The Commonwealth

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Discussion Paper

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Mitigating the Consequences of Rising Household Debt

Executive Summary

Research indicates that high household debt levels create a drag on growth; leading to higher unemployment and risking future banking crises. Whilst household debt can comprise a range of different liabilities, formal credit markets give rise to the bulk of household debt in most countries and have received considerable policy attention in recent years. This paper seeks to inform discussion among Commonwealth countries on the levels of household debt, their various causes, and possible debt mitigation policy responses, including Commonwealth programmes to support financial literacy.

Household debt trends in Commonwealth Countries

The status of household debt varies widely across the Commonwealth. Five member states (Australia, Canada, Cyprus, New Zealand, and the UK) have particularly elevated levels of household debt, with aggregate household debt-to-GDP ratios of 121.7%; 100%; 109%; 91%, and 85% in 2017 respectively. In several other Commonwealth countries household debt levels, although lower, may still give cause for concern. For example, Malaysia had a ratio of 70% in 2016 (up 10 percentage points in five years). However, some countries have significantly reduced their household debt levels in recent years. For example, Malta has reduced its debt to GDP ratio from 60% to 50% in the period 2012 to 2017, and South Africa's ratio has reduced steadily since 2008/09.

Causes and effects of over-indebtedness

However, high debt levels do not in and of themselves indicate over-indebtedness. Over-indebtedness occurs when a household cannot meet its financial commitments from its existing and expected resources, without resorting to significant cuts to consumption which would lead to unreasonably low living standards. Such a situation most commonly arises when the circumstances of borrowers is negatively impacted by life events (such as the onset of ill-health) or changes in the economic environment (e.g. job loss or increases in living costs) *after* credit contracts have been entered into. However, over-indebtedness can also emerge because of supply side problems, including a willingness of lenders to take increased risk, and in some cases, engage in 'irresponsible', 'reckless', and even 'predatory' practices. Borrower behaviour – poor financial literacy skills; leading to bad credit decisions and/or the mismanagement of available resources – can also play a role in the creation of over-indebtedness.

The precise effect of household over-indebtedness depends on both its intensity *and* its duration. Where over-indebtedness is severe (i.e. both intense and protracted) it has been found to contribute to relationship breakdown and poor physical and mental health; lead to

loss of housing, and increased homelessness; and create disincentives and barriers to employment, and to negatively impact the productivity of employees. These negative impacts can also reduce community cohesion and increase the demand for public services and welfare assistance.

Summary of Main Findings from Commonwealth Case Studies

Case studies of household debt in seven developing and advanced economies across the Commonwealth has illuminated seven key takeaways:

1. There is a need for improved oversight and broader regulatory frameworks;
2. There is need for comprehensive credit reporting systems;
3. There is a danger of poorly regulated digital credit expansion;
4. Household finances are impacted by both monetary and fiscal policies;
5. There is a need for more effective insolvency systems and debt relief programmes;
6. Credit reporting can have negative impacts in a downturn; and
7. There is a need to ensure more responsible lending.

Recommendations

The paper concludes with five policy recommendations for managing household debt levels.

Fiscal expansion, as opposed to household credit expansion, may be a preferred route to growth

Although credit expansion can initially boost economic growth, the risks from a sustained upswing in household debt increase over time; the utility of credit for some borrowers diminishes and debt repayments can become a drag on consumption. Risk assessment (by borrowers and lenders alike) is also never likely to be perfect; housing market bubbles can be created; and the pricing of credit products can become extremely regressive, with those on the lowest incomes paying the highest prices. These problems raise fundamental questions about the wisdom of using long-term household credit expansion as a means of generating economic growth.

Improved oversight of household debt burdens is needed

In thirty-three Commonwealth countries there is a lack of data on household debt levels. In some countries, data is restricted to the banking sector and does not capture the activities of Non-Bank Financial Corporations. Countries should therefore seek to ensure that both banks and non-banks are included in their data gathering and regulatory frameworks. Furthermore, in countries with comprehensive data, there is scope for improvement in the measurement of household debt burdens. An *over-indebtedness risk indicator* could be developed which encompasses both the debt-to-*disposable*-income and debt servicing costs-to-*disposable*-income ratios. Such an indicator would provide policymakers with more accurate oversight of developing risks and could potentially be used in the stress-testing of firms.

Financial literacy programmes should draw on best practice

For borrowers, financial literacy and skills programmes could prove beneficial: helping them to identify which products are best suited to their needs; avoid high charges, budget effectively and plan for the future. There is a widespread literature available to guide the design of these programmes, and detailed comparative study of approaches being followed

in the different countries of the Commonwealth, and more generally, should be undertaken to gain insight into what works.

The Commonwealth's financial literacy programme provided capacity building support for Central banks aiming to improve citizens' financial literacy and created a network of financial literacy educators. With the appropriate demand from members, this programme could be integrated with the Secretariat's fintech programme of which fintech training and financial literacy are a major part.

More effective lender conduct regulation is required

On the lender side of the relationship, more interventionist conduct regulation may be required. However, requirements to undertake in-depth affordability assessments incur costs for lenders. These costs may become disproportionate, for example in respect of small to medium sum consumer loans. The cost of supervision and enforcement of conduct rules, and of providing consumer redress mechanisms, are also likely to be high. As an alternative, more comprehensive use of caps on total credit costs should be explored.

More effective debt relief programmes are needed

Effective debt relief programmes and insolvency systems are critical to addressing problems of household over-indebtedness and can have positive macroeconomic benefits. Commonwealth countries should review their insolvency systems drawing on existing research literature to identify best practice. In this respect, the societal benefits of secondary debt markets deserve greater scrutiny, and it may be that debts purchased in these markets are prime candidates for at least a partial write-off moving forwards.

1. Introduction

This paper seeks to inform discussion within Commonwealth countries as to rising levels of household debt: the negative implications of this for households themselves, for financial stability and economic growth; and the policy measures that can be adopted in mitigation.

The paper is provided at a time of extremely challenging global economic conditions. These include the negative impacts on trade and investment created by climate change, geo-political tensions and civil strife in many countries; as well as the financial vulnerabilities arising from the lengthy period of accommodative monetary policy[1]. In its World Economic Outlook Report for July 2019, the IMF identifies that these financial vulnerabilities could become exposed if debt service difficulties increase at a time when the space for monetary policy to counter downturns is constrained. As a result, adverse shocks may become 'more persistent than normal'.

Although the financial vulnerabilities identified by the IMF relate to the private sector as a whole (i.e. both firms and households), recent research[2] has particularly highlighted the negative economic consequences of high *household* debt[3] levels. For example, rising household debt levels (relative to GDP and over a three-year period) have been found to lead to lower output growth, higher unemployment, and a greater probability of future banking crises. These long-term negative impacts have particularly been found in countries with household to debt to GDP ratios in excess of 80%[4].

The paper therefore reviews levels of household debt in Commonwealth countries and illustrates its different causes and the possible policy responses in several case studies. Whilst household debt can comprise a range of different liabilities, the paper particularly focuses on the role played by formal credit markets. These markets give rise to the bulk of household debt in most countries and have received considerable policy attention in recent years. Comparative studies of the policy measures that have been adopted are therefore timely.

Well-functioning formal credit markets provide a mechanism for households to smooth consumption[5] and raise capital for investment. If used wisely, credit can also reduce ongoing living costs and raise living standards. These functions can deliver positive impacts for communities; boosting both local and overall economic growth[6].

However, credit market failures can have very negative impacts, leading to over-indebtedness and resulting in a wide range of negative welfare effects[7].

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[1] IMF World Economic Outlook Update Report, July 2019 available from https://www.imf.org/en/Publications/WEO
[2] Mian, A.R., Sufi, A., & Verner, E. (2017). 'Household Debt and Business Cycles Worldwide'. National Bureau of Economic Research, Working Paper No. 21581 available at https://www.nber.org/papers/w21581
[3] The definition of 'household debt' used in this paper is the same as in the System of National Accounts: "All liabilities of households (including non-profit institutions serving households) that require payments of interest or principal by households to the creditors at a fixed dates in the future. Debt is calculated as the sum of the following liability categories: loans (primarily mortgage loans and consumer credit) and other accounts payable." Other accounts payable includes, for example, payments due to utility providers and outstanding taxes due to central and municipal governments.
[4] Lombardi, M., Mohanty, M. & Shim, I. (2017). 'The real effects of household debt in the short and long run'. BIS Working Papers No. 607. Bank for International Settlements.
[5] For a review of the consumption smoothing theory, see Deaton, A., (2005). 'Franco Modigliani and the life cycle theory of consumption'. Available at SSRN 686475.
[6] Beck, T., Demirgurc-Kunt, A., & Levine, R. (2004). 'Finance, Inequality and Poverty: Cross-Country Evidence'. National Bureau of Economic Research Working Paper No. 10979. Available at https://www.nber.org/papers/w10979
[7] For details of the research underpinning these findings see notes to section 2, below.

- Whilst much over-indebtedness occurs as a result of changes in household circumstances after credit agreements have been entered into, there are also ex ante risks if lenders are unable, or fail, to properly assess loan affordability at the time of granting credit. Further to this, some lenders' profit maximising strategies have been found to involve irresponsible, reckless, and even predatory practices. Conversely, some borrowers may have poor financial literacy skills leading to bad decisions or the mismanagement of household resources;

- Where over-indebtedness occurs, the high level of debt repayment relative to disposable income can make it difficult for households to maintain acceptable living standards; causing them to cut back on consumption or to default on their credit agreements or in respect of household bills. Depending on their severity, these financial pressures can contribute to relationship breakdown; poor health, including mental health, and loss of housing. Over-indebtedness has also been found to create disincentives and barriers to employment, and negatively impact the productivity of employees.

In addition to these household level impacts, the Global Financial Crisis and the subsequent, protracted, economic downturn experienced by many advanced economies, has focused policy-makers attention on the economic and financial stability risks arising from high levels of household over-indebtedness. Many central banks have therefore developed a greater appreciation of the linkages between different parts of the financial system and wider policy making arenas in order to both prevent the build-up of household debt, and to mitigate its impacts where this does occur. These policy arenas include:

- The fiscal and social policies of governments;

- Monetary and macro-prudential policy;

- Micro-prudential and conduct regulation of credit providers, including arrangements for their supervision, enforcement of rules and consumer redress;

- The effectiveness of credit data sharing systems;

- Insolvency legislation and debt relief procedures; and

- Efforts to ensure responsible borrower behaviour (such as financial literacy and skills programmes).

Given the breadth of this policy agenda it is unsurprising that there is considerable variation in the approaches being taken with respect to household debt throughout the Commonwealth. Variation between countries is also to be expected due to their different levels of financial sector development; their legal and institutional history and frameworks, and the resources that they have available to support effective regulation and supervision.

Nevertheless, regardless of the country-specific challenges faced, the accurate measurement and assessment of household debt levels and its risks are critical functions of central banks. In this respect, there is also considerable variation in

approach across the Commonwealth. It is concerning that data on household debt levels is not readily available in many countries, and within these it is possible for household debt burdens to develop to unsustainable levels 'under the radar'. But even in advanced economies, the specific measures being used by central banks to monitor household debt level (such as aggregate debt to income ratios) may be inadequate to accurately assess the financial pressures faced by households.

The paper is structured as follows:

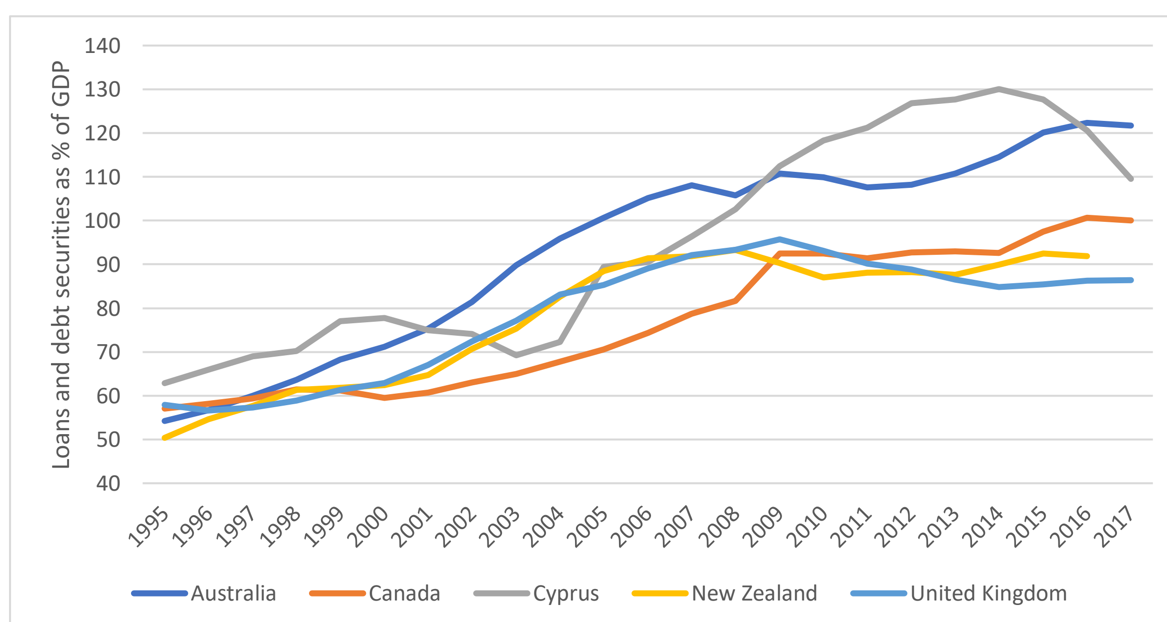
- Section two provides context; reporting household debt to GDP ratios in several Commonwealth countries and the findings from social research concerning the definitions, indicators, causes and effects of household over-indebtedness;
- Section three illustrates the different causes of, and policy responses to, household debt in a selection of Commonwealth countries;
- Section four concludes and makes recommendations for future policy development.

2. Household debt trends and over-indebtedness

2.1 Household debt trends

The IMF's Global Debt Database[8] tracks indicators of household debt for 190 countries. This identifies five Commonwealth countries with particularly elevated levels of household debt relative to GDP. These are Australia, Canada, Cyprus, New Zealand and the UK (figure 1, below). The respective ratios of aggregate household debt to GDP for these countries in 2017 were 121.7%; 100%; 109%; 91%, and 85%.

Figure 1: Household debt as % of GDP: Australia, Canada, Cyprus, New Zealand, and UK



[8] For further details see https://www.imf.org/en/Publications/WP/Issues/2018/05/14/Global-Debt-Database-Methodology-and-Sources-45838

However, the long-term trends in these countries are different in some important respects:

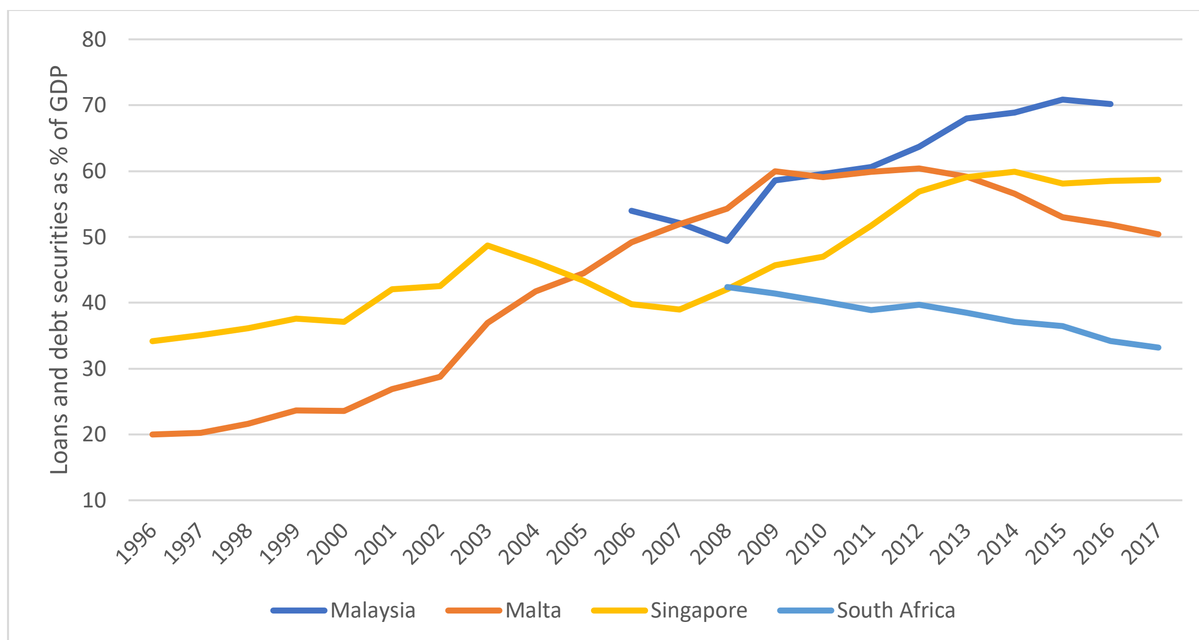
- In Cyprus, the upward trend prior to 2008 is attributed to the significant credit expansion that took place in the island, after EU accession. In particular, broad real estate and housing loans recorded a rapid growth in the run-up to the entry of Cyprus into the European Union in May 2014 and the adoption of the euro in January 2008. In contrast to the other countries, the impact of the 2008 international financial crisis came only with a lag in Cyprus and escalated into a domestic financial crisis that peaked in 2013. Following the agreement of the international bailout programme with the Troika in March 2013 and the bail-in of uninsured depositors in the two major banks in the island, household debt soared between 2013-2015. Many households became unemployed during that time, whilst other suffered a significant cut in their wages and a haircut on their bank deposits. The ratio then peaked at 130% in 2014 (the highest of the five countries). However, it has since fallen back to 109% and appears to be on a firmly downward trend in recent years. In fact, the Quarterly Financial Accounts data for 2019Q1 shows that HH debt in Cyprus dropped to a two-digit figure for the first time since 2008;

- In the UK, the peak in 2009 was 95%, when the ratio was comparable with that of Canada (92%) and New Zealand (90%), but the paths of these countries have since diverged. The ratio in the UK fell to 84% by 2014 and then flattened out through to 2017. In Canada, the ratio was fairly flat from 2009 to 2014 but then rose to 100% in 2016. New Zealand's path lies between these two, although data is not yet available from the IMF for 2017;

- In Australia, a further path can be identified: the ratio reduced slightly between 2009 and 2011 but then rose sharply through to 2016.

In several other Commonwealth countries for which the IMF holds data, household debt levels, although lower, may still give cause for concern (figure 2, below). For example, Malaysia had a ratio of 70% in 2016 (up 10 percentage points in five years), whilst Singapore's household debt to GDP grew most strongly between 2007 and 2014: reaching around 60%, although subsequently flattening out.

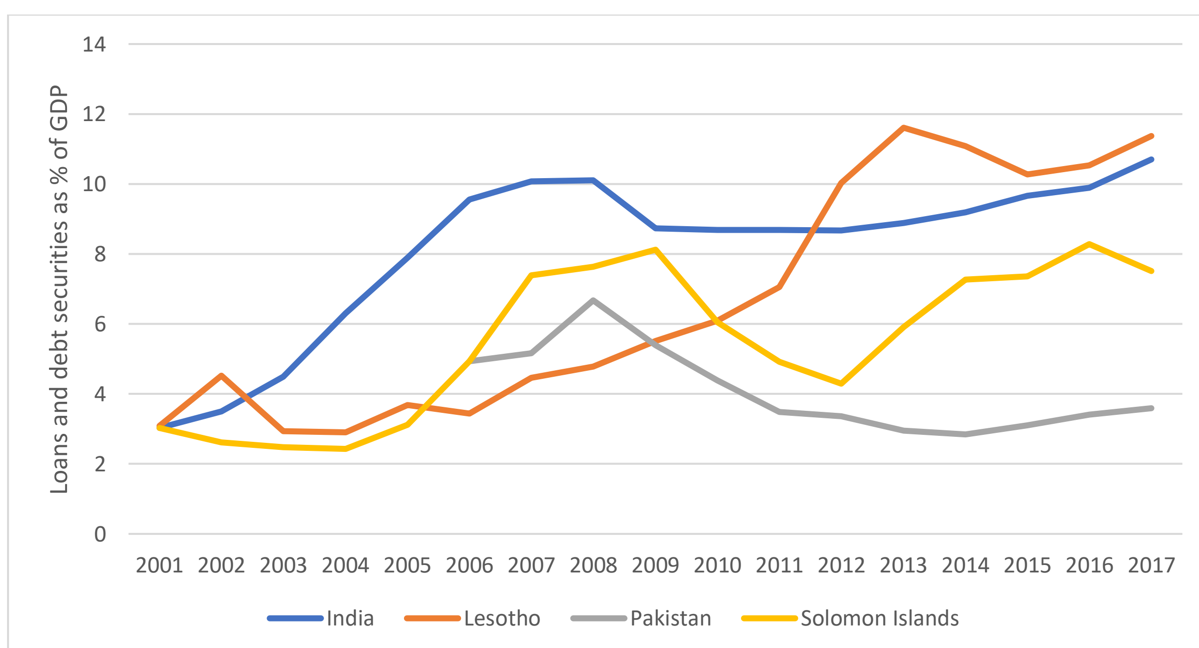
Figure 2: Household debt as % of GDP: Malaysia, Malta, Singapore, and South Africa



However, some countries have reduced their household debt levels in recent years. For example, Malta has reduced its debt to GDP ratio from 60% to 50% in the period 2012 to 2017, and South Africa's ratio has reduced steadily since 2008/09.

Much lower household debt to GDP ratios can be found in several other Commonwealth countries within the IMF's database, although even in some of these countries there are rising trends. For example, India, Lesotho, Pakistan and the Solomon Islands have ratios between just 3.5% and 11.3%, and the most recent trends have been upwards for India and Lesotho (figure 3, below).

Figure 3: Household debt as % of GDP: India, Lesotho, Pakistan, and Solomon Islands



2.2 Household over-indebtedness

Whilst the aggregate ratio of household debt to GDP provides a general measure of indebtedness, it does not capture the extent to which households are experiencing problems repaying their debts or why. However, a considerable body of social research into the problem of over-indebtedness over the past thirty years has yielded insights in these respects.

Although there is no single universally accepted definition of over-indebtedness, studies in the field[9] have tended towards the view that[10]:

> *"…a household is over-indebted when its existing and expected resources are insufficient to meet its financial commitments[11] without lowering its standard of living, which might mean reducing it below what is regarded as the minimum acceptable in the country concerned."*

This has led to the development of a range of indicators to measure levels of over-indebtedness including:

- The cost of servicing debt relative to income;
- The extent of payments in arrears on both credit agreements and household bills;
- The number of outstanding credit commitments, and
- The extent to which debt repayments are perceived by the household as constituting 'a heavy burden'.

Whilst these are helpful in identifying the number of households *experiencing* financial problems at any given point in time, the concept of over-indebtedness has also been extended to include the overall level of financial liabilities relative to: (i) household income (the debt to income ratio); and (ii) the value of household assets (the net wealth ratio).

These are beneficial because the debt to income ratio provides an indicator of the *vulnerability* of households to income (and expenditure) shocks[12] even if (for example because of low interest rates on their debts at the time) they are not currently experiencing payment pressure; whilst the net wealth ratio is seen as an indicator of overall solvency.

However, it should be noted that the net wealth ratio can overstate the solvency of households in some circumstances. This is because asset values can depreciate rapidly (e.g. in a housing market crash) whilst the liabilities held against those assets (e.g. mortgages) remain fixed. In these circumstances, households can find themselves 'trapped' in negative equity[13]. In addition, aggregate measures of household sector net wealth ignore the fact that assets and liabilities are not distributed evenly: many households with significant

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[9] For a useful summary of approaches in several European countries see Ferretti, F. (Ed.) (2016). 'Comparative Perspectives of Consumer Over-Indebtedness: A View from the UK, Germany, Greece and Italy'. Eleven International Publishing. The Hague, Netherlands.

[10] D'Alessio, G. & Iezzi, S. (2013, p.4). 'Household Over-indebtedness: Definition and Measurement with Italian Data'. Occasional Paper No. 149. Bank of Italy. Available at SSRN 2243578.

[11] It should be noted that the term 'financial commitments' in this definition extends beyond credit agreements to include household bills. It is therefore consistent with the definition of 'household debt' used in the System of National Accounts.

[12] See, for example, Alter, A., Xiaochen Feng, A., & Valckx, N. (2018). 'Understanding the Macro-Financial Effects of Household Debt: A Global Perspective'. IMF Working Paper No. 18/76 available from Researchgate.net 324279128

[13] This has several potentially negative macroeconomic implications, including by restricting the mobility of labour (see Hellenbrandt, T. & Kawar, S. (2009) 'The economics and estimation of negative equity', Quarterly Bulletin 2009Q2, Bank of England.

financial assets (savings and investments) are distinct from those holding significant liabilities.

Causes of over-indebtedness

The major causes of over-indebtedness identified in the literature relate to income and expenditure shocks arising as a result of 'life events' or changes in the household's economic environment[14]:

- 'Life events' include relationship breakdown, changes to household composition (e.g. birth of a child), and the onset of illness or disability;

- Changes in the economic environment include rising interest rates; loss of a job; changes in working hours or pay, and real term increases in essential living costs. It follows that debt and debt servicing to income ratios may not completely capture the extent of financial pressure faced by households, where, for example, the cost of living is rising. Measures capturing the *disposable* income of households may therefore be better in this regard[15].

Over-indebtedness can also emerge as a result of other factors. Rather than households using credit to smooth consumption patterns in line with rational life-time income expectations, households in many countries have been demanding credit in response to a long-term stagnation in real wages and increasing income inequality[16].

On the supply-side, this implies a willingness of lenders to take increased risk, and in some cases, engage in 'irresponsible', 'reckless', and even 'predatory' practices[17]:

- Irresponsible or reckless lending involves a failure of lenders to adequately assess the affordability of credit at the time of entering into agreements, or in the case of revolving credit, on an ongoing basis (for example, when offering increases in credit card limits). In addition, lenders may grant loans on the basis of available collateralised real assets and not on the basis of borrowers' income levels;

- Examples of predatory lending practices include lending at high interest rates to low-income households, many of whom are already over-indebted or who have poor credit histories. Predatory practices also include the structuring of products in ways which take advantage of borrowers (e.g. requiring repayment within unreasonable timeframes; imposing high default fees etc.). These practices were widespread in the US sub-prime mortgage market prior to the Global Financial Crisis and continue to be identified in consumer credit markets since[18].

Irresponsible, reckless and predatory practices can cause borrowers to become 'trapped' in a 'spiral' of increasing indebtedness: regularly refinancing agreements in order to release funds simply to cover essential living costs on an ongoing basis· This has led some countries to call for increased use of caps on the cost of credit[19].

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[14] See footnote 9, above.
[15] An alternative measure to capture this at the aggregate level was presented in 'Britain in the Red', TUC. London, 2016. (available at https://www.tuc.org.uk/research-analysis/reports/britain-red-why-we-need-action-help-over-indebted-households). This calculated interest payments as a percentage of the 'household surplus'.
[16] See, for example, Barba, A. & Pivetti, M. 'Rising household debt: Its causes and macro-economic implications – a long-period analysis'. Cambridge Journal of Economics 2009, 33, 113–137.
[17] For a detailed assessment see Gibbons, D. (2014). 'Britain's personal debt crisis: how we got here and what to do about it'. Searching Finance.
[18] For example, in respect of 'payday' lending in the UK – see section 4, below.
[19] See, for example, the UK End the Debt Trap Campaign - https://neweconomics.org/campaigns/end-the-debt-trap

Finally, it should be noted that borrower behaviour can also play a role in the creation of over-indebtedness. For example:

- Poor financial literacy skills can lead to bad credit decisions and/or the mismanagement of available resources. For example, research[20] in the United States has found that only one-third of the population has a good understanding of compound interest or how credit cards operate. People with lower levels of financial literacy are also more likely to use high-cost credit products and report that their debt burdens are excessive; and as much as a third of the charges and fees paid by people with low financial literacy skills can be attributed to ignorance';

- Mental health or psychological problems (including gambling addictions and substance misuse problems) can result in some borrowers seeking out credit that they cannot realistically afford to repay[21]; and

- Cultural factors could also lead to households engaging in excessive borrowing to finance their current needs so they can save a large portion of their income for future purposes. For example, households may want to have a safety net in the form of deposits to safeguard themselves in times of hardship (i.e. recession, loss of job), save for potential future health issues if a national health system is not available, and finance children's education as well as retirement if pension schemes are inadequate.

Effects of over-indebtedness

Whatever the cause, high levels of debt repayment relative to income can make it difficult for households to maintain acceptable living standards, and lead to them cutting back on consumption or defaulting on household bills[22].

The precise impact of over-indebtedness on a household depends on its intensity (for example, as measured through the debt servicing ratio) *and* its duration (e.g. as measured through the overall debt to income ratio)[23]. However, where over-indebtedness is severe (i.e. both intense and protracted) this has been found to:

- Contribute to relationship breakdown and poor health, including mental health[24];

- Lead to loss of housing, and increased homelessness[25]; and

- Create disincentives and barriers to employment[26], and to negatively impact the productivity of employees[27].

[20] Lusardi, A. & Tufano, P. (2009). 'Debt literacy, financial experiences and overindebtedness'. Working Paper 14808. National Bureau of Economic Research.
[21] See footnote 24 below. Also, see the work of the Money and Mental Health Policy Institute in the UK: https://www.moneyandmentalhealth.org/
[22] Gibbons, D., Vaid, L. & Gardiner, L. (2011) 'Can Consumer Credit be Affordable to Households on Low Incomes'. Centre for Responsible Credit. London
[23] For an example of an analysis using this approach see page 5 in Gibbons, D. (2018) 'The collapse of Wonga: Government must act to secure justice for customers, but there are wider lessons to be learnt'. Centre for Responsible Credit. London. Available at https://www.responsible-credit.org.uk/wp-content/uploads/2018/09/The-collapse-of-Wonga.pdf
[24] Richardson, T, Elliott, P. Roberts, R. (2013). 'The Relationship Between Personal Unsecured Debt and Mental and Physical Health: A Systematic Review and Meta-analysis'; Gathergood, J. (2012). 'Debt and Depression: Causal Links and Social Norm Effects'.
[25] Providing help to people debt problems is a common element of homelessness prevention strategies in many countries. See for example, Gaetz, S. & Dej, E. (2017). 'A New Direction: A Framework for Homelessness Prevention'. Canadian Observatory on Homelessness. Toronto.
[26] Gibbons, D. (2010). 'Out of Work and Out of Money: A study of financial inclusion and worklessness in Manchester: how to improve support for people with money problems to obtain and sustain employment'. Manchester City Council.
[27] Joo, S. & Garman, E.T. (1998). 'The potential effects of workplace financial education based on the relationship between personal financial wellness and worker job productivity'.

It should be noted that a range of additional negative welfare impacts have also been identified in respect of children living in over-indebted households[28].

With household over-indebtedness often concentrated demographically and geographically, these negative impacts can also reduce community cohesion and increase the demand for public services and welfare assistance. As such, the economic externalities of over-indebtedness, can be significant[29].

In consequence, the availability and effectiveness of mechanisms to alleviate severe over-indebtedness (i.e. insolvency and debt relief systems) can be critically important. At a macro-economic level, the restructuring of household debt and the redistribution of losses to creditors (who have a low marginal propensity to consume) can produce benefits by preventing household consumption levels from being unduly constrained[30].

Conversely, research[31] has found that the long-term negative impacts of high household debt levels are exacerbated in countries with strong "creditor protections": for example, where creditors can exercise rights to repossess property and recover any further losses from debtors following sale, including within the insolvency procedure itself (e.g. through ongoing payment plans). Such creditor protections may create a higher aggregate debt service burden by acting both as a disincentive to borrowers to default or enter bankruptcy in the first instance and also by negatively impacting the ability of insolvent persons to become economically productive moving forwards.

3. Debt Issues in Selected Commonwealth Countries

3.1 Variations in levels of oversight

Data concerning the level of household debt to GDP is not available from the IMF's Global Debt Database in respect of thirty-three Commonwealth countries, and although many of these may be collecting this data, we struggled to find this in a desk-based review of central bank websites. The absence of data in these countries needs to be urgently addressed, as household debt burdens could be developing 'under the radar' of central banks.

There are some encouraging developments in this respect. For example, the Bank of **Botswana**'s financial stability framework has recently been launched[32], and a Bank survey of lending to households was published in 2018[33].

Whilst the survey was subject to some important limitations; including only data from commercial banks and deposit taking institutions but not from non-bank financial institutions extending credit to households, the Bank has committed to improving the scope and consistency of data, and is looking to implement automated systems and train staff in the financial sector to improve the quality and accuracy of data moving forwards.

[28] The Children's Society & StepChange (2014). 'The Debt Trap: exposing the impact of problem debt on children'. London.
[29] For example, in the UK, the debt advice charity StepChange estimated the wider social costs of debt problems to cost around £8.3 billion in 2014: Stepchange (2014). 'The £8.3bn challenge: the social cost of problem debt in the UK.'
[30] For a comprehensive assessment of the benefits of discharging debts and analysis of the functions of insolvency systems see 'Report on the Treatment of the Insolvency of Natural Persons', World Bank, 2013. Available at https://siteresources.worldbank.org/INTGILD/Resources/WBInsolvencyOfNaturalPersonsReport_01_11_13.pdf
[31] See footnote 4, above.
[32] A Financial Stability Council was formally launched in February 2019, with a Memorandum of Understanding signed between its four constituent members (the Ministry of Finance and Economic Development; Bank of Botswana; Non-Bank Financial Institutions Regulatory Authority; and the Financial Intelligence Agency).
[33] Available from http://www.bankofbotswana.bw/index.php/content/2019032706009-household-indebtedness-survey-report

The survey also yielded important information concerning the position of Botswana's households, identifying that the average debt to income ratios of borrowers in the survey (at 56%) as a potential cause for concern[34].

It is also clear that the Bank is carefully considering issues relating to household debt within its policymaking. For example, its 2019 monetary policy statement[35] noted that its recent accommodative monetary policy stance may be increasing financial vulnerability in the household sector: average wages grew by an average of just 2.3% in the past year, and credit expansion to households considerably outstripped this with a 7% increase in personal loans and 4.9% increase in mortgages.

Whilst the risks from this expansion are currently low – Botswana's economy continues to grow strongly and most credit is held as consumer loans by salaried employees – the Bank has identified the need to better understand the distribution of debt servicing ratios and is concerned about a growth in mortgages with 100% loan to value ratios.

3.2 The risks of credit expansion in the absence of effective regulation

However, there are clear risks that a rapid expansion of credit to households can occur in the absence of adequate oversight and effective regulation.

The Microfinance crisis in India

In 2006 the Krishna District Government of Andhra Pradesh in India closed 57 branches of two large Micro-Finance Institutions ('MFIs'), following reports of unethical collections and illegal operational practices (such as taking savings); poor governance; usurious interest rates, and profiteering. In some cases, these practices contributed to borrowers committing suicide[36].

Regulators were initially slow to respond, but in December 2010, the State Government passed an ordinance requiring MFIs to specify their area of operation, rate of interest and recovery practices. It also became mandatory for MFIs to seek the state government's approval before issuing any fresh loans. This impacted the operations of all MFIs in the state. Borrowers refused to pay their loans back and the capital financing of MFIs ground to a halt[37].

The Indian Micro-Finance Crisis required a strong response from the Reserve Bank of India, and it subsequently put in place regulations for the industry in December 2011. These included capping MFI loan spreads (the margin between the cost of financing loans and the cost paid by borrowers)[38].

Further developments have followed in the years since, with the creation of credit bureaus aimed at helping lenders take appropriate credit decisions and prevent borrowers from becoming over-indebted by taking loans from multiple sources; the introduction of a code of conduct for MFIs ensuring good governance and customer protection and a focus on creating a culture of responsible lending[39].

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[34] The Bank has adopted a benchmark for debt to income ratios of 40% or below.
[35] Available from http://www.bankofbotswana.bw/index.php/content/2009110614041-monetary-policy-statements
[36] See, for example, the BBC news report of 16th December 2010 at https://www.bbc.co.uk/news/world-south-asia-11997571
[37] Priyadarshee, Anurag and Ghalib, Asad K. (2011). 'The Andhra Pradesh Microfinance Crisis in India: Manifestation, Causal Analysis, and Regulatory Response'. Brooks World Poverty Institute Working Paper No. 157. Available at SSRN: 1983206
[38] Ibid, page 8.
[39] It should be noted that the micro-finance sector has recently called for banks to also sign up to the Responsible Lending Code: see https://www.business-standard.com/article/finance/mfis-seek-to-roll-out-common-code-of-lending-with-banks-nbfcs-by-july-119060400873_1.html

There have also been moves to alter the financing of MFIs, by allowing these to transition to 'small finance banks' by taking deposits[40]. A framework for their development was published in 2014 and ten organisations were approved the following year. These are required to focus credit on lower income groups, small businesses and other priorities including farmers and students. However, they are also encouraged to provide improved payment systems, savings vehicles and insurances – for example against crop failures.

Lack of credit reporting in Bangladesh

In **Bangladesh**, which, with India has seen strong economic growth in recent years, the cost of MFI loans was capped at 27% in 2010 and this does not appear to have constrained financial development. For example, MFIs in Bangladesh have successfully delivered loans to improve health and sanitation, although this has required costs to be subsidised by 11% for these to be affordable to borrowers[41].

However, lending by MFIs may be constrained by the lack of credit data sharing. Major MFI's are reported as having reduced lending levels from 2008 onwards due to fears that many borrowers were taking out loans from more than one MFI at a time and that the sector was saturated. Greater emphasis was placed on building up deposits, and the largest MFIs increased their loan-loss provisions[42].

Accurately identifying levels of over-indebtedness amongst Bangladeshi borrowers remains a problem. Although the Bank of Bangladesh established a Credit Information Bureau as far back as 1992, this had, until last year, only recorded details of bank loans over Tk50,000 or credit card lending of more than Tk10,000. As a result, only 0.9% of adults were included in the registry in 2017. This problem was partly addressed by a Bank of Bangladesh circular in April 2018 requiring that all outstanding bank loans of more than Tk1 be registered. However, MFI and other Non-Bank Financial Institutions ('NFBIs') are not currently covered by the Bureau[43].

Despite the absence of a comprehensive credit reporting system, efforts are still being made to expand access to financial services. In recent years, a key component of the government's financial inclusion strategy has been the promotion of "Digital Bangladesh" including the uptake of mobile money and other digital payment platforms. In 2018, 35% of adults were digitally included via a mobile money, bank, or NBFI account with digital access compared with 28% in 2017. More people also used NBFIs for savings and loans than any other type of formal financial institution. Registered account holders were more often women, rural and below-poverty groups[44].

The expansion of 'digital credit' in Kenya

An expansion of 'digital' credit (i.e. short-term loans available through mobile platform platforms) has also taken place in **Kenya**, but this has resulted in a considerable problem of over-indebtedness.

[40] For further details see https://nextbillion.net/microfinance-india-small-finance-banks/

[41] In 2016 the Global Partnership for Results Based Approaches provided a $3 million grant to provide a results-based subsidy to help reduce the debt service burden of poor households for sanitation loans provided by MFIs. Further details of the scheme and its impacts are available at https://www.gprba.org/knowledge/publications/bangladesh-oba-microfinance-sanitation-project-evaluation-report

[42] For a detailed analysis of the development of the Bangladeshi Micro-finance sector see Hasan, M., & Malek, M. (2017). 'Microfinance Market in Bangladesh' available from Researchgate.net 314243671

[43] As reported by United Nations Capital Development Fund (2019). 'Digital Transformation of MFIs in Bangladesh: Opportunities, challenges and way forward'.

[44] Statistics drawn from http://finclusion.org/country/asia/bangladesh.html

The latest Central Bank of Kenya Financial Stability Report available is for 2017[45]. This noted that Kenya's economy, which is heavily reliant on small to medium sized enterprises, was relatively resilient in the face of two major shocks that year– drought which affected food supply, and an extended electioneering period that impacted almost all sectors of the economy. Despite these shocks the economy grew by 4.9% in 2017, although this was slower than the year prior (5.9%). In terms of household debt levels, the report noted the potential dangers arising from a rapid expansion of 'digital credit':

- Digital credit expanded rapidly in Kenya since 2015, and this had been viewed by some as an example of a successful 'financial inclusion' initiative: extending the benefits of credit markets to low income, often unbanked populations[46]. In 2017 there were more than twenty digital credit providers (including banks and non-bank, credit-only lenders operating outside the Central Bank of Kenya's regulatory perimeter) and over a quarter of Kenyans were borrowing digitally. In March 2017, 8.6 million mobile loans were approved, with a total value of KSh 34.5 million.

- However, the cost of borrowing is high. The interest charged on digital loans generally range between 6% to 10% for a one-month loan, compared to 30% per annum for loans from microfinance institutions. It should be noted that the growth in digital loans continued even after the introduction of an interest rate cap imposed by the Kenyan Parliament, and effective from September 2017[47].

- Concerns have been raised that many of the loans are predatory[48]. Certainly, many borrowers experience problems repaying. Just under half of digital borrowers have had problems repaying their digital loans: with poor business performance, loss of income, and poor financial planning cited as the main reasons for this. However, one quarter of borrowers reported that the structure of the product itself causes problems, with repayment periods too short, while just under one fifth said that there was a lack of transparency about fees and loan terms. The central bank also reports that 'digital borrowers are almost twice as likely to have tried mobile betting at least once in their life, as compared to non-users of digital credit. This suggests that digital lending may tempt individuals to take digital loans to finance gambling or other risky behaviours, and in turn reduce the ability to re-pay loans.'

- In response to concerns, the National Treasury has published a draft Financial Markets Conduct Bill which would establish a new conduct regulator with the power to impose interest rate caps on all financial services providers[49]. The draft bill also proposes to provide the new regulator with powers to address 'reckless lending' practices.

The 'reckless lending' provisions in Kenya appear to be modelled on similar provisions brought into effect in **South Africa** in June 2007[50]. However, the Kenyan draft bill also

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[45] https://www.centralbank.go.ke/reports/financial-sector-stability-reports/

[46] 'Kenya: selected issues. Country Report No. 18/296', IMF, October 2018.

[47] This limits interest rates to 4 percentage points above the Central Bank of Kenya's policy rate, and the cap was therefore set at 14.7% at the time of its introduction. Despite this, the number and value of mobile loans has continued to increase (page 26, previous footnote). This continued growth of digital credit appears to be due to many digital lenders operating outside of the central bank's regulatory perimeter. However, even if within this, the cap can be evaded because it does not cover other, non-interest, fees associated with the loan. For example, the KCB one-month mobile loan product charges interest of 1.06% but also a 'negotiation fee' of 6.44%, bringing the total cost to 7.5%. It should also be noted that there may be additional fees whenever loans are 'rolled over' from one month to the next by borrowers struggling to repay on time. For example, M-Shwari charges a further 7.5% fee if the loan has not been repaid after the initial 30-day period has expired.

[48] See, for example, 'Kenya moves to regulate fin-tech fuelled lending craze', Reuters, 25th May 2018 available from https://www.reuters.com/article/us-kenya-fintech-insight/kenya-moves-to-regulate-fintech-fuelled-lending-craze-idUSKCN1IQ1IP

[49] Draft Financial Markets Conduct Bill 2018, available from http://www.treasury.go.ke/tax/finance-bills.html

[50] The South African National Credit Act 2005 was brought into effect in June 2007. It established a National Credit Regulator with the power to impose caps on interest rates and prevent 'reckless lending'. Different interest rate caps are in force for mortgages, unsecured personal loans and short-term credit (defined as loans to be repaid within six months). The reckless lending provisions are designed to ensure that lenders conduct a robust assessment of affordability prior to making credit

proposes to establish a Financial Sector Ombudsman, with responsibility for receiving and adjudicating on complaints; a function which the National Credit Regulator in South Africa has previously come under criticism for failing to undertake effectively[51].

3.3 The fundamentals of household finances in South Africa

With respect to developments in South Africa itself, it should be noted that the provisions of the National Credit Act have not been able to prevent widespread problems of over-indebtedness. Ultimately, the fundamentals of household finances (their income and their costs of living) are the critical factors in this respect.

In South Africa, the latest Financial Stability Report notes that the financial position of households remains weak, 'due to a combination of lower disposable income, a decline in net wealth and a significant increase in household debt.' The poor financial position of households, exacerbated by recent increases in VAT, income taxes and fuel price rises, is feeding through into an increased level of impairment on loans and reduced household consumption with knock on impacts for the wider economy[52].

The ratio of impaired advances to on-balance-sheet loans and advances has increased from 2.79% in October 2017 to 3.58% in August 2018. Some of this has been attributed to the implementation of the new accounting standard IFRS 9[53]. Nevertheless, it is recognised that there has been an increase in credit risk in the banking sector, with the highest default ratios reported in the unsecured lending, revolving credit facilities, and vehicle and asset finance categories.

The potential negative role of credit data sharing

Credit data reporting may start to play a more negative role in these circumstances. Approximately 10 million South African's now have impaired credit records held on the country's registered credit bureaus. This number constitutes around 40% of all credit active consumers[54]. This high level of impaired credit records, together with the stressed financial position of households more generally, is frustrating the South African Government's efforts to expand home ownership[55]. For example, in 2015, 55% of NedBank's mortgage declines were based on the 'unacceptable credit track record' of the applicant, and 42% on 'lack of affordability'[56].

The need for effective debt relief programmes

There arises a need for over-indebted households to be provided with effective relief if shocks to income or expenditure create long-term payment difficulties.

In South Africa households have, until recently, had access to only a limited form of debt relief. Although the National Credit Act provided for over-indebted households to be assisted by registered debt counsellors and for a 'Debt Review' system to be implemented;

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available. If a credit agreement is subsequently found to have been unaffordable to the borrower from the outset, it can be set aside.

[51] See, for example, 'Credit Regulator to be probed for failing consumers', Business Report, 26/11/2016.

[52] Real household disposable income contracted in September 2018 due to a combination of VAT and income tax rises and increased fuel prices - https://www.businesslive.co.za/bd/economy/2018-09-25-households-spend-less-in-second-quarter-as-drop-in-disposable-income-bites-hard/

[53] For details of this accounting standard see https://www.ifrs.org/issued-standards/list-of-standards/ifrs-9-financial-instruments/

[54] 'Credit Bureau Monitor: first quarter, 2019', National Credit Regulator,

[55] The South African Government has pursued a number of initiatives in this respect, including subsidies for lower income households. See, for example, the Finance Linked Individual Subsidy Programme (FLISP) which provides a subsidy to pay the deposit on a house or to decrease the size of the home loan.

[56] However, the low standard of homes available for mortgage also presents a considerable problem: in the same year 81% of ABSA's home loan application declines were based on 'unacceptable security'.

this only provided for the cessation of further charges and the rescheduling of debt repayments and did not allow any writing down of the debtor's liabilities (unless 'reckless lending' is involved). This meant that debtors could be held in the process for many years. Obtaining access to Debt Review also required the debtor to apply via a registered debt counsellor to the Magistrates Court, leading to high costs and making the process unaffordable for those on low incomes. Entering the process also prevented the debtor from accessing further credit until the existing debts have been cleared.

In order to address these problems, the South African Government has recently passed the National Credit Amendment Act. This seeks to expand access to the procedure for those on low incomes and provides a possible route for debts to be written off, in part or in full, after two years. The Act was signed into law on 13th August, but it has received considerable criticism from the Banking Association South Africa, which alleges[57] that it will limit lender appetite to extend credit to low income households in the future, and that if credit is extended this will need to be at a higher price to counterbalance the risks of debtors making use of the procedure.

3.4 Advanced economies with high household debt levels

Given the persistently high level of household debt in several advanced economies within the Commonwealth, many of these have been reviewing their arrangements for debtor relief in recent years, as well as focusing their regulatory efforts on limiting the risks that lenders take in both the mortgage and consumer credit markets moving forwards.

3.4.1 Improving debtor relief in the UK

For example, with respect to debtor relief, the UK:

- Introduced a new form of personal insolvency – the Debt Relief Order ('DRO')[58] – in England and Wales in 2009. This provides a route via debt advice agencies for debtors with low income and low assets[59], to obtain relief from their creditors for a period of 12 months, after which the debts are discharged (written off). Since their introduction, over 250,000 DROs have been made leading to £2.3 billion of debts being written off.

- Placed the Money Advice Service[60] under a statutory duty to improve the quality, availability and consistency of debt advice in 2012. This was in addition to its prior obligations to raise levels of financial literacy and skills. The body is funded by a levy on the financial services industry and, in 2019, its debt advice budget is £56 million, which is expected to meet the cost of delivery of advice to over 530,000 people; and

- Has announced that it will introduce a new 'breathing space' scheme for debtors from 2021 onwards. This will provide people in problem debt with a 60-day period during which creditor enforcement action will be stopped in order to allow for them to seek

[57] See, for example, the coverage of the Bank Association South Africa's position as reported by Business Day 21/08/2019 at https://www.businesslive.co.za/bd/opinion/2019-08-21-cas-coovadia-unsustainable-national-credit-amendment-act-rushed-through/

[58] A similar scheme was also introduced in Cyprus in 2015. In particular, the Insolvency of Natural Persons (Personal Repayment Plans and Debt Relief Orders) Law 65(I)/2015 in Cyprus was adopted on the 18th of April 2015 and enforced on the 7th of May 2015.

[59] To be eligible for a Debt Relief Order, debtors must owe £20,000 or less; have a disposable income of less than £50 to spend each month (i.e. after paying tax, national insurance and normal household expenses); have lived or worked in England or Wales in the last 3 years; have assets worth less than £1000; and not have used the scheme in the previous six years.

[60] This agency has since become the Money and Pensions Service.

advice and obtain access to an appropriate debt solution[61]. Government is also committed to introducing a new 'statutory debt repayment plan' to protect debtors from enforcement action; ensure lenders freeze interest and other charges and allow debtors to make affordable instalments to clear their debt (over a period of up to seven years).

However, there is a disconnect between the UK's public policy objectives of providing relief to debtors and the market's objectives of (i) maintaining payment 'discipline'; (ii) assessing, and pricing for, ongoing risk; and (iii) maximising returns from over-indebted households. This is because:

- The UK's credit bureaus record missed payments and defaults for a period of six years. This may act as a disincentive for borrowers to enter a debt solution, as they will struggle to obtain credit in future should they do so[62];

- Credit scoring creates a 'disciplinary effect[63]': meaning that borrowers strive to make their payments to unsecured creditors when they can no longer reasonably afford to do so, which leads to arrears on household bills or to very negative welfare impacts; and

- The lengthy repayment periods of some debt solutions require households to significantly constrain consumption for many years. Although much of the debt recovered through these plans has likely been sold by originating lenders on secondary debt markets at a fraction of the nominal amount, long-term repayment plans do not provide any write-off of liabilities for debtors.

3.4.2 Reducing Risks in the Mortgage Market

Most household debt in advanced economies is comprised of mortgages, and a sustained period of low interest rates has considerably eased the debt servicing ratios of mortgage borrowers in these countries.

However, an accommodative monetary policy stance can also feed an increased risk appetite amongst mortgage lenders. For example, in the UK the proportion of new mortgage lending at loan to value (LTV) ratios at or above 90% reached a new post-crisis peak of 18.7% at the start of 2019. There is therefore a risk that an increase in mortgage rates (which could, for example, be sparked by a disorderly Brexit in the UK) could create a financial stability risk as well as lead to a sharp cut in household consumption.

To guard against these risks central banks have stress tested lenders; increased capital adequacy requirements, and increasingly turned to mortgage lending restrictions. For example, the Bank of England put in place two key measures in 2014. These were:

- Restricting the number of mortgages that can be extended at Loan to Income ratios at or above 4.5, to 15% of a lender's new mortgage lending; and

- Requiring lenders to stress-test mortgage applicants. In this respect, lenders must assess whether borrowers could still afford their mortgage if, at any point over the

[61] Importantly, the debts included in the breathing space scheme include not just credit debt but also amounts owed in respect of household bills and to governmental bodies (including local authorities).

[62] See, for example, Collard, S., Finney, A. & Davies, S. (2012). 'Working households' experiences of debt problems'. StepChange Debt Charity, and Finney, A & Davies, S (2011). 'Facing the squeeze 2011: A qualitative study of household finances and access to credit.' Personal Finance Research Centre, University of Bristol.

[63] Japelli, T., & Pagano, M. (2005). 'Role and Effects of Credit Information Sharing'. Working Paper 136, Centre for Studies in Economics and Finance available at http://www.csef.it/WP/wp136.pdf

first five years of the loan, their mortgage rate were to be 3 percentage points higher than the reversion rate specified at origination (or, if a reversion rate is not specified, 3 percentage points higher than the product rate at origination).

Mortgage restrictions of these types are in place in several other Commonwealth countries, including in **Cyprus**:

- The maximum allowable LTV ratio is set by the Central Bank of Cyprus at 80% for a primary residence and at 70% for all other real estate purchases;

- A directive to improve affordability assessments and limit the debt servicing ratios of borrowers is also imposed. From 31st March 2014 lenders have been required to assess the total debt servicing burdens of loan applicants and, including the credit facilities being applied for, must not make loans if these exceed 80% of the borrower's net disposable income (i.e. the amount remaining once normal monthly expenditures have been deducted). Additionally, the debt service to income ratio is limited to 65% for loans denominated in foreign currency. It should be noted that this total debt servicing restriction applies to both the mortgage and unsecured credit markets.

However, Cyprus has had to go even further to address problems in its mortgage market due to a very high level of non-performing loans:

- In April 2015, the central bank revised a Directive concerning Arrears Management practices requiring lenders to write to borrowers in arrears with proposals to restructure their debts;

- Debtors were, however, able to apply to the Financial Ombudsman to mediate in this process if the restructuring proposal was not acceptable to them;

- This resulted in a lengthy process of negotiation, and delayed mortgage foreclosures, with concerns that some debtors were 'strategically defaulting' in order to obtain better terms. Although a new accelerated mortgage foreclosure process was implemented from July 2018 onwards, it was acknowledged that help still needed to be made available to vulnerable households in genuine financial distress. This has since resulted in the creation of the ***Estia mortgage loan restructuring programme***:

    - Eligible borrowers are those who have their primary residence valued at EUR 350,000 or less collateralised against loans and who were in substantial[64] arrears with their mortgages prior to 30th September 2017. Households must also have limited means / net wealth, although the specific income limit varies according to household size;

    - Where the eligibility criteria is met, the outstanding debt will be written down to the current open market value of the property (if lower than the contractual amount) and the loan will be restructured over a period of up to 25 years[65]. Interest rates on the loan will be variable and calculated as the Euribor six-month rate plus 2.5% for the first seven years, but they

[64] At least 20% of the total outstanding debt in arrears for more than 90 days immediately preceding 30 September 2017.
[65] The specific period depends on the debtors age.

also capped at a maximum of 3.5%. After seven years the rates will float as the Euribor six-month rate plus 2%;

- The state will also pay one third of the borrower's instalments under the restructured loan, with the borrower remaining liable for the other two thirds.
- In total, it is estimated that EUR3.4 billion or mortgage loans will be eligible for the scheme, and that the maximum total cost to the state will be EUR815 million over 25 years (equivalent to EUR33 million per annum or 0.2% of GDP).
- Banks have now been invited to participate in the scheme, and to invite eligible borrowers to apply. It is expected that payments will then be disbursed from December 2019.

3.4.3 Reducing risks in Consumer Credit Markets

Financial stability risks are not limited to the mortgage market. For example, the Bank of England's Prudential Regulation Authority has conducted stress tests of major bank exposures to consumer credit losses, reporting that[66]:

> *"Loss rates on consumer credit are far higher than for mortgages, as borrowers are much more likely to default on their consumer credit loans in the face of adverse shocks. And because the majority of consumer credit is unsecured, lenders cannot rely on the value of collateral to cushion their losses."*

In consequence, the Bank has recently raised capital adequacy requirements and, together with the completion of structural changes to models of car financing from 2009 onwards[67], consumer credit growth in the UK has slowed to 5.6% in the year to May 2019 (from a peak of almost 11% in late 2016). The aggregate consumer credit debt to income ratio has now stabilised at around 15%.

However, it should be noted that the debt to income ratio may under-estimate the financial pressures faced by households. In the UK, the financial crisis has been followed by a lengthy period of real wage contraction and the impacts of this on household finances have further been exacerbated by cuts in public spending and levels of welfare assistance. Fiscal policy is important here, but it is also clear the debt to income ratio does not capture the impact of falling real wages on debt repayment burdens. These impacts can be significant, for example, where currency values depreciate significantly and the cost of imports, including food and fuel, increase.

The distribution of consumer credit liabilities is also important. Repayment burdens are generally highest for households on lower incomes and the pricing of credit can become highly regressive (the 'poor pay more'). This results from a lack of constraints on the 'risk-based pricing' models used by lenders.

[66] Pg. 16, Financial Stability Report, July 2019. Bank of England.

[67] The Bank of England's Inflation Report for November 2017 (pg.16) reports "around 90% of new cars bought with dealership car finance in 2016, compared with around 50% in 2009. Such finance typically involves personal contract purchases (PCP), a type of agreement with fixed monthly payments that are lower than other forms of car finance. That is because at the end of the loan customers either make an additional payment for a pre-agreed amount to purchase the car or return the vehicle to the dealer. This structural shift will have boosted consumer credit growth, partly because the entire amount of PCP loans are recorded as credit, even though not all customers will make that final payment to purchase the car."

3.4.3.1 The dangers of unconstrained risk-based pricing models

In unconstrained risk-based pricing systems, lenders can be incentivised to use credit reference and other data to identify groups likely to have problems repaying and charge these very high interest rates. They are also incentivised to structure products in ways which take advantage of these groups. For example, products can require full repayment within a very short space of time and impose high default fees on those who fail to do. Alternatively, people struggling to repay on time are encouraged to refinance or 'roll over' their debts, which allows the lender to compound interest.

Recognising this problem, Australia, Canada, and the UK have all moved to impose tougher affordability assessment rules or to control the cost of credit in recent years (see boxes 1 and 2, below).

The regulators in all three countries have also directly intervened in their credit card markets. Unsolicited credit card limit increases have been banned in both Australia and Canada, whilst in the UK a new set of rules were introduced in 2018 which attempt to address the problem of 'persistent credit card debt'.

Box 1: Affordability Assessment Requirements in Australia, Canada and UK

In **Australia** lenders are required to make 'reasonable inquiries' in order to determine whether the applicant can meet their financial obligations under consumer contracts without this causing 'substantial hardship'. The term 'substantial hardship' is not defined. However, the Australian Securities and Investment Commission promotes the use of benchmarks by lenders for this purpose (for example, the use of the Henderson Poverty Index plus an additional margin or use of government benefit levels)[68]. Finally, with respect to credit cards, lenders must conduct their assessments to determine whether the borrower could pay off an amount equivalent to the credit limit within three years.

In **Canada**, a new Federal Financial Consumer Framework was passed into law in December 2018. This provides for regulations to be made to encourage responsible lending conduct and ensure the fair treatment of consumers; and will place banks under an obligation to ensure that products and services are 'appropriate, having regard to the person's circumstances, including their financial needs'. In addition, action has been taken by Provincial Governments. For example, in November 2017, Quebec passed a law requiring lenders to conduct affordability assessments and this also prevents high cost credit being advanced to borrowers with high debt to income ratios.

In the **UK**, the Financial Conduct Authority requires lenders to assess the 'creditworthiness' of borrowers and assess the affordability of loans as part of this. However, lenders are provided with a great deal of discretion, credit can be granted if, after taking account of income and essential expenditure (including other outstanding loan payments) the debtor is able to afford a 'basic quality of life'. This term is not defined.

[68] The National Credit Act also stipulates two specific circumstances were loans are prevented from being made: (i) where the borrower could only comply with their financial obligations by selling their place of residence; and (ii) where the contract is a small amount credit contract (e.g. 'payday loan') and either (a) at the time of the assessment the borrower is in default on another small amount credit contract or (b) in the 90 day period before the assessment the borrower has had two or more other small credit contracts.

Box 2: Controls on the cost of Credit in Australia, Canada and UK

Australia has a range of caps on credit costs in place.

- For loans under AUS$2,000 lenders are prohibited from charging more than 20% of the loan amount as up-front charges and cannot charge more than 4% as monthly fees. They are also prohibited from collecting more than twice the amount lent if the borrower misses a payment or defaults on the loan.

- For loans between AUS$2,000 and AUS$5,000 up-front fees are capped at AUS$400 and the maximum interest rate is 48% (inclusive of all other fees and charges); and

- For loans above AUS$5,000 the total cost is capped at 48% (i.e. there is no separate allowance for arrangement fees)[1].

In **Canada**, the Criminal Code contains provisions to prevent usury: and prohibits loans charging interest of more than 60%. Provinces also have their own laws to regulate payday lending: with interest rate limits ranging from just CA$15 per $100 borrowed (e,g. Ontario) to about CA$25 per $100 (e,g. Prince Edward Island). However, Quebec has in place an annual interest rate limit of just 35%, which effectively bans the product altogether.

In the **UK** a total cost cap on high cost short term credit ('payday loan') agreements was implemented in 2015. This prevents lenders from charging more than 100% of the principal amount in fees, interest and default charges. The total cost cap applies to loans of up to one year in duration, and the cap extends to cover the previous costs incurred on loans that have been refinanced ('rolled over'). On 1st April 2019, the UK also introduced a cap on the cost of Rent-to-own[1] agreements, again set at 100% of the amount borrowed.

4. Conclusions and Policy Recommendations

Whilst credit can be extremely useful to households, and can help generate economic growth, there is a danger that households can become highly leveraged and therefore vulnerable to income and expenditure shocks. If crystallised, this risk can drive a rise in non-performing loans held by financial institutions and, depending on the extent to which financial institutions are able to absorb those losses and the extent to which they are systemically important, to a financial stability risk.

Shocks to the financial system can subsequently constrain lending to households and other economic sectors with severe consequences for growth. Further effects can include higher unemployment and rising demand for public services and welfare assistance, which impact on government budgets. If household spending becomes further constrained and government is unable to generate demand, then a protracted period of economic stagnation can result.

This analysis has formed the basis of much policy making in the aftermath of the financial crisis, which has focused on (i) monitoring the extent of risk arising from household debt levels; (ii) understanding how these risks are distributed throughout the financial system; (iii) requiring major financial institutions to ensure they can absorb potential losses should risks become crystallised (iv) taking measures to improve lending practices and (v) designing better systems of relief for households experiencing repayment problems.

However, in many countries with high levels of household indebtedness, consumption levels remain subdued, and monetary policy accommodative. The debt overhang remains considerable and many households remain extremely vulnerable to income and expenditure shocks. Drawing on the experience of the Commonwealth countries in this study, we make the following conclusions and recommendations for future policy development.

4.1 Fiscal expansion may be a preferred route to growth

Although credit expansion can initially boost economic growth, the risks from a sustained upswing in household debt increase over time; the utility of credit for some borrowers diminishes and debt repayments can become a drag on consumption. This is particularly true if risk-based pricing models are unconstrained and credit continues to expand as a means of refinancing previous borrowing.

Risk assessment (by borrowers and lenders alike) is also never likely to be perfect; housing market bubbles can be created; and the pricing of credit products can become extremely regressive, with those on the lowest incomes paying the highest prices.

These problems raise fundamental questions about the wisdom of using long-term household credit expansion as a means of generating economic growth.

Promoting growth through investment in infrastructure, including human capacity, therefore remains important, and fiscal and monetary policy need to work more closely together to ensure balanced models of economic growth moving forwards.

4.2 Improved oversight of household debt burdens is needed

In thirty-three Commonwealth countries there is a lack of data concerning household debt levels and inadequate oversight of the scale of the problem as a result. In some countries, data is restricted to the banking sector and does not capture the activities of Non-Bank Financial Corporations. However, this sector can be significant and, as has previously been witnessed in India, considerable problems can arise if oversight and regulatory frameworks are inadequate. Countries should therefore seek to ensure that both banks and non-banks are included in their data gathering and regulatory frameworks.

However, even where this is the case, the measures of household debt burdens need to be improved. Aggregate measures of the debt to income ratio do not capture the impact of expenditure shocks on households, which may be caused by an increase in the cost of imports for essential goods and services. Aggregate measures of household wealth also frequently fail to acknowledge that non-financial assets (such as the value of housing) has become over-inflated, and that liabilities exceed their underlying, or long-term, value. Similarly, aggregate measures of household financial assets and liabilities ignore the fact that these assets and liabilities are often held by very different groups of people.

Policymakers may therefore be under-estimating the risk of widespread defaults resulting from relatively small income or expenditure shocks amongst a heavily over-indebted segment of the population.

As the severity of over-indebtedness is defined by *both* its intensity and likely duration, an *over-indebtedness risk indicator* could be developed which encompasses both the debt to *disposable* income and debt servicing costs to *disposable* income ratios. Such an indicator would provide policymakers with more accurate oversight of developing risks and could also be used in the stress-testing of firms.

4.3 Investment in financial literacy programmes is needed

Ultimately, the risks posed by household debt originate in the nature of the relationship that exist between lenders and borrowers. Behaviours on both sides of this relationship can be improved.

Many borrowers suffer from insufficient information. Research by Lusardi and Tufano (2009) shows only a third of their sample population had an adequate level of debt literacy; understanding concepts of compound interest. This lack of financial knowledge is costly, with Lusardi and Tufano estimating that up to one-third of credit card charges and fees paid by less knowledgeable individuals can be attributed to ignorance.

Given the strong relationship between financial literacy – particularly debt literacy – and debt load, financial literacy and skills programmes could prove beneficial for borrowers. Such programmes have proven effective in improving financial literacy. They help individuals to identify which products are best suited to their needs; avoid high charges, budget effectively and plan for the future.

There is a widespread literature available to guide the design of these programmes, and detailed comparative study of approaches being followed in the different countries of the Commonwealth, and more generally, be undertaken to gain insight into what works.

The Commonwealth has been involved for a number of years in mobilizing financial literacy across the different regions, although for the main purpose of improving financial inclusion, the merits of financial literacy for better household debt management is clearly agreeable. The Commonwealth's financial literacy programme involved providing capacity building support for central banks aiming to improve citizens' financial literacy as well as creating a network of financial literacy educators. With the appropriate demand from members, this programme could be integrated with the Secretariat's fintech programme of which fintech training and financial literacy are a major part.

4.4 Improved lender conduct regulation is required

On the lender side of the relationship, more interventionist conduct regulation may be required. There is widespread evidence that some lenders fail to properly assess the affordability of loans and under-estimate future default risks. This particularly the case at times when accommodative monetary policy has reduced the debt servicing burdens of borrowers, which can lead to a relaxation of under-writing standards[69].

However, conduct regulation, such as requirements to undertake in-depth affordability assessments, incurs costs for lenders. These may become disproportionate, for example in respect of small to medium sum consumer loans. The cost of supervision and enforcement of conduct rules, and of providing consumer redress mechanisms, are also likely to be high.

More direct product intervention may be preferable as a result, and there has been a move in many Commonwealth countries in this direction in recent years. In particular, there has been an increase in the use of caps on the cost of credit. In credit markets, price is reflective of risk. Controlling price therefore limits the risks that lenders can take.

To date, caps have generally been used in areas of the consumer credit market where 'market failures' (such as a lack of effective price competition) have been observed. As a result, they have tended to be product specific. However, there may be a case for the

[69] Prior to the financial crisis, rules relating to the quality of lender risk assessment were largely absent from conduct regulation, with an over-reliance on information and disclosure of contract terms ('truth in lending') as a means of helping borrowers make rational decisions.

introduction of a comprehensive total cost cap covering all forms of consumer credit, and this should be explored further. This would limit the overall level of risk-based pricing that could take place within the system as a whole and could be particularly beneficial if it also restricted the continual refinancing of debt.

However, it should be noted that the level at which caps are imposed is critically important. Too low, and caps may unduly restrict supply; too high and the level of risk-taking by lenders will be unaffected. Caps also need to be constructed in ways which prevent lenders from evading their impacts, for example, by including all costs and charges rather than just focusing on interest rates, and by limiting the use of 'rollover' loans or refinancing.

4.5 More effective debt relief programmes are needed

Effective debt relief programmes and insolvency systems are critical to addressing problems of household over-indebtedness and can have positive macroeconomic benefits. However, creditor rights and protections can become too strong within these systems: deterring take-up; preventing early discharge and restricting debtor rehabilitation.

Commonwealth countries should therefore review their insolvency systems drawing on existing research literature to identify best practice. This should include consideration of the recommendations made in the World Bank Report of 2013 on the Treatment of the Insolvency of Natural Persons.

New relief programmes, specific to the nature of the debt overhang observed in some countries may also be required: to write down elements of debt and provide for a restructuring of the remainder. Cyprus' mortgage restructuring programme is a particularly interesting example in this respect, and there will undoubtedly be much to learn from this.

However, it is also apparent that problems exist in respect of the interaction between debtor relief procedures and credit data sharing systems, with public policy objectives to provide debtors with a 'fresh start' in some countries seemingly frustrated by the latter. A wider review of the role of credit databases is needed to determine what information they should hold and for how long.

Finally, non-performing loans bought on the secondary debt markets may contribute to the long-term debt overhang and exercise a drag on household consumption. The economic and societal benefits of secondary debt markets deserve greater scrutiny, and it may be that debts purchased in these markets are prime candidates for at least a partial write-off moving forwards.