When might debt pose problems?

David Sturrock
When might debt cause immediate problems?

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
- 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

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
When is debt a problem?

...with debt servicing greater than 25% income

...in arrears

...under immediate servicing pressure

Immediate servicing pressure

Percentage of individuals in households...

Source: Figure 2.5 and 3.4 of report

© Institute for Fiscal Studies
Lower income households under servicing pressure have fewer financial assets

Percentage of individuals in households under immediate servicing pressure

- Financial assets < 10% Debts
- Financial assets > 10% Debts
- Financial assets > Debts

Source: Figure 3.6 of report
Servicing pressure more persistent for those with lower incomes

Percentage of individuals in households under immediate servicing pressure

- **Persistent**
- **New**

Source: Figure 4.7 of report
Why do individuals enter servicing pressure?

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

Increase in debt servicing costs as a percentage of initial income

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

Percentage of individuals in households under servicing and repayment pressure

Source: Figure 5.1 of report
Financial assets make less difference to the position of low income households

When is debt a problem?

Source: Figure 5.2 of report

© Institute for Fiscal Studies
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
  - Debt = 25% income

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

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

- 30 year-old job-seeker
  - Annual income £4,000
  - Overdraft of £500
  - Debt = 12.5% income

- 30 year-old start-up owner
  - Annual income £100,000
  - Loans and credit card debt of £12,500
  - Debt = 12.5% income
Going beyond a benchmark measure of repayment pressure

Example paths for low-educated, 27 year-old individual with c.£6,000 debt

Source: Authors’ calculations using wave 4 of WAS and waves 1-18 of BHPS
Accounting for income growth improves picture for low income households

Percentage of individuals aged 25 to 49 in households under repayment pressure

- Comparing net debt to current income
- Taking into account multiple future income paths and repayment flows

Source: Figure 5.4 of report
Summary

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?