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Future Issues in Unsecured Consumer Debt

By *Jose Liñares-Zegarra and John O.S. Wilson*

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Future Issues in Unsecured Consumer Debt

José Liñares-Zegarra
Essex Business School, University of Essex, Wivenhoe Park,
Colchester, CO4 3SQ, UK.
Email: jmlina@essex.ac.uk.

John O. S. Wilson
Centre for Responsible Banking & Finance, School of Management, University of St Andrews, The Gateway, North Haugh, St Andrews, Fife, KY16 9RJ, UK.
Email: jsw7@st-andrews.ac.uk

Abstract

The purpose of this article is to provide an overview of the current and future trends in unsecured consumer debt in the UK. The basic claim of this paper is that consumer debt issues are increasingly important as a source of funding for UK households. Substantial changes in the behaviour of consumers and in the traditional functions of financial intermediaries as credit providers have led consumers to face completely new challenges. Understanding these changes in a rapidly changing world could be beneficial to undertake preventive and corrective actions to guarantee a fair access to unsecured debt products for the UK population.

1. Introduction

According to the European Credit Research Institute (ECRI), in 2013 Germany and the UK were the two largest domestic credit markets in the EU-27, comprising around €366.5 billion of assets, or around 40% of the total outstanding amount of consumer loans. In the UK, consumer borrowing on credit cards, personal loans and overdrafts are growing at its fastest rate since the onset of the financial crisis in 2007. Total unsecured borrowing now stands at £239bn, equivalent to £8,936 per household (PWC 2015).

In common with higher income counterparts, low-income households use credit to manage fluctuations in income and significant financial commitments through time. However, there is also evidence that some of low income households use credit to pay for everyday essentials, such as food, rent and bills (FCA 2014). This can lead to highly leveraged households whose ability to service debt and economic well-being is vulnerable to unexpected income or macroeconomic shocks (Brown & Taylor 2008; Jappelli *et al.* 2013). Furthermore, high levels of debt expose households to liquidity and solvency problems as loans fall due for repayment. In this article, we explore some of the current issues and challenges in consumer debt markets, and suggest possible scenarios for addressing these.

Section 2 provides background information of the current developments in the unsecured consumer debt market in UK. In Section 3, we explore the potential issues and problems of the unsecured debt market. Section 4 focuses on the factors that could influence the market in the future and how this may reshape the future trends. The aim here is to: highlight the dynamic character of the market and consumer behavior; and assess how the issues discussed could play out and influence the financial sector and wider economy. In Section 5, we discuss future challenges in the unsecured consumer debt market and debate the potential structural changes that may generate market disruptions such as technology change, security issues and the increasing role of non-bank lenders in the marketplace. Section 6 provides a brief summary.

2. Current trends

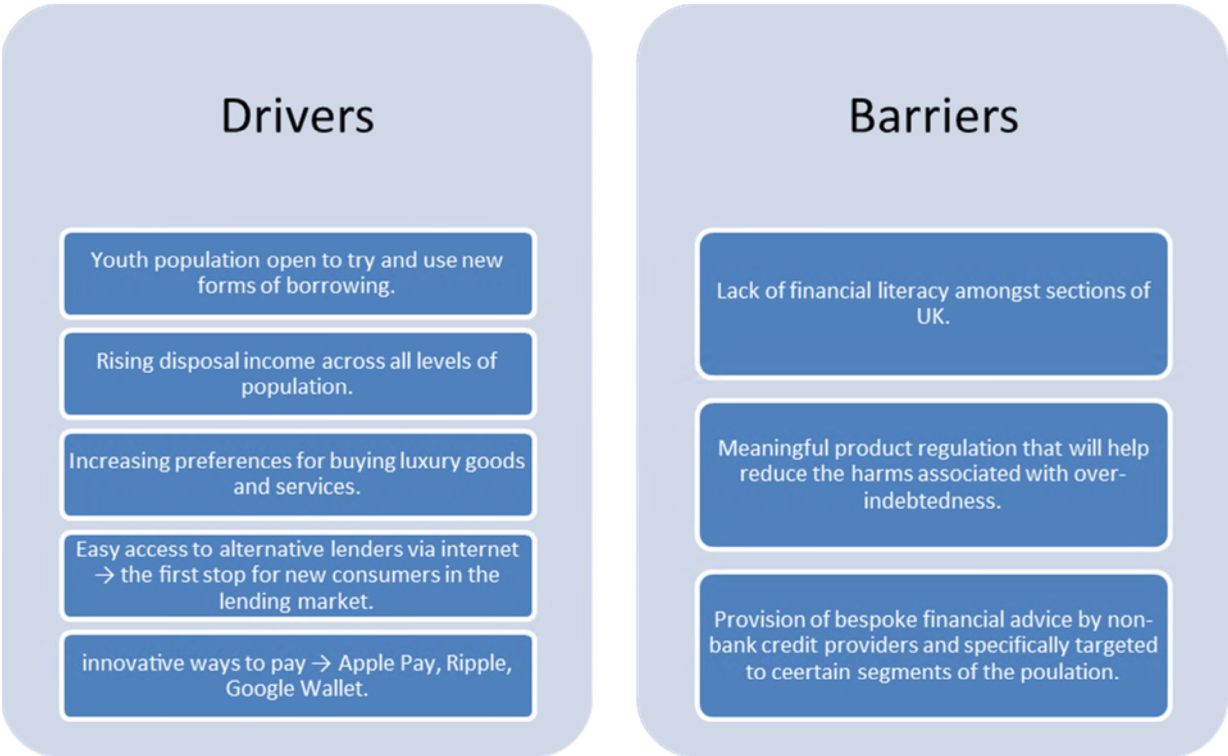
Changes in the consumption patterns and the availability of new sources of finance have accelerated during the last decades. Recent projections suggest that unsecured borrowing will increase between 4% - 6% annually between 2015 and 2017. This projected rise would increase in £10,000 the average unsecured borrowings per household by the end of 2017 (PWC 2015). Consumers are now exposed to a wide-range of choice when making decisions regarding the myriad of financial services and products. Simultaneously, more banks and non-bank lenders (along with peer-to-peer lending platforms) have entered into the market as providers of new and more sophisticated and complex financial products which in some cases go way beyond the knowledge of ordinary consumers. The results from a number of research studies suggests that individuals lack the requisite levels of financial literacy for effective financial decision making (Agarwal *et al.* 2009; Dell'Ariccia & Pence 2009; Hastings *et al.* 2013).[1] For example, Disney and Gathergood (2013) use survey data from a sample of UK households to show that individuals with poor financial literacy are more likely to lack confidence when interpreting credit terms, and are more likely to exhibit confusion over basic financial concepts.

The widespread access to finance for many households and consumers has created an opportunity to take on debt and increase consumption. The increased reliance on unsecured debt by consumers makes them more vulnerable to changes in macroeconomic conditions and the business cycle given that the nominal and real value of their accumulated

[1] For a recent review of the financial literacy literature see Lusardi and Mitchell (2014).

debt is sensitive to the prevailing interest rates (Brown & Taylor 2008). In countries such as US, the expansion in credit card borrowing is thought to be a key force driving the surge in unsecured consumer borrowing and bankruptcy filings over the past thirty years (Livshits 2015; Livshits *et al.* forthcoming). However, the propensity for existing borrowers to file for bankruptcy can be far more complex. Recent research suggests that bankruptcy can be used strategically by borrowers as "fresh start" by discharging outstanding unsecured debts such as credit card debt (White 2011). Figure 1 below summarizes a set of drivers which can explain the recent trends in unsecured consumer lending observed in the UK market.

Figure 1. Potential drivers and barriers in the unsecured consumer debt market



Individuals with higher levels of consumer debt are less financial literate than lower debt counterparts (Disney & Gathergood 2013). Consumers often fail to choose the best price because they search too little, become confused comparing prices, and/or show excessive inertia through too little switching away from past choices or default options (Grubb 2015b). Recent evidence produced by the UK Money Advice Service estimates that

8.2 million UK adults suffer from financial worries, with younger adults, larger families and single parents noticeably at higher risk (Money Advice Service 2016). In addition, recent research for European countries identifies a link between consumer over indebtedness and physical and mental health (Sweet *et al.* 2013; Hodson *et al.* 2014; Keese & Schmitz 2014; Clayton *et al.* 2015). Unsecured credit card debt appears to cause more stress for debtors than outstanding obligations that are secured by collateral (Drentea & Lavrakas 2000).

3. Stresses and strains: what are the pressures on the current reality, and from where?

While banks and credit card companies remain the primary credit providers, there have been significant shifts in the personal loan sector in recent years. Easy and quick access to funding may be revealed in excessive levels of household debt. Evidence suggests that prior to a bankruptcy, individuals appear to systematically increase their utilization of unsecured credit (Cohen-Cole & Morse 2009). Low levels of savings and a potential rise in interest rates (cost of debt) exert financial pressure on indebted households. This may lead to such households being trapped in a debt spiral. Penalty charges for missed loan payments, over-the-limit fees on overdrafts can be substantial and contribute to increasing the probability of loan default.

Angeletos *et al.* (2001) suggest that most consumers prefer to spend today rather than save and pay tomorrow. In fact, the historical inclination of consumers to reduce spending has been considerably mitigated by the widespread availability of credit in recent years (Lander 2008). Consumers tend to be excessively optimistic regarding their long-term prospects and therefore make short-term decisions which are based upon false expectations over the long run (Lander 2008), which in turn leads to relatively more indebtedness in households least able to service debt. Table 1 below describes how certain types of stresses and strains can occur naturally in the market across different areas which in turn can have a potential impact on consumers. These stresses include issues in the contracting stage, debt management, lending standards, the availability of bespoke credit scoring techniques, limited knowledge of the credit market by consumers and the relatively quick access to certain type of lending providers.

Table 1. Potential risks and impact on unsecured consumer lending

Stresses and strains	**Impact**
Complexity of financial terms and conditions (FCA 2015).	Unfair and opaque pricing and excessive/hidden fees → unaffordable debt.
Poor debt management skills of consumers / strict consumer debt recovery process by financial firms (Kus 2015).	Consumer indebtedness when consumers refinance and roll over a loan (particularly in low-income families).
Tightened lending standards.	Certain demographic groups (e.g. young population) can find hard to borrow money from traditional lenders and therefore migrate to alternative providers.
Poor use of risk-based principles by credit providers and standard credit scoring techniques not useful to provide funding to consumers who cannot prove employment or a long credit history.	Consumer credit rationing.
Lack of specific regulatory responses related to predatory lending (Ali *et al.* 2015).	Consumer protection and responsible lending (e.g. cap on the Annual Percentage Rate (APR) for consumer credit loans). But tighter regulation may therefore have negative consequences for some (Rowlingson *et al.* 2016).
Lack of consumer knowledge about lending markets (Gathergood & Weber 2014).	Underbanked consumers are more in risk to be involved in predatory lending techniques.
High cost 'quick' loans with fast-track risk assessment and lack of detailed information regarding credit	Expansion of payday lending and unregulated loan sharks.

The financial soundness of certain groups (students, low-income financially excluded, sick, elderly) within the general population tends to be more vulnerable to changes in macroeconomic conditions. Some have poor credit histories and therefore can be penalized with excessively high rates of interest. New forms of high-cost short-term credit (such as payday loans, home credit from doorstep lending companies among others) are more likely to be used by consumers at the lower end of the income distribution. With traditional financial providers tightening credit criteria, many consumers have search for new credit providers which include new banks (such as Metro bank and Virgin) and specialized alternative lenders with new credit models, such as P2P lending (Zoopa, Rate Setter), guarantor loans (UKCredit, Duo), log book loans (Varooma, MobileMoney) and short-term lending (QuickQuid). These new alternative sources of credit represent a small part of the market, but are growing in popularity. However, unsecured personal loans are the market where P2P platforms are likely to continue to encroach on the market share of incumbent banks (Atz & Bholat 2016).

The role of the digital technology is increasing in all areas of financial services and can be easily accessed using apps and mobile phones. At the same time there are also a range of online tools to help consumers manage their finances and aggregate information from all their different savings, investments and borrowings. By mid-2015, 22.9 million banking apps had been downloaded in the UK (a rise of 8.2 million in one year) with £2.9 billion per week being transferred using these apps (BBA 2015; FCA 2016). Commercial influence has been also found to be important in the decision making process of consumers. For example, Carbó-Valverde and Liñares-Zegarra (2011) show that credit card reward programs can significantly affect the preferences for using credit cards relative to cash to carry out transactions.

4. Drivers of change

The changes described above force consumers to assess the prices and advantages of the financial products offered in the marketplace. Understanding the new market conditions and products and services available require skills and rely on the ability of consumers to manage and evaluate risk. Financial literacy is in general poor and consumers lack the necessary financial knowledge to make financial decisions (Van Rooij *et al.* 2011). Debates around whether and how financial education can improve debt management are likely to continue (Hanna *et al.* 2015). Well designed, resourced and functioning affordable advice is crucial to help consumers make informed financial decisions. Nevertheless, private financial advice needs to be implemented in a cautious way as recent research suggests that advisors can act to maximize their own personal benefit, regardless of the actual needs of clients (Mullainathan *et al.* 2012). In this regard, the role of the government as a provider of unbiased information and advice is crucial for market transparency (Hastings *et al.* 2013).

Regulation will continue to play an important role in increasing transparency in financial promotions, disclosures, and consumer education (Durkin & Elliehausen 2015). The educational system is challenged to teach financial literacy more extensively and effectively to consumers. Consumers are likely to continue to make some financial decisions in settings where automatic features may be infeasible (Tufano 2009). Lander (2008) points out some methods for altering the conduct of lenders to benefit consumers. For example, eliminating teaser rates on credit cards (Bar-Gill 2003). Others have suggested the possibility of imposing a "distress" tax on the lender profits derived from sub-prime borrowers (Mann 2008).

The market share of credit card loans has gradually increased in the UK, amounting to roughly 36% of total consumer loans in 2013 (Bouyon 2015). The consumption decision of younger segments of the population is increasingly influenced by peer-to-peer platforms and groups, mass media and extensive branding campaigns. These developments pose new challenges for consumers in building the capability to understand the risks associated with financial products, and the access to multiple lenders simultaneously (Livshits 2015). This in turn requires more flexible and adaptable regulation and education so as to ensure consumers are well-informed in their decision-making processes. Nevertheless, these measures could promote better decision making for borrowers who stay well informed and in a strong financial position, but not for consumers who are borrowing to "survive" (Lander 2008).

Big data has the potential to further understand consumer behaviour, and identify potential risks. Data related to social media (social connections), geographical location of consumers, mode of access (smartphone, software, etc.) and shopping behaviour (Cullerton 2012; FCA 2016) will enhance understanding of why consumers use certain types of unsecured debt and why particular products are chosen. This is particularly relevant considering that social interaction is associated with households holding larger amounts of debt and assets (Georgarakos *et al.* 2014; Brown *et al.* 2015).

The ethical dimension is also an important factor to be considered along with psychological, socio-cultural and even political factors when studying consumer finances. The complex social contracts in societies suggest that these relationships are not straightforward given that consumers have more complicated motives for consumption rather than simple maintenance to survive. For instance, some credit card contracts are profitable because overconfident consumers typically underweight some elements of price such as over-limit and add-on fees when choosing a card (Grubb 2015a, c).

5. Future Prospects

Thus far we have examined the important factors in the current and future evolution of the market for unsecured consumer debt. In this section, our discussion is motivated by potential structural changes that may generate market disruptions and therefore changes of our expectations about the future.

Fintech will become more relevant as banks and other financial and technology companies invest in 'big data', in order to know their customers better, price risk more accurately, and as an information service regarding various credit options which can be offered to customers. Big data generates substantial benefits, but these must be offset against potential security and privacy concerns, including hacking risks and data breaches. Recent research suggests that certain types of identity theft incidents affect positively the probability of adopting and using credit cards (Kahn & Liñares-Zegarra 2016). The rapid change of new technologies and the increased reliance of consumers in using price comparison websites for shopping around for relatively complex financial products (such as credit cards) could lead to inappropriate decision making of consumers and further financial problems in the long term (if consumers are not fully aware of the fine print of the financial contracts they sign or information disclosed on the websites is too limited to allow for informed and sound decision making).

Regulation has lowered barriers for non-bank lenders and payday loan providers. This could have an important impact on the access to funding for sub-prime borrowers. P2P lending is found to represent one of the latest forms of consumer finance in the UK that works towards so-called financial inclusion; however, it could have ambiguous social outcomes that necessitate further critical investigation (Rogers & Clarke 2016).

An increased focus on high-risk consumers is needed as this market segment can become increasingly important in future. These consumers are likely to shop around more intensively than lower-risk counterparts and as a consequence identify and access the best deals in products like credit cards (e.g. annual percentage rates). This creates inefficiencies (via possible mis-pricing) in the consumer credit market, whereby higher risk consumers are paying lower rates of interest than lower risk counterparts (Liñares-Zegarra & Wilson 2014).

Consumers are often reluctant to seek financial help and advice as it is perceived as costly. Informational frictions can also play a role in the supply side of the market, as borrowers tend to be more informed about their risk profile, which in turn leads to adverse selection problems for lenders (Ausubel 1997; Agarwal *et al.* 2010). More engagement by regulators and financial services providers is required to find suitable ways to encourage consumers to seek help and support at the appropriate time, but also to reduce informational asymmetries. Certain biases are particularly likely to affect the decision making process of consumers when contracting retail financial products (Erta *et al.* 2013). For example, most consumers find financial products complex and many financial decisions require a detailed assessment of risk and uncertainty. Financial decisions may require making trade-offs between the present and the future, many financial decisions are emotional, and it can be difficult to learn about financial products. However, it is also important to consider other cases where consumers may be more debt adverse and fearful of accessing credit, which in turn can generate an unintended reduction in the demand for credit. Finding ways to enhance and promote trust in financial institutions is crucial in overcoming this. Finally, it is also important to monitor closely certain segments of the population: students represent a particular group of novice, sometimes vulnerable and often targeted consumers, who may display limited financial capability and responsibility and therefore are more likely to take the wrong financial or risk decisions (Szmigin & O'Loughlin 2010).

6. Summary

This paper attempts to bring together recent issues related to unsecured consumer lending (credit cards, overdrafts). This includes an overview of the recent trends observed in the market related to non-bank credit providers, financial literacy issues for consumers in vulnerable circumstances and the role for improving debt management. This paper has been written to reach a wider-audience interested in salient issues related to consumer vulnerability rather than the supply-side of the market (e.g. profitability of banks, strategic behaviour of banks, market competition, cross-selling of existing products, etc.).

The different topics covered in this paper highlight evidence of fast-growing alternatives and approaches to lending with respect to traditional channels such as payday loan providers and peer-to-peer lending. These recent trends suggest the relevance of increasing the provision of debt advice services and increased transparency to cope with the increasingly complex credit environment and also over-indebtedness. We acknowledge that the fast changing environment makes it difficult to predict the future trends as these depend on the dominant macroeconomic conditions (changes in monetary policy and tightening in terms and conditions for new unsecured consumer credit) but it would be expected that better debt advice for consumers (e.g. advertising campaigns to increase awareness of credit products) and crafting effective policy and legislation coverage for non-bank providers are needed to improve the quality and availability of credit.

It is still too soon to predict the effects of Brexit in the unsecured consumer lending market, but academic literature can shed light of possible scenarios in terms of saving and supply of credit based on evidence in other countries. For example, Aaberge *et al.* (*forthcoming*) show that a surge in political uncertainty leads to increased household savings in China. Caglayan and Xu (2016) show that change in consumer sentiment and its volatility (in terms of consumer confidence, expected economic situation and price expectations), negatively affects bank lending in the US. Finally, recent research suggests that banks' perception of regulatory uncertainty is correlated with a larger decrease in bank lending (Gissler *et al.* 2016).

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Author Biographies

José Liñares-Zegarra

José is a Lecturer of Finance at Essex Business School. José holds an Honorary Lectureship in the School of Management at University of St Andrews. He is also a Fellow at the Centre for Responsible Banking & Finance at the University of St Andrews. His academic career combines both teaching and research in economics, banking and finance. He has been a Visiting Scholar at the Consumer Payments Research Center at the Federal Reserve Bank of Boston, researcher for the Spanish Savings Banks Foundation and has participated in projects related to the banking industry for the Spanish Ministry of Science and Innovation, the Andalusian Autonomous Government and several financial institutions. In recent years, José Manuel has carried out various empirical studies in retail payments and consumer finances. He has published articles in journals such as the *European Journal of Finance, Journal of Banking & Finance, Journal of Financial Services Research, Review of Network Economics* and *Social Science & Medicine*.

John O.S Wilson

John is Professor of Banking & Finance and Director of Research at the School of Management at the University of St Andrews. He is also Director for the Centre for Responsible Banking & Finance at the University of St Andrews. John's research focuses on banking and credit unions. He has published over 50 refereed journal articles in outlets including *Journal of Money Credit & Banking*; *European Journal of Operational Research*; *Journal of the Royal Statistical Society*; *Economic Inquiry*; *Journal of Banking & Finance*; *Journal of Financial Services Research*; *Financial Markets, Institutions and Instruments*; *Cambridge Journal of Economics*; *International Journal of Industrial Organization*; and *Social Science & Medicine*.

John is the author/co-author of numerous books. These include: *European Banking: Efficiency, Technology and Growth*; *Industrial Organisation: An Analysis of Competitive Markets*; *The Economics of Business Strategy*; *Industrial Organization: Competition Strategy and Policy* (5th edition forthcoming); and *Banking: A Very Short Introduction* (2016). John edited a five volume *Routledge Major Works in Banking*. He co-edited the first and second editions of the *Oxford Handbook of Banking* (with Allen Berger and Phil Molyneux) and the *Handbook of Post Crisis Financial Modelling* (with Emmanuel Haven, Phil Molyneux, Sergei Fedotov and Meryem Duygun).

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