Encouraging Practical Financial Literacy & Sustainable Communities

A paper introducing Fair Money Ltd to members of the Community Development Finance Association

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1. Introduction

This document introduces Fair Money Ltd, a not-for-profit company, limited by guarantee, whose purpose is to demonstrate what real service to customers in the area of financial services looks like.

- We develop a common sense meaning for the term financial literacy and show the nature of the literacy that is necessary for adequate service delivery.
- We explain Fair Money's solution to the financial literacy problem and the sort of service needed to make a difference to the control that customers have over their circumstances.
- Finally we explore where all this might fit with the agenda of CDFIs.

2. Overview

Financial literacy is a social and government objective for good reasons. Without people in general being able to pursue their own interests effectively, the competitive market cannot work, leading to inefficient, wasteful industry and customers who cannot get real service.

Fair Money is looking to correct the heart of the problem by creating an environment where customers can gain effective financial literacy and at the same time get much better value for their money. Measured against any criterion of ability to discern value, financial literacy in the population is declining both in numbers of literate people and standards of literacy. Fair Money aims to reverse this trend.

Literacy is about much more than access to information: communities and peer support are needed to counter sales pressure, and enterprise is needed to develop key missing services and products.

In the broadest terms, people are literate when they can use language to understand others and express themselves, and an important feature of such literacy in a democratic society is being free to engage with others in a coherent manner, be they persons, corporate entities or government agencies.

Drawing a monetary parallel to this, people are financially literate when they can understand their own personal financial situation and the factors that may change it for better or worse. As above, an important feature of financial literacy in a democratic society is being free to engage with others in a coherent manner, particularly those bodies that seek payments for goods or services such as corporate entities or government agencies.

Fair Money support the development of financial literacy to a point where people and communities demonstrate ability to:

- reject unfair commercial propositions and terminate existing unfair contracts
- recognise the difference between consumer choice and options that are usefully different
- negotiate commercial arrangements that give sustainable advantage to all contributors
- report abuses of commercial power to regulators and ombudsmen
- develop the wealth of the local economies they are part of.

3. The Problem

The Fair Money definition of financial literacy has little to do with a person's IQ or level of numeracy. There are many people with degrees and doctorates, and any number of professional qualifications, that have been hoodwinked or taken advantage of by the sales representatives of banks, insurance companies, utilities providers, distributors of electrical goods etc. Indeed, the lack of effective literacy in all sections of society is underlined by the prevalence of what many people regard as exploitative business practices.

Furthermore, for those who wish to take action, just simply engaging with a provider of goods or services is often very difficult, with an increasing trend for shop or branch closures, automated telephone systems and 'non-customer-facing employees'. For the provision of goods and services to be efficient there needs to be effective collaboration between customers and providers to eliminate waste but the potential for genuine two-way dialogue is quickly disappearing. Simply witness the mushrooming growth of companies willing to act as intermediaries to administer complaints about missold endowments.

What is more, wherever regulation is present it is often unhelpful, offers little protection to the consumer and creates an additional layer of cost. It seems that rather than protecting the best interests of all consumers, regulation now simply amounts to preventing the worst excesses of a market that cannot drive customer value because literacy levels are too low.

In short, the environment in which most retail goods and services are sold (and especially financial products) puts ALL individual consumers at a distinct disadvantage.

Regrettably however, for those consumers that are presently outside of the financial system, or on the margins of it, the degree to which they are disadvantaged can be significantly worse. It is incredibly expensive to be poor, a situation which costs tax payers dearly. A recent report has shown that the failure of regeneration schemes was due to the indebtedness of people living in the area. It seems as though money aimed at supporting the poorest people is in effect being passed on to large corporations through indebtedness.

Taking an analytical view of the current position, Fair Money have tried to assess, in broad terms, where unnecessary costs and poor value lie in the provision of existing financial, goods and services.

a) Misunderstanding Consumers

In many cases consumers are misunderstood. The common response of providers in such a situation is to offer wide choice. However, wide choice is often unhelpful as it reduces the chance that a consumer will identify and purchase the most suitable products or services for them, and can be deliberate confusion marketing.

Should consumers try to engage with providers to make their views and their needs known, it is very difficult to do so (due to automated telephone systems etc).

Misunderstanding consumers can also take another form in areas such as financial services, where the products that are sold are thought to be those that consumers want, which is often different to those that the consumers actually need. The commonplace use of sales incentives distorts out of all recognition market signals about need. This could be seen as a form of confusion marketing that relies on poor financial literacy.

b) Disproportionate Focus on Stakeholder Groups Other than Consumers

When products or services are designed, too much emphasis is placed on the:

- return in the short-term that is to be generated for shareholders of the provider
- attainment of short-term target-related bonuses for executives of the provider
- return in the short-term to the distributor of the goods or services.

By comparison, too little emphasis is placed on the benefit to the consumer.

In theory, preferring mutual organisations over plcs should help, as the consumer is also a part owner. However, this does not always work, as product design can be distorted by the wider market, as it is in financial services, where the products offered by mutuals often offer the same commissions to intermediaries as those products offered by plcs.

Indeed, financial services offers another excellent example of how the distribution route can distort product design with stakeholder pensions. Government intervention on product design, specifically in the form of a cap on charges for stakeholder pensions of 1% per annum, led to providers offering a product where the relationship of mutual benefit was distinctly in favour of the consumer. As a result, the take-up of stakeholder pensions has been disappointingly poor as distributors / intermediaries are reluctant to sell them due to the modest commissions. Hence there are now proposals to alter the stakeholder charge cap to 1.5% per annum, to increase the commissions for intermediaries and margins for providers and encourage distribution. This distortion of product design is significantly against the interests of the consumer.

c) Wastage

Wastage is a natural result of the above. Wide consumer choice as a result of misunderstanding consumers and ineffective distribution leads to dreadful wastage which ends up being priced into the products and services.

A broad example of wastage is the cost of sales channels in general. Financial services companies in particular pay large sales incentives that create sales tactics which customers dislike intensely. There is no value created for customers by this cost, so it amounts to waste in the process of product delivery. The cost to providers of maintaining “choice” is so wasteful that products may no longer be worth what they cost on a financially literate analysis.

Were consumers able to clearly communicate with the providers of financial products the value proposition that they would be happy to pay for, consider the cost savings that could be made as wastage is reduced and the consumer market becomes more efficient.

4. Our Solution

Fair Money will help to people to:

- become more aware of the payments they are making for various goods and services
- understand precisely what they are paying for and how costs are distributed
- find out whether those goods or services can be acquired in other ways, offering better value.

This will be achieved by establishing groups of people that make payments, called 'payment clubs'.

An useful analogy for understanding what is meant by payment clubs is to look at investment clubs and what they do.

Investment clubs are formed voluntarily and meet to learn about how to invest successfully and share the associated costs and risks. Club members can share their knowledge and experiences, the emphasis is on finding out, practically, what works best. Usually the administration of the club is done either by one founder member, or by members in rotation. Individual members each put money into a common club bank account, and payments are then aggregated, with investments made on behalf of the club. Investment clubs are not presently regulated as they are a voluntary arrangement, do not provide financial advice and do not remunerate individual members.

Many of the qualities of an investment club are potentially very attractive for a payment club and could give rise to the following benefits:

- sharing of knowledge and experiences
- common access to 'consumer intelligence' using Which? and other similar organisations
- pooling money into a common club bank account and aggregating payments (bulk buying)
- unbundling administration by providers associated with collecting and processing payments
- 'inter-club' engagement to consolidate demand
- identify the specific characteristics of goods and services for providers
- where possible source those goods and services through local providers
- access to e-payment services without needing a personal bank account
- basic banking services in a sales-free and not-for-profit environment
- 'sub-accounts' for club members with the facility for basic cash budgeting (electronic equivalent of 'jars on the shelf')
- individual clubs will be self-governing voluntary self-administered arrangements, so members can run them how they want
- individual clubs could be supported on a local, regional and national basis by a federation structure.

For payment club members, the environment in which they make purchases of retail goods and services will be substantially different to the existing one, they will be at much less of a disadvantage and providers will have to work hard to take cash out of members' pockets.

It is hoped that in time, as the movement grows and inter-club engagement is developed, the environment will change further and payment club members will gradually assume the position of advantage.

5. Failure of the UK Financial Advice Regime

In many ways, it is odd that financial advice in the UK today only focuses on people with net disposable income or excess capital. Indeed, affordability is a key issue that the FSA is vigilant on, and client questionnaires must show that the client can afford to pay the premiums for the products being sold.

What about all those people that rarely if ever have net disposable income, or are in a negative situation where their debt is increasing? If they cannot afford to buy a product then an adviser will not give them advice so the UK financial advice regime completely fails this group of people.

Fair Money believe that all financial advice should start at a review of a client's outgoings to identify where savings can be made. Where there is net disposable income, a discussion can then take place about how to apply that. It may seem a strange notion given the current environment, but the vision would be for financial advisory firms to support payment clubs for their clients. However, as this is very unlikely to happen, a new form of financial service needs to be developed, that includes real advice, focusing on helping people to:

- reduce their vulnerability as consumers
- reduce their outgoings
- and improve their financial literacy.

Any financial advice that can be given to a payment club as a whole or disseminated as intelligence in payment club software becomes affordable and cost effective to people with little or no disposable income. Financial advice given to people who are already in an environment that allows them some measure of control is far more likely to be put to good use.

6. Payment Clubs And The Local economy

Many of the expenses associated with being poor could be viewed as a tax on the local economy. If penalties for late payment and high charges for people with poor credit record can be avoided, then the money that is saved is directly available to the local economy, and the circulation of that money will increase the potential for the development of local services. The payment club environment could deliver very high rates of return on small amounts of investment (i.e. in the form of a cash float), precisely because of the high marginal charges that are being introduced by financial services companies, utility providers and others. Indeed, the fact that these marginal charges affect more than just people on low incomes because of low levels of literacy simply means that payment club mechanisms will be valuable to a very wide class of people.

Since it is necessary to pool both experience and buying power to correct the current situation, it is natural that people will want to take responsibility for the development of the local economy as clubs become significant players in that economy. Clubs will be in position to shape the sorts of goods and services available and the way they are supplied. They will be able to engage in the strategic direction of the retail economy and affect its impact on, for instance, the environment.

7. How Might CDFIs Help?

One barrier to establishing a payment club is being able to pool a kitty of money from the various club members, and to maintain that kitty of money throughout.

There are many people that may find it difficult to find the money initially, and thereafter could again find it difficult at certain times of the year, for instance after Christmas.

A cash float may therefore be required to get the club going and keep it going (almost as a resource to meet short term overdraft needs). The amount might be say £50 or £100 per payment club member.

Were CDFIs to provide this, it could more than pay for itself when the costs incurred by consumers of late payment penalties (which we would describe as wastage) are considered. The float would allow such payments to be made on time with the member reimbursing the club as soon as they are able. The avoidance of the late payment penalty would allow the club member to direct more money than would otherwise be available to purchasing goods and services through the local economy.

8. Where Are We Now?

Fair Money is seeking to establish a number of pilot schemes for payment clubs, so that a software package can be developed to support the running and administration of payment clubs and develop a mechanism and guidance that will help people establish their own clubs in the future. An agreement in principle, has been obtained, to full access of payment clubs to both send and receive payments electronically via the banking system, while maintaining full control of budgeting on a day-by-day basis. These services can be essentially free and self-administered for club members.

In identifying groups of people who would benefit from becoming payment clubs, Fair Money is dependent on groups identifying themselves as ready to act in the interests of their members. No restrictions will be placed on the sorts of people who will be supported, because the potential for cross-support between groups is stronger the more diverse they are. Any group that is already aware of the limitations of consumer choice in meeting their needs is a candidate.

Fair Money is presently working with Wessex Reinvestment Trust and London Rebuilding Society.

If you are interested and would like to engage with us, please contact the authors of this paper.

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