Oxera

Are UK households over-indebted?

Report prepared for:
APACS BBA FLA CCA

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Oxera

Executive Summary

Oxera has been commissioned by the Association for Payment Clearing Services (APACS), the British Bankers' Association (BBA), the Consumer Credit Association (CCA), and the Finance & Leasing Association (FLA) to undertake a study of UK consumer debt. The objective of the study is to provide a realistic assessment of the scale of the debt situation in the UK, based on existing reports[1] and available data.[2]

Over the past few years, several studies have been published on indebtedness and over-indebtedness, undertaken by a number of institutions. These reports have received considerable attention and have been frequently referred to by MPs in recent Treasury Select Committee hearings. Some of the reports have resulted in confusing messages in the media about over-indebtedness and a general misunderstanding of the debt situation in the UK. This may arise from a number of sources, including a lack of an agreed conceptual framework for analysing over-indebtedness, misinterpretation of statistics, and a lack of reliable data.

This report establishes a conceptual framework for analysing over-indebtedness and provides the associations with a reliable compendium of statistics on over-indebtedness and an understanding of the scale of the debt situation in the UK in the current economic climate.

Aggregate UK household debt has increased more than fivefold since 1987, with total debt now above 100% of household disposable income. This UK position is not out of line with changes observed in the other G7 countries over this period. Although unsecured lending has grown faster than secured lending for much of the last decade, over the period since 1987, the proportions of unsecured and secured debt have remained relatively stable. The unsecured debt to disposable income ratio was 23% in 2003. Moreover, despite the growth in aggregate debt levels, household financial assets exceed financial liabilities, such as secured and unsecured debt, while net financial wealth is significantly greater than total household debt. Supported by low official interest rates, interest payments as a proportion of disposable income have remained relatively stable in recent years and are lower than at the start of the 1990s.

Household income, wealth and financial liabilities are not, however, evenly distributed. A thorough assessment of the scale of the indebtedness situation in the UK needs to examine the usage of credit at a household level. Before critically analysing the findings from the different reports, it is important to set out clearly an appropriate framework for judging over-indebtedness.

Defining over-indebtedness

There is no generally accepted definition of over-indebtedness in the literature. Most of the reports analyse over-indebtedness on the basis of various measures (such as the number of people in financial difficulty) without specifically defining the term.

In this report, over-indebtedness is defined as those households or individuals who are in arrears on a structural basis, or are at a significant risk of getting into arrears on a structural basis. This conceptual definition has two important aspects. First, it includes only those households that are in arrears *on a structural basis*; households that are temporarily in

[1] Oxera has been asked to assess the reports listed at the end of this Executive Summary.

[2] The analysis in this report uses data from, among others, the Bank of England, Office of National Statistics, Council of Mortgage Lenders (CML), the British Household Panel Survey (BHPS), and the Family Expenditure Survey (FES).

arrears and/or households that are able but not willing to meet their commitments should be excluded.[3] Second, in theory, every individual who has credit runs a risk of falling behind with payments; however, the definition includes only those who are at a *significant* risk of getting into arrears.

Why does over-indebtedness occur?

In general, when taking the decision to lend money, credit providers use sophisticated risk models to assess the ability of households to bear certain interest payments and repayments during a certain period of time. It is not in the credit provider's interest to lend money to people who are at a significant risk of getting into arrears. Furthermore, before taking out a loan, individuals are also likely to assess their financial situation themselves. The assessments undertaken by both lenders and borrowers should reduce the risk of over-indebtedness; however, in practice, there will always be some borrowers who are not able to meet their financial obligations and who will get into arrears.

First, there is asymmetric information between lender and borrower. A lender can only assess its customer's financial position on the basis of information that is available within the organisation of the lender, and that made available by the borrower and the credit bureau—borrowers may fail to inform the lender about other credit commitments or misinform the lender about their level of income.

Second, the borrower faces uncertainty about future revenues and expenditures and therefore about the affordability of the credit. This means that, even if the borrower were honest and provided the lender with all relevant information, future unanticipated events may lead to default.

This means that credit providers always take certain risks in providing credit, and interest rates are normally set in accordance with these risks. Minimising the risk of default would require credit providers to restrict lending significantly, potentially making it very difficult for a large proportion of the population to obtain access to credit.

An in-depth empirical analysis of the reasons for over-indebtedness is beyond the scope of this report. Some relevant evidence on reasons for getting into financial difficulty and into arrears can be found in the Kempson report (2002). 24% of the households that indicated that they were in financial difficulty or arrears gave reasons related to informational errors: 10% because of over-commitment, and 14% due to low income. The majority of households in financial difficulty or arrears (61%) gave reasons related to uncertainty about future income and expenses.[4]

[3] Some people may be in arrears because they are not willing to meet their financial commitments. Dominy and Kempson (2003) identify groups of people who have little or no intention of paying their creditors on time, such as people withholding money on principle because they believe they are getting poor value for money (most common examples are council tax and water bills), or people who deliberately and routinely wait until late in the debt-recovery cycle before they pay their bills.

[4] Of households surveyed, 45% gave loss of income as the main reason; 12% cited increases/unexpected expenses, and 4% of households indicated debts left by a former partner. Loss of income can be a result of, for example, redundancy, relationship breakdown, sickness or disability.

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Measuring over-indebtedness

Identifying people who are in arrears, or who are at risk of falling into arrears on a structural basis, requires data at household level. Data on arrears, and on the duration and reasons for arrears, can be used to identify individuals who are currently in arrears on a structural basis.

To assess the likelihood of a household falling behind with payments, statistical analysis can be undertaken to ascertain which factors drive arrears and write-offs. Each household's probability of falling into arrears can then be estimated and the effect of a shock (eg, an increase in interest rates or unemployment) can be assessed. Using econometric tools, a relationship between arrears and indicators of indebtedness such as debt:income and debt-service:income ratios, together with socio-demographic characteristics, can be established. Existing studies and risk models used by credit providers show that the probability of falling into arrears depends on financial ratios as well as on socio-demographic characteristics.

No publicly available UK household-level dataset has the requisite data on arrears, income, debt, debt service, and household characteristics. This means that any estimate of the number of households at significant risk of falling into arrears must be based on indicators. Two types of indicator are prevalent in the published studies: subjective indicators and debt-ratio indicators. Subjective indicators are used as a direct measure of the probability of falling into arrears based on a household's view of itself. Debt-ratio indicators are used because the existing statistical evidence finds these to be significant factors that explain over-indebtedness. These measures may give an indication of the number of households that are structurally falling behind with their payments and the number that are at a significant risk of doing so.

Subjective indicators—under this approach, over-indebted consumers are defined as those who *consider* themselves to be over-indebted.

Debt-ratio indicators—this approach looks at a range of 'objective' quantitative ratios, such as debt:income, debt:wealth and debt-service:income ratios. The most relevant indicators are those based on interest payments and minimum repayments as a proportion of disposable income—ie, the minimum amount that debtors are required to repay during a certain period.

This gives a framework to assess the findings from the public-domain reports.

Assessment of the reports

Oxera has been asked to review the reports listed at the end of this Executive Summary. Many of the reports that received attention in relation to the over-indebtedness debate do not have as their (main) objective the assessment of indebtedness and over-indebtedness of individuals/households in the UK. The PwC report reviews recent developments in the credit-card sector in 2002. The CMRC study examines trends and developments in debt management, debt collection and recovery. The CCRG report analyses debt at the aggregate level over time in the UK. The PwC, CMRC, and CCRG reports do not provide any data at household level nor any subjective measures of over-indebtedness, and are therefore unlikely to be useful in assessing over-indebtedness.

The CAB report provides a range of measures but is restricted to data on CAB clients. As the report results are not representative of the UK population, it is of limited use. The ORC Macro study assesses over-indebtedness in the EU; however, it bases its conclusions on over-indebtedness on one subjective measure only.

The six remaining reports (Kempson, MORI (for the CAB), JP Morgan, KPMG, Bank of England, and FSA) do provide data at household level. These reports have been analysed in detail, supplemented by data from the ONS and Bank of England, and credit providers to assess the reliability of the quantitative estimates.

The Bank of England (2003) and Kempson (2002) reports are the most comprehensive. The Kempson report was commissioned by the DTI with the aim of providing information on the causes, extent and effect of over-indebtedness. The report analyses the results of a survey of a sample of households in the UK. The Bank of England report presents new survey evidence on the distribution of unsecured debt in the UK and analyses indebtedness and over-indebtedness of individuals in the UK.

Both reports contain data on the average amount of debt owed by debtors, the participation rate, the distribution of the amount of debt owed by debtors, and the distribution of debt by debt instrument. In addition, the Kempson report presents estimates of interest payments and repayments as a proportion of income, and the Bank of England report provides data on the distribution of debt by income group, and debt:income ratios (at household level by income group). Both the Bank of England and Kempson reports analyse the characteristics of individuals/households with debt problems.

The surveys show that around 40—50% of households and 30—40% of individuals (adults) have some form of unsecured debt—credit-card credit that is paid off in full at the end of the month is not included. These participation rates have remained stable over the past seven years. The average amount of unsecured debt by debtor, as estimated by the surveys, ranges from £3,500 to £6,646 in 2002/03—the latter figure also includes rent arrears.

Although the surveys are representative of the UK population as a whole, and most of them are consistent with each other in terms of participation rates and the average amount of the debtor’s debt, there is a substantial difference between the grossed-up amount of unsecured debt claimed in the survey responses and that reported by credit providers. A reason for the difference may be that respondents feel uncomfortable revealing their real levels of debt. This may result in some respondents not owning up to any debt and/or others understating the true extent of their credit commitments. This is problematic for drawing conclusions on the proportion of households likely to fall into arrears. It also means that no conclusions can be drawn from the fact that the surveys show that average levels of debt have not been increasing. This is likely to be a reflection of the under-reporting, which has been increasing over time.

Given the degree of under-reporting of debt levels, the assessment of over-indebtedness needs to focus in particular on other indicators such as late-payment data and subjective measures.

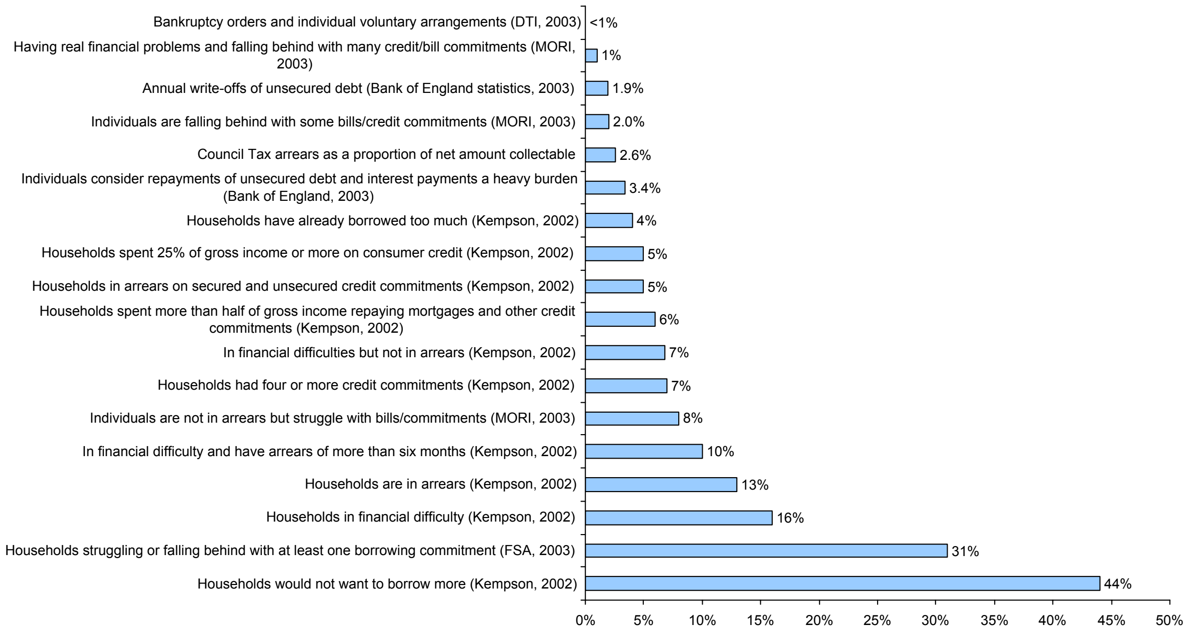
Late-payment data

A number of reports provide data on arrears, bankruptcies, and write-offs. An assessment of over-indebtedness needs to focus on households that are structurally in arrears—for example, due to factors such as long-term unemployment or over-commitment. Households that are not in arrears on a structural basis need to be excluded—they should not be considered over-indebted. For example, households may be in arrears due to a temporary mismatch between income or expenses, or because they may have missed the minimum payment for credit cards. Other households that are in arrears may be able to meet their commitment but may not be willing to do so. Furthermore, some households may still be in arrears but may have started to catch up with their payments. Those households also need to be excluded from arrears data. Other aspects to consider in assessing whether households are in arrears on a structural basis are the number of arrears and the duration of arrears.

Figure 1 presents the late-payments and subjective measures used in the various reports. The Kempson report provides data on arrears and indicates that 13% of households were in arrears at the time the survey was undertaken, with 2.3% of households stating the reason as being an error, or missing or withholding a payment. Of the households in arrears, 46% were falling behind with one commitment, 21% with two commitments, 12% with three, and 20% with four or more commitments.

Around half of the households in arrears (6.7% of households) had been in arrears for more than six months, and one-third of them (4.2% of households) for more than 12 months. The MORI report (for the CAB) gives a lower estimate and indicates that only 3% of individuals reported that they had fallen behind with bills/credit commitments.

Figure 1: Subjective and late payments measures



Subjective measures

The advantage of subjective measures is that they give a direct indication of over-indebtedness by capturing households that are currently managing their credit commitments but are vulnerable, as well as those that are in arrears. The disadvantage of subjective measures is that they assume that households are capable of assessing their own financial situation and will be honest. The proportion of households that will be considered over-indebted will depend on the precise definition used for assessing the subjective evidence.

Figure 1 clearly shows that different subjective measures give different estimates of affected households. In general, the broader the definition of the measures, the higher the number of households or individuals that are affected. For example, 4% of the households in the Kempson survey in 2002 indicated that they had borrowed too much, while 20% indicated that they were in financial difficulty.

It is crucial that the question posed is carefully worded to target the problem of over-indebtedness. The survey undertaken for the Kempson report asks households whether they are in financial difficulty. People in arrears, or who are at a significant risk of getting into arrears, are likely to consider themselves in financial difficulty. However, the question on financial difficulty is relatively broad and not restricted to problems related to interest payments and repayments of loans. For example, people may have difficulty meeting their financial obligations simply because of low income, irrespective of whether they have credit commitments. Thus over-indebtedness will be overstated if too broad a measure is used. However, it is also possible that households do not take sufficient account of the possible impact of external shocks. If this were the case, subjective measures may underestimate the situation of over-indebtedness.

Debt-level indicators

On the basis of Bank of England and ONS data, Oxera estimates the unsecured debt:income ratio in the UK at 23% in 2003. The Bank of England report estimates unsecured debt:income ratios by income group as ranging between 29% and 7%.[5] The debt:income ratio is unlikely to be an indicator of the current payment burden, as only a part of the outstanding stock of debt is payable in the near term. Estimates of debt-service:income ratios are likely to give a clearer picture of the financial burden of credit commitments on households. The Kempson report provides estimates of repayments (including interest) on secured and unsecured credit: 53% of households do not spend anything on unsecured credit; 22% spend less than 10% of their income; 8% spend between 10% and 25%; and 5% spend more than 25% on unsecured credit. Although the measure of 'repayments' used by Kempson is useful in assessing the usage of credit and its financial implications for households, it is not provided by income group, and it is likely to be too broad to assess over-indebtedness. It includes total repayments based on what households actually pay off, including any lump-sum repayments, while households are normally only required to repay a minimum amount of the loan each month or year. Interest payments and *minimum* repayments as a proportion of disposable income are a more relevant measure. This measure is not available in the existing reports.

Preferred measures

Three preferred indicators of over-indebtedness emerge from the detailed analysis of the reports.

Debt-service:income ratios—of all the debt-level indicators, the ratio of interest payments and minimum repayments as a proportion of disposable income will give the best reflection of the financial burden of credit commitments on households. No public-domain estimates exist for this ratio. In aggregate, interest payments on unsecured lending form only around 2.5% of disposable income. Kempson (2002) estimates that 5% of households spend 25% or more of disposable income on *total* repayments and interest payments, although this is not the preferred definition of debt-service costs.

Number of households in arrears—the Kempson report indicates that around 6.7% of households have been in arrears for more than six months. This includes those in arrears on household bills, as well as credit commitments. The MORI survey (for the CAB) indicates that 3% of individuals are falling behind with bills/credit commitments.

Subjective measures of borrowing too much—The Kempson report shows that 4% of the households surveyed indicated that they had already borrowed too much while the Bank of England (2003) report suggests that 3.4% of individuals considered interest payments and repayments of unsecured loans to be a heavy burden. On the basis of these measures, a minority of households could be considered over-indebted.

[5] The unsecured debt:income ratio for individuals with income of less than £4,500 per annum is estimated at 103%. The average amount of debt in this income group was relatively high—£2,400—reflecting a disproportionate number of people with student debt in the group.

Some of the measures indicate that there are more households in arrears than those that have borrowed too much or that find the interest payments and repayments to be a heavy burden. This may indicate that some people who are in arrears are not so on a structural basis—for example, because they are able but unwilling to meet their financial commitments or because they have already started catching up with their repayments and do not therefore consider themselves in difficulty any longer.[6] It may also be that the subjective measures result in underestimates because of some households' inability to assess their own financial situation.

The evidence indicates that over-indebtedness is often a temporary problem for a household. Most people are only in arrears for a relatively short period of time; people are sometimes affected by external shocks, such as a temporary loss in income, but manage to get out of financial difficulty after some time. The Kempson report shows that 6% of households surveyed stated that they had had financial difficulties 12 months prior to the survey, but had since resolved them, while a similar proportion (6%) stated that their financial difficulties had started in the past year. Furthermore, there are no indications that the number of people in financial difficulty has increased over time. The Bank of England report shows that the proportion of individuals reporting debt to be a heavy burden has been broadly stable at around 3.4% over the past nine years, while the proportion reporting debt to be somewhat of a burden has slightly declined over time.

Conclusions and further research

The analysis of debt at macro-level indicates that the UK position is not out of line with changes observed in other G7 countries. Furthermore, although unsecured lending has grown faster than secured lending for much of the last decade, over the period since 1987 the proportions of unsecured and secured debt have remained relatively stable.

Regarding the analysis of households, the conclusion is that there is no one data source at this level that is sufficiently reliable to enable robust conclusions to be drawn on the extent to which over-indebtedness is a problem in the UK. Furthermore, the existing reports do not take a forward-looking approach that evaluates the vulnerability of households to external shocks.[7]

There are indications from the subjective measures that a number of households are under financial pressure; however, this does not necessarily mean that these households are over-indebted. The three preferred measures taken together indicate that a minority of UK households are over-indebted. However, the lack of precision and consistency in the questioning across surveys makes it difficult to draw strong conclusions on the basis of this survey evidence.

[6] The Kempson report indicates that 25% of those saying that they were no longer in difficulty were actually still in arrears. As pointed out by Kempson, a plausible explanation is that they were paying off the money they owed and felt that they had got their finances back under control. This means that these households were not structurally in arrears any longer.

[7] The only exception is the FSA (2004) report, which uses a subjective measure to gauge the potential effects on consumers of a rise in the interest rate. The survey commissioned by the FSA asked people how they would manage repaying their debt in the event of a change in their housing costs. For people with a mortgage, questions were asked which correspond to interest rate rises of 1%, 2.5% and 5%.

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This report indicates that a more thorough understanding is required of the actual financial position of households, and of how other factors affect this position, before robust conclusions can be drawn about whether concerns relating to the possible future consequences of current level of household unsecured debt are well founded.

For the assessment of the scale of the debt situation in the UK, this study uses a number of information sources.

Economic literature—this provides the theoretical framework within which indebtedness and over-indebtedness can be assessed.

Existing studies on (over-)indebtedness in the UK—Oxera was asked to review the following studies:

- Bank of England (2003), 'The Distribution of Unsecured Debt in the United Kingdom: Survey Evidence', December. The study uses evidence from a survey commissioned from NMG Research.
- Citizens' Advice Bureaux (CAB) (2003), 'Survey—In Too Deep', May.
- Credit Card Research Group (CCRG) (2002), 'Debt Behind the Headlines', March.
- Credit Management Research Centre (CMRC), Leeds University Business School (2003), 'Debt Survey 2003: Debt Management, Collection and Recovery', September.
- FSA (2004), 'Financial Risk Outlook'.
- Kempson, E. (2002), 'Over-indebtedness in Britain', commissioned by the DTI, September.
- JP Morgan (2003), 'UK Personal Sector Debt', November.
- MORI (2003), 'Financial Over-Commitment Survey', commissioned by the CAB, July.
- ORC Macro (2001), 'Study of the Problem of Consumer Indebtedness: Statistical Aspects—Submitted to the European Commission', October.
- PricewaterhouseCoopers (PwC) (2002), 'Precious Plastic', November.

Statistical reports and databases—various sources have been consulted including the British Household Panel Database (BHPS), Family Expenditure Survey (FES), APACS, the Bank of England, OECD, the Office for National Statistics (ONS), and Council of Mortgage Lenders (CML), and the following:

– Banks, J. and Johnson, P. (1998), 'How Reliable is the Family Expenditure Survey?—Trends in Incomes and Expenditures over Time', The Institute for Fiscal Studies, January.
– Berthoud, R., and Kempson, E. (1992), 'Credit and Debt—The PSI Report', Policy Studies Institute, London, Table 4.18, p. 65.
– Bridges, S. and Disney, R. (2003), 'Use of Credit and Arrears on Debt among Low Income Families in the United Kingdom', draft manuscript.
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– Dominy, N. and Kempson, E. (2003), 'Can't Pay or Won't Pay?—A Review of Creditor and Debtor Approaches to the Non-payment of Bills', Prepared for the Lord Chancellor's Department, February.
– KMPG (2003), 'Debt Crisis—An Attempt to Make Ends Meet or Frivolous Approach to Spending?', press release, August. The survey was undertaken by YouGov. No report on the survey results is available.
– Whitley, J., Windram, R. and Cox, P. (2004), 'An Empirical Model of Household Arrears', Bank of England Working Paper no. 214.

Contents

1.0 Introduction

1.1 Remit and objectives

Oxera has been commissioned by the Association for Payment Clearing Services (APACS), the British Bankers' Association (BBA), the Consumer Credit Association (CCA), and the Finance & Leasing Association (FLA) to undertake a study of UK consumer debt.

Over the past few years, several studies have been published on indebtedness and over-indebtedness, undertaken by a number of institutions. These reports have received considerable attention and have been frequently referred to by MPs in recent Treasury Select Committee hearings. Some of the reports have resulted in confusing messages in the media about over-indebtedness and a general misunderstanding of the debt situation in the UK. This may arise from a number of sources: a lack of an agreed conceptual framework for analysing over-indebtedness; misinterpretation of statistics; and a lack of reliable data.

The objective of the study for APACS/BBA/CCA/FLA is to provide a realistic assessment of the scale of debt situation in the UK, based on existing reports and available data. The study provides the associations with a reliable compendium of statistics on over-indebtedness and an understanding of the scale of the debt situation in the UK. The study assesses the scale of over-indebtedness in the current economic climate.

1.2 Information sources

For the assessment of the scale of the debt situation in the UK, this study uses a number of information sources.

- Economic literature—this provides the theoretical framework within which indebtedness and over-indebtedness can be assessed.
- Existing studies on (over-)indebtedness in the UK—Oxera was asked to review the following studies:
  - Bank of England (2003), 'The Distribution of Unsecured Debt in the United Kingdom: Survey Evidence', December. The study uses evidence from a survey commissioned from NMG Research.
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- Whitley, J., Windram, R. and Cox, P. (2004), 'An Empirical Model of Household Arrears', Bank of England Working Paper no. 214.

1.3 Outline of report

Despite the attention in the media on over-indebtedness, there is no agreed definition of this concept. The public reports referred to above do not necessarily even set out to draw conclusions on over-indebtedness, and those that do are often not explicit about the definition they are using. Each report draws on one or more indicators of over-indebtedness to support its conclusions. In most cases, the indicators are subtly different, even when they appear to be the same.

A conceptual framework for analysing over-indebtedness is established in section 3, defined as those individuals who are in arrears in a structural way, or are at a significant risk of falling into arrears on this basis. Three quantitative measures are identified which may indicate over-indebtedness—late payments data, subjective measures of indebtedness and debt- and debt service:income ratios. Before this, section 2 sets out the facts at an aggregate level on the expansion of credit usage in the UK. This shows that very few conclusions on over-indebtedness can be reached on the basis of this aggregate-level data.

1.0 Introduction

Section 4 examines the scope and comprehensiveness of the published studies, comparing the aim of each study and its breadth. The robustness of the different surveys conducted is assessed before presenting a comparison of the core data on average debt levels and its distribution in each study. This is examined as a necessary starting point for any debt study.

Section 5 then assesses the evidence on the three types of indicator identified in section 3 as informative on over-indebtedness, based on the data available in the public domain. Section 6 concludes.

This framework may not allow for an assessment of all the various elements of analysis in the reports. The Appendix therefore contains a full assessment of the individual reports.

2.0 Usage of credit—analysis at macro level

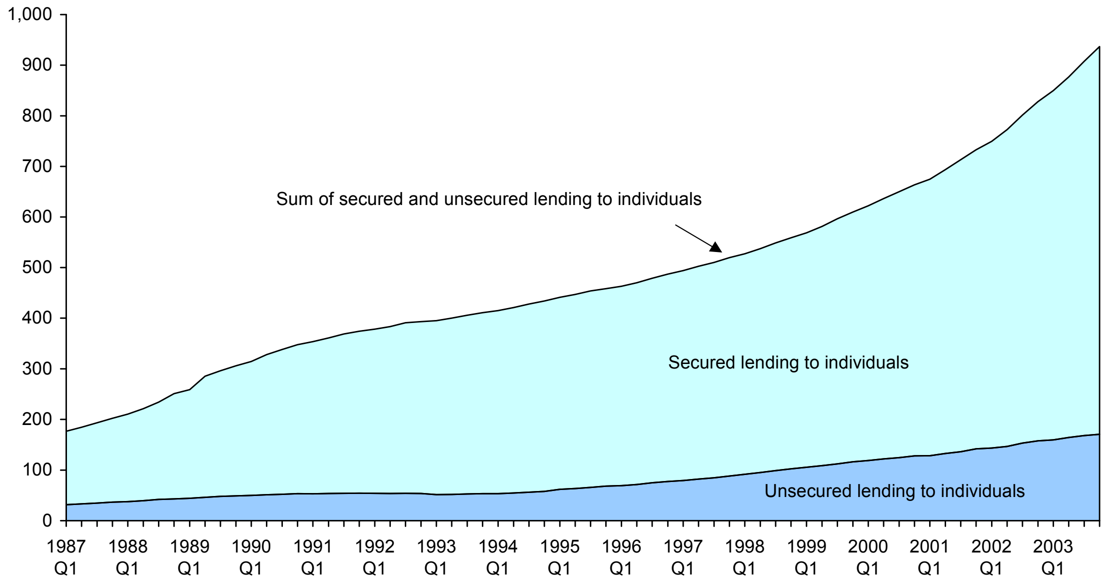
This section examines at aggregate level recent developments of usage of credit in the UK. It assesses the growth in secured and unsecured credit; compares household debt levels against household income and wealth, and interest payments with household income; and investigates the relative share of household interest payments accounted for by secured and unsecured lending.

The focus in this section is the usage of credit at aggregate level over time. Section 3 provides an assessment of usage of credit at household level.

2.1 Composition and growth of aggregate debt

Figure 2.1 highlights the growth in total lending to individuals and, within that, unsecured lending, such as credit cards or personal loans. Total lending was approximately £937 billion by the end of 2003, while unsecured lending was close to £171 billion. These figures can be compared with £177 billion for total lending and around £31 billion for unsecured lending at the start of 1987.

Figure 2.1: Levels of total and unsecured lending to individuals (£ billion)



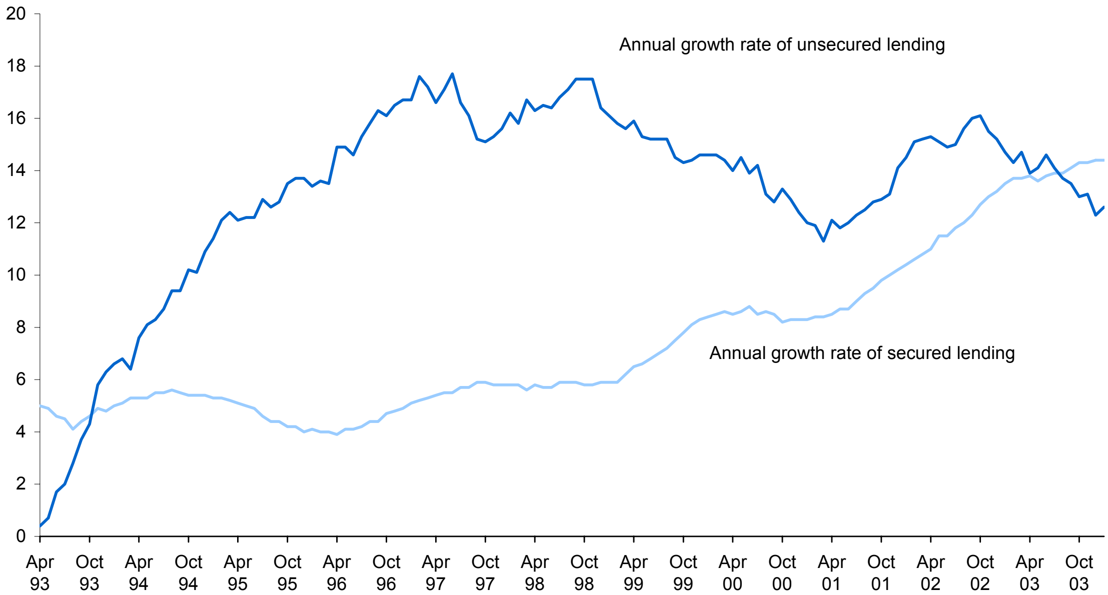
Note: Variables are not seasonally adjusted. They are monthly amounts outstanding of total sterling net secured lending to individuals and housing associations. Housing associations are included as they go on to lend to individuals to purchase affordable housing. By the end of December 2003 bank and building society lending to housing associations accounted for 2.3% of total lending to individuals and housing associations, as reported in Figure 2.1.

Source: Oxera based on Bank of England data.

It is also interesting to examine the rate of growth in secured and unsecured lending. Figure 2.2 highlights the rapid growth of lending, and, in particular, unsecured lending, throughout the latter part of the last decade. The annual growth rate of unsecured lending reached double figures in October 1994 and has remained above that level, peaking at 17.7% in June 1997. For much of the period assessed here, annual rates of growth of unsecured lending surpassed secured lending. However, from August 2003, the latter exceeded the former.

2.0 Usage of credit—analysis at macro level

Figure 2.2: Annual growth rates of secured and unsecured lending (%)



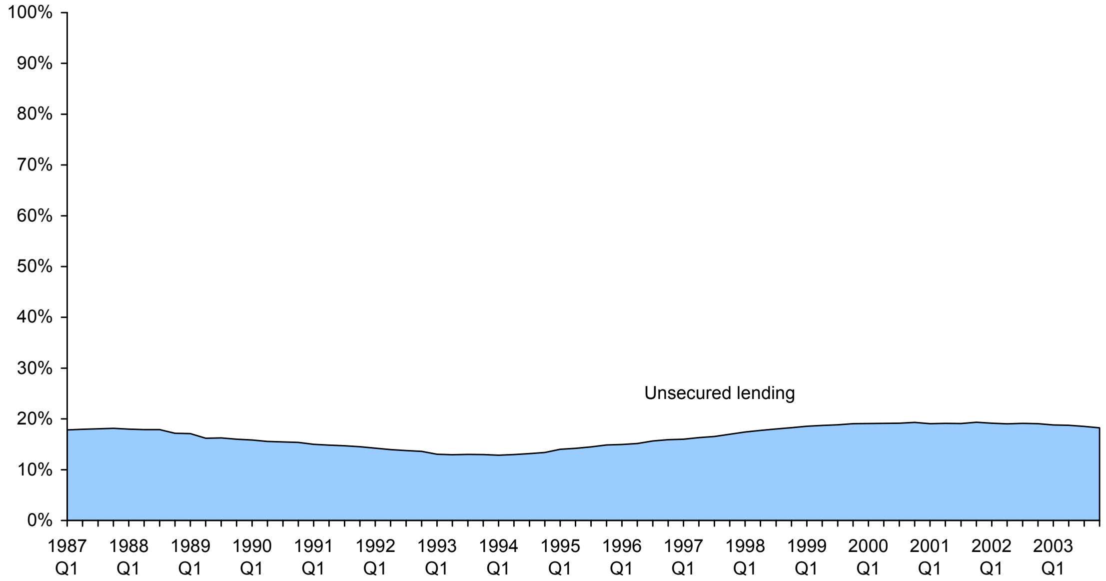
Note: Twelve-month growth rate of total sterling net secured lending to individuals and housing associations, and 12-month growth rate of total sterling net unsecured lending to individuals. Data is seasonally adjusted. Last data for December 2003.

Source: Oxera based on Bank of England data.

Despite the more rapid recent growth in unsecured forms of lending, the share of unsecured compared with secured lending has remained relatively stable since 1987. Indeed, as Figure 2.3 highlights, there is little apparent evidence of a significant trend towards relatively higher levels of unsecured debt since 1987. Although aggregate debt has increased, the proportions of unsecured and secured debt have stayed broadly the same. With the development of remortgaging, borrowers can, over time, switch between unsecured and secured lending. One use of remortgaging, for example, would be to consolidate unsecured debt such as credit-card balances and personal loans at a (most likely) lower interest rate.

2.0 Usage of credit—analysis at macro level

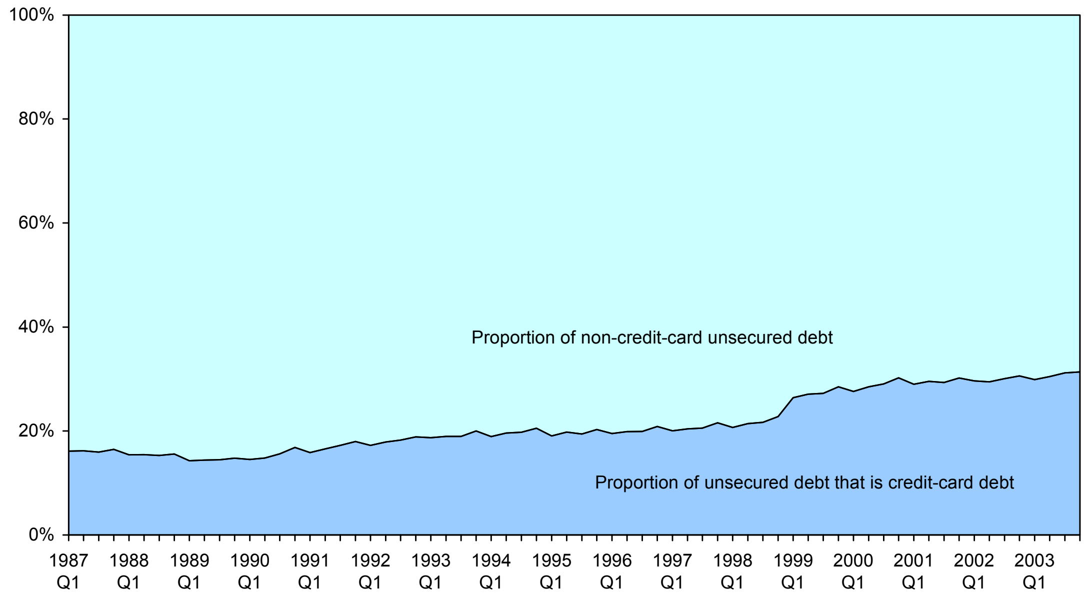
Figure 2.3: Share of unsecured lending within total lending to individuals



Source: Oxera based on Bank of England data.

Figure 2.4 shows the composition of unsecured credit over time. It suggests that, at the end of 2003, credit-card debt accounted for around 31% of total unsecured debt.

Figure 2.4: Relative share of credit-card debt within unsecured lending



Source: Oxera based on Bank of England data.

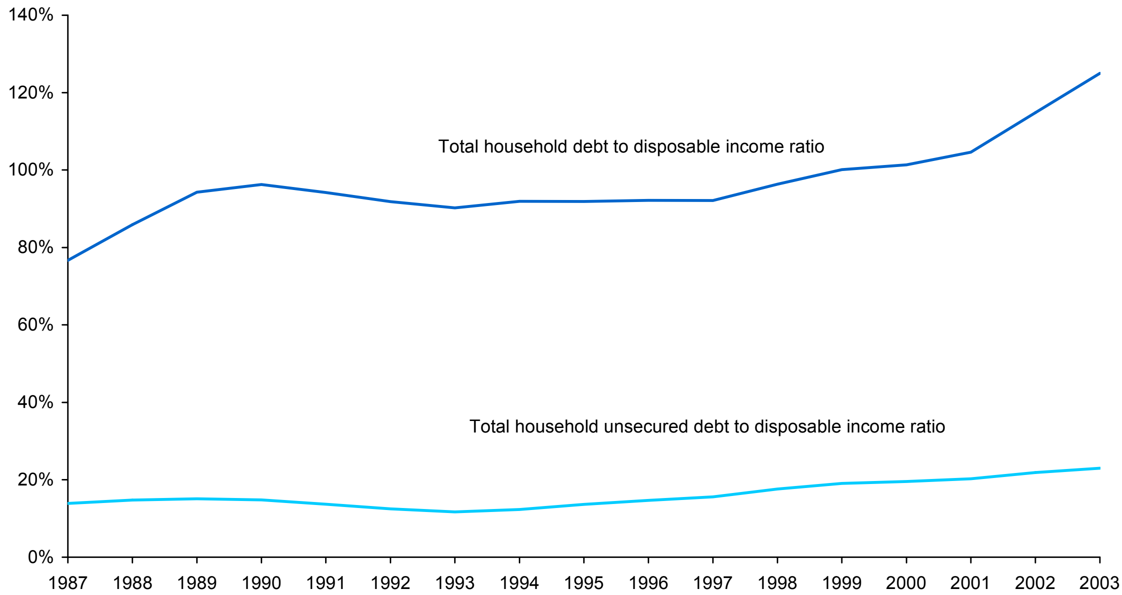
2.0 Usage of credit—analysis at macro level

2.2 Aggregate ratios of household indebtedness

The level of debt is not necessarily a meaningful measure in itself. The income and wealth of people in the UK have grown over time, suggesting that consumers can afford more credit. Comparing the level of debt with income and wealth can therefore be informative.

Figure 2.5 compares unsecured and total lending to individuals with gross household disposable income. Total household debt has increased significantly, relative to disposable income, from 77% in 1987 to 115% in 2002. Oxera's calculations indicate that this is mainly due to the increase in secured debt. The unsecured debt to disposable income ratio over that period increased from 13% in 1987 to 23% in 2003.

Figure 2.5: Ratio of unsecured and total household debt to disposable income



Note: Amounts outstanding at the end of the fourth quarter of total sterling net secured lending to individuals and housing associations, and amounts outstanding of total sterling net unsecured lending to individuals. ONS variable for gross disposable income.

Source: ONS, Bank of England. Oxera calculations.

Aggregate UK household debt has increased more than fivefold since 1987, with total debt now above 100% of household disposable income. Table 2.1 compares the debt:income ratio in the UK with ratios in other G7 countries. It indicates that this UK position is not out of line with changes observed in the other G7 countries over this period.

2.0 Usage of credit—analysis at macro level

Table 2.1: Household debt:income ratios (%)

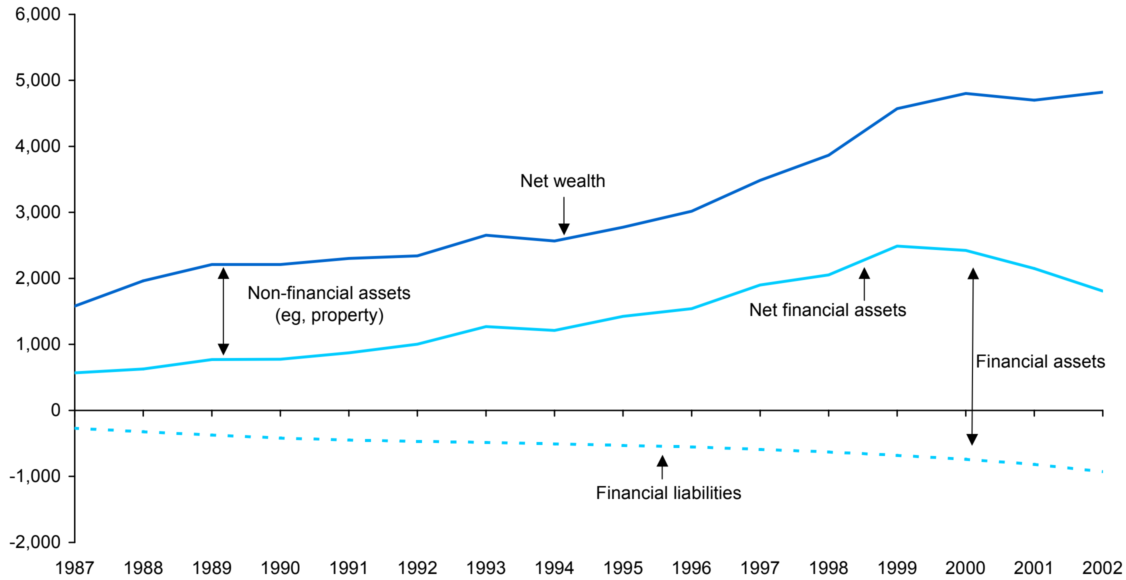
	Canada	France	Germany	Italy	Japan	UK	USA
1991	93.8	80.9	84.9	29.8	130.9	113.5	87.9
1992	96.7	80.3	85.7	30.6	128.3	109.4	87.1
1993	99.5	82.6	91.0	31.8	132.4	106.4	89.3
1994	103.1	84.6	97.0	31.9	132.4	107.5	91.7
1995	103.4	67.9	100.6	30.6	137.1	106.5	93.7
1996	106.8	68.7	104.8	32.0	133.9	105.1	96.0
1997	109.6	69.2	107.6	28.2	134.4	105.0	97.7
1998	112.0	73.8	111.0	30.3	133.6	109.1	99.3
1999	113.9	75.3	114.2	33.8	133.5	111.8	104.0
2000	113.0	76.6	114.4	35.3	133.7	115.6	104.9
2001	115.2	81.7	112.0	35.3	138.8	118.7	108.9
2002	115.7	82.1	112.1	n/a	139.8	128.9	112.4

Source: OECD

Household debt is a stock measure, whereas income is a flow. For consistency, therefore, household debt should arguably be compared with household wealth. ONS data for net household wealth is classified on the basis of the household and not-for-profit sector—the ONS is attempting to separate this variable into household data and NPISH (non-profit institutions serving households) data. The majority of net household and NPISH wealth is accounted for by household wealth.

Figure 2.6 shows the financial position of UK households (and NPISH) at aggregate level. The dotted line represents the financial liabilities, which have increased since 1987. However, despite this growth in lending, the net financial assets (the middle line) and the total wealth position (the upper line) have also grown over this period. This is due to an increase in financial assets (such as equities) and non-financial assets (such as property).

Figure 2.6: Household financial assets, liabilities and net wealth (£ billion)



Source: ONS.

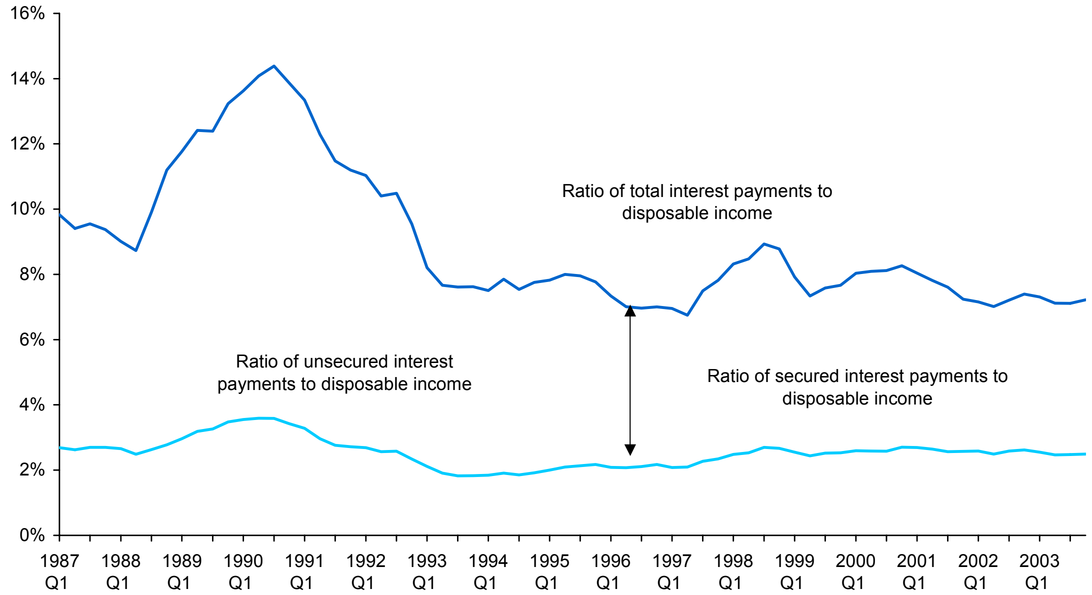
Adding the financial assets to the liabilities (the dotted line) results in the net financial assets position (the middle line). Adding subsequently the non-financial assets results in the total net wealth position of UK households (the upper line).

From an aggregate perspective, therefore, ONS data suggests that both rising financial and non-financial assets could have supported the growth of financial liabilities, namely secured and unsecured lending.

Another important measure to assess the usage of debt is the debt-service:income ratio. Figure 2.7 provides a time-series of the debt-service:income ratio, as measured by comparing interest payments, both secured and unsecured, with household disposable income. Total interest payments as a proportion of household disposable income have declined since the early part of the 1990s, despite the aggregate level of debt increasing over this period. Overall, due to lower interest rates, total interest payments as a proportion of disposable income fell from 10% at the start of 1987 to 7% in the third quarter of 2003, while, within that, and over the same period, the unsecured ratio has fallen from 3% to 2% of disposable income, and the secured ratio from 7% to 5%.

2.0 Usage of credit—analysis at macro level

Figure 2.7: Ratio of unsecured and total interest payments to household disposable income



Note: ONS data for mortgage interest payments (household and NPISH sector) and total interest payments (household and NPISH sector). Last data point is for Q3 2003.

Source: Data from ONS, Bank of England. Oxera calculations.

2.3 Conclusions

Total UK household debt has increased more than fivefold since 1987, with total debt now above 100% of household disposable income. Although unsecured lending has grown faster than secured lending for much of the last decade, over the period since 1987 the proportions of unsecured and secured debt have not changed significantly. Moreover, despite the growth in aggregate debt levels, household financial assets exceed financial liabilities, such as secured and unsecured debt, while net financial wealth is significantly greater than total household debt. Furthermore, supported by low official interest rates, interest payments as a proportion of disposable income have remained relatively stable in recent years and are lower than at the start of the 1990s.

Household income, wealth and financial liabilities are not, however, evenly distributed. It is therefore difficult to make an assessment of the scale of the indebtedness situation in the UK using aggregate data alone. Section 3 below therefore examines the usage of credit at a household level.

3.0 Indebtedness and over-indebtedness of households in the UK

3.1 Definition of over-indebtedness

There is no generally accepted definition of over-indebtedness in the literature. Most of the reports analyse indebtedness and over-indebtedness on the basis of a number of measures (such as the number of people in financial difficulty) without specifically defining the term.[8]

From a strict economic point of view, it could be argued that, as long as an individual's wealth plus present value of expected revenues minus expenditures[9] exceeds the value of their debt, they will be able to meet their financial obligations resulting from credit commitments. Such an individual would not be over-indebted. On the other hand, people whose wealth and present value of revenues minus expenditures is lower than their credit commitments would be considered over-indebted—they could be defined as bankrupt.

In practice, such a definition is unlikely to be useful. First, there is uncertainty about future wealth, income and expenditure, which makes it difficult, if not impossible, to determine whether individuals will be able to pay off their loans. Second, people with debt are likely to face certain financial obligations in the short and medium term. They have to pay interest and are often required to repay a specified proportion of the loan before a certain date, depending on the payment schedule. In particular, unsecured credit often has short maturity or requires a certain minimum payment per month (in the case of credit cards for example). In other words, an assessment of over-indebtedness also needs to focus on whether people are able to meet financial obligations resulting from credit commitments in the short to medium term.

People who are in arrears on a structural basis are likely to be over-indebted—they are unable to meet financial obligations from credit commitments in the short to medium term. However, by looking only at those individuals who are currently unable to repay their debts, this may overlook those who still manage to meet their financial obligations, but who have borrowed so much that they have become vulnerable to external shocks such as increases in interest rates or a temporary loss in income. In other words, they are at a significant risk of falling behind with their payments. Such individuals can also arguably be considered over-indebted.

Thus, people who are in arrears on a structural basis, or who are at a significant risk of getting into arrears on such a basis, are likely to be over-indebted. This conceptual definition has two important aspects.

[8] The ORC report is the only one that explicitly provides a definition of over-indebtedness. It defines over-indebtedness as follows: 'A person is over-indebted if he or she considers that he or she has difficulties in repaying debts, whether consumer debt or a mortgage.'

[9] Economic theory indicates that the present value of a future sum of money (revenues or costs) is equal to the sum of money times a discount factor. A principle of finance theory is that a pound today is worth more than a pound tomorrow. This means that the discount factor is less than 1.

3.0 Indebtedness and over-indebtedness of households in the UK

1) It is limited to people who are in arrears *on a structural basis*. Non-structural cases should be excluded. For example, people may get into arrears simply because they forget to pay a bill (such as the minimum payment on their credit card), because they are able but not willing to pay their bills,[10] or because they face a temporary mismatch between income and expenses as a result of unexpected circumstances such as (temporary) unemployment. If they are able to find a new job relatively quickly, they are likely to be in arrears for only a short period of time. In other words, these people may still be counted in the official statistics as being in arrears but have already started catching up with their payments.

2) The definition only includes people who are at a *significant* risk of getting into arrears on a structural basis. In theory, any individual with credit runs the risk of falling behind with their payments. However, the risk needs to be significant, and the arrears need to be structural. The exact meaning of significance requires further interpretation at a practical level.

This conceptual definition will be used in this report to assess over-indebtedness and to assess the analyses in the existing reports. It is similar to a definition used in a study by the Economic and Social Committee of the European Commission. The Commission defines people as over-indebted if they are unable, *on a structural and ongoing basis*, to pay short-term debts. A household is considered over-indebted if it is:

> Objectively unable, on a structural and ongoing basis, to pay short-term debts taken out to meet the needs considered to be essential, from their habitual income provided by work, financial investments or other usual sources, without recourse to loans to finance debts contracted previously.[11]

Although this definition is similar, it is arguably too narrow for a number of reasons.

– First, people who are unable to pay short-term debt may simply decide to postpone the payment rather than taking recourse to new loans to pay off existing loans—in other words, those who are unable to repay short-term debt are likely to get into arrears. These people should be included, but would not be covered by the definition adopted by the European Commission.

– Second, the Commission's definition only refers to debt taken out to meet the needs considered essential. Loans are often taken out for purchases which would not be considered essential; however, the key question is whether the loan can be repaid, not the purpose of it.

– Third, the definition only includes individuals who are currently unable to repay debt, and does not include those who are at risk of falling behind with their payments. As explained, these people can also be considered over-indebted.

[10] Some people may be in arrears because they are not willing to pay their bills. Dominy and Kempson (2003) identify a number of groups of people who have little or no intention of paying their creditors on time, such as people withholding money on principle because they believe they are getting poor value for money (most common examples are council tax and water bills), or people who deliberately and routinely wait until late in the debt-recovery cycle before they pay their bills.

[11] Economic and Social Committee of the European Commission (2000), 'Production and Consumption on Household Over-indebtedness', CES 212.

3.0 Indebtedness and over-indebtedness of households in the UK

3.2 Why does over-indebtedness occur?

In general, when taking the decision to lend money, credit providers use sophisticated risk models to assess the ability of households to bear certain interest payments and repayments during a certain period of time. Assessing the creditworthiness of customers is of crucial importance to the credit provider's business—it is not in the credit provider's interest to lend money to people who are at a significant risk of getting into arrears.

Furthermore, before taking out a loan, individuals are also likely to assess their financial situation themselves. The assessments undertaken by both lenders and borrowers should reduce the risk of over-indebtedness; however, in practice, there will always be some borrowers who are not able to meet their financial obligations and who get into arrears.

– First, there is asymmetric information between lender and borrower. A lender can only assess its customer's financial position on the basis of information that is available within the organisation of the lender, and that made available by the borrower and the credit bureau—borrowers may fail to inform the lender about other credit commitments or misinform the lender about their level of income.

– Second, the borrower faces uncertainty about future revenues and expenditures and therefore about the affordability of the credit. This means that, even if the borrower were honest and provided the lender with all relevant information, future unanticipated events may lead to default.

This means that credit providers always take a certain risk in providing credit, and interest rates are normally set in accordance with these risks. Reducing the risk of default to a minimum would require the credit providers to restrict lending significantly, possibly making it very difficult for a large proportion of the population to obtain access to credit.

An in-depth empirical analysis of the reasons for over-indebtedness is beyond the scope of this report. Some relevant evidence on reasons for getting in financial difficulty or into arrears can be found in the Kempson report (2002). The reasons reported therein are recast in Table 3.1 into the two categories described above: asymmetry of information and uncertainty. 24% of the households that indicated that they were in financial difficulty or arrears gave reasons related to informational errors: 10% because of over-commitment, and 14% due to low income. The majority of households in financial difficulty or arrears (61%) gave reasons related to uncertainty about future income and expenses. 45% gave loss of income as the main reason;[12] 12% cited increases/unexpected expenses, and 4% of households in financial difficulty or arrears indicated debts left by a former partner as the main reason. The remaining 18% claimed that the reason was due to third-party error or that they had overlooked or deliberately withheld the payment.

[12] Loss of income can be a result of, for example, redundancy, relationship breakdown, sickness or disability.

Table 3.1: Causes of financial difficulty and arrears (%)

	Households in arrears or in financial difficulty	Households in arrears	Households in financial difficulty
Reasons related to 'uncertainty'			
Loss of income	45	42	54
Redundancy	19	18	21
Relationship breakdown	5	6	3
Sickness or disability	5	6	9
Other loss of income	7	12	21
Increased/unexpected expenses	12	11	13
Debts left by former partner	4	2	9
Reasons related to 'asymmetric information'			
Low income	14	15	9
Over-commitment	10	9	13
Other reasons			
Overlooked or withheld payment	8	12	—
Third-party error	5	6	—
Other reason	3	3	1

Note: The categorisation into 'asymmetric information' and 'uncertainty' was undertaken by Oxera. The percentages in the table do not refer to all households, but to those in financial difficulty or arrears. For example, 45% of the households in financial difficulty or arrears indicated that they got into such a situation because of loss of income.

Source: Kempson (2002).

3.3 Measuring over-indebtedness

Identifying individuals who are in arrears or who are at significant risk of getting into arrears on a structural basis requires data at household level. As discussed above, counting only those who are *currently* in arrears as over-indebted, would underestimate the extent of problems. It is important to estimate the number of households that face a significant risk of structural arrears.

Data on arrears, the duration of arrears and reasons for being in arrears can be used to identify individuals who are currently in arrears on a structural basis.

3.0 Indebtedness and over-indebtedness of households in the UK

To assess the likelihood of a household falling behind with payments, statistical analysis can be undertaken to ascertain which factors drive arrears and write-offs. Each household's probability of falling into arrears can then be estimated, and the effect of a shock (eg, an interest rate increase or unemployment) can be assessed. Using econometric tools, a relationship between arrears and indicators of indebtedness such as debt:income and debt-service:income ratios, together with socio-demographic characteristics, can be established. A paper by Bank of England (2004) undertakes such an analysis at aggregate level, and shows that the number of mortgages and credit-card arrears over time are indeed partly explained by debt:income ratios. Undertaking such an analysis at household level would identify the probability of a household falling into arrears due to factors such as debt:income ratios over time.[13] Existing studies and risk models used by credit providers show that the probability of falling into arrears depends on financial ratios as well as on socio-demographic characteristics.

Unfortunately no publicly available UK household-level dataset has the requisite data on arrears, income, debt, debt-service and household characteristics. This means that any estimate of the number of households at significant risk of falling into arrears must be based on indicators. Two types of indicator are prevalent in the published studies—subjective indicators and debt-ratio indicators. Subjective indicators are used as a direct measure of the probability of falling into arrears based on a household's view of itself. Debt-ratio indicators are used because the existing statistical evidence finds these to be significant factors that explain over-indebtedness. These measures may give an indication of the number of households that are structurally falling behind with their payment and the number of households that are at a significant risk of falling in such a situation.

– *Subjective indicators*—under this approach, over-indebted consumers are defined as those who *consider* themselves to be over-indebted. Households are usually surveyed on this question. The subjective approach attempts to take account of demographics and individuals' expectations about future income by assuming that households incorporate all this information when assessing their financial position themselves. The disadvantage is that it assumes that consumers are capable of this assessment and will be honest. Also, it is of crucial importance that the questions asked are very precise to ensure that the results capture the likelihood of becoming over-indebted. For example, the survey undertaken for the Kempson report (2002) asks households whether they are in financial difficulty. Households in arrears on a structural basis, or those that are at a significant risk of getting into arrears will be captured in this measure, as they should consider themselves in financial difficulty. However, financial difficulty is a relatively broad category, not restricted to problems relating to interest payments and repayments of loans. For example, people may have difficulty meeting their financial obligations simply because of low income, irrespective of whether they have credit commitments. This is further discussed in section 5.2.

[13] Such an analysis was undertaken for credit cards in the USA: Black, S.E., and Morgan, D.P., (1998), 'Risk and the Democratisation of Credit Cards', June, Federal Reserve Bank of New York. The study shows that credit-card arrears are partly explained by debt payments:income and debt:income ratios.

3.0 Indebtedness and over-indebtedness of households in the UK

– *Debt-ratio indicators*—this looks at a range of 'objective' quantitative ratios, such as debt:income, debts:assets and debt-service:income ratios. The advantage of the debt-level approach is that it is based on 'hard' data. Furthermore, as indicated, Bank of England (2004) shows that the number of mortgage and credit arrears over time can be partly explained by debt:income ratios. This means that such ratios in principle may provide information about the likelihood of falling into arrears. The disadvantage of this approach is that, without the full statistical analysis, it is difficult to identify the thresholds at which a household is likely to be at a significant risk of falling into arrears. A debt:income ratio only provides a snapshot at a particular point in time and does not take account of the lifecycle of consumption and borrowing of households. Debt:income ratios for young households are therefore likely to be higher than for older households, but they may not be more at risk of falling into arrears. Analysis of this indicator will be most useful where its distribution across households is available.

  More useful variables to consider include interest payments and minimum repayments as a proportion of disposable income. Using these variables, it can be estimated whether households can afford essential household expenditure, interest payments and minimum repayments. Arguably, if a household spends a very high proportion of its income on interest payments and minimum repayments, it is likely to be at a significant risk of falling into arrears.

In conclusion, the preferred approach is to define clearly the measure of over-indebtedness and then identify the statistically significant factors that affect a household's probability of becoming over-indebted. Changes to these factors can then be monitored over time to assess whether increasing credit availability is increasing the risk of over-indebtedness. In the absence of such an econometric analysis, key measures to indicate the likelihood of households becoming over-indebted are subjective measures and debt-level ratios at household level (such as debt:income, and interest payments and repayments as a proportion of income). Section 5 examines the measures used in the reports.

4.0 Scope and comprehensiveness of existing reports

As explained above, an assessment of over-indebtedness requires data at household level and on a number of measures, in particular debt-level ratios such as interest payments and minimum repayments as proportion of income at household level.

The range of measures used in the different reports (listed in section 1.2) can therefore give an indication of the comprehensiveness and quality of the report. Table 4.1 summarises the main focus of the reports and shows the different measures used.

Although some of the reports may have been quoted in the media in the context of over-indebtedness, not all reports have as their (main) objective the assessment of indebtedness and over-indebtedness of individuals/households in the UK.

Table 4.1: Measures of indebtedness and over-indebtedness used in reports

Focus of the report	CCRG Aggregate level	Kempson Household level	CAB Household level (CAB clients)	MORI (for CAB) Household level	CMRC Debt-collection market	JP Morgan Household level	Bank of England Household level	ORC Household level	FSA Household level	PwC Developments credit-card sector
Subjective measures	×	✓	✓	✓	×	✓	✓	✓	✓	×
Late-payments data	✓	✓	✓	✓	✓	✓	×	✓	×	×
Debt-level data at aggregate level (eg, debt:income ratio)	✓	×	✓	×	✓	✓	✓	✓	✓	×
Debt-level data at household level	×	✓	✓	✓	×	✓	✓	✓	✓	×
Average amount of debt per household/individual	×	✓	✓	✓	×	✓	✓	×	✓	×
% of households with unsecured debt (participation rate)	×	✓	✓	✓	×	✓	✓	✓	×	×
Distribution of amount of debt owed by debtors	×	✓	✓	✓	×	✓	✓	×	✓	×
Distribution of debt by debt instrument	×	✓	×	×	×	×	✓	×	✓	×
Distribution of debt by income group	×	×	×	×	×	×	✓	×	×	×
Debt:income ratio (at household level by income group)	×	×	×	×	×	×	✓	×	×	×
Interest payments as a proportion of income	×	×	×	×	×	×	×	×	×	×
Repayments as a proportion of income	×	×	×	×	×	×	×	×	×	×
Interest and repayments as a proportion of income	×	✓	×	×	×	×	×	×	×	×
Minimum repayments as a proportion of income	×	×	×	×	×	×	×	×	×	×

4.0 Scope and comprehensiveness of existing reports

As can be seen in Table 4.1, the PwC, CMRC, and CCRG reports do not give any data at household level, nor any subjective measures of over-indebtedness, and are therefore unlikely to be useful for an assessment of over-indebtedness.

– The PwC report reviews recent developments in the credit-card sector in 2002 and considers likely responses of credit-card issuers to the challenges that they face. It does not analyse indebtedness or over-indebtedness.

– The CMRC study examines trends and developments in debt management, debt collection and recovery and looks at the processes and practices of large volume lenders in the consumer credit industry and those organisations involved in extending commercial credit. The study provides limited data on usage of credit and on indebtedness and over-indebtedness at aggregate level.

– The CCRG report seeks to address the question of whether the current level of debt in the UK is too high and likely to produce a future crisis of over-indebtedness. It analyses usage of credit over time and examines a number of measures of indebtedness at aggregate level. Furthermore, it addresses the questions of whether creditors are behaving responsibly in their lending and whether debtors are fully aware of the consequences of taking on credit.

Citizens Advice Bureaux UK-wide have reported a substantial increase in the number of new debt enquiries. In order to understand more about the reasons for the increase, the CAB report tries to find out more about the problems faced by their debt clients, and provides a range of measures, but is restricted to data on CAB clients. As the report results are not representative for the UK population, it is of limited use.

The ORC Macro study was commissioned by DG Health & Consumer Protection of the European Commission. The study analyses statistical aspects of indebtedness and over-indebtedness in the EU and assesses over-indebtedness in the Member States. It bases its conclusions on over-indebtedness only on one subjective measure.

The six remaining reports (Kempson, MORI (for the CAB), JP Morgan, KPMG, Bank of England, and FSA) do provide data at household level. It is these reports that are analysed in detail in this report, supplemented by data from ONS, BHPS, the FES and credit providers to assess the reliability of the quantitative estimates.

– The MORI (for the CAB) report presents the results of a survey undertaken among individuals in the UK. The objectives were to measure the level of financing debt among the general public, and to assess their likelihood to use the CAB as a source of advice and information about debt. In order to obtain an indication of the latter, the survey asks questions about individuals' financial position. The survey provides data on the average amount of debt owed by debtors, the participation rate (% of households that have unsecured debt), and the distribution of debt owed by debtors.

– The JP Morgan report analyses the concentration and distribution of personal-sector debt in the UK. It also analyses the (potential) effect of over-indebtedness on the financial position of credit providers. The JP Morgan report assesses over-indebtedness using data available in existing reports and does not present new data.

– The Financial Risk Outlook of the FSA highlights economic, financial, political and social developments that affect the FSA's ability to meet its statutory objectives. It includes a section on consumer borrowing that reports survey evidence on growth in borrowing and

4.0 Scope and comprehensiveness of existing reports

the average level of different types of unsecured credit, and provides evidence of consumers struggling to make repayments and assesses the impact of possible increases in interest rates.

The Bank of England (2003) and Kempson (2002) reports are the most comprehensive. The Kempson report was commissioned by the DTI with the aim of providing information on the causes, extent and effect of over-indebtedness. The report analyses the results of a survey undertaken among a sample of households in the UK. The Bank of England report presents new survey evidence on the distribution of unsecured debt in the UK and analyses indebtedness and over-indebtedness of individuals in the UK.

Both reports contain data on the average amount of debt owed by debtors, the participation rate, the distribution of the amount of debt owed by debtors, and the distribution of debt by debt instrument. In addition, the Kempson report also gives estimates of interest payments and repayments as a proportion of income, and the Bank of England report provides data on the distribution of debt by income group, and debt:income ratios (at household level by income group). Both the Bank of England and Kempson reports analyse the characteristics of individuals/households with debt problems.

Although the reports provide useful information and measures, none appear to give a complete picture. As explained above, important data elements for an assessment of over-indebtedness include the distribution of debt by income, and interest payments and repayment as a proportion of income—these are most likely to give an accurate indication of the financial burden resulting from credit commitments. The Bank of England report is the only one that gives the distribution of debt by income but does not, however, provide any data on interest payments and repayments. The Kempson report gives (limited) data on interest payments and repayments but does not make a distinction between them; neither does it give the distribution of debt by income group.

Furthermore, none of the reports provides a forward-looking approach that evaluates the vulnerability of households to external shocks,[14] and none of the reports provide an econometric analysis to establish a link between arrears or write-offs and indicators of indebtedness such as debt:income and debt-service:income ratios. The only exception is Bank of England (2004), which assesses this link at aggregate level (not at household level). Furthermore, Kempson (2002) assesses the link between usage of credit (eg, repayments as a proportion of income) and being in arrears and financial difficulty. However, no formal econometric analysis is undertaken to quantify this relationship.[15]

[14] The only exception is the FSA (2004) report, which uses a subjective measure to gauge the potential effects on consumers of a rise in the interest rate. The survey commissioned by the FSA asked people how they would manage repaying their debt in the event of a change in their housing costs. For people with a mortgage, questions were asked which correspond to interest rates rises of 1%, 2.5% and 5%.

[15] The Kempson report concludes that the more credit commitments households had, and the larger the proportion of their income that was used to repay credit, the more likely they were to have been in arrears, and the more sets of arrears they had.

4.0 Scope and comprehensiveness of existing reports

4.1 Comparison of survey characteristics

Table 4.2 shows the characteristics of the different surveys. There is some degree of variation between the sizes of the survey samples. The BHPS is based on the largest sample (9,249 individuals/5,031 households), while Kempson (2002) has the smallest (1,647 households). However, all surveys ensured that the household interviews were representative of the UK or Great Britain as a whole.

Table 4.2: Summary of survey statistics

Survey	Year	Size of sample	Interview technique	Type of survey	Representative for UK or Great Britain?
BHPS	1995 and 2000	9,249/9,006 individuals/ 5,031/4,916 households	Face-to-face interviews	The same individuals re-interviewed in successive waves, and, if they split-off from original households, all adult members of their new households also interviewed	UK
Kempson	2002	1,647 households	Face-to-face interviews	Randomly selected. Interviews were held with head of household	Great Britain
FSA[1]	2003	1832 individuals	Face-to-face interviews	Survey used was National Statistics Omnibus Survey, which uses a probability random sample, with low levels of non-response on income and other financial information	Great Britain
MORI (for the CAB)	2003	1,986 individuals	Face-to-face interviews in respondents' homes	Nationally representative sample of adults	Great Britain
NMG Research (for Bank of England)	2003	1,950 individuals	Face-to-face interviews in respondents' homes	Nationally representative sample who were interviewed each month	UK
KPMG	2003	2,304 individuals	On-line	n/a	n/a

Note: [1] Results are reported at the level of 'family unit', which the FSA defined as either an individual or a couple together with any dependent children. Debts of unrelated individuals in a household are treated as separate households.

Source: Oxera.

There is also a difference in survey technique. Most surveys are based on face-to-face interviews conducted in respondents' homes, while KPMG used an online internet-based survey. An online survey provides anonymity and may therefore encourage respondents to reveal more about indebtedness.

Any differences in results from these surveys are unlikely to be due to the different survey approaches, except in the case of KPMG, where the anonymity may lead to more truthful answers.

4.2 Comparison of data on unsecured debt from different surveys

Before analysing the conclusions on over-indebtedness, the studies were compared to assess similarities in their estimates of average unsecured debt, participation rates and the distribution of this debt.

Table 4.3 below summarises evidence on participation rates and average debt levels (where available) from the key reports listed above and the BHPS.[16]

Looking at the participation rates, as also highlighted in the Bank of England debt survey, there appears to be a consensus that around 40—50% of households, and 30—40% of individuals (adults), have some form of unsecured debt. Only the estimates given by KPMG and MORI (for the CAB) are slightly higher, which may be explained by the fact that they do not specifically exclude loans that people expect to pay off in full at the end of the month in question.[17] Another reason could be that the KPMG survey is an online survey, and, as explained above, may therefore encourage respondents to reveal more about indebtedness due to the element of anonymity.[18]

The participation rates have remained stable over the past seven years. The BHPS gives a participation rate of 35% (in terms of individuals) in 1995 and 2000, and the Bank of England report a ratio of 34% (also in terms of individuals) in the year 2003.

The reports use different definitions of debt. First, the MORI report (for the CAB) and the KPMG report do not specifically exclude loans that people expect to pay off in full at the end of the month in question. Second, the estimates in the reports include different types of unsecured credit. The estimates of debt in the MORI report (for the CAB) include any type of unsecured credit and remortgages (equity release) or secured loans but does not include any current or main mortgage or a remortgage if it was simply taken out to change to a new rate. The estimates from the Bank of England survey include most types of unsecured credit,[19] while the definition used in the FSA report seems to be slightly broader and also include a number of other types of unsecured debt such as loans from family and friends and rent arrears. The estimates in the Kempson report also include most types of unsecured credit but do not appear to include catalogue or mail order, student loans and DSS Social fund.

[16] For details on these sources, see section 1.2. JP Morgan is not included explicitly since it does not report new evidence on participation and average debt levels, but restates findings from other studies already included in the table.
[17] See also section 4.3.
[18] This point was made in Bank of England (2003). Another possible reason mentioned was that an online survey attracts a sample of participants more likely, for whatever reason, to have larger debts. The survey is representative in terms of gender, age, region, and social class.
[19] It includes hire purchase agreements, personal loans, overdrafts, credit cards (extended credit), catalogue or mail order, student loans, DSS social fund, and other loans.

4.0 Scope and comprehensiveness of existing reports

The CAB survey of its clients yields a high estimate of average debt per debtor at £10,700. This is likely to be because the definition is broader than many of the other studies since it includes mortgage arrears and also because there is a selection bias in the sample. CAB clients are self-selected as having debt situations and hence are seeking assistance from the CAB. As discussed in section 4.1, this indicates that no conclusions on credit-users as a whole can be drawn from this information.

The differences in definition may partly explain why the estimates given by the FSA report and the MORI report (for the CAB) are slightly higher than the Bank of England estimates. As indicated, the FSA estimates of debt include rent arrears, while the MORI (for the CAB) estimates include some types of secured loan. The surveys undertaken by the Bank of England, Kempson, and MORI (for the CAB) range from £3,500 to £3,900 of average debt per debtor in 2002/03. The FSA estimates the average level of debt at £6,464 per debtor in 2003.

Table 4.3: Participation and average debt levels

Source	Date of data	% with unsecured debt	Average debt of debtors (£)[1]	Sample size of survey and unit of analysis	Additional types of debt mentioned
Berthoud and Kempson	1989	48	n/a	2,212 households	Store cards
BHPS	1995	35	2,088	9,249 individuals	n/a
BHPS	1995	43	2,872	5,031 households	n/a
BHPS	2000	35	3,242	9,006 individuals	n/a
BHPS	2000	43	4,375	4,916 households	n/a
Kempson	2002	47	3,500	1,647 households	Store cards/accounts
FSA	2003	56	6464	1832 individuals	Family and friends, rent arrears, store loan, DSS loan
KPMG	2003	71	n/a	2,304 individuals	n/a
MORI (for the CAB)	2003	74	3,900	1,986 individuals	Includes some secured loans and remortgaging
CAB	2003	n/a	10,700	924 individuals (CAB clients)	Include mortgage arrears
Bank of England (with NMG Research)	2003	34	3,500	1,950 individuals	n/a
Bridges and Disney	2004	49	not given	4,659 low-income families	Loans from employers, friends, debt collector
CCRG	2000	n/a	n/a	n/a	Store cards, credit unions

Note: [1] Estimates of the level of debt in this table do not include debt paid off at the end off the month, except for the studies by KPMG and MORI (for the CAB).

Source: Bank of England (2003) and Oxera.

4.0 Scope and comprehensiveness of existing reports

Exploring the difference between the FSA (2003) and Bank of England (2003) further, the data is recast into household averages. Given the participation rates and average debt levels, average debt over all households is £1,190 in Bank of England (2003) and £3,620 in FSA (2003). Around 50% of this difference is due to the FSA and Bank of England defining debt differently—ie, the FSA prompted more types of credit in its survey than the Bank of England; 13% is due to the FSA finding higher average levels of debt; and 37% is due to the SA finding higher participation rates, where both surveys cover the same debt instrument.[20] It is not clear why the FSA survey gives these higher participation rates.

The average amounts of debt per debtor can also be compared over time. It is estimated at £2,088 in 1995 (BHPS), £3,242 in 2000 (BHPS), and £3,500 in 2003 (Bank of England). The increase in debt is limited and does not correspond to increases in aggregate unsecured debt, as reported by credit providers (as shown in section 2). As discussed in detail below, the difference between the growth in debt reported by lenders and borrowers may be because the degree of under-reporting has increased over time.

Table 4.4 summarises survey evidence on the distribution of debt among households. Only four studies reported this, despite it being a very important indicator of over-indebtedness. The results of the surveys undertaken by NMA Research (for Bank of England), MORI (for the CAB) and Kempson are similar. Most debtors owe relatively small amounts, with close to half of debtors owing less than £1,000 and around two-thirds owing less than £3,000. The KPMG survey finds a different distribution with more people with higher levels of debt.

Table 4.4: Distribution of the amount owed by debtors

<table>
<tr><th></th><th>Bank of England with NMG Research (2003)</th><th>MORI (for the CAB) (2003)</th><th>KPMG (2003)</th><th>Kempson (2002)</th></tr>
<tr><td>Under £1,000</td><td>43</td><td>44</td><td>25</td><td rowspan="3">67</td></tr>
<tr><td>£1,000—£1,999</td><td>14</td><td>12</td><td rowspan="4">33</td></tr>
<tr><td>£2,000—£2,999</td><td>7</td><td>7</td></tr>
<tr><td>£3,000—£3,999</td><td>5</td><td>6</td><td rowspan="3">17</td></tr>
<tr><td>£4,000—£4,999</td><td>5</td><td>5</td></tr>
<tr><td>£5,000—£7,499</td><td>8</td><td>4</td><td rowspan="2">20</td></tr>
<tr><td>£7,500—£9,999</td><td>5</td><td>3</td><td>7</td></tr>
<tr><td>£10,000—£14,999</td><td>9</td><td>6</td><td rowspan="2">17</td><td rowspan="3">10</td></tr>
<tr><td>£15,000—£19,999</td><td>2</td><td>3</td></tr>
<tr><td>£20,000 or more</td><td>2</td><td>2</td><td>7</td></tr>
</table>

Source: Bank of England (2003).

[20] Average all household debt is £1,190 for the Bank of England (1993) and £3,620 for FSA (2004). This is a difference of £2,430. If debt instruments that are used in both surveys are compared and if an assumption is made that the FSA had had the same participation rate as the Bank of England, the difference would be £305—this is the higher average debt level effect. £906 is the remainder of the difference when common measures are used and the residual £1,219 reflects differing measures of debt included in the survey.

The surveys indicate that unsecured debt is concentrated among a relatively small number of people. The Bank of England survey shows that around half of the debt reported by its survey participants is owed by around 4% of individuals, with individual debt of over £10,000. Without knowing more about these indebted households (for example income levels), no conclusions can be drawn, but they are more likely to be at risk of falling into arrears than the majority of households that report debts of less than £2,000.

Overall the surveys are reasonably consistent, and differences can be explained, for example by the definitions used or the survey technique.

4.3 Comparison of survey data with industry data

Although most of the surveys are consistent with each other, there is a substantial difference between the implied level of total unsecured debt in the survey responses and that reported by credit providers. Table 4.5 show that the total UK consumer credit amounted to £171 billion at the end of 2003 (as reported by credit providers), whereas the grossed-up figures from the surveys are substantially less than that. The Kempson report gives the proportionately lowest estimate at £40.9 billion (for the year 2002). The Bank of England (2003) and the BHPS (2000) surveys amount to £56.5 billion and £53.2 billion respectively.

Table 4.5: Comparison of debt reported by borrowers and lenders

Survey1	Year	Grossed-up amount of debt for UK (£ billion)[1]	Total amount of credit reported by credit providers (£ billion)[2]	% of debt reported by lenders accounted for by survey data reported by borrowers
BHPS (individuals)	1995	33.7	68.2	49
BHPS (households)	1995	29.4	68.2	43
BHPS (individuals)	2000	53.2	128.0	42
BHPS (households)	2000	46.9	128.0	37
Kempson	2002	40.9	157.8	26
FSA	2003	90.0	170.7	52
Bank of England	2003	56.5	170.7	33

Note:
[1] The estimate from the MORI survey (for the CAB) is not presented in this table since it includes not only unsecured debt but also different types of secured debt. This table compares survey estimates of unsecured debt with unsecured debt reported by lenders.
[2] Credit reported by credit providers is the Bank of England's measure of end-year stock of total unsecured lending to individuals. The grossed-up amount of debt is calculated as follows: percentage of households/individuals with unsecured credit times number of households/individuals in the UK times average debt of debtors. The number of households in Great Britain in 2002 was 24,346,000. The last available statistic for Northern Ireland was 530,369 households in 1991. UK figures are calculated assuming Northern Ireland household data is the same as 1991. Data for number of households is from the Office of Deputy Prime Minister. Data for 2003 reports use 2002 household projection since projection for 2003 is not available. ONS data states that the number of adults in the UK (defined as 16 years of age or over) for 2002 was 47,470,000.

Source: Oxera.

One reason for the difference between borrower-based and lender-based figures of debt could be that the latter includes all forms of consumer credit outstanding at a particular date, including that which does not bear interest such as transactional balances. With the exception of KPMG and MORI (for the CAB), the surveys do not include credit card and other bills being paid off in full in the month of interview—respondents were asked not to include this type of credit.

Estimates indicate that transactional balances on credit cards amounted to approximately between £10.5 billion and £13.5 billion in 2003.[21] In other words, this only explains a small part of the difference between the level of unsecured debt recorded in official statistics and that recorded in consumer surveys that can be explained by transactional balances.

The reason for the difference is most likely to be that respondents have a tendency to under-report their debt. People may feel uncomfortable revealing their real levels of debt. In support of this hypothesis is the fact that BHPS estimates of labour income, housing and secured debt, when aggregated, are largely in line with other data.[22] It is not clear whether the under-reporting is a result of individual households under-reporting their borrowing, or there being more households carrying a similar level of debt. Given that Table 4.4 shows a skewing of debt, with a few households bearing the majority of reported debt, it may be that there is a bias in under-reporting.

Table 4.5 shows that there is some evidence that the gap between the lender-based and borrower-based estimates of aggregate unsecured debt has been increasing over time.[23] The proportion of official lender-based aggregate estimate of unsecured debt that is accounted for by survey-based information declined from 49% in 1995 (BHPS estimate), to 42% in 2000 (BHPS estimate), and 33% in 2003 (Bank of England estimate). The BHPS and Bank of England reports use similar definitions and can therefore be compared over time.

4.4 Summary

Household-level data is necessary to be able to answer questions on over-indebtedness, and, in particular, to be able to address the likelihood that households are at risk of falling into arrears. Comparing the different surveys shows that the underlying survey methodologies seem robust; however, there is a significant under-reporting of debt, as compared with the aggregate figures reported by credit providers. This is problematic for drawing conclusions about the proportion of households likely to fall into arrears, if the current level of debt is understated. It also means that no conclusions can be drawn from the fact that the surveys show that average levels of debt have not been increasing—this is likely to be a reflection of the under-reporting, which has been increasing over time.

[21] *Source*: APACS.

[22] This point was made by the Bank of England (2003), footnote 2 to Box 'Consistency with aggregate figures', p. 421, and is also confirmed by evidence presented in the FSA report. The FSA survey estimates total unsecured debt at £90.5 billion, which compares with actual Bank of England data on outstanding debt of approximately £168 billion at the third quarter of 2003 for the UK. Grossed-up secured debt is approximately £700 billion, which compares with actual data of £739 billion at the third quarter of 2003. Thus, while unsecured debt is significantly underreported, secured debt reported in survey evidence is close to actual data. The same pattern holds true for interest payments. As explained in section 5.3.4, the FES underestimates credit-card interest payments as a proportion of disposable income (and slightly overestimates mortgage interest payments as a proportion of disposable income). Banks and Johnson (1998) show that the FES estimates of earnings and social security closely match the national accounts statistics, while other sources, such as self-employment income and income from investments are significantly under-reported. Furthermore, the estimates of mortgage debt are relatively close to aggregate statistics, although the difference between these two has increased over time. In 1985, 97.5% of mortgage debt reported by lenders was accounted for by survey data reported by borrowers, while in 1992, this had fallen to 86.8%.

[23] This point was also made in Bank of England (2003).

4.0 Scope and comprehensiveness of existing reports

The under-reporting is likely to be driven by a preference not to reveal debt to an interviewer (perhaps coupled with a genuine lack of knowledge on debts). Two facts are suggestive of this—the online survey by KPMG that reported much higher average debt levels (yet still below aggregate estimates) and that, in the BHPS, it is *only* the level of unsecured debt that is substantially under-reported.

The surveys show that the bulk of reported debt is concentrated on a few households. This means that the under-reporting may not be uniform across households, as it is possible that heavily indebted households are more reluctant to admit to this than those with a relatively small debt obligation. If under-reporting is skewed, an adjustment that uniformly increases each household's estimate of debt by the same factor in order to reconcile the survey estimates with the known aggregate estimates, such as that used by JP Morgan,[24] may not give an accurate reflection of the extent of over-indebtedness.

This means that these level measures must be used carefully when drawing conclusions on over-indebtedness, and that survey design in this area should seek to mitigate this problem, or try to quantify its effect across different households. Statistical analysis may be able to correct for this problem, as long as the extent of under-reporting for any particular type of household does not change over time.

[24] For an assessment of the JP Morgan report, see Appendix 1.

5.0 Assessment of indicators

This section provides an assessment of the public-domain evidence on the three key indicators of over-indebtedness: the actual level of arrears currently observed; subjective measures; and debt-level ratios.

5.1 Assessment of 'late-payments' data

A number of reports provide data on arrears, bankruptcies, and write-offs. An assessment of over-indebtedness needs to focus on households that are structurally in arrears—for example, due to factors such as long-term unemployment or over-commitment. Households that are not in arrears on a structural basis need to be excluded—they should not be considered over-indebted. For example, households may be in arrears due to a temporary mismatch between income or expenses, or, for example, due to the fact that they missed the minimum payment on outstanding credit-cards balances. Other people who are in arrears may be able to meet their commitment but may not be willing to do so. Furthermore, some households may still be in arrears but may have started catching up with their payments. Those households also need to be excluded from arrears data. Other factors to consider in assessing whether households are in arrears on a structural basis are the number of arrears and the duration of arrears.

On the basis of interviews with people who were in arrears, Dominy and Kempson (2003) identified four different groups of people who had little or no intention of paying their creditors on time:

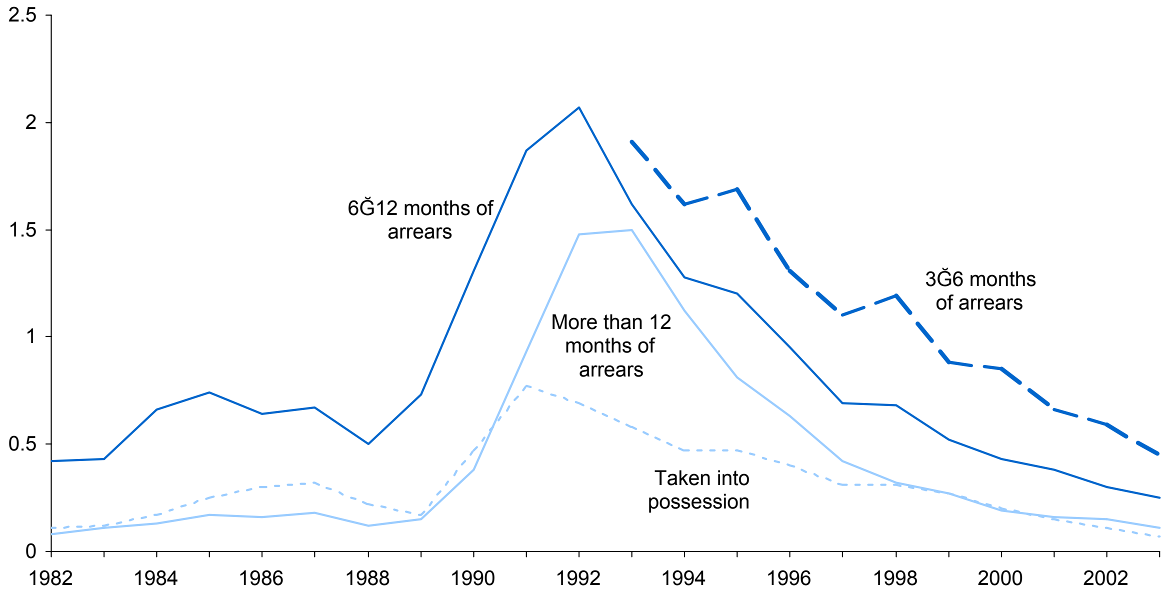
> *'Payment withholders'*—people who did not routinely withhold all their bills but either objected to paying a particular bill on principle or were in dispute with their creditor;
>
> *'Working the system'*—people who routinely waited until late in the debt recovery cycle before paying just about all their bills;
>
> *'Ducking responsibility'*—people who had spent very freely and owed very large sums in consumer credit. They blamed the credit companies for having lent them the money and felt no responsibility for repaying the money they owed;
>
> *'Disorganised'*—people who, unlike the previous three sub-groups, were not deliberately delaying payment, but were so disorganised that some bills got paid on time, while others did not.

As pointed out by Dominy and Kempson (2003), some of the people who are unwilling (but able) to repay the loan may become unable to do so at some point when they have already borrowed too much. However, particularly in the early stage of arrears, it is very likely that these people are able, but not willing, to meet their financial obligations resulting from credit commitments.

5.5.1 'Late payments' data

Figure 5.1 shows the level of mortgage arrears and the number of properties taken into possession (both in percentages of total loans) based on data from the Council of Mortgage Lenders (CML). Following the historically high levels of mortgage arrears and possessions in 1991 and 1992, both have fallen dramatically in the last ten years. At the end of 2002, around 0.81% of borrowers were in arrears of three or more months compared with 5% in 1993; 0.18% of the mortgages were in arrears for longer than 12 months or homes were taken into possession.

Figure 5.1: Mortgage arrears and possessions as a proportion of total loans, 1989 to 2003



Source: CML.

Table 5.1 shows the different types of arrears across all households—data is from Kempson (2002). The low level of mortgage arrears is consistent with the data presented in Figure 5.1. However, households tend to have more arrears on unsecured credit (6%) and other household bills such as council tax and water charges. The Kempson report explains that there was some overlap between the two categories of consumer credit and household bills; 7% of the households were in arrears with household bills only; 4% had difficulties with credit commitments; and 2% were in arrears with both.

The MORI survey (for the CAB) gives lower estimates of arrears: 1% of the individuals surveyed said that they had fallen behind with many bills/credit commitments and 2% said that they had fallen behind with some bills/credit commitments.

5.0 Assessment of indicators

Table 5.1: Types of arrears across all households

	Arrears in past 12 months	Arrears now
Any arrears at all	**18**	**13**
Any consumer credit arrears	**10**	**6**
Overdraft	3	2
Credit card	4	3
Store card	1	1
Mail order	2	1
Hire purchase/credit sale	1	< 1
Loan	2	1
Any household bill arrears	**13**	**9**
Mortgage	1	< 1
Rent	2	1
Gas	4	3
Electricity	3	2
Water	4	3
Council tax	4	3
Other bills	4	2
Base: all householders	1,647	1,647

Source: Kempson (2002).

The Kempson report provides data on the number of arrears per household—this may give an indication of the degree of financial difficulty. Table 5.2 shows that 46% of the households in arrears are falling behind with one commitment; 21% with two commitments; 12% with three; and 20% with four or more commitments.

Table 5.2: Number of arrears in the past 12 months

Number of arrears (household bills and consumer credit)	% of households	% of household in arrears
1	8.6	46
2	3.9	21
3	2.3	12
4 or more	3.8	20
Any arrears	**18.6**	**100**

Source: Based on Table 3.7 in Kempson (2002).

5.0 Assessment of indicators

Kempson (2002) also gives data on the duration of arrears (and financial difficulty). Table 5.3 shows that, while 13% of households were in arrears at the time the survey was undertaken, 6.7% were in arrears for longer than six months, and only 2.3% were in arrears for longer than 12 months.

Table 5.3: Duration of financial difficulty (% of households)

Duration	All in difficulty now	In financial difficulty now, no arrears	In arrears
Under one month	1.0	0.6	0.5
1—3 months	2.8	1.0	1.8
3—6 months	2.0	0.7	1.1
6—12 months	4.1	1.6	2.5
Over 12 months	6.7	2.4	4.2
Refused/don't know	3.0	0.7	2.3
Total	**20.0**	**7.0**	**13.0**

Note: Figures may not sum due to rounding.

Source: Based on Table 3.1 in Kempson (2002).

Furthermore, for those who stated that they were in arrears, 18% said this was due to third-party error or that they had overlooked or deliberately withheld the payment (see Table 3.1). This again suggests that data on total arrears will overstate the number of households facing a structural problem with arrears.[25]

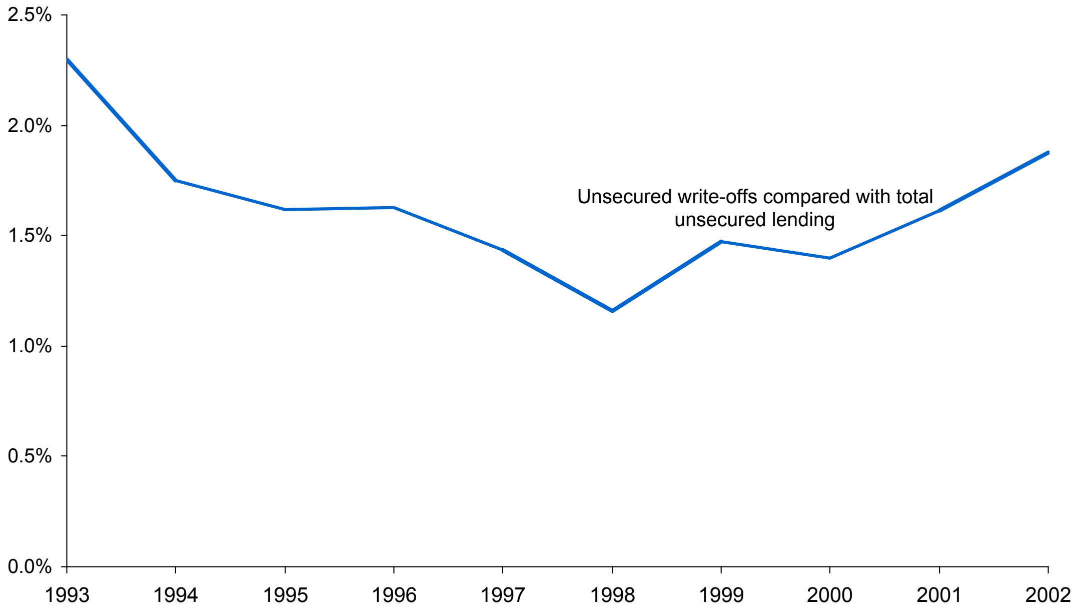
The fact that most people are only in arrears for a relatively short period of time indicates that, to some extent, over-indebtedness is a transitory situation—people are sometimes affected by external shocks, such as a temporary loss of income, but manage to get out of financial difficulty after a period of time. The Kempson report shows that 6% of the households surveyed stated that they had experienced financial difficulties 12 months prior to the survey, but had since resolved them, while a similar proportion (6%) said that their financial difficulties had started in the past year.

A quarter of those claiming that they were no longer in difficulty were actually still in arrears. As pointed out by Kempson, a plausible explanation is that they were paying off the money they owed and felt that they had got their finances back under control. This means that these households were no longer structurally in arrears.

If borrowers are unable to pay back their loans, the debt will at some point be written off by the credit provider. It is therefore useful to examine write-offs related to unsecured credit over time. Figure 5.2 shows that write-offs related to unsecured credit were just under 2% of the total stock of unsecured lending in 2002.

[25] Dominy and Kempson (2003) point out that, in a survey, people are unlikely to give reasons for falling behind with payments that are critical of themselves. In other words, the number of people who were able but unwilling to meet their financial commitments may be underestimated in surveys.

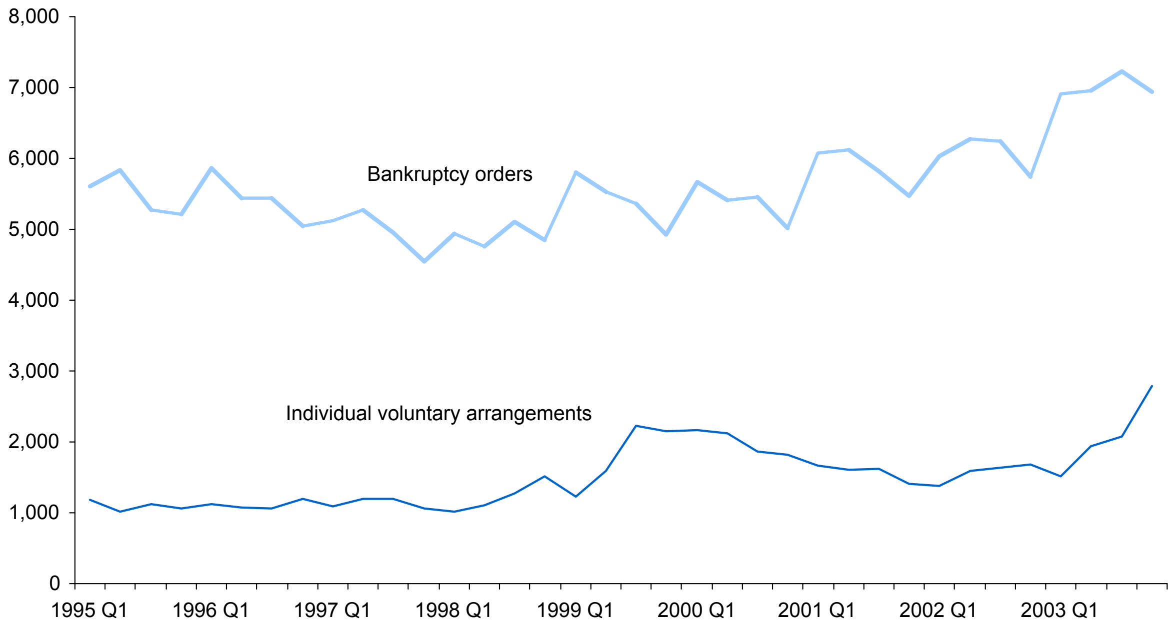
Figure 5.2: Annual write-offs relative to total secured and unsecured lending



Source: Bank of England, Oxera calculations.

One measure of indebtedness that is often highlighted is the number of individual insolvencies. Figure 5.3 below tracks the number of bankruptcy orders and individual voluntary arrangements for England and Wales. Total personal bankruptcies increased by around 19% in 2003, with bankruptcy orders increasing 15% and individual voluntary arrangements, which were introduced as an alternative to bankruptcy, increasing by 32%.

Figure 5.3: Individual insolvencies



Source: DTI.

5.0 Assessment of indicators

5.1.2 Summary

The Kempson report provides data on arrears and indicates that 13% of households were in arrears at the time the survey was undertaken, with 2.3% of households stating the reason being due to an error, or missing or withholding a payment. 46% of the households in arrears were falling behind with one commitment, 21% with two commitments, 12% with three, and 20% with four or more commitments.

Around half of the households in arrears (6.7% of households) had been in arrears for more than six months, and one-third of them (4.2% of households) for more than 12 months. The MORI survey (for the CAB) gives a lower estimate, indicating that only 3% of individuals reported they had fallen behind with bills/credit commitments.

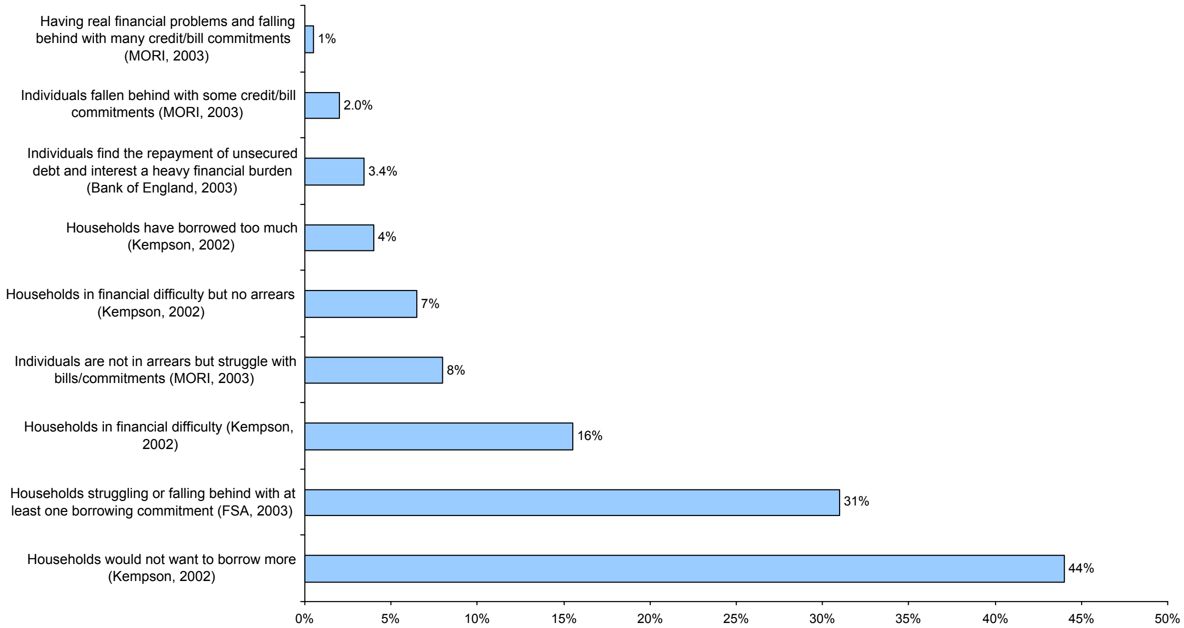
The level of arrears and write-offs is historically low, partly due to current economic conditions—lower interest rates have made borrowing more affordable. As data on arrears gives a picture of the outcome, rather than the situation of indebtedness, other indicators are necessary to identify households that manage to meet their financial obligations but which have borrowed to such an extent that they have become vulnerable to external shocks such as interest rate changes and loss in income—these households can also be considered as over-indebted.

5.2 Assessment of subjective measures

Subjective measures seek to use households' knowledge of their financial position to estimate whether they are at risk of becoming over-indebted by being unable to meet repayments and interest payments, and hence falling into arrears.

Figure 5.4 and Table 5.4 show a number of subjective measures used in the reports by Kempson, FSA, MORI (for the CAB), the Bank of England and the BHPS.

Figure 5.4: Subjective measures of over-indebtedness



Sources: Bank of England (2003), Kempson (2002), MORI (for the CAB) (2003), FSA (2003), and Oxera calculations.

The survey commissioned by the Bank of England from NMG Research provides evidence of the extent to which individuals consider the repayment of their unsecured debt and interest payments to be a financial burden on their household. It finds that 3.4% of individuals consider their unsecured debt to be a heavy burden; 7.5% claim that it is somewhat of a burden; and the remainder do not consider it a problem.

5.0 Assessment of indicators

Table 5.4: Subjective measures

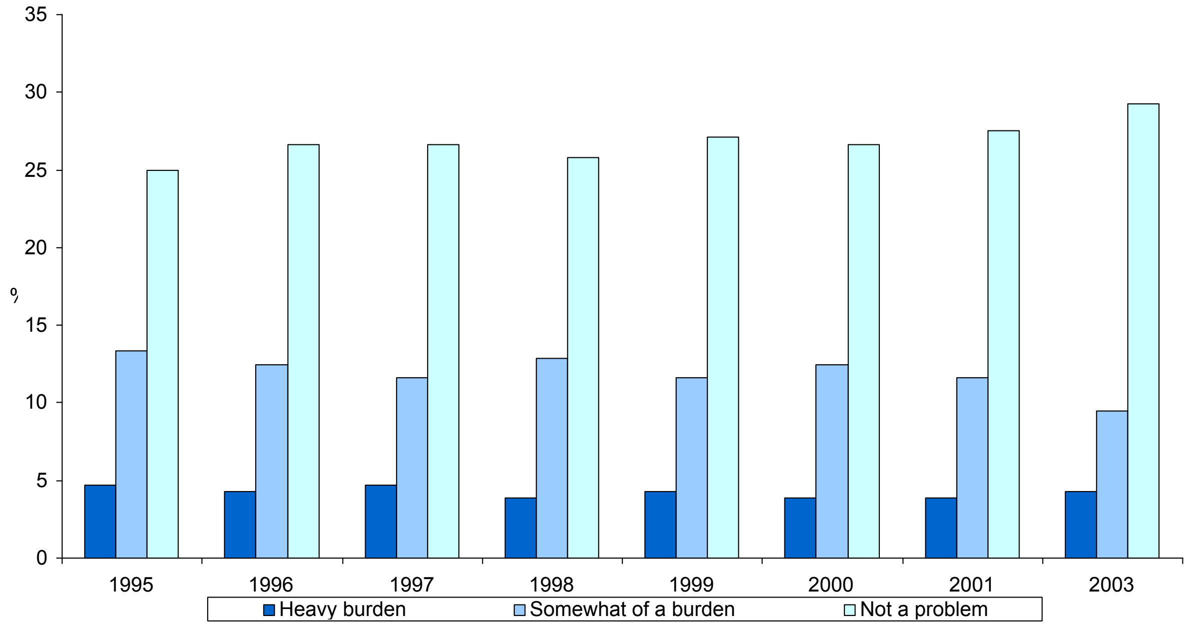
Question asked	Response	Source
To what extent is the repayment of your unsecured debt and the interest a financial burden on your household?	68% of debtors (23.1% of individuals):[1] no problem 22% of debtors (7.5% of individuals):[1] somewhat of a burden 10% of debtors (3.4% of individuals):[1] heavy burden	Bank of England (also used in BHPS)
Are you in financial difficulty?	76—80% of households: no financial difficulties at all 6—7% of households: in financial difficulty but no arrears 13—18% of households: in financial difficulty and in arrears	Kempson (2002)
Could you afford to borrow more?	51% of households can afford to borrow more 44% of households would not want to borrow more 4% of households already borrowed too much 2% of households don't know	Kempson (2002)
We are keeping up with our bills and credit commitments without any difficulties	56% of individuals	MORI (for the CAB) (2003)
We are keeping up with all our credit commitments, but struggle to do so from time to time	26% of individuals	
We are keeping up with all our bills/credit commitments, but it is a constant struggle	8% of individuals	
We are falling behind with some of our bills or credit commitments	2% of individuals	
We are having real financial problems and have fallen behind with many bills or credit commitments	1% of individuals	
Other/Refused to answer question/Don't know	6% of individuals	
We are struggling with at least one of our borrowing commitments	31% of families	FSA (2004)

Note: [1] The Bank of England reports that 10% of debtors find the repayment of unsecured debt and the interest payments a heavy financial burden on their household. The proportion of individuals who indicated that they had unsecured credit was 34%. This means that 3.4% of individuals find the repayment of unsecured debt and the interest payments a heavy financial burden on their household.

Sources: Bank of England (2003); BHPS, Kempson, and the MORI survey (for the CAB).

The question asked in the Bank of England survey is similar to the one in the BHPS (which is undertaken on a regular basis), thereby allowing for a comparison over time. Figure 5.5 shows the trend in the burden of debt. The proportion of individuals reporting debt to be a heavy burden has been broadly stable at around 3.4%, while the proportion reporting debt to be somewhat of a burden has slightly declined over time.

Figure 5.5: Trend in the burden of debt, total individuals



Note: There is no data available yet for the year 2002. BHPS is currently analysing the results of the survey undertaken in 2002.

Sources: BHPS, NMG Research, Bank of England.

The survey evidence suggests that those who report their debt to be a heavy burden also tend to have more of it. The Bank of England report indicates that over 32% of those whose debt is perceived to be a heavy burden have unsecured debt of over £10,000. This is substantially larger than their 13% share in the population of debtors. The average debt of people who say it is a heavy burden is £6,900, compared with £3,900 for those who say it is somewhat of a burden, and £2,900 for those who state that it is not a problem.

Although the question of financial burden may give an indication of indebtedness, it is not necessarily a good indicator for over-indebtedness. People who consider interest payments and repayments a financial burden are not necessarily over-indebted—they may find themselves at a stage of life where high costs related to accommodation and the rearing of children are incurred, but may still be able to meet their financial obligations. This is reflected in the results of the survey of the Bank of England. Of those who find debt to be a heavy burden, 37% are between 25 and 34 years old. This is around double their proportion in the grossed-up sample as a whole, and also higher than their share in the debtor population. The Bank of England report explains that these individuals do not have a particularly high unsecured debt:income ratio, but their finances are likely to be put under strain by mortgage borrowing and other financial commitments.

5.0 Assessment of indicators

The Kempson report includes two subjective measures. Survey respondents were asked for their own view of their level of borrowing. The majority of people interviewed felt comfortable with the level of borrowing in their household. A small minority (4%) said that they had already borrowed more than they could afford; 44% indicated that they would not want to borrow more, while 51% said that they could afford to borrow more.

Only 1% of all households were already heavy borrowers but prepared to borrow further. In other words, almost all people managed to give a reasonable assessment of their own financial situation.

Although this measure is not emphasised in the Kempson report (it is not referred to in the summary conclusion of the report), it is actually a very direct measure of over-indebtedness—whether people feel they have borrowed too much, or more than they can afford. The analysis in the Kempson report shows that there was a link between people's views on the amount of money they had borrowed and the proportion of their gross income that they were spending on repayments, particularly when that excluded mortgages:

> the more of their income being devoted to credit repayments, the more likely people were to say either that they felt unable to borrow any more or that they had already borrowed too much.

The second subjective measure used in the Kempson report is whether people were in financial difficulty. Around 25% of households reported that they had been in financial difficulties of some kind over the past 12 months; 20% were still in difficulty at the time they were interviewed. Kempson reports that three-quarters of the households who reported to be in financial difficulty had commitments in arrears (ie, 18% of the households were in arrears and considered themselves in financial difficulty; after one year this was 13%).

This measure of financial difficulty is broader than the other subjective measure used by Kempson. It gives an indication of people's financial position at a particular point in time, and is not restricted to problems related to interest payments and repayment of loans, or to over-commitment. For example, people may have difficulty in meeting their financial obligations simply due to a low level of income. Furthermore, they may borrow more because they find themselves in financial difficulty due to, for example, life events; or their interest payment and repayments as a proportion of income may increase due to a drop in income. As explained in section 3.2, Kempson shows that financial difficulty is often related to loss of income (45%) due to, for example, unemployment and relationship breakdown and, to a lesser extent, to over-commitment (10%).

The Kempson survey also suggests that most people find themselves in financial difficulty only for a relatively short period of time. Of those in financial difficulty, 34% had been so for less than six months. This may indicate that most of the financial difficulty cases are not related to a structural over-indebtedness, which may take longer to overcome.[26] Furthermore, as discussed in section 5.1.1 the Kempson report shows that 6% of the households surveyed claimed that they had had financial difficulties 12 months prior to the survey, but had since resolved them, while a similar proportion (6%) said that their financial difficulties had started in the past year.

[26] The question on duration is only asked for those currently in financial difficulty, which means that the duration may be longer if the problems persist. Without questioning all respondents on the length of their last period of financial difficulty, this problem cannot be addressed.

5.0 Assessment of indicators

The survey commissioned by the FSA indicates that 31% of families are struggling with at least one of their borrowing commitments. This measure is similar to the question on financial difficulty used in the Kempson report.

The MORI survey commissioned by the CAB asked respondents whether they were keeping up with their bills and credit commitments this measure is similar to the question on financial difficulty in the Kempson report. Most claimed that they did not have problems keeping up with payments and credit commitments; 8% of the individuals surveyed were keeping up with all their bills and credit commitments, but it is 'a constant struggle'; while 2% of respondents were falling behind with some of their bills and credit commitments, and 1% had real financial problems and had fallen behind with many bills or credit commitments.

5.2.1 Summary

The subjective measures give a direct indication of over-indebtedness by capturing households that are currently managing their credit commitments but are vulnerable, as well as those who are in arrears. The proportion of households that will be considered over-indebted will depend on the precise definition used for assessing the subjective evidence. The disadvantage of subjective measures is that they assume that households are capable of assessing their own financial situation and will be honest.

In general, the broader the definition of the measures, the higher the number of households or individuals that are affected. For example, 4% of the households in the Kempson survey in 2002 indicated that they had borrowed too much, while 20% indicated that they were in financial difficulty. The Bank of England report indicates that 3.4% of individuals consider interest payments and repayments of unsecured loans to be a heavy burden.

5.3 Assessment of debt-level indicators

Most of the reports surveyed here examine debt ratios as possible indicators of over-indebtedness. Four measures are compared here: debt-income ratios; debt-wealth ratios; level of debt by income group; and debt-service:income ratios.

5.3.1 Debt:income

Table 5.5 summarises the different debt:income ratios. These are usually reported at an aggregate level and give an indication of the reliability of the data. The CMRC estimates the debt:income ratio in 2001 at 118%, while CCRG gives a slightly lower estimate of 107%, probably due to the fact that it expresses debt as a proportion of *disposable* income. On the basis of aggregate Bank of England data, Oxera estimates the debt to disposable income ratio at 125% in 2003.

The CAB provides an estimate of 111% for the ratio of unsecured debt and mortgage arrears— outstanding balances on mortgages are not included. This percentage looks high but it should be taken into account that it is not representative of the entire UK population, but only for CAB clients.

5.0 Assessment of indicators

The Bank of England (2003) survey estimates unsecured debt:income ratio for individuals with an income of between £4,500 and £9,499 at 29%, while the ratios for all higher-income groups are lower, ranging between 19% and 7%. The unsecured debt:income ratio for the lowest income group (less than £4,500) is estimated at 103%. The Bank of England report points out that the average amount of debt in this income group was relatively high—£2,400—reflecting a disproportionate number of people with student debt in this group. Indebtedness of students requires a separate analysis. This is further discussed in section 5.4.1.

Table 5.5: Debt:income ratios

Ratios	%	Year	Source
Debt:income ratios at aggregate level: (secured and unsecured debt)			
Debt:income ratio	118	2001	CMRC
Debt:income ratio	117	2000	OECD
Debt:disposable income ratio	107	2001	CCRG
Debt:disposable income ratio	115	2002	Oxera calculations (based on Bank of England and ONS data)
Debt:disposable income ratio	125	2003	Oxera calculations (based on Bank of England and ONS data)
Debt:income ratio (unsecured and mortgage arrears included, but mortgages outstanding excluded)	111[1]	2002	MORI (for the CAB)
Debt:income ratio at household level by income group: (unsecured debt only)			
Income less than £4,500	103	2003	Bank of England and NMG Research (survey)
Income between £4,500—£9,499	29		
Income between £9,500—£17,499	19		
Income between £17,500—£24,999	18		
Income between £25,000—£34,999	17		
Income between £35,000—£60,000	13		
Income between £60,000 plus	7		

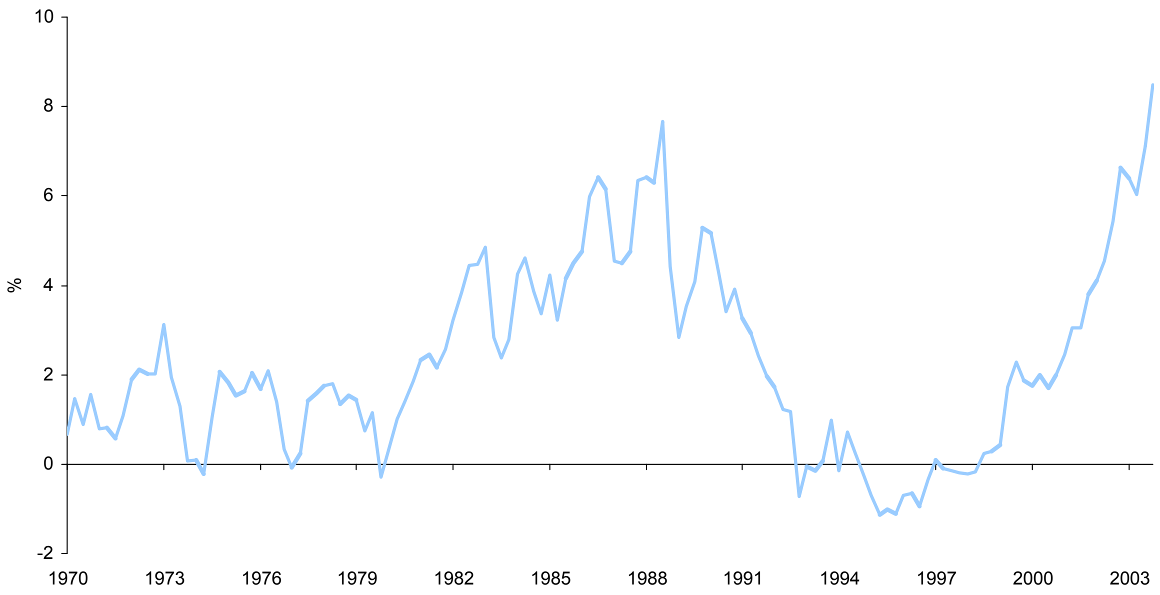
Note: [1] The CAB reports debt as a proportion of *monthly* income. This has been converted in to debt:yearly income ratios. The analysis in the CAB report is based on a survey among CAB clients—ie, people who have sought advice from the CAB.

Although debt:income ratios are not necessarily useful in assessing the financial position of a household at a particular point in time, they can be useful in assessing changes in the financial position of households over time, and in comparing the indebtedness of households in the UK with that of households overseas. It will also be important for assessing the risks of increasing interest rates. As shown in section 2, the debt:income ratio has increased over time. However, compared with other countries, the debt:income ratios in the UK do not seem to be out of line with those of other countries.

The Bank of England estimates unsecured debt:income ratios, while the CCRG and CMRC reports focus on secured and unsecured debt:income ratios. Aside from those who own their home and do not have a mortgage (anymore), virtually every household must make a regular outlay associated with their housing—either a mortgage or a rent payment. Therefore, a debt:income ratio that includes one form of housing expense (a mortgage) but not the other (rent) is unlikely to be useful. An increase in homeownership rate would result in an increase in the level of debt, and thus the debt burden, while reducing the amount of rent. The latter would not be taken into account by the debt:income ratio. In addition, in general, mortgages carry lengthy maturities, which means that only a small proportion of mortgage debt is due for repayment in a given year. In other words, the outstanding balance of the mortgage is unlikely to give an indication of a household's ability to meet its financial obligations at a particular point in time. Secured debt on property can be considered as investment—ie, an alternative form of saving.

On the other hand, driven by lower interest rates, and by the increasing use of new mortgage instruments, mortgages—in particular second mortgages—may now also be used to some extent for consumption expenditure, either directly, or indirectly, by being used to pay off unsecured debt.[27] Mortgage equity withdrawal, as reported by the Bank of England, was £13.4 billion in the third quarter of 2003, or 7% of post-tax income (see Figure 5.6). Furthermore, the only other occasion since 1970 when mortgage equity withdrawal as a proportion of post-tax income exceeded 7% was in 1988 (7.7% of post-tax income), at the height of the consumer and house-price boom in the 1980s.

Figure 5.6: Mortgage equity withdrawal as a percentage of post-tax income



Source: Bank of England statistics.

5.3.2 Debt:wealth ratios

As explained in section 2, household debt is a stock measure and should arguably be compared with net household wealth rather than disposable income (which is a flow figure). Table 5.6 shows a debt:wealth ratio of 16.2% in 2000, as reported in the CCRG study. Oxera

[27] See, also, Davey, M. (2001), 'Mortgage Equity Withdrawal and Consumption', *Bank of England Quarterly Bulletin*, Spring.

estimates the debt:wealth ratio in 2002 at 17.2%. Net household wealth is calculated as the sum of non-financial assets, such as the equity in property, and financial assets, minus households' financial liabilities, such as secured and unsecured debt.

Debt:wealth ratios are useful to compare the financial situation of households over time, but do not necessarily give an indication of over-indebtedness. The fact that the ratio is relatively low does not rule out the possibility that households may face temporal mismatches between income and financial obligations resulting from borrowing commitments. In other words, the debt:wealth ratio does not capture the actual burden of servicing the debt. In addition, wealth (consisting of financial assets and non-financial assets—ie, property) is subject to fluctuation over time, while debt tends to be fixed. Fluctuations in wealth will affect the debt:wealth ratio.

Table 5.6: Debt:wealth ratios

Ratios		Year	Representative	Source
Household debt to net household wealth	16.2%	2000	UK	CCRG
Household debt to net household wealth	17. 2%	2002	UK	Oxera (based on ONS data)

Note: ONS data for gross disposable income and net household and non-profit institutions serving households (NPISH) wealth. The ONS does not as yet separate out statistics on net wealth for households and NPISH, but households do account for the majority of net household and NPISH wealth.

Sources: CCRG and Oxera.

5.3.3 Amount of debt by income group

Table 5.7 shows the average debt owed by debtors according to debt instrument and household income, as estimated by the Bank of England (2003) survey. It shows that the average amount borrowed is strongly related to household income. The exception is the lowest-income group, in which average debt is £2,400, reflecting a disproportionate number of people with student debt in this group.

5.0 Assessment of indicators

Table 5.7: Average debt of debtors by debt instrument and household income

Type of credit	Income levels of those reporting income							
	< £4,500	£4,500—£9,499	£9,500—£17,499	£17,500—£24,999	£25,000—£34,999	£35,000—£59,999	> £60,000	Whole sample
Hire purchase agreement	n/a	1,600	2,000	3,400	1,400	3,800	3,400	2,500
Personal loans	2,000	2,000	3,500	4,800	5,300	5,400	5,300	4,400
Overdraft	700	200	700	1,000	700	800	1,000	700
Credit card	800	1,800	1,000	900	2,300	2,800	1,100	1,400
Catalogue or mail order	200	400	300	300	100	400	n/a	300
Student loan	5,600	6,500	4,000	4,500	6,100	4,300	n/a	6,300
DSS Social fund	300	300	200	n/a	n/a	n/a	n/a	200
Other loans	n/a	300	500	6,100	n/a	n/a	n/a	1,400
Total (any type of unsecured debt)	**2,400**	**1,800**	**2,400**	**3,800**	**5,100**	**5,600**	**6,000**	**3,500**

Source: Bank of England (2003).

This kind of detailed information is not available in any of the other studies apart from the BHPS database. BHPS provides data on debt by income group over time and also provides additional relevant information such as socio-economic group, age, and level of education. However, as explained in section 4.3, like other surveys, the BHPS underestimates the amount of debt owed by households.

5.3.4 Debt-service ratios

Debt:income ratios often have only unsecured debt in their numerator. Although maturities of unsecured debt are often much shorter than mortgage maturities, only a part of the outstanding stock of debt is payable in the near term, which means that the debt:income ratio is unlikely to be an indicator of the current payment burden. Estimates of debt-service:income ratios are likely to give a more accurate reflection of the financial burden of credit commitments on households.

The CCRG report provides estimates of interest payments as a proportion of income, based on data from the Bank of England and ONS—the Bank of England publishes data on effective interest rates based on actual households' interest payments. The CCRG report estimates that, in 2000, the average household spent 7% of its income on interest payments related to secured and unsecured credit (see Table 5.8). Oxera estimates the interest payments related to secured and unsecured credit as 7.2% of disposable income in 2003.

The FES measures interest payments on secured credit and credit-card credit—other types of unsecured credit, such as personal loans and hire purchase, agreements are not included. It estimates the total amount of income spent on these interest payments at around 7% (in 2001/02). Comparison with Oxera estimates on the basis of data from Bank of England and ONS shows that FES underestimates credit-card interest payments and overestimates mortgage interest payments. The FES estimates the credit-card interest payment:income ratio at 0.4%, while aggregate statistics indicate that this would be around 1%. This indicates that the FES also suffers from underreporting.

Table 5.8: Debt-service ratios

Ratio		Year	Source
Interest payments (secured and unsecured debt) as proportion of income	7.0%	2000	Calculated by CCRG on the basis of data from Bank of England, Federal Reserve System, ONS
Interest payments (unsecured debt) as proportion of income	2.5%	2003	Oxera (based on Bank of England and ONS data)
Interest payments (secured debt) as proportion of disposable income	4.6%		
Total: Interest payments on unsecured and secured debt as proportion of income	**7.2%**		
Credit card interest payment as proportion of disposable income	0.4%	2001/02	FES
Mortgage interest payment as proportion of disposable income	6.7%		
Total credit-card and mortgage interest payments as proportion of disposable income[1]	**7.1%**		
Credit-card interest payment as proportion of disposable income	1%	2002	Oxera (based on Bank of England and ONS data)
Mortgage interest payments as proportion of disposable income	4.6%		
Total credit-card and mortgage interest payment as proportion of disposable income	**5.6%**		

Note:[1] FES reports interest payments on mortgages and credit cards only, and not on other types of loan.

The Kempson report also provides estimates of repayments (including interest payments) on secured and unsecured credit. Table 5.9 shows that 53% of the households do not spend anything at all on unsecured credit; 22% spend less than 10% of their income; 8% of the households spend between 10% and 25%; and 5% spend more than 25% on unsecured credit. On average, households spend 5.8% on unsecured credit.[28]

Of households with mortgages, 46% spend on average up to 25% on mortgage repayments; 18% spend between 25% and 50%; and 14% of the households spend more than 50%. On average, households with mortgages spend 30% of their income on mortgages.

[28] This percentage is calculated on the basis of the information in Table 5.9. The mid-points in the ranges were used in the calculation.

Table 5.9: Repayments as proportion of income (% of households)

Repayment as proportion of income	Repayments unsecured credit	Repayments secured and unsecured debt	Repayments on mortgages
Nothing	53	37	-
Up to 10%	22	17	15
10—25%	8	17	31
25—50%	3	9	18
50% or more	2	6	14
Amount unknown	12	14	22
Base: all householders	1,647	1,647	675

Source: Kempson (2002).

Although Kempson's measure of 'repayments' is useful in assessing the usage of credit and its financial implications for households, it is likely to be too broad to assess over-indebtedness. It includes total repayments based on what households actually pay off, including any lump-sum repayments, while households are normally only required to repay a minimum amount of the loan each month or year. For example, the minimum repayment on credit cards is typically in the range 2—5%. For personal loans and hire purchase agreements, the minimum amount to be paid normally depends on the repayment schedule.[29] In other words, interest payments and *minimum* repayments as a proportion of disposable income is a more relevant measure. It measures the short-term impact of credit commitments on the household budget, and therefore allows a degree of assessment as to whether a household is able to bear the financial burden of interest payments and repayments. This measure is not available in the existing reports.

It is useful to compare repayments as a proportion of income over time. Berthoud and Kempson (1992) estimate total repayments and interest payments (unsecured credit) as a proportion of income, on average, at 8.4% in 1989, compared with 5.8% in 2002. In other words, despite households having on average higher levels of debt compared with around ten years ago, they spend less on repayments and interest. People can afford to borrow more due to lower interest rates.

[29] For mortgages, the repayment schedule can often be changed. Another reason for not including mortgage repayment is that, as explained above, they could be considered as accommodation costs.

5.4 Other measures of indebtedness and over-indebtedness

The CAB report provides data on the number of debt enquiries, as shown in Table 5.10. It shows that there has been a sharp increase in the number of debt enquiries dealt with by the CAB since 1997—debt enquiries rose by 24% since 1997/98 to reach a total of nearly 1.1m in 2001/02. The growth in enquiries has been particularly marked in the area of consumer credit (47% increase since 1997/98); consumer credit constituted nearly two-thirds (0.7m) of all enquiries about debt to the CAB in 2001/02.

Table 5.10: New CAB debt enquiries in the UK, 1997—2002

Type of debt enquiry	1997/8	1998/9	1999/00	2000/01	2001/02	% increase
Consumer	**465,194**	**544,961**	**626,984**	**638,568**	**683,677**	**47**
Housing	138,695	142,895	139,289	134,290	125,392	—10
Utility	93,144	98,654	100,735	97,024	90,118	—3
Tax	73,906	72,105	73,012	76,188	75,944	3
Benefits[1]	29,132	33,392	35,539	37,124	38,442	32
Legal[2]	24,896	24,147	24,372	23,438	23,537	—5
Employment[3]	17,072	17,063	18,716	18,507	16,620	—3
Relationship[4]	17,107	16,557	15,690	15,530	12,189	—29
Total	**862,019**	**952,734**	**1,031,377**	**1,038,066**	**1,066,509**	**24**

Note: [1] Benefit debt comprises fund debts and benefit overpayments. [2] Legal debt comprises unpaid magistrate court fines, court costs, and unpaid legal bills. [3] Employment debt comprises overpayment of wages and loans from employers. [4] Relationship debt comprises arrears of child support and other forms of maintenance.

Source: CAB (2003).

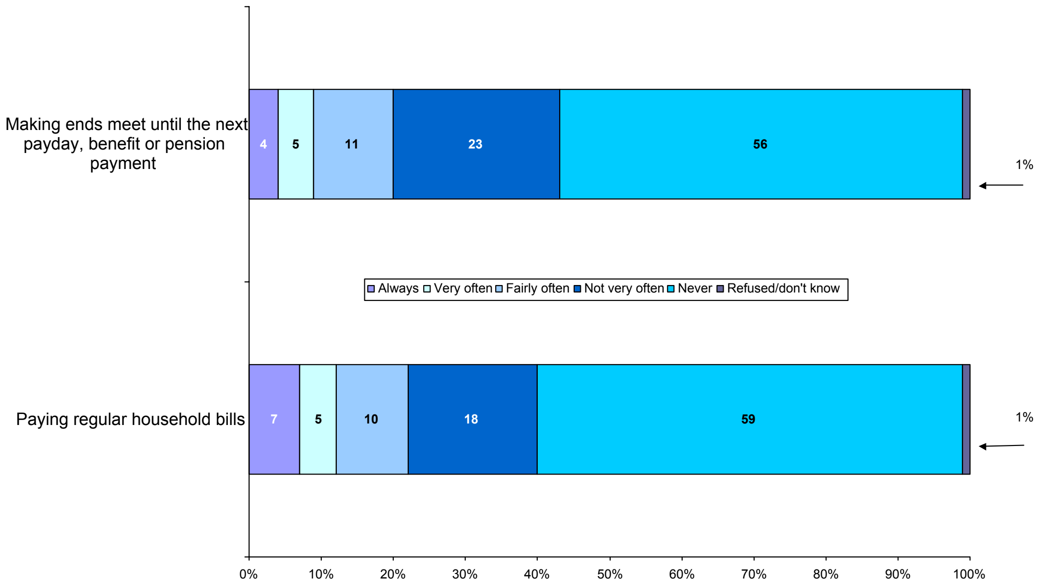
The CAB takes these statistics as the main evidence that the problem of personal indebtedness in the UK is getting worse. Although it explains that increased capacity could account for the rise in the overall number of new debt enquiries (funding for dedicated debt advisers in the CAB has become available), it does not explain the particularly sharp increase in the number of consumer credit debt enquiries, as one might have expected all categories of debt enquiries to have increased, in response to greater provision of advice.

The increase in consumer credit debt enquiries may also be caused by the fact that credit products have become more complex and have received a great deal of attention in the media, making people more aware of potential issues and problems and more likely to contact a CAB. Furthermore, one person can account for more than one enquiry and not every enquiry is a problem—for example, it could be a request for information or clarification. In any case, although the number of enquiries may give an indication of potential problems and concerns related to consumer credit, it is unlikely to give an indication of the scale of the problem of (over-) indebtedness.

A further measure reported in the MORI 2003 survey (for the CAB) is the purpose of the loan or credit (see Figure 5.7). Around 10% of households report that they always or very often use loans and credit to make ends meet and pay regular bills. This may simply refer to regularly using an overdraft for a few days each month; however, as reflected in the

European Commission definition reported in section 3, it is often considered to be of concern if households use credit to pay for essentials.

Figure 5.7: Use of loans and credit for regular household bills



Source: MORI (for the CAB) (2003).

5.5 Debt among students

It could be argued that indebtedness of students requires a separate analysis. Income, income expectations, expenses and the conditions against which loans are taken out are often different in the case of students compared with other groups of the population. Student loans often carry relatively low interest rates or are free of interest (eg, overdrafts), and often have a longer maturity than normal consumer credit. This means that, in spite of the fact that some students may have high amounts of unsecured debt, the debt is unlikely to result in a heavy short-term financial burden.

In assessing over-indebtedness, it is therefore important to identify the amount of debt owed by students. Not doing so could result in a relatively high amount of debt for low-income households, giving the false impression that these households are over-indebted.

Most of the reports do not indicate how they deal with debt owed by students. The Bank of England (2003) report is an exception and explains that student loans were included. It estimates the average student loan debt at £6,300, which is consistent with the estimate of £6,136 from a recent survey among students (see Table 5.11). The table shows that the vast majority of students (93%) have some type of unsecured debt. Money from student loans accounted for 84% of all students' borrowing, while overdrafts accounted for 11%, and commercial credit a further 3%.

The amount of borrowing is much higher for students in their third year of study. The survey indicates that students with debt in their third year and above had borrowed £10,144 on average.

Table 5.11: Student loans

	Mean credit of student with debt (£)	% of students with borrowings	Mean credit of all students (£)	Median of all students (£)	% of total borrowing
Source of borrowing:					
Commercial credit[1]	925	24	222	0	3
Overdraft	1,111	65	722	500	11
Arrears	550	2	11	0	<1
Informal loans from family and friends	517	6	31	0	1
Outstanding student loan debt	6,136	89	5,461	3,905	84
Outstanding student hardship loan	438	8	35	0	1
Total borrowing	**6,696**	**93**	**6,481**	**5,500**	**100**
Students per year of study:					
First	3,651	91	3,322	3,428	
Second	7,247	94	6,812	7,000	
Third	10,444	95	9,922	10,569	
Final	10,339	92	9,512	10,250	
Not final	5,307	96	5,095	4,400	

Note: [1] This includes bank loans, credit and store cards, and hire purchase.

Source: Callender and Wilkinson (2003).

A relatively large proportion of students (65%) use overdrafts—for comparison, the Bank of England report indicates that only 7% of households have overdrafts. The average amount of overdraft per student (£1,111) is also slightly higher than for households in general (£700). This may reflect the fact that overdrafts are often offered for free to students.

A small proportion of students (24%) have commercial credit; a very small proportion of students are in arrears (2%), or have informal loans from family and friends (2%).

6.0 Conclusions

Households or individuals who are in arrears on a structural basis, or are at a significant risk of getting into arrears on a structural basis, are likely to be over-indebted. This conceptual definition has two important aspects. First, it includes only those households that are in arrears *on a structural basis*—households that are temporarily in arrears and/or households that are able but not willing to meet their commitments should be excluded. Second, in theory, every individual who has credit runs a risk of falling behind with payments; however, the definition includes only those people who are at a *significant* risk of getting into arrears.

Identifying people who are in arrears, or who are at risk of falling into arrears on a structural basis, requires data at household level. Data on arrears, and on the duration of, and reasons for, arrears can be used to identify individuals who are currently in arrears on a structural basis.

To assess the likelihood of a household falling behind with payments, statistical analysis can be undertaken to ascertain which factors drive arrears and write-offs. Each household's probability of falling into arrears can then be estimated and the effect of a shock (eg, an increase in interest rates or unemployment) can be assessed. Using econometric tools, a relationship between arrears and indicators of indebtedness such as debt:income and debt-service:income ratios, together with socio-demographic characteristics can be established. Existing studies and risk models used by credit providers show that the probability of falling into arrears depends on financial ratios as well as on socio-demographic characteristics.

No publicly available UK household-level dataset has the requisite data on arrears, income, debt, debt service, and household characteristics. This means that any estimate of the number of households at significant risk of falling into arrears must be based on indicators. Two types of indicator are prevalent in the published studies—subjective indicators and debt-ratio indicators. Subjective indicators are used as a direct measure of the probability of falling into arrears based on a household's view of itself. Debt-ratio indicators are used because the existing statistical evidence finds these to be significant factors that explain of over-indebtedness. These measures may give an indication of the number of households that are structurally falling behind with their payments and the number of households that are at a significant risk of doing so.

– *Subjective indicators*—under this approach, over-indebted consumers are defined as those who *consider* themselves to be over-indebted.

– *Debt-ratio indicators*—this approach looks at a range of 'objective' quantitative ratios, such as debt:income, debts:wealth and debt-service:income ratios. The most relevant indicators will be those based on interest payments and minimum repayments as a proportion of disposable income—ie, the minimum amount that debtors are required to repay during a certain period.

This gives a framework to assess the findings from the different public-domain reports.

Oxera has been asked to review the reports listed in section 1.2. Many of the reports that received attention in relation to the over-indebtedness debate do not in fact have as their (main) objective the assessment of indebtedness and over-indebtedness of individuals/households in the UK.

6.0 Conclusions

The PwC report reviews recent developments in the credit-card sector in 2002. The CMRC study examines trends and developments in debt management, debt collection and recovery. The CCRG report analyses debt at aggregate level over time in the UK. The PwC, CMRC, and CCRG reports do not provide any data at household level nor any subjective measures of over-indebtedness, and are therefore unlikely to be useful in assessing over-indebtedness.

The CAB report provides a range of measures but is restricted to data on CAB clients. As the report results are not representative for the UK population, it is of limited use. The ORC Macro study assesses over-indebtedness in the EU; however, it bases its conclusions on over-indebtedness on one subjective measure only.

The six remaining reports (Kempson, MORI (for the CAB), JP Morgan, KPMG, Bank of England, and FSA) do provide data at household level. These reports have been analysed in detail, supplemented by data from ONS and Bank of England, and credit providers to assess the reliability of the quantitative estimates.

The surveys show that around 40—50% of households, and 30—40% of individuals (adults) have some form of unsecured debt—credit-card credit that is paid off in full at the end of the month is not included. These participation rates have remained stable over the past seven years. The average amount of unsecured debt by debtor as estimated by the surveys ranges from £3,500 to £6,646 in 2002/03—the latter figure also includes rent arrears.

Although the surveys are representative of the UK population as a whole, and most of them are consistent with each other in terms of participation rates and the average amount of the debtor's debt, there is a substantial difference between the grossed-up amount of unsecured debt claimed in the survey responses and that reported by credit providers. A reason for the difference may be that respondents feel uncomfortable revealing their real levels of debt. This may result in some respondents not owning up to any debt and/or others understating the true extent of their credit commitments. This is problematic for drawing conclusions on the proportion of households likely to fall into arrears. It also means that no conclusions can be drawn from the fact that the surveys show that average levels of debt have not been increasing. This is likely to be a reflection of the under-reporting, which has been increasing over time.

Given the degree of under-reporting of debt levels, the assessment of over-indebtedness needs to focus in particular on other indicators such as late-payment data and subjective measures.

Late-payment data

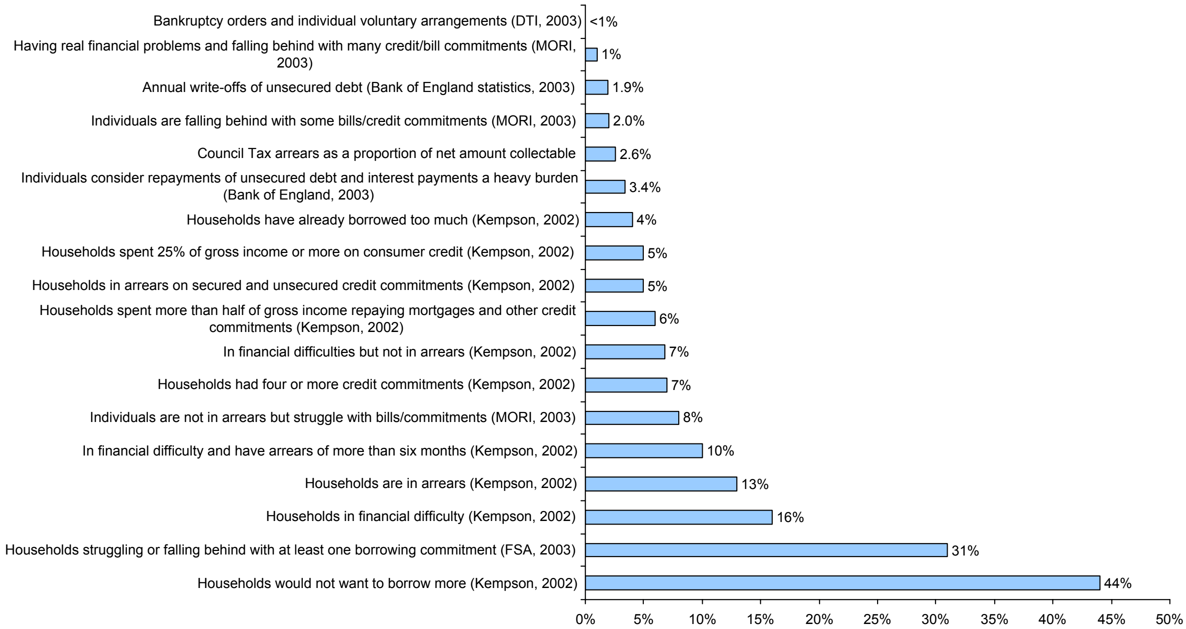
A number of reports provide data on arrears, bankruptcies, and write-offs. An assessment of over-indebtedness needs to focus on households that are structurally in arrears—for example, due to factors such as long-term unemployment or over-commitment. Households that are not in arrears on a structural basis need to be excluded—they should not be considered over-indebted. For example, households may be in arrears due to a temporary mismatch between income or expenses, or because they may have missed the minimum payment for credit cards. Other households that are in arrears may be able to meet their commitment but may not be willing to do so. Furthermore, some households may still be in arrears but may have started to catch up with their payments. Those households also need to be excluded from arrears data. Other aspects to consider in assessing whether households are in arrears on a structural basis are the number of arrears and the duration of arrears.

6.0 Conclusions

Figure 6.1 presents the late-payments and subjective measures used in the different reports. The Kempson report provides data on arrears and indicates that 13% of households were in arrears at the time the survey was undertaken, with 2.3% of households stating the reason as being an error, or missing or withholding a payment. Of the households in arrears, 46% were falling behind with one commitment, 21% with two commitments, 12% with three, and 20% with four or more commitments.

Around half of the households in arrears (6.7% of households) had been in arrears for more than six months, and one-third of them (4.2% of households) for more than 12 months. The MORI survey (for the CAB) gives a lower estimate and indicates that only 3% of individuals reported that they had fallen behind with bills/credit commitments.

Figure 6.1: Subjective and late payments measures



Subjective measures

The advantage of subjective measures is that they give a direct indication of over-indebtedness by capturing households that are currently managing their credit commitments but are vulnerable, as well as those that are in arrears. The disadvantage of subjective measures is that they assume that households are capable of assessing their own financial situation and will be honest. The proportion of households that will be considered over-indebted will depend on the precise definition used for assessing the subjective evidence.

Figure 6.1 clearly shows that different subjective measures give different estimates of affected households. In general, the broader the definition of the measures, the higher the number of households or individuals that are affected. For example, 4% of the households in the Kempson survey in 2002 indicated that they had borrowed too much, while 20% indicated that they were in financial difficulty.

6.0 Conclusions

It is crucial that the question posed is carefully worded to target the problem of over-indebtedness. The survey undertaken for the Kempson report asks households whether they are in financial difficulty. People in arrears, or who are at a significant risk of getting into arrears, are likely to consider themselves in financial difficulty. However, the question on financial difficulty is relatively broad and not restricted to problems related to interest payments and repayments of loans. For example, people may have difficulty meeting their financial obligations simply because of low income, irrespective of whether they have credit commitments. Thus over-indebtedness will be over-stated if too broad a measure is used. However, it is also possible that households do not take sufficient account of the possible impact of external shocks. If this were the case, subjective measures may underestimate the situation of over-indebtedness.

Debt-level indicators

On the basis of Bank of England and ONS data, Oxera estimates the unsecured debt:income ratio in the UK at 23% in 2003. The Bank of England reports estimates debt:income ratios by income group as ranging between 29% and 7%.[30] The debt:income ratio is unlikely to be an indicator of the current payment burden, as only a part of the outstanding stock of debt is payable in the near term. Estimates of debt-service:income ratios are likely to give a clearer picture of the financial burden of credit commitments on households. The Kempson report provides estimates of repayments (including interest) on secured and unsecured credit: 53% of households do not spend anything on unsecured credit; 22% spend less than 10% of their income; 8% spend between 10% and 25%; and 5% spend more than 25% on unsecured credit. Although the measure of ‘repayments’ used by Kempson is useful in assessing the usage of credit and its financial implications for households, it is not provided by income group, and it is likely to be too broad to assess over-indebtedness. It includes total repayments based on what households actually pay off, including any lump-sum repayments, while households are normally only required to repay a minimum amount of the loan each month or year. Interest payments and *minimum* repayments as a proportion of disposable income, is a more relevant measure. This measure is not available in the existing reports.

Preferred measures

Three preferred indicators of over-indebtedness emerge from the detailed analysis of the reports.

– *Debt-service:income ratios*—of all the debt-level indicators, the ratio of interest payments and minimum repayments as a proportion of disposable income will give the best reflection of the financial burden of credit commitments on households. No public-domain estimates exist for this ratio. In aggregate, interest payments on unsecured lending form only around 2.5% of disposable income. Kempson (2002) estimates that 5% of households spend 25% or more of disposable income on *total* repayments and interest payments, although this is not the preferred definition of debt-service costs.

[30] The unsecured debt:income ratio for individuals with income of less than £4,500 per annum is estimated at 103%. The average amount of debt in this income group was relatively high—£2,400—reflecting a disproportionate number of people with student debt in the group.

6.0 Conclusions

– *Number of households in arrears*—the Kempson report indicates that around 6.7% of households have been in arrears for more than six months. This includes those in arrears on household bills, as well as credit commitments. The MORI survey (for the CAB) indicates that 3% of individuals are falling behind with bills/credit commitments.

– *Subjective measures of borrowing too much*—The Kempson report shows that 4% of the households surveyed indicated that they had already borrowed too much while the Bank of England (2003) report indicated that 3.4% of individuals considered interest payments and repayments of unsecured loans to be a heavy burden. On the basis of these measures, a minority of households could be considered over-indebted.

Some of the measures indicate that there are more households in arrears than households that have borrowed too much or that find the interest payments and repayments to be a heavy burden. This may indicate that some people who are in arrears are not so on a structural basis—for example, because they are able but unwilling to meet their financial commitments or because they have already started catching up with their repayments and do not therefore consider themselves in difficulty any longer.[31] It may also be that the subjective measures result in underestimates because of some households' inability to assess their own financial situation.

The evidence indicates that over-indebtedness is often a temporary problem for a household. Most people are only in arrears for a relatively short period of time—people are sometimes affected by external shocks, such as a temporary loss in income, but manage to get out of financial difficulty after some time. The Kempson report shows that 6% of households surveyed stated that they had had financial difficulties 12 months prior to the survey, but had since resolved them, while a similar proportion (6%) stated that their financial difficulties had started in the past year. Furthermore, there are no indications that the number of people in financial difficulty has increased over time. The Bank of England report shows that the proportion of individuals reporting debt to be a heavy burden has been broadly stable at around 3.4% over the past nine years, while the proportion reporting debt to be somewhat of a burden has slightly declined over time.

Conclusions and further research

The analysis of debt at macro-level indicates that the UK position is not out of line with changes observed in other G7 countries. Furthermore, although unsecured lending has grown faster than secured lending for much of the last decade, over the period since 1987 the proportions of unsecured and secured debt have remained relatively stable.

Regarding the analysis of households, the conclusion is that there is no one data source at this level that is sufficiently reliable to enable robust conclusions to be drawn on the extent to which over-indebtedness is a problem in the UK. Furthermore, the existing reports do not take a forward-looking approach that evaluates the vulnerability of households to external shocks.[32]

[31] The Kempson report indicates that 25% of those saying that they were no longer in difficulty were actually still in arrears. As pointed out by Kempson, a plausible explanation is that they were paying off the money they owed and felt that they had got their finances back under control. This means that these households were not structurally in arrears any longer.

[32] The only exception is the FSA (2004) report, which uses a subjective measure to gauge the potential effects on consumers of an interest rate rise. The survey commissioned by the FSA asked people how they would manage repaying their debt in the event of a change in their housing costs. For people with a mortgage, questions were asked which correspond to interest rates rises of 1%, 2.5% and 5%.

6.0 Conclusions

There are indications from the subjective measures that a number of households are under financial pressure; however, this does not necessarily mean that these households are over-indebted. The three preferred measures taken together indicate that a minority of UK households are over-indebted. However, the lack of precision and consistency in the questioning across surveys makes it difficult to draw strong conclusions on the basis of this survey evidence.

This report indicates that a more thorough understanding is required of the actual financial position of households, and of how other factors affect this position, before robust conclusions can be drawn about whether concerns relating to the possible future consequences of the current level of household unsecured debt are well founded.

A1.1 Bank of England

The Bank of England report analyses the level and distribution of unsecured consumer credit. It is based on a survey commissioned from NMG Research asking people about their unsecured borrowings and whether these are a burden to them. The report concludes the following:

> In summary, recent growth of unsecured debt has not yet caused wide-scale debt situations. Moreover, the survey evidence suggests that most unsecured borrowing is arranged through personal loans and HP agreements where borrowers have little discretion to increase their debt without the permission of lenders. There is, however, evidence of large unsecured borrowing relative to income by a small proportion of individuals. This may not necessarily be a problem currently, although it could become one if these borrowers experienced adverse financial shocks, such as unexpected increase in interest rates or falls in income.

Survey evidence

The survey collects data on adults' level of debt and their income, and asks respondents to what extent the repayment of debt and interest is a financial burden on their households. The report details the distribution of unsecured debt and income, and concludes that there are relatively few cases where debt levels are high compared with household income—most debtors report that they owe relatively small amounts, with close to half owing less than £1,000 and two-thirds owing less than £3,000. For all income groups, the mean debt:income ratio of debtors is less than 30%. The only exception is the lowest-income group (with annual income less than £4,500), which has a mean debt:income ratio of 103%. As pointed out in the report, the average amount of debt in this income group is relatively high (£2,400), reflecting a disproportionate number of people with student debt in this group. Excluding students is likely to result in a lower debt estimate.

The distribution of debt across the sample is unequal, which suggests that a large proportion of outstanding unsecured debt is concentrated among relatively few people. The Bank of England report estimates that approximately half of the identified aggregate amount of debt obtained by grossing up the survey results is owed by approximately 4% of adults, each with individual debt of over £10,000.

In addition, the survey presents qualitative evidence of the extent to which individuals consider the repayment of their unsecured debt to be a burden on their household. It finds that 10% of debtors (3.4% of individuals)[33] consider their unsecured debt to be a heavy burden, 22% state that it is somewhat of a burden, and the remainder do not consider it to be a problem. Approximately half of the people who say the repayment of debt is a heavy financial burden belong to social class DE, approximately 40% live in local authority rented accommodation, few have other assets, and a disproportionate number are aged between 25 and 35. The report concludes that the figures on the proportion of people reporting debt to be a heavy burden indicate that a significant minority of debtors are struggling with their unsecured debt.

The financial burden question in the survey is similar to that in the British Household Panel Survey (which is undertaken on a regular basis) and therefore allows for a

[33] The proportion of individuals who indicated that they had unsecured credit was 34%. This means that 3.4% of individuals find the repayment of unsecured debt and interest payments a heavy financial burden on their household.

comparison over time. However, although the question may give an indication of indebtedness, it is not necessarily a good indicator for over-indebtedness. People who consider interest payments and repayments a financial burden are not necessarily over-indebted—they may still be able to meet their financial obligations. This is also reflected in the results of the survey: 37% of those who find debt to be a heavy burden are between 25 and 34 years old. This is about double their proportion in the grossed-up sample as a whole and also higher than their share in the debtor population. The Bank of England report explains that these individuals do not have a particularly high unsecured debt:income ratio; however, their finances are likely to be put under strain by mortgage borrowing and other financial demands at a stage in their lives when they are starting families and buying homes. In other words, the financial burden question may overstate the problem of over-indebtedness.

Nevertheless, the evidence does suggest that those who report their debt to be a heavy burden also tend to have more debt. Over 32% of those who perceive their debt as a heavy burden have unsecured debt above £10,000. This is substantially larger than their 13% share in the population of debtors. The average debt of people who state that it is a heavy burden is £6,900, compared with £3,900 for those who say it is somewhat of a burden and £2,900 for those who say it is not a problem. The survey indicates that unsecured debt in aggregate is, to some extent, concentrated among those who experience difficulties in repaying it: almost 20% of unsecured debt is owed by those who consider it a heavy burden, and 25% by those who say it is somewhat of a problem.

Finally, the report looks at changes over time and concludes the following:

> There does not appear to have been any upward trend in the participation rate over time. But the debt:income ratio of borrowers has doubled between 1995 and 2003. Since 2000, the increase has been concentrated among those with household income above £17,500. This confirms Kempson’s analysis of 1989 to 2002 period that ‘the large increase in consumer borrowing is not due to a larger proportion of the population owing money’.
>
> There has been an increase since 1995 in the proportion of households who consider their debt not to be a burden despite the general rise in unsecured debt. This may reflect falling interest rates on unsecured debt and the relatively small share of unsecured debt in household sector wealth. But the debt levels of those reporting it to be a burden have increased disproportionately.

Assessment
Overall, the Bank of England report gives a reasonably balanced, although limited, analysis of indebtedness in the UK. It provides new data on the distribution of unsecured debt and the usage of different types of unsecured credit by income group.

– The report concludes that the proportion of people reporting debt to be a heavy burden indicates that a significant minority of debtors are struggling with their unsecured debt. As explained above, the financial burden question may overstate the problem of over-indebtedness.

– The report assesses the robustness of the survey results, in particular those on participation rates and average debt levels, by comparing them with other evidence. This comparison indicates that the evidence obtained by the Bank of England is consistent with that obtained in other surveys, such as the Kempson report. However, as noted in the Bank of England report, the survey estimates the aggregate level of debt at £56.8 billion, which is significantly less than the total UK consumer credit of

£168.4 billion reported at the end of September 2003 by credit providers (see section 4 above). Other surveys also seem to result in under-reporting. This issue is discussed in section 4.3 above.

– The report concludes that ‘the recent growth of unsecured debt has not as yet caused wide-scale debt problems but there is evidence of large unsecured borrowing relative to income by a small proportion of individuals’, and that ‘this may not necessarily be a problem currently, although it could become one if these borrowers experience adverse financial shocks, such as unexpected increases in interest rates or fall in income.’ This last conclusion requires further research and cannot be drawn on the basis of the evidence provided in the Bank of England report. In order to assess whether households would be sensitive to external shocks, evidence is needed on current interest payments and minimum repayments as a proportion of disposable income. However, the Bank of England report only presents debt:income ratios, and does not provide data on interest payments or repayments of loans as a proportion of income. In general, debt:income ratios can be used to assess changes in financial position over time but are not necessarily useful to assess the financial situation at a particular point in time. Although maturities of unsecured debt are often much shorter than in the case of mortgages, only a part of the outstanding stock of debt is payable in the near term.

A1.2 PricewaterhouseCoopers

The PwC report reviews developments in the credit-card sector in 2002, and considers likely responses of credit-card issuers to the challenges they face. It does not analyse indebtedness or over-indebtedness.

The only information in the report that is relevant to indebtedness is that, according to APACS, the average outstanding balances per credit-card user had risen from £1,326 in 2000 to £1,406 as at December 2001—an increase of 6%. PwC estimates the growth of underlying (non-convenience) borrowings at approximately 8.8% per annum per person, which is significantly higher than inflation. It concludes that, while this rate of increase is not sustainable in the long term, reductions in interest rates have acted to reduce the overall interest burden. In other words, people can afford to borrow more due to lower interest rates.

A1.3 CCRG

The CCRG report seeks to address two connected questions:

> First: is the current level of debt in the UK too high: are we storing up problems likely to produce a future crisis of over-indebtedness?
>
> Secondly, are creditors behaving responsibly in their lending and are debtors fully aware of the consequences of taking credit: what role do lenders have to play in helping individuals who have fallen into difficulties with debt?

The report describes the growth of credit and debt over time in the UK, and assesses the sustainability of the current position given underlying macroeconomic conditions and probable future developments.

Regarding the growth in credit, the report makes the following points.

> Data stretching back to 1980 suggests that lending to individuals grew remarkably in the final two decades of the 20th century. Outstandings equalled £723 billion at the end of 2001, up from £64 billion in 1980. Such rapid growth probably reflects, according to the Bank of England: 'A steady response to financial liberalisation from a starting position of sub-optimal debt levels'.
>
> While consumer credit has grown rapidly, credit card outstandings amounted to just £1.2 billion in 1980; by 2001 this figure was £40 billion—an increase of 3,200%.

Moreover, the report notes that lending secured on dwellings still accounts for 80.8% of total lending to individuals, with credit-card outstanding making up 5.6%.

The CCRG report assesses the level of debt in the UK by analysing a number of ratios, such as debt:income, debt:wealth, and debt-service:income at aggregate level over time. Data from the Bank of England, the Office of National Statistics and OECD is used. The main points are summarised below.

- The debt:income ratio in the UK has grown slightly, from approximately 90% in 1990 to 107% at the end of 2001. Comparisons with debt:income ratios in other countries suggest that the position in the UK is not unusual. Data from the OECD shows that the debt:income ratio in Germany was 115.1% in 2000, and in the USA 106%. Mortgage equity withdrawals reached record levels of over £7 billion at the end of 2001, up from just £2 billion at the same time in 2000. However, taken as a proportion of disposable income, mortgage equity withdrawals represented just 4% in 2000, well short of peak levels of 8% recorded in 1998. Debt:wealth ratios in the UK have decreased from 18.9% in 1990 to 16.2% in 2000. In other words, while the UK household sector debt:income ratio has increased, it has been more than matched by rapid gains in wealth. The report notes that these measures alone are not sufficiently reliable indicators of the affordability of debt. Wealth may not be shared equally, and, as such, may not reside in the hands of those most in debt. Furthermore, while debt is fixed in value, the price of shares and property are not. CCRG therefore concludes that the debt-service:income ratio is a better measure of affordability.

- CCRG defines the debt-service:income ratio as the amount spent on interest payments as a proportion of disposable income. It shows that, because UK base rates have fallen (from a peak of 15% in 1989 to 4% in 2000), the cost of debt in the UK has reached a historical low—interest repayments as a proportion of disposable income were 7% in 2000.

- The report points out that holding significant levels of credit exposes the debtor to an inevitable amount of risk from external shocks. However, it argues that the most 'obvious' shock of a sudden jump in interest rates (which would substantially increase the debt burden) is an unlikely scenario—they expect interest rates to move slowly, giving lenders and borrowers time to adjust their behaviour.

Assessment

The CCRG report gives a useful overview of a number of indebtedness ratios over time and across countries. Although it analyses interest payments over time, it does not provide estimates of minimum repayments. The latter should arguably be taken into account in order to obtain a full picture of the financial burden resulting from credit commitments. Furthermore, an assessment of affordability and sustainability of current levels of debt requires analysis at household level. The CCRG report refers to other studies that indicate that the problem of individual over-indebtedness is worsening, but does not provide an analysis. It discusses some choices that people who are over-indebted face (ignore the problem, contact their creditor, seek third-party advice/debt management, and apply for bankruptcy), and possible causes for getting into difficulty with credit cards, as identified in a study by Rowlingson and Kempson[34] (change in circumstances, overspending, low priority given to repaying credit cards, misunderstanding and issuer practices).

A1.4 JP Morgan

The JP Morgan report analyses the level and distribution of unsecured and secured consumer credit in the UK. The report does not collect new data, but combines various elements of data available in existing reports, including surveys by MORI (for the CAB) and NOP Financial Research, a report published by the CML, a report from the CAB, a NMG Research survey commissioned by the Bank of England, and data from the Bank of England and the BBA.

Unsecured credit
The JP Morgan report uses data on the distribution of debt from the MORI survey commissioned by the CAB (see Table A1.1), and estimates the total amount of debt in the UK at £115 billion, based on the assumption that there are approximately 40m individuals in the UK, of which 30m carry unsecured debt—the MORI survey estimates the participation rate at 74%.[35] It compares this estimate with the amount of credit reported by credit providers of £168 billion (from the Bank of England), and concludes that, in order to reconcile the data from the Bank of England and the MORI survey, a multiple needs to be applied to the top end of the debt ranges (shown in Table A1.1)—the multiple is estimated at 1.31.

JP Morgan concludes the following:

> Of the 30m borrowers, 56% (or 16.8m) have just £26bn (16%) of the £168bn total unsecured debt.
>
> The 3.3m 'most indebted' borrowers are estimated to have accumulated £73bn, or 44% of the total unsecured consumer debt.

With regard to these conclusions, JP Morgan assumes that the under-reporting is equally distributed among the individuals surveyed: it is not clear whether this is the case in practice. It is possible that people with a total amount of unsecured debt of £1,000 feel more comfortable revealing their debt level than those with a much higher amount of debt. In particular, people in financial difficulty or on a relatively low income may feel less comfortable about revealing their amount of debt than those with a relatively better financial position. In other words, it is not clear who is responsible for the under-reporting.

The MORI survey indicates that 3.3m borrowers have accumulated approximately 44% of the total unsecured consumer debt, but does not provide any information about their income levels. An assessment of over-indebtedness requires comparison of levels of debt and debt servicing to income.

[34] Rowlingson K. and Kempson E. (1994), 'Paying with Plastic—A Study of Credit Card Debt', PSI Publishing.

[35] JP Morgan's estimates of the number of individuals and borrowers in the UK are similar in magnitude to ONS data, which states that there were individuals 47,470,000 in the UK in 2002. (Individuals are defined by the ONS as those aged 16 or above, similar to the definition used in the MORI survey). Given a participation rate of 74%, this results in 35m borrowers.

Table A1.1: Distribution of the amounts owed by debtors

	Proportion of borrowers with debt in range (%)	Number of borrowing customers	Range average (£)	Actual averaged debt per consumer (£)	Total balance (£m)
Under £1,000	44	13.2	500	1,306	17,233
£1,000—£1,999	12	3.6	1,500	2,611	9,400
£2,000—£2,999	7	2.1	2,500	3,917	8,225
£3,000—£3,999	6	1.8	3,500	5,222	9,400
£4,000—£4,999	5	1.5	4,500	6,528	9,791
£5,000—£7,499	4	1.2	6,250	9,791	11,750
£7,500—£9,999	3	0.9	8,750	13,055	11,750
£10,000—£14,999	6	1.8	12,500	19,583	35,249
£15,000—£19,999	3	0.9	17,500	26,110	23,499
£20,000 or more	2	0.6	22,500	32,763	19,583
All respondents	**92**	**27.6**			155,877
Don’t know/refused to answer	8	2.4	3,837		12,533
			(average of sample)		
All borrowing consumers	100	30			168,410

Source: JP Morgan (2003).

JP Morgan does not have data on the amount of debt by income group or decile. It therefore presents a number of hypothetical low-income individuals with an annual gross income of £20,000 and a mortgage of £64,000: a ‘prudent’ individual with no unsecured credit; a ‘carefree’ individual with £10,700 unsecured debt; and a ‘stressed’ individual with £20,000 unsecured debt. JP Morgan estimates the interest-servicing cost of mortgages in a number of scenarios with base rates at 3.75%, 4.5%, and 5%, and mortgage interest rates of 0.9% plus base rate. It assumes an interest rate on secured credit of 15% in all scenarios.[36]

JP Morgan concludes that the ‘stressed’ individual with £20,000 of unsecured debt in addition to a mortgage sees 45% of their income absorbed by interest servicing, with base rates at 5%. However, JP Morgan indicates that the stress is not really a function of rising interest rates; it is the result of the initial over-indebtedness. The ‘stressed’ borrower already pays 39% of their income simply to service debt with rates at 3.75%. In other words, the additional servicing cost imposed by rates rising to 5% is only £70 per month.

[36] JP Morgan keeps the 15% interest rate on unsecured credit the same in all scenarios, on the assumption that unsecured credit interest rates do not move with the base rate.

JP Morgan assumes an interest rate on unsecured credit of 15%: this looks high. Estimates on the basis of Bank of England data show that the effective interest rate on unsecured credit was approximately 10% in November 2003.[37] Furthermore, although the examples are interesting, they are hypothetical. It is not clear how many households find themselves in a similar situation—the MORI survey indicates that there are a number of households with unsecured debt higher than £20,000, but does not give any information about their income.

Secured credit
The JP Morgan report analyses secured debt:income ratios at aggregate level for different regions in the UK (see Table A1.2), and concludes that, despite recent press, there is little evidence of a systematic over-leveraging of the UK mortgage borrower. The highest average income multiple is in London, and remains below 3.

Table A1.2: Gross lending for house purchase

Region	Number of loans (000s)	Average advance (£)	Value of loans extended (£)	Average income of borrowers (£)	Average income multiple
Greater London	28	154,810	4,300	54,267	2.85
South East	56	120,587	6,800	45,653	2.64
South West	25	95,827	2,400	37,360	2.56
East Anglia	12	92,335	1,100	37,196	2.48
West Midlands	22	84,467	1,800	33,066	2.55
East Midlands	22	80,062	1,700	34,332	2.33
North West	31	76,396	2,300	33,032	2.31
Yorks & Humberside	26	74,097	1,900	32,171	2.30
Wales	14	69,982	1,000	31,542	2.22
North	16	64,085	1,000	29,668	2.16
Scotland	32	63,558	2,000	30,010	2.12
Northern Ireland	8	62,363	500	28,570	2.18
UK	**70**	**92,627**	**26,800**	**37,359**	**2.48**

Source: CML (reported in JP Morgan).

CML only provides average income and does not give information about the level of mortgage debt by income group or decile. JP Morgan therefore analyses three scenarios:

– an ‘average borrower in London’, with a gross annual income of £54,000 and a mortgage of £154,000;
– an ‘aspirational’ borrower, with a gross annual income of £40,000 and a mortgage of £200,000;

[37] The effective interest rate on credit cards, as reported by the Bank of England, was 13.78% in November 2003. The effective interest rate on other unsecured lending ranged between 8.85% and 9.28%—the midpoint is 9.07%. The Bank of England reports that total credit-card credit amounted to £53,011m, and other unsecured credit to £17,001m in November 2003. This results in a weighted average effective interest rate of approximately 10%.

– a ‘big ticket’ borrower, with a gross annual income of £120,000 and a mortgage of £600,000.

The analysis shows debt-service:income ratios in scenarios with base rates of 3.75%, 4.5%, and 5% plus 90 basis points. JP Morgan concludes that the average London borrower would be untroubled by a 5% base rate, and that even the aspirational and big-ticket borrowers would still be able to service their debt with base rates at 5%, albeit perhaps uncomfortably.

Nevertheless, these examples are hypothetical: given the fact that there is no data on the level of mortgage by income group or decile, it is not clear how many people would find themselves in a situation as described in the above scenarios.

A1.5 MORI (for the CAB)

This report presents the findings of a MORI survey among 1,986 adults in Great Britain, conducted on behalf of the CAB in July 2003. The objectives of the research were to measure the level of financial debt among the general public, and to assess the likelihood that they would use the CAB as a source of advice and information about debt.

The report is descriptive, focusing on the survey results rather than a critical evaluation of the over-indebtedness situation in the UK. It does not provide a clear definition of what the researchers believe to be ‘over-indebted’. Instead, a number of measures are presented to inform about the financial situation of individuals, their use of loan and credit facilities, and their reliance on the CAB.

The main measure of (over-)indebtedness presented is a subjective one, based on the surveyed adults’ assessment of their financial situation. The report summarises the results as follows:

> Although most people (56%) say they do not have problems keeping up with payments and credit commitments, a significant minority do find themselves in financial difficulties (26% struggle from time to time and 11% have more serious problems).

The detailed survey results are shown in Table A1.3.

Table A1.3: Individuals’ subjective assessment of their financial situation

	% of respondents
We are keeping up with our bills and credit commitments without any difficulties	56
We are keeping up with all our credit commitments, but struggle to do so from time to time	26
We are keeping up with all our bills/credit commitments, but it is a constant struggle	8
We are falling behind with some of our bills or credit commitments	2
We are having real financial problems and have fallen behind with many bills or credit commitments	1
Other/Refused/Don’t know	6

Source: MORI (2003).

Further analysis in the report (eg, a breakdown of total responses according to respondents’ characteristics) seems to suggest that the researchers set the relevant cut-off to be individuals that ‘struggle constantly to keep up with payments or are falling/have fallen behind with payments’—ie, 11% of total respondents.

The survey also informs about the total amounts owed by respondents (eg, 8% owe more than £10,000 and the average loan and credit debt of those with outstanding balances is £3,900). However, since the amount owed is presented as an absolute amount rather than in relation to income or wealth, it is not a good indicator of the debt problem faced by individual households.

Further survey results relate to households’ possession of loans and credit facilities. For example, 54% of surveyed individuals have a credit card, and 42% have an overdraft facility at a bank or building society; other sources of loans or credit are used less frequently. Statistics on the possession of debt facilities do not inform about the scale of any debt problem; what matters is the use of the facilities and the sustainability of the level of debt taken out by households. The survey seeks to inform about this in three main ways.

– First, the survey presents statistics about the frequency of the use of overdraft facilities on bank or building society accounts. While many of those with overdraft facilities never use the facility (36%) or use it only once or twice a year (29%), 13% are overdrawn at least once every month and 6% are always overdrawn. The report does not evaluate or comment on these statistics, and without any further data on the size of the overdrafts (relative to the individual’s financial position), these statistics do not give a good indication of (over-) indebtedness if considered in isolation.

– A somewhat better indicator is the second set of statistics, which shows the extent to which individuals use loans and credits to pay regular household bills and make ends meet until the next payday, benefit or pension payment. For example, 12% use their loans and credit facilities ‘always’ or ‘very often’ for paying regular bills and 9% to make ends meet; about 10% do this ‘fairly often’. Nearly 60% ‘never’ use loans and credit for paying bills and making ends meet, and the remainder do so ‘not very often’.

– The third set of statistics refers to evidence on households’ repayment of credit- or store-card debt. 9% of individuals do not usually have an outstanding balance on their cards at the end of the month and 49% pay any balance off in full. On the other hand, 41% pay less than the full balance, of whom 10% make the minimum payment but no more, and 2% do not even meet the minimum payment. It is difficult to draw inferences from these statistics without a further understanding of what drives households’ repayment behaviour.

The final part of the MORI survey relates to households’ usage of the CAB. 30% of the public have sought advice from the CAB, although this represents any type of enquiry, not those specifically related to debt. The survey also suggests that 34% of individuals would use the CAB for advice if in financial difficulty, but the emphasis is on ‘would use’ rather than ‘have used’. Neither statistic is therefore informative about the debt situation in the UK.

Overall, the main evidence presented in the MORI report which helps to assess the scale of the UK debt situation is based on the subjective measure of whether individuals consider themselves to ‘struggle financially’ and have constant difficulties in keeping up with their financial commitments. 11% of individuals consider themselves to be in this position. The more objective measures (ie, on debt usage and repayment) are informative;

however, without further analysis and a clear definition of when debt is too much debt, they cannot (and are not intended to) provide useful measures of over-indebtedness in the UK.

A1.6 CAB

The CAB study examines the debt problems faced by clients who seek advice from the CAB. It reports that there has been a sharp rise in debt enquiries to the CAB—increasing by 24% since 1997/98 to reach a total of nearly 1.1m enquiries in 2001/02. This growth in enquiries has been particularly sharp in the area of consumer credit (47% since 1997/98); consumer credit constituted nearly two-thirds (0.7m) of all enquiries about debt to the CAB in 2001/02.

The CAB takes these statistics as the principal evidence that the problem of personal indebtedness in the UK is getting worse, and correspondingly proposes a number of recommendations to tackle the problem.

The CAB supports its conclusion of a growing debt problem by citing statistics obtained from other research, including:

– Statistics from the Insolvency Service, which show that, from 1997 to 2002, the number of personal insolvencies increased by 25% to 30,587;
– The Kempson report, which suggests that 25% of UK households were in financial difficulties in the 12 months preceding the survey conducted for the report, and 20% were still in financial difficulty at the time of the survey;
– Research quoted in the FSA's 'Financial Risks Outlook 2003', which indicates that 6.1m households find it 'moderately difficult' or 'difficult' to meet their debt repayments.

The CAB report questions the picture portrayed by other statistics that show that there is only a limited debt problem in the UK; these include the following:

– The proportion of consumer credit accounts in arrears has been static at approximately 5% since 1996—this statistic is criticised mainly because it does not show whether someone is over-committed relative to their income or struggling to pay all their commitments.

– There was a 36% decrease in the number of county court judgements during 1995—2001—this statistic is criticised because the fall in the number of judgements may be due to a greater proportion of cases settled outside of court.

– The number of mortgage repossessions has decreased by two-thirds from 32,770 in 1997 to 11,970 at the end of 2002—the report indicates that this statistic presents the wrong picture because the decrease is mainly due to low interest rates and the fall in unemployment; moreover, the overall decrease is argued to hide the growing problem of possession action by sub-prime lenders.

Although the report criticises these other statistics, it does not provide better statistics to allow an assessment of over-indebtedness in the UK. The report places emphasis on the observed increase in the number of debt enquiries to the CAB. This increase may indeed indicate that more people are experiencing problems with their debt, but it does not provide evidence of over-indebtedness. For example, the number of enquiries may overestimate the number of households with debt problems if these reflect multiple enquiries by the same households—estimates indicate that the average person with a debt problem usually equates to between five and ten enquiries each.[38] Also, not all people who turn to the CAB may be in financial difficulty—the fact that they are seeking advice from the CAB may be unrelated to their level of debt. Furthermore, the increase in consumer credit debt enquiries may also be caused by the fact that credit products have become more complex and have received a great deal of attention in the media, making people more aware of potential issues and problems and more likely to contact a CAB. It therefore seems difficult to sustain one of the main conclusions of the report—namely, that the problem of personal indebtedness is getting worse—based on evidence of a growing number of CAB debt enquiries alone.

The CAB study reports the results of a survey of 924 people who made debt enquiries to the CAB in May 2001. The total household debt among the CAB clients in the sample ranged from £132 to £111,000, including mortgage arrears but excluding outstanding mortgages.

In addition to presenting absolute debt levels, the study relates total household debt to monthly net income, and reports that ‘a significant proportion of clients faced debts in proportion to their income which were totally unmanageable, on average nearly 14 times their monthly income.’ However, no details are provided on how the threshold for ‘manageability’ is defined or the percentage of people who face ‘unmanageable’ debt.

The survey results further inform about the number of debts per household, the most common types of debt, debt collection and recovery actions of creditors, and the reasons behind the debt problems. It also examines how the CAB debt clients cope with their debt problems. When asked how well they were coping with their debt problem, 7% indicated that they were coping well and 27% were coping but only just. 36% stated that they felt unable to cope and were already feeling in crisis by the time they had approached the CAB for help, and another 27% felt they were not coping but not yet in crisis.

The statistics about debt levels and ability to cope with debt problems cannot be used directly to infer the scale of the (over-)indebtedness situation for the UK population at large—the survey was carried out among CAB clients and is therefore not representative of the entire UK population, as most enquiries to the CAB about debt are usually by people who are already in debt. Also, most people seeking advice are poorer than the general population—the average net monthly household income of debt clients is less than half of the average monthly household income of the UK population; similarly, 43% of surveyed clients received income support, jobseekers’ allowance or tax credit. This explains why the average level of debt in the CAB sample is £10,700, which is significantly higher than the average debt levels reported in other studies by the Bank of England, Kempson, and MORI, for example (see section 4 above). It also explains why a much higher percentage of individuals indicate that they are unable to cope with their debt and are in financial crisis (36%) compared with other studies, such as that by MORI, where 11% of surveyed households indicate that they are constantly struggling financially. Thus, the CAB statistics are of limited use in assessing the debt situation for the UK population at large.

[38] See Pearson, N. (National Money Advice Co-ordinator, Advice UK, formerly known as Federation of Information and Advice Centres), (2001), ‘Debt Statistics are Misleading—Letter to the Editor’, *Credit Today*, February.

A1.7 CMRC

The objective of this study was to examine trends in debt management, debt collection and recovery, and investigate the practices of large-volume lenders in the consumer and commercial credit sectors. Three specific aims were to:

– Examine current practices in collection and recovery, and how these are expected to change;
– Study trends in commercial lending and its impact on debt collection;[39]
– Survey the characteristics and practices of the outsourced debt-collection industry.

This study does not focus specifically on the question of levels of over-indebtedness, but on one symptom of it: levels of bad debt and default rates. No definition of (over-) indebtedness is provided, although an association is made between over-commitment and indebtedness. Furthermore, the study offers insight into the debt-management practices of lenders that are obviously linked to lending practices.

Although the study is motivated by a stated increase in the level of bad debt, this work predominantly constitutes a qualitative study, with no time-series data on the level or proportion of bad debt to support its analysis. The study does make a number of statements about the level of consumer borrowing and indebtedness, which are summarised in Table A1.4, with a critique on the source and validity of the statements.

In general, the statistics reported are unsourced, and, where sources are cited or can be assumed so that their accuracy can be checked, the results are misreported or misinterpreted. In general, the errors in reporting are such as to overstate the extent to which over-indebtedness is a problem. This casts doubt on the reliability of the study overall and means that the conclusions drawn on indebtedness cannot be considered robust.

[39] The results on commercial lending and default rates are not considered further in this appendix.

Table A1.4: Statements on over-indebtedness in the CMRC report

Statement	Page	Source and accuracy
Household owes sums equivalent to 118% of income	4	Accurate, but no source
6m households are struggling with repayments	4	FSA
Household debt relative to income level has grown substantially	5	Accurate, but no source
The number of people experiencing 'financial difficulties' or with 'unmanageable debt' has risen by 47% over the past five years	5	CAB. This is an inaccurate representation of the CAB results. The CAB reports a 24% increase in all debt enquiries, within which those related to consumer credit have increased by 47%. These are debt enquiries and do not indicate anything about the financial position of the enquirer
Consumer credit outstanding for the average household is over £98,000 for mortgage debt and over £24,000 for non-mortgage debt	5	FSA. Inaccurate representation of the FSA results for non-mortgage debt. It appears to sum the average debt per household *that has that debt* without weighting this by the proportion of all households that have that debt. That is, it assumes all households have student loans, car loans, etc. This will significantly overstate the amount of debt
A customer experiencing financial difficulties will have approximately £25,000 of debt spread across 15 creditors	5	No source. Looks high compared with CAB survey, which shows that only 10% of their clients have more than ten debts, with an average of £10,700
The growth of the debt-collection agency market in the last two years is estimated at almost 70%	5	No source
The total volume of outstanding loans reached £1,114 billion in 2000	14	Bank of England. Difficult to replicate. Bank of England figures show outstandings to be £500 billion in 2000
Estimates of the value of debt outsourced to the debt-collection agents range from £3 to £5 billion, but the potential market size is estimated to be up to £60 billion if debt purchase is included	14	No source. The £60 billion includes commercial debt. Elsewhere in the document it refers to 'in excess of £5 bn', rather than the range reported here
In consumer markets, record numbers of individuals [are] getting into financial difficulty, with debts spread across several creditors	14	No source
Figures 2.3 and 2.4 purport to show the breakdown of consumer credit by type	18	No source. Reports gross lending, when net lending would be more appropriate. Figure 2.4 is inconsistent with Bank of England data that shows credit cards to be 29% of outstanding consumer credit, not more than 50%, as shown in the figure
'An increasing number of people are building credit card balances rather than settling at the end of the month. Cash advances on credit cards have also become more common.'	20	No source. Not supported by APACS data

Statement	Page	Source and accuracy
'A common finding from our study of large volume collection activities was that customers would often find themselves in financial difficulty and arrears on consumer debt due to 'over-commitment' i.e. too many debt repayments in relation to current levels of income. Recent survey evidence suggests that over-commitment continues to be cited as the major reason for payment difficulties' 'Over-commitment may stem from a number of causes, clearly changes in levels of income e.g. due to unemployment or divorce may leave a customer unable to meet commitments that were arranged on the basis of higher levels of expected income. It may, however, be a function of the mismanagement of personal finances or rash spending sprees. These latter two are the most likely reasons for over-commitment i.e. general indebtedness where the consumer takes on too much debt in relation to income and spending sprees where injudicious spending begins to cause mounting problems in servicing current debts'	21	No source and contradicted by the DTI results

As outlined above, the main focus of the study is not over-indebtedness, but the business responses and opportunities that arise from bad debt. As such, the main conclusions from the most recent survey of lenders' practices with regard to bad debt are outlined below.

- Lenders are developing a more sophisticated understanding of customers' borrowing patterns through increased use of:
  - behavioural models, both for initial lending decisions and for all subsequent credit extensions;
  - compilation of account data with credit reference information and lifestyle data;
  - an expansion of 'closed user groups', where lenders share information about customers.
- Once a customer starts to get into financial difficulty, lenders are also responding more flexibly to the problems:
  - 'debt resting' is used to assist low-risk customers who undergo an adverse event, such as divorce or employment change;
  - proactive responses to certain types of customer behaviour that are indicators of trouble (eg, changes in spending or repayment patterns) to pre-empt problems by providing money-management services or restructuring finances.

It is clear from the interviews conducted for this report that the main driver from the lenders' viewpoint is the profitability of the customer, and that lending to customers who cannot repay is not good business practice. This implies that risk-adjusted bad debt should have fallen overall, given the reported efforts by lenders to improve lending decisions and customer management. No statistics on bad debt over time are reported to test this hypothesis.

In addition, the report suggests that lenders are more sophisticated in their debt-recovery procedures. Thus, while many outsource aspects of this process and sell off bad-debt portfolios, this is only after significant efforts have been made internally to recover the debt. As a result, the 'quality' of the outsourced debt is falling, undermining the business model for independent debt-collection businesses. Once a lender has determined a debt to be too difficult to recover, the probability of success of an external provider is very low. Thus, any evidence on increasing commissions on outsourced debt or falling numbers of independent debt-collection agencies will say little about changes in bad debt overall, but more about the improved processes in the main lenders.

While this report is motivated by an apparent increase in over-indebtedness, little evidence is presented to support the assumption that this has indeed occurred. Furthermore, the qualitative evidence on the ways in which lenders' behaviour has changed over time suggests that over-indebtedness (as reflected in risk-adjusted bad debt) should have reduced. No supporting statistics are provided on levels of bad debt.

A1.8 FSA

The FSA's 'Financial Risk Outlook 2004' includes a section on consumer borrowing, which reports on the growth in borrowing, evidence of consumers struggling to face repayments, and the impact of possible future increases in interest rates. The report concludes that:

> Borrowing continues to grow strongly, and there is more evidence of some consumers having difficulties meeting their debt commitments. This is despite a generally favourable economic environment. It is a public awareness concern for us and others if consumers do not understand the risks associated with borrowing.

Summary
The FSA's report seeks to assess potential risks to financial stability, and the state of the financial markets and associated firms. It examines consumer borrowing in the UK and notes that, compared with the previous year, net household borrowing grew by a record 14.1% in 2003, with secured lending up 14.4%. The two key sections of the report contain an update of previously reported survey work on individual debt-holdings in Great Britain and a survey of how debtors would cope with differing scenarios for UK interest rates.

The FSA commissioned questions in the September 2003 National Statistics Omnibus Survey on debt and borrowing. The results have been reported at the family-unit level, which is defined as either an individual or a couple, together with any dependent children. Debts of unrelated adults in a household are treated separately. Just over half of the families surveyed had unsecured debt, with an average debt of £6,500, while just over two-fifths had a secured debt of £70,000 on average. Despite the growth in debt, the overall level of arrears in both mortgage and unsecured lending remains low, supported by factors such as low borrowing costs and benign economic conditions. The risks were, however, that consumers might underestimate the real costs of debt or be over-optimistic about future income. Higher interest rates, unemployment or falling house prices could all lead to a worsening of conditions.

Evidence of consumers already facing difficulties can be found in the survey cited in the ‘Financial Risk Outlook 2003’, which reported that 6.1m families had some difficulties meeting debt repayments.[40] The more recent National Statistics Omnibus Survey (September 2003) suggests that 6.9m families in debt were either struggling or falling behind with at least one of their borrowing commitments. Furthermore, families in debt spent on average 31% of total gross income on debt servicing, while the average amount spent for those families struggling with debt commitments was 41%. In addition, the Omnibus Survey found that families with overdrafts and those that rented property were more likely to report difficulties.

Other indicators of over-indebtedness reported include the number of new debt enquiries to advice agencies, with the CAB dealing with more than 1m debt enquiries, and a 17% increase in personal bankruptcies in the year up to the third quarter of 2003. The Omnibus Survey found that one in six respondents would consider bankruptcy if they were unable to cope with debt repayments, and one-half prepared to consider it as a last resort. This is of particular interest as the Provisions of Enterprise Act 2002, which came into force on April 1st 2004, reduces the period of time before an individual is discharged from bankruptcy from three years to one.

Economic forecasters and financial markets, as implied by forward rates on short sterling contracts, expect increases in official UK interest rates, although the timing is uncertain. The Omnibus Survey was also used to gauge the ability of people to repay debt when faced with changes to housing costs. Mortgage borrowers were asked how they would cope with one-off increases in interest rates of 1%, 2.5% and 5%. The Omnibus Survey found that a rise of one percentage point in interest rates increased the proportion of respondents who said they would struggle with at least one form of borrowing from 31% to 38%. Of those surveyed, 56% replied that they would still be able to cope without difficulty, while 6% would fall behind with at least one form of borrowing.

The report notes one of the definitions of over-indebtedness by the DTI Taskforce on Overindebtedness (2003), namely that households are over-indebted if they spend more than one-half of gross income on debt-servicing costs including a mortgage. Omnibus survey responses suggest this would encompass approximately 1.8m families (6% of all families, and 17% of those with a debt). Three-quarters of these are found to ‘have some difficulty’ with a 1 percentage point increase in interest rates. With a one percentage point increase, most respondents suggested that they would cut back spending in other areas, remortgage or talk to their lender about rearranging payments.

Assessment
This report provides an update on survey evidence on the level of indebtedness in the UK and provides an assessment of the sensitivity of households to increases in interest rates.

As explained in section 4 above, the FSA’s Financial Risk Outlook survey reveals an under-reporting of debt—in particular, unsecured debt is significantly under-reported, while secured debt reported in survey evidence is close to actual data.

The report admits that while the Omnibus survey asks mortgage borrowers to assess a one-off increase in interest rates from 1 to 5 percentage points, it is likely that such increases would be introduced more gradually. However, the report notes that an increase

[40] B&W Deloitte (2002),‘Wealth and Portfolio Choice’, unpublished; survey commissioned by the FSA.

in interest rates would be of most concern to over-indebted households that are defined in the report as those spending more than one-half of gross income on total debt repayments. One problem with that definition of over-indebtedness is that repaying mortgages could be regarded as a form of saving and a payment for accommodation. It is not clear, therefore, that this is a reasonable threshold to measure the problem of over-indebtedness.

Overall, this report is based on subjective measures with limited hard new data presented. That said, the grossed-up estimates of unsecured debt do suggest that the average levels of unsecured debt reported in the survey are closer to actual levels than in some other survey evidence.

A1.9 ORC Macro

This report assesses levels of household indebtedness across EU Member States, relying mainly on survey responses to the European Community Household Panel and the EU's harmonised Household Budget Survey. Its objective is to 'enable the phenomena of overindebtedness to be estimated as accurately as possible at each Member State level'. The report includes the conclusion that 'There is no clear evidence that increasing the availability of consumer loans increases the percentage of over-indebted households.'

Summary
The report collects data from datasets across the EU, which, in the case of the UK, are the British Household Panel Survey, the BHPS and the FES. As the authors note, there is no agreed definition of over-indebtedness and they propose that 'a person is over-indebted if he or she considers that he or she has difficulties in repaying debts, whether consumer debt or a mortgage.' This measure is justified on the basis that households weigh up expected earnings and liquid assets against servicing the debt and because it takes into account factors differing across countries, such as the legal framework for treating debt and stage of economic cycle.

Using their definition of over-indebtedness and classifying persons of 18 years or more in a household where the head of household is reported as having difficulties, the ORC report suggests that 18% of households in the UK were over-indebted in 1996. This corresponds to around 9.2m individuals, with 50% of households with loans other than mortgages over-indebted.

Assessing the findings across the EU Member States, the ORC report concludes that 'there is no clear evidence that increasing the availability of consumer loans increases the percentage of over-indebted households… In most countries where consumer lending is more extensive, the proportion of the over-indebted among those who borrow is generally lower.' This group includes the UK. The authors suggest that as consumer lending becomes more prevalent, those who have less urgent need to access debt borrow. In addition, the report identifies another group of countries, including Germany, where consumer borrowing is low, but where there is a high proportion of indebted households with debt problems.

The report notes that information on indebtedness could be derived from macro sources, such as financial institutions, micro data, such as sample surveys, or on the basis of legal information. The relative merits and de-merits of these sources are discussed. Macro data, for example, is assessed to be timely and reliable, but lacks information on individual borrowers. While micro data does provide such information, the report notes that little or no information exists on individual holdings of assets. Legal information benefits from cooperation among debtors, but is collected at the stage of default, a specific outcome, and is difficult to compare across countries.

The report also assesses a number of issues related to the presence of over-indebtedness and household characteristics. Among the patterns found are that there is ‘no obvious observable relation between age and borrowing problems’ and that the proportion of households with loans who face difficulties is high or very high in almost all countries and age groups. Over-indebted households appear to have lower consumption:income ratios, despite being, in absolute terms, not much different from the average household. The authors indicate that this suggests over-indebted households reduced consumption to pay back debts.

Assessment
The ORC report attempts to identify the proportion of over-indebted households on the basis of survey responses and relies on one subjective measure—ie, people who consider that they have difficulties in repaying debts, whether consumer debt or a mortgage. This is measured on the basis of a survey among household in the EU Member States. The measures assume that people are capable of assessing their own financial situation and are honest.

Consumption functions were estimated, and support the notation that income, age and demographic trends are correlated with consumption expenditure. While this provides a basis for comparing responses on over-indebtedness with these variables, they add little to the analysis.

Overall, the report highlights that higher levels of consumer lending are not necessarily concomitant with more over-indebtedness. In countries with higher consumer lending, for example, the marginal borrower is likely to be in less urgent need of borrowing. Furthermore, the report usefully highlights the notation of ‘under-indebted’, where households face financial difficulties but have no debt or only go into debt to resolve financial troubles, even though the rationale for debt is supported by the Life Cycle hypothesis.

A1.10 Kempson report

The Kempson report was commissioned by the DTI to provide information on the causes, extent and effect of over-indebtedness. The report analyses the results of a survey undertaken among a sample of 1,647 households in the UK.

It is a comprehensive report containing data on usage of debt and the extent and nature of financial difficulties, and is the only report that looks at what causes over-indebtedness. Data collected through the 2002 survey is compared with the survey undertaken in 1989 by Berthoud and Kempson. Furthermore, the report analyses lending practices that may have contributed to excessive lending and over-indebtedness. The latter is not further discussed in this assessment.

Main conclusions of the analysis
The Kempson report concludes the following on usage of credit:

> Most of the users had only one or two credit commitments, owed modest amounts and were paying less than a tenth of their gross income on credit repayments. A small number of households were heavy credit users: with five or more current commitments; owing £10,000 or more; or spending a quarter or more of their income

> on repaying consumer credit. Each of these groups accounted for around one in twenty households, and these was some degree in overlap between them. These heavy users spanned all ages from twenty to late fifties, but were disproportionately two-parent families with children, who were buying their home on a mortgage. They tended to fall into one of three groups. The two-largest groups were households with low-to-middle incomes, who had borrowed relatively small amounts of money, although the repayments were a high proportion of their income; and households who had experienced a drop in income in the past 12 months, leaving them with high levels of credit of use relative to their incomes. The smallest group were people on middle to high incomes who had borrowed large amounts. (Kempson 2002, p. 22)

When households were asked whether they would be able to afford to borrow more, 4% indicated that they had already borrowed too much, while 44% would not want to borrow more; 51% indicated that they could afford to borrow more. Only 1% of all households were already heavily borrowed but prepared to borrow further.

The second part of the Kempson report analyses the extent and nature of financial difficulties, the characteristics of people who are likely to get into financial difficulty, and the duration and reasons for financial difficulties. It draws the following conclusions:

> A quarter of households had been in financial difficulties in the past 12 months and two in ten were still having problems at the time of the survey. About a third of those in currently financial difficulty said that they had been facing these problems for a year or more. It does not, however, appear that the problem is getting worse. The same proportion of households has sorted out their problems in the past year as said that their problems had only recently started.
>
> Young people setting up home and with young families ran the greatest risk of being in financial difficulty; new babies and relationship breakdown also raised the risk. At the same time risks were high among households with low and unstable incomes.
>
> Overall, more households had fallen behind with the payment of household bills than had got into arrears with consumer credit commitments. But, when we take into account the fact that all households have to meet regular bills but only a half are credit users, the risk associated with particular types of credit become more apparent. Indeed the more credit a household used the greater was their risk of falling into arrears—not just with their credit repayments but also with household bills.
>
> Loss of income was the main cause of difficulties household faced and was cited by half of people interviewed who were in financial difficulty. The second most common reason among households was having a low income; but this was the main explanation given by the under 25s. Fewer people (one in ten) attributed their problems to over-commitment; heavy credit commitments did greatly increase the chance of arrears. (Kempson 2002, p. 37)

Overall, the report concludes that the historically high levels of borrowing are problematic for a only small number of people, but that a far greater number would, potentially, be at risk of serious difficulties in an economic downturn or a period of sustained increase of interest rates.

Assessment
The Kempson report is one of the most comprehensive reports on over-indebtedness and provides a considerable amount of useful data. A number of issues are worth highlighting:

- Of the households surveyed, 4% indicated that they have already borrowed too much. Although this subjective measure is not emphasised in the Kempson report, it is a very direct measure of over-indebtedness. Kempson focuses on people who consider themselves to be in financial difficulty. This measure is relatively broad and is not restricted to problems related to interest payments and repayments of loans, or to over-commitment. For example, people may have difficulty in meeting their financial obligations simply due to a low level of income. Furthermore, people may borrow more because they find themselves in financial difficulty due to, for example, life events; or their interest payments and repayments as a proportion of income may increase due to a drop in income. Kempson shows that financial difficulty is often related to loss of income (45%) due to, for example, unemployment and relationship breakdown and, to a lesser extent, to over-commitment (10%).

- The Kempson report provides estimates of repayments (including interest payments) on secured and unsecured credit. Although the measure 'repayments' is useful to assess the usage of credit and its financial implications for households, it is likely to be too broad to assess over-indebtedness. It includes total repayments based on what households actually pay off, including any lump-sum repayments, while households are normally only required to repay a minimum amount of the loan each month or year. In other words, interest payments and *minimum* repayments as a proportion of disposable income is a more relevant measure. It measures the short-term impact of credit commitments on the household budget and therefore allows to some extent for an assessment of whether a household is able to bear the financial burden of interest payments and repayments.

- Furthermore, like the other reports, the Kempson report underestimates the level of debt owed by households. The Kempson report does not compare its findings with other reports or industry data, and does not address the issue of under-reporting.

- The Kempson report analyses the characteristics of people in financial difficulty and examines which type of people are more likely to get in financial difficulty. The analysis shows that financial difficulties and arrears are strongly associated with low incomes. However, the report does not provide an econometric analysis to establish a link between arrears and indicators of indebtedness. As explained in section 3.3, such an analysis would identify the probability that a household is likely to fall into arrears from factors such as debt:income ratios over time.

- Finally, the Kempson report concludes that the historically high levels of borrowing are problematic for a only small number of people, but that a far greater number would, potentially, be at risk of serious difficulties in an economic downturn or a period of sustained increase of interest rates. However, it does not undertake any scenario analysis to give a quantification to this statement.

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