When might debt pose problems?

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When might debt cause immediate problems?

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In economic terms, debts have their most direct negative impact on household living standards when they use up disposable income

- Debt servicing reduces income available to spend on essential items
- Other e.g. psychological effects of debt possible

Household is judged to be under "immediate servicing pressure" if either:

- Spending 25% or more of monthly net income on servicing debts

  OR

- Two or more payments behind on one or more credit agreement, or bill – “in arrears”

Despite lower debt, young, low-educated individuals more likely to be under pressure

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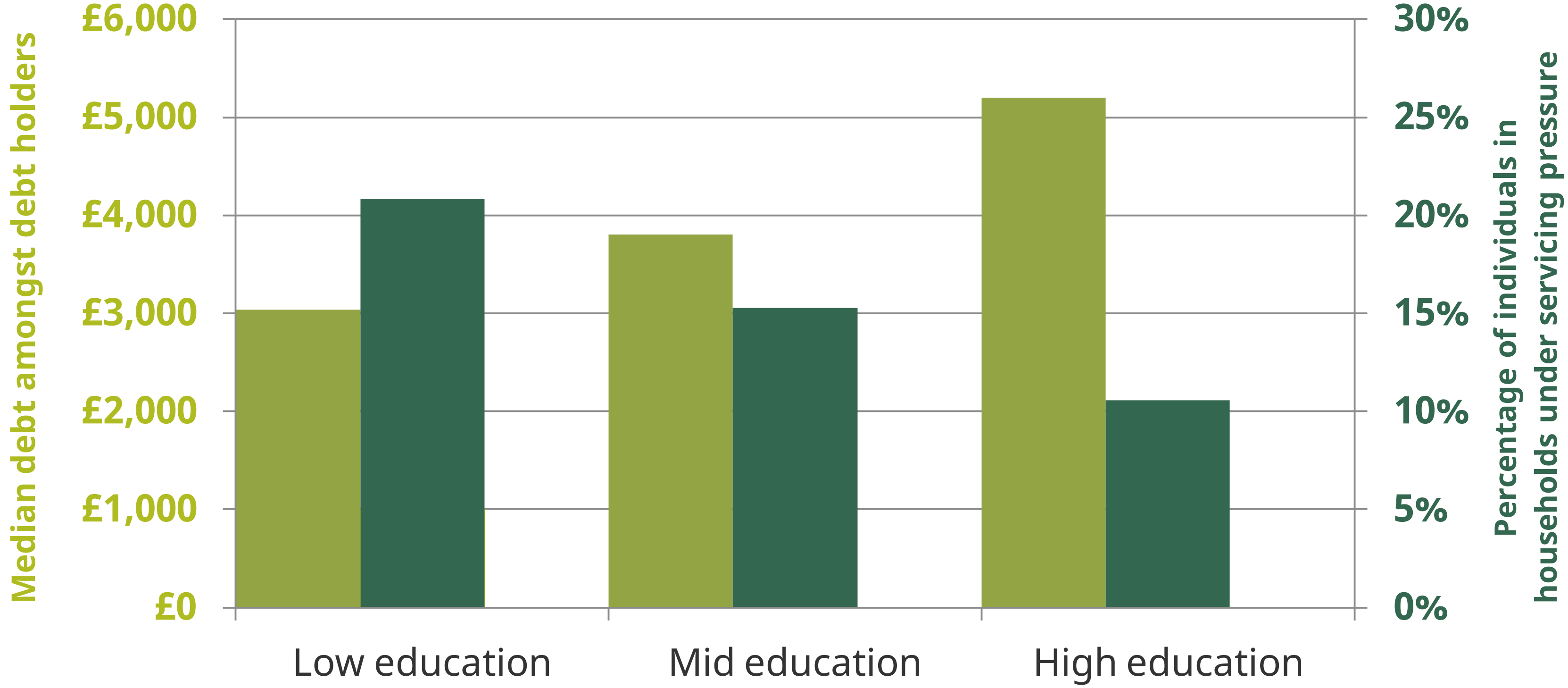
Median debt level for holders of consumer debt and percentage of individuals in households in servicing pressure, for those aged 20-39



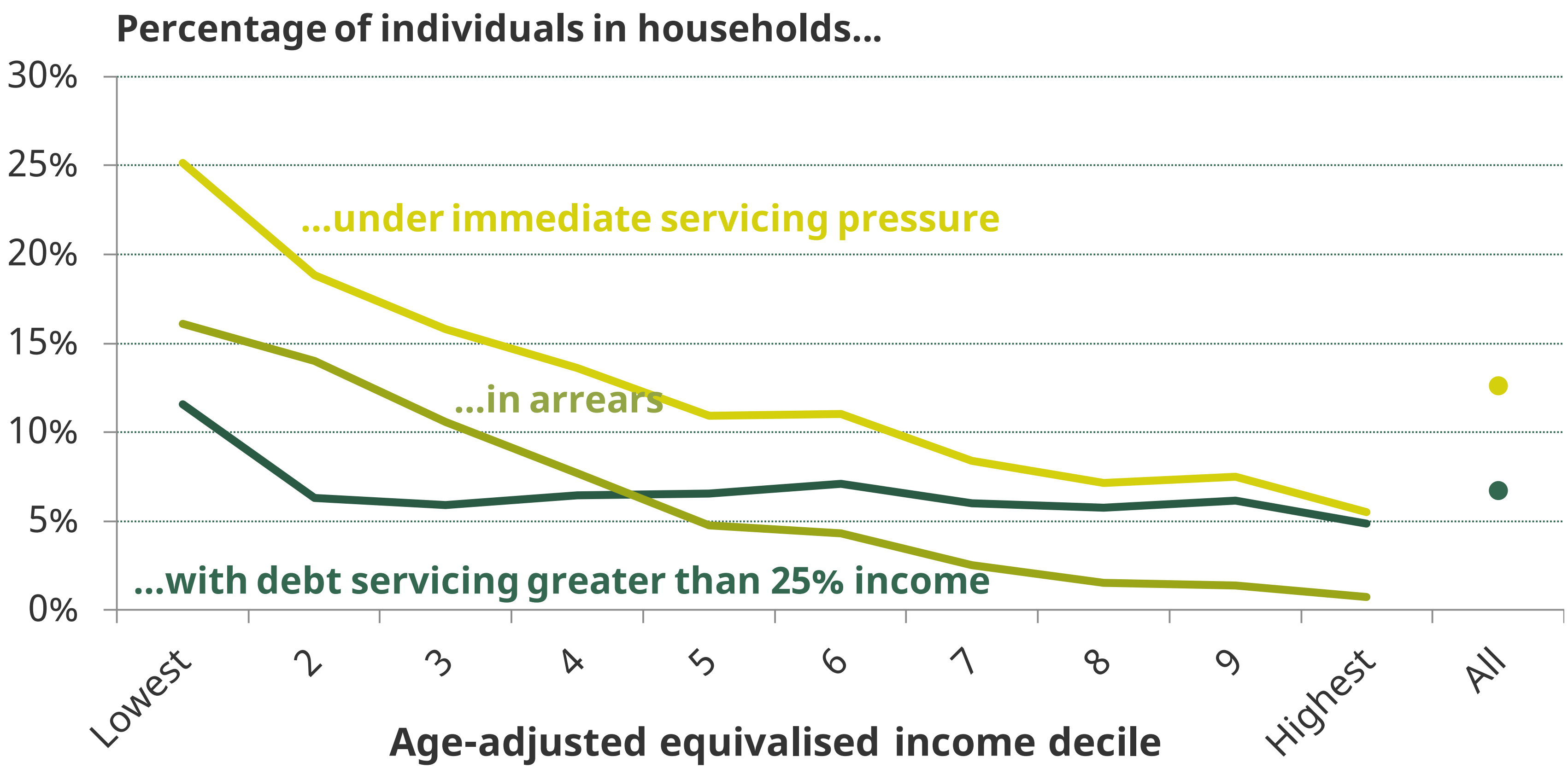
Low education: Completed full time education aged 16 or below

Mid education: Completed full time education aged 17 or 18

High education: Completed full time education aged 19 or older

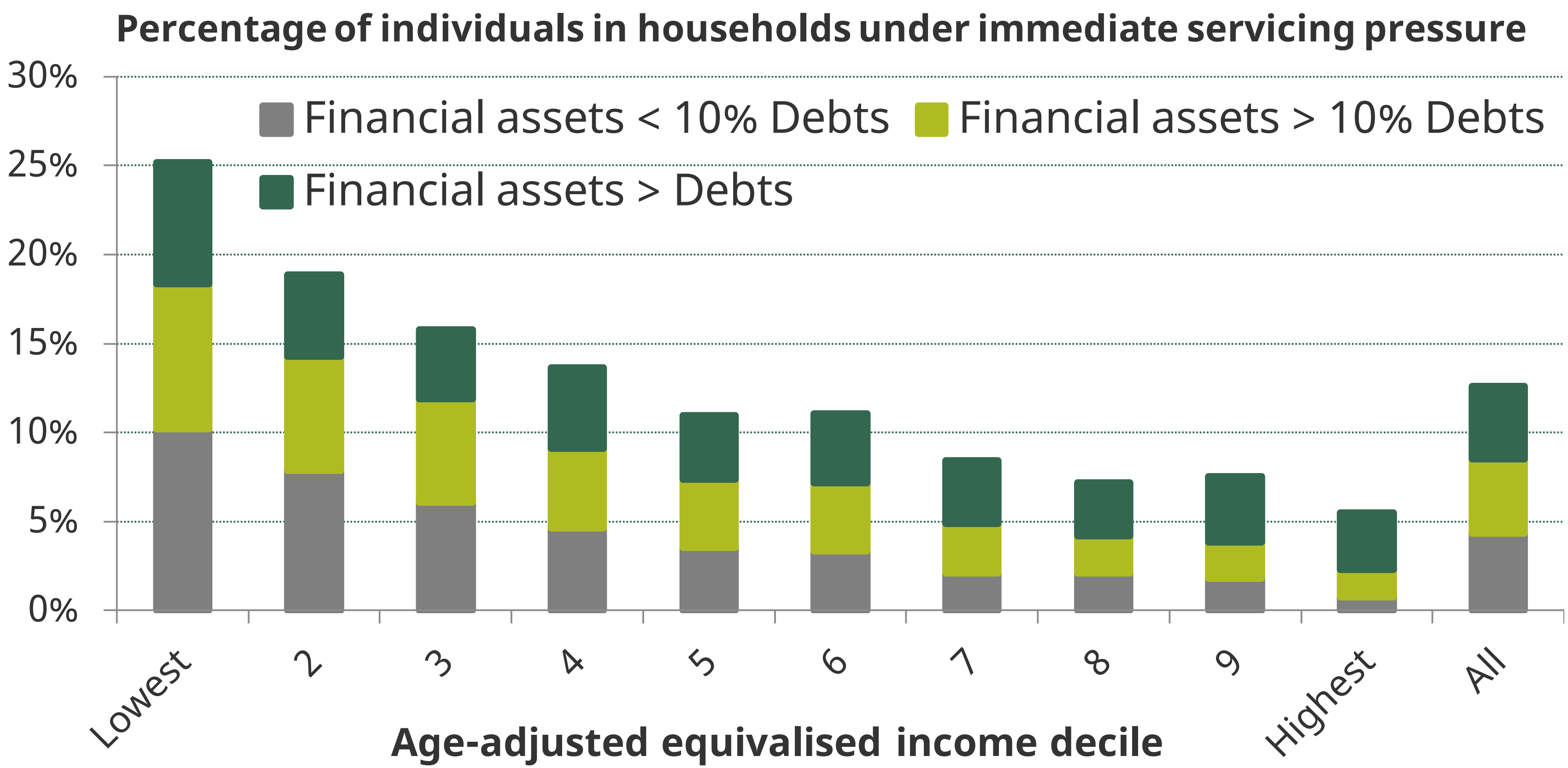
Source: Authors' calculations using waves 3 and 4 of WAS

Immediate servicing pressure



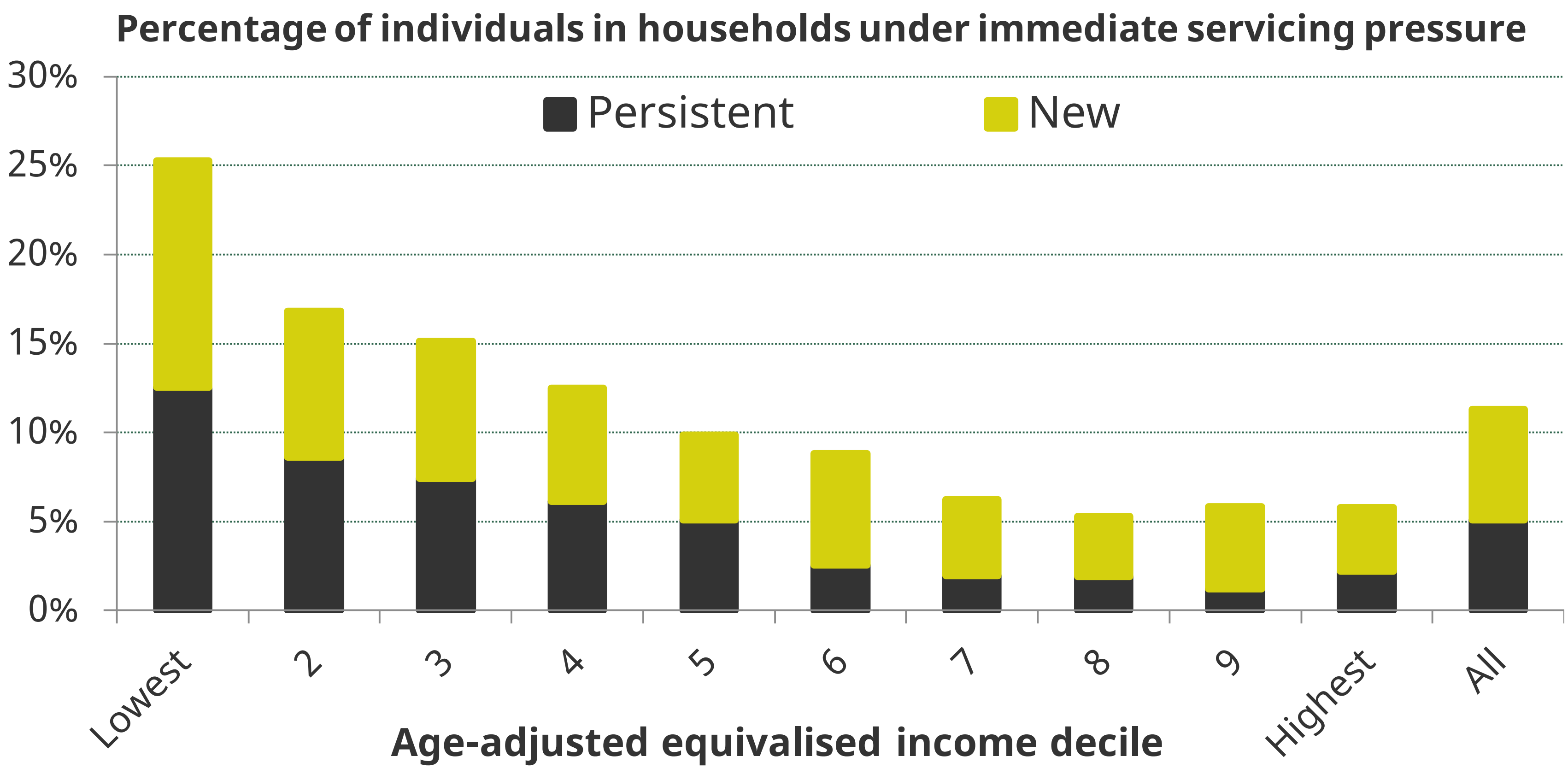
Source: Figure 2.5 and 3.4 of report

Lower income households under servicing pressure have fewer financial assets



Source: Figure 3.6 of report

Servicing pressure more persistent for those with lower incomes



Source: Figure 4.7 of report

Why do individuals enter servicing pressure?

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Income falls explain only a small proportion of entries into servicing pressure

- Just 15% of those who entered would have done so if their servicing costs had not changed from wave 3 to wave 4.

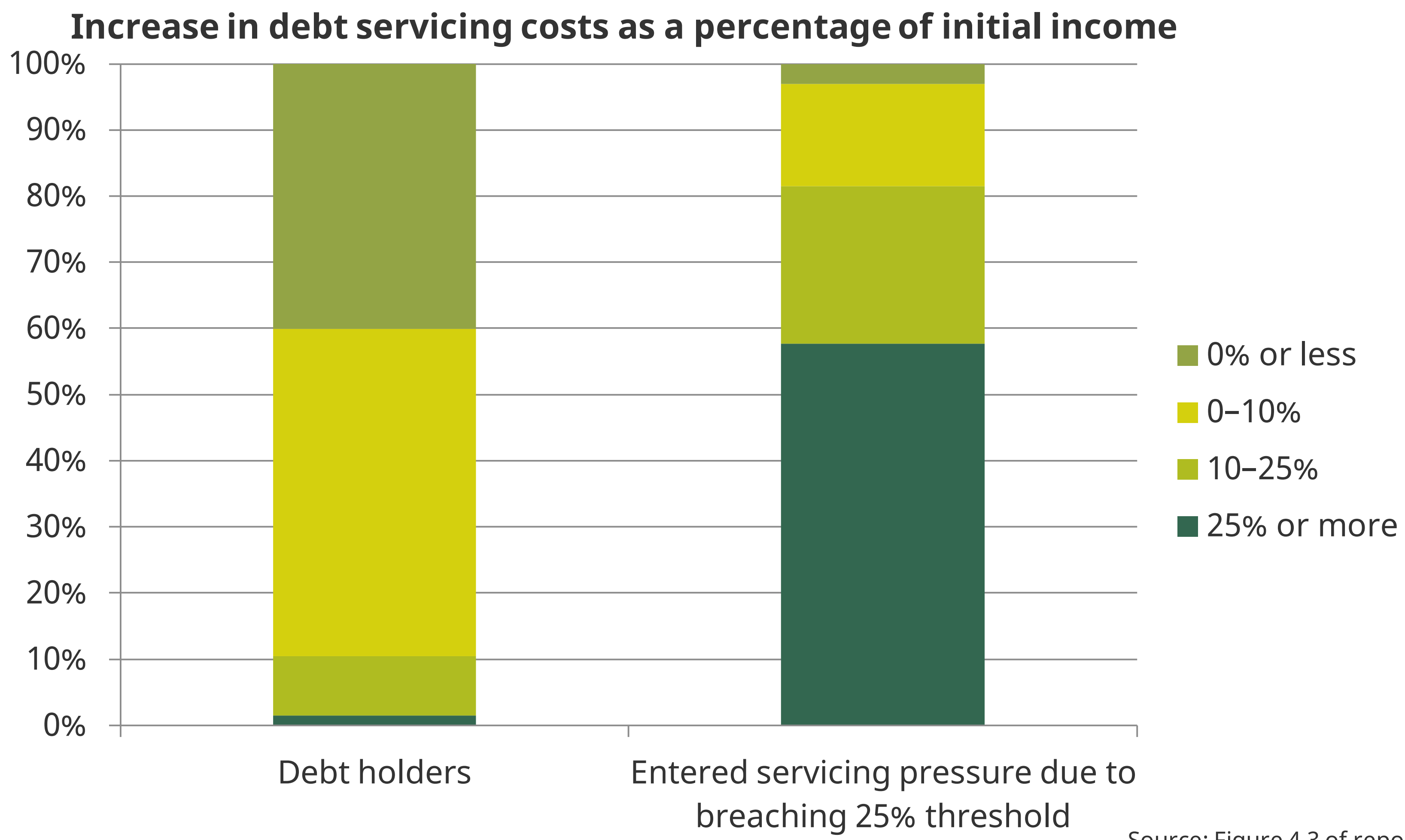
Rising debt servicing in fact more important

- 56% of those who entered servicing pressure would have done so even if income had not changed

There could be deeper explanations for increases in debt servicing

- Possible indirect role for income falls –unlikely the main explanation
- “Life events” in last 2 years somewhat more common amongst entrants
  - Marriage/cohabitation ending (2% vs 1%); more children (10% vs 6%)

Entry into servicing pressure explained more by taking on of new debt than by income falls



Source: Figure 4.3 of report

When might households struggle to repay debt?

Move from looking at snapshot of debt servicing to examine total debt that must be repaid in the medium term

- Do total repayment obligations look difficult to fulfil?

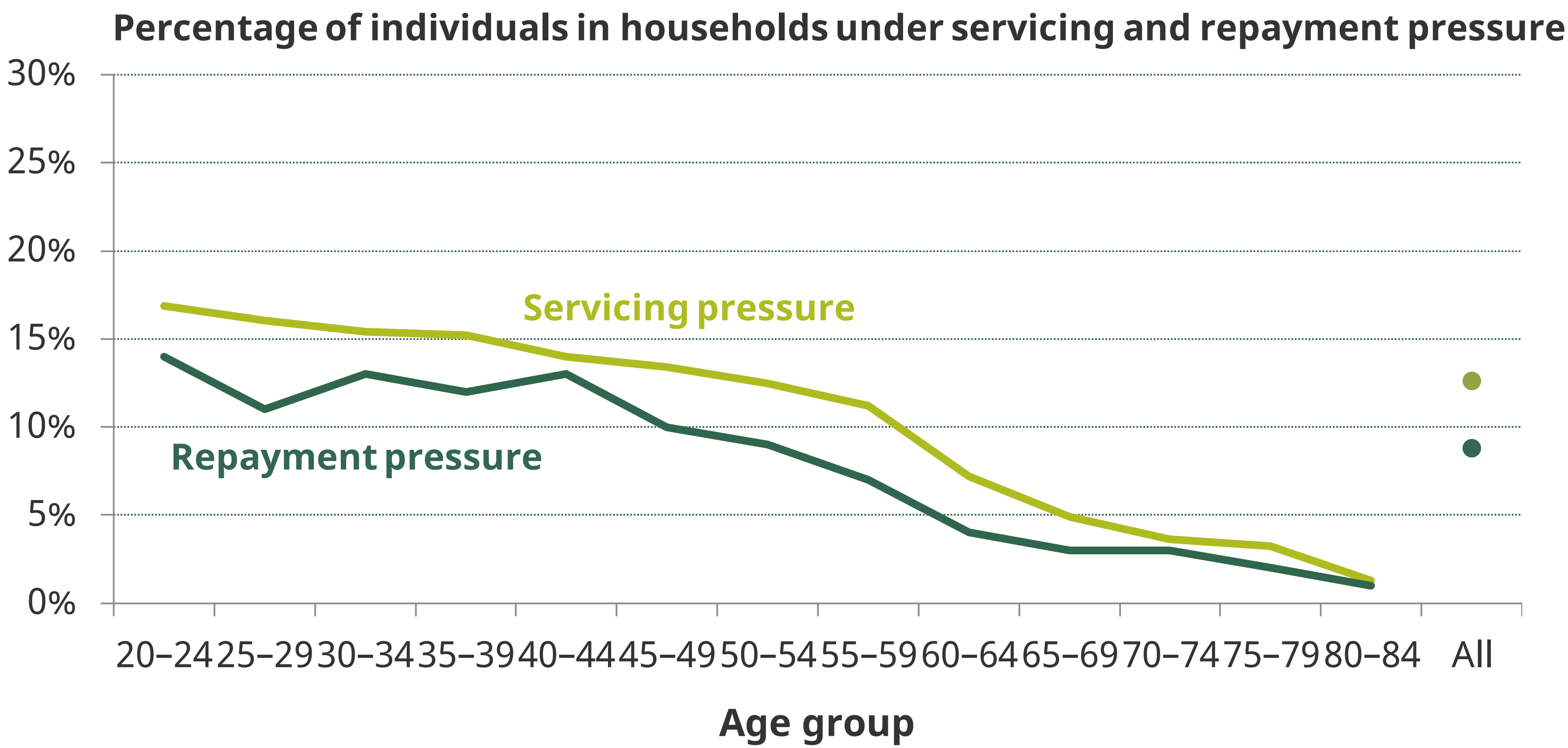
Why does this matter?

- If servicing costs are currently very high but repayments will end soon, debts may be more manageable
- Larger repayment burden means lower lifetime resources

Household is under “repayment pressure" if

- Stock of consumer debt (less financial assets) is greater than 20% of net annual income

Young people are more likely to be under repayment pressure



Source: Figure 5.1 of report

Financial assets make less difference to the position of low income households

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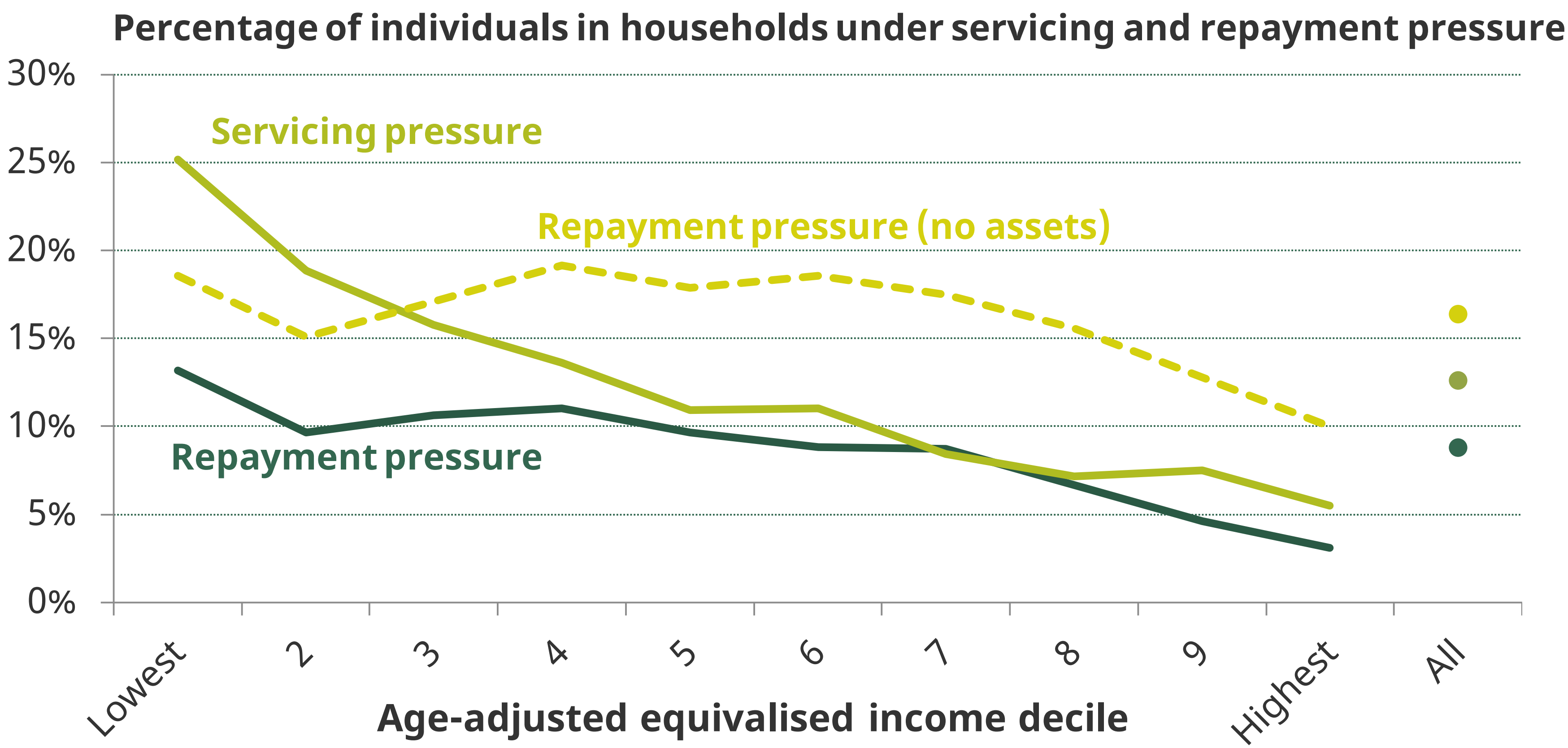


Source: Figure 5.2 of report

Going beyond a benchmark measure of repayment pressure

Why do we want a forward-looking approach?

- 25 year-old university graduate
- Annual income £24,000
- Hire-purchase debt for car of £6,000
- **<u>Debt = 25% income</u>**

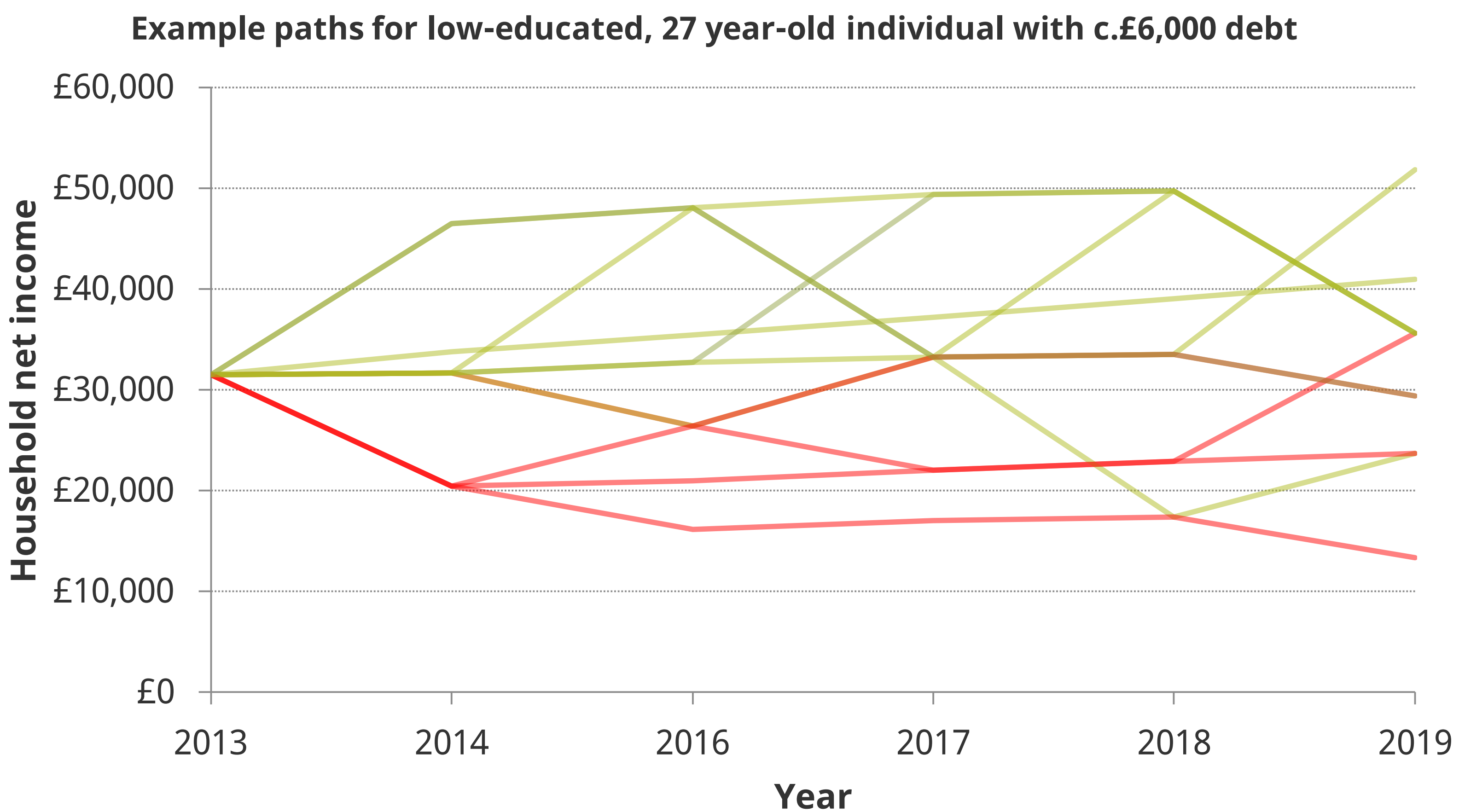
- 50 year-old school-leaver
- Annual income £30,000
- Credit-card debt of £7,500
- **<u>Debt = 25% income</u>**

Why do we want to account for multiple possible future paths?

- 30 year-old job-seeker
- Annual income £4,000
- Overdraft of £500
- **<u>Debt =12.5% income</u>**

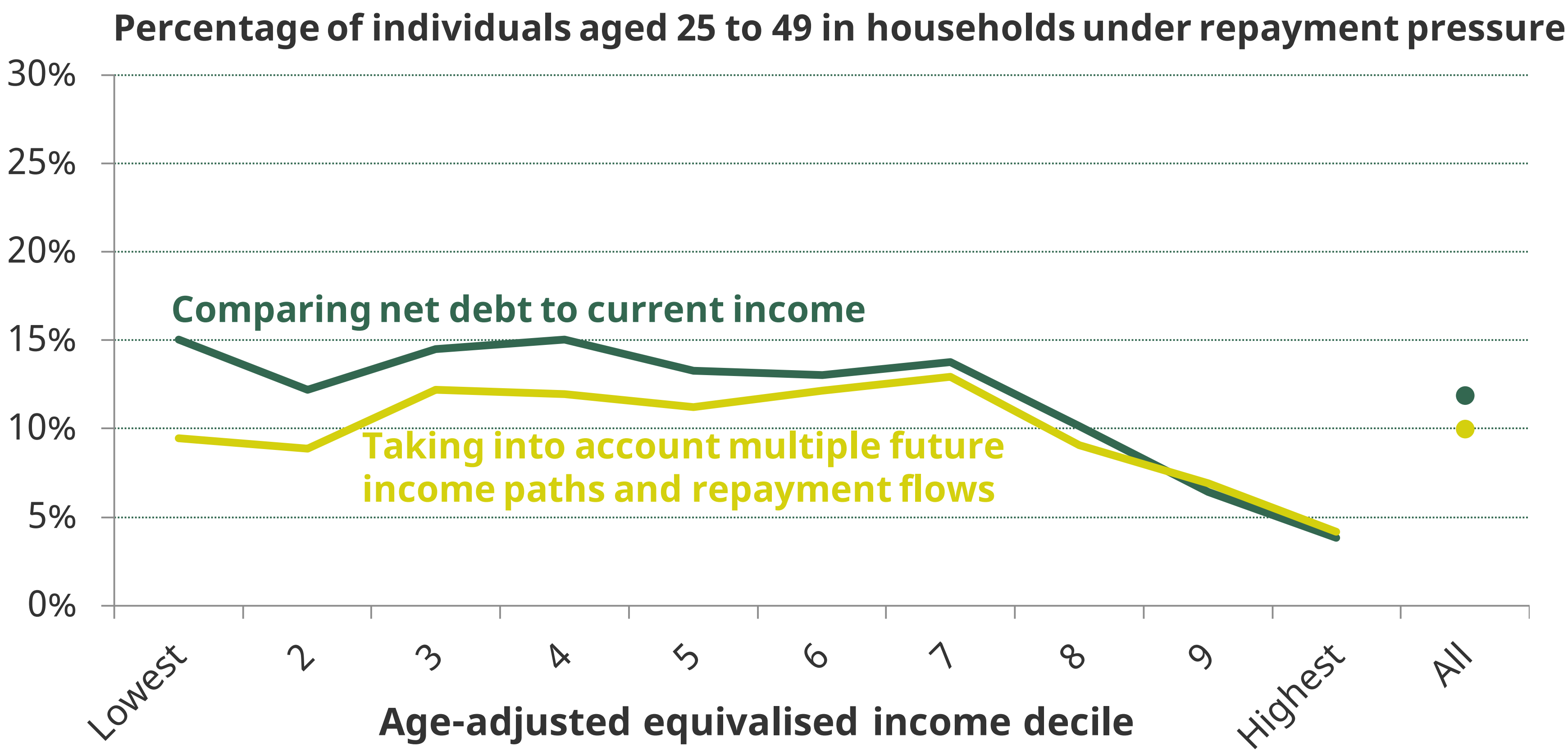
- 30 year-old start-up owner
- Annual income £100,000
- Loans and credit card debt of £12,500
- **<u>Debt = 12.5% income</u>**

Going beyond a benchmark measure of repayment pressure



Source: Authors' calculations using wave 4 of WAS and waves 1-18 of BHPS

Accounting for income growth improves picture for low income households



Source: Figure 5.4 of report

Summary

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Low income households most likely to be under servicing pressure

- Less likely to have significant financial assets compared to debts
- More likely to be persistently under servicing pressure

Entry into pressure explained more by new debt than income falls

- More than half would have entered even if income remained constant

Similar patterns in ability to repay debt over the medium-term

- Those who currently have low income more likely to see gain that makes debt more manageable

Conclusions

Size of overall unsecured debt tells us little about scale of 'problem debt'

Important to consider other economic circumstances of debt holding households and how circumstances evolve over time

- Assets – many households could repay debts if they chose
- Dynamics – entries largely caused by new debt rather than falls in income

Still important questions to be answered

- Why do some households with significant financial assets not use those assets to repay potentially problematic debts?
- Why do households take on new debt that ends up consuming a large share of net income?