Unsustainable Household Debt: Problems of Measurement

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Summary: In the wake of the Global Financial Crisis, a significant research effort has been made to better understand the links between household debt levels, financial stability risks, and the ongoing implications of the 'debt overhang' for economic growth. However, accurately measuring the household debt burden remains problematic. Aggregate measures of household indebtedness (e. g. household liabilities relative to income) fail to fully capture the debt servicing burdens of households, particularly in periods when real incomes are declining (as has been the case in the UK in recent years). They also provide no insight into the distribution of debt burdens, which may be important for both future financial stability and economic growth.

We attempt to address this problem by combining a new analysis of aggregate data with insights gleaned from household debt surveys. We first construct a new measure of debt interest payments as a percentage of the overall household surplus from the aggregate data. This indicates a significant increase in household debt burdens between 2016 and 2018. We test the validity of this measure by analysing household debt surveys over the period, and report on the most affected households. The findings support a case for a lowering of the thresholds used in official measures of financial vulnerability and over-indebtedness and for greater impetus in policymaking to relieve the financial pressures of households in debt.

Zusammenfassung: Im Zuge der globalen Finanzkrise wurden erhebliche Forschungsanstrengungen unternommen, um die Zusammenhänge zwischen der Verschuldung der privaten Haushalte, den Risiken für die Finanzstabilität und den anhaltenden Auswirkungen des ‚Schuldenüberhangs' auf das Wirtschaftswachstum besser zu verstehen. Die genaue Messung der Schuldenlast der privaten Haushalte bleibt jedoch problematisch. Aggregierte Messungen der Verschuldung der Haushalte (z. B. Verbindlichkeiten der Haushalte im Verhältnis zum Einkommen) erfassen die Schuldendienstbelastung der Haushalte nicht vollständig, insbesondere in Zeiten sinkender Realeinkommen (wie in den letzten Jahren in Großbritannien). Sie geben auch keinen Einblick in die Verteilung der Schuldenlast, was sowohl für die künftige Finanzstabilität als auch für das Wirtschaftswachstum wichtig sein kann.

Wir versuchen, dieses Problem zu lösen, indem wir eine neue Analyse der aggregierten Daten mit Erkenntnissen aus den Erhebungen über die Verschuldung der Haushalte kombinieren. Zunächst konstruieren wir aus den

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aggregierten Daten ein neues Maß für die Schuldzinszahlungen als Prozentsatz des gesamten Haushaltsüberschusses. Dies deutet auf einen signifikanten Anstieg der Schuldenlast der Haushalte zwischen 2016 und 2018 hin. Wir testen die Validität dieses Maßes, indem wir die Verschuldungserhebungen der Haushalte in diesem Zeitraum analysieren und über die am stärksten betroffenen Haushalte berichten. Die Ergebnisse sprechen für eine Absenkung der Schwellenwerte für die offizielle Messung der finanziellen Verwundbarkeit und Überschuldung sowie für einen stärkeren Beitrag der Politik zur Entlastung der verschuldeten Haushalte.

Introduction

Following the Global Financial Crisis there has been a considerable research effort to better understand the role that high household debt levels play both as a contributor to financial stability risk and as a constraint to future economic growth. Reviewing the findings from several major post-crisis empirical studies, Lombardi et al (2017) identify that (i) high debt levels predict the likelihood of future financial crises and are a "key determinant of the intensity of the ensuing recession" (p. 3); (ii) household debt servicing costs predict the likelihood of recession; (iii) that there is an "unconditional" correlation between household debt growth and reduced growth after a three year time lag; (iv) that the distribution of household debt and its concentration in households with a high marginal propensity to consume can aggravate these negative impacts; and (v) that there are also negative impacts even during the period of the "credit boom"; which can lead to a misallocation of resources and constrain productivity.

Several of the studies under review have also yielded insights into the *causes* of elevated household debt levels. For example, Mian et al's (2017) investigation of the links between household debt and growth considered two hypotheses:

- The "credit demand hypothesis", which viewed rising borrowing as a rational response of households to expectations of increased future income; spurring higher consumption and borrowing in anticipation; and
- The "credit supply hypothesis", whereby increased borrowing is driven by an expansion in the availability of credit. In this case, households borrow excessively in response to an extension of credit supply and this leads to an eventual slowdown in GDP growth.

Analysis of panel data from thirty countries over the period 1960 to 2012 led the authors to firmly reject the former hypothesis and support the latter, highlighting a need to prevent households from over-extending themselves during a credit boom.

Taking a similar approach but analysing panel data from fifty-four countries over the period 1990 to 2015, Lombardi et al (2017) identify an intensification of negative long-run effects on economic growth where the household debt to GDP ratio exceeds 80 %. They also point to greater impacts in countries with strong "creditor protections": for example, where creditors can efficiently exercise rights to repossess property and recover any further losses from debtors following sale. Such creditor protections may create a higher debt service burden by acting as a disincentive to borrowers to default or enter bankruptcy. Whilst this reduces losses for creditors it extends the duration of the "debt overhang".

Although not investigated by Lombardi et al (2017), credit referencing systems have also previously been found to create significant "disciplinary effects" (Padilla and Pagano 2000) and may therefore

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also have a bearing on the duration of the debt overhang. This is because the fear of impairing credit records may induce borrowers to maintain payments even when doing so requires them to significantly curtail consumption and living standards. Whilst such disciplinary impacts may be desired as a means of countering moral hazard, they may also prevent borrowers in genuine difficulty from accessing insolvency procedures designed to assist them (see, for example, Dawney et al. 2018), and can result in a wide range of negative welfare outcomes.

It also follows that borrowers can prioritise the repayment of their credit debts over payment of household bills, such as for fuel, and that an overly punitive credit scoring system can therefore transfer default risk to utility and other service providers; increasing the likelihood of arrears on those accounts.

Finally, it should be noted that the incentive to maintain good payment records may also encourage borrowers to refinance rather than default: in which case interest and charges multiply in reference to the original principal borrowed, reducing the utility of credit use.

The findings from this literature point to the importance of preventing an unsustainable build-up of household debt and to a need to ensure that households in financial difficulty are provided with effective relief.

However, questions inevitably arise as to what constitutes an "unsustainable" debt burden, and which households need targeting for assistance. In the UK, policymakers have tended to look to a range of both objective and subjective measures to guide their actions in these respects. For example, the Bank of England uses a mortgage debt servicing measure based on the level of household mortgage repayments relative to pre-tax income: considering a ratio of 40% to indicate an increased risk of default. A similar measure of debt servicing costs has also previously been used to monitor financial pressures in the consumer credit market: with households spending more than 25% of their pre-tax income on consumer credit repayments considered to be over-indebted (UK Treasury Committee 2003–04). In addition, several subjective, self-reported measures have also been used: for example, in household debt surveys where people in debt are asked how much of a burden the payments represent or how concerned they are about their financial position.

Whilst none of the individual measures are perfect, they can be used in combination to provide a balanced assessment of the level and nature of indebtedness. In some cases, such as the use of aggregate data to determine debt servicing ratios, we also believe that they can be improved further.

The remainder of this paper focuses on these issues: assessing the current level of over-indebtedness using the existing measures and, where appropriate, making suggestions for improvements. The paper begins with a brief overview of the current Bank of England assessment of household indebtedness in the UK; discusses the limitations of the Bank's approach; suggests an alternative aggregate measure; tests this as a means of explaining the results from recent household debt surveys and concludes by making recommendations for future household debt monitoring and policymaking.

Current UK Measures of Household Indebtedness

In its most recent Financial Stability Report, the Bank of England (2019) highlights (p. 47) that the overall household debt to income ratio in the UK has reduced from its peak of 141% prior to the Global Financial Crisis to 121% as at the second quarter of 2019. Despite this ratio remaining elevated in historical terms, the Bank maintains that "the proportion of very highly indebted households in the UK remains low". In support of this statement, the Bank references the findings from its regular household debt survey[1], with respect to observed mortgage debt servicing ratios:

> "The share of households with a mortgage debt servicing ratio at or above 40% – a level above which they are much more likely to experience repayment difficulties – has remained low, at 0.9% to 1.4% over the past two years ..."

The Bank also highlights that the proportion of the stock of mortgages with high loan to value (LTV) ratios (i.e. above 75%) is "little changed in recent years" at 20% (Bank of England 2019, p. 49).

Finally, with reference to consumer credit, the Bank notes that growth in this market was 6.1% in the year to October 2019, "much lower than its post crisis peak of 10.9% in late 2016." However, the Bank makes no reference to the distribution of high debt servicing ratios within this market nor to any of the subjective indicators concerning the extent to which debt is seen as a burden by respondents to its survey. This is perhaps surprising, because the Bank also reports that, during its recent stress-testing exercise for the banking sector, it found that "consumer credit accounted for 41% of losses on banks' UK lending, despite being only 7% of exposures"(Bank of England 2019, p. 48).

Is the Bank Under-estimating the Household Debt Burden?

In our view, there are three main reasons to be concerned about the Bank's approach to the measurement of household debt. Firstly, since the financial crisis, many UK households have been subject to a lengthy income squeeze. According to the Office for National Statistics, real average weekly earnings as at July 2018 were still 2% lower than they were a decade previously. Further to this, the average disguises growing income inequality in the UK. There was not a single year between 2008 and 2017 when the lowest income quintile received a real term increase in earnings[2]. In contrast, the upper quartile of earners saw real earnings increase by more than 4% in six of these years, and by more than 2% in all of them.

The real income position of households is important because debt to income and debt repayment to income ratios do not capture changes in financial pressure arising from the expenditure side of household balance sheets – such as rising fuel and food prices. A debt repayment to income ratio can remain stable (or even reduce), whilst the financial pressures on households are increasing due to falling real terms spending power. As such, it is the extent to which households have sufficient *disposable* income to service their debts which is important.

1 The Bank commissions a regular household debt survey from NMG Consulting. For further details and to download the data see https://www.bankofengland.co.uk/statistics/research-datasets.

2 Distribution of earnings in the UK: 2017, Office for National Statistics.

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Secondly, the level of outstanding debt is just as important as the debt servicing requirements. This is because the level of debt, interest rate, and the debt servicing requirements from borrowers *combine* to determine the length of time that debts will take to clear. A high (and even growing level of debt) may be serviceable in the short term if interest rates are low and other pressures on income are limited. However, rising levels of debt in these circumstances creates an increased risk moving forwards, and makes households more vulnerable to income and expenditure shocks.

Finally, it should be noted that whilst the composition of household debt in the Bank's calculation of overall debt to income ratios includes both mortgage lending and consumer credit, it does not include student loan debt nor "other amounts outstanding" from households, such as arrears on household bills. If repayment pressure on these other forms of debt increases it could spill over into increased default in the mortgage or consumer credit markets. Such an event could, for example, occur if interest rates or repayment requirements are increased on student loan debt; or if utility or other service providers (including local authorities collecting municipal taxes) implement aggressive debt collection policies.

Nevertheless, it should be noted that the Bank of England has taken steps to prevent the build-up of unsustainable debt in the mortgage market. In June 2014, the Financial Policy Committee introduced two policies for this purpose: (i) a loan to income "flow limit", which restricts the number of new mortgages extended at loan to income ratios of 4.5 or higher to 15% of new mortgages issued by a lender; and (ii) an affordability test requirement that lenders assess whether borrowers could still afford their mortgages if at any point over the first five years of the loan their mortgage rate were to be more than three percentage points higher than the reversion rate specified in the originating contract.

However, aside from maintaining a low interest rate environment from 2008 onwards, very little has been done to help highly indebted households to deleverage. Although total liabilities[3] relative to total household resources[4] fell from 137% to 122% between 2008 and 2015, subsequent years have seen this ratio increase to 128%. Most of this growth took place between 2015 and the middle of 2017, and the ratio has stabilised at this level (which is high in overall historical terms) since.

Consumer credit growth particularly outstripped that of incomes in this period, and in these markets the rules concerning affordability assessment are much weaker than is the case for mortgage lending. The Financial Conduct Authority (FCA) does not place limits on the amount of consumer credit that can be advanced relative to income and imposes very few restrictions on the refinancing of debts[5]. Although the FCA's rules state that borrowers must be able to afford a "basic quality of life" once all non-discretionary payments (household bills and other credit payments) have been accounted for, this term is not defined and is therefore open to lender interpretation[6].

3 Series NIWK in the UK National Accounts.

4 Series HABN plus Series HAZA in the UK National Accounts.

5 There are restrictions on the 'rolling over' of loans within the payday loan sector but these form a tiny percentage of the overall consumer credit market in the UK.

6 It should be noted that this has recently caused problems for lenders as well as for borrowers. This is because borrowers in high cost sectors of the consumer credit market are increasingly making complaints about unaffordable lending to the UK's Financial Ombudsman,

Towards Improved Measures of the Household Debt Burden

Given the concerns outlined above, it follows that we should be seeking to develop measures which (i) provide insights concerning the debt and debt repayment burdens relative to disposable income; (ii) help us assess the distribution of persistent and severe debt burdens, and the likely trajectory of these given wider economic conditions; and (iii) consider the totality of household indebtedness, including the likely impact of policy changes with respect to student loan financing and household bill collection.

The current aggregate measure used by UK policymakers is unfortunately of little use in these respects. The Office for Budget Responsibility (OBR) currently uses data from the UK's National Accounts to track and forecast the household debt servicing burden by dividing figures on total household debt interest payments[7] by gross household income[8]. This indicates that the debt servicing burden currently stands at around 4% – less than half of its level in 2008.

This reduction in overall debt servicing costs is explained by the low interest rate environment maintained in the UK since 2008. Low Bank of England base rates have particularly impacted the cost of mortgage borrowing, and as this market accounted for 78% of the total stock of outstanding household debt in 2018 (Harari 2018), the overall debt servicing to income ratio has plummeted.

However, in our view, the measure is misleading because it takes no account of the increased cost of living pressures faced by households in recent years. To address this, we construct a new measure from the aggregate data by deducting household consumption from income and by calculating interest payments as a percentage of the remaining "surplus"[9]. This reveals a very different, and far more uncomfortable picture (figure 1, below).

There are two key points to note from this comparison. Firstly, as would be expected, the absolute level of debt interest servicing burden is much higher using the Household Surplus measure. For example, in 1987 through to 1990 (when the UK experienced a severe recession and mortgage repossession crisis) the Household Surplus measure indicates that debt interest payments constituted over half of all household disposable incomes. This compares to a debt servicing requirement on the OBR measure in that year of just 12.3%.

Secondly, and more importantly, although the general trajectories of the two measures are similar in many years, there are significant differences. In particular, the two measures first depart from 1996 through to 1999. In our view, the household surplus measure more accurately reflects the pressures on UK households in these years: real wage growth halved from 4.2% in 1997 to 2.1% the

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leading to awards of compensation. The lack of clarity contained in the FCA's rules provides for lenders and the Ombudsman to reach very different conclusions as to whether loans are affordable from the outset.

7 Rolling 4 quarter sum of series J4X3 from the National Accounts.

8 Rolling 4 quarter sum of series RPHQ from the National Accounts.

9 We also calculate this for the *household sector only* (S. 14 in the system of national accounts) as opposed to the OBR's published measure, which includes Not for Profit Institutions Serving Households (S. 15). Our calculations therefore use the series AE7P for debt interest payments and HADA for Gross Savings (i.e. income less consumption). The ratio is arrived at by calculating the rolling 4 quarter sums for these series and then using: AE7P / (AE7P + HADA). Series AE7P must be added back into the denominator because debt interest payments are already netted off in the calculation of household incomes within the System of National Accounts.

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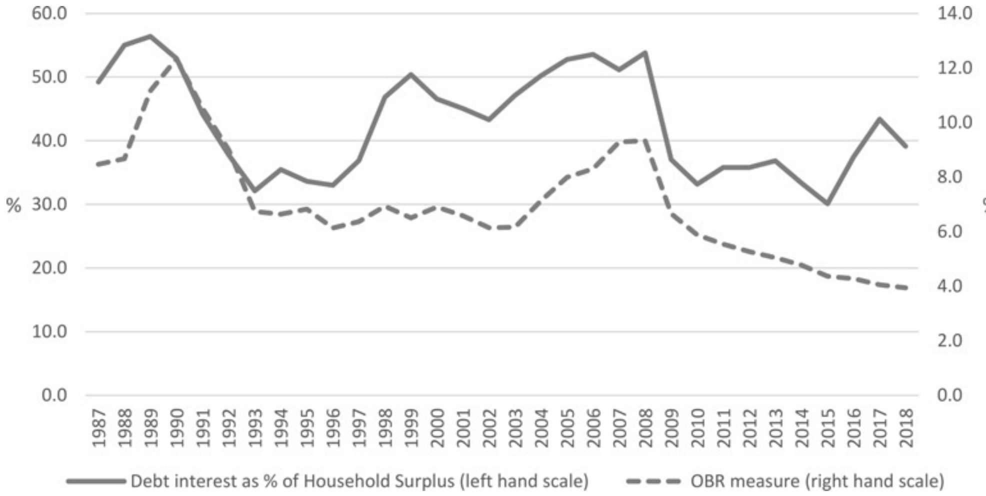
Figure 1

Comparison of Debt Interest Servicing Measures



following year and remained at under 3% in 1999. It then recovered to 4.2% and 4.4% in 2000 and 2001 respectively, which is also reflected in an improvement in the Household Surplus based measure over these years.

The trajectories of the two measures are then very similar from 2002 to 2008: real wages grew by an average of just 1.5% over these years. This is not reflected in the OBR measure (which starts to grow from a slightly later date of 2003), but the period also witnessed the UK's most rapid credit expansion of modern times, with total outstanding amounts (including both mortgages and consumer credit) more than doubling in six years. This impacts on both measures and accounts for the overall similarity in their trajectories.

However, most recently the two measures have again departed, and significantly. Whilst the OBR measure continues to fall, the measure based on the household surplus rose significantly to over 43% between 2015 and 2017. This reflects the fact that sterling depreciated rapidly from June 2015 through to February 2017, causing inflation to rise from 0% to 2.7%. Although inflation fell back slightly in 2018 and eased the financial pressures on households to some degree, the Household Surplus measure indicates that debt repayment burdens remain elevated at around 40%.

Although still lower than the apparent crisis threshold on this measure (50%) we would expect to see signs of (i) households cutting back on consumption in order to service their debts; (ii) an increase in borrowing for debt refinancing purposes, and/or (iii) an increase in defaults. In contrast, looking at the OBR's measure we would expect to see the opposite: either an increase in consumer demand, debt repayment (deleveraging) or rising savings levels; particularly amongst households with mortgages.

Supplementing the Aggregate Measures

In order to test the validity of the two measures we turn to household survey data, and specifically to the NMG Consulting survey commissioned by the Bank of England. This survey provides information concerning the amounts of different types of debt held by approximately 6,000 households together with their income levels and levels of actual debt repayment (including both interest and capital repayments) being made on both mortgages and consumer credits. It also gathers subjective information concerning the extent to which respondents considered their debts to be a burden and asks for details of the actions that households are taking in order to deal with their debts.

Analysing the survey responses, we find some, but limited, evidence to support the OBR measure. For example, the average mortgage debt to income ratio reduced by only 1.2% (from 158% in 2016 to 156%) between 2016 and 2018, despite the average mortgage debt servicing income falling by 12.5% (from 15.2% to 13.3%) over the period. With respect to consumer credit debts, the average debt to income ratio also fell from 18.7% to 15.6%, but there was a slight increase in the debt servicing ratio: from 8.5% to 9.8%.

However, many more households described their debts as a heavy burden in 2018 than was the case two years prior. In fact, one in every five respondents in 2018 reported their debts to be a "heavy burden": over a third higher than in 2016.

Mortgage borrowers; households living in private rented accommodation, and households renting from a local authority were all over-represented in this group[10]. We now look at each of these groups in further detail.

12% of all **mortgage borrowers** in the survey reported that their debts were a heavy burden in 2018: up by one third since 2016. The reasons for this are complex. Certainly, the self-reported burden of debt does not appear to be related to low income or to a lack of employment. The average household pre-tax income of this group was well above median, at £ 56,000[11], and 75% of households in this category were in employment and a further 5% in self-employment. Only 6% reported being unemployed or long-term sick or disabled, with the remainder largely comprised of retired households.

Neither can the reporting of heavy burdens be attributed to the group's monthly mortgage payments, which averaged £ 706. On an annual basis the average mortgage debt servicing ratio was therefore just 15%, and well below the Bank of England's threshold for identifying borrowers at risk of falling into arrears or being forced to cut back on consumption. Similarly, the average outstanding mortgage was just 1.6 times the average income level, and the average mortgage term was fifteen years. It is therefore extremely unlikely that the mortgage commitments of these households constituted sufficient reason in themselves for their debts to be described as a heavy burden.

10 However, it should be noted that in addition to these tenures we found that debts were also reported as a heavy burden by 10% of Housing Association tenants and 6% of outright owners.

11 Exchange rate 1 £ = 1.11 Euro (31. 12. 1018) (https://www.bankofengland.co.uk/statistics/exchange-rates).

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Nevertheless, nearly half (43%) of this group reported that they had in fact been more than two months in arrears with their mortgage payments in the twelve months before the survey. The prevalence of mortgage arrears within this group has nearly doubled over the past two years (2016: 23.6%). Further to this, nearly two thirds (61%) reported that they were cutting back on spending as a result of their debts in both 2016 and 2018.

A possible explanation of these behaviours lies with the consumer credit commitments of these households. All of these had outstanding consumer credit debts (in both 2016 and 2018) and the average amount owed was in 2018 was £ 12,470. Although this was only 3% higher than in 2016, there was a significant increase in the average monthly payments required of these debtors over the period. In 2018, the average monthly payment being made towards consumer credit debts was £ 636, compared to £ 482 two years earlier. On average the consumer debt servicing ratio for the group was 13% percent in 2018 compared to 11% two years previously.

The cause of the significant increase in consumer credit repayments is not clear, although it is notable that 17% of this group were borrowing from high cost payday lenders in 2018 compared to 12% in 2016. Signs of financial distress are also apparent in the numbers falling into arrears with their credit repayments. In 2018, just under half (46%) reported having done so, compared to around one in five (21%) two years previously. When asked to provide an explanation for this, the most common response in the survey was that “there was an increase in other bills or unexpected expenses/costs”.

Whilst the consumer debt servicing ratios for the group are well below the commonly used threshold of 25% percent taken to indicate over-indebtedness, the survey therefore suggests that cost of living pressures have rendered this threshold too high to predict emerging financial difficulties.

Finally, it should be noted that many of the group also had large amounts of outstanding student debt. In 2018, 12% percent of these had student loan debts, with the amounts averaging just over £ 9,300 per household. The vast majority (85%) of these also had incomes which would require them to make student loan repayments from their earnings. Unfortunately, no data on outstanding student loan balances was collected by the survey in 2016 to provide for a comparison in this respect.

Turning to **private sector tenants** reporting their debts to be a heavy burden, we set out the main metrics from our survey analysis in table 1, below.

The survey findings indicate that the proportion of private tenants reporting debts to be a heavy burden grew by 11% between 2016 and 2018. In both years, there are signs of widespread financial distress amongst this group: around one third reported arrears in their payments, and 70% reported cutting back on spending. The group also saw an average reduction in household incomes of nearly 9%. However, the most common reason given for falling into arrears was again because of increases “in other bills or other unexpected expenses/costs”.

Nevertheless, there are signs of some improvement in the debt position of this group: the average consumer credit debt held by these households reduced from £ 12,480 to £ 9,820 and the average monthly payment from £ 441 to £ 291. This led to a decline in the average debt servicing ratio from 16.3% to 11.8%. This reduction in debt servicing costs may have been due to reductions in the

Table 1

Private Tenants with 'Heavy' Debt Burdens. Key Metrics, NMG Survey 2016 & 2018

	2016	2018	% change
Percentage of tenants reporting debts as 'heavy burden'	14.6	16.2	11.0
Holding consumer credit debts (%)	100	100	0
Average household income	£ 32,400	£ 29,569	-8.7
Average consumer credit debt	£ 12,480	£ 9,820	-21.3
Average debt to income ratio	38.5	33.2	-13.8
Average monthly debt repayment	£ 441	£ 291	-34.0
Average debt servicing to income ratio	16.3	11.8	-27.7
Percentage of tenants reporting arrears	35.5	31.5	-11.3
Percentage of tenants cutting back on spending	69.3	71.9	3.8

Source: https://www.bankofengland.co.uk/statistics/research-datasets.

effective interest rates charged on overdrafts, which fell from 10.1% in 2016 to 8.3% in 2018. This form of borrowing was used by just under one in five households in the group in 2018. Similarly, the impact of the FCA's cap on payday lending costs (brought into effect in 2015) may have also fed through into a reduction in servicing requirements: approximately one in ten members of the group were borrowing from payday lenders in 2018.

With regard to student loan debts, around one fifth of the group held these, with the average amount of debt standing at £ 15,677. Although this figure is higher than for households with mortgages, the proportion of private tenants whose income exceeded the Government's earning thresholds to trigger repayments was much lower, at about 54%.

Finally, regarding **local authority tenants** (table 2, below) we find that 14.7% of these reported their debts to be a heavy burden in the 2018 survey: up by around 8% on the 2016 figure.

Table 2

Local Authority Tenants with 'Heavy' Debt Burdens. Key Metrics, NMG Survey 2016 & 2018

	2016	2018	% change
Percentage of tenants reporting debts as 'heavy burden'	13.6	14.7	8.1
Holding consumer credit debts	100	100	0
Average household income	£ 18,842	£ 26,514	40.7
Average consumer credit debt	£ 5,471	£ 6,488	18.6
Average debt to income ratio	29.0	24.5	-15.7
Average monthly debt repayment	£ 344	£ 307	-10.8
Average debt servicing to income ratio	75.5	56.8	-24.7
Percentage of tenants reporting arrears	35.7	32.2	-9.8
Percentage of tenants cutting back on spending	8.7	40.3	363.2

Source: https://www.bankofengland.co.uk/statistics/research-datasets

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However, average incomes for this group rose significantly over the two years, which may be the result of a reduced unemployment rate amongst the survey respondents. This fell from 5.7% in 2016 to just 1.7% in 2018. Despite this, it should be noted that the level of consumer credit debt rose by around 18%, but that the average level of debt servicing costs reduced by 10%. This was far less than the reduction in servicing costs experienced by private renters, which may be explained by the fact that local authority tenants are less likely to use overdrafts and more likely to use high cost forms of borrowing including sub-prime credit cards and mail order catalogues.

Regardless of the improvement in debt servicing ratios over the period, it is apparent that the debt repayment obligations of this group are particularly onerous. The average debt servicing ratio in 2018 remained in excess of 50%: over twice as high as the threshold commonly used as an indicator of over-indebtedness. Yet, the arrears rate for this group remained similar to those of mortgage borrowers and private tenants, at about one third. This is perhaps surprising given the much higher debt repayment burdens reported by local authority tenants. However, an explanation for this may lie with the dramatic increase in the number of local authority tenants cutting back on spending. In 2016, this was just 8.7% but by 2018 this had increased to 40.3%. This would appear to indicate that this group of local authority tenants are making every effort to maintain payments despite, on average, being heavily over-indebted. The growth in consumer credit liabilities may also indicate that some are borrowing more, albeit at slightly reduced interest rates, to refinance previous debts.

Finally, one in eight households in this group also had outstanding student loan debts, although, as with private tenants, only half of them appeared to exceed the earnings thresholds which would require them to make repayments. Of those holding student loan debts, the average outstanding amount was £ 12.180.

Conclusions and Policy Implications

Measures of debt to income and debt servicing to income ratios ignore the impact of cost of living increases on household budgets. In the UK, the measures are becoming increasingly redundant as a means of assessing the financial health of households, and the thresholds used by the Bank of England and other policymakers appear to be set at far too high a level to provide any real guide to policymaking.

Although the general picture in recent years has been one of households marginally deleveraging, this disguises the fact that a significant minority are in dire financial straits: cutting back on their consumption in order to maintain their debt repayments and falling into arrears with their payments.

Based on our analysis of the Bank of England's NMG household debt survey for 2018 provided above, and by extrapolating these findings to the overall population, we estimate that at least 3.3 million households, containing around 8 million people (roughly 12% of the total population), are currently in major financial difficulty in the UK[12]. However, the vast majority of these have not

12 This is a lower end estimate, as it does not include households in the survey who expressed the view that their debts were "somewhat" of a burden and who are also cutting back on consumption in response. If included in the calculation, then the estimate of struggling households rises to 3.9 million (containing 9.24 million people).

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fallen into arrears with payments nor are their debt servicing to income ratios such that they would be identified as in difficulty. They are cutting back on consumption, indicating a significant debt overhang in the UK, but the extent of this is largely unknown to policymakers. The NMG survey does not provide information concerning the scale of cuts to spending amongst these households and further research is required in this area.

Nevertheless, our findings indicate the need for policy makers to pay greater attention to the debt overhang that exists in the UK at the present time and to develop alternative measures, or to lower existing thresholds, to better reflect the financial realities being faced by many households. Those problems may, of course, worsen further in the event that a disorderly Brexit leads to higher prices for imported goods and services.

There is also sufficient evidence available to policymakers to encourage not only an improvement in the monitoring of household debt problems, but also action to address it. In our view, the number of households cutting back on spending (particularly amongst very highly indebted local authority tenants) as opposed to defaulting on payments to their consumer credit lenders may indicate a problem of access to effective debt remedies.

This does not mean that appropriate debt remedies do not exist. For example, the Government introduced a Debt Relief Order (DRO) scheme for households with low income and assets[13] in England and Wales in 2009. This provides a route via debt advice agencies for debtors to obtain relief from their creditors for a period of 12 months, after which the debts are discharged (written off). However, households in financial difficulty may be reluctant to enter into a DRO (or other available insolvency procedures) due to a fear that they will be prevented from accessing credit for a lengthy period thereafter. Indeed, the disciplinary effects of credit scoring are likely to be driving people to cut back on spending or refinance their debts rather than miss their repayments and seek advice and assistance.

In this sense there may be a disconnect between the UK's public policy objectives of providing relief to debtors and the market's objectives of (i) maintaining payment discipline; (ii) assessing, and pricing for, ongoing risk; and (iii) maximising returns from over-indebted households. At the present time, the FCA is undertaking a market study into the role of credit information services, and we hope that this informs further work to rebalance interests in favour of the stated public policy objectives moving forwards.

Whether or not, and to what extent, debtor households are electing to refinance their debts rather than enter into debt solutions should also be given much greater consideration by policymakers. The prior literature indicates that this may be a key determinant of the debt overhang and its negative impact on economic growth. However, to date, there are no specific measures of the level of refinancing that is taking place within the consumer credit market. Neither do household surveys ask for details of refinancing arrangements from debtors themselves. We therefore recommend that the Bank of England include questions on this aspect within future household debt surveys.

13 To be eligible for a Debt Relief Order, debtors must owe £ 20,000 or less; have a disposable income of less than £ 50 to spend each month (i.e. after paying tax, national insurance and normal household expenses); have lived or worked in England or Wales in the last 3 years; have assets worth less than £ 1,000; and not have used the scheme in the previous six years.

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Finally, we also consider that further research is needed to determine the impact of other types of debt. This includes the impact of student debt loan repayments on the financial position of households. Unfortunately, household survey data concerning the level of payments being made on these loans was not available in 2016, and the complexity of the student loans scheme (which has two different earnings thresholds depending whether or not the loan was taken out before or after 2012) means that it is not possible to calculate the actual repayments being made. Similarly, the NMG survey does not report on the level of arrears on household bills. However, it is likely that in addition to cutting back on expenditure many financially stressed households are falling into arrears with these. This constitutes a "spillover" effect, whereby default risk is effectively transferred from credit markets to other areas of the economy. Examining this further should be of particular interest to utility providers and local authorities.

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