

# II The UK environment

## 1 The macroeconomic background

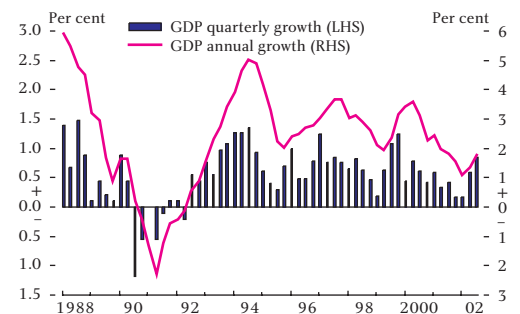
Activity in the UK has recovered somewhat according to data released since the June 2002 *Review*. GDP is estimated to have grown by 0.6% in 2002 Q2 and 0.8% in Q3, following little growth around the turn of the year (Chart 112). But expectations have become somewhat more pessimistic, according to survey evidence and Consensus forecasts, probably reflecting the weaker-than-expected world economic recovery and the further equity price falls since June. The November modal projection of the Bank's Monetary Policy Committee was for annual GDP growth to continue to recover from the current rate of 1.8% to a little above the long-term trend rate by early 2003, assisted by robust household demand and public spending. Thereafter growth was projected to slow towards trend. This profile was broadly similar to that shown in the August 2002 *Inflation Report*.

Notwithstanding the favourable aggregate environment, persistent imbalances in the economy pose risks to stability. Consumer spending rose by nearly 4% in the year to 2002 Q3, while business investment fell by over 12% during the same period. The Q3 output data suggest a further rise in services sector growth, together with only a modest rebound in manufacturing activity (since partially reversed). The UK's current account deficit widened a little further in Q2, bringing the cumulative deficit in 2002 H1 to nearly £8 billion (1.5% of GDP).

Despite the persistent current account deficit, the UK's net external liabilities are estimated to have fallen from a peak of over £140 billion at end-March 1999 (16.2% of GDP) to zero at end-June 2002. This mainly reflected increases in net direct investment assets in the early part of this period. More recently, falling equity prices have reduced net portfolio equity liabilities, given that the stock of such liabilities exceeds the stock of corresponding assets<sup>42</sup>.

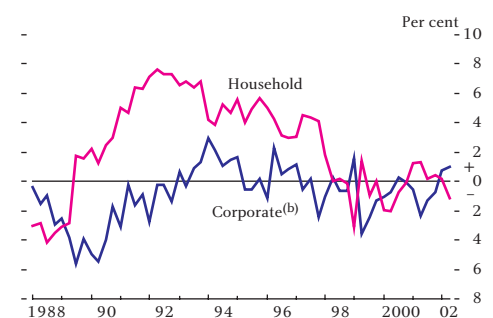
There were offsetting movements in 2002 H1 in the net financial positions of the non-bank private sectors: from deficit to surplus for the corporate sector and from surplus to deficit for the household sector (Chart 113). Indebtedness in relation to income continued to rise in both sectors, but more slowly in the corporate sector and more rapidly in the household sector.

**Chart 112:**  
**Real GDP growth**



Source: ONS.

**Chart 113:**  
**Financial balances of the corporate and household sectors<sup>(a)</sup>**



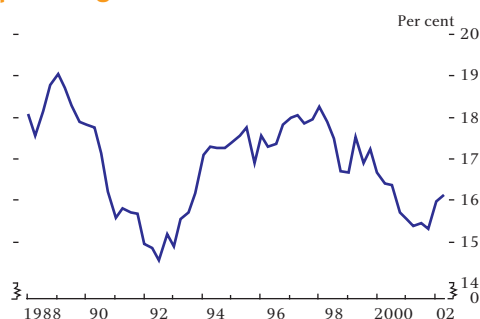
Source: ONS.

(a) As a percentage of GDP. Data are seasonally adjusted.

(b) Corporate sector includes private non-financial corporations only.

42: See Westwood, R and Young, J (2002), 'The external balance sheet of the United Kingdom: recent developments', *Quarterly Bulletin*, Winter.

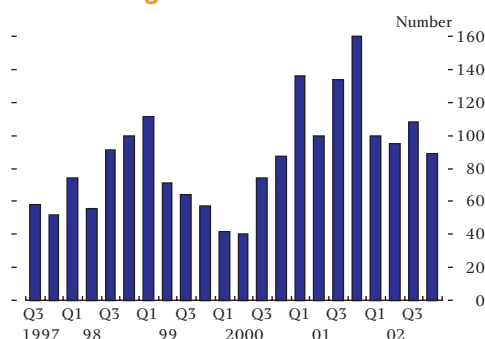
**Chart 114:**  
Gross trading profits of PNFCS as a percentage of GDP<sup>(a)(b)(c)</sup>



Sources: ONS and Bank of England.

- (a) GDP at current prices. Data are seasonally adjusted.
- (b) Excluding alignment adjustment.
- (c) PNFCS excluding oil companies.

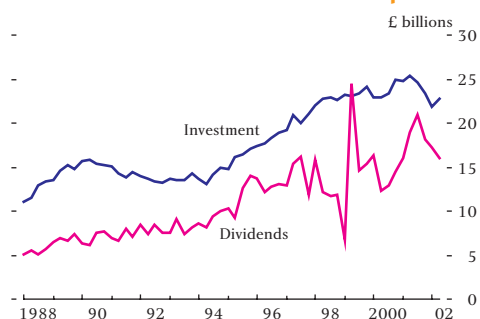
**Chart 115:**  
Profit warnings<sup>(a)(b)</sup>



Sources: LexisNexis Professional (since Sep. 2002), Reuters and Bank of England.

- (a) Fledgling and Alternative Investment Market companies are included.
- (b) 2002 Q4 warnings grossed up using data to 27 Nov. 2002.

**Chart 116:**  
PNFCS' investment and dividends paid<sup>(a)</sup>



Sources: ONS and Bank of England.

- (a) Data are seasonally adjusted and at current prices.

## 2 The corporate sector

Data released since the June 2002 *Review* suggest a modest recovery in corporate profitability, but cutbacks in dividend payments and capital spending have continued, associated with companies' efforts to repair balance sheets. Capital gearing has fallen back in relation to the replacement cost of capital, but equity market weakness has pushed gearing up in relation to market valuations. Income gearing and liquidity have both improved, helping to keep corporate liquidations at modest levels.

### Profitability

Following declines between mid-1999 and late-2001, non-oil private non-financial companies' (PNFCS) gross trading profits recovered somewhat in 2002 H1, rising by over 9% in the year to Q2 according to national accounts data. This has attenuated a little the four-year decline in the profitability of the corporate sector in relation to GDP (Chart 114). Company accounts data, however, showed some deterioration in operating profit margins among the relatively small proportion of quoted companies that have reported results both for the year to end-March or end-June 2002 and the corresponding previous year. There has been a greater deterioration for the larger companies in this group.

Profit warnings have been running at lower levels so far this year than last, but remain higher than in the 1999–2000 period (Chart 115). Research at the Bank suggests that such warnings contain forward-looking information about corporate profitability and more generally the corporate sector's financial position<sup>43</sup>. But the confidence attached to profit forecasts and analysts' earnings expectations may have been undermined somewhat by the accounting problems in the USA revealed by the Enron, WorldCom and other corporate failures, notwithstanding the corrective actions taken since the problems came to light.

### The financial balance and corporate sector adjustment

The modest recovery in profits helped the corporate sector to return to financial surplus in 2002 H1 – of close to 1% of GDP, following a deficit of 1.2% in 2001 (Chart 113). But the turnaround also reflected the actions taken by companies to adjust to the earlier deterioration in balance sheets. The June 2002 *Review* noted tentative signs of such adjustment late last year, but subsequent evidence suggests that it intensified this year<sup>44</sup>. Dividend payments have now fallen for three

43: See Kearns, A, and Whitley, J (2002), 'The balance sheet information content of UK company profit warnings', *Quarterly Bulletin*, Autumn, pages 292-298.

44: Research suggests that the corrective actions taken by the corporate sector to improve balance sheets are very much what might be expected following a build-up of indebtedness and a cyclical downturn. See Benito, A and Young, G (2002) 'Financial pressure and balance sheet adjustment by UK firms', Bank of England Working Paper no. 168.

successive quarters, by nearly 24% in total since 2001 Q3 (Chart 116). Gross domestic fixed capital formation declined by nearly 10% in the year to 2002 Q2, also reflecting concerns over prospects for demand. And companies scaled back expenditure on M&A activity last year and early this year. Adjustment has been accompanied by signs of reduced demand for labour, although so far this has been manifested mainly in reductions in hours worked rather than lower employment.

## External financing

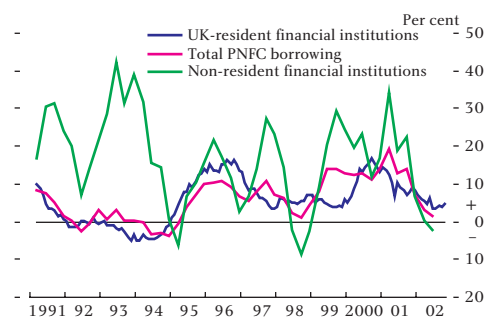
The developments reported above have contributed to a stabilisation of companies' external financing needs. Increased recourse to bank and bond finance between 1999 and 2001 reduced the share of equity and increased the share of debt finance over that period. But equity still has much more weight in the overall average cost of capital<sup>45</sup>, and the recent equity price declines have pushed up the weighted average cost of capital further, not only relative to risk-free rates, but also in absolute terms. This too will have restrained companies' demand for external finance.

Sterling borrowing from UK-resident banks has continued to slow, growing by around 4.5% in the year to October, down from around 8% a year earlier (Chart 117). This mainly reflects reduced demand, but another factor may be a tightening by banks of terms and conditions associated with loans to UK companies whose credit quality is thought to have deteriorated. Foreign-owned banks account for most of the slowdown in total lending to UK companies (Chart 118); some of them may have become more cautious about granting loans, or have reassessed the pricing of those loans, because of increased provisions and pressure on profits in their home markets. This may also explain anecdotal evidence of reduced foreign bank participation in the syndicated loan market, where refinancing activity has fallen slightly this year (Chart 119). Acquisition-related syndicated loans appear to have recovered somewhat in 2002, but the data are dominated by Network Rail's acquisition of Railtrack.

International public bond issuance by UK companies, too, has fallen back since July (Chart 120), especially at lower ratings. Again, this probably reflects changes in both the demand for and supply of finance, associated in both cases with a retreat from risk. A lower risk appetite on the part of investors is consistent with rising UK corporate bond spreads at lower ratings (Chart 121), where credit risk accounts for a larger proportion of the observed spread (as described in Section I) and where such risk appears to have increased more than for higher-rated companies. Since June, for example, bond spreads (over swap rates) have risen by some 110 basis points for double- and

45: As at end-June 2002, equity accounted for some 58% of the stock of PNFCs' external finance, with borrowing from banks and other financial institutions accounting for a further 27%, and bond finance 10%, of the stock (the other 5% was trade credit).

**Chart 117:**  
Growth of bank borrowing by UK PNFCs<sup>(a)(b)(c)</sup>



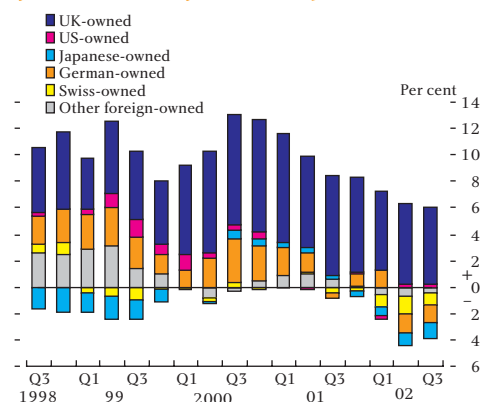
Sources: ONS and Bank of England.

(a) Twelve-month growth rates.

(b) UK resident data are monthly and include lending in sterling only.

(c) Total PNFC and non-resident data are quarterly, and include lending in both sterling and foreign currency.

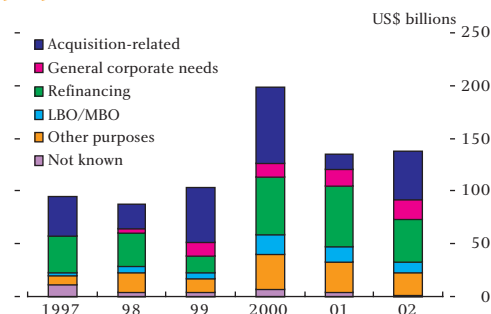
**Chart 118:**  
Contributions to growth in bank borrowing by UK PNFCs, by ownership of bank<sup>(a)</sup>



Source: Bank of England.

(a) Peer-group comparison of contributions to annual growth in bank lending to PNFCs by UK-resident banks and building societies. Data exclude securitisations.

**Chart 119:**  
Syndicated finance raised by UK PNFCs, by purpose of loan<sup>(a)(b)(c)</sup>



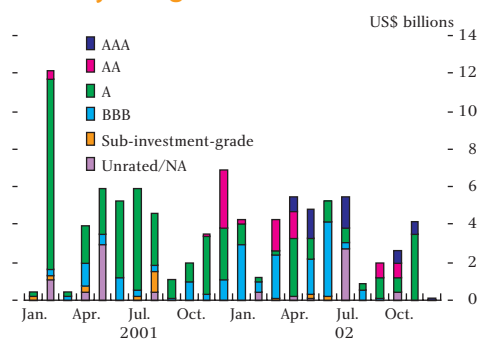
Sources: Dealogic and Bank of England.

(a) Syndicated loan facilities granted to UK PNFCs, sorted by signing date.

(b) Purpose of loan is the principal purpose (ie the first code assigned to each loan in Dealogic Loanware).

(c) 2002 data cover the period from 1 Jan. 2002 to 22 Nov. 2002, annualised.

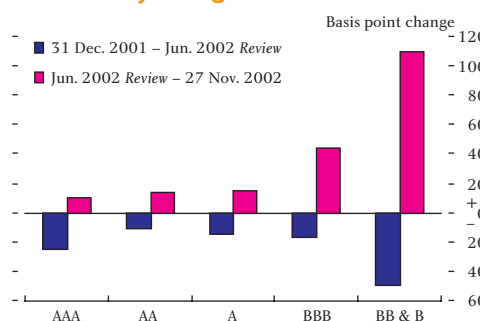
**Chart 120:**  
**International public bond issuance by UK PNFCs by rating<sup>(a)(b)(c)</sup>**



Sources: Dealogic and Bank of England.

- (a) Bond issues sorted by payment date.
- (b) The Standard & Poor's rating is used, where available. Otherwise, Moody's Investors Service or Fitch IBCA ratings are used.
- (c) Data cover bond issues announced up to 22 Nov. 2002.

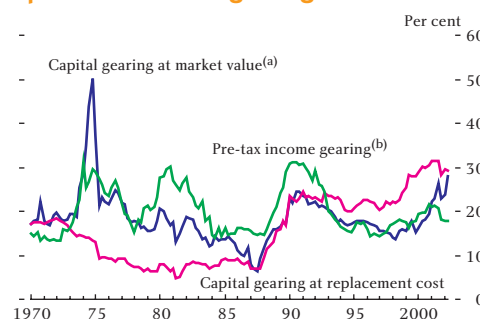
**Chart 121:**  
**Credit spread changes on bonds issued by UK PNFCs by rating<sup>(a)</sup>**



Sources: Merrill Lynch and Bank of England.

- (a) Change in the unweighted average of asset swap spreads between the dates shown. The calculation is based on all bond issues, in all currencies, by those UK-domiciled PNFCs included in the Merrill Lynch Global High Grade and Global High Yield Corporate Indices. Asset swap spread is defined as the option-adjusted spread over London Inter-Bank Offered Rate of a matched floating rate bond.

**Chart 122:**  
**Capital and income gearing of PNFCs**



Sources: ONS and Bank of England.

- (a) PNFCs' net debt divided by the market valuation of PNFCs.
- (b) PNFCs' interest paid divided by profits before tax and interest. Data are seasonally adjusted.

single-B rated UK issuers in aggregate, by around 45 basis points for triple-B issuers, and by only 10–15 basis points for A and higher-rated companies (where issuance has recovered recently).

Greater differentiation of credit risk leaves lower-rated companies with fewer financing alternatives, in the light also of falling equity prices and increased equity market volatility. Total equity issuance this year has, however, been higher than last year in value, partly reflecting recourse by both PNFCs and financial companies to rights issues, although many have had to be both deeply discounted and underwritten to ensure take-up. Some recent rights issues appear to have been motivated by debt reduction rather than by acquisition of other companies, which was the principal objective of equity issuance in 1999 and 2000.

### Gearing and debt service costs

Lower borrowing will help to reduce corporate sector capital gearing ratios, which have risen to historically high levels in recent years (Chart 122). Indeed, indebtedness relative to the capital stock measured at replacement cost has eased back somewhat over the past year. But, notwithstanding the slowdown in corporate debt accumulation, equity market weakness has pushed capital gearing up further in relation to the market value of the capital stock – it rose by 4 percentage points in 2002 Q2, reaching levels above those in the early 1990s. Further falls in equity prices since June are likely to have raised this measure of gearing again in Q3.

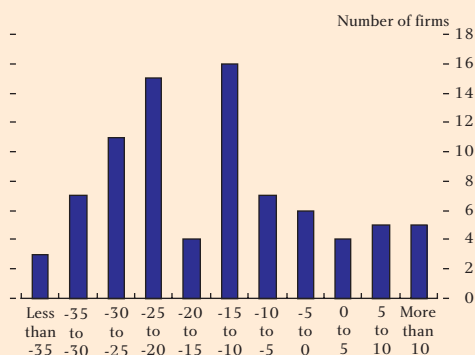
High gearing together with continuing equity market weakness may necessitate further adjustment by companies with large defined-benefit pension schemes. In a sample of 83 FTSE-100 UK companies that have produced data on net pension liabilities under FRS 17 assumptions, all but 15 were estimated to have had pension fund deficits (on an FRS 17 basis) at 27 November 2002. In 46 cases, these deficits were relatively modest – less than 5% of market capitalisation – but in six cases the deficit exceeded 20% of market capitalisation. The 22 companies with deficits in excess of 5% of market capitalisation had lower profitability and interest cover on average than the 46 companies with deficits below 5% of market capitalisation. But there was little difference in the average capital gearing of the two groups. The likely effects on the corporate sector's financial position are considered in more detail in Box 3.

The somewhat more difficult financial environment has not as yet caused major debt servicing difficulties for companies. Indeed, income gearing has eased a little further since the June 2002 Review and is at its lowest for nearly three years (Chart 122). This reflects both a fall of over 11% in debt interest payments over the past year, in turn attributable to lower bond yields together with the slower growth of debt, and also the

### Box 3: Funding company-sponsored pension schemes

Deficits on company-sponsored defined-benefit pension schemes provide a snapshot of the additional contributions that companies need to make to meet their future liabilities. Chart A shows the distribution of deficits as a proportion of fund liabilities for 83 FTSE-100 companies which have disclosed deficits on an FRS 17 basis, updated for share price movements to 27 November 2002<sup>1</sup>. Because both the future return from the assets of any pension fund, and the future cost of meeting the liabilities, are uncertain, no single valuation can encapsulate what contributions the sponsoring company might need to make over time. Instead, an estimate of the possible range of contributions and their likelihood of occurring is helpful.

**Chart A:**  
The distribution of surpluses/deficits as percentage of total liabilities<sup>(a)</sup>



Sources: Individual annual reports and Bank calculations.  
(a) Surplus/deficit as percentage of total liabilities.

This can be estimated by simulating the net contributions made by an hypothetical company that acts to keep its fund broadly in balance, topping-up the fund when a deficit appears and making withdrawals when it moves into surplus.

It is assumed here that the expected real return on the pension portfolio is 6.1% pa with a standard deviation of 17.5 percentage points, in line with historical experience for a typical pension portfolio with 75% of its assets invested in equities. The real interest rate used to discount pension liabilities is

3.35% pa, broadly consistent with current real corporate bond yields.

By investing the fund in assets with an expected yield higher than is necessary to meet its liabilities, the sponsoring company would hope over time to be able to withdraw more profits from the fund than it needs to make top-up contributions. For a company whose pension fund is initially in balance, the median present value of withdrawals net of top-up contributions is estimated to be substantial at around half the initial value of the fund. For companies that start with a pension fund deficit, any prospective benefits are reduced according to the size of the initial deficit. Thus, for a company with a deficit worth a quarter of its pension liabilities, the median present value of net withdrawals would be worth a quarter rather than a half of the initial liabilities. Nevertheless, there is a better than evens chance that it will be able to make net withdrawals from the fund over time.

While this analysis provides some reassurance even for sponsoring companies with large pension fund deficits, it would be wrong to underestimate the risks. Given the parameter values assumed here, there is around a one-in-five chance that companies would lose money in this way and a one-in-ten chance that their losses would amount to more than a quarter of the initial value of the fund. Moreover, the distribution of future returns on asset portfolios could be worse than has been assumed. This would shift the risk towards a greater possibility of loss. And even in the central case, deficits would occur in individual years. These are likely to be most problematic where company pension funds are large in relation to the firm's main business, since the necessary size of any top-up contribution could be a substantial share of resources. Six FTSE-100 companies had deficits in excess of 20% of their market capitalisation at end-November. When other debts are taken into account, the financial position of such companies would appear more vulnerable and the burden of increased pension fund contributions would be particularly acute.

<sup>1</sup>: FRS 17 is the new method for accounting for pensions. It has not been fully implemented, although companies are required to make additional disclosures on this basis in the notes to their accounts.

modest recovery in profitability. Even if income gearing were to rise somewhat, most companies currently possess substantial liquid assets with which to service the debt. Corporate liquidity, as measured by the ratio of cash plus deposits to income or liabilities, has been rising since 1999 and is currently historically high on some indicators.

## Corporate defaults and failures

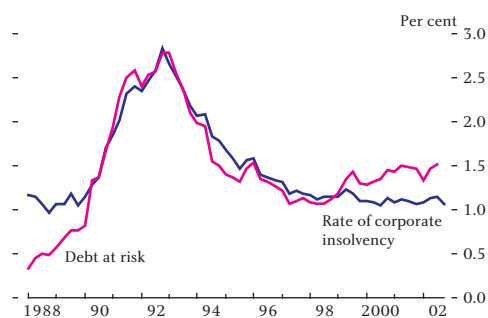
These modest levels of income gearing help to explain the continued low rate of corporate liquidations in the UK, although rising overall indebtedness has pushed up aggregate 'debt at risk'<sup>46</sup> (Chart 123). Corporate liquidations fell in 2002 Q3, reflecting a 6% fall in insolvencies reported to the DTI, although they remained 5.2% higher than a year earlier. The Dun and Bradstreet statistics (which, unlike the DTI numbers, include unincorporated businesses) showed a small rise in liquidations in Q3, to a level 5.5% above that of a year earlier. The modest rise in liquidations over the past year is broadly as predicted by models of implied corporate default probability, especially those based on market indicators such as equity price levels and volatilities. Corporate recovery bankers report a rise in corporate workout activity this year, involving mainly large rather than small companies. This is consistent with statistics showing a greater rise in defaults (on quoted debt) by value than by number.

Turning to the immediate outlook, the earlier reduction in GDP growth in 2001 Q4 and 2002 Q1 will tend to have a lagged effect, other things being equal, in raising insolvencies in late 2002 and in 2003. But the rise in profitability and reduction in capital gearing at replacement cost in 2002 H1, together with – crucially – the resilience of the income gearing position, suggest that any rise in corporate liquidations over the next year may well be modest. There is little sign as yet of any major rise in receiverships, administrations and company voluntary arrangements, which are often a good predictor of subsequent liquidations. The latest Euler Trade Indemnity survey indicates that policyholder claims against bad debts rose somewhat in Q3, although the level remains 6% below that of a year ago.

## Sectoral developments

For any given aggregate exposure to the corporate sector, the risks to UK banks would be greater the more the exposure is concentrated in more vulnerable sub-sectors. Nearly half of the outstanding stock of loans granted by large UK-owned banks to non-financial companies goes to the manufacturing and real estate sectors taken together (Chart 124). Exposures to telecoms and electricity companies are low but the probability of default has risen.

**Chart 123:**  
Corporate liquidation rate and 'debt at risk'<sup>(a)(b)</sup>

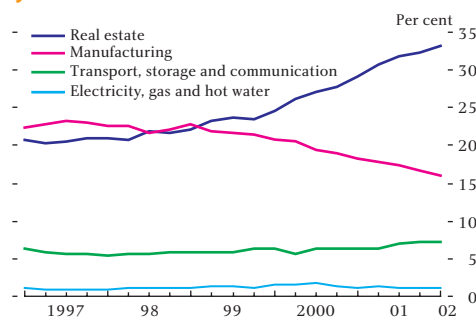


Sources: DTI and Bank of England.

(a) Data annualised and seasonally adjusted.

(b) Rate of corporate insolvencies multiplied by net debt of PNFCs, expressed as a percentage of GDP at current prices.

**Chart 124:**  
Share of non-financial corporates' total borrowing from large UK-owned banks, by sector<sup>(a)(b)</sup>



Source: Bank of England

(a) Percentage share of total stock of non-financial corporate sector borrowing from large UK-owned banks resident in the UK. Includes borrowing in all currencies.

(b) Data comprise the ten largest such banks, by total consolidated assets, as at Jun. 2002. Data include borrowing from groups' subsidiaries prior to merger or acquisition.

<sup>46</sup>: 'Debt at risk' is defined as the product of debt outstanding and the liquidations rate as a proportion of nominal GDP. See Benito, A, Whitley, J, and Young, G, 'Analysing corporate and household sector balance sheets', in the December 2001 *Review*.

## Manufacturing

Profitability in manufacturing remains weak, with the net rate of return on capital, at 4% in 2002 Q2, well below the PNFC average (11.5% in 2002 Q2). This reflects longer-run structural factors, the strength of sterling and, more recently, the slow growth in world economic activity. But profitability has improved a little this year compared with last. The sector has also continued to repay bank debt, so its debt-to-assets ratio has fallen from 36% to 31% over the past year<sup>47</sup>. These modest improvements may help to explain the decline in credit downgrades in manufacturing (relative to the service sector) over the past year. But market perceptions of credit quality have continued to deteriorate; for example, bond spreads for manufacturers of capital goods have risen sharply since June (Chart 125).

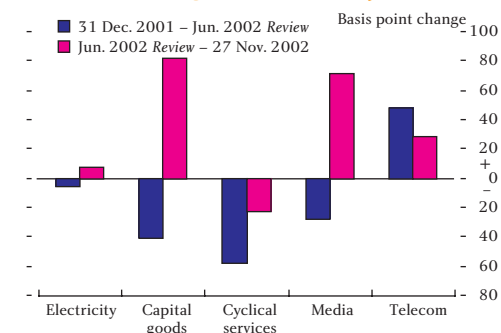
## Telecommunications

Previous *Reviews* have discussed the weakness in financial performance and credit quality in the UK telecoms sector. The mean profit margin was -10% in 2001 (-16% if weighted by debt) and several of the more indebted companies have again recorded losses thus far in 2002. A third of credit downgrades during 2002 and seven of the eight defaults on private quoted-company debt by UK companies have occurred in telecoms. No UK telecoms company is currently rated higher than single-A and access to finance remains difficult for low-rated borrowers. However, bond spreads of investment-grade issuers have only risen a little further since June (Chart 125) and have fallen most recently, which may reflect progress made by some of these companies in reducing their high levels of debt; syndicated loans and bond issuance have declined substantially this year (Chart 126).

## Electricity

Financial problems have become more acute in the electricity sector. The New Electricity Trading Arrangements (NETA) have revealed the extent of overcapacity in electricity generation, and wholesale electricity prices have fallen by some 40% since they were first proposed in 1998<sup>48</sup>. For some generating companies, particularly 'baseload' generators (those that cannot readily adjust output), prices are now below the average costs of production. This has caused difficulties across the electricity market, including most notably for British Energy, the UK's largest electricity generator. And retailers of electricity, which might expect to benefit from wholesale prices falling by more than retail prices, may not have done so if they entered into fixed-price contracts to purchase electricity. However, although individual companies have experienced difficulties, and there have been some rating downgrades, credit spreads on outstanding bond issues by UK investment-grade companies are little changed in the course of the year. And, given that major

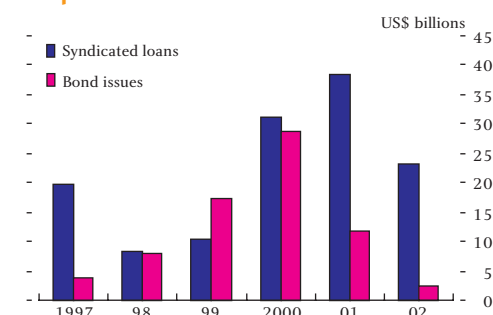
**Chart 125:**  
Credit spread changes on bonds issued by UK investment-grade PNFCs, by sector<sup>(a)</sup>



Sources: Merrill Lynch and Bank of England.

(a) Change in the unweighted average of asset swap spreads between the dates shown. The calculation is based upon all issues in all currencies, by those UK domiciled PNFCs included in the Merrill Lynch Global High Grade Corporate Index. Asset swap spread is defined as the option-adjusted spread over London Inter-Bank Offered Rate of a matched floating rate bond.

**Chart 126:**  
Gross syndicated loan and bond finance raised by UK telecommunications companies<sup>(a)(b)(c)</sup>



Sources: Dealogic and Bank of England.

(a) Syndicated loan facilities granted, sorted by signing date.

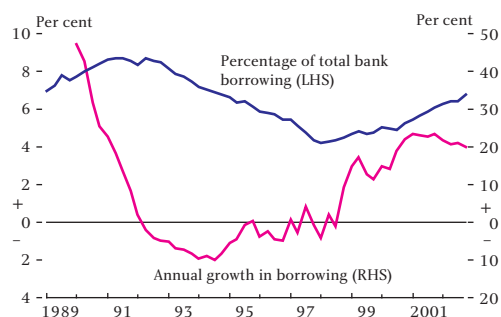
(b) International public bond issues, sorted by payment date.

(c) 2002 data cover the period from 1 Jan. 2002 to 22 Nov. 2002, annualised.

47: Based on a 10% sample for 2002.

48: NETA came into operation in March 2001.

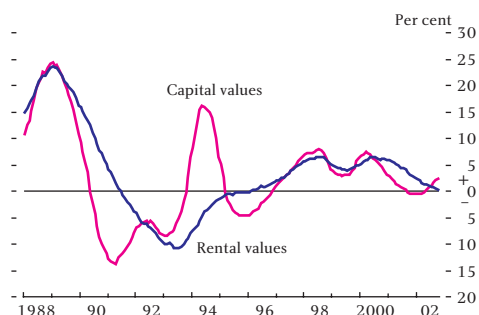
**Chart 127:**  
**Bank borrowing by the real estate sector**<sup>(a)(b)</sup>



Source: Bank of England.

- (a) Expressed as a percentage of total borrowing from UK-resident banks.
- (b) Annual growth of borrowing by real estate sector from UK-resident banks.

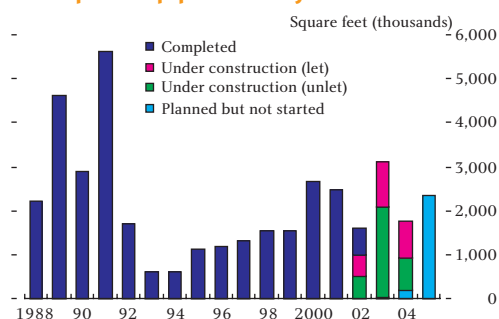
**Chart 128:**  
**Annual growth in capital and rental values**<sup>(a)</sup>



Source: Investment Property Databank.

- (a) Using the all-property index.

**Chart 129:**  
**Development pipeline: City offices**



Source: Insignia Richard Ellis.

UK banks' exposures to the sector have remained relatively stable at around 1% of their total loans to non-financial companies (Chart 124), necessary reductions in electricity capacity are unlikely to impose substantial pressure on those banks.

### Commercial property

Previous *Reviews* have noted the now prolonged rapid growth of bank borrowing by the real estate sector, which has averaged more than 20% at an annual rate since 2000<sup>49</sup>. Such borrowing reached nearly 7% of total bank borrowing in 2002 Q3, still below the peak of almost 9% in the early 1990s, but well above the trough of 4% some five years ago (Chart 127).

Persistent rapid borrowing growth sits oddly, on the face of it, with the weakness in the commercial lettings market, where annual rental value growth slowed from a local peak of 6.3% in mid-2000 to only 0.3% in October 2002 (Chart 128). Much of the recent growth in borrowing appears to have financed investment in existing property, rather than new development, possibly reflecting the recent outperformance of property as an investment class at a time of depressed equity markets and continued low interest rates. Some market commentators and feedback from the Bank's Property Forum<sup>50</sup> suggest, however, that this divergence between strong investment and a weak lettings market is unsustainable.

The relative attractiveness of property as an investment might diminish if the equity market recovered. That could reinforce the downward pressure on capital values from current and prospective conditions in the lettings market. There is clearly a risk of significant falls in rental values in certain sub-sectors, notably the City office market given the pressure on financial companies. City office vacancy rates have increased rapidly since 2001, although they remain well below the peaks seen in 1992. With substantial new City developments under construction or planned and due to come on-stream in 2003/04 (Chart 129), vacancies will increase further if the take-up of space does not rise. Availability of second-hand space in the City is at its highest since 1993. But elsewhere, and especially in the retail sector, rental growth looks more robust. Moreover, the current low level of interest rates, if sustained, is likely to mitigate the effects of any given fall in rental values on borrower default. Apart from the specific risks associated with the City office market, therefore, the main risks for the commercial property sector are those linked to the overall macroeconomic outlook.

49: See also the speech delivered by David Clementi at the Chartered Surveyors Livery Company, Goldsmiths' Hall, London, 29 April 2002 ([www.bankofengland.co.uk/speeches/speech170.pdf](http://www.bankofengland.co.uk/speeches/speech170.pdf)).

50: For background on the Property Forum, see the Box on page 72 of the November 1999 *Review*.

### 3 The household sector

Buoyant growth in incomes last year was followed by slower growth in 2002 H1, partly reflecting the corporate sector adjustments considered above. With consumption remaining resilient, savings have fallen and households have moved back into financial deficit. The counterpart to the elimination of the substantial financial surplus of earlier years (Chart 113) has been rapid growth in borrowing.

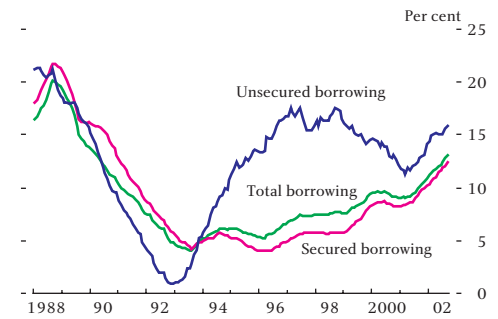
#### The build-up of debt

The growth rate of household borrowing has continued to rise this year, reaching just over 13% in the year to 2002 Q3, the highest since 1990 (Chart 130). This primarily reflects the strength of mortgage borrowing, which accounts for over 80% of total household debt and which grew by a further 12.4% in the year to Q3. The robustness of mortgage borrowing reflects such inter-related factors as low interest rates, intense competition among lenders, buoyant housing market activity and above all house prices currently rising at annual rates of around 25%–30%<sup>51</sup>. Borrowing has been boosted by a further increase in mortgage equity withdrawal, which has risen substantially since 1995. By 2002 Q2, it amounted to about half of new borrowing and was equivalent to 6% of post-tax incomes, not far short of the 8% peak recorded in the housing market boom of the late 1980s (Chart 131). It has been facilitated by competition and product innovation in the mortgage market, as manifested in the growth of remortgaging and the introduction of ‘flexible mortgages’.

Some households may have used mortgage equity withdrawal as a lower-cost substitute for new unsecured debt in financing consumption, although others may have used it to repay existing debts or to purchase financial assets. Nevertheless, unsecured borrowing overall has also continued to grow rapidly, especially the credit card component, which rose by 19% over the past year (Chart 132). The share of credit cards in total household sector unsecured debt outstanding is now around 30%, compared with 20% in the mid-1990s. Credit card ownership has widened over this period and increases in the proportion of credit card balances on which interest is paid, and in the average duration of credit card debt, suggest that the use of credit cards as a means of short-term borrowing is becoming more widespread<sup>52</sup>. The factors lying behind the growth of unsecured borrowing are considered in more detail in Box 4.

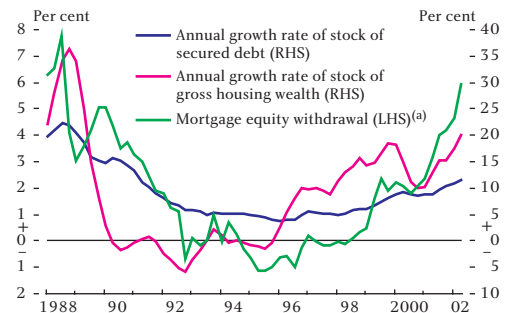
Continued rapid borrowing growth has pushed up the household sector’s debt-income ratio to 120% in 2002 Q2, over 10 percentage points above the peak of the early 1990s

**Chart 130:**  
Annual growth rate of borrowing by individuals<sup>(a)</sup>



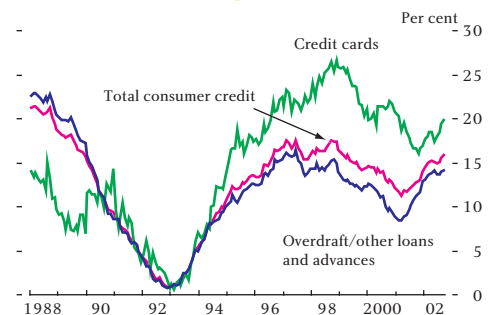
Source: Bank of England.  
(a) Data are seasonally adjusted.

**Chart 131:**  
Mortgage equity withdrawal and components of net housing equity



Sources: ONS and Bank of England.  
(a) As a percentage of post-tax incomes.

**Chart 132:**  
Annual growth rate of components of unsecured borrowing<sup>(a)</sup>



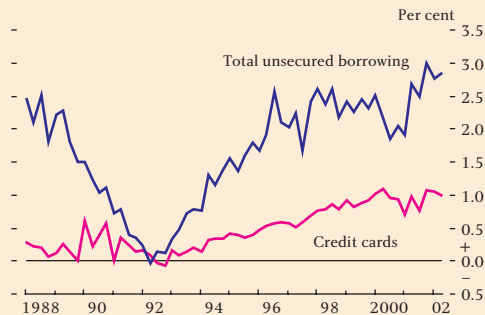
Source: Bank of England.  
(a) Data are seasonally adjusted.

51: Depending on whether the Nationwide or Halifax measure is used.

52: Page 80 of the June 2001 *Review* and page 10 of the November 2002 *Inflation Report*.

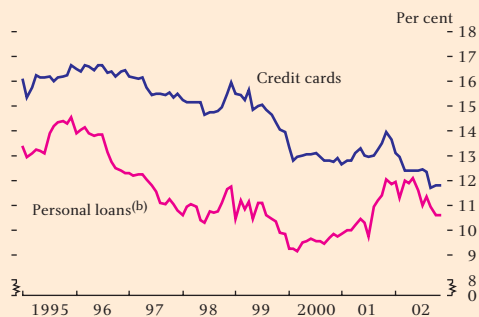
## Box 4: The growth of household unsecured debt

**Chart A:**  
Unsecured borrowing as a percentage of post-tax income



Source: ONS.

**Chart B:**  
Interest spreads on unsecured credit<sup>(a)</sup>

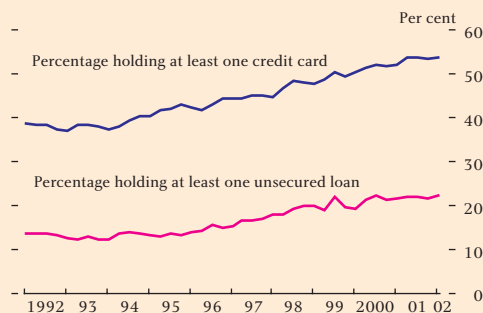


Source: Bank of England.

(a) Weighted average of quoted interest rates on new business less Repo rate.

(b) Rate based on loan of £3,500.

**Chart C:**  
Percentage of people holding unsecured debt



Source: NOP Financial Research Survey.

As a result of its rapid growth in recent years, unsecured debt now accounts for 19% of total household debt outstanding, compared with about 14% ten years ago. In 2001 Q3, unsecured net advances were equivalent to 2.8% of household post-tax income, a rate comparable to that recorded at the peak of the late 1980s consumer boom (Chart A). This has coincided with sharply higher mortgage equity withdrawal in recent years, so in aggregate there is little indication that lower cost secured borrowing has displaced higher-cost unsecured borrowing<sup>1</sup>.

Unsecured debt is intrinsically riskier for lenders than secured, so the factors underlying its rapid growth over recent years are of particular interest. Strong demand for credit reflects a robust employment market, sustained growth in real incomes and historically low interest rates. But lending growth has also been in part supply-driven. In particular, the effect on borrowing costs of lower official interest rates in recent years has been accentuated by increased competition, reflected in a narrowing in interest spreads on new business, especially credit cards (Chart B). Rates charged on good quality loans are likely to have fallen particularly sharply given increased use of risk-based pricing. The latter may also have facilitated lenders' attempts to widen their customer base, increasing access to credit for groups for whom it had previously been too costly or unavailable.

Survey evidence suggests the penetration of personal loans and credit cards has increased significantly in recent years (Chart C), particularly among lower income groups<sup>2</sup>. There have been significant changes in the socio-economic mix of credit card holders, with the share in groups A, B and C1 falling from 69% to 58% between 1996 and 2001, whilst the percentage in D and E groups rose from 13% to 24%<sup>3</sup>. The June 2002 *Review* showed that between 1995 and 2000 unsecured debt-income ratios increased most rapidly for young and low-income groups<sup>4</sup> (from relatively high levels compared with other groups). To the extent that younger or lower income households are more susceptible than others to income shocks, these changes in the distribution of unsecured debt could suggest that aggregate data might underestimate changes in the vulnerability of the household sector as a whole. Even if this were the case, however, the implications for lenders would depend on how far any increase in risk arising from a change in the distribution of their loan portfolios has been anticipated in pricing policy.

1: In spite of developments in the mortgage market, such as the growth of remortgaging, which have tended to facilitate equity release.

2: Relatively young households may of course have less access to equity withdrawal as an alternative, particularly given the increase in the average age of first-time buyers in recent years.

3: APACS Consumer Payments Survey, August 2002.

4: June 2002 *Review*, page 83.

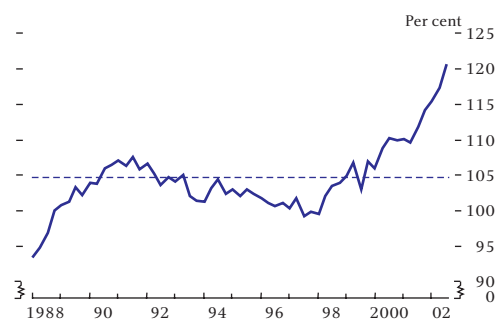
(Chart 133). There are tentative signs from some – but not all – housing market indicators that the rate of growth of loan demand related to house purchase may have moderated in Q3. However, remortgaging activity has remained persistently high and was associated with further strong growth in mortgage equity withdrawal in Q3, according to data from the Council of Mortgage Lenders and the British Bankers Association. Moreover, survey evidence suggesting that households' confidence in their own financial position – if not in the wider economy – remains robust does not point to a marked weakening in their prospective appetite for debt. On the supply side, competition among lenders for new business remains strong and banking contacts are not themselves expecting slower loan demand growth in the short term. As noted in Section III and as also confirmed by those contacts, there is little indication of any generalised tightening in lenders' terms and conditions.

### Balance sheet indicators and vulnerabilities

Despite rapidly growing debt and lower equity prices, the deterioration in the household sector's balance sheet position, as measured by capital gearing, has been limited (Chart 134). This largely reflects the buoyancy of housing wealth, which accounts for about half of households' gross assets. Household debt in relation to *financial* wealth (ie excluding housing) has risen more rapidly and by 2002 Q2 was approaching the highs of the early 1990s (Chart 134). It is likely to have risen further since then given falls in equity markets in Q3. Liabilities relative to *liquid* financial assets, which are particularly relevant to the ability of households to absorb unexpected increases in payments or falls in income, have also risen sharply (Chart 135).

These developments have raised further the vulnerability of the household sector to substantial rises in interest rates or falls in income, while the balance sheet position is more susceptible to a further fall in equity prices or a major correction in the housing market. That said, interest rates are expected by financial markets to rise only modestly over the next year, and a large fall in household incomes is not the most likely outcome, as discussed in the November 2002 *Inflation Report*. Equity prices have recovered a little recently, although any renewed substantial falls might induce households to seek to rebuild balance sheets via an increase in saving<sup>53</sup>. There is little sign of any such effect as yet, mainly because rapid increases in house prices have supported consumer demand and offset the impact of lower equity prices. But, as also emphasised in the November *Inflation Report*, recent rates of house price inflation are unsustainable. A slowdown in house price inflation could reinforce prospective balance sheet adjustment by households. If it were accompanied by unexpected falls in household incomes, the consequences would be likely to

**Chart 133:**  
Household sector debt as a percentage of income<sup>(a)(b)</sup>

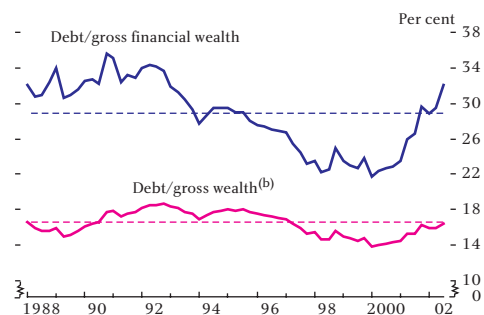


Sources: ONS and Bank of England.

(a) Debt is total liabilities. Income is household post-tax income.

(b) Dashed line indicates average of series from 1988.

**Chart 134:**  
Household sector capital gearing<sup>(a)</sup>

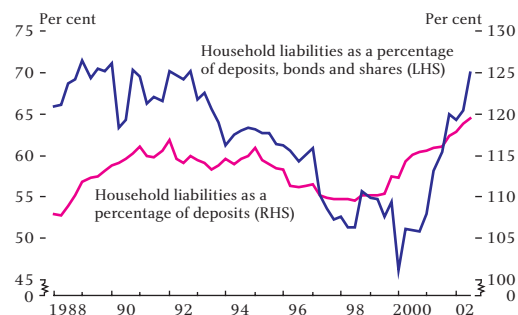


Sources: ONS and Bank of England.

(a) Dashed lines indicate average of series from 1988.

(b) Gross financial plus housing wealth.

**Chart 135:**  
Household liabilities relative to liquid financial assets<sup>(a)</sup>

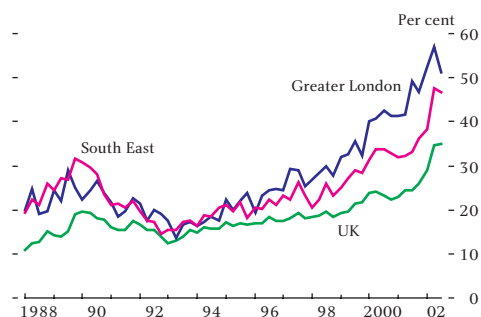


Sources: ONS and Bank of England.

(a) Data are not seasonally adjusted.

53: There are signs of adjustment on the assets side of the balance sheet, involving shifts from equity holdings to more liquid assets, such as bank deposits.

**Chart 136:**  
**Percentage of first-time buyers with  
 advance-to-income ratios of greater than  
 three**



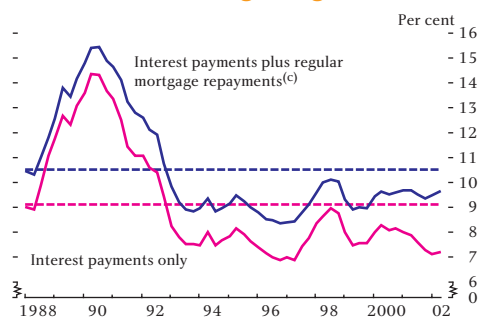
Sources: Council of Mortgage Lenders and Bank of England.

be most severe for those households whose income gearing is highest and whose loan-to-income ratios have become most stretched recently. In that context, there has been a significant rise in recent quarters in the proportion of first-time buyers with high loan-to-income ratios (Chart 136). These ratios vary on a regional basis: the Greater London area, with the highest such multiples, may be particularly vulnerable, especially given pressures on the financial services industry.

### Evidence from disaggregated data

The risks associated with rising aggregate indebtedness would be increased if the rises had been concentrated among the most vulnerable households. The latest British Household Panel Survey (BHPS)<sup>54</sup> shows that the lowest-income and youngest households have increased their debt-income ratios by more than other groups – and from higher levels – between 1995 and 2000. But they still accounted for only 5% of total debt in the BHPS sample for 2000. More recent data from the Financial Research Survey (FRS)<sup>55</sup> show that lower-income groups have higher ratios of unsecured loans to income than most higher-income groups. The low-income households are less likely to have substantial housing wealth and may be more vulnerable to financial shocks, such as spells of unemployment.

**Chart 137:**  
**Measures of income gearing<sup>(a)(b)</sup>**



Sources: ONS and Bank of England.

(a) Payments as a percentage of household post-tax income.

(b) Dashed lines indicate average of series from 1988.

(c) See page 82 of the Jun. 2002 *Review* for how this series is constructed.

### Debt servicing costs and arrears

Notwithstanding the rapid accumulation of debt in recent years and the risks associated with it, there is still very little sign of households facing difficulties in servicing debt. In particular, mortgage arrears continue to run at historically low levels and there has not been any marked recent deterioration in the trend in credit card arrears. This is not surprising, given that household income gearing, which is likely to be most directly associated with the risk of default, remains well below the average levels of the past fifteen years (Chart 137). This is also true of alternative measures of income gearing that include regular repayments of mortgage principal, although, unlike the interest-only measure, these have not fallen further since 2001<sup>56</sup>. Modest income gearing in turn reflects continued growth in household incomes and employment and historically low interest rates on both mortgage and unsecured debt. Households may in consequence believe that 'sustainable' debt levels have risen. But this perception could change rapidly if interest rates were to rise substantially, incomes fall or unemployment rise. Furthermore, the perception may not fully take into account the persistence of the real burden of debt in a low-inflation environment.

54: The BHPS is an annual survey of households in Britain. It is based on a nationally representative sample of adult members in around 5,500 households originally surveyed in 1991 and re-surveyed each year thereafter.

55: The Financial Research Survey, carried out by National Opinion Polls, is a monthly monitor of the personal finance markets in Great Britain. See page 94, footnote 68 of the December 2001 *Review*.

56: For a fuller discussion of alternative measures of income gearing, see page 82 of the June 2002 *Review*.