Personal credit in perspective

*The **Governor** examines*[1] *the role of credit, more particularly lending to the personal sector, in its macroeconomic, prudential and social aspects. He argues that the figures for personal sector lending have been affected in recent years by financial innovation and a shift in the personal sector's behaviour, and have to be interpreted in the light of these changes: the recent pace of credit growth must argue for caution, but its economic significance should not be judged simplistically on the basis of past relationships between borrowing and lending. He goes on to consider the prudential and social implications of the easing of credit availability and the need this creates for both individuals and institutions to adjust their behaviour and attitudes.*

. . . much attention has been focused recently on lending to the personal sector. You will, for example, have seen—indeed some of you may have written—headlines such as 'Accelerating Credit Growth Fuels Consumer Boom'. I should like to spend a little time this afternoon on this aspect of credit, considering in turn its macroeconomic significance, some supervisory implications and the social questions which can arise from the easy availability of consumer credit.

But first, let me say a few words about the role of credit more generally in the economy.

As a nation, our attitude to credit is typically ambivalent. There is a tendency to think of credit as something intrinsically reprehensible. Most of us carry around somewhere in our subconscious the familiar admonition 'neither a borrower nor a lender be'. But at the same time it is very hard to envisage the effective functioning of the economy without credit to oil the wheels. Its role is to allow flexibility in the timing of expenditures, enabling them to be separated in time from the receipt of income.

This tends to be more readily accepted in the case of industry and commerce, where credit—to finance an expansion of production through investment, the employment of additional labour or a build-up of stocks—is taken in anticipation of future sales. But credit performs exactly the same function for consumers, enabling them to make large purchases or investments at a convenient or opportune time, and to pay for them in accordance with their expected pattern of income. I find nothing reprehensible about that—indeed rather the reverse.

So in general I welcome the changes in the financial structure which, over the past few years, have resulted from, and in, more competition between lenders to the personal sector, and which have led to the increased availability of personal sector credit. It must be an advantage for the individual to have more choice between different types of borrowing facility, and greater flexibility over the timing of his expenditure and in the arrangement of his portfolio of assets and liabilities. And there are macroeconomic benefits too. For example, with the ending of mortgage queues, activity in the housing market is less prone to proceed in fits and starts, governed by the availability of mortgage finance.

But, like all good things, there can be too much of it.

From the macroeconomic viewpoint, too rapid an expansion of credit, unless matched by an equivalent growth of firmly-held financial assets, can lead to excessive growth of demand in real or financial markets. The persistent pressure of excessive credit growth clearly can produce an over-liquid economy, with the added potential for inflation which that entails. So the question is one of degree. Has the growth of credit—and of credit to the personal sector in particular—in fact been too fast?

As you would expect there is not a simple or straightforward answer to that question.

In aggregate, bank lending in sterling to the domestic private sector as a whole certainly has been growing very rapidly—accelerating to over 20% a year in the last two years. Looking behind the aggregate figures, a principal cause of this acceleration has been a remarkable surge in *lending to financial institutions.* It has nearly doubled since 1985, to getting on for a quarter of the outstanding total stock of bank lending—though it has tended to grow more slowly since the summer. This development has no doubt a good deal to do with the recent structural changes in our system of financial intermediation and to this extent its significance for the behaviour of the wider economy may be limited.

Bank lending to industrial and commercial companies, although quickening in the last six months or so, has generally been more restrained in recent years as borrowers have found a wide variety of alternative sources of finance in both domestic and overseas money and capital markets.

(1) In a speech at the annual luncheon of the Newspaper Conference, on 29 January.

Bank lending to the personal sector has also grown relatively fast—by nearly 50% in the past two years and by over a quarter last year alone. This is what has prompted the headlines to which I referred earlier.

But looking at the banks' personal lending more closely, one finds that the most important and rapidly growing part of it is mortgage lending. The banks' other consumer lending has been growing fairly steadily, at a rate of around 18% a year for most of the 1980s. And much of the recent acceleration in the banks' mortgage lending has been at the expense of slower growth in mortgage lending by building societies. Taking banks and building societies together, the *total* increase in credit granted to the personal sector was 40% in the past two years and less than 20% in 1987.

Even so, personal sector borrowing in total has been rising a good deal faster than personal incomes for a number of years. This has much to do with the more intensive competition between financial intermediaries, particularly in the mortgage field, which has made it easier, for example, for homeowners to borrow against the accumulated equity in their houses. Not all of this increased borrowing has fed through immediately into higher consumer spending. Much of it has gone into a parallel increase in the personal sector's holdings of financial assets, including deposits with banks and building societies. To this degree, therefore, what we have seen is a change in the personal sector's *financial* behaviour resulting from the freer availability of credit, which may be of less economic significance than would have been implied by earlier relationships between borrowing and spending. Such a shift in behaviour is likely to take some years to complete, but we simply cannot tell how much longer it will take or how far we are away from a new equilibrium.

The point I am making is that the simple credit figures need to be seen in perspective. The monthly bank lending data, in particular—and these typically attract most public attention—have to be interpreted with great care. They have in our view for some time given a misleading impression of monetary conditions in the economy, and of the extent to which we have been going through a consumer credit boom in the traditional sense. In these and other respects we need, I think, to be wary of over-simple and over-hasty conclusions.

In making these remarks I do not at all mean to suggest that we can be relaxed about the recent pace of credit growth, including the growth of consumer credit. It has been, and continues to be of concern to the Bank and, together with the associated rapid increase in broad money, it is one of the factors—alongside the strength of domestic demand and the continuing less than satisfactory development of underlying labour costs—which inclines us to our present generally cautious monetary stance. But there could be a danger of over-reaction if we simply took the credit figures at their face value.

These developments in personal sector lending, of course, also prompt a supervisory interest. Historically the risk/reward ratio in lending to the personal sector, particularly on mortgages, has been relatively attractive in this country, and it is this past experience as much as anything which has attracted so many new lenders into the field. But more intense competition must tend to encourage lenders to take on higher risks at the same time that lending margins are being squeezed. Past experience may not therefore be an adequate guide to the future; and lenders, and their supervisors, must be conscious of the steeply rising ratio of personal sector debt to income. Although broadly paralleled by a rising wealth-to-income ratio at the macroeconomic level, this may well lead to an increasing number of individual borrowers having difficulty in servicing their debts.

Thus far the signs are not disturbing. Certainly, since the ending of hire-purchase terms control, we have seen some lengthening in the term of consumer credit; and mortgage lenders have gradually increased the amount that they are prepared to lend, both as a proportion of the value of the property and as a multiple of income. I have become aware recently of a number of instances of income multiples of up to four times the primary income, which suggests this process is going further. But in parallel with these developments, techniques for assessing and monitoring credit have been improved; and for the most part the fuller credit terms are being extended selectively, in cases where the borrower is well known to the lender, who can therefore better judge the risks. My impression at present is that experience of arrears and bad debts on personal sector lending generally is getting no worse and in some areas is even tending to improve—as indeed it should, given the improving climate for employment. Welcome though this is, it cannot, of course, be taken as grounds for complacency, and you may be assured that we will remain vigilant in this respect in our own supervisory activity.

Let me then turn to the third aspect of personal sector lending—its social aspect: that is to say the problem of the easy availability of credit from a multiplicity of sources to the individual borrower, who may thereby be tempted to take on more debt than he or she can handle. There have been a number of well-publicised instances in recent months, which have quite properly given rise to concern. Because of the real personal suffering which can be involved, it is perhaps this aspect of personal sector credit which gives me the most immediate anxiety.

Attitudes to this problem tend to divide between those who believe that the fault lies with the borrowers, who need protection from themselves; and those who believe that the blame lies with over-zealous lenders—pushing credit, so to speak, down the unwilling throats of reluctant consumers.

I am bound to say that I find it hard to envisage many instances where the borrower can be spared *all*

responsibility for his actions, and there can be very few cases of a lender consciously making an advance which he knows has little chance of being repaid. But there certainly are cases where the credit assessment is made with insufficient care. It is not for me to take sides in this debate; my purpose is rather to consider the remedies.

There are already legal safeguards to protect borrowers through the Consumer Credit Act and through codes relating to advertising standards, for example; and I myself doubt whether the present problem can be effectively addressed through further general legislation. More can no doubt be done in educating borrowers over the longer term. But in the immediate term we have to look to the lenders, who must—and mostly do—accept a social responsibility to minimise the incidence of over-borrowing by consumers. I would commend to you in this regard the Code of Practice adopted by the Finance Houses Association last year.

There is, however, a corollary to expecting lenders to accept a social responsibility in this form. *We* must then accept that they will need to be more intrusive in their enquiries into a prospective borrower's financial position, and, in particular, in a world in which a single borrower has access to a vast array of credit sources, that lenders must be able to pool their knowledge about the financial position of individual borrowers. I have spoken about this in the past, and I am glad to say that much progress is already being made in this direction.

Of course, I understand that such arrangements must be subject to appropriate safeguards. They must, for example, ensure that the individuals may have access to such information as far as it concerns them, and this is rightly ensured by the Consumer Credit Act. More generally there must be arrangements to protect the confidentiality of the information, and to ensure that it is available only to those participating lenders from whom credit has been specifically requested. I do understand the difficulties and sensitivities, but I hope that we can collectively make rapid progress in defining those safeguards, and thus reduce the present inhibitions on pooling both 'black' and in time I hope also 'white' credit information. Without this, I am afraid that we are likely to see yet more instances of personal difficulty and distress. We cannot expect lenders to do an effective job in preventing this, if we are not prepared to provide them with the means of carrying it out.

Mr Chairman, I have addressed the role of credit from a number of viewpoints—macroeconomic, prudential and social. Rapid growth of credit, and the attendant build-up of liquidity will always be watched with care by the monetary authorities particularly in a period of financial innovation and changing behaviour, which add to the difficulties of interpretation of events. There is perhaps nowadays a greater awareness of prudential issues, and in general a greater degree of vigilance than in earlier times. But the social issues do I think represent the largest concern; and with the easing of credit availability that has become established in recent years, we must encourage both individuals and institutions to adjust their behaviour and attitudes.