tomorrow's borrowers:

personal debt by 2025 and the policy response

A research report by the Smith Institute

THE SMITH INSTITUTE

The Smith Institute

The Smith Institute is an independent think tank which provides a high-level forum for thought leadership and debate on public policy and politics. It seeks to engage politicians, senior decision makers, practitioners, academia, opinion formers and commentators on promoting policies for a fairer society.

StepChange Debt Charity

StepChange Debt Charity is the largest specialist debt advice charity operating in the UK. In 2012, over 400,000 people contacted our telephone advice line or on-line debt remedy tool for free, impartial advice about problem debt. StepChange is the UK's largest charitable provider of free-to-client debt management plans (DMP), having introduced DMPs to the UK in 1993. This experience provides us with a wealth of knowledge about problem debt, consumer credit debt in particular, and its impact on UK households.

tomorrow's borrowers:

personal debt by 2025 and the policy response

A research report by the Smith Institute

Published by The Smith Institute

Contents

Foreword
Paul Hackett, Director of the Smith Institute

Too many people in Britain have unsustainable levels of financial debt. Unfortunately, as this report shows, there are many reasons why this will get worse before it gets better. The problem is not a symptom of the recent financial crisis and austerity. It has been with us for some time. Indeed, household debt today is much higher than a decade ago and more pronounced for those on low incomes with few assets and those on middle incomes with unsecured credit. Moreover, indebtedness will not magically disappear when we move from austerity to prosperity.

Of course, access to personal credit and borrowing can be a force for good. Most people are not in unmanageable debt; neither are they so-called "zombie debtors" who are only able to pay off the interest on what they owe. But household debt is rising, and more adults are struggling to manage their money. An inability to manage personal debt can bring distress and unhappiness not only to the individual but also to friends and family. Furthermore, it has a proven negative impact on society and the economy.

However, indebtedness is a complex phenomenon and effective solutions depend on individual circumstances as well as on an array of cultural, psychological, educational and socioeconomic factors. As a result, many of the pressures that will lead to greater indebtedness cannot be countered by policy action. But in other areas linked to unmanageable debt, such as the operation of the credit markets, housing, the labour market and welfare, policy actions can make a difference. As the menu of policy recommendations in this report makes clear, government, regulators and the financial services industry can, if they wish, take action to mitigate some of the risks of greater indebtedness. Tomorrow's borrowers don't have to be in a worse position than today's.

Our aim in putting together this report was to explore how the pressures on household indebtedness might vary at the limits of the foreseeable future; and, on the basis of what we found, to consider what preventive policy actions and interventions might be appropriate. While we accept that some of our assumptions are contestable and some of our projections may turn out to be wrong, we believe the report does provide a fairly robust look ahead at the future. At the very least, it successfully places the spotlight on a very important issue and, we hope, makes a useful contribution to the personal-debt policy debate.

This report was written by the Smith Institute's research team, with guidance and advice from Peter Tutton, head of policy at StepChange Debt Charity, and Lord Wilf Stevenson, the charity's chair. The work draws on the excellent research and analysis on personal debt undertaken by Kitty Ussher, a well-regarded British economist and research fellow at the Smith Institute. The Institute held three roundtable discussions between May and September 2013 to discuss the project. A range of organisations attended these events, including representatives from the financial services industry, the regulatory bodies, debt advice agencies, and the third sector. The report has also been much improved by the ability to talk informally to a large number of experts and practitioners who gave freely of their time. The institute would like to thank all those who contributed.

Executive summary

Executive summary

This report is based on evidence and analysis taken from a variety of sources, including new data from the Office for National Statistics. It identifies who is most at risk of personal indebtedness today and who, on current trends, is most at risk tomorrow (in the period up to 2025). On the basis of this analysis, the report discusses the direction of travel for early action by policy makers to reduce the potential for the negative outcomes that known economic and demographic trends might otherwise be expected to produce. The aim of the report is to encourage policy discussion around what changes could be made to mitigate the risks of higher indebtedness for "tomorrow's borrowers".

Today's borrowers

Around 25% of UK households today report feeling burdened by debt. The report breaks this down and suggests that there are two distinct cohorts of indebted households in the UK: a "£12,000 debt with some assets" group; and a "£2,000 debt with low assets" group. Each of these groups comprises about one in 10 households, and more than half of these are in unmanageable debt because of an external event (such as redundancy or divorce).

Households in the "£12,000 debt with some assets"[1] group would feel comfortable being described as middle class and are likely to have a mortgage and a reasonably high level of training. They are young, often couple households, and are either in work or at least not long-term unemployed. They have large amounts of unsecured credit; nearly half of their debts are contracted loan agreements outside of hire purchase, overdraft or credit card debt (which are also high). This is a very vulnerable group, who could easily be tipped into crisis. To the extent that they are financing debt by new borrowing, they can keep going until the market closes on them. The main factors associated with unsustainable indebtedness for this group are high levels of initial gearing plus a personal financial shock.

Those in the "£2,000 debt with few assets" group have low assets in both human and economic terms. They are more likely to be in lower-paid occupations and less likely to be mortgage holders. The unemployment rate for this group is twice the national average. Their arrears are entrenched and it will take them a long time to earn their way out of debt. They are also young, but more likely to be single, including lone parents, and less likely to have a degree. Nearly a third of the debts accumulated

1 This is a median value; some households have far higher amounts of net financial debt.

by this group are accounted for by formal loan agreements outside of credit card, hire purchase and overdrafts. They also have a higher incidence of household arrears, although in amounts that are low compared with other forms of formal credit.

Tomorrow's borrowers
Levels of personal debt will be shaped by how key socioeconomic and demographic trends and drivers might vary over time. These trends are blended in the report with a range of assumptions about the future, such as: interest rates tending to be higher than now; an ageing and growing population; more single-person households; a less generous welfare state; more people renting privately; sluggish real wage growth: rising student debt; wider wealth inequalities; mortgages remaining hard to come by while unsecured credit is not; an improvement in average financial literacy due to its inclusion on the school curriculum; and a labour market that remains flexible.

Analysis of these trends suggests that without further action the pressures towards more personal indebtedness by around 2025 will increase. It will take people longer to pay off the debts incurred in youth. Debt will persist for longer and people will need to continue working longer to meet their financial commitments. Problem debt among pensioners will rise, particularly for those unable to build up a housing asset that offers cost-free living later. In addition, and regardless of this age effect, for the "£12,000 debt with some assets" group the continued availability of credit, particularly online, will make it easier to build up high levels of financial commitment.

Our analysis suggests that the incidence of financial shocks experienced by a typical household might be expected to rise, meaning there will be no let-up in the opportunities for a precarious situation to become a crisis.

Main policy recommendations
The report's recommendations focus on five key policy areas: demographics and household composition; the economy and public finances; the housing market; the labour market; and the consumer credit market.

Demographics and household composition
Demographic trends suggest that, without a significant change in behaviour, more people (especially single-person households) will accumulate more debt in early life and take longer to pay it off. Preventive actions are needed to mitigate the risks for the most vulnerable, including:

- ensuring that welfare reforms (such as the benefit cap) do not push single

parents and divorcees into unmanageable debt;
- continuing to guarantee that the state pension will provide the basis for an adequate retirement income;
- a concerted national campaign led by the government to raise awareness of credit dependency, particularly among the young; and
- government and debt charities seeking to address the worryingly low levels of financial literacy among older people, by providing a financial MOT for those aged 50 and on retirement, which could include information and guidance on retirement income and debt management.

Problem debt, the economy and public finances

While preventing and dampening economic shocks will help protect households from acute debt problems, growth will not by itself reduce the risks of problem debt. Welfare reform and prolonged austerity risk leaving some of the poorest and most debt-vulnerable households behind as the economy returns to trend growth. The challenge for government is to ensure that the benefits of growth reach those households most vulnerable to debt. Steps towards this might include:

- encouraging households on low and middle incomes to save (in part by incentivising saving for particular life events and by reintroducing Savings Gateway type matched accounts for low-income/low-asset households, where government matches a proportion of an individual's savings);
- government enabling the mass development of so-called "jam jar" accounts that allow customers to split their account balance into separate budgets for spending, saving and bill payments;
- debt charities and agencies closely monitoring the effects of welfare reform on household vulnerability to debt, and helping ensure that people take up the benefits to which they are entitled;
- the government ensuring that direct payment of both universal credit to tenants and monthly benefit payments does not increase the debt vulnerability of low-income households or increase the use of high-cost credit; and
- adopting a minimum income standard as an official measure alongside poverty measures, setting a target for at least working households to achieve this standard and reporting annually on progress.

Problem debt and the housing market

A continued housing crisis will increase the risk that more households will experience problem debt. The policy response should include:

- ensuring an adequate supply of affordable housing (of suitable size and quality), especially in high-demand areas;
- planning against the eventuality that financially vulnerable households may face a mortgage affordability crisis when rates start to rise – as a counterbalance to subsidised access to mortgage finance for first-time buyers;
- making sure that mortgage lenders show forbearance and flexibility in response to the coming crisis of which the Financial Conduct Authority has warned as the next wave of interest-only mortgages mature and financially vulnerable households have to start making capital repayments;
- consideration by policy makers of how best to incentivise the development of other routes into home ownership that are likely to work well for lower-income households (like shared ownership or home purchase plans that could have a different risk profile over time from traditional mortgage finance);
- evaluation by policy makers of the options for reforming the private rented sector to offer tenants greater security of tenure and more control over the manner and amount of rent increases;
- reform of the "bedroom tax" if it is creating rent arrears and personal debt problems; and
- making sure that the rules for universal credit do not exclude homeowners with earned income from help with mortgage interest payments.

Problem debt and the labour market

There is broad agreement among debt experts that work is the best route out of poverty. Work should also protect households against the risk of unmanageable debt. But both these aims presuppose that tomorrow's borrowers (young and old) will be able to get work that delivers an adequate, predictable and secure income. The report concludes that government could do more to:

- combat low pay and in-work poverty, including encouraging firms to adopt the living wage and invest more in skills training;
- provide more debt advice and support to the growing numbers of self-employed people with problem debt;
- support insurance and rainy-day provision by working with the financial industry on developing simple and transparent income/employment protection products;
- ensure that those who take out income/employment insurance should not be penalised by the benefit system; and
- make contributory benefits a more effective safety net for working households.

Problem debt and the consumer credit market

A major policy challenge for government and regulators is to prevent debt problems escalating and to ensure that financially excluded consumers have better access to affordable credit that is designed to suit their needs. Recommended actions to achieve these aims include:

- the Financial Conduct Authority using its powers to set threshold conditions for authorisation to thoroughly scrutinise the business models of consumer credit firms operating in sectors with past evidence of consumer detriment – payday lenders and other high-risk sectors should be required to apply for authorisation as soon as possible;
- ensuring credit products are suitable and do not contain "bear traps" for consumers to fall into (for instance, this could be used to control roll-overs for payday loans);
- the FCA taking action against unfair and excessive default charges to prevent debts escalating as a result of a borrower's financial difficulties;
- incorporating industry best practice on arrears management/debt collection to ensure that households in financial difficulty who engage with their debt problem are protected from further collections and enforcement activity;
- ensuring high standards of business conduct in the debt management sector;
- tightening the Lending Code once more so that minimum payments on credit cards reflect a standard timescale for paying off the entirety that is owed; and
- the government maintaining its support for third-sector lenders, such as credit unions – extension of access to credit unions through the Post Office may be one way forward.

Introduction

Introduction

Personal debt is a large and increasingly pressing problem in our society. StepChange Debt Charity reports that 400,000 people sought advice in 2012, an 11% increase on the previous year and the first increase since the 2009 recession year. But this is only a small fraction of the 6 million households that the charity estimates are already in financial difficulty or at risk of falling into financial difficulty.

There is no doubt that debt problems can have a devastating effect on the people who experience them, and that this results in significant external costs for society. For instance, research into the links between debt and mental health found that people facing unmanageable debts have a 33% higher risk of developing depression and anxiety-related problems than people without financial problems. The report cites lost employment costs for each case of poor mental health at £11,432 and annual costs of health and social service use at £1,508.[2] The Relationship Foundation's *Family Pressure Gauge* highlights the "burden of household debt" as a key reason why UK families are under greater financial pressure than families elsewhere in Europe. Money worries are cited as a major source of argument, relationship conflict and family breakdown.

The Relationships Foundation estimates an overall annual cost of family breakdown at £46 billion, or £1,541 a year for each UK taxpayer.[3] Other research found that debt advice interventions supporting tenants in financial difficulties could save social landlords nearly £50 million a year in debt-related costs.[4] StepChange Debt Charity estimates that the burden of contractual debt repayments on disposable household incomes of people contacting them in 2012 pushed an additional 49,000 children into effective income poverty.[5]

So there is a compelling case for policy makers to act. Our analysis in this paper shows that high levels of indebtedness are not going to go away. We explore the reasons why people tend to become over-indebted, using previously unpublished data to characterise the one in four households that have more cash debt than savings. We then look to see how the picture might be affected by what we know about likely economic and demographic trends over time. We sketch a scenario of which cohorts of

2 Knapp, M, McDaid, D and Parsonage, M (eds) *Mental Health Promotion and Mental Illness Prevention: The Economic Case* (Department of Health, 2011)
3 *The UK Family Pressure Gauge: Where Are the Most Pressured Families?* (2012); *Counting the Cost of Family Failure 2013 Update* (2013)
4 Evans, G and McAteer, M *Does Debt Advice Pay: A Business Case for Social Landlords* (Financial Inclusion Centre, 2011)
5 StepChange Debt Charity *Statistical Yearbook 2102* (2013)

people will be particularly at risk from getting into debt between now and 2025: which of today's teenagers will be tomorrow's borrowers?

Finally, we set out a direction of travel and recommendations for policy makers on how these risks can be mitigated. There is a strong public-interest case for creating an environment where there is less build-up of consumer debt in the first place, and where, if individuals do have rising debt levels, the journey towards dealing with them is swifter. The observations and recommendations relate to the two "most at risk" cohort groups, with an emphasis on the key policy areas where preventive action seems most appropriate.

Throughout we focus on consumer debt, rather than mortgage debt. The reason for this is that we are interested in the concept of over-indebtedness, which focuses on consumer debt payments taking up a too-large proportion of household budgeting. If this is the case, it will always reflect in the cash position of a household just as an insolvent company often ends up with cash-flow problems. That is, if a household has overall difficulties, including with mortgage payments, they are likely to show up in its cash position. We hope it is a neat way of capturing a household's overall level of difficulty.

Methodology

Our starting point is the Office for National Statistics' Wealth and Assets Survey. We obtained new data to explore the characteristics of people with negative net financial assets; that is, households where unsecured debts exceed cash savings.[6] The latest Wealth and Assets Survey data points currently available are for 2008-10, which is an important caveat to our findings. Nevertheless it provides a starting point for the discussion on future trends that is to follow. A literature review checks the ONS results against earlier academic research on the characteristics of households with pervasive debts and summarises the available evidence on the drivers of indebtedness. In this way we build up a picture of the forces and characteristics that are associated with high levels of indebtedness today.

The second part of the research is an analysis of the consensus view on how key economic and demographic variables are expected to alter over time from now to around 2025, and how this will affect patterns of indebtedness. In particular we look at predicted trends on:

6 According to the ONS, individuals living in households with negative financial wealth (where liabilities such as borrowing, overdrafts and debts exceed assets such as savings) varies from 21% in Scotland to 35% in the North East.

- population and household formation;
- characteristics of the housing market such as tenure, mortgage credit availability and interest rates;
- developments in the market for unsecured credit including demand factors such as changes in financial capability;
- projected trends in the labour market; and
- macroeconomic variables such as economic growth and public finances.

In each case we take the existing direction of public policy as given and presume no discontinuities in the policy environment. We have taken a reference point of 2025 in order to look beyond any cyclical effects. It is not possible to say in what stage of the economic cycle we will be at that time. It is the underlying trends that we are interested in. In any one year the rate of saving and borrowing will additionally be affected by other factors, in particular the level of consumer confidence, which will in turn be affected by a plethora of other economic and softer indicators at any one time.

Throughout, our analysis is supplemented by qualitative interviews with expert academics, policy makers, regulators and practitioners in the not-for-profit and private sectors. This was particularly helpful where data was scarce, for example in projections of the future nature of the credit market. We also held three roundtable events with stakeholders and experts to scope out the project and road-test emerging conclusions.

Time will tell whether our analysis is correct, but it will not be possible to know unless the government continues to monitor what is happening within households. As such we hope that the Office for National Statistics will continue to undertake its Wealth and Assets Survey and publish separately the net financial liability series to monitor changes in the net cash debt position of households.

Part 1

Today's borrowers

Today's borrowers

Borrowing in itself is not an unwise or immoral act. Indeed, it is often a very good idea to borrow, particularly if the cash is used to invest, so raising the ability of an individual, household or wider family to gain greater income or assets in future. In other cases, it is a bad idea, symptomatic of an underlying problem. If an individual has no realistic prospect of being able to clear their debts, then borrowing to meet immediate needs will only make things worse. That individual is insolvent and at some stage will need to rethink their overall financial situation.

However, the definitions of problem debt can easily become confused. Policy makers continue to grapple with the question of what types of debt should cause them concern. The phrase "over-indebted" is used to signify levels of debt that are worthy of policy interest, but there is no clear consensus as to what precisely is meant by this.

Definitions and measurement

The government commonly uses a composite measure for problem debt, consisting of four objective measures and one subjective measure. The objective measures are: having a ratio of unsecured debt repayments to gross household income exceeding 25%; a ratio of all debt repayments to gross household income exceeding 50%; being in arrears; and the number of credit commitments outstanding.

The subjective measure is self-reporting that debt is burdensome.[7] The ONS report *Poverty and Social Exclusion* in the UK and EU, 2005-2011, for example, states that although overall levels of severe material deprivation in the UK have changed little in recent years, the percentage of people in the UK who say they would be unable to meet an unexpected but necessary financial expense has markedly increased since the start of the economic downturn, up from 26.6% in 2007 to 36.6% in 2011.

However, there are a number of difficulties with self-reporting. First, there is some evidence that the subjective measure is linked to other issues to do with the individual's well-being that are not directly linked to the amount of debt they have. Two people with the same level of debt might report differently as to whether that debt is burdensome. Second, households with different characteristics might score high on one objective measure but low on another. For example, a tenant who has substantial arrears on rent and/or household utility bills might have a low ratio of debt repayments to income.

7 See, for example: Bryan, M, Taylor, M and Veliziotis, M *Over-indebtedness in Great Britain: An Analysis Using the Wealth and Assets Survey and Household Annual Debtors' Survey* (Institute of Social & Economic Research at the University of Essex, October 2010)

Conversely, a mortgage holder who also has a hire-purchase arrangement and credit card(s) might have a very high level of debt repayments to household income but little in the way of arrears, particularly if the requested minimum payments by creditors are being made.[8]

For our purposes, we consider the level of debt to be problematic if it is likely to increase, or in some other sense appears unsustainable, without a change in circumstance or behaviour. That is to say, we view the level of debt accumulated by an individual or household in the same way as an auditor might view the debt level of a company, or a credit rating analyst might view the debt level of a sovereign government. The crucial question therefore is: is it reasonable to presume that the overall level of debt will fall over a foreseeable timescale if no changes are made? If the household were a company, would an auditor conclude it was trading itself out of insolvency? If the answer is no, then the household is over-indebted; some kind of a rethink and action are required.

This could be as simple as a breathing space to give time to rebudget and agree payment plans with creditors, or a more structural change to a household's balance sheet, for example through selling physical assets, moving home, changing jobs or applying for a debt relief order or bankruptcy.

Levels of debt and wealth

In today's Britain it is fairly common to be in some kind of debt. At the beginning of 2013, the total value of all loans held by individuals in the UK stood at £1.4 trillion.[9] Averaged out across the total adult population, this figure is equivalent to just under £30,000 for each person over the age of 20.[10] Of this total amount, the vast majority – 89% – is mortgage debt. The remainder, around £158 billion, is consumer credit, of which around a third is credit card debt.[11] Student loans, which do not need to be paid back unless income reaches £21,000 a year, are not included in this figure (the value of outstanding student loans administered by the Student Loan Company in England was £40.3 billion at the end of the academic year 2011/12[12]).

The Office for National Statistics has published data on the extent to which different household types have some form of financial debt (regardless of any savings or assets

8 For a good discussion of these issues, see: Disney, R, Bridges, S and Gathergood, J *Drivers of Over-indebtedness* (DBIS, October 2008)
9 Bank of England Bankstats table A5.2, seasonally adjusted (excludes student loans)
10 Office for National Statistics *Population and Household Estimates for the United Kingdom* (17 December 2012), table 1(a). Shows total adult population aged 20 or over at time of 2011 census to be 48,084,000
11 Bank of England Bankstats table A5.6, seasonally adjusted
12 House of Commons Library *Student Loan Statistics* (29 November 2012)

as well). This shows that people with dependent children were most likely to have financial liabilities: 74% of lone-parent households with dependent children and 69% of couples with dependent children reported financial liabilities in the 2008-10 survey. By contrast, people above state retirement age were the least likely to have financial liabilities: 17% of single-pensioner households and 18% of couple-pensioner households had financial liabilities.

Taken in isolation, however, these figures are not particularly meaningful because they tell only part of the story; we do not know anything about the income or assets of the individuals or families involved and so there is no indication as to whether these levels of debt are problematic.

Partly to address this issue, the ONS has (since 2006) started to compile data on the net wealth position of households in Britain, which includes levels of all types of debt as well as assets. To date, two Wealth and Assets Surveys have been conducted, one covering 2006-08, and the second covering 2008-10. The main result of this work has been to compile sufficient data to break down the net wealth position of all households; this gives a more holistic picture of how affluence is spread across the population than the usual breakdown by income.

By way of introduction to this data set, the main results of the wealth distribution across the population are shown in the table below:

Table 1: Distribution of adults in households with different levels of total wealth 2008-10

	< £12.5K	£12.5K but < £40K	£40K but < £100K	£100K but < £150K	£150K but < £250K	£250K but < £300K	£300K but < £450K	£450K but < £600K	£600K but < £1 million	£1 million or more
Percentage of total	**7.8**	**8.9**	**10.4**	**7.2**	**13.6**	**6.0**	**13.6**	**9.0**	**12.7**	**10.9**

Source: ONS Wealth and Assets Survey
NB: Total household wealth is net wealth created by adding different types of household wealth: property wealth (net), financial wealth (net), physical wealth and private pension wealth.

A shortcut to considering the extent to which levels of debt are problematic is to examine the financial wealth position of households: that is, to consider the cash position in isolation. Just as a business that is fundamentally insolvent cannot avoid cash-flow difficulties, so a household that is in financial difficulties will deplete cash savings and build up debt. Of course, if that household also has non-financial assets such as property then it has the option of selling these assets to pay off debt and so might avoid insolvency or bankruptcy. However, being faced with this stark choice in an unplanned way is still consistent with having a debt problem. It is also quite possible to have high levels of debt that are being serviced with high income such that no crisis as such ever arises. We would categorise these people as being highly vulnerable to a change in circumstances that would make their levels of debt unsustainable.

In July 2012, the ONS published its main results on financial wealth using the survey data for 2008-10.[13] In January 2013, a further article was published on the financial liabilities of borrowers in Britain.[14] This data showed that around half (51%) of all households in Britain had some form of financial liabilities in 2008-10, with total liabilities across the population as a whole adding up to £95 billion.

Of these households that had some form of financial debt, half again reported it to be either somewhat of a burden (31.5%) or a heavy burden (18%). That is, overall, around a quarter of households in Britain say they are feeling burdened to a greater or lesser extent by their financial debts.[15] The reason for this soon becomes apparent. The ONS asked people to list all their financial assets and liabilities, and then computed the net position for each household. This analysis showed that nearly a quarter of households (24.3%) had negative net financial wealth; their cash assets were less than their liabilities. So notwithstanding the problems in relying on a person's reported perception of how much debt they have, it remains the case that roughly the same amount of households report their debts as burdensome as have more debt than savings. It seems reasonable to presume that there is significant overlap between these two categories: if your assets are less than your liabilities then the debt will feel burdensome.

The table below reproduces the key result of the ONS research on the net financial position of households in Britain. To recap, the definition of financial wealth is cash assets less unsecured (non-mortgage) debts owed.

The ONS has not split the population according to standard deciles. This is because there are distinct clusters and characteristics of households at different places in the financial wealth distribution, which makes it more useful to divide the population in a slightly different way while still keeping 10 bands in total, in order to draw out these trends.

13 *Wealth in Great Britain Wave Two, 2008-2010: Part 2*, Chapter 3 (ONS, 12 July 2012)
14 *Welsh Households Had the Least Financial Debt in 2008-10* (ONS, 28 January 2013)
15 According to StepChange Debt Charity the average debts owed by its clients is £18,000, equivalent to roughly their entire net household income.

Table 2: Net financial position of households in Britain

Household net financial wealth (£)	Percentage of all households (%)	Mean (£)	Median (£)
Greater than £5K net liabilities	11.1	-17,300	-11,800
Between £500 and £5K net liabilities	9.7	-2,200	-2,000
Up to £500 net liabilities	3.5	-200	-300
0-£500 financial wealth	7.3	200	200
£500-£5K	15.4	2,200	2,000
£5K-£12.5K	11.7	8,200	8,000
£12.5K-25K	9.6	18,100	17,900
£25K-50K	10.8	36,200	35,600
£50K-£100K	9.4	71,000	69,400
Above £100K net financial wealth	11.7	277,700	179,500

Source: ONS Wealth and Assets survey
Note: These percentages are as a proportion of all households in the UK, including figures for the small proportion (less than 1%) who did not report.

Debt over the lifecycle

Before getting into more detail on the characteristics of the various cohorts within this distribution, it is worth just presenting the data in a different way to understand how this distribution alters over time. There is a clear (inverse) connection between levels of indebtedness and age, as the table below shows.

So, for example, while 19.1% of people aged 16-24 live in households with net financial liabilities of over £5,000, only 1.9% of people aged over 65 live in households with that level of debt.

The lifecycle hypothesis put forward by economist Franco Modigliani in the 1950s indeed proposes that it is perfectly rational to choose to use debt in early life to smooth consumption patterns over a lifetime.[16] For those in work, the passage of time enables liabilities to be paid off by an income that increases as seniority grows; a process accelerated by parents' ability to offer more hours into the labour market as their children grow older. When the mortgage is paid off, monthly housing costs are slashed and so there is more money available to pay off any other debts. Discrete life events also nudge in the same direction: an inheritance can clear liabilities as can receipt of a pension lump sum prior to purchasing an annuity. Homeowners may get a windfall from downsizing in later life.

Table 3: Household net financial wealth 2008-10, by age of persons

	All ages	16-24	25-34	35-44	45-54	55-64	65+
Greater than £5K net liabilities	12.2	19.1	20.4	16.0	12.6	7.0	1.9
Between £500 and £5K net liabilities	9.4	13.5	14.4	12.9	8.9	5.7	3.0
Up to £500 net liabilities	3.0	4.9	4.1	3.3	3.4	2.3	1.1
0-£500 financial wealth	5.9	6.8	5.7	5.7	5.4	5.3	6.6
£500-£5K	14.4	14.8	17.6	14.9	12.2	11.1	15.4
£5K-£12.5K	11.2	8.7	11	11	10.4	9.7	14.9
£12.5K-25K	9.9	8.4	8.5	8.6	10.4	9.9	12.6
£25K-50K	11.3	8.4	8.1	10.2	11.9	13.8	14.1
£50K-£100K	9.9	6.7	5.1	8.3	10.9	13.8	13.1
Above £100K net financial wealth	12.8	8.6	5.2	9.2	14.1	21.5	17.2
TOTAL (after rounding)	100	100	100	100	100	100	100

Source: ONS Wealth and Assets Survey

Alternative explanations are that individuals learn from their mistakes the hard way and become more adept at financial management as they get older, or that the ageing process itself makes them more risk-averse, more concerned about saving for old age rather than living for the now.

16 Modigliani, F "The Life Cycle Hypothesis of Saving, the Demand for Wealth and the Supply of Capital" in *Social Research* vol 33, no 2 (1966)

That the incidence of burdensome debt is far less in later life does pose the question of whether it should be seen as a problem at all; for most individuals it eventually corrects itself. In our expert interviews, however, there was almost unanimous agreement that debt is indeed a problem. For a start, in future debt levels may not lessen with time to the same extent as previously, as we discuss in the opening section to part two below. But there are also very strong economic and welfare reasons to reduce high levels of financial indebtedness in households, even among the young, because of the stress of being in a situation that feels irresolvable or out of control and the strain caused by efforts to resolve it. One of our expert interviewees stated that the key emotion expressed by debt clients is simply "I can't see a way out of this", leading to grave concerns about the effect of debt on overall levels of well-being.

The clinical psychologist Oliver James goes as far as to state:

... a person with six or more personal debts is six times more likely to be mentally ill than someone with none, regardless of their social class: the more debts, the greater the risk...[17]

In its 2012 annual survey of clients, StepChange Debt Charity reports that in three out of four cases clients said that, by the time they sought help, anxieties over unmanageable debt had "undermined their confidence to support themselves and their families" and 40% said their relationship with family and friends had been affected by their debt problems.[18]

There is some anecdotal evidence from practitioners that debt problems are extending into later life, although this is not yet showing up in the national data. One of our interviewees also made the point that the baby-boomer cohort might be more comfortable than their predecessors with the idea of remaining in debt as they enter retirement, having lived with credit cards all their lives; indeed, some may think it rational to keep borrowing in later life for as long as lenders will lend, particularly if scheduled payments can be spread forward into a time-period that they consider to be no longer relevant to them.

There is also an important cyclical element to be taken into account. The most recently available data from the ONS covers the period at the worst stage of the recent credit crunch, when families felt over-extended but did not yet have the means to repay debt. Since then, low consumer confidence and a desire to pay off debts have led to

17 *The Observer*, 12 May 2013, p11
18 StepChange Debt Charity *Statistical Yearbook 2012* (2013), p5

increased levels of savings.[19] We expect the next data point to show some improvements in the net debt positions of individual households as a result. Indeed, StepChange Debt Charity reports that the average total unsecured debts of its clients fell by nearly a third between 2008 and 2012, even though the number of people contacting the agency rose in 2012.[20] But it is the underlying trends that we are interested in; we simply take the most recent data as a starting point.

Characteristics of households with problem debt

According to the ONS data[21] roughly a quarter of total households have net financial wealth (including net property wealth). People in the most indebted band, who have net financial liabilities of over £5,000, make up around 11% of total households. They are more likely than not to owe far more than that: the median net financial liability of households in this group is £11,800 and some owe many multiples of this, as indicated by an average net debt of higher than £17,000. This fits the anecdotal evidence as well: one of our interviewees who works with highly indebted individuals suggested that their average client had around £18,000 of debt owed to seven different creditors.

The ONS analysis also shows that there are slightly more men than women among those most indebted, and that they are disproportionately young; around 19% of people aged 16-24 are in the most-indebted group of households, and 20% of those aged 25-34. Perhaps because of this age distribution, they are extremely unlikely to be retired, and are more likely to be in the labour force than the average – both working and unemployed.

Turning to socioeconomic classification, those people in Britain with the highest level of financial debt have an average representation in lower managerial and professional, intermediate and semi-routine professions. They are overrepresented in lower supervisory and technical professions, and underrepresented in large employers and higher managerial and higher professional occupations. However, they are also slightly underrepresented among those who have never worked or are long-term unemployed.

Interestingly, although they make up a lower proportion of the higher socioeconomic classes than would be accounted for just by the size of the group, they have a significantly higher representation here than households with some, but less debt,

19 The UK savings ratio decreased to 4.2% in Q1 2013, compared with 5.9% in Q4 2012 and an average of 6.4% in 1955-2013 and 4% for most of the period 1997-2006, according to the ONS.
20 StepChange Debt Charity *Statistical Yearbook 2012* (2013)
21 Primarily from Wealth and Assets Survey publication of 12 July 2012, Chapter 3, titled "Financial Wealth 2008-10". Also includes previously unpublished data on household net financial wealth

Table 4: Net financial wealth (banded), by household type

Net financial wealth band of household	< -£5,000	-£5,000 but < -£500	-£500 but < £0	£0 but < £500	£500 but < £5,000	£5,000 but < £12,500	£12,500 but < £25,000	£25,000 but < £50,000	£50,000 but < £100,000	£100,000 or more	Total
Single household, over state pension age	1.8	3.1	1.8	11.2	21.7	17.9	11.5	12.3	10.2	8.5	100.0
Single household, under SPA	11.0	14.4	7.1	12.6	17.3	9.5	7.3	7.0	7.1	6.6	100.0
Married/cohabiting, at least one person over SPA, no children	1.9	2.4	0.9	3.5	10.6	13.2	12.4	15.8	15.3	24.1	100.0
Married/cohabiting, both under SPA, no children	17.3	7.7	2.7	3.5	11.0	10.5	10.7	11.7	10.4	14.5	100.0
Married/cohabiting, with dependent or non-dependent children	16.1	10.7	2.7	3.8	14.3	10.6	9.2	11.3	9.2	12.0	100.0
Lone parent with dependent or non-dependent children	13.2	21.3	8.2	13.9	17.2	8.5	5.6	5.2	3.4	3.5	100.0
Two or more families/ other household type	14.3	11.0	*	6.5	17.7	10.9	10.2	9.4	8.9	9.5	100.0
Weighted number of house-holds	2,750,700	2,405,300	855,500	1,793,700	3,796,000	2,882,500	2,370,600	2,664,000	2,321,500	2,885,400	100.0
Total number of responding households	1,775	1,619	592	1,277	2,752	2,227	1,928	2,292	2,190	3,518	100.0

Source: ONS Wealth and Assets Survey
Notes: 1. SPA is state pension age (65 for men and 60 for women); 2. Cells indicated with * represent suppression due to low base numbers; 3. Some household type categories have been combined due to low base numbers.

perhaps signifying that a significant proportion of the group are recent graduates just starting out. Indeed, those in this group are as likely as the national average to have degrees, and more likely than the average to have other, non-degree qualifications.

In terms of household characteristics, they are more likely than their population size suggests to consist of couple households, either with or without children. Lone parents and extended families are also slightly more likely to lie in this cohort than its size alone would suggest, and single households slightly less so.

The composition of the debt (see table below) does indicate that those in the most-indebted group may well have recently qualified: 8.2% of their debt is accounted for by student loans. However, this is dwarfed by the massive 46% of their debt that comes from formal loan arrangements, that is contracts for credit not including hire-purchase, overdraft, or credit card debt, which other categories account for 10%, 4% and 20% of their debt respectively. This suggests that their high levels of debt are being driven by payday and other types of loan arrangements, usually for defined purchases.

Two problem debt groups

The 9.7% of all households who lie in the medium-indebtedness band, with net financial liabilities of between £500 and £5,000, are also disproportionately young. However, they are slightly more likely to be female and less likely than the population as a whole to have a degree. Their holding of non-degree qualifications is a bit higher than the average across the population, and they are no more likely than the average to have no qualifications at all. They are more likely to be economically active, again because they are less likely to be retired. However, those who are in work have a lower socioeconomic classification than the average; they are disproportionately represented in the lower categories of semi-routine and routine occupations. One in five of all the people who are in the labour force but unemployed fall into this category; twice the number than if there were no connection between unemployment and being in this category.

For those who are not economically active, however, the main reasons for this are that they are either sick/disabled or looking after the family or home; this could explain why they have been unable to clear their debts. The value of the debt, after taking account of savings, is evenly spread either side of the £2,000 mark; the mean and median values of the debts of households in this cohort are both at around similar levels.

Turning to household composition, this second group has a very high representation of lone parents – one in five lone-parent families have debts at this level, although

Table 5: Financial liability product by UK households, 2008–10 (net financial wealth band)
Percentages (%)

Net financial wealth band	Credit cards	Store cards	Mail orders	Hire purcheses	Formal loans	Student loans	Informal loans	Arrears from household bills	Overdrawn current accounts	Other financial liabilities	All financial liabilities	No. of responding households	Weighted frequency of house-holds
<-£5000	20.8	0.4	1.2	10.9	46.5	8.2	1.3	0.9	4.0	5.8	100.0	1,775	2,751,000
-£5,000 but < -£500	28.1	1.0	3.0	17.1	28.5	4.9	1.4	4.4	8.0	3.7	100.0	1,619	2,405,000
-£500 but < £0	28.5	1.2	4.2	11.0	18.0	*	0.6	7.4	13.3	15.8	100.0	592	855,000
£0 but < £500	31.1	1.2	3.5	11.4	36.6	*	0.8	4.1	6.5	4.9	100.0	1,277	1,794,000
£500 but < £5,000	25.6	0.7	1.5	19.2	31.2	*	2.0	1.3	8.3	10.2	100.0	2,752	3,796,000
£5,000 but < £12,500	26.2	0.5	1.2	18.1	32.8	9.8	0.8	*	6.4	4.2	100.0	2,227	2,882,000
£12,500 but < £25,000	24.4	0.3	0.5	21.7	33.9	*	1.3	*	5.0	12.9	100.0	1,928	2,371,000
£25,000 but < £50,000	25.5	0.5	0.8	19.7	32.6	8.6	2.5	*	6.8	3.1	100.0	2,292	2,664,000
£50,000 but < £100,000	19.2	0.4	0.2	25.2	33.7	10.9	0.8	*	5.5	4.1	100.0	2,190	2,322,000
£100,000 or more	25.1	0.4	0.3	22.0	26.6	8.4	1.5	*	7.9	7.9	100.0	3,518	2,885,000
Total	22.7	0.5	1.3	14.5	40.0	7.9	1.4	1.2	5.3	5.2	100.0	20,170	24,730,000

Source: ONS Wealth and Assets Survey
Notes: 1. Cells indicated with * represent suppression due to low base numbers.; 2. Some types of financial liabilities were combined due to low base numbers.

it may be that the driver for this is the group's age; older households with grown-up children may not describe themselves as lone parents. Single households are also disproportionately in this group; couples less so.

Looking at the composition of the debt for this group, there is a higher component of arrears – at 4.4% – than the higher-debt group, although that is still far less than payday and other formal lending, which accounts for 28% of the total debts of this group. The group also has a higher proportion of its total debts accounted for by credit card, hire purchase and overdrafts when compared against the first group, although of course by definition this is all relative to the overall size of the outstanding debt.

Perhaps the best way of describing the differences between the two groups is therefore as follows: on aggregate the higher-debt group has 10 times the amount of payday-type loans, which therefore dominates any comparison. As the table above shows, the higher-debt group also has six times the amount of store card loans, five times the amount of credit card and hire purchase loans and roughly the same level of household arrears.

For completeness, it might be worth briefly considering the characteristics of households in the low-net-indebtedness band, with net financial liabilities of between zero and £500, even though this group makes up only around 3% of all households. This group is also likely to be younger than the average and so less likely to be retired. However, they are less likely to be economically active than people with higher levels of net debt, predominantly due to sickness/disability or looking after family/home. Students are also overrepresented: 6% of all students fall into this cohort, despite it accounting for only 3% of the population.

For those who do work, they do so in lower-skill occupations: routine and semi-routine occupations are overrepresented in this group. And a significant proportion of people are looking for work: 10% of all households with people actively looking for work in Britain fall into this small-debt cohort. Their far smaller levels of debt are more likely to be made up of arrears, overdrafts, credit card loans and informal borrowing, although there is an element of payday type lending as well. This is a group of people that has got itself into a net debt position of around £200-300 simply because it has not managed to make ends meet.

Further detail on the characteristics of people with the lowest financial and physical assets (not the net position) in the UK is given in the annex.

In summary, the ONS data supports the conclusion that there are two main types of highly indebted households, each of which comprises about one in 10 of all households in Britain. Both are young, but very generally speaking they are differentiated in the following way:

'£12,000 net debt with some assets' group	**'£2,000 net debt with few assets' group**
Couple, with or without children	Single, with or without children
Very high payday lending	Lower but significant payday lending
Higher qualifications	Intermediate qualifications

This interpretation broadly fits with an academic round-up of the available evidence on the drivers of over-indebtedness, supplemented by qualitative interviews, that was presented in a report written by the Department for Business, Investment & Skills in 2008 by academics from the University of Nottingham.[22] However, the ONS data throws up a higher incidence of consumer-credit type arrangements from both cohorts, perhaps indicating how much that market has grown in the intervening years.

The Nottingham report describes two main types of over-indebted households. The first – corresponding perhaps to our £2,000 debt group – consists of households with, as their report puts it, "more or less persistent difficulties in managing their finances for longer periods of time, arising largely from a lack of lifetime resources".

These households tend to have low levels of education, high outgoings relative to income, and low employment prospects, alongside the lack of a stable breadwinner and of other forms of asset or collateral. When borrowing, they have access only to inferior forms of credit or rely on social-fund types of government schemes and are expert at so-called "cycling" of bills as they come due, juggling creditors expertly based on a judgment of which bill is the most crucial to pay to keep the wolf from the door.

Some arrears, for example, to utility companies, may be built up over a long period of time, as a result of a judgment that these companies are unlikely to disconnect the service. Indeed, arrears tend mainly to be in household bills rather than expensive consumer credit (this is not supported by the ONS characterisation). There is some, but not conclusive, evidence that some of these problems are resolvable if the household moves from having one to two earners, if job prospects are improved, or if the household succeeds in getting on the housing ladder.

22 Disney, R, Bridges, S and Gathergood, J *Drivers of Over-indebtedness* (DBIS, October 2008)

The second group described by the Nottingham report appears a better fit with the "£12,000 debt with some assets" group described above. These are middle-income households with higher levels of overall assets, who perhaps did not feel financially burdened until recently, and who had been accustomed to have someone in work on a medium income. However, perhaps without fully realising it, they had a high exposure to risk, characterised by high debt payments relative to income, but felt that these were risks they could manage; hire-purchase arrangements and mortgage payments were being adhered to, credit card minimum payments were being made.

More recent data from the 2012 StepChange Debt Charity client survey shows that those clients with a credit card tend to have very high personal-loan and payday-loan debts, again suggesting the existence of a cohort who are in work but extremely highly geared, and therefore vulnerable.

This group then hits difficulty when there is a shock to the system causing income to fall. These shocks fall into two main categories: either loss of employment (including the failure of a business or other form of self-employment) or marital breakdown leaving at least one partner with more commitments than they can afford. Illness can also cause the same problem, although it often takes longer to manifest itself.

In all cases the high household gearing that had previously felt manageable then becomes very unmanageable, particularly if there is insufficient insurance in place; households in this category are soon reporting difficulties in meeting their obligations. Kempson[23] shows that around half of all cases of over-indebtedness are caused by a shock of this kind. Around two-thirds of StepChange Debt Charity clients cite an external event as being the cause of debt, be it unemployment/redundancy (25%), a fall in income (19%), separation/divorce (10%), or disability/illness (11%).[24]

Econometric analysis by the Bank of England using the British Household Panel Survey data series also showed that highly leveraged households reporting a negative financial "surprise" are more likely subsequently to report a heavy debt burden; or to put it another way, changes in self-reported debt problems appear to be related to unanticipated adverse financial shocks to the household.[25]

23 Kempson, E *Over-indebtedness in Britain*, a report to then Department of Trade & Industry (2002)
24 StepChange Debt Charity *Statistical Yearbook 2012* (2013), p5
25 Del-Rio, A and Young, G *The Determinants of Unsecured Borrowing: Evidence from the British Household Panel Survey*, Bank of England working paper no 263 (2005). Note there is considerable evidence here and elsewhere that self-reported debt problems are also related to wider psychological well-being issues and other lifestyle attitudes.

Multivariate analysis of indebtedness

It is also worth comparing the two-cohort approach with previous econometric studies that explore the characteristics of indebted households. Most relevant of these is an analysis by the University of Essex that used the results from the first wave of the Wealth and Assets Survey (2006-08) to conduct an analysis of relationships between household characteristic and the various measures that the government uses to collectively define over-indebtedness.[26]

First, looking at the top-level characteristics of households that meet the definition of over-indebtedness showed an association between relatively high risks of over-indebtedness and the following factors:

- being a young adult, particularly aged 25-35;
- being a tenant, in particular a social tenant;
- being in a low-income household;
- being a lone parent; and
- being unemployed, sick or disabled.

There is also a strong relationship between over-indebtedness and attitudes to debt, with people who agree with the statements "I buy things when I can't really afford them" and "I buy things on credit and pay later" and disagreeing that they are "more a saver than spender" most likely to be over-indebted. In a sense this is unsurprising, although it does suggest that two people with the same external factors might have very different debt levels depending on their attitude.

The University of Essex team then conducted an econometric multivariant analysis to explore the existence of relationships between various aspects of their definition of over-indebtedness and household characteristics. The following conclusions, taken from their study, show the results of this analysis:

- The probability of arrears and of debt being a heavy burden are positively associated with: having dependent children, being separated or divorced, unemployed or sick or disabled, and being a tenant. They are negatively associated with: being married, in work, retired, highly educated and an outright homeowner, and with being older.

- The numbers of credit commitments are higher for: women, those with

26 As above

dependent children, who are separated, divorced or widowed, employed in a high-skill occupation, with a mortgage or are tenants. They are negatively associated with: being older, an outright homeowner, non-employed, and never having worked or being long-term unemployed.

On the surface, some of these conclusions might appear contradictory. There is, for example, a positive correlation between the number of credit commitments and being employed in a high-skill occupation. However, there is also a negative correlation between employment and being in arrears or reporting debt as a heavy burden. As discussed in the opening section to this part of our report, this is likely to be a problem of definitions. Indeed, the Essex University team themselves explain that "the indicators represent different dimensions of credit behaviour which may not all be immediately problematic", concluding that disentangling the indicators more clearly should be a priority for future research, and in particular understanding better the journeys that people make in and out of high levels of debt, in order to form a judgment about sustainability.

For this reason, describing the characteristics of over-indebted households as consisting of two separate groups seems to be the most fruitful approach. It makes sense of our initial observation from the 2008-10 Wealth and Assets Survey that people with net negative financial liabilities mainly appear to fall into two distinct groups: the "£2,000 debt with few assets" group, which corresponds best to low-skill groups and single people, and the "£12,000 debt with some assets" group, which corresponds better to over-geared middle-income young-couple households that have experienced a financial shock. It also starts to unpack some of the apparent contradictions in the Essex University study around the relationship between credit commitments and levels of employment and education.

Of course – a point to which the Essex study alluded – most causes of over-indebtedness have another source as well, namely the inability of the household to be financially prudent. All lending arrangements (with the possible exception of some forms of household arrears) ultimately involve the decision and agreement of the borrower. Official data shows that levels of indebtedness does not always correlate ti income and personal circumstance. Indeed, many of the most indebted are those who have had a reasonable start in life.

Lenders also have an interest in portraying indebted households as being somehow unlucky, else it would suggest that at best their credit risk models were wanting in some way, or at worst that they were knowingly lending to people who could not afford to repay. Perhaps the best way to summarise the situation came from one of our interviewees, who has a long history of working with debt clients:

The seeds of a problem are usually a combination of bad luck, bad judgment, stupidity and greed. These factors transcend social class and income levels. But if you have a low income, it is very hard to get out of it.

Schematic display of over-indebtedness in Britain today

	Failure of business or loss of job ↓	
Ill health →	**MORTGAGE PAYER** Under 35, settling down High unsecured credit Keen to maintain lifestyle	← Household split
Buys credit for short-term purchases →		**TENANT** Low income/unemployed/ill health and/or lone parent Lenient landlord Under 35 No savings Juggles liabilities Prioritises today over tomorrow

Part 2

Tomorrow's borrowers

Tomorrow's borrowers

In part one of this report we established two main ways to characterise the incidence of high levels of debt among households in the UK. The first is dynamic, and considers the relationship between debt and age. The second is static and, based on previous econometric research, highlights the positive correlations between aspects of the government's definition of over-indebtedness and factors such as attitude to risk and being a young adult, a tenant, in a low-income household, a lone parent, unemployed, sick or disabled.

However, it appeared more useful within a static analysis to define over-indebtedness not with reference to a basket of indicators as the government has done, but instead to look at households with negative net financial wealth, as defined by the ONS Wealth and Assets Survey (in other words, households that have more financial debt than savings). When viewed in this way, it is plausible to suggest that over-indebted households fall into one of two cohorts: our "£12,000 debt with some assets" cohort (associated in particular with young couples in possession of decent levels of education who choose to live off credit and then become overextended, partly through a negative external change in circumstances); and the "£2,000 debt with few assets" group (associated more with young, single people either with or without children, who are more likely to be tenants on low wages and less likely to have higher levels of education).

In this section we sketch scenarios of how these broad pictures might be expected to change over the next decade or so, with 2025 as a future reference point. This is far enough away that no inference can be made about the point in the economic cycle; it is long-term underlying trends that we are interested in identifying. We do not, for example, presume that inflation will be anything but its long-term Bank of England reference rate. Yet it is near enough that some official economic and demographic forecasts are available to provide guides to our scenarios, as well as information on market expectations, for example through forward yield curves.

Our focus is on how the various long-run trends that we know are associated with indebtedness are expected to change over the next decade and beyond. We group these into five main policy categories: the economy and public finances; demographic trends including household composition; changes in the labour market; housing market trends; and finally the consumer credit market. For each category we offer some specific policy recommendations that we think could help mitigate the risks of future indebtedness.

Personal debt, demographics and household composition

Over the next few decades, the UK population is expected to grow in size and the average

age to rise. The ONS projects that the proportion of the population aged over 65 will rise from 17% in 2012 to 26% in 2061.[27] This equates to an almost 20% increase in the dependency ratio.[28] It is the knock-on effects of this altered ratio on the healthcare system and public-sector pensions that will put pressure on public finances.

Delving into this in more detail shows that the ONS expects the number of people aged 16-54 to rise by an annual average rate of 0.1%; the number aged 55-64 to rise by an annual average of 0.2%; those aged 65-84 to rise by 0.9% on average each year; and those over 85 to rise by 2.7% each year. This will result in the percentage of people aged between 16 and 64 falling from just over half the total population to nearer 45% over the same time period, even though the absolute number in this group will rise due to the rising overall level of the population.

The effect of demographic change alone on indebtedness is difficult to predict. We know that indebtedness is (inversely) correlated with age, so a higher absolute number of younger people might lead to concerns that indebtedness will rise. Research by the Financial Inclusion Centre, for example, showed that almost three-quarters of people in the 18-24 and 25-39 age groups now have unsecured debts, compared with 60% of the 40-54 age group.[29] However, this effect works in the opposite direction if the figures are looked at as a proportion of the total population.

For the purpose of this analysis, we will consider proportions of the total population as it gives a more accurate picture of the scale of the problem affecting the country as a whole. As a first-order static effect, therefore, the fact that society is ageing will reduce the incidence of indebtedness as a proportion of the population. However, as we shall see at the end of this section, the dynamic effect is far more complex.

Turning to household composition, a more dramatic picture unfolds. The Department for Communities & Local Government publishes 20-year projections on the composition of households; the latest is to 2033.[30] They show that the number of households in the UK is projected to rise from 26 million in 2008 to 30.3 million in 2023 and 32.8 million in 2033.[31] The main driver will be population growth, accounting for nearly three-quarters of the increase in households between 2008 and 2033. Two-thirds of the increase in households

27 As above

28 The dependency ratio is defined as the number of dependents (aged 0-14 and over 65) to the total population (aged 15-64).

29 Financial Inclusion Centre *Debt and the Generations*, Debt and the Family series, report 2 (2011)

30 Department for Communities & Local Government *Household Projections 2008-2033* (November 2010)

31 These figures are based on the DCLG assumptions on migration, which are a little above the "low migration" case presumed by the Office for Budget Responsibility, as noted above. However, the DCLG also shows that the "natural change in the population accounts for over three-fifths of the growth in households" (p9).

will come from increases in one-person households, mainly in the older age groups; by 2033, 19% of the population of England is projected to be living alone, compared with 14% in 2008. Generally, the increase in the number of households where the head of the household is under 35 will be less than the average.

Table 6 shows how the household composition is expected to change by family type in England:

Table 6: Household projections by selected household type, England

(thousands, unless otherwise indicated)	2008	2028	2033	Average annual change, 2008-2033	Total change 2008-2033 (%)
One-person households	7,316	10,517	11,279	159	54%
Couple, no other adults	9,411	10,581	10,792	55	15%
Lone parent	1,688	2,551	2,687	40	59%
All households	**21,731**	**26,472**	**27,563**	**232**	**27%**
Average household size (persons/household)	2.33	2.19	2.16		

Source: Department for Communities & Local Government

The key point to note is that the number of lone-parent households is expected to rise, by around 40,000 households each year on average. This is a faster rate than any other household type, meaning that by 2033, lone-parent households will make up 9.8% of all households, compared with 7.8% in 2008. In absolute terms, however, this increase is dwarfed by the massive increase in (mainly older) one-person households.

In keeping with this overall trend, while the number of households in England with dependent children will increase (by around 31,000 households per year), the number of households with no children will rise much faster (by over 200,000 households each year). By 2033, 75.8% of households will have no dependent children, compared with 72.8% in 2008. However, it should be noted that the absolute number of households with dependent children will increase from 5.9 million to 6.7 million over the same time period.

It seems reasonable to presume that the above projected trends in household composition will change the relationship between debt and asset accumulation, especially for the "£2,000 debt with few assets" group. Older people, and more single older people, on lower incomes are likely to be trapped in problem debt. Many of the "£12,000 debt with some assets" group are also likely to struggle if they are unable to increase their incomes. A growing number of older homeowners could also find themselves asset-rich but income-poor.

Some of the key policy challenges emerging from these trends are as follows:

- People approaching state pension age in 2025 might need to work longer to address their outstanding credit liabilities. However, Age UK recently reported finding an association between self-employment and moving into problem debt.[32] It will not always be best for older people to work their way out of debt problems. The government can help by continuing to guarantee that the state pension will provide the basis for an adequate retirement income for tomorrow's pensioners. But the government, the credit industry and debt advice groups will also need to work together now to ensure the right support is there to help older people manage their debts in future.

- The Financial Conduct Authority's recent report on interest-only mortgages found that 40,000 households aged 65 and over will see their interest-only mortgage mature between 2017 and 2032. Half of these households will have a shortfall of more than £50,000.[33] Many of these older homeowners will need support to find the right solution for them. It will be important for mortgage lenders to show forbearance and flexibility to allow people who can meet their mortgage payments to stay in their current home where possible and where this is what they want. We urge the Financial Conduct Authority to ensure firms treat these consumers with the utmost fairness. Furthermore, we agree with Age UK that lenders should not allow blanket age limits on lending to get in the way of a fair solution.

- For some borrowers an alternative product like equity release might be a good

32 *Problem Debt among Older People*, Age UK's summary of research by the International Longevity Centre – UK (Age UK, 2013)
33 Ibid

solution. We urge the government and the FCA to play close attention to the equity release market to ensure the right range of advice and product providers and the right standards of business conduct necessary to ensure a fair and competitive market.

- Making work pay is particularly applicable to single parents, many of whom will need support to overcome barriers (such as childcare costs) to secure employment that pays a living wage. However, policy here seems to be currently moving in the wrong direction in terms of reducing vulnerability to debt. Recent figures released by the Department for Work & Pensions on households facing the benefits cap in four London boroughs showed that 74% of households affected were single parents with child dependents.[34] The government should review this policy to ensure that welfare reform does not deliver a negative impact to single parents that could trigger households falling into unmanageable debt.

Personal debt, the economy and public finances

Britain will get richer as a nation over the next two decades. Notwithstanding the usual ups and downs of the business cycle, the trend real rate of GDP growth is expected to be between 2.3% and 2.4% from now to 2025 (and beyond), consistent with annual productivity increases of 2.2% on an output-per-worker basis, which is in line with the average of the last 50 years.[35]

The question for our analysis is whether this will lead to greater levels of indebtedness. If the growth in prosperity were expected to lead to greater redistribution to low-wage workers (perhaps through tax credits and other transfers), or to the young in general, that would point to lower levels of indebtedness. However, the opposite is more likely to be true. For while the economy is forecast to grow, the pressure on public finances is expected to grow faster. Indeed, the Office for Budget Responsibility predicts that the public finances will be unsustainable without further tightening before the end of our forecast period. Its most recent fiscal sustainability report states:

Under our central projections, the government would need to increase taxes and/or cut spending permanently by around 2.6% of GDP from 2017-18 onwards to satisfy the inter-temporal budget constraint [ability to meet future obligations].[36]

34 *Benefit Cap – Number of Households Capped across Phased Area Local Authorities Data to June 2013* (DWP, August 2013)
35 OBR *Fiscal Sustainability Report* (July 2012), central forecast. Presumes "low" net levels of inward migration, consistent with current direction of policy, of around 140,000 people per year.
36 As above

We do not envisage therefore that (on current trends and without major policy change) there will be additional resources available to meet the needs of those in financial difficulty from the growth in national prosperity. Rather, there is every indication, given the exponential growth in demand for healthcare and other public services, that there will be further fiscal tightening. At the same time we are unlikely to see any sudden shift in intergenerational transfers of private wealth. Partly as a result of escalating property prices, the over-60s now own around half of all assets in the UK, compared with 14% for the under 40s, and 31% for the under 50s.[37]

On the other hand, the very fact that economies grow means that there will remain opportunities for those able to take advantage of them. A change in the rate of savings as a result of sustained growth and higher (as well as better-paid) employment would certainly help those vulnerable to indebtedness. However, talk of a new "savings culture" seems somewhat detached from the reality of many people on low incomes. DWP figures currently show that 67% of people of working age with no savings are in poverty (defined as on incomes below 60% of the median). That figure is likely to increase rather than decrease.

Regulators are aware of the demographic pressures on the public purse. They are also seeking to take on board the lessons learned from the financial crisis of 2007-08 to build considerations of systemic financial risk into the policy-making process. This has a clear spill-over to household financial risk. For example, the sharp fall in output and rise in unemployment through 2008-09 produced a huge surge in the already high number of people contacting debt advice agencies for help.

The government and financial sector regulators need to ensure that the UK does not see a return to unsustainable growth in mortgage and consumer credit followed by a sharp contraction leaving exposed borrowers high and dry. However, it is worth pointing out that while preventing and dampening economic shocks will help protect households from acute debt problems, economic growth will not by itself reduce the risk of problem debt. For instance, in the 21 quarters of continuous growth spanning Q1 2000 to Q1 2008, personal insolvencies in England and Wales increased threefold.

The challenge for government is to ensure that the benefits of growth reach those households most vulnerable to debt, particularly low-income households. Steps towards this might include:

37 See work by the University of Nottingham's Centre for Policy Evaluation on drivers of indebtedness

- adopting a minimum income standard (such as that published by the Joseph Rowntree Foundation[38]) as an official measure alongside poverty measures, setting a target for at least working households to achieve this standard and reporting annually on progress;
- helping households benefit from growth by ensuring essential goods and services such as utilities are affordable for all;
- maximising the longer-term legacy of growth by encouraging households on low and middle incomes to save. The government should build on the work of the Sergeant review on transparent savings products by incentivising saving for particular life events and by reintroducing Savings Gateway type scheme[39] matched accounts for low-income/low-asset households, whereby government matches a proportion of an individual's savings;[40] and
- ensuring that central and local government are good creditors, operating to similar standards of conduct in collections and enforcement activity as those expected of private-sector credit businesses.

Fiscal tightening and welfare reform and retrenchment may leave some of the poorest and most debt-vulnerable households falling further behind as the economy return to trend growth. The government needs to plan now to prevent this, not least considering how scarce public resources might be better retargeted at households at most risk of financial difficulty. It will also become more important to ensure that individuals and families take up the benefits they are entitled to, especially during the phased introduction of universal credit in 2013-17.

Personal debt and the labour market

There are several different ways in which projected future changes in the labour market might be expected to influence future levels of indebtedness. On the aggregate level, the story looks broadly positive: the underlying long-run unemployment rate is projected to fall over the forecast period to a long-run trend of 5.4%, compared with the current rate of around 7.5%.[41] However, under the surface are other developments that are less positive. To unpack them it is easiest to consider our two debt cohorts separately.

38 The Joseph Rowntree Foundation publishes annual updates of its minimum income standard for the UK, to reflect changes in costs and living standards. The standard is based on asking members of the public to identify the items and services a household would require to reach a minimum acceptable standard of living, covering essential needs and allowing household members to participate in society.
39 The Savings Gateway was abolished in June 2010. It was a scheme whereby the government would pay a "match" equal to some proportion of an amount an individual has saved. The scheme was targeted at those on low incomes who struggle to save.
40 The 2013 Sergeant review of simple financial products made seven recommendations on helping consumers navigate the financial marketplace.
41 Office for Budget Responsibility's NAIRU long-term unemployment rate

As discussed in part one of this report, households in the "£2,000 debt with few assets" group are associated with lower skill and pay levels and are more likely than average to be lone parents and/or unemployed. To this end, the projected rolling out of government policy to shift lone parents from income support to job seeker's allowance would be expected to raise employment levels and so open up the prospect of higher levels of income for part of this cohort. However, lone parents who are out of work are only a small proportion of this total group. Over the longer term, this group is likely to suffer from the increased stratification of pay in the UK, with the pay of lower-skilled workers diverging increasingly from that of professional socioeconomic groups.

Data from the Annual Survey of Hours and Earnings shows that in the last 30 years the average annual pay rise for the lowest-paid 10% of employees has been 0.3% after inflation, and for the bottom 50% it has been 0.9%. Macroeconomic productivity increases across the economy as a whole have had far more of an effect on pay at the top than on pay at the bottom of the distribution. Analysis by the Resolution Foundation suggests a decoupling in the early 1990s of median wages from productivity increases.[42] This in part explains the widening of wage inequality and the growth in prevalence of low pay. According to the TUC, the UK now has the second-highest prevalence of low pay among leading economies (21% of all employees on pay below two-thirds of the median), behind only the US.[43] Official data compiled by the Poverty Site shows that around 3.5 million employees aged over 22 were paid less than £7 per hour in 2010, and two-thirds of these were women. At all ages, at least 30% of part-time employees were paid less than £7 per hour in 2010.

Since the financial crisis, the percentage of those paid less than the living wage has increased.[44] The number of people earning below the living wage (as opposed to being low-paid), for example, rose from 3.4 million in 2009 to 4.8 million in 2012.[45] On current trends there is no reason to expect any convergence between the wage levels of the low-paid and high-paid sections of the economy, nor that the ever-rising increase in productivity on aggregate will have any kind of automatic link to the income of the lower-paid.

42 *Gaining from Growth: The Final Report of the Commission on Living Standards Resolution Foundation* (2012); Pessoa, JP and van Reenen, J *Decoupling of Wage Growth and Productivity Growth: Myth and Reality* (Resolution Foundation, 2012)
43 TUC *How to Boost the Wage Share* (2013)
44 As of October 2013, the living wage was £8.55 in London and £7.45 for the rest of the UK.
45 Whittaker, M and Hurrell, A *Low Pay Britain 2013* (Resolution Foundation, 2012)

Table 7: Population below living wage, by age

	Number below living wage	% in group below living wage	% this group accounts for of those below living wage
16-20	947,000	77%	20%
21-25	851,000	37%	18%
26-30	474,000	17%	10%
31-35	347,000	13%	7%
36-40	347,000	12%	7%
41-45	417,000	13%	9%
46-50	430,000	13%	9%
51-55	365,000	14%	8%
56-60	293,000	15%	6%
61-65	193,000	19%	4%
66+	122,000	32%	3%

Source: Whittaker, M and Hurrell, A *Low Pay Britain 2013* (Resolution Foundation, 2012)

However, there could be a reduction in the number of low-paid workers as a consequence of a return to near-full employment, an extension of collective bargaining and continued real increases in the national minimum wage. According to recent Smith Institute studies on low pay, levels of income inequality and in-work poverty were considerably lower in the post-war period as a result of full employment, the development of a redistributive welfare state, and institutions in the labour market that achieved a reasonably fair initial distribution of incomes (what is now called "pre-distribution").

Although much of what happens in the world of work is beyond the reach of the state, the evidence suggests:

Government can affect the initial distribution of market incomes through statutory minimum wages, "fair wages" policies in procurement, and the statutory extension of collective agreements.[46]

46 *Just Desserts?* (Smith Institute, 2013)

Wider adoption of the living wage could also make a difference. However, it will take time to scale up the living wage, which currently covers only around 50,000-70,000 low-paid employees. Women, who account for 62% of all non-living-wage employees[47] (and many of whom work part-time), are likely to be the main beneficiaries.

According to the Living Wage Foundation, if all employees were paid the living wage then the average net benefit (after tax and benefits) to households with one member or more previously paid below the living wage would be around £850 a year. The cash gains of such a move would be fairly evenly distributed across the income scale. However, in proportional terms those at the bottom would gain most (especially those not claiming or entitled to benefits), with those affected in the bottom 10% of households seeing a 7% increase in their disposable income. It is, however, worth noting again that there are *fewer* households containing someone earning below the living wage at the bottom than in the middle of the income distribution.

The persistence of a low-wage economy is bad news for people who turn to credit in order to make ends meet. StepChange Debt Charity data shows that a rising number of people resort to unsecured credit to fill the gap between declining incomes and the rising cost of living.[48] According to KPMG's "Financial Well-being Barometer" (a composite indicator designed to give a single-figure snapshot of households' financial health) people earning below the living wage continue to experience a rise in their debt levels. Its survey data indicated that people earning below the living wage fared worse than those on or above this hourly pay threshold in terms of overall financial well-being.[49]

It is worth noting, however, that while the phenomenon of a wide gap between high-productivity, high-wage jobs and low-productivity, low-wage jobs may be a permanent feature of modern economies, that is a different thing from saying that the individuals who experience low wages at some stage in their life are not able to access higher wages at other stages. Furthermore, it is by no means inevitable that wage growth will remain flat and that the numbers of low-paid workers will increase. Government policies to assist the low-paid and a shift in bargaining power over incomes could boost earnings. According to the IMF's commentary on the US economy:

47 According to the Resolution Foundation (*Low Pay Britain*), around 3 million women are paid below the living wage.
48 Ibid, p2
49 *Current Trends in Household Finances and Structural Analysis of Hourly Wages*, living wage research for KPMG (2012)

Without the prospect of a recovery in the incomes of poor and middle income households over a reasonable time horizon, the inevitable result is that loans keep growing, and therefore so does leverage and the probability of a major crisis… restoration of poor and middle income households' bargaining power can be very effective, leading to the prospect of a sustained reduction in leverage that should reduce the probability of a further (financial) crisis.[50]

One of the striking aspects of the analysis undertaken by the Resolution Foundation is the dynamic nature of low-pay Britain. Of the 10 million adults (supporting 5 million children) who earn below median income but are not dependent on benefits, only 1 million have been in that category for each of the last 15 years. In any one year, around a third of people leave the group, and two-thirds of these move up the income scale. People who move down are more likely to have children, to lack a job or to be a carer. Those who move up are more likely to have a degree, a job and no children, and to own property. Over a four-year period, around half of all working-age people would find themselves in this group (earning below median income but not dependent on benefits) for at least a year. This dynamism shows that it can be normal to exit the so-called "squeezed" part of Britain and that targeted interventions at vulnerable times can make a big difference to outcomes. It may be inevitable that there is greater stratification of the labour market, but not that an individual should be stuck at a low level.

Our analysis of the "£12,000 debt with some assets" group in the previous section suggests a connection between indebtedness and a change to an individual's labour market position, either because they were already highly geared and then experienced a loss of income, or because they lost their job and used credit to maintain their standard of living.

There are several emerging labour market trends that would seem to make the risks of indebtedness higher for this group. Anecdotally, our interviews suggested that the labour market is becoming more insecure, with greater risks of redundancy (and so of a shock causing debt levels to rise), increasing numbers of self-employed, part-time and agency workers, and the rise of zero-hours contracts (whereby no minimum hours are guaranteed and only actual hours worked are paid). A shift away from public-sector towards private-sector employment is also reducing job security. All these trends can be expected to increase the incidence of labour market "shocks" on a household and so either the crystallisation of high gearing into a debt problem, or increased borrowing to maintain a previous lifestyle.

50 Kumhof, M and Ranciere, R *Inequality, Leverage and Crises*, IMF working paper (2010)

However, despite the perceptions of job insecurity in the labour market, there is little in the data to suggest a marked change in actual job security. Of course, there were job losses in the recession, starting in the private sector and later in the public sector. That was coupled with a rise in involuntary part-time working, self-employment and workers taking second-preference jobs. Yet despite an underlying sense that people no longer have "a job for life" the length of job tenure across the economy as a whole has not shown a clear trend. Indeed, according to the official Labour Force Survey the annual level of redundancies is the same today as it was between 1994 and 2007. So while it remains the case that individuals who lose their jobs risk their financial position becoming precarious, particularly if they already have high levels of debt, across the economy as a whole there is little to suggest that there will be more involuntary churn in the labour market than would be expected from cyclical effects – at least over the short to medium term.

A longer-term trend towards greater self-employment would suggest an increase in vulnerability to over-indebtedness; data from StepChange Debt Charity in 2013 showed that self-employed clients owed £10,000 more in unsecured debt than the average for charity clients; and that the self-employed had an average debt load of 18.6 times their annual income, compared with clients in part-time or full-time employment who had an average debt load of 4.1 times their annual earnings. There is also significant anecdotal evidence of a link between self-employment status and/or very small businesses and high levels of indebtedness, due to a blurring in the eyes of the individual between business and personal finance, which was supported by our expert interviews.

There is broad agreement among debt experts that work should be the best route out of poverty. Work should also protect households against the risk of unmanageable debt. But both these aims presuppose that tomorrow's borrowers (young and old) will be able to get work that delivers an adequate, predictable and secure income. It also assumes that that government will take stronger action to tackle low pay and job insecurity, as well as improving the pathways from lower-skilled occupations through to higher-skilled ones.

Even if we return to near-full employment and these improvements to the labour market happen, tomorrow's borrowers will need help to avoid debt problems. One possible way forward (especially for the "£12,000 debt with some assets" cohort, and for the growing numbers of self-employed) would be to extend affordable income and employment protection insurance. Indeed, our analysis of future trends in the labour market indicates a greater role for insurance and rainy-day provision, given that income shocks due to unpredicted life events are key triggers for unmanageable debt problems. However, the structure of the market at the moment is such that individual insurance policies against these risks can be prohibitively expensive, especially for those on low incomes.[51] As such, we recommend that the government should:

- work with the financial services to help make such income/employment insurance products more affordable, especially to those on low to middle incomes;
- make sure that those taking out insurance are not penalised by the benefits system;
- provide more debt advice and support to the growing numbers of low-income self-employed; and
- seek to make contributory benefits a more effective safety net for working households.

One of the main changes affecting many young people entering tomorrow's labour market will be the increasing penetration of student loan debt. Effectively servicing the debt and paying it down will obviously depend on a person's lifetime earnings. However, for some of tomorrow's borrowers (especially the "£12,000 debt with some assets" group) it may become a real burden. For example, an ex-student in work who borrowed £27,000 is estimated to have to pay back £71,000 over 25 years; whereas the same student on a starting salary of £50,000 a year will pay back £41,000 over seven-and-a-half years.

Although these debts do not have to be paid back when the individual is not in work, increasing levels of student debt may have two other negative effects. The first is that when the individual is in work, student loan repayments can reduce disposable incomes so making credit more attractive. The second negative effect – borne out by our qualitative interviews – is that young people starting with an already high level of student debt may feel that the addition of another few thousand pounds of high-interest, unsecured credit will make little difference to their overall financial picture. If this is indeed the prevailing response, the effect on consumer debt will be large: by the early 2030s, the stock of student loans will be around 6% of total GDP.[52]

This is an area that arguably lends itself to policy intervention, not least if many of

51 Unemployment insurance conditions vary a lot and the industry has been accused by the media of mis-selling policies to those on low incomes.
52 OBR *Fiscal Sustainability Report* (July 2012)

tomorrow's borrowers struggle to pay the loans back in later life (according to IPPR's new "commission on the future of higher education", around 40% of student loans will be written off because students will not earn enough to pay the money back). While such issues are outside the main scope of this report, the government has the option of course of reducing the cap on tuition fees or reforming the student loans system – which is forecast to total more than £120 billion by 2025 in outstanding debt.[53]

Personal debt and the housing market

There are several different ways in which anticipated changes in the housing market might be expected to affect the overall picture on indebtedness. Current mortgage holders will be affected by future changes in interest rates. Future households will be affected by broad underlying changes in the tenure structure, and by the attitude of the new Financial Policy Committee of the Bank of England towards future mortgage lending. The overall picture of asset distribution is also affected to a very large degree by the variation in house prices in different parts of the country.

Starting with interest rates, it is presumed that the average long-term mortgage rate in the medium term will be higher than at present, and that it will rise in line with Bank of England base rates as the economy recovers. However, the gap between residential mortgage rates and the Bank of England base rate will probably narrow, simply because it is wide at the moment. That is to say, mortgage rates will rise alongside Bank of England rates, but not as fast. At the time of writing, the financial market yield curves seem to be expecting that nominal base rates will rise to about 4% by around 2025, although inflation expectations are such that this is still only around 0.5% in real terms (as compared with minus 2% in real terms today).[54]

Base rates are expected to begin rising in the second half of 2014. However, these short-to-medium-term forecasts have been consistently pushed out over the last few years as expectations of GDP recovery have changed. All we can really say with certainty for the purpose of our analysis is that the rise in base rates will happen, simply because they are so unusually low at the moment.

The question is what the effect will be on the financial position of mortgage holders. All else being equal, there will certainly be a negative effect, almost by definition. But all else is not equal, as interest rates will rise only if policy makers believe it is necessary to curb inflationary expectations, which in turn are positively linked to lower unemployment, higher GDP, higher household incomes and greater across-the-board

53 DBIS estimate in 2011

54 http://www.bankofengland.co.uk/statistics/pages/yieldcurve/default.aspx

confidence. If markets worked perfectly then higher interest rates over the longer term would have little effect on overall debt; rather they would simply flatten a growing demand for credit that came from a more ebullient economy.

In the shorter term, however, most forecasters presume that interest rates are now so low against historic trends that they will start to rise before real incomes do. The latest forecasts commissioned by the Department for Communities & Local Government, which presumed that interest rates would start to rise in the third quarter of 2013, showed that this would lead to a 3.5% increase in the six-month-arrears rate and a 10.6% increase in the number of repossessions by the end of 2013, compared with 2011.[55] However, this was dependent on unemployment falling more slowly and interest rates rising more quickly than now appears likely. Even if there is a spike in mortgage arrears and repossessions at some point in the next five years, as interest rates revert to more normal levels while wages increase sluggishly, that alone does not enable us to make much in the way of longer-term predictions.

There is also the added concern over the 1.5 million interest-only mortgages (worth £120 billion) scheduled to expire before 2020. According to the Financial Services Authority, a growing number of interest-only mortgagees (around 320,000) risk losing their property because they are struggling to meet the payments. Many more could face financial problems if current levels of forbearance weaken. Martin Wheatley, chief executive of the new Financial Conduct Authority, commented that these mortgages were "a ticking time-bomb".[56]

More relevant to our 2025 scenario is the attitude of the regulators towards the availability of mortgage credit in future. Given that a major cause of the most recent financial crisis was lending to people who could not afford repayment, we presume that increased capital controls, lower loan-to-value ratios, and an improved understanding of the systemic dangers of asset price bubbles are all here to stay. For the foreseeable future there will be a macro-prudential regulatory environment that will not be conducive to massive owner-occupier expansion. Rather, lending institutions will be required to hold higher capital against their lending than has previously been the case; gearing ratios will remain low by historical standards, and borrowers will have to provide higher deposits than was the case before the financial crisis.

Ironically, therefore, although the intention behind curbing mortgage credit is to prevent a systemic build-up of housing debt in the financial system, a side effect will

55 Aron, J and Muellbauer, J *New Forecast Scenarios for UK Mortgage Arrears and Possessions* (DCLG, August 2012)
56 Mail online, April 2012

be greater consumer indebtedness over time due to the inability of households to build housing assets.

The widening ratio[57] of earnings to house prices will certainly make it harder to get on the housing ladder if you are young, have insecure work, or are on a lower income, and particularly so in London and the South East, where competition for the available housing stock is particularly high. Indeed, there is nothing to suggest that the north-south divide in house prices will ease: the ONS projections of changes to household formation referred to in the demographics section above show that some of the largest increases in the number of households will be in the South East and London.

Putting all this together, it is plausible to suggest that the level of home ownership has peaked. In fact, as the table below shows, the high point was in 2003. Over the past 10 years the effect of falling real wages and escalating house prices has been to reduce the ability of people to purchase homes. The trend has been for the over-50s (the majority of whom own their homes outright) to use their property as a pension. With fewer homeowners, the next generation will be in a less beneficial position. As Andrew Heywood, the Smith Institute's housing expert, commented:

High and rising levels of owner-occupation are an assumption embedded in policies across the spectrum of government activity. If levels are to continue to fall, government must examine the implications for the economy in terms of investment and consumer spending. Welfare provision has been increasingly predicated on assumptions about the ability of individual households to fund life's contingencies, their service provision and care from their own resources. In practice this has involved drawing on housing equity. If home ownership levels continue to fall, then many of those on lower or less secure incomes will be increasingly reliant on the state to provide that support. This calls into question the moves in the direction of asset-based welfare of the past 30 years.[58]

In future, cautious lending policies combined with lack of supply will continue this trend. At the same time, social renting is also in decline, primarily because of lack of investment in sub-market homes. Taking up the slack is the private rented sector, which is the most expensive for the household over its lifecycle because the rent is at market rates and continues to be paid into older age when other households might

57 According to the ONS Annual Survey of Hours and Earnings, the ratio of median house prices to median earnings has risen for England as a whole from 3.5 in 1997 to 6.7 in 2012, and for London over the same period from 4 to 8.5.
58 Heywood, A *The End of the Affair* (Smith Institute, 2011)

expect to have paid off their mortgages.[59]

Nevertheless, the private rented sector will continue to attract more people into it: from young professionals unable to raise sufficient deposit to buy a home, through to new migrants and people with low assets unable to access social housing. Recent surveys suggest that half the adults in the UK aged under 35 live in a home they don't own and that this trend is likely to continue as younger people's attitude to renting versus home ownership changes.[60]

Table 8: Changing tenures in the UK, 1999-2012
All households (%)

	Owner-occupiers	Social renters	Private renters	All tenures
1999	69.9	20.2	9.9	100.0
2000	70.6	19.5	10.0	100.0
2001	70.4	19.5	10.1	100.0
2002	70.5	19.2	10.3	100.0
2003	70.9	18.3	10.8	100.0
2004	70.7	18.3	11.0	100.0
2005	70.7	17.7	11.7	100.0
2006	70.1	17.7	12.2	100.0
2007	69.6	17.7	12.7	100.0
2008	68.3	17.7	13.9	100.0
2008/09	67.9	17.8	14.2	100.0
2009/10	67.4	17.0	15.6	100.0
2010/11	66.0	17.5	16.5	100.0
2011/12	65.3	17.3	17.4	100.0

Source: Communities and Local Government Select Committee *The Private Rented Sector* (2013)

59 According to House of Commons data (from the Communities and Local Government Select Committee), the private rented sector in 2011/12 accounted for 17.4% of English households, compared with 9.9% in 1999. It now accounts for slightly more homes (3.8 million) than the social rented sector, although significantly less than home ownership (14.4 million).
60 See LV survey as reported in "Generation OK to Rent" on PR Newswire, 13 September 2013

Overall we consider it plausible to presume that home-ownership levels might fall to below 60% by 2025 (down from 65% now) and that the private rented sector might easily account for well over 20% of homes by 2020, with levels of housing association and local authority owned properties remaining steady or slowly declining.[61]

Without growth in supply and constraints on market rents, private renters in high-demand areas are likely to face higher rents, and therefore will arguably find it harder to accumulate wealth; psychologically the prospect of building an asset will feel increasingly remote. Given the known connection between being a tenant and having high levels of indebtedness, particularly among low-income earners, it seems plausible to presume that these housing market pressures will increase the risk of households getting into high levels of debt. Indeed, the trend among those presenting debt problems is that people in the private rented sector are likely to have much higher unsecured debts than those in the social sector, probably because of higher rental costs.[62] According to Shelter, non-refundable lettings agents' charges and associated costs are also a factor in forcing renters into debt.

That said, the projected increase in reliance on the private rented sector might lead to tighter budget constraints as tenants judge their risks of eviction to be greater than if their landlord were a local authority or housing association. This might lead to less financial risk taking, or to greater upheaval as tenants increasingly vanish to avoid being pursued for arrears by private landlords. The low levels of insurance protection to cover rents in case of emergency among those privately renting may also increase the risk of indebtedness.

What is unclear at the moment is whether the government's recent initiatives to provide a guarantee in place of a deposit for home buyers will significantly increase access to the housing market. To the extent that it does, it could be that the self-identification of a household as owning its own home (albeit with help) could cause a positive change in attitude towards saving and borrowing that makes the household more financially resilient. Conversely, given that the households helped into home ownership by the government deposit guarantee will be the marginal ones to which lenders would not otherwise have extended credit, they are likely to have few savings and so the addition of mortgage debt to their commitments may make them more precarious in the face of external shocks. Alternatively, they may falsely aspire to a homeowner-type lifestyle by borrowing even when they cannot really afford it. This of course could change dramatically if the UK experienced a sub-prime mortgage crisis.

61 Forecasts consistent with Smith Institute analysis in *The End of the Affair* (2011) and DCLG data
62 Ibid, p16

Overall it is too early to explore these causalities, and given that the magnitude of all government interventions in the household mortgage market is small (around £5 billion) compared with the overall stock of mortgages (around £1.2 trillion), and that these interventions are temporary, it seems sensible for now to presume there will be little overall effect in either direction on levels of over-indebtedness from the initiatives announced in 2013.

We believe that changes to the housing market up to 2025 seem likely to increase the risk that more households (notably in the private rented sector) will experience problem debt. There are three key elements to this: affordability, sustainability and the additional debt vulnerability of tenants as opposed to homeowners. The main policy challenges will be as follows:

- It will be imperative to ensure an adequate supply of affordable housing (of suitable size and quality), especially in high-demand areas.

- Current government policy aims to increase access to home ownership for households that would be described in this report as being in the "£12,000 debt with some assets" group. This is taking place in a historically low-income environment that stretches affordability at a time when house prices remain high relative to incomes in many (if not most) high-demand areas. There is a clear danger that households may face a mortgage affordability crisis when rates start to rise, which will also have a negative impact on their ability to service consumer credit repayments. According to the Centre for Economic & Business Research, if interest rates return to the long-run average, 67% of home-owning households paying unsecured creditors through a debt management plan would no longer be able to do so.[63] The government needs to plan for this eventuality now as a counterbalance to subsidising access to mortgage finance for first-time buyers.

- Policy makers need to consider how best to incentivise the development of other routes into home ownership that are likely to work well for lower-income households (like shared ownership or home-purchase plans that could have a different risk profile over time from traditional mortgage finance).

- We also urge policy makers to consider options for reforming the private rented sector so that this offers tenants greater security of tenure and more control over the manner and amount of rent increases.

63 StepChange Debt Charity *Consumer Debt and Money Report Q2 2012* (2012)

- Government, housing providers and energy companies need to do more to tackle fuel poverty, which could become more critical for tomorrow's borrowers if energy bills continue to rise at rates well above inflation.[64]

Both homeowners and tenants face on-going problems with sustaining housing payments. In particular, StepChange Debt Charity reports an increase in households struggling with rent arrears in both the private and social rented sectors. We believe policy makers could do more to ensure safety nets are effective in helping households sustain housing payments. For instance:

- The government must ensure that direct payment of universal credit housing payments to tenants and of monthly benefit payments does not increase the debt vulnerability of low-income households or increase the use of high-cost credit to make ends meet.

- The government should reform the "bedroom tax" if it is creating rent arrears and personal debt problems.

- The government should reconsider the universal credit rules that exclude homeowners in paid work from receiving help with mortgage interest payments.

Personal debt and the consumer credit market

Across the economy as a whole, consumers have outstanding debts (excluding mortgages and student loans) of around £158 billion, according to the latest data from the Bank of England.[65] The bulk of this – around two-thirds – is lent by deposit-taking organisations such as banks, of which only around 3% are mutual organisations. The remainder is lent by "other consumer lenders", which include payday lenders and other specialist finance providers. Around 35% of the debt is owed on credit cards.

Two immediate trends are discernible. The first is how levels of consumer debt have reacted to the recent economic cycle; namely that people have been paying off debt since the credit crisis struck. The second is the extent to which, within this, bank debt has fallen faster than other consumer lending, implying a degree of substitution for bank lending by other forms of borrowing in recent years. Given that bank lending tends to be cheaper than other borrowing, this would imply that consumers are finding it easier to turn to other sources of credit. This fits with calculations by the Office of

64 According to a uSwitch survey in 2013, energy prices have risen by around two-thirds in the past five years. As a result, the number of families in debt to their energy supplier has risen to around one in five households.
65 Bank of England Bankstats table A5.6, consumer credit excluding student loans, seasonally adjusted.

Fair Trading that the value of payday loans rose from £900 million in 2008 to over £2 billion three years later.[66]

Recent research by Ipsos MORI for the DBIS showed that most borrowers used payday loans to meet an urgent household need of some description. Only a small minority used payday loans to fund non-necessary expenses, such as holidays.

Generally, participants who had taken out a payday loan typically reported that doing so was a "last resort"; they had done so because they lacked other viable credit options, and because their need for the money was immediate and critical at the time of taking out the loan. Those who were able to access alternative sources of finance – and, crucially, felt comfortable in doing so – were less likely to take out payday loans. Friends and families were the most important source of alternative credit across all types of people interviewed. Most participants who had taken out a payday loan felt that loans from high-street banks were unsuitable for their needs due to bank loans being longer-term or more difficult to obtain than payday lending.[67]

However, it is worth noting that payday loans still only account for less than 2% of total consumer borrowing[68] – this compares with credit cards, which currently account for around 23% of consumer credit, and hire purchase at 14.5%. It is worth noting, though, that although payday loans are still a small part of the consumer credit market they are highly concentrated among the younger age group (according to the Consumer Finance Association's research, 74% of payday loan borrowers are under 44 years old).

Little in the way of consensus exists about how the consumer credit market will evolve in the future. However, during the course of our qualitative expert interviews, a few broad trends emerged that are relevant to our discussion.

First, it seems plausible to presume that high-street banks will make every effort to withdraw from the higher-risk end of the consumer credit market. They will focus their efforts on existing current-account customers where they know, from the data they have, that the risk is low. This is partly due to their on-going need to de-risk their balance sheets and partly because they can earn sufficient return on capital from their core businesses working with higher-value retail customers not to need to diversify into higher-risk areas.

66 OFT press release, 6 March 2013
67 Ipsos MORI *Making Consumer Market Fairer* (DBIS, October 2013)
68 According to the Competition Commission (*Payday Lending Market Investigation*, 2013), UK gross lending (excluding student loans) was £176.2 billion in 2011/12, of which £2.2 billion was new payday loans.

Second, we presume that internet lending will increase. At present, available products take a variety of different forms. The first, typified by new, high-profile entrant Wonga, gives online consumers the ability to choose (within limits) how much they want to borrow over a relatively short period at an agreed cost. This cost is transparent and equivalent to a high (and in some case extremely high) annualised rate, although the term of the agreement is typically a small number of weeks. Individuals can build firm-specific credit ratings that can be used to inform future lending decisions by the company; most of the decision making is based on an algorithm.

Another variant, typified by payday loans which are also available on the high street, gives consumers the ability to borrow a given sum for a defined period at a fixed fee, often requiring proof of income or perhaps proof that the individual has a mortgage. That loan can then be rolled over for a longer period of time for an increase in the fee. A recent study by the Office of Fair Trading showed that some business models in this category positively rely on individuals' inability to pay back the initial capital; although only 10% of loans are rolled over more than once, interest payments from these roll-overs account for 35% of the sector's revenue. Moreover, despite an industry code that emphasises the importance of not lending to those who cannot afford it, the OFT also found that only around one in five lenders consider affordability when a loan is rolled over or refinanced.[69] Another, and growing, form of online lending is finance for a defined e-purchase, giving the ability to spread payments over an extended period of time. With internet shopping growing fast, the availability of such financing deals will become more transparent to consumers.

Note that the increase in online shopping via credit card will not of itself lead to greater credit card debt – in the last four years, for example, while online credit card usage grew, the proportion of purchases that attracted interest fell.[70] Rather it is the availability of credit online that will raise volumes – it will just be really easy to do it.

The presumption that online credit will increase is already causing lower-cost lenders such as credit unions to consider entering the market. However, it remains to be seen if they can offer more prudent products with a business model that is sustainable.[71] The credit union sector has continued to grow since it took hold in the UK some 25 years ago, although it has nothing like the scale of operation seen in the US.[72] There

69 OFT compliance review published 6 March 2013
70 British Bankers Association
71 With government support under the Credit Union Expansion Project, the Association of British Credit Unions is aiming to increase total membership from 1.5 million to 2.5 million by 2018.
72 The membership of credit unions in the UK constitutes less than 2% of the population, compared with about 70% in Ireland and 43% in the US and Canada.

is pressure (and government support) to scale up the sector, but the development of a more professional service with a much wider coverage will take time. A rise in the interest-rate ceiling for credit union loans from 2% to 3% on the reducing balance is expected to help, not least in reducing losses made on small loans. However, many credit unions are wary of growing too fast and being portrayed as a direct substitute for payday lenders.

In order for credit unions to offer a viable alternative to home credit and payday loans they need experienced paid staff (not volunteers); acceptance that administrative and credit control costs will be much higher and that bad debt rates will increase. Currently, the increased costs and professional expertise needed for credit unions to compete with the home credit model are too high. There is no possibility of matching 30 day pay day loans for a 3% interest charge increase despite the fact that they remain exempt from much of the regulations applied to commercial short-term lenders.[73]

According to research by Consumer Focus, a third of consumers (and 40% of those on low incomes) would be interested in joining a credit union, but 70% say they cannot because they do not think there is one nearby. Consumer Focus suggests offering credit union services for low-income households through the Post Office network:

Low income consumers trust and value the Post Office network, but they very often do not feel comfortable and may be unwilling to use High Street banks for transactional accounts, savings products or loans. Our research suggests that a partnership between credit unions and the Post Office would not only help to secure widespread coverage for credit unions, it may also offer them a significant commercial and development opportunity.[74]

The third broad trend that we have identified in the consumer credit market relates to the regulatory attitude towards payday lending. Although at the time of writing, the regulatory journey had not reached its destination, the publication by the OFT in March 2013 of its review of compliance by the payday lending industry, accompanied soon afterwards by revocation of the licences of a small number of individual firms, signalled its intention to get tough. In October 2013 a DBIS survey on payday loans concluded:

... there is still a long way to go in the lenders' treatment of customers in financial difficulty. Lenders themselves reported that less than a third had any specific policies

73 Consumer Finance Association response to *HMT Consultation on Credit Union Maximum Interest Rate Cap* (2013)
74 Consumer Focus *Credit Where Credit's Due* (2012)

to avoid marketing to vulnerable consumer groups. The consumer survey found that a vast majority of both small and large lenders did not treat customers in difficulty sympathetically, did not freeze interest rates or charges for such customers and did not tell them about free sources of advice.[75]

As a consequence of the inquiry into payday loans the Financial Conduct Authority (in October 2013) proposed new rules to protect borrowers, including preventing lenders from rolling over loans more than twice and controls over how many times they can reclaim payments from a person's bank account. The Financial Conduct Authority (which takes over regulation of the 50,000 firms with consumer credit licences in April 2014) claims that under the proposed rules up to 30% of consumers being offered payday loans would no longer be able to access them, mostly people on low incomes.

Although Australia, most parts of the US and some European countries have capped payday loan interest rates, some commentators continue to argue that such an approach could push borrowers into the hands of backstreet loan sharks. However, calls for a cap have intensified, with the Labour Party pledging to cap interest rates charged by payday lenders. Whether there is a cap or not, the next three to four years will perhaps see more emphasis on paying back loans in a competitive market and less tolerance of business models that encourage repeat borrowing, rolling over and refinancing of debt. However, having a competitive market has other disadvantages, even if it becomes harder for an individual to roll over an existing debt with the same company.

On the demand side, there is a further development that will exert a more benign influence on the consumer credit market, namely increased financial literacy education, which one might presume would lead to less risky behaviour.

Pressure to improve financial education in schools has been building for some time, following reports by Ofsted and the All-party Parliamentary Group on Financial Education. A recent survey (June 2013) by the Personal Finance Education Group showed that young people had serious gaps in their financial knowledge on debt and overdrafts.

The decision this year by the government to include the teaching of personal finance skills within the compulsory citizenship programmes of the national curriculum for key stages three and four (ages 11-16) has been widely welcomed. The revised curriculum seeks to ensure that students:

75 DBIS report on surveys of the payday lending good practice charter and codes of practice, October 2013

... are equipped with the financial skills to enable them to manage their money on a day-to-day basis as well as to plan for future financial needs.[76]

Specifically, in key stage three, students will be taught:

... the functions and uses of money, the importance of personal budgeting, money management and a range of financial products and services.

In key stage four, this will be extended to:

... wages, taxes, credit, debt, financial risk and a range of more sophisticated financial products and services.

In addition, financial education will be taught as part of the non-statutory personal, social, health and economic education. Early guidance on the draft mathematics curriculum for key stage four also makes reference to the need to incorporate an understanding of financial products.

While a number of schools have already incorporated an element of financial education within their teaching, it will become compulsory from autumn 2014. We presume that the compulsory teaching of personal finance education will have a small but positive impact on levels of over-indebtedness in future decades; just under half of StepChange Debt Charity clients when surveyed agreed that they would have avoided unmanageable debt if they had received more financial education in school, compared with around a fifth who disagreed.[77]

Levels of financial literacy are also worryingly low for older people. A recent survey by HSBC found that 39% of respondents aged 30-60 had made no plans for financial retirement.[78] The government and debt charities could seek to address this by providing a financial MOT for those aged 50 and on retirement.[79] Part of the financial MOT could include information and guidance on retirement income and debt management.

Understanding problem debt is far from straightforward. People often do not make rational economic choices about debt, and there is evidence that behavioural factors

76 http://media.education.gov.uk/assets/files/pdf/c/citizenship%2005-02-13.pdf
77 Ibid, p36
78 HSBC *The Future of Retirement* (2013)
79 See: *Selling Off the Family Silver* (Smith Institute/Hanover, 2013)

may in fact lead households to "over-borrow" as well as "under-save".[80] Behavioural problems can also cause less-aware consumers to pay more than others, to the benefit of the providers. According to the Financial Conduct Authority:

When analysing problems we need to develop possible explanations as to the underlying cause and then build evidence. We must investigate whether consumers are making mistakes, and if so which biases may be the cause. Crucial evidence includes how consumers choose in different settings (e.g. do consumers choose differently as they gain experience?), their awareness of essential product information and their self-reported needs and objectives.... Behavioural economics holds great potential as an analytical tool for the organisation. Intervening early, for example, will require assessing which products are likely to cause detriment to consumers. Such judgements must be informed by a solid understanding of what mistakes consumers are most prone to and which features of products may be problematic.[81]

Behavioural economics can help us better understand problem debt, although consumer psychology is arguably underdeveloped. Little is understood, for example, about whether taking out consumer credit loans is habit-forming or whether it leads people to be warier in future, having had their fingers burned. Work by the Resolution Foundation shows clearly that when real wages of those below median wage levels began to become sticky from 2003, borrowing to maintain lifestyle standards increased. It is not known whether this cohort will feel they learned their lesson from the problems subsequently experienced, or whether smoothing income by borrowing has instead become ingrained.[82] More research needs to be done around the psychological effects on the new cohorts of indebted individuals, and whether someone who has sought help for debt problems tends to repeat the same mistakes in future.

Overall, presuming no further policy changes beyond these over the scenario period, it seems the market for consumer credit can only grow and that it will remain relatively easily accessible, particularly for households with the characteristics of the ONS's most highly indebted group. An individual's decision to borrow will be private and often impulsive, influenced by an internet search for cash or a consumer product rather than by a face-to-face conversation. Their success or otherwise will be decided by their credit rating – whereby paying off a debt is considered a good thing even if another debt is taken out to do so, while many unsecured credit arrangements are not even

80 See the work by the American group Innovations for Poverty Action, and Karlan, D and Zinman, J *Borrow Less Tomorrow: Behavioral Approaches to Debt Reduction* (2012)
81 FCA *Applying Behavioural Economics at the FCA*, occasional paper no 1 (2013)
82 See the earlier discussion on the effect of having a high student loan

recorded, and homeowners are considered a better bet than others even though they already have a mortgage – and not by any meaningful consideration of their overall budget constraints.

The extent to which this scenario can be alleviated by public policy action depends on how interventionist policy makers are prepared to be. There is no doubt that there is a flourishing market in consumer credit. There is both strong demand and strong supply, leading to a high number of transactions. The question is whether it is in the public interest for the markets to be as large as they are, and for them to continue expanding.

There is also a public policy challenge to ensure that financially excluded consumers have better access to affordable credit designed to suit their needs. Continued support for third-sector lending must form a bigger part of that solution. However, greater help to credit unions should not distract from the need to ensure that the banks and other conventional lenders do more to meet the reasonable credit needs of both our £2,000 and £12,000 category borrowers.

In the credit card market, recent alterations to the industry Lending Code (sponsored by the British Bankers Association, the Building Societies Association, and the UK Cards Association) now make it impossible for credit card borrowers to make minimum payments that do not include an element of paying back the capital. However, in some cases this has led to a situation where lenders have reduced the minimum payment required as the outstanding level of debt falls, in order to maximise the amount of interest being paid. According to the consumer affairs minister, Jo Swinson, "lenders are not living up to the spirit or the letter of the code of practice that they signed up to".

There is a case for tightening the Lending Code once more, so that minimum payments on credit cards and other forms of unsecured credit should reflect a standard target timescale for paying off the entirety owed, for example over a maximum period of two years. This will increase transparency to the borrower and make it more commonplace to eliminate debt earlier. This could also be included in the Financial Conduct Authority's new credit rules, which will be introduced in April 2014.

Responsibility for consumer credit will transfer to the Financial Conduct Authority. The direction of travel is set: it remains only for the regulator to use its considerable powers and resources to ensure that all sections of the consumer credit market produce good outcomes for consumers. Our brief observations are that the FCA will need to:

- ensure that responsible lending rules are robust, particularly in high-risk areas like payday lending;
- use its power to set threshold conditions for authorisation to thoroughly scrutinise the business models of consumer credit firms operating in sectors with past evidence of consumer detriment – payday lenders and other high-risk sectors should be required to apply for authorisation as soon as possible;
- use its rule-making powers to ensure credit products are suitable and do not contain "bear traps" for consumers to fall into (for instance, this could be used to control roll-overs for payday loans, to prevent unfair snatch-back of cars subject to "bill of sale" lending, and to ensure that the minimum repayments on credit cards reflect a reasonable standard timescale for repayment);
- take action against unfair and excessive default charges to prevent debts escalating as a result of a borrower's financial difficulties;
- incorporate industry best practice on arrears management or debt collection to ensure that households in financial difficulty who engage with their debt problem are protected from further collections and enforcement activity; and
- ensure high standards of business conduct in the debt management sector.

Part 3

Conclusion

Conclusion

This report has tried to blend existing and new data with expert opinion and comment in order to better understand the characteristics associated with over-indebtedness in today's Britain. Using that evidence base and known assumptions, we have explored the drivers that lead to household indebtedness and highlighted how patterns of indebtedness for the most vulnerable groups might be expected to change over time. Most importantly, in light of what we have shown might happen in the period up to 2025, we have offered a selection of policy recommendations, most of which seek to mitigate major risks for tomorrow's borrowers.

The first conclusion we can draw from this analysis is that the future outlook for tomorrow's borrowers is worrying. Without further action, the personal debt problems we face as a nation look set to worsen. The overhang of unmanageable debt from the pre-recession period is unlikely to disappear soon, and further bouts of fiscal austerity and welfare reform alongside sluggish wage growth are expected to push more vulnerable households into problem debt. Unless household budgets improve and public attitudes to debt change, the debt advice agencies are likely to experience an increase in demand for their services.

Some of the forces that will lead to greater pressure on indebtedness, such as macroeconomic and demographic change, are hard for government to do anything about. Others, such as the operation of the welfare system, housing markets, and the world of work, provide more scope for change. There is also plenty that the government and the regulators can do to improve the credit markets and to ensure better debt advice. However, there is clearly no simple solution that willl prevent tomorrow's debt problem getting worse. A combination of interrelated policy actions is needed, not least to tackle the UK's entrenched savings problem.

There is also a dynamic effect to be considered, namely how an individual's relationship with debt alters over time. Having high levels of debt are associated with youth, at least from the snapshot that was taken by the ONS in 2008-10. Yet in our expert interviews there is some evidence, at least anecdotally, that this may be changing. A greater number of older people are now presenting with high levels of debts, and many of tomorrow's borrowers have made no plans for their retirement.

According to research by Age UK and the International Longevity Centre, the proportion of older people who are classified as having problem debt (including problem mortgage debt) has already risen to almost a third of those in this age group who have borrowings overall – equivalent to around 1.1 million people. There is every reason to think that this will continue into the foreseeable future. Put bluntly, the economic and demographic changes we anticipate suggest that people will accumulate greater debts in early life and take longer to pay them off. In a graph of net financial liabilities against age, the line will slope downwards more gently to the right.

The pressures for this are manifold. With real wages sluggish, income will be lower, meaning it will take longer to pay off debt. StepChange Debt Charity notes that the average income of its clients has fallen by 4.4% between 2009 and 2012, and that "if that trend continues over the next three years 59% of clients will have a negative budget".[83] The addition of more and more student loans into the equation will further reduce disposable income. On the other side of the equation, housing costs will be higher, particularly in London and the South East, for those who are not able to get on the housing ladder and who will therefore continue renting for longer. Increasing longevity will postpone the transfer of assets from older to younger generations and also reduce the size of those assets once the increasing costs of care in later life are paid for. This will all give people good reason to continue working for longer, where possible, even beyond the recently raised state retirement age. If that is not possible, due to outdated skills or ill health, then debts will persist, reducing further the transfer of assets to succeeding generations.

For older people, part of the solution must surely be doing everything possible to support those who want to remain in work for longer, to give them an opportunity to generate more income. Recent surveys[84] show that today's workers do not resent working for longer than their parents did, in part because they cannot afford to fully retire. Semi-retirement is becoming more common. This may lead to the abolition of mandatory retirement ages in the professions where they still exist and an extension of the right to part-time and flexible working for older people to make it easier for them to continue offering their skills to the labour market.

Taking a longitudinal approach also enables a discussion of how savings products can be introduced that act as a counterbalance to the pressures towards higher levels of debt. After all, saving is the opposite of debt. If you want less of the financial vulnerability that comes from debt, you need more of the financial resilience that comes from saving. This is not easy in the face of the very low levels of savings among low-income households and a low-wage economy. Nevertheless, the problems are not insurmountable and the policy levers are under-explored.

83 StepChange Debt Charity *Statistical Yearbook 2012*
84 Such as the HSBC survey *The Future of Retirement* (2013)

For the "£2,000 debt with few assets" group, we recommend more initiatives to encourage savings, including the possible reintroduction of the Savings Gateway scheme whereby government matches a proportion of individual savings to enable an asset to start to be built. Government could also assist with the mass development of so-called "jam jar" accounts that allow customers to split their account balance into separate budgets for spending, saving and bill payment, with real-time alerts if problems arise, supported by access to trained money managers to provide budgeting advice. Where appropriate, these can be linked to existing support networks that have an interest in a household keeping on top of its finances, such as credit unions, social landlords or debt advice agencies. Government's continued support for the underdeveloped credit union sector is critical in this respect, and could include helping credit unions expand through the Post Office network.

For the "£12,000 debt with some assets" group, the key is partly better debt management and a greater sense of ownership over any future financial position. It will also be important to encourage greater intergenerational transfer of resources where that is possible. Savings products for children are a good start here; the experience of the last decade has been that wider family members have been motivated to contribute to a child trust fund or junior ISA where they are established. The government should explore what other forms of long-term savings products could encourage the build-up of personal assets. Creating a long-term child savings vehicle for a particular type of later-life investment such as training, childcare or house purchase might further encourage intergenerational transfers of resources.

Asset-based welfare policies take time to have an impact. If tomorrow's borrowers had greater assets to begin with, they would not need to access the credit markets to the same extent. They might also feel they had a greater stake in their own financial futures. Moreover, if they already had credits that could be spent on lifelong learning, on a housing deposit, or on helping them remain in the labour market when their children were young, they would find it easier to make the transition out of debt and into a net positive financial asset territory earlier in their lives.

As we have suggested in this report, the situation for those facing financial difficulties is unlikely to improve without changes in the labour market. Job loss and reduced income are key reasons for debt problems, as is the growth in more recent years of in-work poverty. Failure to address the UK's wages crisis will continue to undermine other flanking policies, particularly welfare reform. Indeed, the combination of falling wages and falling benefits will push more lower-to-middle-income households into debt. Rising employment will make a big difference to the levels of future indebtedness, but it is worth noting that today's youth unemployment will have a long-term scarring effect and that we are seeing a rise in the number of self-employed people (and people who run their own businesses) suffering personal debt problems.

The rising cost of housing is also a major cause for concern. Arrears on rents and household bills have been rising, and there is a continuing affordability problem in areas of high housing demand. In order to meet household growth, there will need to be a significant and sustained increase in housing supply, including more low-cost homes. However, even if there is a major increase in new homes it will require decades to take effect and will (in the short term at least) not alter the imbalances in household wealth between the young and older generations. In the meantime, some of tomorrow's borrowers are likely to face a mortgage affordability crisis when rates start to rise, which will also have a negative impact on their ability to service consumer credit repayments.

Policy reforms can make a big difference. But we acknowledge that something dramatic also has to change in regard to public attitudes to personal debt. The feedback from the expert interviews and roundtable discussions we held was that policy makers needed to better understand consumer behaviour and consumer choice. As Martin Wheatley, chief executive of the Financial Conduct Authority, put it recently, "*Buyer beware* becomes hard to defend when unsophisticated customers are buying seriously complicated financial products, where the risk of failure is far more dangerous than a decision in the supermarket to buy three bananas instead of one."[85] Personal indebtedness, however, is a complex phenomenon and often the individuals concerned are not even aware of the level of financial risk they are taking on. Research by debt charities shows that many problem debtors wait for a year or more before seeking advice about their debts. Such lack of awareness is clearly one of the reasons those in debt turn to high-cost credit to deal with financial difficulties in a way that will actually worsen their problems.

Part of the problem seems to be that Britain has not had a meaningful public conversation about credit dependency. It has become an unspoken part of our national life. This surely needs to change. There needs to be a concerted national campaign designed to bring the issue out into the open and change attitudes and behaviour. This campaign needs to be on a par with the AIDS awareness campaign of the 1980s or the "five a day" fruit and vegetable campaign that began in the 1990s. Most effective would be a generic message that stops debt problems escalating, using role models

85 Martin Wheatley's FCA speech at the LSE, 2013

and case studies. Possible themes could be around seeking help early, or having a plan to repay debt, or ensuring that the length of term of the debt does not exceed the term of the benefit for which the loan was originally taken out. Messages could be tested among target audiences and backed up by debt support agencies. Where local face-to-face services are available, signposting should also be provided through public agencies such as schools, housing associations and the NHS.

The evidence presented in this report – of one in four households having a negative cash position, and one in ten having net debts of over £5,000, with households in this category owing half their debts to high-interest creditors – seems consistent with a significant proportion of people in Britain having unsustainable levels of debt. This presents a serious problem, which (as we highlight in the report) has negative consequences for the individuals concerned and for society as a whole. Preventing an increase in unmanageable personal debt must then surely be in the public interest.

However, curbing the market for consumer credit, and specifically reducing the number of transactions conducted by people who are unable to repay, is far from easy and requires determined action by government and the regulators. It also demands changes in policies affecting where we live and the world of work, as well as a much bigger effort at improving financial literacy, especially among the young. Tackling problem debt in society is a huge and interconnected policy challenge, but given what we know about tomorrow's borrowers it is a task that government, the regulators and the financial services industry itself cannot afford to ignore.

Annex 1

Wealth and debt by households

Wealth and debt by households

In February 2013, in response to a request from the Smith Institute, the ONS published some further data on financial and physical wealth (possessions) by household characteristic.[86] This breaks down all households by key characteristics, and then shows the distribution of total net financial and physical wealth within each defining characteristic.

For example, a breakdown by age alone shows that the half a million households in Britain that have a representative adult of age 16-24, the average (mean) level of financial and physical wealth is £15,000 but that the 10th percentile value is *minus* £1,000; that is around 50,000 households of this type have debts, less the value of savings and possessions, of £1,000 or more.[87]

Looking across the 25 million households in Great Britain as a whole, the mean value of financial and physical wealth is £85,000 and the 10th percentile value is £6,000. In order to understand the types of households that are most likely to be in financial debt, we look at the groups where the 10th percentile value is less than half the national average, that is £3,000 or under. This yields the results in table 9.

This data gives a picture of the types of households that have the lowest levels of financial and physical assets in Britain. They are likely to be headed by one adult aged under 35 who is in low-paid work and probably does not identify with any form of community religion. If that adult is female, there are likely to be children in the household; if it is male that is less likely. The household is either renting at the bottom of the private rented market or is in local authority or housing association accommodation (with the exception of a few people on shared-equity schemes) in an area where economic resources are weak, quite possibly in London.

If you belong to an ethnic minority you are more likely to lie in this group than if you are white British, although the number of ethnic-minority households is still a relatively small proportion of the total. Perhaps due to the socioeconomic characteristics of this group, it appears to correspond more to the "£2,000 debt and few assets" and the "can't make ends meet" groups rather than the "high debts with some assets" cohort identified in the report. Put bluntly, these are the poorest people in Britain on a number of different measures; their financial debts are part of that picture.

86 ONS data on financial and physical wealth by household characteristics, February 2013
87 Note these figures are not comparable with the table above as they include physical wealth.

Table 9: Characteristics of households that have 10th percentile net financial and physical wealth distribution of £3,000 or under

Characteristic	**10th percentile value of financial plus physical assets of this group (£)**	**Number of households with this amount of financial plus physical assets or less** (10% of total with this characteristic)
Black African	-3,000	26,900
Aged between 16-24	-1,000	55,300
Privately renting	0	260,000
Renting from LA or HA	2,000	483,300
Lone parent, dependent children, female	2,000	151,300
Single household, working age, female	2,000	115,600
Never worked/long-term unemployed	2,000	53,900
Muslim	2,000	65,000
Black Caribbean	2,000	33,900
Part rent-part mortgage (shared ownership)	2,000	10,600
Live in part of England with Index of Multiple Deprivation score in lowest 30%	3,000	594,600
"No religion"	3,000	422,000
Semi-routine occupations	3,000	371,400
Aged 25-34	3,000	355,000
Routine occupations	3,000	319,200
Living in London	3,000	296,700
Single household, working age, male	3,000	230,600
Ethnicity "other white" (as opposed to "white British" or "mixed")	3,000	79,500
Pakistani	3,000	25,300
"Other religion"	3,000	20,200
Lone parent, dependent children, male	2000	15,600
Buddhist	3,000	7,700
Chinese	3,000	4,800

Note: The groups listed in the table above are not exclusive; there may well be considerable overlap between different characteristics. For example, a single mother living in local authority accommodation in a part of England characterised as having a high multiple deprivation score who does not identify with any religion, is not working and has financial assets including the value of possessions (but not property) of less than £2,000 would be counted five times in the above table.

The Smith Institute

The Smith Institute is an independent think tank which provides a high-level forum for thought leadership and debate on public policy and politics. It seeks to engage politicians, senior decision makers, practitioners, academia, opinion formers and commentators on promoting policies for a fairer society.

If you would like to know more about the Smith Institute please write to:

The Smith Institute
Somerset House
South Wing
Strand
London
WC2R 1LA

Telephone +44 (0)20 7845 5845
Email info@smith-institute.org.uk
Website www.smith-institute.org.uk

The Smith Institute is a not-for-profit company (registered as SI Research Limited, 07098225)