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Risk Waiver

Closing the protection gap for consumers and opening the credit flow for providers

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ResPublica
changing the terms of debate

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We intend Green Papers to spark debate and more extensive work and research. We hope that this publication does just this.

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by Ian Liddell-Grainger MP
and Heather Wheeler MP

"This insightful report by ResPublica highlights how credit protection products could help to kick-start consumer and business lending. Risk Waiver rightfully explores the potential for insurance protection products to acts as a form of credit stimulus."

The financial crisis of 2008 had enormous economic implications for the world economy, and Britain was no exception. Our economy plunged into the longest and deepest recession since records began, and British businesses and consumers suffered as never before.

Nearly five years on, Britain's economy is now on the road back to recovery. But the latest growth figures show that, even though the economy has returned to growth, the sheer scale of the crisis has meant that the recovery has been slow and sporadic. Because of this, it is imperative that we continue to explore new and innovative ways of encouraging economic growth.

Since the great global financial crisis Britain has been suffering a severe squeeze in household and business credit. The Coalition Government has made attempts to address this by keeping interest rates low and by establishing schemes such as the Enterprise Finance Guarantee, Funding for Lending and the new Help to Buy scheme. But, as access to finance is essential for economic growth, it is crucial that we exhaust all possibilities in our attempts to meet the demands of consumers and businesses for additional credit both private and Government-led.

It is a sad fact that the current squeeze on credit is having such a disproportionate effect on the cornerstone of our economy - small businesses. The Government has made huge strides to encourage their growth, yet many still struggle to gain access to credit with lending to small businesses falling by more than a quarter since 2009. The state of our credit markets is making it difficult for our small businesses and entrepreneurs to flourish, and causing us to trail behind our international competitors.

Our households have also suffered from a severe lack of credit. In these harsh economic times, access to finance can assist households in paying their bills and living costs. Demand for household credit is increasing but a stagnant credit market makes it much harder for families to make ends meet.

The demands from businesses and consumers clearly illustrates that there is an appetite for more credit that must be addressed. This insightful report by ResPublica highlights how credit protection products could help to kick-start consumer and business lending. *Risk Waiver* rightfully explores the potential for insurance protection products to act as a form of credit stimulus.

Protection products provide a valuable means of safeguarding consumer and business loans. One particular product that this report highlights, and which is quite common in the US, is debt waiver. This innovative protection product offers a payment waiver facility to customers in circumstances where they cannot make their payments due to illness, injury or unemployment.

The innovative aspect of these products is that, instead of the onus being on the customer to take out protection, the lender takes it out on their behalf. This effectively shifts the burden of responsibility away from the consumer, compelling the lender, rather than the borrower, to cover the loan in the event of illness, injury, unemployment and, where appropriate, death. In this way it encourages responsible lending in making the lender accountable for the loans which they issue.

Products which compel the lender to cover the loan will not only provide proper consumer protection, but they have the potential to restore confidence, for both borrowers and lenders, in the credit market and so increase lending. Introducing more credit protection has proved a success in the United States, where debt waiver products have proved a successful way to safeguard loans and release more credit into the economy – and these could be successfully introduced here.

The current credit squeeze is prolonging our economic stagnation. For our businesses and households to flourish once again we must have more favourable lending conditions. With this, it is imperative that we encourage our financial institutions to adopt and develop innovative products like debt waiver.

"Products which compel the lender to cover the loan will not only provide proper consumer protection, but they have the potential to restore confidence, for both borrowers and lenders."

Executive Summary

"Current Government attempts to increase lending to consumers and businesses are clearly failing. Providing protection on the loans lenders issue would shore up the beleaguered lending sector by creating an economy where credit is both widely available and inherently more secure."

Lending to UK consumers and businesses has stagnated over the last five years. The credit our businesses and households rely upon to prosper is simply not as available as it should be.

Recent polls illustrate that consumer confidence has remained stubbornly low since the recession. This lack of confidence ultimately bears out in consumer spending levels, which are currently still 3.9 per cent down on pre-recession levels. Also, taken as an average, workers are in real terms earning no more than they were ten years ago. Given that consumer spending in total comprises 65 per cent of the UK's GDP, a broadening of credit supply would have a substantial impact on economic growth and household earnings.

However, it would be irresponsible to simply expand consumer credit without commensurably increasing the levels of consumer protection. It is a worrying fact that 83 per cent of those with a loan are unprotected should they be unable to make payments through being sick or losing their job. This huge 'protection gap' is down to a general lack of trust in protection products, mostly brought about by the PPI mis-selling scandal. Since then, this trust gap has widened significantly and presents an additional obstacle to the expansion of consumer markets. Both protection and trust need to be addressed if future lending is to be responsible and secure.

Lending levels to UK businesses are in an equally dire situation. The latest Bank of England figures suggest that, despite numerous initiatives by the Government, corporate credit supply is still below its 2008 levels. This paucity of credit disproportionately affects smaller firms, which lack large cash reserves to fall back on.

SMEs classified as a single group represent 99.9 per cent of all private businesses, 59.1 per cent of private sector employment and 48.8 per cent of private sector turnover. Disturbingly, since 2009 lending to SMEs has fallen by 25 per cent and loan rejection rates in the UK are twice what they are in France and Germany. SMEs are the workhorses of the British economy, and credit conditions unfavourable to SMEs inevitably result in problems with GDP and jobs growth.

The Government has not been idle on these issues. The Enterprise Finance Guarantee, Funding for Lending and historically low interest rates have all attempted to increase consumer and business lending and spending. But each initiative has met with little success. This is because these solutions simply ignore the underlying causes for decreased spending – credit markets shackled by overbearing credit risk.

The Government's plan to boost growth through the Local Enterprise Partnerships and Enterprise Zones, whilst admirable, will ultimately fail for those same reasons. Current Government pump-priming initiatives are akin to frequent transplanting of the heart of a sick patient, while it is the circulatory system that is damaged. The Government needs a new approach to credit supply that tackles the underlying causes of the credit slowdown.

Credit protection products provide a valuable means of safeguarding consumer and business loans. One particularly innovative product not currently available in the UK is 'debt waiver'. These products, which waive the debt in the wake of an insured event, are commonplace in the US. They offer a waiver facility to their customers that guarantees that the lender, rather than the borrower, covers the loan in the eventuality of illness, injury, unemployment and where appropriate, death. This shifts the burden of default away from customers and places the onus on the lenders to provide such waiver safeguards.

The history of debt waiver in the US shows that waiver products could provide a fair and transparent means by which to safeguard loans. In the US, these products have consistently been shown to improve the lenders' financial results whilst enabling the greater availability of credit to the market. Shoring up the credit market with protection products in such a way could become a feasible option for closing the 'protection gap' whilst at the same time encouraging lending by reducing the impact of excessive credit risk and the fear of taking out a loan.

The total gross lending in the UK plummeted from £140.5 billion in 2007 Q2 to £60.7 billion in 2012 Q4, a reduction of 56.8% compared with the lending volume before the credit crunch. Studies in both the US and the EU have shown that falling credit supply shrinks real GDP growth. Five years after the credit crunch a US study has found that if core lending declines by 4%, then real GDP reduces by 0.6%. A European paper studying the same effect found that, in the Eurozone, if core lending declines by 5% there is a long-term reduction in real output growth of 1.6%. Transposing those findings to the situation in the UK gives some startling indications of the possible impact of credit contraction.

Given that the UK's 2012 GDP was £1445.2 billion, the American study would suggest a real output loss for the UK between 2007 and 2012 of £123.1 billion, whereas the European paper would suggest a loss equivalent to £262.7 billion. On a conservative estimate placing the UK directly between both studies, the loss in GDP from the contraction in lending between 2007 and 2012 was £193 billion.

Protection products like 'debt waiver' could both secure loans and get lending going again.

Key recommendations of this report are:

1. Close the protection gap: HM Treasury should immediately conduct a review of the state of consumer protection in credit markets. This review needs to determine a comprehensive plan of action that seeks to close the 'protection gap' as quickly as possible.

2. Introduce compulsory loan protection: Following the example of the car insurance market, the Government should consider making it compulsory for lenders to provide protection insurance on the loans that they issue. This will both safeguard customers and protect lenders' loan books.

3. A 'kitemark' for safe insurers: The Association of British Insurers (ABI) and other relevant member bodies should develop a Code of Conduct for protection products that goes beyond the current Financial Conduct Authority (FCA) proposals to ensure that scandals like the mis-selling of PPI do not reoccur. The ABI should also consider supporting this Code with a 'kitemark' system of accreditation in order to highlight 'safe' lenders.

4. Fast-track 'debt waiver': The FCA should immediately commission a comprehensive review of best practice and lending policy from the experience of 'debt waiver' in the US. This will ensure the speedy adoption of waiver and cancellation products in the UK – benefiting both customers and lenders.

5. Facilitate greater financial innovation: In order to ensure that products like 'debt waivers' can be introduced to the UK market as quickly as possible, the regulators should adopt a 'fast track' policy for the regulatory testing of innovative financial insurance products that have a proven track record of success in developed economies. This should, for financial institutions, reduce all those costs associated with the development of new products.

Current Government attempts to increase lending to consumers and businesses are clearly failing. Providing protection on the loans lenders issue would shore up the beleaguered lending sector by creating an economy where credit is both widely available and inherently more secure.

1. Introduction

Current attempts by the Government to get financial institutions lending again are simply not up to the task. The financial crisis, while it affected all parts of the financial sector, has hit credit markets particularly hard over recent years. Radical action needs to be taken if consumers and businesses are to lead us out of our current economic stagnation.

The main difficulty facing policy makers is that, since the recession, almost all lenders have dramatically downsized their appetite for risk. Further, the imposition of tougher capital ratio requirements and the general re-entrenchment of the banking sector as a whole have helped to ensure that lending to both consumers and businesses remains depressed.

In the need to preserve capital in face of Basel III, the reluctance of financial institutions to release credit to their customers stems in part from a heightened appreciation of credit risk in the economy, i.e. a perceived decrease in the ability of borrowers to pay back their loans.

This is not to say that risk in general is an anathema to economic growth. Financial risk is a fact of all economies and is a product of the entrepreneurial spirit that drives innovation and powers the economy. But it can be the case that levels of credit risk are at such a level that they stifle the investment needed for innovation and economic growth. Such is the case now.

Across the UK, consumers and businesses (particularly smaller firms) are in dire need of credit, which they simply cannot access due to the current state of the UK lending market. Reducing the risks facing lenders would have significant effects on the household costs of consumers and the balance sheets of British businesses.

Since the crash, not enough energy has been spent by policy makers to look at holistic approaches to reducing the presence of credit risk in the economy. Initiatives like the Enterprise Finance Guarantee and 'Help to Buy' schemes inject taxpayer-funded and backed finance into the consumer and business credit markets without tackling the underlying problems of the financial sector, including the overbearing presence of credit risk.

Policy makers should look to establish and promote more innovative approaches to releasing credit that do not rely on standard Government responses, but instead encourage those financial institutions that are best equipped to supply credit to the economy to innovate us out of our current malaise.

2. Lending to Consumers

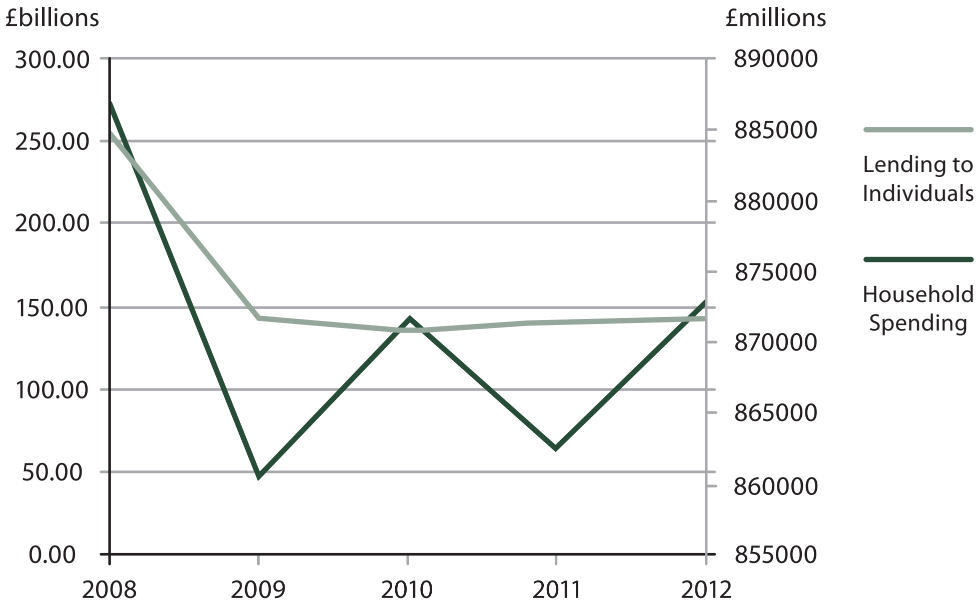
"Low interest rates over recent years have clearly been ineffective in driving up consumer spending, and the Government needs to explore alternative measures to get our households spending again."

In 2011, total consumer spending accounted for nearly 65 per cent of UK GDP.[1] Worryingly, over the last five years, household finances have been put under significant strain. The consistently negative economic environment has helped to keep consumer spending down.

Inflation as measured by the Consumer Price Index has persistently been above the Bank of England target of 2 per cent over recent years, and the Bank of England is clear that inflation is likely to seriously affect household finances for at least two more years.[2]

Add to this the 0.7 per cent decrease in take-home pay over the last 12 months,[3] and the fact that in real terms workers are earning no more than they were ten years ago,[4] it is clear consumers are being hit particularly hard by the on-going economic malaise. This is even worse for those households on lower incomes, who will not see a return to 2008 levels of earning until 2018 – resulting in a 'lost decade' for earnings.[5] Further, not only has consumer confidence been depressed since the recession, in 2013 Q1 it dropped even further to a new recent low.[6]

UK Household Spending Vs Lending 2008 - 2012



Source: Bank of England; Office for National Statistics

Increases in consumer spending are one of the key ways in which the UK economy will return to sustained and meaningful growth. Deflated consumer spending is particularly worrying given household spending is still 3.9 per cent down on pre-recession levels.[7] Low interest rates over recent years have clearly been ineffective in driving up consumer spending, and the Government needs to explore alternative measures to get our households spending again.

In tougher times, most households need access to bank credit (loans and overdrafts) in order to purchase standard household items. The problem is that the amount of lending currently available to consumers market is insufficient to kick-start consumer spending. Current statistics released by the Bank of England show that household credit availability is still 55 per cent less than it was in 2008.[8] Even though the availability of credit has increased by 65 per cent over the last year, demand has outpaced this with an increase of 75 per cent.[9]

This disparity between supply and demand has much to do with the reluctance of banks to lend to consumers due to a heightened sense of credit risk.

Whilst we do need long term increases in earnings, short term boosts to consumer spending can be achieved through an expansion of the, currently depressed, consumer credit market.

However, simply expanding consumer credit without commensurably increasing consumer protection will just create problems for the economy further down the line – with credit providers becoming increasingly hesitant to release credit to over-exposed customers. Policy makers must look to address both these issues concurrently.

3. The Protection Gap

"Not only has the PPI scandal seriously hit the bank balances of British financial institutions, but it has rendered the protection insurance market as a whole completely and utterly toxic to consumers."

The hole left in protection by the PPI mis-selling scandal has led to an increasingly widening 'protection gap'.

The 'protection gap' is the number of people who currently have loans but are not protected or insured from the loss of income brought about by involuntary unemployment, injury or illness. Current estimates suggest that as many as 96 per cent of those who have a loan taken out with a UK lender do not have any protection against inability to pay .[10] These customers, in the event of unforeseen life events, such as illness or redundancy will not be covered on their loans from loss of earnings. This is a worrying concern for consumers, especially given a recent survey that found that 20 per cent of people who have just become unemployed would find themselves in severe financial difficulties within one month – more than half said this would be the case after three months.[11]

This gap between loans and protection is always present, but over recent years this gap has expanded rapidly. Over the last decade the consumer protection gap for life assurance products has increased by 20 per cent and for income protection products by 46 per cent.[12] Much of this growth is a direct result of the damage done to the insurance industry by the scandal surrounding the mis-selling and mis-marketing of Payment Protection Insurance (PPI).

PPI was designed to cover repayments of loans and credit cards in the event of illness or injury. In most circumstances this insurance was sold at the same time as the credit product. At the height of its popularity in 2008, there were some 20 million PPI policies active in the UK market. At the time, PPI add-ons were a common component of almost all consumer credit products, despite the fact that 40 per cent of consumers were unaware of possessing such a protection product.[13] Unfortunately, from the middle of the last decade onwards these insurance products steadily became toxic to customers.

Alarm bells first sounded on the practices used to sell and market PPI products in 2005. At the time, the Citizens Advice Bureau (CAB) conducted a review and investigation into lender practices regarding the sale of PPI products.

The CAB report concluded that PPI was in the main expensive, ineffective, inefficient and often mis-sold. Summarised it stated:

- **Expensive**: The investigation found that premiums were often adding 20 per cent on to the cost of the loan, and in some case up to 50 per cent.

- **Ineffective**: Often policies were structured so that policy holders would find it difficult to pursue a pay-out even if genuinely ill.

- **Inefficient**: The report claimed that the procedures for approved claims were unnecessarily lengthy and complicated.

- **Mis-sold**: Many PPI policies that were sold were included in the overall cost of the loan without the customer's knowledge. In many cases customers were also told the PPI was essential to the success of their claim application, despite the fact that would never be able to claim in the case of economic inactivity (as for example with the self-employed). This mis-selling was often done through third parties.[14]

In response to all of this, the FSA (as it was then) banned the sale of PPI products alongside loan applications in 2009[15]. The Competition Commission also confirmed that PPI products can no longer be sold concurrently alongside credit products, and must be purchased at least seven days after initial loan agreement.[16] So far, in restitution for mis-selling and mis-marketing PPI products, UK financial institutions have paid out approximately £10 billion in compensation to their customers.[17]

Not only has the PPI scandal seriously hit the bank balances of British financial institutions, but it has rendered the protection insurance market as a whole completely and utterly toxic to consumers. This has left a substantial gap in protection, one that is unlikely to be filled anytime soon by the current products on the markets.

There have been a few attempts by lenders to replace PPI, and there are several alternatives currently in the market. One such alternative was a product branded as Short-term Income Protection (STIP). This represented an attempt by lenders to offer a product similar to PPI without the toxicity associated with the PPI 'brand'. However, most firms have withdrawn these products now due to the fact the Competition Commission was unconvinced that these deviated enough from standard PPI products to be considered separate.[18]

A longer-term version of protection is currently branded as Income Protection Insurance. Unlike PPI, this does not just cover cost of payments, but up to 60 per cent of loss of income brought about from unforeseen life circumstances. The key problem is that lenders have to embrace a much higher level of risk and exposure due to the fact that this goes beyond the debt of a single loan to insuring up to 60% of the customer's entire earnings. Because of this fact, lenders have a general, and perhaps understandable, reluctance to offer earnings-based protection products as a substitute for PPI.[19]

Because of this apparent lack of viable alternatives to PPI, policy makers in Government have the double problem of trying to incentivise greater consumer lending whilst at the same time not worsening the consumer 'protection gap'. A solution which seeks and addresses an expansion of credit availability without a corresponding deterioration in credit quality needs to be found to these interrelated problems. Along with the consumer credit market, policy makers will also urgently need to address the similar, yet separate crisis currently engulfing British SMEs.

4. Lending to SMEs

A cursory glance at the business credit market will reveal a story similar to that of the consumer credit market. The latest survey data from the Bank of England shows that, despite loans to businesses totalling £69.6 billion, little of this went to smaller firms and corporate credit supply is still below its pre-2008 levels. The survey findings concluded that the reduced appetite for corporate lending was the result of slow economic growth and fear of risk.[20] In a sluggish economy, it is Small and Medium-sized Enterprises (SMEs) that suffer most from a lack of credit.

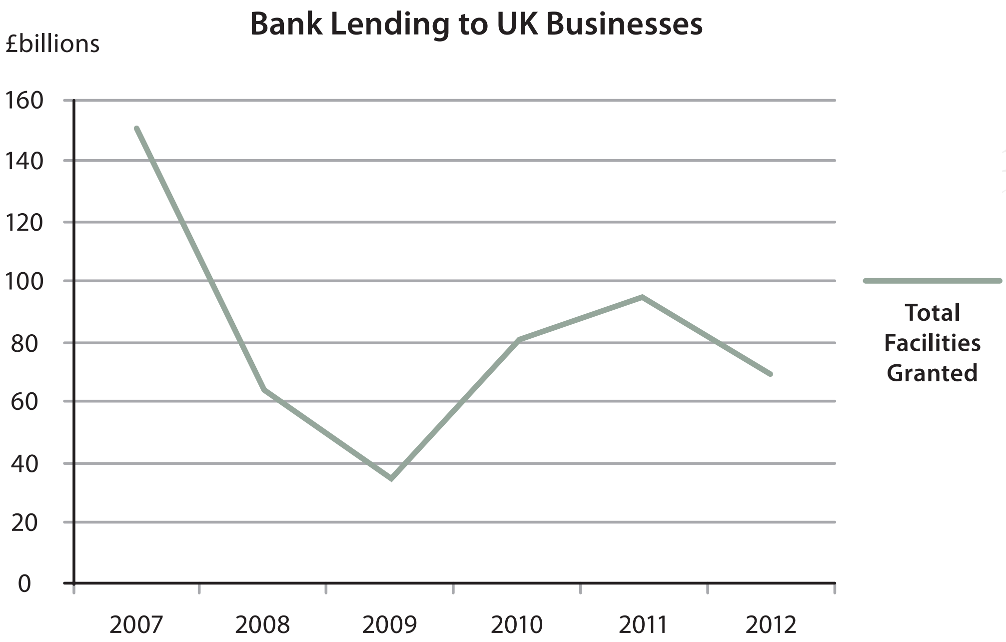
SMEs represent an extremely important component of the private sector. SMEs classified as a single group represent 99.9 per cent of all private businesses, 59.1 per cent of private sector employment and 48.8 per cent of private sector turnover.[21] A serious reduction in credit to SMEs will, therefore, have a detrimental effect on jobs growth. (*See figure opposite.*)

Current estimates suggest that, although 37 per cent of SMEs do not require credit finance, the majority of smaller firms rely on business credit to help plug holes in their finances.[22] The sad fact is that, since 2009, SME lending has fallen more than 25 per cent,[23] and loan rejection rates in the UK are twice that of our greatest European competitors: France and Germany.[24] Recent statistics suggest that, of those SMEs that applied for credit, 23 per cent had their applications rejected in 2011-12.[25]

SMEs are the workhorses of the British economy. An economy that has credit conditions unfavourable to SMEs will inevitably suffer from economic growth problems. One of the reasons that the UK is experiencing a period of anaemic growth is because of the torrid time most SMEs are currently experiencing.

SMEs as a group are disproportionately affected when it comes to accessing much needed credit, and SMEs rated as 'above average' risk have risen. This is due to a greater reluctance on the part of lenders, because of current perceptions of credit risk, to lend to smaller businesses.[26]

In order that innovative ideas like debt waiver can be used to increase credit supply to our small business sector, we need to tackle the underlying problem that we still lack an adequate calculation of small business risk. Part of this is because we lack adequate means of assessing good as opposed to bad credit risks when it comes to SME lending. Instead, we aggregate the good with the bad and conclude on average that the risk of lending to SME's is too high. The Government, Local Enterprise Partnerships (LEPs) and the banking sector must collaborate to produce a new system of risk that adequately identifies and assesses the individual risk and potential of each company that applies for credit. European economies such as Germany or Northern Italy have built their world class SME sector through being able to assess individually the potential and ability of each company, we simply lack the infrastructure and institutional knowledge to achieve this. If we can build a new set of lending skills and new risk matrices then products like debt waiver can unlock the credit supply for our businesses.



Source: Bank of England

However given the lack of the aforementioned, it is not surprising that as the general economy worsens so do the credit ratings for SMEs, which have deteriorated ominously over recent years. Current estimates suggest that, over the last decade, SMEs rated as low risk have fallen from 42 per cent to 19 per cent, and SMEs rated as 'above average risk' have risen from 9 per cent to 28 per cent.[27]

This is in spite of the fact that banks have increased their lending and overdraft profit margins since the crash. Granted, much of the current predicament is due the banking sector's attempts to consolidate their loan books under new capital requirements, but it is also largely down to the perceived inherent risk in the current SME credit market.

Because of lending conditions, credit providers are understandably reluctant to lend to firms perceived as higher risk. This inevitably has had an impact of UK economic growth prospects. Recent research suggests that it is smaller, high-risk firms that are likely to create two-thirds of the UK's new jobs each year.[28] Limiting credit to these high-growth firms is again seriously impeding economic growth. Government intervention here is crucial if the economy is to get moving again.

This lack of good credit is keenly felt by those in the business community. A survey found that only 16 per cent of SMEs interviewed felt that credit was easier to obtain now than a year. Furthermore, Government hopes that the newly established British Business Bank will, when operative, combat this crisis of credit are simply not echoed by those in the business community. Of those surveyed, almost 75 per cent said that they wouldn't approach the Business Bank for lending, and 42 per cent (rising from just 26 per cent the previous quarter) that they would be tapping personal savings to fill the gap in their finances instead.[29]

5. Government Attempts to Increase Corporate and Consumer Lending

"Evidence suggests that, while the Government schemes may have some positive effect on British businesses and consumers, it is clear from Bank of England lending statistics that they themselves have been, and will continue to be, insufficient at kick-starting lending."

The Government is completely aware of the lack of credit available to consumers and businesses. In response to the credit crisis it has established several schemes specifically designed to boost bank lending.

Its flagship debt finance programme is the Enterprise Finance Guarantee scheme. This is a Government loan guarantee scheme that facilitates lending to businesses that have already been turned down for a loan. There are currently 43 providers accredited for this scheme, with £600 million ear-marked for the programme. Current statistics from BIS show that the value of loans offered by lenders to businesses through this scheme has in fact declined by 55 per cent since it was first launched in 2009.[30]

The Funding for Lending scheme is another initiative intended to open up the credit markets for businesses. This scheme, launched in April 2012, is designed to encourage banks and building societies to increase their lending to British businesses. Through this scheme HM Treasury provides funding to lenders for an extended period, with price and quantity being linked to lending performance. In total, £80 billion has been allocated and there are plans to extend the scheme to 2015. A recent announcement by the Chancellor confirms that the scheme will be re-jigged to place greater emphasis on SME finance and will now be available to a wider selection of lenders, including invoice finance houses and leasing firms.[31] It is too early to come to any conclusions on this project yet, but going by earlier examples, it is unlikely the Funding for Lending will succeed where both its earlier variant and the Enterprise Finance Guarantee scheme have also failed.

The Government has also announced the creation of the British Business Bank. Launched in April 2013, this state-backed lending bank will pool together a number of already operating HM Treasury schemes. It will bring together £2.9 billion of existing capital and introduce approximately £1 billion of new capital in order to provide financial support to SMEs.[32] Current schemes that will be brought together under the new Business Bank include the Enterprise Finance Guarantee, the UK Innovation Investment Fund and the Business Finance Partnership. It is hoped that this bank will address long-standing and structural gaps in the supply of finance to British firms, and will have a particular focus on SMEs. The finance will be released in stages, with £300m released in April 2013 and most of the rest at full launch in early 2014. Most European countries already have an equivalent of the Business Bank, and have done for some time. But the timelines detailed for the injection of added capital beyond the current schemes that will come under the Bank are probably too lengthy. Britain's businesses need immediate assistance with their cash flow problems.

Aside from these schemes targeting businesses, the Government also announced in the 2013 Budget Statement a new loan and guarantee scheme for actual and prospective homeowners called Help to Buy. This dual-scheme is intended to kick-start the house building sector and increase home ownership.

Since the crash, increased deposit requirements and tighter mortgage conditions have conspired to drastically reduce the number of new home purchases. Mortgages taken out by first-time buyer are still, despite a slight upturn, almost half of what they were at their peak in 2007.[33]

Help to Buy is divided into two streams: one which provides a loan to new homeowners for equity in the initial purchase, and another that supplies a mortgage guarantee to lenders. The equity scheme only applies to those looking to buy new build homes and can cover up to 20 per cent of the cost of the property. The guarantee scheme will provide lenders with the option to purchase a Government guarantee that compensates them for a portion of their losses in the event of default. Together they total £5.4 billion and represent a significant outlay of Government spending.

The Help to Buy scheme has similarities to the federal assistance programme operated in the US through the lenders Fannie Mae and Freddie Mac. The lending practices of these two firms eventually helped create a housing bubble that resulted in the sub-prime crisis.

There are fears that Help to Buy could go the way of Fannie Mae and Freddie Mac. But as current Government plans are to limit the scheme to three years, and it will be delivered to a deflated housing market, it is unlikely that it will result in a housing bubble. On the whole though, the Help to Buy scheme does represent a substantial exposure to risks for the taxpayers and would only aid those looking to enter the housing market for the first time. For all other consumer credit needs, there is a lack of credible solutions.

Evidence suggests that, while the Government schemes mentioned above may have some positive effect on British businesses and consumers, it is clear from Bank of England lending statistics that they themselves have been and will continue to be insufficient at kick-starting lending. One area that could be decisive in addressing these problems is that of credit protection and insurance market.

6. Protection Products and Debt Waiver

"In the US, debt waiver has been shown to improve the lenders' financial results. Because the use of protection products like debt waivers spread the risk of default, lenders who take out such products usually possess loan books with a lower percentage of delinquent loans."

Protection products provide a valuable means of safeguarding consumer and business interests. They protect customers from loss of income and they part indemnify the lenders against losses brought about by unpaid loans. There are various innovative products in the marketplace that UK firms do not currently utilise. One of these is debt waiver products.

Debt waiver and debt cancellation clauses are commonplace in the US. They were developed in the US in response to the tough economic environment of the Great Depression. Like PPI or Business Loan Protection, debt waiver clauses offer short-term income protection – but that's where the similarities end. What these products do is offer a waiver facility to their customers that is written into the loan agreement, and which guarantees that the lender, rather than the insured, covers or waives the loan in the eventuality of sickness, injury, unemployment and death.

Under debt waiver policies, the lender themselves take on an insurance policy on the loan rather than the customer – this then has the effect of transferring the risk, associated with the insured events within the loan, from the lenders balance sheet onto a specialist insurer, equipped to indemnify such risks, rather than with the customer. This is a radical shift from the way lenders normally provide credit in the UK, where the onus is on the customers to insure their own ability to pay rather than the lender indemnifying their own loan. Debt waiver and debt cancellation clauses have the potential to be far more widely used in the UK and unlock much of the pent-up demand by easing the risk of supply.

Under waiver policies, the lender would be able to protect themselves against an unmet debt for a set duration in the event of the borrower being unable to service the debt due to loss of income brought about by unforeseen circumstances. In the US, it is typical for a debt waiver repayment clause to last for six to nine months, (or potentially longer) which gives borrowers a reprieve to take stock of their financial situation and to make alternative arrangements.

Where a debt waiver clause or indemnity is incorporated into a loan agreement to safeguard the consumer's risk from loss of income, this may help regenerate customer trust and satisfaction, which has almost vanished following the PPI scandal, and if this vehicle could be transferred to the SME market it could help revive lending for small businesses as well.

Both the Office for Fair Trading and the Financial Services Authority (as it was then), have both cleared debt waiver products for use in the UK, stating that they are distinguishable from PPI and similar products as they are not legally classified as insurance.[34] They have stipulated specific rules to be used in the design of such "waiver" clauses to ensure that they are not mis-sold and are aligned with positive borrowing outcomes. The OFT/FSA consultation did go on to lay down some rules that lenders should adhere to when selling debt waiver in order to ensure that the mistakes from the PPI mis-selling scandal are not made again.

When developing their products, lenders need to ensure:

1. That the particular product is tailor-made for the target market and not a catch-all product applicable across the board to all customers regardless of background.

2. That the product in question covers the needs of the target market and is not, as was the case with PPI, offered to those who would never be able to benefit from taking on the product.

3. That the product does not create barriers to customers comparing, exiting or switching cover.[35]

Lenders in general need a fair and transparent means by which to safeguard their loans in case of default. Protection products like debt waiver could, by meeting those requirements detailed above, provide the means by which this could be done.

Debt waiver products are typically structured and priced in one of two ways. The cost to the lender can be passed on to the borrower either as an additional cost written into and absorbed by the loan agreement, or it can be separately and compliantly marketed as an optional add-on to the loan. Given that Waiver is an integral part of the loan, provided and indemnified primarily by the lender to the borrower, it can be offered to the borrower at the time of purchase, unlike PPI. Waiver is not considered to be an insurance product by the FCA and OFT, however it is regulated as part of the lending arrangement.

The former integrated waiver offer has been proven to be best suited to smaller lenders that have less complicated credit product offers and would benefit from simplicity. The add-on, optional waiver product is best suited to High Street lenders with experience of selling similar protection products and which as a whole market a wider selection of financial products. In some cases the lender can absorb the cost of the waiver policy themselves. This may be particularly true for those banks and building societies looking for a competitive advantage.

In the US, debt waiver has been shown to improve the lenders' financial results. Because the use of protection products like debt waivers spread the risk of default, lenders who take out such products usually possess loan books with a lower percentage of delinquent loans. Further, as a greater proportion of loans are protected, lenders earn greater levels of income and return on assets.[36]

Shoring-up the credit market with protection products in such a way could be a good means of mitigating the effects of excessive credit risk. The question is, can protection products like debt waiver provide enough protection to lenders to actually get them lending again?

7. Protection Products and Credit Easing

"Clearly, any easing of credit safeguarding by the wider use of protection products would have beneficial effects on economic growth and job creation."

Because of the scandal surrounding PPI, there is a general reluctance for many credit providers to be involved in any meaningful way with riskier, but historically viable loans. Bridging the 'protection gap' through debt waiver products would not only reap benefits for currently unprotected consumers, but would further incentivise lenders to release credit to the personal loans market. A similar approach could be used by lenders and Local Enterprise Partnerships with SMEs, which would then become much more attractive customers for credit.

Waiver products would in this way play a dual role for the personal credit market: firstly, by indemnifying substantial parts of lender loans books and stimulate lending; secondly, by securing loans for customers so that, in the case of unforeseen difficulties, consumers and businesses will not be over-exposed to hardship brought about by the loss of income.

Policy makers need to sit up and take note of the gaping hole left behind by the PPI mis-selling scandal and the difference debt waiver products could make in this regard. The consumer and credit markets are in dire straits. Further, given the need for increased spending in these dark times, policy makers need to be more innovative with their approaches to stimulating consumer credit.

Prior to the blanket-ban, many lenders used PPI as a means of cross-subsidising their consumer credit activities.[37] Evidence submitted to the Competition Commission's review into the PPI scandal concluded that PPI income did have a significant effect on loan pricing.[38] One respondent to the Commission's call of evidence even went as far to say that personal loans would be unprofitable without the income from PPI.[39]

This assertion has in part been corroborated by academic analysis of bank lender activities. A study of European banks found that, post-diversification, it has become common place for lenders to supplement income from loan products with additional income from add-on products.[40] A similarly wide-ranging paper found that credit protection products allow banks to run with lower interest rates.[41] In this way, protection products like debt waiver can stimulate bank lending and growth.

Clearly there exists a link between the selling of protection products and the ease at which lenders can release credit. The findings of this report are preliminary, but an in-depth analysis of UK bank microdata to clarify this relationship would reap benefits for British consumers and businesses. The regulatory authorities should, as a matter of urgency, analyse this data to determine how protection products could form a key part of the UK growth strategy (see below for further details).

There is the potential for protection products like debt waivers to release bank credit to households and businesses. In this way, protection products can have a positive effect on economic growth. An analysis of Eurozone credit institutions found that there was a positive contemporaneous relationship between changes in real GDP growth and loan growth, as well as a significant negative relationship between real GDP growth and tougher credit standards brought about by tougher lending requirements.[42]

In 2010, a team of researchers at the Federal Reserve Board in the US affirmed that tougher credit standards imposed by lenders do indeed reduce the level of core lending capacity, which in turn has a knock-on effect on real GDP growth. They concluded that after five years core lending capacity declines by 4% and real GDP by 0.6%.[43] In the Eurozone study mentioned earlier they concluded that a 5% decrease in credit growth produces a long-run multiplier effect which is a 1.6% reduction of real GDP.[44]

The total gross lending in the UK plummeted from £140.5 billion in 2007 Q2 to £60.7 billion in 2012 Q4, a reduction of 56.8% compared with the lending volume before the credit crunch.[45] If we apply this to the formula calculated by the Federal Reserve Board to the UK, then a decrease in lending over that period has cost the UK economy 8.52% in real GDP growth over the last five years, whereas if we take the European study that effect is as high as 18.18%. Given that the UK's 2012 GDP was £1445.2 billion,[46] a share of 8.52% would be equal to a real output loss between 2007 and 2012 worth £123.1 billion, whereas an 18.18% share is equivalent to a loss of £262.7 billion. On a conservative estimate placing the UK directly between both studies, the loss in GDP from the contraction in lending between 2007 and 2012 was £193 billion.

Now of course such direct comparisons cannot be made as credit may pay a greater or lesser role in the US or European economy than it does in the UK, but the scale of UK impact is probably somewhere between the two. In addition, the debate about the multiplier effect of credit or demand side contraction is far from settled, though the weight of opinion is that it is greatly under-estimated and suggestion was made in respect of austerity by the IMF in 2012 that the multiplier effect in the UK could be as high as 1.7%.[47]

Clearly, any easing of credit safeguarding by the wider use of protection products would have beneficial effects on economic growth and job creation. What is needed is for policy makers to adopt a clear and robust strategy for reducing credit risk in the financial sector.

8. Conclusion and Recommendations

"The only way to have credit supply meet credit demand is to facilitate durable change from within the financial industry itself."

Many of the UK's economic problems stem from a lack of available consumer and business credit. HM Treasury, BIS and the FCA must promote new ways of stimulating credit supply and demand that do not rely either on large capital injections from Government departments through a dysfunctional credit infra-structure or taxpayer-backed loan guarantees. Real reform of the credit system must, if it is to be sustainable, originate from within the industry itself. Much more needs to be done by policy makers to promote ingenuity and institutional innovation in the financial sector.

But it must not be forgotten that the financial crisis was a product of lax credit regulation and risk monitoring. Any stimulation of credit market must also be supported by a comprehensive framework of credit protection and insurance.

The recommendations of this report are divided into two sections. The first set of recommendations illustrate where future opportunities lie for protection products as a whole, and what the Government and the financial industry must do to ensure their fruition. The second set of recommendations are there to indicate what needs to be done to incentivise the uptake of debt waiver products as a means of stimulating credit and protecting consumers. The recommendations on debt waiver products are there to indicate what can be done immediately without waiting for the necessary longer-term, sectoral reform.

1. Close the protection gap: The 'protection gap', or more precisely the current status quo, is a clear and present danger to consumers and lenders. Riskier customers are more often than not denied credit by lenders, and over three-quarters of those with loans are unprotected in the event of loss of earnings brought about by circumstances outside of their control. The Department for Business, Innovation and Skills and HM Treasury should immediately conduct a joint review on the state of customer protection in credit markets. A detailed plan of action needs to be drafted that seeks to recognise and close the 'protection gap', and puts in place a system of monitoring that prevents it from manifesting again.

2. Encourage state-owned banks to innovate: Both Government 'bailed-out' banks, RBS and the Lloyds Banking Group, should be encouraged by the Government to act in the greater good and enable new protection product innovations that safeguard credit, protect customers and stimulate lending. Where these two lenders lead, others will follow.

3. Introduce compulsory loan protection: The Government should, in a manner similar to that of the Canadian mortgage market, and in a fashion used in the UK for mandatory insurances like motor insurance, make it compulsory for lenders to provide some form of credit protection, safeguards or insurance on loans that they issue. In Canada, the system of compulsory mortgage insurance has helped the Canadian housing market to weather the financial storm better than most other developed economies. Policy makers should look at the viability of installing such a system of compulsory insurance for both personal and business lending here.

4. A 'kitemark' for safe insurers: The PPI scandal represents a particular nadir for consumer trust in the banks. The gap in protection that developed from the scandal is the result of mis-selling and mis-marketing on behalf of the banking industry. The financial sector must collectively act to ensure that the abusive mis-selling of PPI does not reoccur and leave consumers exposed to excessive risks again. This report recommends that the insurance sector, preferably through the Association of British Insurers or similar trade body, draft and approve a new Code of Conduct for the selling and marketing of future protection products. This must go beyond the guidance offered by the FCA and should be supported by a 'kitemark' system of accreditation, which would do much to reassure customers by highlighting 'safe' providers.

5. 'Debt waiver' for small and medium sized businesses: If we are to also address not just the consumer credit crisis but also that affecting our small business sector, we need a new way of assessing risk in small and medium-sized businesses. It is imperative that LEPs innovate in this regard and try to construct with local business credit providers a new way of properly distinguishing and assessing risk in small and medium sized businesses. Only if we produce a credit risk system that does not aggregate but rather differentiates small business risk – will innovative products like debt waiver be able to open up the credit supply for SMEs as well. We recommend that Government convenes a working group with LEPs and banks to construct a new database that could go to scale for the assessment of small company credit risk. This would be the first step in opening up business credit to new products like 'debt waiver' and new opportunities like peer-to-peer business lending.

The below recommendations refer to 'debt waiver' and similar products specifically.

6. Fast-track 'debt waiver': The history of debt waiver products in the US is a long one, and stems back to the last great economic crisis in the 1930s. Even though there is no or little experience of these products in the UK, much can be drawn from the US experience to implement similar products over here. The FCA should build on its guidance on debt waiver products by commissioning a comprehensive review of best practice and lending policy from the US. This will ensure the speedy and effective adoption of waiver and cancellation products in the UK – to the benefit of customers and lenders.

7. Facilitate greater financial innovation: Introducing a new product to the market, and navigating all the regulatory and financial hurdles that present themselves, can be a complicated and drawn-out process. To combat this, the FCA should adopt a 'fast track' policy for the regulatory testing of innovative financial insurance products that have a proven track record of success in developed economies. This way, urgent financial products like debt waivers could be cleared for approval and implemented across the industry as speedily as possible.

Current Government attempts to get lending going largely focus on large public sector intervention. But, this mentality ignores the underlying problems affecting the capacity for banks to lend, namely the inherent presence of significant credit risk in the financial sector.

The only way to have credit supply meet credit demand is to facilitate durable change from within the financial industry itself. Eliminating large parts of the risk curve for banks and building societies through the use of loan protection products would help to shore up the beleaguered lending sector and create a flourishing economy where credit is both widely available and inherently more secure.

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New Economies, Innovative Markets

This workstream seeks to provide practical solutions for a moral capitalism and sustainable economy. This includes encouraging new market entry, ensuring supply chain resilience through more localised control, promoting greater diversity of business models and facilitating wider asset distribution, in order to achieve an economy based on trust and reciprocity.

Current and forthcoming work will build upon the ideas outlined in our past output which have had a continuing impact on the British policy landscape. Examples of our successes in 2012 include ResPublica's report recommending a new community bond to unlock investment in infrastructure, and an on-going series of publications on diversifying the energy market by enabling community-led projects to go to scale, the recommendations of which were reflected in a private members' bill and endorsed by Friends of the Earth. In 2013 this workstream will encompass our research on financial institutions and intermediaries, re-defining economic competition, SMEs and social enterprise, and governance prerogatives for a more responsible form of capitalism.

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CUNA Mutual Europe launched in the UK in 1971 and has 50 years' experience underwriting and administering financial solutions for Building Societies and other mutual organisations including Credit Unions. Since launching, CUNA Mutual Group has grown to become the current market leader in the supply of insurance products to mutuals, with an annual turnover of $13 billion US Dollars. CUNA Mutual Europe is part of CUNA Mutual Group, the worldwide leading provider of financial services to mutuals, including building societies, credit unions, and co-operatives.

The financial crisis of 2008 had an enormous effect on the UK lending market. Ever since the great crash, Britain has been suffering from a severe squeeze of household and corporate credit. Despite many laudable attempts by the Government to get the lending market going again, statistics suggest that government intervention is not having the desired effect.

What is needed is an approach to credit stimulation that seeks to counter one of the key underlying causes to the credit drought: credit risk. *Risk Waiver: closing the protection gap and opening the credit flow* explores the potential for credit protection products to act as a form of stimulus and get lending going again.

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