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FAIR BANKING FOR ALL

Why the UK needs a Fair Banking Act to tackle financial exclusion

A policy paper

Mutual Banks Association

Acknowledgements

This paper builds on discussions held in four workshops during 2022 and early 2023, and many more one-to-one conversations. As such, it brings together the expertise and perspectives of people working within a wide range of financial institutions, including credit unions, Community Development Finance Institutions, regional mutual banks, ethical banks, building societies, mainstream banks, as well as a range of financial inclusion experts. The authors would like to thank all those who have given their time to co-developing this paper. It is also informed by the perspectives of people with lived experience of financial exclusion.

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Executive Summary

Financial exclusion in the UK

Exclusion from fair and affordable financial services and products is an entrenched problem in the UK for individuals, small and medium-sized enterprises (SMEs) and social enterprises.

Financial exclusion for individuals can mean having difficulty in physically accessing services, facing 'high-bar' risk assessments, and lacking awareness of financial products. It also includes being subject to the poverty premium, whereby those on lower incomes pay more for essential services than their better-off counterparts, a situation affecting 14 million people in the UK. Lack of access to responsible and affordable credit is a major factor in this vulnerability, and risks pushing people towards illegal money lending. Financial exclusion is intersectional – certain groups with protected characteristics are more vulnerable to exclusion and the poverty premium than others, even within low-income households overall.

The cost of living crisis combined with the ongoing impacts of the Covid-19 pandemic is exacerbating the problem, with recent research showing 17.5 million people can now be considered 'financially vulnerable' in the UK.[1] The consequences of financial exclusion have significant negative impacts on wellbeing, mental health and the ability to participate fully in society.

Exclusion from financial services and products also affects people trying to start or expand social enterprises and small and medium-sized enterprises (SMEs). SMEs are the lifeblood of local economies and a significant contributor of private sector employment (providing over 60% in 2020), yet they struggle to secure bank loans: the shortfall in finance facing the sector was recently estimated at £19 billion. Social enterprises also face difficulties in accessing finance, with their leaders identifying a lack of understanding among social investors of their operating and business models, despite a collective turnover of £60 billion. As with personal banking, some of the barriers faced by SMEs and social enterprises are intersectional, with enterprises led by women and people from Black and ethnic minority groups experiencing higher rates of being declined for products and services, and lower levels of investment, than others.

Addressing financial exclusion

The UK Government has made a commitment to tackling financial exclusion, and recognises the role of effective regulation, direct government intervention and partnership work with the financial services industry and civil society in doing so. This is also evident through a range of initiatives and policies. Many retail banks and building societies, too, have developed products and initiatives that address aspects of financial exclusion. However, a significant lack of data seriously hampers efforts to assess or evaluate the relative contributions of different retail banking institutions to tackling the problem.

The scale of the problem, and the fact that it is growing, shows that far more needs to be done.

The small, but expanding, purpose-driven banking sector could work powerfully and effectively with retail banks and building societies to comprehensively tackle financial exclusion for individuals, SMEs and social enterprises. These stakeholder institutions include Community Development Finance Institutions (CDFIs), credit unions, emerging

regional mutual banks, ethical banks, and building societies (the latter can also sit within mainstream retail banking given their asset size). However, these institutions still face substantial challenges and barriers to establishing or scaling up, particularly to increase the supply of affordable credit at the national level.[2]

A step change solution: a Fair Banking Act

Entrenched problems need policies that produce a step change in response: a Fair Banking Act for the UK would be a response commensurate with the scale of the problem. Under the Act, banks and building societies would be required to disclose the extent to which they are meeting the needs of financially excluded people and small businesses in the diverse communities they serve, determine the level of action needed to address the problem, and provide mechanisms for doing so.

A Fair Banking Act would apply to retail banks with a banking licence in the UK – including challenger banks – and building societies. It would provide a permanent, transformative and practical solution to the UK's high levels of financial exclusion by providing:

- **A true picture of every retail banking institution's performance on financial exclusion,** by mandating a transparent, publicly available and easily interpreted data disclosure framework.
- **Clear ratings that show which banks are doing well and which need to improve.** Ratings would be derived from the results reported under the disclosure framework.
- **Identified ways banks in which can improve and thus help tackle financial exclusion.** Major banks and building societies would be able to improve their rating by:
    - **Expanding responsible lending:** including expanding the provision of responsible, affordable and fair lending to underserved communities, demographics and protected-characteristic groups, either directly or via a partnership with a purpose-driven finance institution.
    - **Providing fair services:** to those who are underserved and excluded, either directly or via a partnership with a purpose-driven banking institution.
    - **Partnering with purpose-driven banking organisations:** partnership agreements between banks and purpose-driven banking institutions would enable these responsible, specialised organisations to expand their services and support for financially excluded people and businesses.

The Financial Conduct Authority would have the key role in determining the data disclosure framework and financial inclusion ratings awarded to obligated institutions. Those with the highest ratings would be publicly recognised for their positive impacts in addressing financial exclusion. The Government would need to consider what other suitable incentives could be put in place, including, if necessary, interventions to improve the performance of those who are contributing to financial exclusion rather than helping solve it.

The experience of the USA, which has had a similar piece of legislation – the Community Reinvestment Act- in place for several decades, shows how an Act of this kind can help lead to a transformation in services for communities that have been excluded. It also shows that positive outcomes exist for commercial banks, which gain opportunities for growth in areas they were not previously active in. And it offers banks the opportunity to improve their environmental, social and governance (ESG) performance, and help to become drivers of financial inclusion.

The scale of financial exclusion in the UK is truly shocking and is growing due to the cost of living crisis and increasing debt problems. It represents a major market failure that will require a transformative response to fix. A Fair Banking Act would provide a real opportunity to forge a partnership between banks and building societies, purpose-driven finance organisations and government that would create a step change reduction in financial exclusion. It would offer real hope to the millions of people who are struggling to access essential financial services, and the small businesses that can't get the support they need from the financial system. It's time to fix the UK's financial exclusion problem: a Fair Banking Act is needed now, more than ever.

Financial exclusion in the UK

Exclusion from fair and affordable financial services and products is an entrenched problem in the UK for individuals, small and medium-sized enterprises (SMEs) and social enterprises.

What financial exclusion means for individuals

Building on the UK Government's definition, and in consultation with stakeholders across the financial inclusion sector, Fair4All Finance describes financial *inclusion* as meaning: "...individuals, regardless of their background, income or personal circumstances are aware of and have timely access to appropriate and affordable financial products and services which enable them to manage their finances day to day, build their long-term financial resilience and wellbeing, and participate in society."[3] Financial *exclusion,* therefore, can be defined as being unable to access essential financial services or products, and for individuals can include:

- Difficulty in physically accessing services, for example due to the closure of bank branches and struggling, or not wishing, to use online services
- 'High-bar' risk assessments that mean lenders mark individuals as not credit-worthy
- A lack of awareness of available products.[4]

Financial exclusion also occurs where the pricing of products is unaffordable and likely to increase the financial pressure that many lower-income households face. This forms part of the 'poverty premium' – which affects 14 million people in the UK[5] – whereby those on lower incomes pay more for essential services than their better-off counterparts. In the consumer credit sector, this often leads to spiralling indebtedness.

Financial exclusion is also intersectional – certain groups with protected characteristics are more vulnerable to exclusion and the poverty premium than others, even within low-income households overall. Recent research has found that Black households are more likely than other groups to be excluded from the credit card market, Asian households struggle to obtain bank loans, and that lone parents, younger households, and people with mental health difficulties are more likely to use high-cost credit.[6]

Overall, nearly 11 million people feel locked out of the finance system, but the real scale of the problem is likely to be significantly larger.[7] According to research from Fair4All Finance, 17.5 million people can now be considered 'financially vulnerable' in the UK,[8] based on a range of financial needs and behaviours.

> **"I've been with [bank] for eight years. You feel like you should build up a rapport with your bank if you've never had a problem with them. Then if you ask for something, just a different account, it's like 'no sorry you can't because you're still on a low income or you've still technically got a slightly bad credit score'. I'm not asking for a massive overdraft; I'm just asking to move up one account so I can get maybe slight benefits from that account that would help me."**
>
> **"A lot of lenders won't even accept me, so I have to take what I'm given."**
>
> Source: Attendees of 'Lived experience of financial exclusion' workshop, Finance Innovation Lab, January 2023.

Lack of access to affordable credit and the cost of living crisis

Lack of access to responsible and affordable credit is a major factor in vulnerability to financial exclusion. Before the Covid-19 pandemic, high-cost credit products were being used by over 3 million people in the UK, with typical income levels between £15,500 and £18,000, including benefits.[9] Research by the Financial Conduct Authority (FCA) indicates that the high cost of credit and poor lending practices have led to many becoming trapped in a cycle of repeat borrowing and long-term indebtedness.[10]

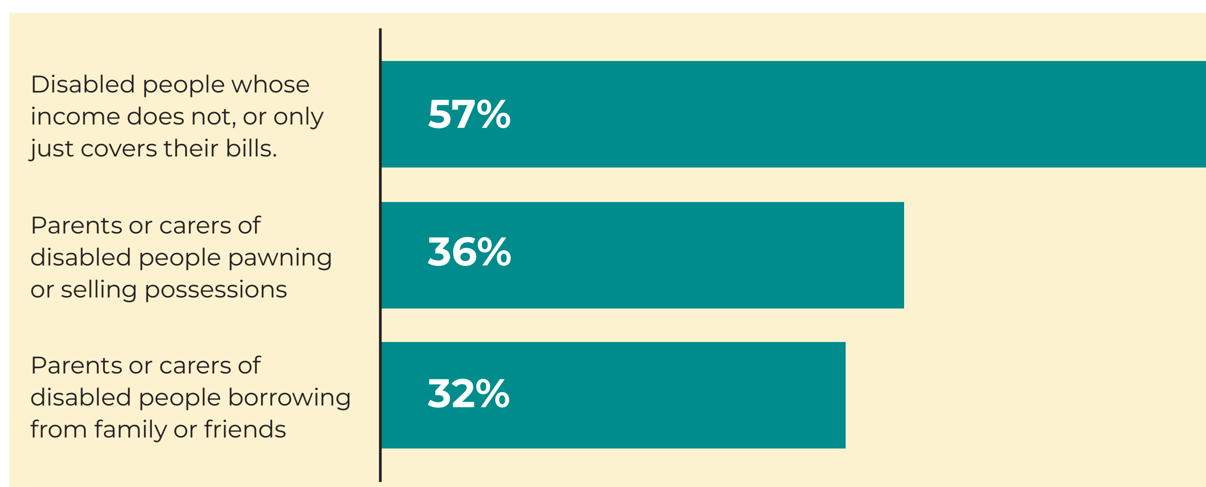
The number of 'financially underserved' people struggling to access credit from mainstream lenders is estimated to have increased by over 50% in the past six years, particularly as the pandemic and cost of living crisis have increased vulnerability and perceived creditworthiness of those living on lower incomes.[11]

Regulatory action to address poor lending practices, combined with increasing numbers of consumer complaints made to the Financial Ombudsman concerning irresponsible lending, has driven many of the worst lenders out of the market, but this may also be contributing to an increase in illegal lending. A recent estimate suggests as many as 1.08 million people in England are borrowing from an illegal money lender, equivalent to 2.4% of all households.[12] Given half of the victims that the organisation Stop Loan Sharks helped in 2021 had borrowed money from a loan shark to pay for food and fuel,[13] we can fairly assume these figures, and the consequent human cost, will only increase in the current economic context.

With extreme pressure on household budgets, reduced financial resilience and limited affordable credit options, financial precarity is a reality for many.

Lack of savings and insurance

Many households do not enjoy the security of savings or insurance to see them through harder times. The number of people with low 'financial resilience', characterised by having less than £100 in savings, jumped by 3.5 million to 14.1 million during the pandemic, and one in four households have no home contents insurance.[14] The disability equality charity Scope finds that 57% of disabled people say their income does not cover or only just covers their bills, resulting in 36% of parents or carers pawning or selling possessions and 32% borrowing from family or friends in 2022.[15] Many households with disabled people make use of energy pre-payment meters[16] which cost more to use than bills paid by direct debit, however Government's recent intervention to end forced installation practices is noted.



Source: *Cost of Living: The Impact for Disabled People*. (Scope, 2022).

The digital banking revolution and reduced access to cash

The move to a cash-free and increasingly digital financial system is also exacerbating the problem. There are still more than 1 million people in the UK without a bank account[17] and 47% of the population describe cash as an economic necessity.[18] Thirty-four per cent of bank branches closed between 2012 and 2021 and use of cash for payments dropped by 28% between 2017 and 2020, indicating a move to a cashless society. As this trend continues it will particularly affect older people, those on lower incomes and those with certain physical and mental health problems.[19] Reduced access to cash forms part of the poverty premium: Bangladeshi and Pakistani British people and Black British people are disproportionately likely to live in deprived areas and as a consequence are more likely to need to pay to access cash than people living in less deprived areas; lone parents are also more likely to need to pay to access cash.[20]

The move to online banking is also not fully accessible, with 1.9 million people in the UK unable to afford access to the internet[21] and 9 million without the foundational skills to participate in a digital society.[22] Even of those with access to the internet, 23% report not feeling comfortable banking online, and, just prior to the Covid-19 pandemic, over a quarter of people managed their money through using their local bank branch rather than the internet.[23]

Digital Literacy and Accessibility

- 1.9 million people are unable to afford access to the internet.[1]
- 9 million people lack the foundational skills to access the internet.[2]
- 23% of people don't feel comfortable banking online.[3]

Sources:
1 Good Things Foundation.
2 Lloyds Bank UK.
3 YouGov.

Social and economic impacts for individuals

Financial exclusion has significant negative impacts on wellbeing and mental health, and on the ability to participate fully in society. Over-indebtedness has been found to contribute to relationship breakdown, poor health – including mental health – and loss of housing. It can also harm debtors' employability, reduce their productivity at work and affect the welfare of their children. At its most severe, over-indebtedness can also be a contributory factor in suicide.[24]

These impacts carry significant costs for wider society. In 2018 the National Audit Office estimated that:

- Roughly one in 12 over-indebted individuals will experience mental health problems such as anxiety or depression, with each of these creating a direct additional cost for health services of around £300 per year.
- When factoring in additional costs arising from mental health problems caused by over-indebtedness such as costs for social care services and knock-on impacts on employment, the amount rises to £11,100 per person per year.
- A further 3% of over-indebted individuals will also be more likely to move into, or remain in, state-subsidised housing, creating additional costs of £9,739 per year.[25]

Money worries are the biggest cause of stress for UK employees. This often results in absenteeism, with 4.2 million worker days lost every year in the UK because of a lack of financial wellbeing, equating to £626 million in lost output.[26] Productivity and growth across the UK's regions will be damaged if a significant proportion of the population are disadvantaged as a result of not being able to access the personal financial services they need.

What financial exclusion means for small and medium-sized enterprises, and social enterprises

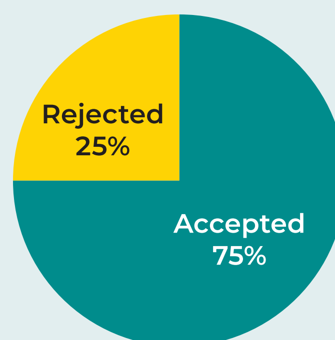
Exclusion from financial services and products does not just affect people who are trying to secure their individual, or household security: it also affects them when trying to start or expand small and medium-sized enterprises (SMEs) or social enterprises.

How SMEs are underserved by the financial system

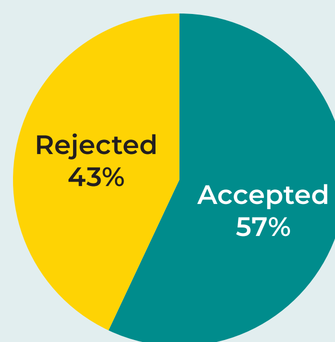
At the start of 2020, SMEs – businesses with fewer than 250 employees[27] – provided over 60% of private sector employment in the UK.[28] They are the lifeblood of local economies, yet SMEs have been underserved by the financial system, as these examples show:

- Before the Covid-19 pandemic, no more than 5% of bank lending went to SMEs and in 2019 they faced an estimated finance shortfall of £22 billion.[29]
- In 2019, 43% of businesses that applied for finance in highly deprived areas were rejected, compared with 25% from less deprived areas. Businesses from highly deprived areas are also more likely to be deterred from applying for finance, despite having a greater appetite to grow significantly.[30]
- Women-led businesses are more likely than male-led businesses to make applications to their bank for a core product like a loan or overdraft, with a quarter of these being declined – compared with a 16% decline rate for male-led businesses.[31]
- Ethnic minority-led SMEs are less likely to obtain the finance they applied for – 48% are made an offer by lenders compared with 78% for SMEs overall[32] – and ethnic minority-led businesses are more likely to be discouraged from applying for external finance.[33]
- Bank branch closures affect small businesses by reducing face-to-face support, with research suggesting that lending to SMEs has declined in areas where branches have closed.[34 35]

Businesses applying for finance in less deprived areas



Businesses applying for finance in highly deprived areas



Source: *Nations and Regions Tracker: Small Business Finance Markets 2022* (British Business Bank, 2022).

The loan amounts required by SMEs tend to be small, yet the cost of servicing them can be high and may yield lower financial reward,[36] making them less attractive than bigger businesses for mainstream banks. SMEs are particularly reliant on bank lending because they have difficulty accessing market-based finance, such as the issuing of shares or bonds. Other internal bank processes exacerbate the problem, including the use of automated risk assessment algorithms[37] or credit ratings which limit banks' knowledge of applicants' full circumstances and may automatically exclude many SMEs. Finally, bank requirements on collateral often don't take into account SME contexts, particularly those located within areas of deprivation.[38] SMEs, and particularly those in deprived areas, therefore face an uphill battle to secure the capital they need.

This exclusion of SMEs stifles productivity and economic growth, particularly in the more deprived regions of the UK, and will also hinder SMEs' ability to align with the UK's green taxonomy: this framework for defining environmentally sustainable investments[39] will become increasingly important to SMEs as they seek to invest in decarbonising their processes, products and services, and will no doubt impact those who bid for contracts as part of supply chains to larger companies that are themselves becoming aligned with the green taxonomy.

Social enterprises also face difficulties in accessing finance. Despite the size of the sector – 100,000 businesses, employing 2 million people, with a turnover of £60 billion – social enterprise leaders say that social investors do not understand their operating and business models.[40] Social enterprise investment is also weighted towards London. Women-led social enterprises receive lower levels of investment than those led by men, and Black and ethnic minority-led social enterprises find it particularly difficult to secure investment.[41]

The lack of appropriate patient and flexible sources of capital is one of the issues facing both SMEs[42] and social enterprises.[43] SMEs and social enterprises have a clear role to play in revitalising local economies, yet with the UK having some the of the "highest levels of sustained inequality in Europe"[44] and significant differences in productivity within and between places, major intervention is needed to improve this picture. Financial exclusion represents an important market failure: it means viable businesses are not funded and individuals are declined for products they could, in fact, successfully manage.

Responses to financial exclusion

This section explores the response of government, retail banks and building societies to financial exclusion, and how the data available on financial exclusion is insufficient.

The UK Government's financial inclusion agenda

Since 2019, the Government has set out annually its commitment to improve levels of financial inclusion and its forward-looking priorities in a report published by the Treasury. This agenda, as defined in the latest report, comprises:

- Efforts to "widen access to useful and affordable financial services for all, regardless of background or income"; and
- Ensuring that "individuals can manage their money well... [and that] the Government continues to work in partnership with industry to support individuals to build financial resilience to deal with unexpected circumstances." [45]

To achieve these ambitions, the Treasury reports also note the importance of:

- **Effective regulation,** particularly the remit of the Financial Conduct Authority (FCA) to ensure that markets are working fairly – that it is protecting consumers and "considering access to financial services within its competition objective"
- **Direct government intervention** – for example, to support households in financial difficulty
- **Partnership working** with the financial services industry and civil society to achieve outcomes in an "effective and sustainable way".[46]

The latest report (for the period 2021/22) lists a wide range of initiatives contributing to the financial inclusion agenda that are either being taken forward directly by the Government and the FCA or that are engaging the financial and third sectors in the development of innovative approaches – see box.

The UK Government's response to financial exclusion

- Establishing and widening access to basic bank accounts, including through the Prisoner Banking Scheme, and by providing access for Ukrainian nationals.
- Legislating to provide the FCA with new powers to ensure the continuation of access to cash, and the Access to Cash Review.
- Strengthening the regulation of interest-free buy now, pay later (BNPL) credit agreements.
- The implementation of 'Open Banking', to provide account information services that can identify what individuals and households spend on household, insurance and mortgage bills, and if there may be cheaper alternatives available. Measures to extend this into other financial services are being considered but are not without financial exclusion concerns.
- The English portion of dormant assets funding supports the expansion of affordable credit by channeling a portion of dormant assets to credit unions and CDFIs; the devolved nations decide on their own priorities for dormant assets.

The UK Government's response to financial exclusion *continued*

- Providing funding to the Money and Pensions Service to support its UK Strategy for Financial Wellbeing and the associated delivery plans for Scotland, Wales and Northern Ireland.
- Introducing a Consumer Duty making provision for customers who are in vulnerable circumstances. This, however, requires people to have overcome the initial hurdle of having been accepted as a customer and nor does the Duty open up more products to include those who are excluded from financial markets.

Further details on the above can be found in the *Financial Inclusion Report 2021–2022*, published by HM Treasury.

For SMEs specifically, Government actions have included:

- Extending the Recovery Loan Scheme to support continued SME lending and giving CDFIs a fee discount on using the scheme.
- Offering mentoring and an allowance to people on Universal Credit who were looking to start a business, through the New Enterprise Allowance, though this is no longer available.
- Enabling CDFIs to use money raised through Community Investment Tax Relief (CITR) in conjunction with the Enterprise Finance Guarantee (now the Recovery Loan Scheme).
- Committing more funding to the British Business Bank's regional SME loan programmes. However, neither this nor the CITR is accessible to personal lending CDFIs, and no similar alternatives exist.

While we welcome these initiatives and the Government's continued commitment to financial inclusion, we have seen above that financial exclusion remains stubbornly persistent and is growing. An intervention that responds to the scale of this market failure is needed from the Government, especially given the wider economic context.

Assessing the contribution of banks and building societies to the financial inclusion agenda

Many retail banks and building societies have taken steps to help the Government deliver on its commitment to improve levels of financial inclusion. Examples include:

- Support and assistance for those who have experienced domestic abuse.
- Bank accounts for those experiencing homelessness.
- Services for people who are victims of modern slavery and human trafficking, including access to basic bank accounts without the need for photo identification or proof of address.
- Basic bank accounts for refugees.
- With LINK, consumer groups and the Post Office, major retail banks developed a mechanism where any community that faces closure of a core cash service will have their needs independently assessed by LINK, and communities are now able to proactively request such a review by LINK.[47]
- Through the FCA, Payment Deferral Guidance was provided to help customers manage their ability to meet borrowing commitments across a range of products during the Covid-19 pandemic.[48]
- Financial education programmes and digital education, including for young people, and providing devices and data to be digitally connected.

However, it remains difficult to assess the value of the contributions that individual banks and building societies are making to this agenda and to compare these. Several banks and building societies make explicit statements about their commitment to financial inclusion in their own annual reports that are of direct relevance,[49 50]. However, with the exception of reporting their delivery of basic bank accounts relative to their overall share of the personal current account market, there is no analysis published by government or the industry that provides a thorough assessment of the relative performance of the UK's main banks with respect to key areas of the Government's financial inclusion strategy.

Again, the scale of the problem, and the fact that it is growing, shows that the industry is not doing enough to tackle this problem and significant intervention will be needed.

The need for better financial inclusion data

In 2013, seven of the UK's largest banks and building societies reached an agreement with the Government to publish their local postcode-level lending data, with the intention of targeting financial exclusion by examining local lending markets and finance providers, and identifying gaps. This data covers unsecured personal loans, mortgages, and overdrafts to SMEs. However, it does not cover credit cards, insurance, non-bank lending products such as payday loans, or access to cash. A fuller picture of financial exclusion needs to include these products.

While individual banks are identifiable from the data, and it is possible to compare bank by bank lending across geographical areas, the current data focuses on one indicator of total lending (loan value), which cannot provide a full insight into local lending markets or behaviour.[51] Furthermore, lending data based on geography is not sufficient, given that personal lending interacts with factors such as housing, labour markets, age, gender, race and ethnicity, so this data does not enable a full understanding of the distributional implications of varied access to credit, or other aspects of financial exclusion.[52]

FCA financial inclusion metrics

The FCA has published its intended financial inclusion outcomes and several relevant metrics to monitor its progress in achieving these. The most relevant metrics are:[53]

- Reduction in the proportion of consumers who, in the last two years, have been offered a financial product or service they wanted, but at a price, or with terms and conditions they felt to be 'completely unreasonable'
- Increase in consumer satisfaction with their providers
- Reduction over time in upheld Financial Ombudsman Service complaints about unsuitable advice or mis-sold products and services
- Reduction in the proportion of consumers who were declined a product or service in the last two years, which, in their view, was due to non-financial factors such as their age, health or ethnicity.

However, making comparisons of relative bank performance from the annual reports or using FCA metrics is not currently possible, particularly as many of them presume the offer of a product in the first place. Individual banks report on measures that they have themselves selected and included in the different ESG reporting frameworks they have adopted and there is a lack of consistency with respect to both the indicators selected and their measurement.[54]

Apart from the number of complaints upheld by the Financial Ombudsman Service, which depend on consumers identifying that they have received a poor

value product in the first place, the data underpinning the FCA's metrics of most relevance to financial inclusion is collected through its Financial Lives Survey.[55] There is therefore no breakdown to the level of individual financial institutions available.

As a result, it is currently not possible to properly assess the extent to which individual financial institutions are tackling or contributing to the problems of financial exclusion.

The role of purpose-driven banking providers

In this section we outline and consider the purpose-driven banking sector in the UK and why this sector is uniquely placed and qualified to play a bigger role. The small but growing purpose-driven banking sector could work powerfully and effectively together with retail banks and building societies to comprehensively tackle financial exclusion for individuals, SMEs and social enterprises.

Purpose-driven banking organisations, also known as 'stakeholder' institutions, include Community Development Finance Institutions (CDFIs), credit unions, ethical banks, building societies and emerging regional mutual banks. Driven by social and/or environmental purpose, this is embedded in an institution's mission and supported by mission, governance, ownership, culture and leadership structures. Having purpose at the core of the business changes what is created and supported by finance and banking, with growth and profit directed to supporting the financial wellbeing of customers, providing resources to local businesses, contributing to local wealth creation and circulation, providing for sustainable housing or making positive investments for a sustainable world.[56]

These institutions are able to take a more holistic approach to assessing an individual or small business' needs and are able to take decisions based on a deeper understanding of risk and what is considered profitable that mainstream financial services cannot. Financial resilience support for individuals is often provided alongside, in the form of money advice, help in accessing grants and benefits and longer-term strategies such as saving, which further strengthens financial wellbeing.

The purpose-driven banking sector in the UK

There are 389 **credit unions** across the UK, which are cooperative organisations owned by their members. Membership of a credit union is based on a common bond such as working for a particular employer or in a particular industry, or simply living or working in a specified geographical area. During 2022, credit unions' total income exceeded £60 million for the first time, and expenditure £50 million.[57] The sector continued to see a rise in members in 2022, and loans as a percentage of total assets across the UK reached a record 41.8% during that year.

Traditionally, credit unions have been small, not-for-profit providers of savings services and loans for members. However, many now offer additional products such as prepaid debit cards, insurance products, cash ISAs and mortgages. Changes proposed by the Prudential Regulation Authority to the regulatory regime for credit unions would broaden the investments they can make,[58] while the proposed Financial Services and Markets Bill includes a provision to allow credit unions to offer a wider range of products and services to their members. This includes hire purchase agreements, conditional sale agreements and insurance distribution services.

The purpose-driven banking sector in the UK *continued*

Community Development Finance Institutions (CDFIs) are social enterprises focused on lending. There are two main types. Personal CDFIs provide affordable credit to low-income consumers as an alternative to high-cost credit. They serve a segment of the market that is outside the risk appetite of mainstream lenders and some high-cost lenders. There are currently around 50 CDFIs in the UK, of which 10 offer personal loans to consumers: £59 million was lent to 138,000 customers in 2021.[59] Enterprise CDFIs focus on lending to small businesses and social enterprises to improve local employment: in 2021, CDFIs lent £65 million to 890 businesses, with £73,000 being the average loan size. They are regionally-based, with a strong presence in the Midlands and north of England. Some CDFIs lend to both individuals and businesses.

Two of the nascent **regional mutual banks** have submitted their Regulatory Business Plans to the regulators, while another community bank is working with an existing banking licence holder to develop its proposition. Fully owned by their members (every customer will be a member), these banks aim to provide full-service retail banking for individuals and SMEs, including bank accounts, savings, loans and mortgages. Their aim is to provide a local offer with new technology to serve the communities they are part of, in order to contribute to economic development and local resilience.

Ethical banks, of which there are five in the UK, provide a range of retail banking services, including current accounts, loans and savings. Examples of these larger institutions working in partnership with smaller ones include Triodos Bank and Unity Trust Bank working with CDFIs to promote financial inclusion.

Building societies, of which there are 43 in the UK, are mutual institutions whose statutory 'principal purpose' must be to make loans that are secured on residential property. Building societies can provide a wide range of other services, including other types of lending, current accounts, investment advice and insurance mediation services. Given their mutual ownership model, building societies are considered part of the stakeholder model, purpose-driven banking sector, but the diversity of size within this sector means they also exist within mainstream retail banking. The biggest, Nationwide, sits among the largest UK banks by asset size.

Source: *Barriers to Growing the Purpose-Driven Banking Sector in the UK*.[60]

> **Thank you for the following: 1. Rewarding loyalty with an excellent rate for loans; 2. Easy access information about loans; 3. Quick, no fuss, no over-documentation, and trust in your members; 4. A very personal service; 5. No strings with early repayments.**
>
> Customer with No1 CopperPot Credit Union.

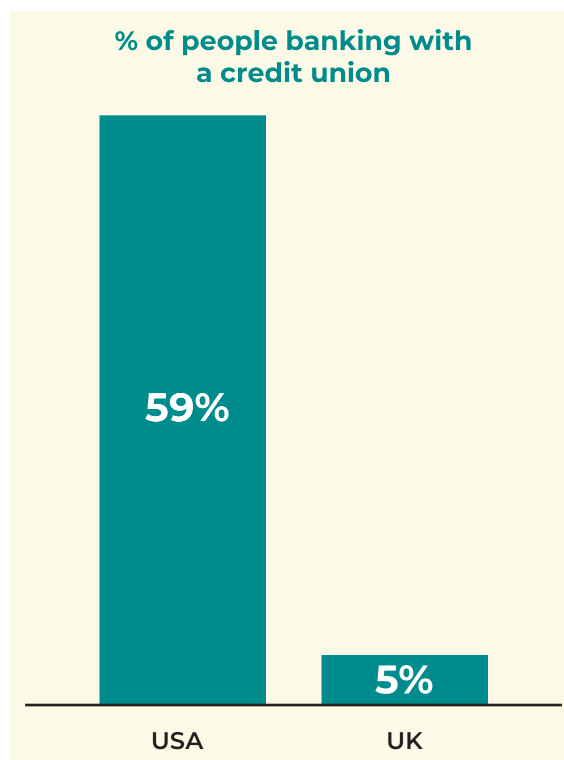
> **And if you ever wonder why micro-businesses are so powerful, it's because of this: they can change communities and families' destinies by lifting them out of poverty.**
>
> CG, individual lending customer, Purple Shoots

> I went to the credit union. The woman said, 'if you save with us for 10 weeks you can take a loan out.' Then she said, 'you've saved up so much you can actually take over £2,000 out.' Then she went, 'But do you really need that £2,000? Don't take out more than what you need.' I actually thought about it and decided, 'do you know what, I don't actually need a lot of that.' What sort of loan companies would turn around and [ask] you, do you need that amount?
>
> Lived experience of financial exclusion workshop attendee, Finance Innovation Lab, January 2023

> When we initially approached our high street bank for a CBILS loan, they immediately said 'no' without even speaking with us. It is great that SWIG takes the time to understand the business. I was impressed with the process, as it matched the entrepreneurial culture we have at Bay's Kitchen. Our business manager was a delight to deal with: she really took the time to understand our journey and why we needed finance.
>
> Ben Hayes, Commercial Director at Bay's Kitchen, supported by SWIG Finance.

Purpose-driven finance institutions are part of the mainstream in other economies. For example, 59% of people bank with a credit union in the United States, compared with just under 5% in Great Britain.[61] In Germany the 'three pillar' banking system's network of public savings banks and 819 cooperatives form part of the mainstream banking picture, alongside commercial banks.[62] In the UK, the sector is small and although it is scaling up and increasing its sustainability, it cannot match the size of other providers such as high-cost credit businesses.

For example, recent modelling estimated that the gap in provision for people in financially vulnerable circumstances will rise to at least £3 billion by 2025. The modelling suggested that purpose-driven banking organisations provide only 0.6 billion or 8% of the overall requirement with the rest comprising high-cost credit options, buy now pay later, or illegal providers.[63] And yet access to responsible, affordable credit to pay for essential household items has myriad benefits for wellbeing: an evaluation of CDFI Fair For You, for example, found over 70% of its customers were able to stop using high-cost credit.[64]



Source: 'Statistical Report 2020.' (World Council of Credit Unions).

A strong purpose-driven finance sector, and consequently a diverse banking system, has benefits not only for individuals and SMEs but for the wider economy, too.

International evidence shows that a more diverse banking system can:[65]

- Lend proportionately more to the real economy (the part of the economy that focuses on production of goods and services, rather than that which focuses on financial services), including small businesses
- Generally, provide more extensive branch networks
- Produce more consistent and less volatile returns
- Have safer business models with higher loan quality
- Help to reduce regional inequality
- Be resilient in times of crisis, less procyclical and less likely to cut back lending.

Despite engaging in modernisation programmes, mergers, partnership and new innovative forms of collaboration, these purpose-driven banking institutions still face substantial challenges and barriers to establishing or scaling up, particularly to increasing the supply of affordable credit at the national level.[66] A partnership between regulators, retail banks and building societies and purpose-driven finance providers, and promoting the types of investments that have been so successful elsewhere, could be significant steps towards tackling the UK's financial exclusion problem.

Partnership arrangements between purpose-driven finance providers and commercial banks

In France, the purpose-driven finance sector has flourished thanks to partnering with commercial banks, which provide financial and practical support as well as support in advocating to government. In 2021 responsible credit provider Adie loaned €143 million to nearly 30,000 people, with a recent evaluation estimating that every €1 loaned by Adie yields an investment of €2.53 into the community.[67] In Italy, microfinance institution PerMicro – which provides business and personal loans and insurance to socially excluded groups – operates in partnership with commercial banks. This includes borrowing from various banks to on-lend to 'unbankable' customers and to fund its operations, involving banks in their equity and sharing infrastructure such as front and back-office functions, branches and ATMs with banks.[68]

Commercial banks in the UK have also engaged in voluntary schemes. This includes JPMorgan Chase's £1.2 million commitment to expand the No Interest Loan Scheme currently being piloted by Fair4All Finance;[69] Lloyds Banking Group's £6 million funding to its Credit Union Development Fund,[70] shared between over 100 credit unions; and NatWest's £900,000 funding to CDFIs to enable them to provide accessible credit, hardship grants and financial education.[71]

And yet, the extent of financial exclusion in the UK and the impact on individuals and businesses shows that voluntary arrangements are not comprehensive enough, and do not go anywhere near far enough, to address the problem. A policy that would have a transformative impact is needed.

Why a Fair Banking Act can tackle the UK's financial exclusion problem

While the responses the Government, regulator and banks have made are welcome, the figures for financial exclusion affecting both individuals and businesses illuminate the scale of the problem still to be addressed. Entrenched problems need transformative policies in response.

Without such a policy to address financial exclusion, financial vulnerability and precarity caused by unequal access to financial products and services will remain, and be deepened by the cost of living crisis. In turn, this reduces the opportunity for banks, government, SMEs, social enterprises and individuals to create thriving, sustainable, economies and communities.

A Fair Banking Act would be a response commensurate with the problem. What precisely this could look like is explored in more detail in the next section, but the basics are straightforward. Its implementation would need to take account of the nuanced picture across the four nations of the UK in terms of policies and support already in place around financial exclusion.

This would require banks and building societies to disclose the extent to which they are meeting the needs of everyone in the diverse communities they serve, focusing particularly on those who are financially excluded. Institutions would be assessed against their service, lending and financial inclusion-focused partnerships with the purpose-driven finance sector, which would then determine the level of action the institution needs to take. This could be, for example, creating new services targeting those communities, or providing support to purpose-driven finance institutions that are able to do this.

A Fair Banking Act would include a comprehensive financial inclusion reporting framework, with results broken down to the level of individual banks and building societies. The purpose of this would be to help government, regulators, civil society and customers better understand the contributions these institutions are making to financial inclusion. Common metrics for assessing the baseline performance of the UK's retail banks and building societies in addressing financial exclusion would be set under this framework. Banks and building societies would use these metrics to take action directly informed by a list of eligible activities, which would include working in partnership with specialist responsible finance providers. The activity, and its associated outcomes and impacts, would then inform where banks sit on a ratings scale, with this rating decision made by the FCA.

The process would be underpinned by the involvement of communities, those with lived experience of financial exclusion and civil society groups, both in the interrogation of data under the reporting framework, inputting into the development of partnership agreements between obligated institutions and specialist responsible finance providers, and assessing the outcomes and impact achieved.

A Fair Banking Act that results in meaningful impact with clear requirements and assessment would produce a step change to ensure individuals, SMEs and social enterprises can manage day-to-day

financial pressures and build longer-term resilience, supporting improved wellbeing. The impacts would be felt and seen at community level, with positive changes in tackling deprivation, promoting enterprise, employment and local economic activity.

The Act could achieve the following key outcomes:

- **Meeting the banking and credit needs of underserved communities, SMEs and social enterprises, through a long-term, sustainable solution.** This means that underserved groups would have access to relationship-based banking services (whether in person or remotely) that work to fully understand a person's or business's circumstances before making lending decisions. This would greatly increase access to fair, affordable and responsible credit, and significantly decrease financial exclusion.
- **Giving people with experience of financial exclusion a say in what is needed and better access to services and support.** This would mean having greater access to in-person services, as well as access to support that strengthens financial resilience. This could include, for example, programmes that support individual consumers to maximise their income (such as through ensuring all benefits people are entitled to are claimed), support for people to save, financial education, programmes to address 'discouraged' customers - those who do not apply for a product in the first place, in the belief they will be declined - and business planning support.
- **Building a stronger purpose-driven banking sector, working more closely with mainstream banking institutions in order to provide services to people and businesses who would otherwise be financially excluded.** This would be likely to take the form of partnerships between banks, building societies and specialist responsible finance providers. These partnerships and their accompanying agreements would need to recognise, and take account of, the capital needs of purpose-driven stakeholder finance institutions, which reflect the diverse risk profiles of the customers they serve and the capacity requirements of those institutions. For example, agreements could either support an institution to scale-up and become self-sufficient, or recognise that some lending institutions will likely need ongoing support.

The Community Reinvestment Act in the USA – a major policy intervention to support financial inclusion

In the United States, the Community Reinvestment Act (CRA) has been described as "one of the seminal pieces of legislation to address systemic inequities in access to credit". The Act is currently being revised to meet the changing way banking is delivered.[72] It exists as a specific mechanism to address financial exclusion and places obligations on regulators to assess the performance of mainstream banks in meeting the credit needs of the whole community, while operating in a safe and sound manner.

This has led to a significant improvement in the provision of services to low-income and marginalised communities through major growth in purpose-driven banking providers.

- In 2020, banks provided $271 billion to low- and moderate-income communities.[73] In 2019, CDFIs and credit unions managed more than $150 billion, which included microenterprise and SME lending.[74]
- In the period 1990–2009, these purpose-driven banking providers created or preserved nearly 200,000 jobs, around 43,000 microenterprises and SMEs, 580,000 housing units and 10,000 community facility projects, via $20 billion lent through CRA mechanisms.[75]
- More recently, in partnership with the Opportunity Finance Network (an umbrella body for CDFIs and credit unions), one major US bank has delivered more than 322,000 hours of technical assistance and $781 million in financing to minority-owned small businesses, enabling more than 103,000 jobs across the country.[76]
- In the 40 years since its founding in 1973, Chicago-based pioneering community lender Shorebank made $4.1 billion in mission investments and financed more than 59,000 affordable homes.[77]

Large banks are assessed via a CRA examination every two to three years, and smaller ones every four to five. The exam includes tests on lending patterns, local investment and service standards against which banks are scored.[78] Assessment considers the distribution of branches in low- and moderate-income communities, the effectiveness of alternative delivery mechanisms and the extent to which services are tailored to the needs of the area. The ratings subsequently given to banks are taken into account in applications for mergers or acquisitions and can also have a reputational impact. The community is able to contribute to the evaluation of banks' provision both during CRA exams and when merger applications are made.[79]

What a Fair Banking Act should look like

Obligated institutions

The Fair Banking Act would apply to retail banks with a banking licence in the UK – including challenger banks – and building societies. Obligated institutions would be rated on their baseline performance in addressing financial exclusion, then assessed periodically to determine their progress. For the purposes of ratings, obligations and assessment, banks would be categorised as large, medium or small according to their UK asset size. This will allow for a simple framework for small and medium sized institutions, with obligations focused on large institutions which make up the vast majority of the banking system.

Financial exclusion does not just occur in relation to access to retail banking; sectors such as insurance can also be exclusionary in their operations and decision-making. The expectation would be that further sectors and actors would be added to the remit of the Act over time, and after an initial review period. This could expand obligated institutions to include insurance, fintech companies and other technology platforms that offer financial services and products.

A transparent data framework

A transparent data disclosure framework would be developed in order to provide the baseline picture of banks' performance on financial inclusion. As we have seen, the current level of information and disclosure is inadequate. A better framework could potentially start from ward level and include data that captures spatial, demographic and protected characteristic dimensions of financial exclusion.

A precedent for such collection exists in the Community Investment Tax Relief (CITR) decision-making mechanism, which determines which CDFIs qualify to receive the CITR.

Such a disclosure framework would assist regulators in their decision-making and would directly inform the initial baseline and subsequent progress ratings banks achieve on how well they address financial exclusion – and therefore what action the regulators take in response.

The data also needs to be publicly available, easily accessible and presented in a way that can be interpreted and used across institutions, so that mainstream and purpose-driven finance institutions, regulators, academics and civil society organisations can use themit. As such, the disclosure framework needs to be co-designed by these institutions, with the responsibility for collecting and collating the data held by the obligated banks and building societies that the Fair Banking Act covers.

Assessments and ratings

Ratings would need to be based on a national picture of a bank's performance in addressing financial exclusion, in conjunction with place-based elements that rate performance in identified low-income neighbourhoods. Progress ratings need to take account of the complexity of financial exclusion in the UK, with a place-based approach being a necessary, though not fully sufficient, part of this.

The evaluation framework for assessing an obligated institution's performance should be anchored to the extent to

which financially excluded people across defined geographies, demographics and characteristics become aware of, understand, and have timely access to appropriate and affordable financial products and services that enable them to manage their finances day to day, build their long-term financial resilience and wellbeing, and participate in society.

Activities that count towards different ratings levels should correspond with the size of the obligated institution. So, relative to their size, banks or building societies with a poor rating for addressing financial exclusion would be expected to improve more than those with better ratings.

We propose that banks be rated in relation to the following categories, with the assessment fundamentally aiming to ascertain how well each obligated institution is performing in relation to the extent of the problem of financial inclusion. However, the exact metrics and criteria will need to be developed further once a data disclosure framework is in place, in order to establish a baseline of how effectively mainstream banks are currently serving people on low incomes, SMEs and social enterprises.

1. **Lending – expanding the provision of responsible, affordable and fair lending to underserved communities, demographic groups and people with protected characteristics, either directly or via a partnership with a purpose-driven banking institution**. This could include:
   - The number of loans and amounts lent to individuals, SMEs and social enterprises based in areas classed as being the most deprived in the country
   - The number of loans and amounts lent to people on low incomes
   - The number of loans and amounts lent to individuals and businesses that are more often declined in relation to demographic or protected characteristics.
2. **Service – either directly, or via a partnership with a purpose-driven banking institution**. This could include:
   - The extent to which the bank/building society involves people with lived experience of financial exclusion in the design of its services and products
   - Whether the bank/building society has products and services specifically aimed at tackling financial exclusion, and the scale and impact of these
   - The number and proportion of branches and ATMs located in areas of high deprivation and how they serve rural populations
   - The extent to which branch coverage, hours of operation and services available meet community needs (including access to cash and basic bank accounts)
   - The extent to which a holistic decision-making approach is taken on individual, SME and social enterprise lending.
3. **Partnership agreements – with purpose-driven banking providers such as credit unions, CDFIs, regional mutual banks and, where appropriate, ethical banks and building societies.** This could include:
   - Providing capital for on-lending
   - Risk sharing, such as providing first loss capital
   - Providing grants
   - In-kind support, such as providing free premises, learning and development, sharing back-office services, technology, and so on.

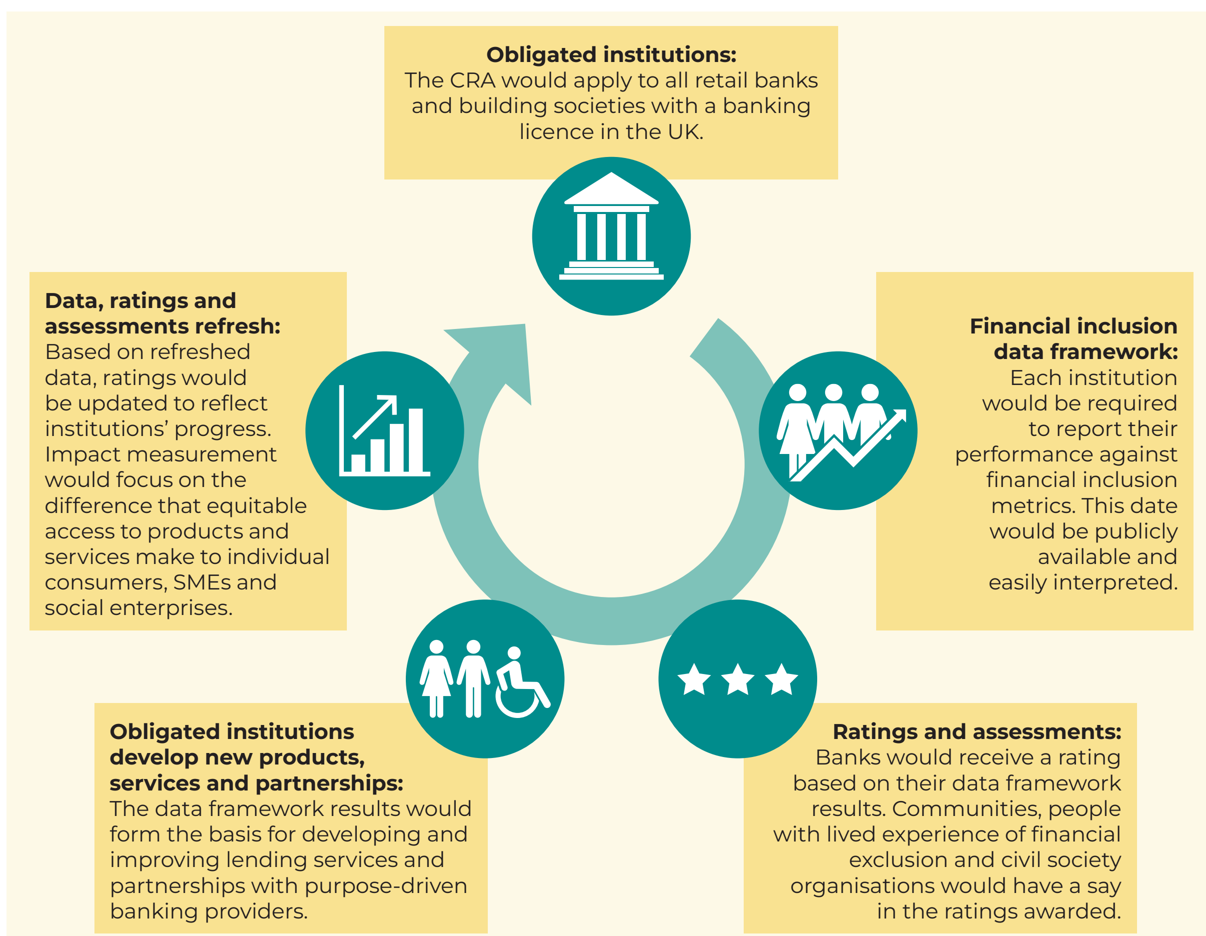
An impact approach would need to be adopted, to ensure activities remain focused on addressing the consequences of financial exclusion and to differentiate the impact of the Fair Banking Act on communities from other changes in the regulatory, political or economic landscapes.[80]

Impacts should focus on the difference that equitable access to products and

services makes to individual consumers, SMEs and social enterprises in terms of their ability to manage their day-to-day finance, build long-term financial resilience and support improved individual and community wellbeing. This will, by necessity, cover the joint roles of banks and purpose-driven stakeholder finance in addressing financial exclusion.

Outcomes and impact should also be measured at the community level, including how far Fair Banking Act activity is supporting efforts to tackle deprivation, and promote enterprise, employment and local economic activity. This should include how SMEs will be able to meet the changes in supply chains and contracts they need to make in order to meet the demands of a green taxonomy and should emphasise activity that contributes to the UK's target of reaching net zero by 2050. In addition, local communities should be provided with meaningful opportunities to review and comment on the performance assessments for their areas, with those assessments refreshed regularly.

The final rating and assessment system, and the mechanism for partnership arrangements between banks or building societies and purpose-driven banking providers, would need to be designed after full and considered consultation with the UK's financial institutions, those with lived experience of financial exclusion, civil society organisations, academics and others. It should be possible through that process to develop a transparent and comparative performance rating system for financial institutions that identifies outstanding contributions as well as those in need of improvement. This rating system would need to be robust enough to avoid the risk of 'ratings inflation' and ensure that assessments and ratings are meaningful, both to the institutions that receive them and to those who will be observing.



As with the scope of what is considered an obligated institution, the Fair Banking Act could leave room for considering the expansion of what counts as eligible activity at a defined review period. This could include, for example, investment in community energy efficiency or social housing, with projects similarly subject to outcome and impact assessments. This does not, of course, preclude banks from undertaking such investment before that time.

Banks could realise these activities in a number of ways: for example, by developing agreements with purpose driven banking institutions that are, or will be, able to provide services shareholder banks cannot, and with the involvement of other actors including the physical and online communities across which they operate, civil society organisations working in the financial inclusion space, and local decision-makers. Contribution to a centrally distributed fund would be another way to realise obligations under the Act.

The role of regulators

The Financial Conduct Authority (FCA) would have the key role in determining the baseline and financial inclusion ratings awarded to banks and in conducting the cycle of ratings assessments, the rationale and underlying data, all of which would need to be made publicly available. The operation of the Fair Banking Act within each institution would become part of the overview of activities that the Prudential Regulation Authority undertakes of firms in order to ensure they are being run in a safe and sound way.

Banks and building societies with the highest ratings should be publicly recognised for their positive impacts in addressing financial exclusion. However, while reputational rewards are likely to drive improvements in performance in and of itself, these may not be sufficient on their own and the Government would need to consider what other suitable measures could be put in place, including, if necessary, interventions to improve performance.

Crucially, the Act would give banks and building societies confidence that they have the support of the regulators to engage with purpose-driven banking institutions, and therefore consumers, that their own institution cannot serve. In overseeing ratings and assessment, the Act offers a key way for the FCA to contribute to and reliably track financial inclusion, and therefore banks' contribution to the wider ESG picture.

Other important steps could be taken to raise financial inclusion up the regulatory policy agenda, which would combine well with a Fair Banking Act. Most importantly, the Financial Inclusion Commission, Fair By Design and the Finance for Our Future campaign are calling on the Government to introduce a cross-cutting duty for the FCA to have regard to financial inclusion across all its work. This would include a statutory duty to report to Parliament annually, on:

- The state of financial inclusion in the UK
- Measures the FCA has taken, and is planning to take, to advance financial inclusion
- Recommended additional measures the Government and other public bodies could take to promote financial inclusion.[81]

The Treasury Select Committee has also called for the FCA to have this duty,[82] while the House of Lords Liaison Committee states the FCA should "promote [financial inclusion] as a key objective and have the powers to enforce a statutory duty of care on banks is required", arguing that the work of the FCA on financial inclusion is "limited by the objectives defined in its statutory remit".[83] This duty would be a major improvement in efforts to address financial exclusion, and would give further impetus for the Government to adopt a Fair Banking Act to help the regulators fulfil their mandate.

What a Fair Banking Act means for UK retail banks and building societies

A Fair Banking Act offers retail banks and building societies a clear route to engage in activity with social outcomes and impact, which is becoming ever more important as investors and consumers pay closer attention to environmental, social and governance (ESG) performance.

The experience of the Community Reinvestment Act in the United States shows that it can deliver positive outcomes for banks, which, while having seen the CRA as a 'regulatory must-do', later realised it led to profitable (or at least, as profitable) opportunities in areas where they weren't previously active. Moreover, industry leaders[84] and research show that the CRA has not led to banks making risky loans, and this held true even during the 2008 financial crisis.[85] One major US bank notes that expanded access to banking can help people become better consumers of other financial products[86] and has found that working in partnership with purpose-driven banking providers is critical to expanding outreach and enhances banks' understanding of consumer needs.[87]

A Fair Banking Act in the UK would act to give assurance to banks and building societies that they will have regulatory support to work in partnership with financial institutions that have business models and processes that can reach customers they cannot. It recognises those banks that are already comprehensively proactive in their financial inclusion approach and activities, and sets an expectation of improvement for those that still have more progress to make.

A Fair Banking Act recognises that retail banks and building societies do not currently comprehensively deliver services such as access to affordable credit, branches and cash and have no market incentive to rectify this situation – and therefore, millions of people remain financially excluded. Yet it is these institutions, together with larger building societies, that are the bedrock of the retail banking system. As such, the Fair Banking Act offers a structure to meet their potential to participate in the communities they operate in, in partnership with regulators and purpose-driven banking providers. This would be achieved in a way that would not interfere with the ability to make decisions based on their determination of credit-worthiness.

Conclusion

Retail banking is changing rapidly, and yet in many ways is still not able to keep up with the needs of all consumers, whether individuals, SMEs or social enterprises. Intersectional inequities are reflected in the way people are financially excluded from accessing, and being accepted for, retail banking products. This has serious wellbeing consequences for individuals and families, and subsequent economic costs. It has consequences for communities too, as enterprises that have the potential to contribute to the economic and social fabric of villages, towns, cities and regions struggle to do so when they cannot secure the banking services they need.

While the Government, banks and building societies have implemented a range of policies, initiatives and products, the financial exclusion problem continues to grow. It is also difficult to assess the contribution that individual institutions providing retail banking services are making to tackling it. There is no comprehensive and holistic reporting framework that enables a full understanding of the distributional implications of varied access to banking products and services; without that, we cannot see effectively what action needs to be taken, either for geographical communities or those who want to access banking online.

The retail banking picture is completed by a thriving, but under-resourced, purpose-driven banking sector. These CDFIs, credit unions and nascent regional mutual and community banks, plus ethical banks and building societies, could bring their unique approach to work effectively with their larger retail bank counterparts in comprehensively tackling financial exclusion. No structure yet exists to drive forward a comprehensive, partnership response from both these types of actors, in combination with regulators.

A Fair Banking Act would provide this structure by establishing a financial inclusion data disclosure framework and a corresponding ratings system that assesses retail banking institutions on their performance at tackling financial exclusion. Positive ratings would reflect strong performance under the categories of lending, service and partnerships with purpose-driven banking providers.

Full and considered consultation with the UK's financial institutions, those with lived experience of financial exclusion, civil society organisations, academics and others would be essential to fully develop the features of the Act beyond the proposals set out in this paper.

A Fair Banking Act for the UK has the potential to make a major step change in correcting the market failure of financial exclusion, achieving lasting positive social impact in terms of increased financial resilience – and therefore wellbeing – and playing a key role in strengthening local communities and their economies.

It is an Act that is needed now, more than ever.

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