Oxera

Agenda

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Over-indebtedness: what's new?

Since the publication in 2004 of Oxera's study on over-indebtedness in the UK, consumer borrowing has continued to rise, passing the £1 trillion threshold,[1] and the level of household debt continues to make the headlines. Yet the latest data does not suggest that current levels of indebtedness are unsustainable. What are the recent trends in indebtedness and what progress have the government and the banking community made in this area in the past year?

Oxera's 2004 report discussed the challenges of defining over-indebtedness, assessing the options for measuring it, and examining whether there is a problem of over-indebtedness in the UK. It concluded that only a small minority of UK households were over-indebted. This article explores the latest evidence on whether UK households are over-indebted, touching on the drivers of this and recent initiatives undertaken in this area.

On the surface ...

There are various indicators of the state of the UK's personal finances. In January 2005, the Financial Services Authority (FSA) published its Financial Risk Outlook, reporting that just over two-fifths of families have secured debts with an average balance of £67,662, while 53% of families have an average balance of unsecured debts of £7,065 (with the latter showing a 9% rise against 2003 levels).[2] The proportion of total household debt to income has continued to rise, reaching nearly 150%.[3] The average British household is spending 8.5% of its disposable income on interest payments: 5.5% secured debt and 3% unsecured debt.[4]

While these aggregate measures show that UK households' appetite for debt has not diminished in the past year, they do not necessarily shed light on the ability of households to bear this debt. To examine whether a problem of over-indebtedness actually exists and, if so, how serious this might be, indebtedness needs to be considered at a household level.

What is over-indebtedness and how is it measured?

Intuitively, households are *over*-indebted if they are unable to meet their debt obligations. A household or individual is over-indebted if they are in arrears on a structural basis—that is, unable to meet their debt obligations for more than a temporary period. This includes those who are unable to pay but not those who *choose* not to pay. Since concern about indebtedness levels relates not only to those households that are currently over-indebted, but also to those that are at risk of becoming over-indebted, the definition can be extended to those that are at a significant risk of falling into this category.

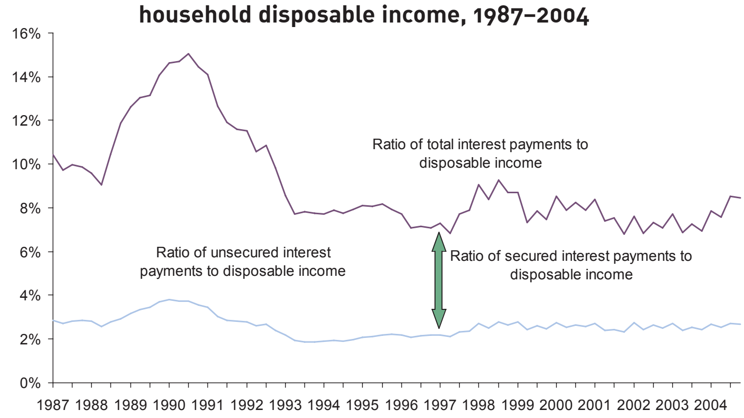
Two types of data can be used to assess whether households are over-indebted: subjective and objective. Subjective data is that based on the opinions of debtors themselves as to how much of a burden their debt places on them. Objective data is 'hard' data that gives an indication of the burden of debt—eg, debt to income or wealth ratios, and debt service to income ratios. While subjective data has the advantage of providing a direct indication of the perceived ability of households to bear their debt, it has a disadvantage in that households may under-report their debt levels (due to the stigma associated with debt, for example) or over-report them because they find financial commitments burdensome, despite being manageable. While objective data is not subject to these limitations, it does not capture the ability of a household to meet its debt commitments—eg, it will rarely capture knowledge of future income changes.

Given these limitations, subjective and objective types of data are most effectively used alongside each other. The extent to which objective and subjective data provides consistent assessments of over-indebtedness is debatable. Research by the Department of Trade and Industry (DTI) suggests that not all indicators overlap.[5] For example, only 36% of households in arrears for more than three months (objective data) considered that their borrowing repayments were a heavy burden (subjective data). This overlap might be expected to be higher, and the low level of overlap suggests that different measures can lead to different conclusions on over-indebtedness.

Oxera's report, 'Are UK Households Over-indebted?', prepared for Association of Payment Clearing Services, British Bankers' Association, Consumer Credit Association and the Finance & Leasing Association, April 2004, is available at www.oxera.com.

Recent research by the Bank of England has found that there is a 'systematic relationship' between the perceived burden of debt and one determining factor captured by objective data—namely, the ratio of unsecured debt to income.[6] The data suggests that the likelihood of households reporting debt problems increases as the unsecured debt to income ratio rises: for those with an unsecured debt to income ratio of between 12% (the 70th percentile of the sample) and 27% (the 90th percentile), the probability of reporting debt problems as 'somewhat of a burden' rose by 17%, while the probability of reporting debt problems as a 'heavy burden' rose by 4%, relative to the reference group.[7] The research also found that the probability of households with high debt to income ratios (between the 70th and 90th percentiles) reporting debt problems was significantly higher if a negative financial shock was suffered in the current or previous period. This finding suggests that there is a dynamic interaction in the overlap between objective data, subjective data and changing circumstances.

Figure 1 **Ratio of unsecured and total interest payments to household disposable income, 1987–2004**



Source: Office of National Statistics data and Oxera calculations.

What does the data suggest about levels of indebtedness?

Overall, both the subjective and objective measures of indebtedness suggest that current debt levels in the UK remain sustainable. While debt to income ratios and debt service ratios have continued to rise, levels of arrears have fallen and the majority of households are of the opinion that their (unsecured) debt levels are manageable. Although insolvency levels have exceeded the 1990s peak, these remain a small proportion of the population.

The debt to income ratio

Since 1998, debt to income ratios have been broadly rising, with rapid increases since 2001. By the end of 2004, the debt to income ratio had reached nearly 150% of disposable annual income. The Bank of England's most recent Financial Stability Review suggests that this ratio will continue to increase as mortgage debts adjust to the increase in the ratio of house prices to earnings over recent years.[8] It also notes that an increase in the number of homeowners is likely to increase this ratio going forward. The Financial Stability Review notes that the current level of nearly 150% is still around 20% lower than in the USA, suggesting that there is scope for further increases.

While the debt to income ratio gives a broad indication of the burden of debt on households, the composition of unsecured to secured debt is important. Figure 1 shows the level of interest payments relative to disposable income for secured and unsecured debt since 1987. While the proportion of disposable income spent on interest payments for unsecured debt has remained relatively stable since the early 1990s, the proportion spent on secured interest payments has risen slightly in the past 12–18 months. This is likely to reflect increases in the base rate in 2004 and the greater impact that the base rate has on interest rates for mortgages relative to interest rates on unsecured debts. Figure 1 shows that, in 2004, the average British household spent 8.5% of disposable income servicing debts. This remains significantly lower than that spent in the late 1980s through to the early 1990s.

Another study by the Bank of England has focused on the increasing levels of unsecured debt, drawing on data from the British Household Panel Survey (BHPS) from 1995 and 2000.[9] It finds that *levels* of unsecured borrowing have increased across all categories of household, but that *participation* in the unsecured debt market has not increased. There appears to be no compelling evidence to suggest that the increases in unsecured borrowing have been concentrated in high-risk households.

Arrears

As well as measures of the ratio of debt to income, and the composition of secured and unsecured debt, examining indicators such as arrears, possessions and insolvency levels provides a direct indication of the level of unsustainable debt. A survey carried out for the DTI in 2004 found that 6% of the survey sample were in arrears on at least one credit or domestic bill.[10] This can be compared with an earlier 'snapshot' taken in 2002, which found that 13% of the sample were in arrears.[11] While the bases for these surveys are not directly comparable, these results do suggest that the level of arrears is falling, indicating that households are coping with their debt levels.

In addition to this, recent data on mortgage arrears shows that the level of both arrears and possessions are falling to near historical lows, with the exception of the 3–6 month category.[12] From 2003 to 2004, there was a slight increase in the number of mortgages in arrears in this category, although it is not clear whether this is a genuine increase or if it is due to reclassification of mortgagors from the 6 months-plus arrears category being moved back into the 3–6 month category as they reduce their arrears when repayments are made.[13] The broad trend of falling mortgage arrears and repossessions therefore also suggests that households have not become more indebted.

Personal insolvency

In contrast to the general trend of falling arrears levels and repossessions, Figure 2 shows that personal insolvency levels (comprising bankruptcies and Individual Voluntary Agreements) have been rising quite steeply since 2003. These are now 30% above the annual peak in insolvencies in the early 1990s.[14] Part of this increase in bankruptcies could be due to a change in the bankruptcy law in April 2004, which enables the 'honest majority' of bankrupts to be discharged from bankruptcy after a maximum of one year, rather than the previous three-year period, making bankruptcy a more attractive option for those in serious financial difficulty. However, the Financial Stability Review argues that the effect of this change on the incentives to opt for bankruptcy appears small, while also noting that the upward trend in insolvencies began before the change in the bankruptcy law was introduced. While there has been marked growth in the number of personal insolvencies, overall, their level remains relatively low as a proportion of those holding debt—only one person in 1,000 becomes insolvent each year, which is one-fifth of the insolvency rate in the USA.[15] This suggests that, although there have been marked increases in levels of personal insolvencies, these are not at a level which implies that, overall, household debt levels are unsustainable.

The burden of debt

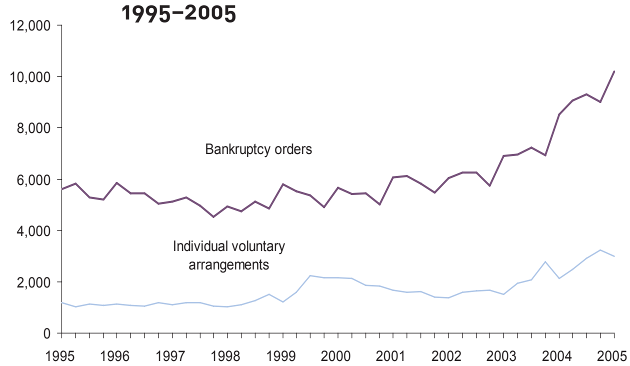
Given the rising debt to income ratios and higher numbers of personal insolvencies, what do households say about the burden that their debt repayments place on them?

Figure 3 shows how households rate the burden of their unsecured debt. It is based on data for all households holding unsecured debt, rather than all households. Overall, Figure 3 shows that households' assessment of the burden of their debt has remained relatively stable from 1995 to 2004. Households' latest assessment of the burden of debt shows that the proportion that consider their debt to be a 'heavy burden' fell slightly from 2003 to 2004. Fewer debtors considered that their debt was 'not a problem' in 2004, and more considered that it was 'somewhat of a problem'. This raises the possibility that, while such debtors are not currently over-indebted, a change in relevant circumstances (such as an increase in the interest rate) could increase the difficulties they have in meeting their debt commitments in the future.

A minority of households assess their debt as being a heavy burden. A subjective assessment of over-indebtedness in the UK therefore tallies with some of the objective data discussed above.

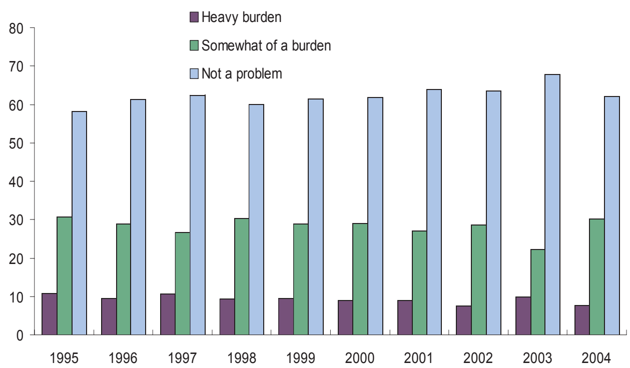
This analysis supports the argument that there is a small minority of households struggling with their debt. The Bank of England explored this and found that younger age groups appear to struggle with debt more than older age groups, and that tenants are more likely to struggle with debt more than homeowners.

Figure 2 Personal insolvency levels: bankruptcies and Individual Voluntary Agreements, 1995–2005



Source: DTI (2005), 'Insolvencies in the First Quarter 2005', statistics release, May 6th.

Figure 3 Household assessment of the burden of unsecured debt (%)



Source: Bank of England (2004), 'British Household Indebtedness and Financial Stress: A Household-level Picture', *Quarterly Bulletin*, Winter, p. 424.

Using data from the BHPS from 1995 and 2000, the Bank of England found that, in 2000, more households (relative to 1995) in the younger age category considered their debts a heavy burden, while fewer households in the older age category did so.[16] The paper found that these changes in assessed debt burdens between age groups were largely due to changes in economic circumstances as opposed to an unrelated shift in attitudes—the median debt to income ratio for the younger age category rose from just under 7.7% in 1995 to 10–14% in 2000, which is higher than that for older age categories.

In relation to the distribution of debt problems between homeowners and tenants, the Bank of England found that debt problems are concentrated among tenants,[17] and that the proportion of tenants with unsecured debt increased significantly between 1995 and 2004, from 31% to 46%. This is significant because tenants have less flexibility than homeowners if they face difficulty servicing their unsecured debt (homeowners have the potential to remortgage their property to see them through financial shocks). As regards the burden that their debt placed on them, 11% of tenants faced difficulty paying for their accommodation, while only 4% of homeowners did.[18]

Policies designed to tackle underlying drivers

In its 2003 White Paper on the consumer credit market, the government committed itself to tackling over-indebtedness in the UK.[19] As part of this, the DTI publishes an annual action plan on indebtedness, including a progress report, and a quarterly monitoring report on over-indebtedness.[20]

In May 2005, the Consumer Credit Bill was introduced in the House of Commons. It aims to protect consumers and create a more competitive credit market. In addition to this, the Treasury has been examining elements of access to affordable credit, as well as introducing a range of stakeholder products to encourage saving. Improvements to the administrative procedures for dealing with debt recovery are being addressed by the Department for Constitutional Affairs, which is also looking at ways of helping those who have multiple debts.

Furthermore, the Office of the Deputy Prime Minister has investigated the safety nets that are available to homeowners in the event of, for example, illness or unemployment, and has proposed measures to improve such protection.[21] Research suggests that only 12% of borrowers have short-, medium-, or long-term cover for their mortgage commitments, and that there is no formal safety-net provision to address issues of relationship breakdown or reduced income—two of the main reasons for households falling into arrears. Although some payment-protection products have earned a poor reputation due to mis-selling, they do enable a transfer of risk away from individual households to those better placed to manage risk through a portfolio of household policies.

The lending industry has also introduced changes in the past year, issuing a revised set of banking codes in April 2005 and working on the sharing of positive credit data (data which shows individuals' positive credit records). Through the British Bankers' Association, the major UK banks have agreed to share positive data on credit card and loan arrangements by the end of 2005.

Conclusions

While levels of indebtedness in the UK have continued to increase, neither the subjective nor objective data suggests that this has reached unsustainable levels. The data indicates that the majority of households are managing their debts and that, while there has been an increase in the number of personal insolvencies, these remain at a low level and are accompanied by falling levels of arrears. This assessment is consistent with the Bank of England's assessment of indebtedness in the UK:

> household debt remains affordable. While circumstances can change suddenly, the survey evidence suggests that, by the standards of the past decade, relatively few households are currently close to a stressed position.[22]

Where over-indebtedness does occur, some remedial steps have been taken in the past year: the sharing of financial data between banks will improve their ability to lend responsibly, while the development of further safety nets will help households cope with financial shocks.

[1] Financial Services Authority (2005), 'Financial Risk Outlook 2005'.
[2] Ibid, p. 41.
[3] Department of Trade and Industry (2005), 'Over-indebtedness Monitoring Paper Q1 2005', June, p. 5.
[4] Oxera calculations based on Office of National Statistics data.
[5] DTI (2005), 'Over-indebtedness in Britain: A DTI Report on the MORI Financial Service Survey 2004', June.
[6] Bank of England (2005), 'The Impact of Unsecured Debt on Financial Distress among British Households', Del-Rio, A. and Young, G., Working Paper no. 262.
[7] The reference group had a debt to income ratio of less than 0.5%. Bank of England (2005), op. cit., p. 22.
[8] Bank of England (2005), 'Financial Stability Review', June, **18**.
[9] Bank of England (2005), 'The Determinants of Unsecured Borrowing: Evidence from the British Household Panel Survey', Del-Rio, A. and Young, G.
[10] DTI (2005), 'Over-indebtedness in Britain: A DTI Report on the MORI Financial Service Survey 2004', June, p. 6.
[11] Kempson, E. (2002), 'Over-indebtedness in Britain: A Report to the Department of Trade and Industry', September.
[12] Table AP1: Mortgage Arrears, by Number of Months in Arrears, Council of Mortgage Lenders website, http://www.cml.org.uk/servlet/dycon/zt-cml/cml/live/en/cml/xls_stats_AP1.xls.
[13] Assessing the causality here is complicated by the lack of consistent classification by mortgage lenders when providing this data to the Council of Mortgage Lenders: it is up to individual mortgage lenders whether they reclassify households into lower arrears categories or exclude them altogether when they start repaying arrears.
[14] Bank of England (2005), 'Financial Stability Review', June, **18**, p. 17.
[15] Ibid.
[16] Specifically, those under 30 years of age were more concerned about debt in 2000 relative to 1995, while those over 30 were relatively less concerned.
[17] Bank of England (2004), 'British Household Indebtedness and Financial Stress: A Household-level Picture', *Quarterly Bulletin 2004,* Winter, p. 415.
[18] Ibid, p. 423.
[19] DTI (2003), 'Fair, Clear and Competitive: The Consumer Credit Market in the 21st Century', December.
[20] The first of these monitoring reports is DTI (2005), 'Over-indebtedness Monitoring Paper Q1 2005', June.
[21] Office of the Deputy Prime Minister (2004), 'Homeowners Risk and Safety-Nets: Mortgage Payment Protection Insurance (MPPI) and Beyond', April.
[22] Bank of England (2004), op. cit, p. 426.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email d_holt@oxera.co.uk

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