…inflationary environment where…the cost of food, cost of fuel…are…increasing… some of our proxies to estimate current affordability [are insufficient]." (Interviewee 5, CDFI)*

The above statements show that the sector is aware that the data they rely on to assess likely applicant expenditure, such as ONS data, is quickly made redundant by the fast pace of price increases. Further, self-reported data on expenditure was seen as less useful than before, as customers had not fully comprehended how the cost-of-living crisis had affected their spending.

A small group of lenders were seeing an **increase in concerning applicant behaviours** that was making it harder to make lending decisions. These were not widely reported by the interviewees but were material within the small number of organisations that reported them. Some lenders reported an increase in applicants applying to other lenders for loans whilst waiting for a decision:

> *"But they've gone [whilst waiting for loan decision] and got a £400 payday loan or whatever they call them now or a pawnbroker loan, for example." (Interviewee 12, CDFI)*

"You…will get more and more customers who, if they go for one loan online, they might get offered two loans at the same time. Three loans. Do they take the one loan or do they take three loans and it's very difficult." (Interviewee 22, CDFI)

"…we're…seeing a lot more not pursued…that's where people have…applied with us, somebody else, somebody else…and depending on how quickly we reach a decision or get back to the member, they might have gone elsewhere or just don't wanna provide the information for us to be able to continue the applications. We're running at 11% not pursued applications…which is up from there will be before 5% not pursued" (Interviewee 15, large employee credit union)

This was partly associated with the tightening of lending assessments and the time involved for affordable credit providers in assessing applications to lend responsibly. This would lead to increases in discontinued loan applications or leave consumers with multiple loans they might be unable to service. Another trend, observed primarily by Scottish lenders, was that more borrowers were becoming bankrupt as soon as they receive the loan:

"…they might take a loan and within a few weeks they taken the loan. That in on a trustee and it makes you wonder that they know before they applied for the credit" (Loan officer, medium-sized community credit union)

"we've seen a lot more situations where an individual has taken out a loan and then within a week of taking out the loan…they've gone into a trust deed…In terms of their finances [they're] just trying to get cash in before they before they move into that formal arrangement… it would probably be [around] 20-30…we would only see a handful in any given month of trust deeds coming in and now you know it's more than a handful. You know it's double digits…it's definitely on the increase" (Interviewee 19, CDFI)

Lenders were suspecting that these borrowers were maximising their liquidity before going into an arrangement that would curb their access to finance in the future. More broadly, several lenders, credit unions especially, expressed concern about commercial debt management companies aggressively promoting unsuitable debt remedies to their members.

BNPL payments represent another barrier to the loan application assessment process, as many reported that they are often not visible in financial statements:

"…buy now pay later is a big unknown as well. People can seem to put buy now, pay later against anything now to make ends meet. So, food, your heating, your bills… They put their name to it now so that there could be all this hidden credit as well, down the line that we can pick up a little bit through open banking but don't quite get the full story." (Interviewee 8, CDFI)

"…we also think that buy now pay later has had a big impact on us in the…November, December cohort… What we couldn't see, as if they're taken out lots of buy now, pay later so we can ask the question, but it's hidden. It's hidden on the bank statement [and] on the credit reference agency data until either they start paying it or the buy now pay later lender sells it to a debt collection agency." (Interviewee 22, CDFI)

As noted in the quotes above, BNPL only becomes visible when the applicant starts making payments or when the debt is sold to a debt collection agency. Loan applicants also rarely, if ever, report having bought items using BNPL:[21]

> *"…when I'm doing income and expenditure forms with customers, they always forget to mention the Klarna…you always have to prompt them…it's like they use it and forget about it… It's like they just don't take it as credit… lot of them are small amounts like £6.13 or. But they've got about 7 and a week and they add up and I don't think they realize how much they're relying on them." (Loan officer, medium-sized community credit union)*

Loan applicants do not perceive BNPL agreements as credit, often forget taking them out because of the small amount, and do not realise the cumulative impact on their finances.

4.3. Nature of demand shifting to smaller loans for living costs

There is a mixed picture on the demand and value of lending with several lenders reporting an increase, but most reporting a fall in demand and lending. Around 8-9 lenders are seeing an **increase in the demand for loans and the value lent**:

> *"Loan demand has gone up in the last couple of months. We expected it to go up after Covid-19. People are now changing their cars, holding weddings and spending on big ticket items, which they weren't doing during Covid-19. We are seeing more applications for loans for bigger ticket items in the last 4 months." (Interviewee 17, large employee credit union)*

> *"…in the [last] 12 months…demand has returned…and recently…our loan book was…returning…to levels…we saw in Feb 2020… we're trying to do…better…marketing… We are doing more payroll lending" (Interviewee 18, medium-sized community credit union)*

This was often, as highlighted by the second interviewee, on the back of recent marketing campaigns or generated through online lead generators. Some of these lenders were also seeing a shift to better-off, lower risk clients:

> *"…we are seeing an uplift in higher value loans…connected with [our] marketing… we realized there were members whose finances had grown during COVID [or] was stable, some of them on benefits because it was stable income, or they were in sectors where they actually did overtime. [This] was a mix of existing members and new people coming to find us with the best credit scores that we've ever seen… strong credit scores for [a] bank." (Interviewee 20, medium-sized community credit union)*

However, most lenders are seeing **a fall, stagnation or lower-than projected growth in the value and demand** for loans:

> *"But people aren't in general borrowing as much as we were expecting them to. [We're] no further ahead than we were this time last year, whereas we wanted to be quite significantly increased… [lending is] 1.3 million down 1.4 million down, which after six months, seven months. It's quite a big gap." (Interviewee 7, medium-sized community credit union)*

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[21] Since June 2022, major BNPL companies share their borrowers' details on CRA files to identifying BNPL arrangements, in theory, ought to become easier

> *"Our loan book had gone over 3,000,000 and we've really struggled…just…to tread water to stay still…I think it's about 2.98 [million] at the moment…really not making any gains in the last two years." (Interviewee 6, medium-sized employee credit union)*

> *"So, normally historically we'd have about 6000 new applicants a month. It's down to about four and a half now, so again a bit of a drop there as people are no doubt prioritizing other cost of living day to day. You know, keeping the lights on... we haven't done the loan volumes we'd expected." (Interviewee 8, CDFI)*

As per the quote above, this trend can be explained by people spending savings accumulated during Covid-19 and cutting nonessential expenditure. We discuss this in greater detail below. Other lenders were still seeing significant growth in the value lent, but lower than projected:

> *"…we grew our own book by 22% [in 2019] and then in 2021 we grew by 28% and that's the kind of level of growth that we'd like to keep sustaining over the next few years. But this year has proven more challenging and so far, I think…year to date our loan book growth is more like 16, 17, 18% sort of region, so high teens, which is still reasonable, but…not quite what we'd hope for." (Interviewee 14, medium-sized employee credit union)*

The difference in target and actual growth rate was often significant around 10 percentage points, experienced by the credit union in the quote above, or hundreds of thousand or even over £1m down. For many lenders, this decline or lower than expected growth in lending is driven by **lower average loan amounts**. Some applicants are not buying or postponing certain purchases:

> *"we're getting is a drop off in applications because people are saying…I don't want to get into debt at the moment...I'm going to make the car last another 12 months…which is good for them, but…a bit tougher for us." (Interviewee 6, medium-sized employee credit union)*

> *"…our returning customers aren't going for the slightly more luxury £700 sofas or whatever. They're just not interested. So that's really dropping down how much they're applying for. Again, they're only really coming back to us if they need another washing machine or something essential" (Interviewee 10, CDFI)*

Others had built up substantial savings during Covid-19 that they were using to pay for home improvements and other non-essential items:

> *"I think the people who are…doing big [home improvement] projects [are] the people who managed to save enough from not going out to fancy restaurants and things during COVID. [They've] built up cash to spend on stuff like that. And the people who would be borrowing to do bigger projects….just aren't borrowing." (Interviewee 7, medium-sized community credit union)*

Reduced demand and lending for home improvement, car and holidays would reduce average loan amounts because they are traditionally higher ticket loans. Many lenders reported that the numbers of applicants had increased but the value was down substantially:

"…we did more loans than usual, but probably about 2/3 of the value to what we're definitely seeing is more people applying. So, it was like Christmas kind of numbers, but for smaller amounts." (Interviewee 3, medium-sized community credit union)

"[The] average loan in February was up at [6,800], March…6900…April 5,800, May 5,600 so you can see there's a tail off…which…does make a huge difference if you're doing…900 loan applications and… getting used to be 506 hundred out the door…that's…already, you know, 60 grand down…20% drop in the average loan size just in the two months…since it probably hit the news." (Interviewee 15, large employee credit union)

The drops in average amounts were often material, 20% in the case of the credit union in the above quote, with significant cumulative effects in terms of amount lent. Many lenders reported **greater demand and disbursement of smaller loans to cover basic living costs**:

"So, we have definitely seen people putting purpose of loan as essential bills and even food shopping…we were [lending for] things like…unexpected [bills]. That's fine, but we wouldn't really…do loans for regular bills." (Interviewee 3, medium-sized community credit union)

"…we have had applications over the last few weeks where when you asked them because they've put other, it's just to see me through the month or to travel to work because I can't afford the petrol for the rest of the month." (Loan officer, large employee credit union)

This increase in demand and disbursement of smaller loans to tie people over is indicative of the level of financial distress they are facing not being able to cover basic living costs.

4.4. Rate of growth in savings is falling or slowing as members withdraw more and deposit less

Many credit unions report a **fall or slowdown in the rate of growth in savings**:

"But we're starting to see a decline in our savings, so last month they decreased by 50 grand, which is unusual…And normally we, you know, we see a month-on-month increase" (Interviewee 3, medium-sized community credit union)

"…we tend to build liquidity in the early part of the year up to the summer and then we shed it up to Christmas… typically in March, April, May, we're building cash and people are putting money in. But what we saw in March for the first time in the history of the credit union for [that] month…was a negative…outflow on the savings book across the whole book. We've never seen before for that time of year ever before. It's always been a…general accumulation and I think that's quite telling." (Interviewee 14, medium-sized employee credit union)

As noted in the above quotes, the credit unions would typically be seeing an increase in shares in the first half of the year, making the lower levels of savings unusual.

There are multiple determinants behind this fall in savings. The **lower level of savings was partly due to greater withdrawals**:

> *"…net growth [is usually] around half a million per month…for…June… sometimes a little bit more, sometimes a little bit less…now…share intake around the 4,000,000…Then 3 1/2 maybe exiting. That shifted to a 600K drop. And that was a small reduction in intake, but…more was withdrawn than came in" (Interviewee 24, large employee credit union)*

In the case of the credit union above, the drop in savings driven by a small fall in intake, but largely by withdrawals. Part of this is **customers withdrawing savings accumulated during Covid-19**:

> *"I guess part of that is sort of, but people have accumulated, some people have accumulated quite a lot of savings during COVID" (Interviewee 4, large community credit union)*

> *"I think partly it's because…the additional savings people accumulated during COVID meant that they had something to draw on that maybe they wouldn't have had otherwise. So that's part of it." (Interviewee 6, medium-sized employee credit union)*

Most credit unions saw a significant increase in savings during Covid-19 and some members may now be reducing their savings to pre-Covid-19 levels. However, lenders also attributed the fall in savings to the financial pressures their customers were under because of rising living costs:

> *"We have found in last few months that our member's ability to save has fallen…We are now seeing growth…which is 20% lower. This is because household bills have increased. For many people the rainy day has arrived…" (Interviewee 17, large employee credit union)*

Members on a lower income were reportedly less likely to top up their savings by rounding up bills and payments:

> *"We offer direct benefit coming in, for example, the child will benefit could be coming in to pay their loan and their loan is…15 pounds…a week and they're getting £21.00…they would usually just say don't send me that £6 back, just put into my savings because the one they didn't missed it at that time. But it was building up…a healthy wee pot. But now…week to two weeks, they phone in for that." (Loan officer, medium-sized community credit union)*

This is a concerning trend, as the small pots of savings low-income consumers accumulate through depositing small amounts can enhance their resilience to external shocks. Several credit unions also reported an increase in member requests to release linked savings:

> *"…we have always tied in our members savings to…the value of the loan…we had to bring in a new policy... So… if they are struggling, we're starting to release some of the shares back to them…We've never, ever allowed that [before]." (Interviewee 13, large community credit union)*

Some lenders were introducing new policies to allow members in financial difficulties to access some or all or their savings. Members were **increasingly taking out savings to cover basic living costs**:

> *"[We are seeing more] people using savings to subsidize living or taking out loans to subsidise living" (Interviewee 15, large employer-based credit union)*

> *"That sort of surplus and asking for it to go back, and they're quite honest on the phone, they'll say…I need to top up my gas and electricity…or have not got any petrol in my car or I'm needing to go and get milk and bread…It's not like, oh, I need it for a takeaway, or I need it to buy myself this. They're needing it for day-to-day living. Yes, for necessities where they never used to." (Loan officer, medium-sized community credit union)*

It is concerning that credit union members are drawing down savings, including linked savings, and making fewer top-up payments to their accounts so they can make ends meet. It suggests they are in significant short-term or long-term financial difficulties, as they are unable to cover their expenses within their regular income. Moreover, they have a smaller or no savings buffer to cope with unexpected costs or income shocks.

4.5. Mixed picture on portfolio quality, though mostly pointing to deterioration

A significant group of lenders – around 8-10 – are already seeing a **decline in portfolio quality**, reflected in an increase in missed payments, lending written off and provisioning:

> *"So, our bad debt…has cracked up to 2%. From about 0.2% before the pandemic. So that's been an impact on us." (Interviewee 6, medium-sized employee credit union)*

> *"We've got 17% of loans…in arears at the end of March… Compared to 12 - 13% at the end of March 21…that's 4.4 percentage points. Arrears have been high. They've already grown quite significantly over the last three months by a few 100,000 over and above budget." (Interviewee 14, medium-sized employee credit union)*

> *"More defaults when even the first payment hasn't been made…one of the…biggest concerns on that picture, as the…people who have taken out a loan and not even made the first payment. So, we're seeing a heck of a lot more than that, which is a concern because those accounts are so much less likely to pay in the longer term" (Interviewee 12, CDFI)*

Some of the increases were significant – 2-4 percentage points – and had potential long-term negative effects on write-offs and arrears. Managers thought it was too early to attribute the increase in delinquency to the cost-of-living crisis, though they saw it as likely driver. Other lenders were not seeing any effects, but the **majority of lenders were expecting loan delinquency to increase** over the coming months:

> *"We can see…expenditure values are going up, which are impacting kind of…your income and expenditure calculations and your affordability. So, we're…planning for a deterioration" (Interviewee 2, large community credit union)*

> *"The biggest concern…is not so…much for the next six months. It's gonna be coming to October time when the…cost of energy…rises again and it's when you start need to turn the lights on and the heating on" (Interviewee 7, medium-sized community credit union)*

Increasing numbers of customers may see their expenditure rise to an unsustainable level when the energy price cap is lifted in October. Some lenders were also concerned about the impact of rising prices on delinquency for borrowers approved for a loan before the crisis, as the increased expenditure may make it difficult for them to repay their loan.

Many lenders are seeking to mitigate against future deterioration of portfolio quality by **imposing tighter lending criteria and reducing lending to higher-risk customers**:

> *"We don't now lend to anyone that has a net income of less than £1300 a month. That's one of the big mitigants for us." (Interviewee 25, CDFI)*

> *"We've changed our lending policy…to really cut on that debt. So, basically, it's auto is the policy because they don't have enough disposable income for us…to justify giving them more credit" (Interviewee 23, medium-sized community credit union)*

The requirement for all borrowers to have at least a net income of £1,300 a month indicates the lender expects expenditures to increase substantially and the need for greater incomes to meet loan repayments. Lenders are tightening lending criteria and increasingly emphasising portfolio monitoring because managers see **loan delinquency as one of greatest risks associated with the crisis**. Loan loss provisioning is one of the greatest costs for the sector negatively affecting profits:

> *"I think the supplier costs continue to rise. But the…two biggies are gonna be salaries and impairment and impairment is by far the largest." (Interviewee 11, medium-sized community credit union)*

> *"We raise 100% on 2nd missed payment. Umm, so this is partly why this year our profits will be down." (Interviewee 24, medium-sized community credit union)*

To be prudent and comply with regulatory requirements, credit unions and CDFIs have to set aside an allowance to cover loan losses in the income statement depending on the proportion of the portfolio with repayments past due by a given number of days. Bad debt is also a key source of volatility for lenders:

> *"…bad debt [is] a big driver of our performance as a business month to month is how much we had to write off in bad debt. It's the key driver key source of volatility in our sort of financial position" (Interviewee 14, medium-sized employee credit union)*

Bad debts can be a source of rapid and unpredictable change in the bottom line, as economic shocks can severely impair the ability to repay of significant numbers of borrowers. Further, loan losses reduce the amount of lending providers can do:

> *"We are definitely seeing an increase in people struggling to make their repayments…I would say we are seeing an increase in trend which is not great from our point of view because it means we've got less money to lend to somebody else." (Interviewee 10, CDFI)*

If borrowers do not repay, it reduces the amount of capital a provider can use to lend. Lenders also have to set aside capital (loan loss reserves) to prepare for potential loan losses.

4.6. Cost and income pressures on sector, but impact on bottom line uneven

Lenders are facing **often significant cost pressures**, as their supplier, utility and staff costs are increasing:

> *"…there are definitely wage pressures…because people are looking for other opportunities." (Interviewee 9, CDFI)*

> *"…all of our suppliers increase their cost. [Our] lending platform was a 6% rise. They put on our cost this year and…that sticks in my throat." (Interviewee 12, CDFI)*

The combination of a tight labour market and increasing living costs meant that lenders had to significantly increase wages to recruit and retain staff:

> *"…we can't give a 9% pay rise because we're charity…we are losing staff not because they don't want to work here, but because the pull of somebody offering £5000 more when their household bills have gone up. It's just too great…we've had a member of staff that has left. We couldn't have matched her salary because we would have had to have matched everybody else in that salary so it would have cost us about £40,000 more on payroll" (Interviewee 12, CDFI)*

> *"We continue to face some cost pressure on salaries…mostly because of the cost of getting new people in…I think that's one of the areas where…there's a strong financial services industry [it's] potentially get a struggle to compete." (Interviewee 7, medium-sized community credit union)*

> *"It's really, really, really tough and…it's a job seeker's market right now we had we were recruiting for a couple of posts now and we had some interviews set up with five interviews set up and nobody turned up nobody." (Interviewee 19, CDFI)*

Several lenders reported of difficulties in recruiting staff at several levels, including no one turning up for interviews and having to increase wages to attract applications. These difficulties were felt more acutely by lenders in areas with a strong financial services industry and greater competition for staff. Few lenders reported having lost employees due to competition from other firms, but several had increased or would be increasing salaries to retain and support staff due to rising living costs.

Lenders felt there was **great uncertainty about how the cost-of-living crisis will develop** and how this will impact their bottom line and customers. Managers were uncertain about the duration, outcome and impact of the global events driving rising prices:

> *"You know, for our board, when I sit with the Chair, we go through our risk register. We tried to be mindful of what's, you know, alert to what's in the news as much as they can…with everything going with the war in Ukraine…don't know really what's gonna happen, do we?" (Interviewee 20, medium-sized community credit union)*

“Will the war in…Ukraine finish quickly and…these macro events…have been such a big impact …we're just trying our best to look to the future, mitigate the rest we can…and hope that some of those macro mitigations happen as well.” (Interviewee 22, CDFI)

Managers often mentioned the development of the war in Ukraine as a factor making it difficult to predict the duration and impact of the cost-of-living crisis. As a consequence, it was difficult to forecast growth, arrears, and costs:

“…it is a bit in the air now, I think guess growth forecasting is where we are struggling most.” (Interviewee 5, CDFI)

“…as far as the [impact of the] cost-of-living crisis is concerned [on] our…business…I don't know in six months’ time if the picture [will] be a lot bleaker than this [or if it will] prove to be not so profound. It's hard to know.” (Interviewee 14, medium-sized employee credit unions)

Notwithstanding the uncertainty about the future, some lenders, especially some community credit unions and CDFIs focusing on lending to financially excluded consumers on the lowest incomes, see the **cost-of-living crisis as an existential threat to the sector**:

“When the banks collapsed in 2008… I remember being really worried about the future of the credit union. I'm more worried this time than I was…then. [Unless things change] we're not going to be here in 5-10 years’ time.” (Interviewee 11, medium-sized community credit union)

“I worry whether this sector will be here after the crisis or not …it's a struggle…we all have…minimum APR for the credit risk of our customers and with increasing costs and not much headroom to increase…APRs there's a real challenge of whether…there’ll be a customer base that that we're suitable still to enter.” (Interviewee 22, CDFI)

These lenders saw the cost-of-living crisis as a potential perfect storm. Their current and future income is likely to fall due to the increase in loan delinquency, and lower amounts lent. They are facing greater supplier, staff, and bad debt provisioning costs:

“it's quite torrid…as well as the COVID bit, this whole cost of living piece. Cost of living almost makes it sound quite simple. It's…everything our costs are higher. Income is more squeezed. You've gotta spend more money to get your income.” (Interviewee 12, CDFI)

Some of these lenders emerged from Covid-19 with a reduced capacity to generate income, due to a smaller loan book, and having incurred significant costs in adjusting to remote working and service delivery. Conversely, other lenders, especially well capitalised, profitable lenders, expected the cost-of-living crisis to have **limited or no impact on their bottom line**. They were well capitalised, had large loan portfolios to generate interest income, and strong profitability to help them weather the crisis:

“The legal minimum capital ratios 5%...for credit unions below 10 million of assets. Internally, we set ours at 15%. So…we could triple our lending book. Today. I got the cash today and without impacting the regulator and also means if there's a really bad shock, we'll still be here.” (Interviewee 24, medium-sized community credit union)

> *“You take bad debt costs away from the organization. We're still gonna invest in technology and increase our cost that [we’re not] overly concerned about increased operating costs from a business standpoint, from a people standpoint. That's more of a dilemma for…small CDFIs and…credit unions.” (Interviewee 25, large employee credit union)*

They would be able to cope with increased operating costs and delinquency even if the economic effects of the cost-of-living were significant. Some lenders thought the cost-of-living crisis would have limited effects on their business because they were tightening lending criteria and would not be lending to the customers worst affected by the crisis:

> *“…the cost of living will ultimately take some customers…because it will become no longer affordable for them, but…at the same time, we expect that there are people that probably sit price wise below our current segments that will move into our segments…So, from that lens alone, I would say we’re acquisitionally commercially neutral.” (Interviewee 9, CDFI)*

> *“I'm concerned about the cost-of-living crisis and the effect it has on our…business, but more so on our consumers. It would be nice to be able to lend to more people, but that's not going to happen.” (Interviewee 25, CDFI)*

As a result, they did not expect a significant deterioration in portfolio quality. These lenders were more concerned about the impact of the crisis would have on their customers, as many of them would be unable to borrow from them in the future.

5. Concluding remarks

It is too early to say something conclusive about the effect of the cost-of-living crisis on the affordable credit sector and its customers:

- The cost-of-living crisis is still unfolding and evolving with further price rises expected later in 2022 and 2023.
- There is great uncertainty about the global factors affecting inflation, such as the war in Ukraine, as well as future government responses and policies.
- It is uncertain if the effects of the cost-of-living crisis on households, especially those on lower incomes, will be short-lived or if they will significantly affect their financial circumstances in the long run.

Nevertheless, combined, the quantitative and more anecdotal evidence collected from managers and loan officers, point to two main conclusions:

- The combination of rising living costs, long-term financial precarity and Covid-19 has pushed many customers into, sometimes severe, financial difficulties. Credit union members are saving less and withdrawing more savings, part of which they are using to cover basic living costs. Consumers, including repeat customers, are more likely to be declined by affordable credit providers than before the crisis. Although not universal, some groups of borrowers are increasingly likely to miss payments. The cost-of-living crisis has magnified the effects of Covid-19 and disrupted the financial juggling act of many low-income consumers. Credit, especially BNPL, has often exacerbated rather than relieved the financial difficulties of many consumers.
- The impact on lenders is more uncertain and uneven, but the cost-of-living crisis, especially coming on the back of Covid-19, poses a potentially existential threat to some lenders. Many factors potentially influence the impact on the bottom line of lenders, including financial starting point, size, target market, scope, and capacity to move upmarket, and impact of Covid-19. Well capitalised lenders with large loan books, scope to lend to lower risk consumers, and surplus to invest in and recruit staff seem well positioned to weather the crisis. Many lenders are externalising the impact on customers by not lending to riskier, worst affected segments. However, the combination of a reduced loan book to generate (future) income, greater loan losses, and increased staffing costs pose a potential existential threat to some lenders.

Appendix A: Interview guide

1. Can you start by telling me a bit about your organisation (size etc.)?
    a. When founded
    b. Legal form and structure (e.g., part of group, owned by larger organisation)
    c. Target market
    d. Services provided (including nonfinancial services)
    e. Key supporters and shareholders

Recently there has been a lot of talk about the cost-of-living crisis with high inflation (especially for fuel and energy), tax rises (NIC) and increasing interest rates, but with wages and benefits not keeping up or falling behind.

2. Have you seen any effects of these developments on your organisation or your customers? If so, what are these?

3. What effects, if any, have you seen of rising living costs on your loan applicants and customers? Ask about projected/expected future effects
    a. Income (level/trend disposable/real incomes)
    b. Expenditure (level/trend essential spending, non-essential consumption)
    c. Savings (level of savings, savings behaviour, withdrawal of savings, closure of savings accounts)
    d. Debt levels (level, trend and type of debts)
    e. Borrowing behaviour (borrowing for essential items etc.)

4. Are you offering additional support to help customers (e.g., additional forbearance, emergency loans)?
    a. Additional forbearance
    b. Emergency loans
    c. Referral for additional support

5. Have you seen any effects on your lending activity? If so, what changes have you observed? Ask about projected/expected future effects
    a. Demand (nature/level, loan amounts requested, stated loan purpose, quality of applications)
    b. Underwriting (approval rates, volume of loans, amounts awarded, reasons decline)
    c. Portfolio quality (missed payments, payment holidays/forbearance requests, arrears, write-off)

6. Has there been any other financial or operational effects? If so, what have these been? Ask about projected/expected future effects
    a. Increased operating (salaries, rent, electricity) or borrowing costs
    b. Fall in income (loan interest income, investment income)
    c. Reduced liquidity
    d. Regulatory ratios/Capital Asset Ratios/financing covenants
    e. Viability/sustainability/bottom line

7. Have you made any changes to your underwriting and portfolio management procedures (e.g., criteria, communication, bad debt provisioning)? If so, please provide details

8. Do you think your organisation, or your customers will require additional support to weather the crisis? If so, what (grant funding, hardship funds, regulatory change)?