Personal credit problems

*The **Governor** reviews[1] the rapid growth of personal borrowing over recent years and, while welcoming the benefits of greater competition in the provision of personal credit, points up some possible problems which banks and other lenders will need to address. He warns that historical default experience may not necessarily provide a satisfactory guide to the future. High interest rates, the higher level of indebtedness and slower economic growth could all contribute to an increase in the incidence of payments difficulties, which would call for restraint and sensitivity on the part of lenders: and lenders will need to keep their procedures both for granting and for monitoring credit under review to ensure they are adequate for changing circumstances. The **Governor** goes on to review the implications for monetary policy of higher consumer indebtedness.*

I would like to take as my starting point this evening an admirable guide published recently by the Office of Fair Trading under the title 'Moneyfax'. Its purpose is to guide young borrowers through the maze of personal credit. It is full of good practical advice, which if followed ought to spare many people a great deal of worry and needless hardship. For some, of course, this advice may well come too late, but they can skip straight to Section 12, and copy out the following model letter:

> 'Dear Creditor
>
> I am writing to inform you that I am presently having financial difficulties because of [here you insert your reason].
>
> My total monthly income is £474 . . .
> Monthly outgoings are £409 . . .
>
> leaving me a balance of £65 to repay my debts.
>
> I have other credit commitments and with that in mind I have calculated that I can afford to repay £12.50 per month towards clearing my credit agreement with yourselves. I have not calculated this sum to include interest as I would be very grateful if you would stop any further interest in order that I can repay the original balance.
>
> I apologise for any inconvenience this situation may cause and hope that you may agree to my request.'

This may perhaps lack some of the exuberance of letters drafted in similar circumstances by Mr Wilkins Micawber; but it is brisk, businesslike and to the point, calculated to bring a pallor to the cheek of even the most hardened credit manager. Indeed when you think about it, it is quite an alarming document for a creditor to receive; if it were submitted by a heavily-indebted developing country, the figures suitably enhanced with a series of noughts, the consequences would be said to be 'systemic'—that being, as you will know, a strong word in the central banker's vocabulary.

Now there are those who like to trace a parallel between the fashion for lending to ldcs in the 1970s and the growth of consumer credit in the 1980s. In both cases, lenders seemed morally certain that they were dealing with an absolutely sound banking proposition. As little as ten years ago, I recall hearing the conventional wisdom that sovereign governments could never default; that they would always have export earnings to service their existing debts and as a basis for replacing them with new ones. More recently it has been quite difficult to question the view that personal borrowers have ample security in the form of house property—as well as certain income cover as a consequence of growing real earnings. This belief has underpinned, over the past few years, what must by any historical standards be seen as a fairly liberal approach to personal sector credit. And as with the earlier phase of lending to ldcs, there has been some pretty intense competition between lenders, prompting questions about the quality of credit assessment and loan pricing. In both cases, moreover, historical default rates were cited as evidence that problems could never arise in acute form in the future.

Although the parallel should give pause for thought, I doubt that it can be taken all that far. Personal credit is spread widely, in relatively small sums, and for the most part to individuals who do enjoy reasonable security of income and whose loans are covered by realisable assets in the United Kingdom. Lending to problem ldcs, by contrast, is focused on a few debtors, in extremely large amounts, whose security is in the last resort not readily accessible to the bailiffs. We can remember, too, the saying: 'If I can't pay my loan of £1,000, that's my problem; if I can't pay my loan of £1 billion, it's the bank's problem.'

But I want to suggest this evening that there are nevertheless problems that banks and other lenders to the personal sector need to address. For example, I would not be so certain that historical default experience necessarily

(1) In a speech at the Finance Houses Association Annual Dinner, on 8 March.

provides a satisfactory guide to the future. Higher interest rates, combined with much higher levels of indebtedness, seem to me very likely to increase the incidence of payment difficulties and defaults above what we have recently seen, while a softer housing market may well diminish the security against which loans have been made. Lenders will need to ensure that they can identify these cases quickly—and then deal with them with appropriate sensitivity. I need hardly remind you that there is an important social aspect to personal credit problems; rightly or wrongly, lenders are vulnerable to public censure in cases of difficulty, even where, by any objective standard, the problem may have been more one of irresponsible borrowing than of irresponsible lending. And a few lenders may also need to consider whether their procedures for granting credit may have become too much influenced by the competitive environment of recent years.

Growth of personal borrowing

I should perhaps start by asking why personal debt has been rising so sharply? For the increase is dramatic: between the middle of 1976 and the middle of last year the total stock rose sevenfold in money terms, and the ratio of debt to personal disposable income rose from about 50% to more than 100%. It is clear that deregulation, innovation, and competition in financial markets have all played a part. Constraints which previously restricted access to borrowing or consumer choice have been lifted. Credit has been available from more sources and for a greater variety of purposes. Mortgage queues have disappeared, and loans are granted against very high proportions of property valuations—100% in some cases—and for higher multiples of the borrower's income.

Greater availability of credit is of course only a part of the story. Rising real incomes and increasing confidence in economic prospects have also played their part. When people feel prosperous and confident they tend to borrow money: at other times they are more likely to save. This partly explains the paradox that in the 1970s, with negative real interest rates, savings ratios rose; in the 1980s, with positive real rates, they fell. Despite three wet summers in a row, people appear to have stopped anticipating rainy days!

Debt problems

Available statistics are not very informative about the seriousness of debt-related problems. Mortgage difficulties, which are the largest element, appear to be running at a higher level than at the beginning of the decade, but in the last three years arrears have actually been falling, and on the basis of first-half figures, we also saw repossessions fall last year. In the consumer credit field, there is very little to go on. The statistics, despite the very welcome efforts of the FHA, are notoriously incomplete and out-of-date. But it would in any case be wrong, in present conditions, to rely too much on backward-looking indicators. Higher interest rates are bound to cause more widespread difficulties, especially among those first-time buyers who may have over-committed themselves ahead of last year's changes to mortgage interest relief. And they will not be alone in needing to devote an even higher proportion of their income to servicing their debts than would normally be the case. Moreover, with the economy beginning to slow, reducing the opportunities for overtime working, we may well see a further squeeze on household finances.

Of course, in aggregate terms, personal borrowing looks quite small when set against the growth of personal sector assets. Since 1980, the total liabilities of the personal sector have grown by £230 billion—but their assets have grown by five times that amount. This might not suggest that the personal sector is over-extended—but we must remember that those building up assets are not necessarily the same as those building up debts; and the valuation and liquidity of personal sector assets must be vulnerable to change in economic and financial conditions in a way that the nominal amount of debt is not. In aggregate, this may not be too serious, given the huge disparity between assets and liabilities—but there may still be enough individual cases of difficulty to add up to a material credit problem. We are conditioned here to expect nominal house property values to rise steadily, and from time to time spectacularly. Unlike other countries, we have not for many years experienced the pressures on individual finances that can result from a fall in values, or from a persistently illiquid market. It is clear now, however, that there has been a setback to the housing market in some parts of the country, with turnover sharply reduced and prices already declining in real terms.

Given this combination of circumstances, it seems to me unlikely that last year's experience with mortgage arrears will be sustained. Building societies are already reporting an increase in 'short' arrears; and the full impact of higher mortgage rates has yet to be felt. Outside the mortgage field, the risks might if anything be greater, for borrowers tend, understandably, to place a higher priority on maintaining mortgage payments than on other forms of debt servicing. If such problems emerge, they will I suggest require very careful and sensitive handling, especially in cases of hardship. Banks and building societies have a good record in this field, and the FHA has taken a lead in promoting good practice. An increasing number of lenders acknowledge the difficulties that their customers can get into by offering counselling and other services either directly or through advice centres. I hope that these arrangements will be widely respected: it would serve no purpose if the restraint of some lenders simply permitted others to enforce their own claims against the debtor.

But restraint and sensitivity in the face of repayment difficulties can be only one side of the story. Lenders need to have approaches to provisioning and to monitoring of arrears in order to ensure that difficulties are addressed

before they get out of hand. We have also to look to the future, and consider whether procedures for granting credit are soundly based. Major lenders have I know developed sophisticated techniques for assessing credit-worthiness, which may well have contributed to the better default and recovery experience of recent years. But like any 'expert system', these must be kept under close review as conditions change and in the light of any difficulties that emerge. Smaller granters of credit certainly need to ensure that the routine checks they undertake are adequate. And while I certainly acknowledge the difficulties, improved arrangements for sharing credit information can I believe play a useful part in all this.

Supervision

If the recent growth in personal credit brings problems in its wake, we should perhaps not be too surprised. As Brian Quinn, our Head of Banking Supervision, said in a speech more than two years ago, 'the banks, and those who compete with them, should be asking themselves if it is not in their own business interests to temper their lending in this area before the volume of arrears becomes a matter of prudential concern'.

Have we yet reached that point? Clearly, we must be concerned as supervisors about any impact on individual banks or the banking system as a whole of an increase in default rates. But I do not yet see grounds for immediate concern. Over the past two years we have reviewed with a number of major lenders their processes for monitoring and providing against consumer credit, to ensure that the systems are in place to identify problems at an early stage and to protect assets. Generally, we consider that they now are, and I would still judge the problems to lie more between banks and their customers than between banks and their supervisors. But for quite a few years now, and without seeking to stand in the way of competition and innovation, we have encouraged banks and other lenders to greater caution in expanding their personal credit books; and we have urged them to keep a close eye on their systems, both for granting and monitoring credit. The position is plainly one to be kept under review.

Monetary policy

I should not leave this subject without saying something about the role of monetary policy. Personal credit, especially that part related to the housing market, played a considerable part in the acceleration of demand last year and consequently in the inflationary pressures against which high interest rates are directed. And high interest rises are inescapably the catalyst for many of the pressures that I have been describing tonight. So it is fair to ask whether we have got the balance right. Do present policies bear too hard on the consumer?—and should we have tried to choke off the growth in personal credit sooner and more directly through, for example, specific controls on credit?

As to present policy, I have no doubts at all. Excessive growth in consumer demand last year was fuelled largely by personal sector borrowing. The higher income gearing of the personal sector makes it more sensitive than in the past to interest rate changes, and an increase in short-term interest rates therefore represents a very appropriate response to excessive consumer borrowing. And while we need to be alert to individual problems, the cooling down of the housing market, and the lower growth of mortgage commitments, personal sector credit and spending are precisely the response that we look for.

Whether action should have been taken earlier to choke off the growth of consumer credit is perhaps a better question. I think that with the benefit of hindsight it is possible to say that interest rates were allowed to fall too far in the wake of the Stock Exchange crash, and that we should have responded earlier and more vigorously to the signs, tentative though they were at the beginning of 1988, that demand pressures were building up again. But I am certain that it would have been quite wrong to impose specific controls on personal credit as such. Even when such controls work in the short term, they tend to distort: and much of the difficulty that we have experienced over the past decade has resulted from the unwinding of just such distortions. In the longer term, controls simply do not work in practice, particularly in the modern world. Our markets are too open, and credit granting has now become far too competitive and sophisticated for us to attempt controls such as those we tried in the 1960s, or even any reasonable variation on them.

Conclusion

In general I have no doubt that greater competition in the field of personal credit is to be welcomed. In the main, competition in banking has benefited consumers, providing wider choice and keener pricing of services. But there is a balance to be struck. I have suggested in the past that competition in retail financial services needs to be tempered with a proper caution, and this applies with particular force in the field of personal credit. I do not believe it right to characterise the recent behaviour of lenders in the personal credit field as irresponsible, though I know the charge is often made. Nevertheless, the rapid growth of the past few years, and the likely emergence this year of increases in payment difficulties and individual cases of default, should I suggest cause all lenders to review very carefully their procedures for granting and controlling credit in so sensitive a market.