

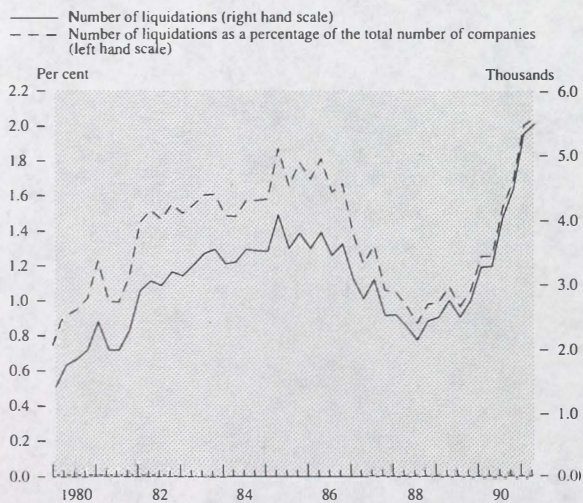
# Patterns of default in the non-financial private sectors

The current recession has been accompanied by an unprecedented rise in the incidence of default on loans by both households and companies. This note<sup>(1)</sup> seeks to clarify the reasons for these patterns of default, relating them not only to general economic conditions but also to the state of private sector balance sheets, which have exhibited a considerable increase in gearing over the 1980s. A range of other factors are also considered.

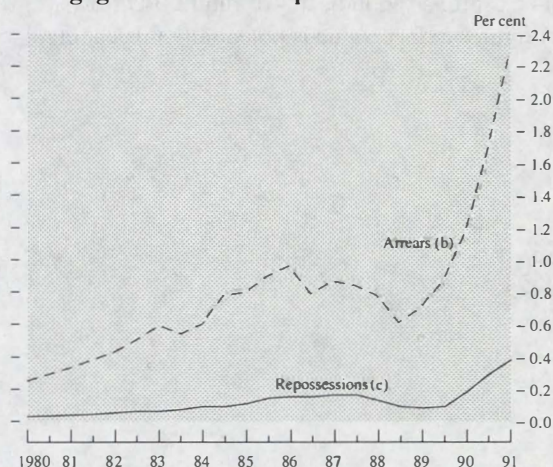
## Introduction

Company liquidations and personal sector mortgage defaults have both risen sharply over the last year and currently stand at record levels. In the first half of 1991, company insolvencies reached 10,833 (4.0% of the total number of companies registered at Company's House) compared with 6,549 (2.7%) in the equivalent period a year earlier.<sup>(2)</sup> Of the former figure, 4,149 were compulsory while 6,684 companies were wound up without a court order. In the same period, figures produced by the Council for Mortgage Lenders show that 221,900 mortgages (2.3% of the outstanding stock) were more than six months in arrears, compared with 109,370 (1.2% of the outstanding stock) a year earlier, and that 36,610 dwellings were repossessed (0.4% of the outstanding stock of mortgages), more than double the number recorded a year earlier. Personal bankruptcies and consumer credit defaults are also at record levels. Although the combination of recession and high interest rates is likely to have been the main cause of this rise in defaults, the much more moderate increase in company failures and mortgage arrears which accompanied the more severe downturn and higher interest

**Chart 1**  
Company liquidations<sup>(a)</sup>

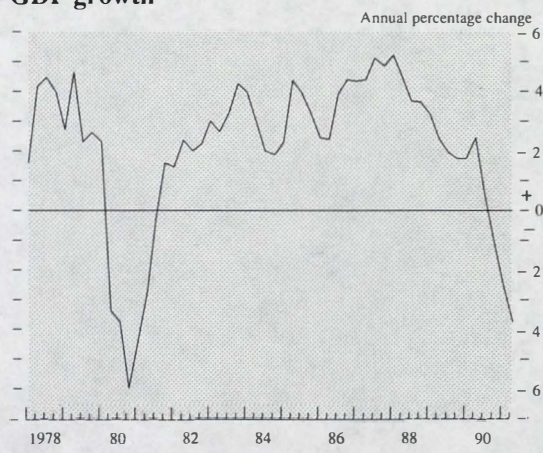


**Chart 2**  
Mortgage arrears and repossessions<sup>(a)</sup>



- (a) Half yearly data.  
(b) Mortgages over 6 months in arrears as a percentage of the outstanding stock of mortgages.  
(c) Repossessions as a percentage of the outstanding stock of mortgages.

**Chart 3**  
GDP growth



rates of the 1980–81 period suggests that other factors may also have been important (Charts 1, 2 and 3).

## Common factors

Similar factors may affect both corporate and personal default. One important common determinant is the level of

(1) Prepared by Michael Joyce and John Lomax of the Bank's Economics Division.

(2) Figures from Dun and Bradstreet do, however, show a fall in the third quarter compared with the second quarter, although business failures remained at a very high level.

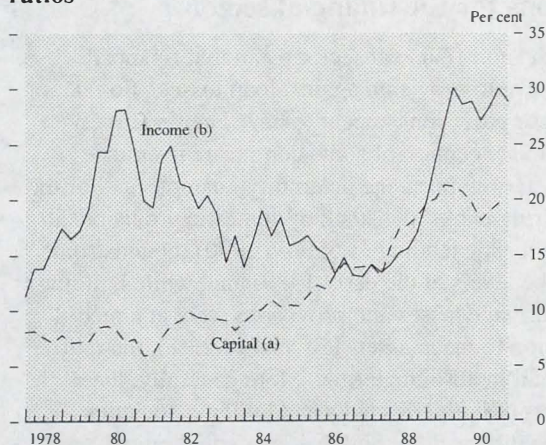


gearing, both capital gearing (debt as a proportion of assets) and income gearing (interest payments as a proportion of income), with higher levels of indebtedness associated with a greater likelihood that fixed contractual obligations to creditors (principally interest payments) cannot be met. Borrowers who have taken out loans on illiquid assets or assets whose value subsequently falls are particularly vulnerable.<sup>(1)</sup>

There may also be a relationship between the default rate and inflation. When there are limits on borrowing, a company or household in financial distress has to survive on cash flow. With non-indexed and variable-rate debt, a rise in inflation and the nominal interest rate reduces cash flow<sup>(2)</sup> (implicitly, in this situation, interest payments include some capital repayment). However, although this factor is important, it is unlikely to explain why default rates have risen so rapidly during 1990–91 compared with the early 1980s, given the much lower levels of inflation during the recent downturn.

In general, company liquidation rates (insolvencies as a proportion of the total number of companies) are higher than personal sector repossessions in relation to the number of mortgages outstanding. Part of the explanation lies in the greater liquidity of the second-hand market for residential dwellings: corporate assets are more difficult to resell because of difficulties in ascertaining quality.<sup>(3)</sup> Another factor explaining higher corporate default rates is the greater volatility of company incomes. Personal sector incomes are generally more stable, a characteristic underpinned by social security payments of individuals' mortgage interest in the event of unemployment.

**Chart 4**  
Company sector income and capital gearing ratios



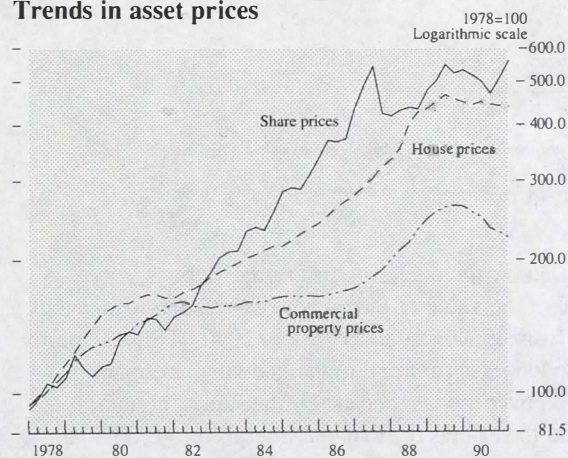
(a) Net debt at book value as a percentage of replacement cost capital stock; data not yet available for 1991 Q2.  
(b) Net interest payments as a percentage of post-tax income.

## Corporate defaults

Company liquidations have increased more sharply recently than at the same stage of the last recession, when defaults significantly lagged the deterioration in companies' financial position (Chart 1). But corporate indebtedness has been much higher both at the outset of the recession and subsequently (Chart 4). ICCs' capital gearing (net debt at book value as a percentage of replacement cost capital stock) was 19% in 1990 compared with 9% in 1980. Their net income gearing (net interest payments as a percentage of post-tax income) was also a little higher, 28% as opposed to 26% on the same comparison. Gross income gearing (gross interest payments as a percentage of post-tax income) rose from 34% to 37%. Although much of this increase would seem to have been voluntary, as debt became more attractive relative to equity,<sup>(4)</sup> the fall in aggregate demand left companies in an exposed position.

A number of factors besides increased gearing may also have contributed to higher corporate default rates. The sharp fall in share prices in 1990 and the more protracted decline in commercial property prices (Chart 5) could have exerted an influence, since such movements reduce the value of corporate collateral, possibly making distress borrowing more difficult. In addition, the increased proportion of small or newly established companies may have boosted the number of liquidations since both tend to rely heavily on bank finance. Moreover, given the length of the post-1980 upswing, an unusually large proportion of companies had no previous experience of dealing with recession.

**Chart 5**  
Trends in asset prices



The recent rise in company liquidations may additionally, and to a much greater extent than in 1980, have been induced by the downturn in the housing market. It is not possible to obtain data at a sufficiently disaggregated level to confirm

- (1) Default may arise from illiquidity even in the absence of insolvency, so that a company could go into liquidation, or a household suffer repossession, even if the market value of its assets exceeds the amount of outstanding debt.
- (2) See S.B. Wadhvani, 'Inflation, bankruptcy, default premia and the stock market', *Economic Journal*, 96 (March 1986), pages 120–38.
- (3) See G. Akerlof, 'The market for "lemons": qualitative uncertainty and the market mechanism', *Quarterly Journal of Economics*, 84 (1970), pages 488–500.
- (4) See 'Industrial and commercial companies' gearing' in the May 1991 *Bulletin*, pages 228–33. The principal factors identified were that: competition in the banking sector depressed margins on debt finance; confidence in the future persuaded firms that debt service would not be difficult; there were changes in the taxation regime; conflict between managers and shareholders over investment strategies may have become particularly acute, the resolution of which could have required a greater use of debt; finally, with the proliferation of new financial instruments, companies may have felt more able to manage risk.

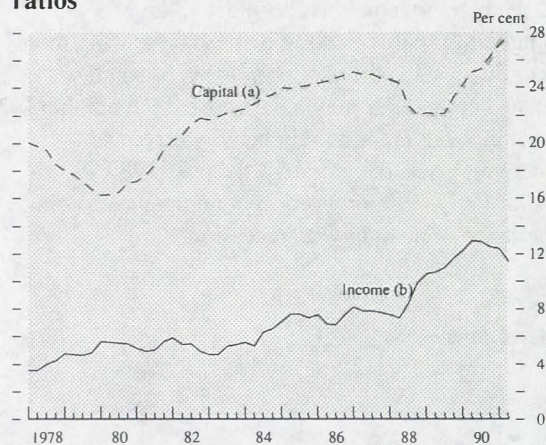


this argument, but it is consistent with the data that are available. Thus, the annual percentage increase in construction sector liquidations in 1990 (up 49.3%) was much higher than in 1980 (up 20.3%). The same is also true of the non-food retail sector (which includes, for example, furniture and DIY sales), where the corresponding figures are 52.7% and 33.8%. By contrast, the manufacturing sector—which is affected less by housing market developments—has experienced a much more limited rise in liquidations, with an annual increase of 26.1% in 1990, compared with 101.6% in 1980.

### Personal sector mortgage default

The differences in recent trends in personal sector mortgage default from the 1980–81 period may also be partly attributable to the rise in gearing (Chart 6), which has increased the likelihood of households encountering debt problems. Household income gearing (gross interest payments<sup>(1)</sup> as a proportion of disposable income) stood at 13% in 1990 compared with 5% in 1980, while

**Chart 6**  
Personal sector income and capital gearing ratios



(a) Outstanding stock of mortgages as a percentage of the value of owner-occupied housing stock.

(b) Households' gross interest payments as a percentage of disposable income.

housing-related capital gearing (mortgage debt as a percentage of the value of the owner-occupied housing stock) increased from 15% in 1980 to 25% in 1990. This rise partly reflects the longer-term trend towards owner-occupation (encouraged over the last decade by the sale of council houses) and the effects of financial liberalisation. The latter has allowed borrowers to take out mortgages that are larger both as a multiple of income and as a proportion of property valuation. For example, between 1980 and 1990 the average advance to income ratio for first-time buyers rose from 1.67 to 2.19, while the average percentage advance to first-time buyers rose from 73.8 to 82.5 over the same period.

The rapid acceleration of house prices during the late 1980s (which received added impetus from the rush by house buyers to beat the ending of multiple mortgage tax relief in August

1988) meant that highly geared first-time buyers were especially vulnerable when interest rates began rising during 1988, and their exposure increased when house prices began falling at the end of 1989. At the same time as debt service ratios stood at record levels, higher levels of capital gearing, aggravated in some circumstances by house prices falling below the level of outstanding debt (Chart 5), may have made lenders less tolerant of arrears and less willing to help borrowers through remortgaging. Subdued housing market turnover since the end of 1988 has also made it difficult for borrowers to clear arrears by trading down, and some may have thought it in their best interests to default once their mortgages exceeded the value of their homes—although the borrower in this situation still remains legally liable for any outstanding debt after the property has been sold. Figures produced by the Council for Mortgage Lenders suggest that of the 36,610 properties repossessed in the first half of this year 45% were voluntary, in the sense that they did not involve a court order.

Another factor which may be relevant to explaining the difference between the early 1980s and the early 1990s is the different regional and social impact of recent rises in unemployment. In comparison with the last recession, recent rises in unemployment have had a greater relative impact on the South East of England. Whereas during the 1980–81 period the unemployment rate in the South East was on average 3½ percentage points lower than the national average, it currently stands close to one percentage point lower, while the unemployment rate in Greater London is equal to the national average of 8.7%. It follows that recent rises in unemployment may have had a relatively greater impact on property-owning white-collar workers than was the case in the early 1980s; moreover, the latter will also be more highly geared than average.

### Implications for the financial sector

Defaults in the non-financial sector mean that financial institutions have to provision against loan losses. So far, however, these provisions appear to have been relatively minor, with the exception of some composite insurance companies offering mortgage indemnity guarantees. For the big four clearing banks, the stock of domestic provisions in relation to domestic lending (1.65% in 1990) remains some way below the levels of the early 1980s and, while building societies' mortgage losses and provisions were at a record level in relation to mean assets last year (0.23%), the ratio remained small in absolute terms. More generally, the balance sheets of both UK banks and building societies appear reasonably healthy, both having capital ratios comfortably in excess of the Basle requirements.

### Short-term prospects

Pressures on household and corporate borrowers have been eased significantly since last October by a series of interest rate reductions, which have reduced base rates by a

(1) There are no published data available on mortgage interest payments alone.



cumulative 4½ percentage points to date. This has already contributed to a fall in households' income gearing, which stood at 11.4% in the second quarter compared with a peak of 12.9% in the second quarter of last year. The rise in companies' income gearing has also stabilised. Economic recovery, coupled with the current low-inflation environment, should lead to a further improvement in borrowers' financial positions. However, these developments are likely to take time to feed through into lower corporate liquidations and personal sector mortgage defaults. In the case of mortgage default, for example, there are now nearly 60,000 mortgages more than 12 months in arrears and some part of these arrears will inevitably translate into additional repossessions.

The question of the relationship between current arrears and future repossession has aroused much interest because of the

potential impact of the latter on house prices. The relationship between the two is unlikely to be one-for-one, not least because lenders themselves will be wary of the impact on house prices from further sales of repossessed dwellings; lower house prices not only increase the potential losses to lenders of selling repossessed dwellings but also increase the likelihood of further mortgage default. Furthermore, when conditions in the housing market pick up, some serious arrears could be prevented from becoming repossessions, through households trading down or remortgaging.

As regards future prospects, both mortgage defaults and corporate liquidations should, in due course, decline; at the same time, pressures on financial intermediaries to make further provisions against loan losses should also moderate.