Making a market: the UK retail financial services industry and the rise of the complex sub-prime credit market

Dawn Burton[1], David Knights[2], Andrew Leyshon[3*], Catrina Alferoff[2] and Paula Signoretta[3]

1 Leeds University Business School, University of Leeds, Leeds, LS2 9JT, UK

2 School of Management, Keele University, Keele, Staffordshire, ST5 5BG, UK

3 School of Geography, University of Nottingham, Nottingham, NG7 2RD, UK

***** Corresponding author

Submitted to *Competition and Change*

June 2003

13,903 words

Making a market: the UK retail financial services industry and the rise of the complex sub-prime credit market

Abstract

Except as a technical topic within finance or economics, credit is a much-neglected topic in the social sciences. This paper is concerned with a particular growth and development in the field of credit that appears to have intensified over the last couple of decades. Since the introduction of credit scoring, large sections of the population have been deprived of borrowing money from the mainstream institutions and this has led to the growth and differentiation of the sub-prime market. One part of this market concentrates on consumers with comparatively low incomes and offers loans of limited denominations and collects the repayments door-to-door on a weekly basis. We call this the traditional sub-prime market for credit. Here interest rates are extremely high, largely to cover the costs of household collections but also to insure against default. A second part of the market is what is termed the complex sub-prime market, where customers are categorised as 'non-standard' because of their financial history, which may or may not include earning very low incomes. The distinction between these two markets coincides with that between the 'old' and the 'new' economy. The complex sub-prime market largely distributes its service electronically through the Internet and telephone call centres, whereas the traditional sub-prime market is dependent upon a face-to-face delivery system. In place of a standard pricing system, the complex sub-prime companies operate a risk pricing strategy related to the customer's repayment history. The paper examines these two sub-prime markets from the point of view of their evolution, their importance to customers, and issues of education and regulation.

I. Introduction

Traditionally, the financial services have been a central element in the management of the economy in the UK and other western societies. They have always had close ties and complex interdependent interests with governmental regimes and a broad interpretation would see them as quasi-governmental agencies. Explicitly this has been connected with their role in mediating the funding of government debt and in serving as a vehicle for seeking to regulate the economic cycle through interest rate policy and the central management of credit. Less explicitly, the quasi-public role for financial services has taken the form of promoting financial self-discipline, social control and the maintenance of social order (Donzelot, 1980). Financial services have provided mediation between the individual citizen and civil society by locking consumers into the economy through their savings and investments, the insurance of human and physical assets, pensions and annuities, and the discounting of future income through loans. As both recipient and victim of government intervention, financial services have enjoyed a diverse range of fiscal privileges (such as, tax on savings and pensions), on the one hand, yet had their prices (that is, interest rates) and supply (for example, credit restrictions, exchange controls) constrained by the state, on the other. At the same time, financial services have existed in the general knowledge that the state would be very reluctant to allow financial institutions to fail because of the potential negative impact on confidence and trust within the rest of the economy. For financial services are an ‘obligatory passage point’ (Latour, 1990) for settling accounts, protecting risks, funding projects, social security, capital flows, and institutional investment. Historically their practices have been integrally linked to ‘social projects and forms of political rule’ (Knights and Vurdubakis, 1993: 759). Yet, it may be argued that this entanglement has taken on a new intensification with the ‘rolling back of the frontiers of the state’ (*ibid*. 758) in neo liberal regimes (Burton, 1994, Leyshon and Thrift, 1997).

As a topic for social science, in contradistinction to its treatment as a technical issue of financial analysis or for its consequences for the problems of financial debt[1], credit has been severely neglected. It could be argued that this is no more than a subset of the argument that, with limited yet significant exceptions (e.g. Marx, 1884; Simmel, 1990/1907; Crump, 1978; 1981; Ingham, 1984; Strange, 1986; 1988; Dodd, 1994), the analysis of money more generally is neglected in the social sciences. Corbridge, Martin and Thrift (1994), for example, argue that this neglect has been the result of a 'productionist' mentality, where the preoccupations of social scientists have been on economic production rather than consumption. However, as it has become more of a preoccupation of Western populations, consumption has assumed a place in academic research (Bauman, 1992). Likewise, the analysis of financial services have benefited from this development and, as a consequence, have begun to assume a place in social science more appropriate to its importance in the economy as a whole (Burton, 1994; Knights and Tinker, 1997; Leyshon and Thrift, 1997; Morgan and Knights, 1997). None of these studies, however, have been exclusively concerned with credit. Here the literature is much thinner (e.g. Ritzer, 1995; Shaoul, 1992; 1997; Jeacle and Walsh, 2002) and none of it really focuses on the subject matter of this paper – credit for the less affluent members of the population.

Although financial services have become increasingly pervasive, financial exclusion has also emerged as a significant problem among individuals in lower socio-economic groups (Collard, et al., 2001). As financial services have become integral within everyday life within contemporary society, their absence among certain social groups becomes more noticeable and problematic (Leyshon and Thrift, 1996). Evidence from the Government's Social Exclusion Unit reveals that 1.5 million low income households, comprising over two million adults, do not make use of mainstream financial services in managing their affairs. More than 10 per cent of households have no access to banking facilities. Despite the introduction of Basic Bank Accounts – introduced as a result of government pressure to provide a 'no-frills' money transmission product for the less well off – many individuals in low-income households continue to encounter barriers in opening bank or building society accounts. They do not require customers to be credit-rated because while they allow money transmission they do not permit customers to run up overdrafts or go into debt. However, many low-income individuals and households have expressed as aversion to these accounts for fear of running up debts, indicating a significant ignorance of the purpose of Basic Bank Accounts among the target group (Birmingham Settlement,

---

[1] For example, Corbridge et al (1994) have 26 references to debt but not even one reference to credit in their index.

2002). There is also a marked polarisation of assets in the UK. During the period 1979-1997 the ratio of households without any assets doubled from 5 to 10 per cent of the population (Policy Action Team 14, HM Treasury, 1999). Households that are most likely to be financial excluded are those headed by very young or very old people, lone parents or single pensioners, and by African-Caribbean, Pakistani or Bangladeshi people. These are some of the poorest households in Britain that have incomes of between £50 and £150 a week (Kempson and Whyley, 1999a).

The market for credit has undergone rapid change in recent years, as providers have sought to plug the gap left by more precise and technical calculations of credit risk through credit scoring. In effect, the risk aversive behaviour of the mainstream credit providers resulted in a section of the population being denied access to credit or, alternatively, pushed back on illegal moneylenders charging very high rates of interest. The *sub-prime* or non-standard market for credit, where low-income households excluded by the mainstream could secure loans, was thus given a boost by the more restrictive lending practices of the prime market. But restrictive credit scoring technologies also left space for another development that is perhaps a subset of the sub-prime market to which we give the name the *complex sub- prime market.* The major problem with credit scoring is that it is a technology constructed on the basis of a linear conception of the subject who is expected to have a stable or continuously improving employment and credit career. Recent research, and predictions of the future, suggests that consumers may not necessarily have continuous employment and life-chance careers, and/or the stable life experiences that are the life-blood of credit scoring techniques (see for example, Allen and Henry, 1997; Leslie and Butz, 1998; Vosko, 2001). For example, there are 1.8 million contingent or non-permanent employees in the UK, representing about 7 per cent of the UK working population. The number of men employed in such positions almost doubled between 1988 and 1999 (Cam, Purcell and Tailby, 2003). Meanwhile, household stability has declined dramatically with one in every three marriages ending in divorce – an event that has severely disruptive financial consequences – while married households are now a minority category, and there has been a large increase in single parenting (Lewis, 2001).

Constructing the subject from a series of life-style characteristics in a universal and unilinear manner, as credit scoring does, may not only result in the exclusion of many credit-worthy consumers but also, on the other side, could admit many malfeasants[2]. Treating the consumer as a universal subject with a stable linear history can have negative as well as positive consequences for both the consumers and providers of credit and it may be seen as a damaging side effect of the technology of credit scoring. The sub-prime and complex sub-prime market provision has awoken to this and the growth and profitability of their business has encouraged the prime market providers at least to dip their toes in the water by developing or acquiring subsidiaries to service these alternative markets. Broadly, it is the complexities of the credit market that have been partly opened up by the new surveillance technologies of credit scoring that is the focus of this paper.

Our argument is that the credit market has expanded dramatically in terms of volume over recent years as the result of changing economic and social circumstances. For example, there has been an increase of consumer credit of approximately 1300% over the last 10 years (see www.statistics.gov.uk /statbase /TSDtimezone.asp). There was £64 bn of outstanding personal debt in the UK by the end of 2000, according to government figures (Howells, 2001). The corollary of this indebtedness is that there is an estimated £27bn shortfall, or savings gap, in provision for security in older age (Oliver Wyman, 2001). Consumerism, comparatively high incomes, low interest rates and the proactive marketing of credit from a highly competitive sector of the financial services have provided the conditions for this exponential growth in borrowing. An increase in the volume of credit has occurred alongside a proliferation in its forms. Much of this growth and proliferation, as we have argued earlier, has been a product of new provision responding to financial exclusion from the prime market and its technology of credit scoring. However, some of the expansion could be seen as stemming from a more lax credit policy, as new-entrants struggle competitively for a

[2] While anecdotal, we know of one person whose employment status allowed him to run up credit card and bank account debts of over £100,000 that, because of holding no capital assets such as property, could be written off through going bankrupt with fairly limited negative consequences for his life. It is unlikely that this is an isolated case but the credit industry is not keen to advertise the fact since it represents a lacuna in what they would want us to believe is a near perfect credit scoring technology. Even when his debts had become unserviceable let alone repayable, this consumer was still bombarded with numerous credit card offers. It could be argued that the frantic competition for market share leaves the credit card companies vulnerable to major scams of this kind that could be classified as a form of white blouse/collar crime.

share of the market. The disciplinary procedures of the prime providers have opened up or widened the gap between the credit worthy and the excluded. There is a space that lies between standard credit on the one hand, and the unlicensed, illegal moneylenders on the other, with the latter largely regarded as unacceptable exploiters of the poor (see Department of Trade and Industry, 2002). Within this space, two types of credit providers are to be found: the traditional sub-prime companies and the new complex sub-prime providers. These two sets of firms can be seen to correspond broadly to the dichotomy between the 'old' and the 'new' economy.

As has been suggested, there is a fairly limited social science literature on credit and almost nothing that resembles a theorisation of these developments. Rowlingson (1994) recognises that moneylenders have provided a valuable service to certain sections of the community, but does so without theorising or historicising their existence. In fact, the provision of personal credit has a long history, stretching back at least as far as the 16th century when small haberdashers gave free credit to their customers and demanded it likewise from their suppliers (Davis, 1966: 57; 61). Personal credit proliferated during the 18th century due to the scarcity of coins (ibid. 185). Part of this evolution was the emergence of the less respectable or more unsavoury moneylender, who often used clothes retailing as a front for a more profitable trade in money:

> The London tally-man had an evil reputation as a moneylender whose shoddy goods were primarily a bait for clients and who made more money out of exorbitant interest and (so long as imprisonment for small debts was in force) out of defaults, than honest trading (Davis, 1966, 244-5).

To this day, licensed moneylenders ply their trade often in relation to the drapery business, but what we have to recognise is that the discipline of the weekly collection is what makes it possible for consumers to borrow without default. Moreover, while traditional sub-prime companies build in the cost of default into the prices they charge, they do not make additional money from penalty fees charged to defaulting customers. However, the new providers offering a more remote technologically driven service are substituting the discipline of personal embarrassment with economic sanctions such that defaulting on a payment immediately and automatically generates a penalty in the form of a ratcheting-up of the interest rate.

Just as the sub-prime and complex prime providers have moved in to plug the gap created by the mainstream industry avoiding or departing from the more risky, unsecured sections of the market, we also attempt to fill a theoretical lacunae that has been opened up by this space. We are fortunate in being able to draw on Rowlingson's (1994) excellent descriptive account of the traditional sub prime market in the early 1990s. Her research not only records the number of companies and agents, the high rates of interest charged but also how the market was highly personal, friendly and female dominated (both in terms of agents and customers), and the convenience of the weekly call by the agent. She concludes that the licensed moneylenders provide a valuable service to a section of the population that would otherwise be denied credit (op.cit. p. 165). However, Rowlingson did not anticipate the proliferation of the sub-prime market from its principal method of distribution through a face-to-face, door-to-door delivery system to also include more remote alternatives, using sophisticated information and communication technologies.

Central to this development is the role of information and knowledge in the process of credit creation, its provision and administration. The combined effects of increased competition, because of economic deregulation and fear of the political regulators, have resulted in a major rethink of distribution strategies in financial services. The context against which this rethinking has occurred is the dramatic improvement in information and communication technologies, of which the Internet is merely the latest manifestation.

Given that credit-scoring technologies are often inappropriate in the non-prime market, how do lenders overcome information asymmetries and develop ways of determining the credit worthiness of their customers? Clearly, the sub-prime providers depend on the personal and often tacit knowledge of their door-to-door agents, combined with the disciplinary effects of the regular call. Defaults thus kept to a minimum can then be readily insured against through the high rates of interest on the loans. In effect, a premium is extracted from the majority of 'good' customers who maintain regular payments to cover those that default (Leyshon *et. al.*, 2004).

The newer complex prime market providers generally have chosen to avoid such labour intensive and expensive distribution channels. In their place they have sought to rely on the new 'forensic' technologies and electronic payment systems backed up by elements of ‘secured’ lending (e.g. car loans) and/or automatic penalties for payment defaults (e.g. a hierarchy of interest charges related to repayment history). Here, then, we have a complex set of developments that the social sciences have largely ignored. This is understandable up to a point since credit is basically a means to some other consumption end. But only up to a point. In neglecting the production and distribution of credit, researchers fail to consider how providers *adapt* to, as well as produce, certain kinds of consumer subjectivity. For example, following Foucault, Jeacle and Walsh (2002) examine the nature of consumer credit in the context of the rise of the US department store. However, they concentrate only on the ways in which credit and its methods of allocation have traditionally disciplined (or constituted) subjects. While this is valuable, it is equally important to show how the industry has adapted and responded to social and economic change, especially when the disciplining process has the effect of dividing off populations such that some (and not just those with no or low incomes) are excluded from credit.

The paper is structured as follows. Part II begins with an assessment of the definitions and scope of the three markets that are the empirical focus – the prime, sub-prime and complex sub-prime markets. It elaborates how the sub-prime and complex sub-prime markets have been created by the stricter and more exclusive credit rating practices of the prime market providers. Part III focuses more directly on the sub-prime markets, contrasting the ‘old economy’ face-to-face modes of delivery with the ‘new economy’ remote delivery systems that deploy advanced ICTs as mechanisms of forensic, surveillance, and distribution control over customers. In Part IV we examine how the ‘new economy’ sector of the sub-prime market has widened its scope to offer a full range of services (e.g. basic unsecured loans, partially secured loans, credit cards, and mortgages) and practices. It also reports on the expansion of the sector especially through second mortgages and an aggressive marketing of consolidation loans that restructure a client’s diverse debts within a single loan. Part V examines the problems of regulation especially for a sector that is not regulated at the point of sale, as are all other financial services. Although the Consumer Credit Act of 1974 was under review at the time of writing, there was no proposal to incorporate credit within the Financial Services Authority’s regulatory responsibility as has occurred with respect to domestic mortgages. The logic presumably is that domestic property is a capital investment in a way that goods bought on credit are not.

It means that credit will continue to be regulated by the Department of Trade and Industry and more focused on products rather than regulated at the point of sale. In Part VI we summarise the issues we have raised and examine the public policy and other implications of the growth and development of sub-prime markets. Part VII concludes the paper.

II The prime, sub-prime, and complex sub-prime markets: definitions and scope

Traditionally financial institutions in the UK have focused greater attention on the more affluent middle and upper classes in society. While Home Service or industrial branch insurance and the Friendly Societies have serviced the lower end of the market since the mid-19th century, these organizations have continually sought to extend their business upmarket. Banking and credit, on the other hand, have continuously expanded to incorporate the mass market. Due partly to post war affluence, but also to employers wishing to bankroll their wage and salary administration, bank accounts have become almost universal. The expansion of home ownership, and particularly the selling off of state housing and the growth of the credit card, has also extended credit downmarket. The consumer base for financial services has thus widened considerably sine the 1960s (Burton, 1994), although middle class consumers remain the segment of choice for the sector.

The financial services consumer has therefore been constructed by financial institutions according to a set of preferred characteristics and in particular sorts of ways (Knights, Sturdy and Morgan, 1994). Positive features include full-time, permanent employment, preferably with large employers, home ownership, married status, and a good credit history (Leyshon and Thrift, 1999). These characteristics and other positive attributes similar to them are indicative of individuals within the prime lending market. These individuals are readily approved by credit-scoring procedures and marketing strategies are designed to attract them. By contrast, consumers without these positive attributes are considered less desirable and are forced either to live without credit or pay the higher prices of alternatives – all of which are variants of the non-standard market.

Sub-prime and complex sub-prime credit means different things to different lenders but it is often defined by what it is not, rather than by what it is. For most lenders sub-prime means risks that are not 'blue chip'. For some companies, finance on cars over five years old will be classified as sub-prime. Individuals that have moved jobs more than three times in the last two years may be seen as sub-prime. For many mortgage lenders, the self-employed may be sub-prime. However, this is a largely superficial level of analysis, for all of these groups could be excellent risks and highly profitable areas of business. For example, the car could be a classic sports car, the person moving jobs could be a high earning company director, the self-employed person could be a highly paid, successful consultant. Some sub-prime consumers can be highly profitable even-though they fail a company's rigid rules for granting credit. Not all sub-prime risks are bad risks, which raises fundamental issue about the concept of risk-based pricing.

In the UK there are approximately eight million people considered 'non-standard' by the finance industry and who are routinely refused credit from prime lenders. This represents nearly 23 per cent of the population aged between 18 and 65 (Holmes, 2002). Approximately one quarter of all applications for credit are refused, a statistic that indicates the huge potential of the sub-prime market (Ryman-Tubb, 1999). A number of factors have contributed to such large numbers of people routinely failing to acquire credit. The boom-bust housing market of the late 1980s and early 1990s resulted in extensive negative equity and repossession, which damaged the credit standing of a major section of the market. As prime lenders tightened their criteria as a result of prior overzealous lending, many potential borrowers found themselves disenfranchised from credit (Euroweek, 1998).

The increase in temporary workers discussed earlier has also contributed to a growing pool of potential customers within the sub-prime market. The self-employed are also categorised as sub-prime borrowers since they may not have stable income or patterns of employment, and are perceived as a higher risk than employees in established companies. Currently, only two thirds of heads of home-buying households have 'permanent' full-time jobs, while a fifth have part-time, temporary work, or are self-employed (Council of Mortgage Lenders, 2001).

The numbers of individuals declared bankrupt is also an important contributory factor to the growing sub-prime pool since conventional lenders do not normally lend to bankrupts for three years while they are serving their discharge nor for a further two years afterwards. There are 50,000 undischarged bankrupts in Britain, the numbers of which is growing at 12 per cent per year (Jenkins, 2000). Personal bankrupts are not just credit card spendthrifts and victims of the consumer society. Many bankruptcies are the product of failed small businesses. If trends in the US are anything to go by, the rate of bankruptcy in the UK could increase further (Nelson, 1999).[3]

Credit scoring programmes also adversely score individuals that have defaulted on a hire purchase arrangement or other loans, or have county court judgements (CCJs) against them. By 1995, there were over 8 million county court judgements registered and outstanding in the UK. CCJs are the attribute most commonly associated with non-standard lending. Irrespective of whether a CCJ is satisfied or not, it remains on an individual's credit record for six years. A peak of 8.5 million CCJs were on credit records in 1995, as a result of repayment difficulties borne out of recession. By 2000, this figure had fallen to just 5.4 million, the lowest level for a decade (M2 Presswire, 2001). Another area of default that relegates some borrowers into the sub-prime market is mortgage arrears. In 1997, more than 2.5 million people had arrears on their mortgage account (Bolton, 1997).

The sub-prime market has emerged to cater for those individuals with adverse credit histories who, because of their credit rating, fall outside standard lending criteria. Complex sub-prime, meanwhile, is a specialised sub-category of the market that fulfils the needs of consumers who fall outside of standing lending criteria because their needs and circumstances are slightly unusual, but whose credit histories are not necessarily impaired. Consumers in the complex sub-prime market have fallen between the proverbial rock and a hard place: they have been rejected by standard

[3] Indeed there are so many bankruptcies in the US that it has become far more socially acceptable than it once was and has led to new definitions of bankruptcy status. Ironically, individual consumers declaring themselves bankrupt and therefore 'wiping the slate clean', automatically become good credit risks for banks and other financial institutions (Klein, 1999). Similar trends are afoot in the UK. The Enterprise Bill currently going through a second reading in the Lords at the time of writing will allow 'innocent' individuals who go bankrupt to be discharged after one year or even less as opposed to the current three years. Distinctions will be drawn between culpable and non-culpable bankrupts and thereby generating 'good' debtors who are allowed a fresh start and bad ones that are punished (Financial Times, 2002). It is notable that many basic bank accounts in the UK, that were designed to

lenders but do not belong to the traditional sub-prime market. For the most part, they require bespoke solutions catering for their individual needs.

Complex sub-prime demands a different approach to underwriting, whereby a skilled underwriter who has the ability to think ‘outside the box’ considers each case on its own merits. By definition, it is not possible to provide a definitive profile of a complex sub-prime client. Their circumstances and requirements vary. However, one example of a real life scenario is presented in Box 1 (Cummings, 2001). This couple were far removed from what might be seen as the typical sub-prime borrower. Sun Bank, one of the key players in the complex prime mortgage market, reflects the ethos of the complex market in its publicity, which rejects credit scoring in favour of person-to-person interaction, claiming that, ‘Our systems don’t force us to cherry-pick narrow categories which means that we lend to those clients whose circumstances and/or needs are out of the ‘ordinary’’.

Insert Box 1 about here

The prime, sub-prime and complex sub-prime categorisation goes some way to assessing the realities of obtaining credit for consumers in Britain. However, what is not known are the numbers of individuals failing to apply for credit for fear of being turned down. Research in the US indicates that the numbers can be considerable, with certain minority groups, such as African-Americans, Hispanics and single females being more likely to be discouraged from applying to particular lenders, even though they are not more likely to default (Crook, 1999).

III ‘Old’/ ‘New’ Economy Sub-Prime Credit Provision

New developments in the sub-prime credit market have generated radically different types of organisations than those found in the ‘old economy’ suppliers who collect premiums from door to door and are hence extremely labour intensive (Table 1). Moneylenders and industrial branch insurance sales people collect premiums from customer’s homes on their ‘round’, with applications for new loans completed by

help disadvantaged customers that would otherwise use the sub-prime market, actively discriminate against bankrupts.

agents on behalf of customers in their homes. In contrast, new modes of sub-prime lending are not labour intensive. They predominantly take the form of direct marketing through advertisements in the tabloid newspapers, 'informercials' on commercial channels (particularly Channel 4 in the afternoons) and on web sites. Sub-prime providers have, therefore, adopted many of the newer practices of call centres and Internet delivery adopted in other areas of financial services in recent years (Knights Noble, Vurdubakis and Willmott, 2001). As in other part of the financial services industry (Leyshon and Pollard, 2000), the deployment of these non-labour intensive, 'at-a-distance' means of service provision have lowered the barriers to entry to the sub-prime market which has seen a rapid increase in the number of firms active within it.

Insert Table 1 about here

The personalised nature of the service delivery is also a defining feature of traditional providers. Moneylenders and mail order agents could become close to their clients, in some cases 'like one of the family', if they were not blood relatives already (Ford and Rowlingson, 1996). One of the important hurdles to be overcome in the development in the delivery of financial services 'at-a-distance' is to compensate for the absence of the personal face-to-face relationships between producers and consumers (Burton, 2002a). Many complex sub-prime companies stress the importance of a personal approach to lending decisions in their marketing communications, despite not providing a face-to-face delivery. This strategy is likely to be particularly welcomed by consumers that have been rejected by traditional credit scoring procedures that they may have perceived as impersonal and clinical. It is exemplified, for example, in Firstplus' advertising copy: 'Make your dreams a reality with a secured loan that offers you competitive rates, an extended repayment period and an intelligent, people-based approach to lending'. An extension of this personalised approach are customer testimonials that were actively used in promotional literature especially on web sites. An attempt to develop 'parasocial' relationships (Stephens et al., 1996) is evident with respect to Ocean Finance's television commercials, that included no less than six different customer testimonials.

While old economy, door-to-door sub-prime suppliers (such as Provident Financial, Shopacheck, S&U, etc.) have been low users of technology, the new providers rely on more remote distribution strategies of media advertising, direct mail, telesales and the Internet, and tend to be heavy users of ICTs for both communications and managing customer accounts. Most sub-prime companies have web sites that provide marketing material including brochures, product information, and sections on frequently asked questions, customer testimonials, and budget calculators. It is noteworthy that complex sub-prime financial service suppliers were the first to offer mortgages on-line. Many companies also incorporate on-line application procedures as part of the package. Fully automated mortgage application processes include on-line case tracking, direct email contact with the case underwriter, product matching quotations and downloadable marketing material. The use of the Internet has enabled both a quicker processing time and swifter decision-making. In addition, technology is often presented as a way to keep costs down for customers. Some of these positive features are reflected, for example, in Future-Mortgages.co.uk advertising slogans, which include the following strap line: 'Consider it Done. Same Products. Same Answer. Just Faster' (Bolton, 2000).

A further distinguishing feature between old and new economy sub-prime providers is their level of marketing expertise. Traditional providers displayed very low levels of marketing expertise. Marketing largely took the form of relationship marketing among friends and relatives and developing and utlizing personal networks of contacts within localities. Analysing markets and calculating the profitability of each was not on the agenda. Within the new sub-prime institutions, marketing expertise is prominent and not getting it right can have some profound consequences. The challenge for sub-prime institutions is to find the right prospects for their products but simultaneously to identify those who have the ability to pay. The inability to get this right has led to high profile failures in the US, including The Money Store and First Plus Financial, who were both overly optimistic about the overall market's ability to support sub-prime loan portfolios. As a result, the Federal Reserve has established more detailed guidelines on capital ratios for sub-prime lenders (Federal Reserve, 2001). This demonstrates that these at-a-distance, 'new economy' means of evaluating credit-worthiness can be somewhat more risky than the 'old economy' more tacit, evaluations through face-to-face contact. They, of course, lack the discipline that is engendered by the weekly visit of the agent who the client does not want to disappoint by defaulting but also who ordinarily times her call (e.g. on pay day) to best coincide with the probability of securing the repayment.

Because they often rely on remote distribution and even when a subsidiary of a big corporate brand are denied its facilities to avoid brand erosion, the ‘new’ economy companies will use celebrity endorsements in their advertising. For example, TV-celebrity Carol Vorderman endorses the Firstplus secured loan, giving the product a strong air of respectability. As a well-known statistician, she conjures up images of intelligent purchasers buying a reputable product. A personalised approach was also reflected in pseudo paternalistic attitudes towards consumers with respect to building up a good credit history and putting negative experiences behind them. The purchase of their products, if serviced competently, could erase poor financial performance in the past, holding out the promise of a better credit standing in the future.

To a large degree, credit scoring is kept separate from marketing with different chains of command in operation within large US financial institutions (Treacy and Carey, 2000). The overwhelming focus has been on developing strong prospect databases. A strong database is one that is multi-sourced, since a single provider cannot provide all the important information. The main sources of data in sub-prime mortgage lending include that from credit bureaus, data compilers, census information and data from public records, including tax records and mortgage deeds. The high degree of multi-sourcing has resulted in a very dense network of organisations operating in the sub-prime market. Among the various sources of data, that from the credit bureaus is the most important. Sub-prime providers such as Centex have calculated that when they solicit business from a ‘prospect universe’, there is a five times greater probability that they will originate a successful response to a loan offer. A very high consideration is given over to making the targeting as cost effective as possible. The preferred method of database marketing is telesales, since prospects can be immediately transferred to a loan officer if they want a loan. Direct mail is another option although it is not normally the first choice. Much of the telemarketing is outsourced to specialist operations since it is fairly simple to implement and it is not a complex script. The use of 0800 numbers and web sites further enhance marketing opportunities.

Used car superstores directed at the sub-prime market emerged as a substantial presence in the US in the late 1990s. The characteristics of the so-called ‘hi-tech, big-box stores’ include an extremely large section of used cars and high volume selling. A theme park atmosphere, including unified signage and areas for video entertainment for children and sometimes the addition of fast food. Computer screens are used for bringing up displays of cars in inventory plus retail data on prices and features. Non-negotiable on-price selling, and the availability of sub-prime in addition to ordinary finance, support sales in such outlets.

The new sub-prime players are, therefore, fundamentally different from traditional suppliers in the alternative credit market. They can be seen to reflect the ‘new economy’ of micro-electronic information, communication, distribution and administration of accounts, trading more remotely than their ‘old economy’ counterparts. While occupying a market space that is a ‘fall out’ from the prime market having excluded large numbers through their credit scoring technologies, complex sub-prime providers actually use much more sophisticated credit rating technologies through differential pricing according to risk profile. This ensures that they make a profit regardless of the level of risk. A hierarchy of price banding means that a client will be charged automatically in accordance with the stability of their repayment history. Unlike the dot.coms, this sector of the ‘new’ economy seems destined to remain comparatively secure and indeed to expand since it has adapted to changing customer segments and, in effect, customises at least at the level of risk assessment and pricing. The next section of the paper examines the way in which the new economy sub-prime providers have expanded the nature and scope of their market.

IV Nature and scope of sub-prime products

Forecasting financial risk has been one of the major growth areas in statistics and probability modelling over the last thirty years. Credit scoring and behavioural scoring with respect to consumer lending has increased rapidly. In the US or UK average adult is being credit scored or behaviour scored at least once every week. To cope with the increasing demand, the number of credit analysts doubled during the second half of the 1990s. Although many consumers are unaware of being scored this does not detract from its importance (Thomas, 2000).

Credit scoring has its roots in the US and was first used by finance houses and mail order companies to predict the level of risk associated with providing credit to particular groups of consumers (Leyshon and Thrift, 1999). Decisions on whether to provide loans were made by credit analysts using rules of thumb acquired over many years of experience. During the war years many credit analysts were drafted into military service and this resulted in a shortage of individuals with the requisite expertise. Organisations captured the skills of the analysts by getting them to write down their rules of thumb so that they could be used by non-specialists to make credit decisions (Johnston, 1992). The development of credit cards in the 1960s made the banks and other credit card issuers realise the usefulness of scoring, particularly when allied to the emergence of commercial computing power, as the number of individuals applying for credit made it impossible in economic and manpower terms to use a manual system. In the process they also found that credit scoring was a much better predictor than judgmental schemes and default rates declined by 50 per cent or more (Myers and Forgy, 1963).

By the 1980s, the successful use of credit scoring in issuing credit cards meant that banks were willing to extend its use to other personal sector products including personal loans, home loans and small business and corporate sector lending. Furthermore, in the 1990s, the growth in direct marketing has led to the use of scorecards to improve the response rate to advertising campaigns. Currently, scorecards are being used not just to minimise that chance of customer default on a loan but in terms of assessing how the firm can maximize the profit it can make from that consumer. Issues such as estimating response, usage, retention, attrition and debt management are increasingly becoming important issues. Contemporary methods for credit scoring include statistical models, credit scoring methods, rules of thumb and intuition. The technique often depends on the complexity of the institution and the size and type of the loan. Credit scoring does not completely eliminate the need for non-automated decision-making. The selection of cut off scores is an interpretative decision in instances where applicants have scores between accept and reject. To personalise or remove human interpretation from credit assessment altogether, many institutions have explored the use of artificial intelligence techniques including neural systems and fuzzy logic that aim to reproduce ways in which the brain deals with and learns from information (Malhotra and Malhotra, 2002).

Developments in computing have enabled financial institutions to extend risk assessments beyond the relatively crude credit scoring techniques. The latter have a standard price or interest rate and either accept or reject applicants on the basis of class, occupation, and other lifestyle characteristics. By contrast, the complex sub-prime providers vary the price in accordance with the risk. An example of risk-based pricing in the UK is provided by Future Mortgages an on-line financial services supplier. The company varies its mortgage rate according to the consumer's previous credit history and loan to value ratio (Table 2). The highest rates of mortgage interest are charged for consumers who have significant amounts of credit arrears or have a number of County Court Judgements against them, but bankrupts are excluded until discharged. The lowest rates of interest offered apply to consumers who have a maximum two months credit arrears with no deterioration within the last three months. County Court Judgements are acceptable, but there has to be no evidence of deterioration within the last three months. Bankrupts will not be considered.

Insert Table 2 about here

In the UK sub-prime mortgage market, interest rates are generally set at three to four percentage points higher than standard loans despite there being more competition in this market in recent years. Lenders argue that these higher costs are a result of higher underwriting payments and pre-credit scoring underwriting skills that are needed to assess the riskiness of loans. However, it is worth noting that although sub-prime loans are set at higher levels of interest because of the risk of default, it is not necessarily always the case that sub-prime borrowers, even the ones with poor credit histories, do default. In recent times of full employment, comparative affluence, and low interest rates, defaults have been running at very low levels and sub-prime borrowers in the UK are less likely to default or declare themselves bankrupt than US consumers (Euroweek, 1998). To a large degree the expansion of the market is being switched from sub-prime borrowers with poor credit histories to the self-employed and temporary workers. The numbers of individuals with poor credit histories is actually falling (Mackintosh, 2000).

The scope of financial products available in the sub-prime market has been continually widened along the consumer lending spectrum to virtually include all the products in the prime market, including credit cards, mortgages, car loans, and consolidation loans. Because of the limited economic rationality or lack of knowledge about comparative interest rates among consumers, consolidation can promise savings even though charging well above prime market rates. This is largely because of the comparatively high interest rates charged on what are essentially unsecured loans when credit card balances are not settled at the end of each month. In this respect the sub-prime market operates in parallel to the prime market. Historically, the sub-prime personal loan market has been the preserve of finance companies through consumers wishing to purchase household furnishings and cars on higher purchase (ABA, 1997). As the market has expanded to other financial services including credit cards and mortgages, new players have been brought into the market.

One development that has acted as a catalyst for established financial services firms to move into sub-prime is the market for consolidation loans. One of the market leaders in the area is Firstplus, a wholly owned subsidiary of Woolwich Plc that was established in 1997. Since its foundation it has provided loans for over 50,000 households. The company provides consumers with secured personal loans for up to 25 per cent more than the value of their property (less their current mortgage balance) up to a maximum of £60,000. In its publicity the organisation states, 'A Firstplus loan lets you pay off expensive credit card bills, store cards, car and bank loans and wrap them into one concurrent, affordable monthly repayment'.

Car financing is a market that is experiencing rapid growth within the sub-prime market in the UK[4]. One of the key players, Yes Car Credit, was established in 1997 and specialises in selling quality second hand cars. With a nationwide network of offices, it has provided finance for over a quarter of a million people since its launch. In its publicity the company states, 'At Yes Car Credit we exclusively approve people who have been refused credit elsewhere, whether they have CCJs/decrees, defaults, mortgage arrears, Council/Poll Tax problems, or simply no credit history. We can also

[4] The US sub-prime market is the fastest expanding of all lending sectors, and the financing of second hand cars to people with bad credit histories is the area exhibiting the largest expansion (Ryman-Tubb, 1999). The growing respectability of this sub-market is reflected by the fact that the world's largest provider of motor vehicle finance, Ford Motor Credit Co., created a new subsidiary in the late 1990s, Fairlane Credit, specifically designed to address the needs of the sub-prime market (ABA, 1997).

help the recently self-employed, tenants and people in the armed forces'. The company owns the cars it sells and provides the finance, therefore cutting out intermediaries. The company's interest rates are in excess of 19 per cent and are therefore higher than the normal rate charged by finance companies (see www.yescarcredit.net).

Potential credit card borrowers in the prime sector of the market are characteristically deluged with offers of pre-approved credit cards. Financial institutions have clambered for their business by providing numerous offers of interest free borrowing for a specified period of time that allows savvy middle class consumers to move debt from one supplier to another without paying interest. Many other affluent consumers pay their credit debt off at the end of each month, a practice that is highly unprofitable for issuers. Sub-prime borrowers are unlikely to be afforded such luxuries. If they do not already own a credit card, they are likely only to be offered secured cards, or at higher than average interest rates and fees. Unsecured credit cards have been somewhat of a late and reluctant addition to the sub-prime portfolio, but can be highly profitable since many borrowers are likely to use them for revolving credit by paying a minimum balance each month at premium rates of interest.

In the US, both Visa and MasterCard have a portfolio of unsecured, partially secured, and secured credit cards. MasterCard's AmeriOneCard is specifically designed for people with limited, damaged, poor or even no credit history. In its publicity it states that no credit or bad credit is not a problem, there is a 100 per cent guaranteed approval rate, no current account is required, there will be no credit checks, and no employment verification. Secured credit cards require a deposit in direct proportion to the credit line granted (e.g. a $300 deposit is required for a $300 credit line). Partially secured cards require a deposit and the credit line is double that value (e.g. a $300 deposit will generate a $600 credit line).

During the last five years it is the sub-prime mortgage market in the UK that has attracted the most attention from financial service suppliers. The sub-prime mortgage market grew by 20 per cent in 1999, lending £5.9 billion, a share of almost 6 per cent of the total mortgage market. Furthermore, the potential for growth is considerable. Fewer than one in five of the population designated as 'non-standard' own their own home as opposed to 41 per cent of the total population (Mackintosh, 2000). A number of high street lenders are already in the market through separately branded and managed subsidiaries. Some of these organisations include Abbey National's HMC, Britannia's Verso, Bradford and Bingley's Mortgage Express, Bank of Scotland's The Mortgage Business and the Skipton Building Society's Ambro. Other companies operate in the 'grey' area between the prime and the sub-prime market. For example, Chelsea Building Society and Bristol and West are two such companies. Chelsea's Prospect Impaired Mortgage allows customers to have up to £10,000 of County Court Judgement's against them. First Active, a telephone and Internet company, also offer special deals for those with a CCJ history (Jenkins, 2000). One of the most well established dedicated sub-prime mortgage lenders, the Kensington Mortgage Company, provides mortgages for discharged bankrupts after one year of discharge compared to five years for standard lenders, but the company charges 2-3.5 per cent above standard rates.

The heightened credibility of the sub-prime mortgage market is reflected in the fact that there are 14 sub-prime lenders with membership of the Council of Mortgage Lenders (CML), including Future Mortgages, Southern Pacific Mortgages and the Kensington Mortgage Company. To prove the seriousness of the market, the CML has also set up a Non Conforming Lenders Working Group. This is an important development in the continuing emergence and growth of sub-prime lending and confirms the sectors respectability (Bolton, 2000).

V Sub-prime and the regulatory environment

The sheer growth of this market for credit presents distinctive regulatory problems since it comes under the purview of the increasingly outdated Consumer Credit Act of 1974. While this is currently under review, it provides only a loosely monitored licensing system and virtually no regulation at the point of sale, as in all other parts of the financial services. There has been some debate as to whether credit should come under the regulatory auspices of the Financial Services Authority (FSA). The sector has sought to resist this, but realises that its poor image could lead to an even more heavy handed regulatory approach, if some politicians have their way to outlaw providers who charged exorbitant interest rates. However, the mortgage part of the sector is to be regulated by the FSA from 2004/5 so that the exclusion of other forms of credit from this form of regulation is an anomaly.

A failure to supervise institutions effectively could in the longer term outweigh the potential benefits for consumers. The regulation of the sub-prime market has caused considerable concern in the US where the market is well established. In 2000, the Federal Reserve conducted an investigation into whether a stronger regulatory framework was needed to crackdown on what it perceived to be a practice of 'abusive' or 'predatory' lending. The Federal Reserve has defined predatory lending practices as those that 'have been designed to transfer wealth from the borrower to the lender/ loan originator without a commensurate exchange of value' (Federal Reserve, 2001: 10). There were particular concerns that mortgage companies were deceptively burdening vulnerable low-income borrowers with high interest rate loans and exorbitant fees that they were unable to pay, which resulted in default and re-possession of property. The US Equal Credit Opportunities Act 1976, outlawed the use of certain characteristics in the decision to grant in respect of gender, marital status, race, whether or not an individual receives welfare payments, colour, religion, national origin and age (Crook, 1999). This legislation has been reflected in statements by the Head of the Federal Reserve in respect of the sub-prime market when he stated that banks 'should discriminate, provided that the word means to measure and price risk properly with regard to legitimate economic characteristics' (Federal Reserve, 2001). He made clear that lenders 'should be prosecuted for discriminating if the word means granting credit or setting interest rates on the grounds pertaining to race, gender or other prohibited characteristics'. However, it is noteworthy that in the US, sub-prime lending is concentrated in black neighbourhoods (51%), low-income areas (26%), with only 9 per cent in predominantly white neighbourhoods and 7 per cent within upper income households (Sanghera, 2000).

Research in the US has identified a number of forms of lending discrimination in risk-based pricing of which regulators need to be aware including 'overt discrimination', 'disparate treatment' and 'disparate impact' (Federal Reserve, 2001). Overt discrimination involves situations where a lender blatantly discriminates on a prohibited basis. This form of discrimination was not thought to be widely prevalent in the US. Disparate treatment occurs when neutral practices are not neutrally applied, this often occurs through the use of employee discretion. For example, a lender may have neutral underwriting guidelines that establish credit eligibility. Nevertheless, the lender may make exceptions based on ‘compensating factors’ or overriding credit-scoring decisions. Similarly, a lender may provide some flexibility in documenting certain factors such as income or employment. When such flexibility is not exercised even-handedly between members of protected and non-protected classes, disparate treatment can and does occur. In risk-based pricing programs it is critical to review the process by which borrowers are assigned to risk classifications or ‘slotted’. Regulators in the US have made it clear that they will carefully review the slotting process when examining risk based pricing.

Disparate impact is the third category of discrimination and is by far the one that is most controversial. Disparate impact focuses on neutral practices that are neutrally applied but have a disparate adverse impact on members of protected classes. Assuming that borrowers are slotted even-handedly among risk classifications and that there are no price variations within each tier, the borrowers in the more risky credit classifications will pay higher prices than those in the less risky classifications. If one assumes that members of protected classes, on balance, may have credit characteristics that place them in riskier classifications, the matrix structure could result in some people receiving less favourable credit terms. If a disparate impact does result from a particular practice, a lender is asked to justify the practice. In particular, lenders may be called upon to demonstrate that the factors it uses to stratify risk are in fact predictive of risk; that is, that they are empirically based and statistically sound (Ryman-Tubb, 1999). This final point is a difficulty in the fast changing financial sector because large-scale historical and statistical data does not exist or the data and therefore the relationships of risk become out of date very quickly (Frank, 1996).

In the UK, specific sub-prime regulation is not as developed as in the US. Yet it is interesting to note that some of the marketing practices in the US, would not be allowed in the UK under the existing OFT Guidelines (OFT, 1997). For example, there should be no cold calling by telephone or home visits. Brokers, intermediaries and direct salespeople should not visit the borrowers home except at the borrowers specific invitation. Firms should avoid engaging in credit advertising by telephone to consumers who are known to be non-status if the credit being advertised would be secured on the borrower's home. In 1990, the Office of Fair Trading (OFT) expressed reservations about businesses marketing credit to individuals with serious debt problems. A number of factors were raised including the failure to assess the consumer's ability to pay, offers of inappropriate and sometimes catastrophic loans, and failure to explain that high brokerage fees could be charged and deducted from the loan. In September 1991, the OFT published a report entitled *Unjust Credit Transactions*. The report expressed particular concern about abuses affecting secured lending where non-status borrowers were induced to borrow on excessive or oppressive terms against the security of their home without adequately assessing their ability to repay the loan. A number of examples of unjust credit transactions included the following:

- marketing loans explicitly to those in debt;
- limited or no enquiries about income;
- a preoccupation with the value of the security rather than the ability to repay;
- undisclosed or unexplained and substantial fees;
- very high interest rates;
- increasing the rate of interest when the loan was in arrears;
- failing to give, or misrepresenting interest rates and Annual Percentage Rates (APRs), misrepresentation of the form, nature, purpose or long-term implications of the loan agreement; and,
- unacceptably high pressure selling techniques.

A further warning was issued in 1997 reinforcing many of these features as a result of further complaints that culminated in a report on Non-Status Lending: Guidelines for Lenders and Brokers. The Guidelines are wide-ranging in scope including advertising and marketing, transparency issues between lender and borrower, selling methods, underwriting principles, contract terms, dual interest rates and early redemption.

There is also disquiet within the financial services industry about some elements of the regulation governing sub-prime markets. For example, industry sources suggest that the scope for mis-selling sub-prime mortgage products is particularly rife due to the differential commissions independent financial advisors or other intermediaries attract for selling sub-prime products. The debate is not around introducing restrictive practices, for if a lender wishes as part of its sales strategy to pay intermediaries a certain fee level, which is not really the concern of regulators. Their concern is primarily about transparency or fee disclosure. One perspective on this is that the client should have all the relevant information, including information about fees, paid as a result of their mortgage application, so that the mortgage recommended is the most suitable regardless of the fee.

Until recently the regulation of mortgage practices was extremely limited because it fell outside the FSA regulatory regime which was focused on savings and investment rather than borrowing. But since the mortgage is a major means to capital appreciation through home ownership, its exclusion was not even justified on the basis of the FSA's terms of reference. More importantly, home mortgages are one of the most significant of investments for the average consumer and there have been a number of scandals surrounding their distribution, not least of which was the linking of life assurance endowments to them. This particularly came to light when, because of the fall in the value of the stock market, endowments were delivering a shortfall on the mortgage loan on maturity. Since these were regulated under the FSA, customers could demand compensation if the endowment had been sold without full information about the absence of any guarantees on maturity values. It is here that the various distributors of mortgages (e.g. banks, building societies, intermediaries, sales representatives, and professionals such as accountants or legal advisers) could have been guilty of misselling. Although the endowment advice was regulated under the FSA, it raised the spectre of a relatively poorly regulated mass commodity in mortgages. There had been a voluntary Mortgage Code since the 1990s but no compulsion. This has now been changed and the FSA has taken responsibility for regulating the mortgage providers who in turn are to regulate their own staff and the intermediary distributors, a comparatively costly burden (Bolton, 2001).

VI Discussion: public policy and other implications of the sub-prime market

The complexity of risk-based priced financial products and the obvious difficulties of regulating the market clearly raise some important public policy issues. There is little question that, while considered exploitative by many due to the high interest rates and/ or other charges, the sub-prime sector provides products that significant minorities of the population seek or cannot resist. In short, it provides a valuable service (Rowlingson, 1994). We do not wish merely to reproduce the discussion that Rowlingson provides in drawing up a balance sheet between the positive claims of the sector and the negative view of critics. While some of her findings can apply to the fast growing 'new' economy, complex sub-prime sector, the high costs of door to door collection, cross subsidisation from the poor to the even poorer through standard charging rather than risk pricing are specific to the 'old' economy sector that she studied. She also concluded that putting a ceiling on interest rates could result in every provider setting rates near the maximum when they could actually be lower. This is even more the case in the 'new' economy sector where rates are much more directly related to risk as calculated through what we have called the forensic micro-electronic technologies. Overall, because many, if not most, of the clients of the sub-prime only have the choice of borrowing through this medium or not at all, their eradication would only lead consumers into the hands of the much more exploitative illegal money lending sector. Heavy regulation other than interest rate caps might also increase the cost of borrowing in the sub-prime sector since the providers would most likely pass the costs on to the consumer.

The most vociferous demand on the part of regulators is for transparency and other government agencies and consumer interest groups generally endorse this. Part of the reasoning behind this pressure is the belief that when consumers have all the information, they can compare offerings and put pressure on providers to compete with one another to become more efficient. This is the rationale that informs competition policy and it is clearly based on the theory of the sovereign consumer driving efficiency through the power of their rational economic choices. In practice, this rarely works as the model suggests because of a range of factors from the absence or limited levels of economic rationality among consumers, through low levels of knowledge with which to evaluate diverse information, to problems of information overload. These obstacles to rational choice within the sub-prime credit market are intensified and therefore even less applicable than in other areas of consumption. Still the regulators pursue the transparency goal with almost irrational enthusiasm (Knights *et. al.*, 1999). This preoccupation with transparency as a regulatory principle for intervention is not only promoted by the FSA but also by other agencies[5], including consumer pressure groups such as the Consumers Association.

Aldridge (1998) notes that an informed public of sovereign consumers that are rich in cultural capital has not accompanied a massing of the financial services market in the UK. As a consequence of their lack of cultural capital in the form of financial education, consumers have, in effect, co-operated in their own exploitation by allowing unethical financial advisors to miss-sell pensions, mortgage, and insurance. He adds that the development of a commodified mass-market of financial services implies a lowering of the threshold not just in economic terms but also in relation to the level of cultural capital (in the form of financial education) needed for their acquisition. The lack of financial education would be viewed as having a disproportionately negative effect on consumers in lower socio-economic groups that comprise the non-status, non-conforming or sub-prime borrowers. This issue was recognised by the OFT (1997:6) when it stated that these groups of consumers ‘maybe less knowledgeable or experienced in financial matters than the generality of consumers, and on the whole they are more vulnerable’.

The lack of experience of financial services and institutions could also be compounded by other factors such as low levels of numeracy and literacy. Wallendorf (2001) highlights the importance of integrating the issue of literacy into discussions of consumer behaviour *per se*. The ability to read is clearly an important aspect of most forms of consumer education, but low levels of literacy can also have important implications for other aspects of higher order information processing including responding to persuasion, decision-making and discerning the meanings of products and brands. While low levels of numeracy and literacy clearly restrict a consumer’s power to make rational choices, they are probably less important than the

[5] The absence of transparency has been a central complaint of a Treasury Select Committee criticism of the prime market credit card interest charges. Because of different settlement procedures and charges,

tendency for consumers to disregard detailed terms of contract when the desire for, or convenience of, the product is strong. Credit card borrowing among the highly educated is evidence of this. Highly educated prime market consumers regularly allow their debts on the credit card to accumulate thus paying rates of interest that begin to approach the lower end of the sub-prime market whereas they could readily borrow from their banks or mortgage companies at standard rates of interest. It could be argued that credit card debt just creeps up on a consumer largely because of the convenience and no-hassle factor, but it results in what might be seen as a 'stealth cost' in high interest charges on outstanding balances.

Consumer education can be a particularly valuable strategy in relation to the marketing of complex services and in the context of particular groups of consumers (Burton, 2002a, 2002b). However, financial institutions in the UK have failed to use consumer education as a competitive strategy, unlike practices in the US where consumer education is highly segmented according to the needs of particular groups of consumers (Burton, 2001). The few consumer education initiatives that have been introduced in the UK and those that do exist have been relatively recent in origin. Many educational initiatives have been directed at young people in formal education environments (Ewells and Knights, 1999). It also has to be said that many of these initiatives have had an ulterior motive, such as that of recruiting future staff (Knights et al., 1999). Currently the Personal Finance Education Group (pfeg) – an organization composed of the industry, educators, regulators, and government departments – is developing educational materials for schools to use in their Citizenship and Personal Health and Social Education curricula (see www.pfeg.org).

McNeal (1978) suggests that there are considerable advantages of viewing consumer education as part of a competitive strategy. One positive aspect is that of obtaining and keeping satisfied customers. In this respect, consumer education could be an essential aspect of a relationship marketing strategy. A second feature is developing a positive attitude among consumers towards a product or company: 'Being honest, open, informative - telling the whole story about a product - impresses people' (page 52). A third positive aspect of incorporating consumer education as competitive strategy is that it may please consumer advocates and reduce confrontations with

annual percentage rates (APRs) are not meaningful as a way of comparing one credit card with another them. Viewed from this position, appeals from government and consumer groups that businesses should take a more active role in developing and delivering consumer education is a blessing in disguise. What might first appear to be a somewhat onerous task could be a rewarding strategy. Put simply, consumer education could be a major competitive strategy that will generate more income for business, more satisfaction for consumers, and appease government and consumer groups. In a highly competitive marketplace a consumer education strategy could be integrated into promotion, product/service design and service quality. Another benefit of education is probably its aggregate impact in that – like consumer advertising – the whole market expands thus benefiting all companies although creating the problem of 'free riders'.

However, to be most effective, such educational programmes would need to be targeted at particular areas. There exist distinctive 'ecologies' of financial knowledge that have particular geographies (Leyshon, et. al., 2004). At the extremes are affluent, middle-class suburbs comprising the financially 'super-included' that have high levels of financial knowledge and income. Individuals in these households hold multiple accounts and there is considerable movement of products among consumers (such as in the case of credit cards, for example). These affluent consumers are beneficiaries of the competition between financial institutions. At the other extreme are individuals in the lower socio-economic groups who reside in poor inner cities or on local authority housing estates and who generally have poor levels of financial knowledge. These groups comprise the financially marginal or excluded that are disadvantaged by the absence of a financial infrastructure in the form of mainstream financial services branches and, in some cases, even ATMs where education is most needed but often most restricted, because of low levels of confidence, literacy and numeracy.

Affluent consumers are actively encouraged to shop around between mainstream financial suppliers. The financial media, by undertaking comparisons between different financial service offerings, facilitates this process. It is well established that most financial service consumers do not shop around (FSA, 1999; FSA, 2000) and that their propensity to do so varies between different financial services products (Burton, 1994). For those consumers that have to resort to sub-prime providers,

---

(Today, 2002).

shopping around for the best deal is not a realistic option. For example, each time a sub-prime consumer applies for a mortgage, a credit check is run that counts against the consumers credit history. If this undertaken with more than three different lenders, the credit record looks more risky. Consumers are largely forced into the hands of intermediaries, but this can be a risky business particularly in the context of less scrupulous brokers. Arrangement fees for sub-prime mortgages can be up to six times the standard rate. Financial intermediaries therefore have a vested interest in keeping their customers ignorant.

The inappropriate practices identified by the OFT with respect to the sub-prime market that were outlined in an earlier section of the paper, clearly signal a need for an integrated industry education strategy specifically designed for the needs of sub-prime borrowers. What an appropriate programme would include and how it might be most effectively delivered are issues that need to be addressed as a point of urgency in the near future. However, we do not believe that education alone is a solution to the problems. Not only does it take a long time before it is effective but in parts of the sub-prime market, there is often not the base of numeracy and literacy from which to begin an educational programme.

VII Summary and conclusion

We can see that the sub-prime market plugs a gap that has expanded and become more differentiated partly because of the increasingly restrictive developments of credit scoring in the context of standard pricing within the prime market. While the old economy, traditional sub-prime door-to-door providers have a long history, credit scoring has been both a condition and consequence of the new economy providers. Standard pricing forms of credit scoring began to exclude a much broader section of consumers whose histories and life styles did not facilitate securing high enough credit scores for acceptance in the prime market. But credit scoring also enabled the new sub-prime providers to rate risk and to differentially price their customers in a bespoke manner. However, this interpretation is a little too simple because the sub-prime providers would appear to be not simply responding to, but also *constituting*, this market. Their advertisements, agents, telesales, and a variety of innovative sales gimmicks (such as debt consolidation) are not simply a response to, so much as a creation of, consumer demand. They have much support in this construction of a market since consumers are perpetually bombarded with demands to consume. In a consumer society, ‘appropriate’ consumption is a part of what of what constitutes a sense of self. Indeed, for some commentators consumption has displaced production as an essential aspect of identity (Miller, 1995).

The early debate around the ‘new’ economy tended to see it as a solution to production problems (such as the high costs of bank branches) and assumed that consumers would fall in line. In many ways this did not happen and, as a result, we have seen an equally hyped negative narrative around the ‘new’ economy (Knights et al., 2002). The sub-prime credit companies could be seen as unique and comparatively successful because they began not with their own production or distribution problems so much as those of the consumer and then drew on the new technology and differential risk pricing to manage the problem in a bespoke, customised manner. As an alternative to the ‘old’ economy of door-to-door collections, companies deployed the banking system to facilitate electronic collections of repayments and a forensic technology to generate risk-pricing alternatives to standard pricing.

As regards regulation, we believe that the preoccupation with transparency is misplaced. Consumers are already overloaded with information in the field of personal finance and this often encourages them to trust anyone who can cut through the mass of information and guide them in what to do. Clearly we are not against transparency but, following Foucault (1984), we would not be entirely supportive of it either. Instead we remain sceptical that regulators should accord it so much *priority.* The reasoning of the regulators is drawn from an ‘old’ economy world where a universal rationality independent of context was seen as appropriate. Whether that was ever as appropriate as claimed is questionable, but given the diversity and fast changing nature of many people’s contemporary lives, it has currently to be treated with some scepticism. This raises the issue of how different kinds of ‘rationalities’ operate within different cultural milieux, and at different phases of a person’s life. For some people, the use of moneylenders might appear rational as they are living in environments that are at times ‘short-term’ and volatile. Here the flexibility and short lending periods of moneylenders may ‘make perfect sense’ within what may be a transitory period of a person’s life. The sub-prime providers have clearly been sensitive to the highly complex, fragile, precarious and shifting life world for many consumers for credit and have been innovative in both responding to, and attempting to extend, this market. The regulators would do well to be as innovative and flexible in their strategies if they are to meet the challenge that they face.

References

ABA (1997) ‘Three Trends are Reshaping Auto Finance’, *ABA Banking Journal*, 89 (2) pp. 34-7.

Aldridge, A., ‘Habitus and Cultural Capital in the Field of Personal Finance’, *Sociological Review*, vol. 1, no 1, 1998, pp. 1-23.

Allen, J. and Henry, N. (1997) 'Ulrich Beck's risk society at work: Labour and employment in the contract service industries', *Trans Institute of British Geographers*, **NS 22,** 180-196.

Anderson-Gough, F., Knights, D., McLean, C. and Ewels, J. (1997) *Personal Finance Education Within Schools*, Financial Services Research Centre Working Paper, UMIST, UK.

Bauman, Z. (2000) *Liquid Modernity*, Cambridge; Polity.

Birmingham Settlement (2002) Personal communication.

Bolton, M. (2000) ‘A Break From the Norm’, *Mortgage Guide*, October, 15-17.

Burton, D. (1994), *Financial Services and the Consumer,* Routledge, London.

Burton, D. (2000), “Consumer education, service quality and the 4ps”, in Edvardsson, B., Brown, S.W., Johnston, R., Scheuing, E.E. (eds) *Service quality in the new economy: interdisciplinary and international dimensions*, New York: International Service Quality Association, pp 242-250.

Burton, D. (2002a) ‘Postmodernism, social relations and remote shopping’, *European Journal of Marketing*, 36, **7/8**, 792-810.

Burton, D. (2002b) ‘Consumer Education and Service Quality: conceptual issues and practical implications’, *Journal of Services Marketing*, 16 (2) 125-142.

Cam S., Purcell J and Tailby S (2003) ‘Contingent Employment in The UK’ in O. Bergström & D. Storrie, Editors (2003) *Contingent Employment in Europe and the United States,* Cheltenham: Edward Elgar.

Carey, J. J. (1996) ‘The Sub-prime Credit Market: Identifying Good Risks for Unsecured Cards’, *Credit World*, 85 (10) pp. 13-16.

Coogan, M. (2001) ‘New Year’s Key Issues’, *Mortgage Finance Gazette*, January, pp. 15

Council of Mortgage Lenders (2001) CML Urges Policy Re-think to Help Home-owners in Poverty, Press Release 24th April.

Crook, J. (1999) 'Who is Discouraged from Applying for Credit?', *Economic Letters*, 65, 165-172.

Cummings, C. (2001) 'You Can Put a Square Peg in a Round Hole', *Mortgage*, April, 11-12.

Davis, D (1966) *A History of Shopping*, London: Routledge and Kegan Paul.

Department of Trade and Industry (2002) *Tackling loan sharks – and more!* A consultation document on the financial limit and exempt agreements of the Consumer Credit Act 1974, No. CA005/002, Department of Trade and Industry, London.

Dodd, N (1994) *The Sociology of Money*, Polity Press, Oxford.

Donzelot, J. (1980), *The Policing of Families: Welfare Versus the State*, London, Hutchinson

Euroweek (1998) 'UK Sub-prime Springs into Life', *Euroweek*: London., pp 16-8

Ewels, J. and Knights, D. (1999) 'Personal Finance Education: In the Hands of the New Regulator?', *Quarterly Account: the Journal of the Money Advice Association,* Summer.

Foucault, M. (1984) 'What is enlightnement?', in *The Foucault Reader* (Ed, Rabinow, P.) Penguin, London.

Frank, J.N. (1996) 'Scoring Takes on a New Meaning', *Credit Card Management*, 9 (6) 155-160.

Federal Reserve (2001) Expanded Guidance for Subprime Lending Programs, http://www.federalreserve.gov/boarddocs/srletters/2001/sr0104a1.pdf

FSA, (1999), *'Consumer Education: A strategy for promoting public understanding of the financial system'.* Policy statement

FSA (2000) Better Informed Consumers: Assessing the implications for consumer education of research by BMRB, April.

Financial Times (2002) 'Creditor Concern', *Financial Times*, 3 July, pp. 18.

Ford, J. and Rowlingson, K. (1996) 'Producing Consumption: women and the making of credit markets', in Edgell, S., Hetherington, K. and Warde, A. *Consumption Matters*, Blackwell Publishers: Oxford.

HM Treasury (1999) Policy Action Team 14 Access to Financial Services, (http://www.cabinet-office.gov.uk/seu/2001/PATaudit/14.htm)

Howells Kim (2001) Interview on Personal Debt, Today Programme, Radio 4, 15.01.01

Ingham, G (1984*) Capitalism Divided: The City and Industry in British Social Development*, Macmillan, London.

Jenkins, P. (2000) ‘A colourful past doesn’t always make you uncomfortable’, *Financial Times*, 24 June.

Johnson, R.W. (1992) ‘Legal, Social and Economic Issues Implementing Scoring in the US’, in Thomas, L.C., Crook, J.N. and Edelman, D.B. (eds) *Credit Scoring and Credit Control*, Oxford University Press, Oxford, pp. 19-23.

Kempson, E. and Whyley, C. (1999a) *Kept Out Or Opted Out? Understanding and Combating Financial Exclusion*, Bristol/York, The Policy Press/Joseph Rowntree Foundation.

Kempson, E. and Whyley, C. (1999b) *Extortionate Credit in the UK*, A Report to the Department of Trade and Industry, London.

Klein, L. (1999) *It’s in the Cards*, Westport, Ct: Praeger.

Knights, D., A. Sturdy and G. Morgan, (1994) `The Consumer Rules: An Examination of the Rhetoric and "Reality" of Marketing in Financial Services', *European Journal of Marketing*, Vol. 28/3, pp. 42-54.

Knights, D., Ewels, J., McLean, C and Odih, P., (1999) *Educating the Public in Personal Finance: Problems and Prospects*, Keele University Department of Management.

Knights, D., Noble, F., Vurdubakis, T and Willmott, H, (2001) Strategies of Distribution in Financial Services : Discourses of Innovation and Resistance in the Development of Virtual Channels, Keele Management Department,

Knights, D and T. Tinker (editors) *Financial Service Institutions and Social Transformations: International Studies of a Sector in Transition*, London: Macmillan, 1997.

Morgan G. and D. Knights, editors (1997) *Deregulation and European Financial Services*, London: Macmillan.

OECD, *Consumer Information about Financial Services*, OECD, Paris, 1992.

Latour, B (1987) *Science in Action*, Massachusetts: Harvard University Press.

Leslie, D. and Butz, D. (1998) '"GM suicide": Flexibility, space, and the injured body', *Economic Geography*, **74,** 360-378.

Lewis, J. (2001) *The End of Marriage? individualism and intimate relations,* Edward Elgar, Cheltenham.

Leyshon A, Burton D, Knights D, Alferoff C, and Signoretta P. (2004) ‘Ecologies of retail financial services’, *Environment and Planning A* (forthcoming)

Leyshon, A. and Pollard, J. (2000) 'Geographies of industrial convergence: the case of retail banking', *Transactions of the Institute of British Geographers,* **25,** 203-220.

Leyshon A and N Thrift (1997) *Money/Space: geographies of monetary transformation,* Routledge, London.

Leyshon, A. and Thrift, N. (1999) 'Lists come alive: electronic systems of knowledge and the rise of credit-scoring in retail banking', *Economy and Society,* **28,** 434-466.

Leyshon, A., Thrift, N. and Pratt, J. (1998) ‘Reading Financial Services: texts, consumers and financial literacy’, *Environment and Planning D: Society and Space*, 16, 29-55.

Mackintosh, J. (2000) ‘Venture Capitalists to Cash in on Non-standard Loans Market: The Once-ignored Sector is Now Attracting Admiring Glances from Some of the Big Banks’, *Financial Times*, 25th October, pp. 31.

M2 Presswire (2001) ‘The British ‘Credit Underclass’ is Decreasing in Size’, M2 Communications Ltd, 3 October.

Malhotra, R. and Malhotra, D.K. (2002) ‘Differentiating Between Good Credits and Bad Credits Using Neuro-Fuzzy Systems’, *European Journal of Operational Research*, 136, 190-211.

Mitchell, J. (1992) *Banks and their Obligations to Society*, The Chartered Institute of Bankers: London.

Myers, J.H. and Forgy, E.W. (1963) ‘The Development of Numerical Credit Evaluation Systems’, *Journal of American Statistics Association*, 58 September, pp. 799-806.

Office of Fair Trading (1997) *Non-status Lending: Guidelines for Lenders and Brokers*, OFT: London.

Oliver Wyman (2001) *The Future Regulation of UK savings and investment: Targeting the savings gap*, commissioned by the ABI, London: Wyman & Co.

Orr, A. (2001) ‘Predicting a Need’, *Target Marketing*, 24 (2) pp. 62-4.

Reinbach, A. (1995) ‘Sub-prime Credits Beckon to Banks’, *US Banker*, October, 105 (10) 55-59.

Ritzer, G (1995) *Expressing America: a critique of the global credit card society,* Pine Forge Press, Thousand Oaks, California.

Rowlingson, K. (1994) *Moneylenders and their Customers*, Policy Studies Institute: London.

Ryman-Tubb, N. (1999) ‘Prime Time for Sub-prime’, *Credit Management*, November, pp. 18-9.

Sanghera, S. (2000) ‘Fed in Predatory Lending Probe’, *Financial Times*, July 11th.

Thomas, L.C. (2000) ‘A Survey of Credit and Behavioural Scoring: forecasting financial risk of lending to consumers’, *International Journal of Forecasting*, 16, 149-172.

Stephens, D.L., Hill, R.P. and Bergman, K. (1996) ‘Enhancing the Consumer-Product Relationship: Lessons from the QVC Home Shopping Channel’, *Journal of Business Research*, 37, 193-200.

Taylor, R. (1978) ‘Marilyn’s Friends and Rita’s Customers: a study of party selling as play and work’, *Sociological Review*, 28, 2, 573-94.

Today (2002) Radio 4 Interview with a spokesperson from the Treasury Select Committee on Banking competition asks for more information for the consumer – transparency 30th July.

Treacy, W.F. and Carey, M. (2000) ‘Credit and Risk Rating Systems at Large US Banks’, *Journal of Banking and Finance*, 24, 167-201.

Vosko, L. F. (2001) *Temporary Work: the gendered rise of a precarious employment relationship*, University of Toronto, Toronto.

Box 1: ‘Complex prime’

‘Sandra and Jack Patterson are both lecturers at two different universities in the Midlands and both live in separate university accommodation.

Having recently got married, they now wish to buy a house to live in at the weekends and during holidays and have found an idyllic cottage but have encountered problems seeking a mortgage. The property required is currently valued at £170,000, but they have only a £5,000 deposit. What is more, their joint incomes amount to £45,000, meaning that they require a mortgage of about 3.8 times their joint income, at an LTV of 97%.

With the help of their IFA, a mortgage application is sent to a complex [sub-] prime lender, accompanied by a covering letter explaining the case scenario.

After discussions, a mortgage is agreed after the lender was able to take a different perspective on the case. The lender knew that the couple’s outgoings were lower than normal as all boarding was provided during the week. It was also known that Sandra and Jack earned additional income in the summer months, as evidenced on their bank statements. Taking this into account the lender knew that they had the ability to repay the loan.

To reduce the overall LTV, the lender also took security on their investment policies. That meant Jack did not have to cash in his policies for extra deposit and therefore escaped the high surrender penalties. More importantly, they were able to buy their cottage’.

Source: Money Management, April 2001: 12

Table 1: Distinctions between Traditional and New Sub-prime Financial Services Providers

Traditional sub-prime suppliers	*New sub-prime suppliers*
Labour intensive	Highly automated
Low use of technology	Extensive use of technology
Idiosyncratic modes of delivery	Highly structured delivery
Personal contact	Impersonal
Low level of marketing expertise	High level of marketing expertise

Table 2: Status Mortgages at Future Mortgages

Future 85 LTV 85 %	Arrears maximum of 6 months, no deterioration in last 3 months CCJs any number up to £6,000 IVA satisfied or being well conducted Bankruptcy discharged Rate: 7.7% (LIBOR +3.5%)
Future 80 LTV 80%	Arrears any amount considered CCJs any number considered IVA satisfied or being well conducted Bankruptcy discharged Rate 8.2% (LIBOR +4%)
Future 75 LTV 75%	Arrears maximum 2 months (no deterioration in last 3 months) CCJs any number up to £2,000 (no deterioration in last 3 months) IVA not acceptable Bankruptcy not acceptable Rate: 6.7% (LIBOR +2.5%)