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HOUSEHOLD FINANCE REVIEW - Q2 2022

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This review explores trends in household spending, saving and borrowing through the second quarter of 2022. Confidence continued to fall, below the lows of both Brexit and the Global financial crisis as cost-of-living pressures accelerated and households felt the squeeze. Here we look in detail at spending and borrowing patterns as households negotiate these challenges.

FOREWORD FROM ACCENTURE

The Q2 data on UK household finances shows that consumer spending held firm during the quarter, and house-buying activity returned to pre-pandemic levels. But these relatively positive indicators were accompanied by a sharp fall in consumer confidence.

The average mortgaged UK household seems to continue to purchase items (and spend on travel which had significantly been restricted during the pandemic) while anticipating an intensifying squeeze on their finances in the coming months as inflation continues to rise.

The sense of foreboding is deepened by the findings on the "wiggle room" for the average mortgaged household – the disposable income left over after paying the mortgage and basic outgoings. If the 1.3 million existing borrowers coming to the end of their fixed rates this year were to refinance now, they'd have only a quarter of their net income left over.

What's more, the severity of the spending squeeze will vary between different segments of the population, even among mortgage buyers, and the lower-income households will be impacted the most – and many are already feeling the strain.

For lenders, the darkening outlook brings a number of implications. Quite rightly, they're watching for emerging signs of financial distress among customers. But the current situation also highlights some ways lenders can help customers to ride out the turbulence.

In the past few weeks, the tightening squeeze on spending has seen an uptick in people's usage of physical cash rather than electronic payments – an interesting trend whereby it appears people going back to cash might highlight the more traditional forms of budget management. This definitely underlines the continued need for improved financial literacy and education. This is a need that lenders can help to meet through steps like offering clearer information and making digital transactions and financial management tools even more transparent and intuitive.

The overall message? Times are getting tough for customers, but they are going to get tougher. And lenders can help them weather the storm.

Q2 2022 HIGHLIGHTS

- Despite a significant fall in consumer confidence, consumer spending patterns remain stable with households appearing to make purchases now ahead of further price rises to come, including in the travel sector as consumers return to foreign holidays after a two-year absence.
- House purchase activity looks to have returned to pre-pandemic norms – for now. But headwinds from cost-of-living pressures are likely to put a brake on demand going forwards.
- Cost-of-living and interest rate rises will create significant pressures for mortgaged households leaving some with little or no wiggle room in their budgets without making changes to spending and borrowing patterns. The affordability tests embedded within lending decisions ensure borrowers have the flex within their finances to manage a significant degree of pressure, but the current inflationary environment will push some to the limit of this buffer.
- Internal mortgage refinancing (Product Transfer) business fell away in Q1, but external remortgage activity grew year on year, suggesting borrowers are shopping around more to find the best deals as interest rates have begun to rise rapidly after years of very low rates.
- Despite the escalating cost-of-living pressures, household savings accumulated through the pandemic have stopped growing but have yet to show signs of reversal, while overdraft and card debt levels remained low. However, within aggregate figures it is likely that some, particularly amongst lower income brackets, are feeling considerable strain already.
- Mortgage arrears fell overall but, within this, early arrears ticked up for the first time since early 2021. This may suggest that the arrears cycle has started to move upwards (in line with forecasts) as cost-of-living and higher interest rates begin to take their toll, but more data are needed to confirm a trend of increasing mortgage payment problems.

UK ECONOMIC CONTEXT AND OUTLOOK

Two, connected, economic stories dominated in the second quarter of 2022, the backdrop for our latest Household Finance Review – the continuing rise in inflation and the Bank of England action to prevent it from becoming persistent.

In July CPI inflation hit 10.1 per cent, the fastest pace of price growth in 40 years. The factors that have been pushing inflation higher since the end of 2021 continued to be present in the first half of 2022. Transport costs, mainly fuel, food prices, and hospitality were the most significant contributors to inflation in the year to June. Much of this is global in nature, and surging inflation is a concern for policy makers across advanced economies.

Those concerns will persist in the coming quarters, not least as a consequence of the ongoing conflict in Ukraine and the impact on energy prices and supply, and the risks to food production from the hot weather. A significant driver of future inflation in the UK will be the increase in the energy price cap, which has recently been announced as £3,549 and will come into effect in October 2022.

In its August Monetary Policy Report the Bank of England estimates that CPI inflation will peak in the region of 13 per cent in Q4 and remain elevated through much of next year. Its response was to accelerate the pace of interest rate rises in August, with the Monetary Policy Committee members voting in favour of a 50 basis point increase to 1.75 per cent, further signalling that it would act 'forcefully' if significantly above-target inflation looked set to become more persistent.

The sharp rise in the price of, largely, essential items for households is eating into disposable incomes. While labour market conditions in the UK remain tight, with the unemployment rate remaining low at 3.8 per cent, and some pick-up in nominal earnings growth, pay rises are falling far short of inflation. Consumers' concern about this has been evident in the collapse in confidence, which coincided with the announcement of the last tranche of energy price and tax increases in early Spring and has continued in subsequent months. Consumers are particularly downbeat about economic prospects and their own financial situation in the next 12 months.

The ONS Opinion and Lifestyle survey shows that many households are already taking steps to manage budgets, including cutting back on discretionary spend and reducing energy use. As we noted in the last Review, these costs hit all households, but the impact is most acute across lower income households, which are more likely to be taking some action to reduce spending as a result of cost-of-living increases.

As the pressure on household finances, and business costs, has become more evident forecasters have become more downbeat about wider economic growth prospects in the coming years. Again, this is a position not unique to the UK economy. The Bank of England is now expecting the UK economy to tip into recession in the final months of 2022 and for GDP to decline through 2023. Official data for the UK GDP in the second quarter confirmed that the economy had stalled. Initial estimates show a 0.1 per cent contraction in output in the three months to June.

The month-on-month profile over the quarter was bumpy as a consequence of some one-off factors, such as the additional June bank holiday and increased construction activity following storms earlier in the year. In addition, there was some return to normal – a boost from a return to face-to-face GP appointments and the wind down of Covid-19 vaccinations and track-and-trace. The data, however, continue to show some defiance of cost-of-living pressures, with growth coming from travel sectors and hospitality – trends supported by our own card spending data, discussed in later sections. However, retail activity continues to disappoint – in part consumer caution and some lingering supply chain challenges affecting areas such as vehicle sales.

As noted, the Bank of England has made some significant downgrades to its expectations for the future path of the UK economy. The International Monetary Fund (IMF) similarly revised down its expectations for global growth this year and next. There are, however, a number of uncertainties to that outlook. The dominant one is the prospects for future energy costs, predominantly linked to the Russian invasion of Ukraine. In addition, the government's policy response will not be clear until the election process of the next conservative leader has run its course and a new cabinet has been installed. Pressure is mounting on the need for further targeted support for households in the face of the forthcoming hike in the energy price cap – just one of

a number of policy priorities the new prime minister will be required to make some swift decisions on. Finally, tighter monetary conditions, while necessary to tackle inflation, will also bear down on demand in the year ahead. How these factors evolve will most likely determine not whether the UK economy will enter a recession, but its depth and duration.

Overall, it is clear the remainder of the year will prove challenging to UK households as they cope with elevated pressures to costs of living, especially those households towards the lower end of the income distribution. In the coming quarter, external forecasters expect a gradual slowdown in economic growth, meanwhile inflation has been continually revised upwards. In comparison, the labour market outlook remains relatively stable, with unemployment projected to rise marginally. For the year as a whole, NIESR forecast annual GDP growth at 3.5 per cent, CPI inflation to increase by 7.8 per cent and the unemployment rate to average at 4.4 per cent.

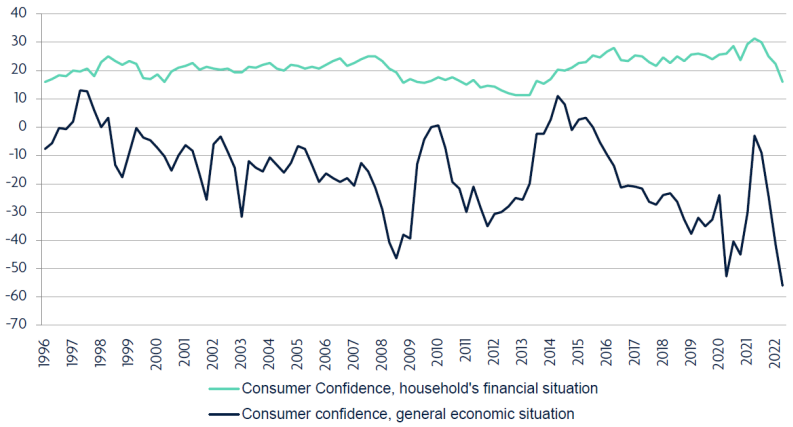
With the new prime minister now installed, the timing and degree of support that is expected to be announced shortly will have a significant bearing on changes to the forecast outlook.

CONFIDENCE PLUNGING AS COST-OF-LIVING BEGINS TO BITE...

Even amidst war in Ukraine and domestic political upheaval, the escalating cost-of-living pressures taking hold across the country have increasingly dominated the news cycle. With national insurance contributions and energy price rises coming into effect from April, households began to see real pressure on their balance sheets. This pressure is felt most significantly amongst lower-income segments, but the stark forecasts of double-digit inflation and, within this, triple-digit energy price rises through this year and next, have impacted on consumer sentiment in a more widespread way as households anticipate still-tougher times ahead.

Reflecting this, consumer confidence dropped again in Q2. In particular, households' confidence in the economy plunged to a reading of -56, the lowest reading since at least 1996, below previous lows seen at the start of the pandemic and, before this, the beginning of the Global Financial Crisis (**Chart 1**).

Chart 1: Consumer confidence



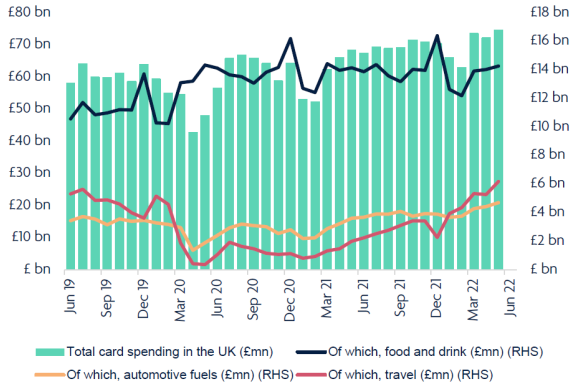
SOURCE: GFK

Households' confidence in their own position also dropped away sharply and is now well below the readings seen throughout the worst of the pandemic. This change – in an indicator which is typically much more upbeat than households' view of the wider economy – is all the more stark when considering that this time last year, confidence in their own financial position was at a record high as the majority of social distancing and other Covid-19 restrictions were lifted.

..BUT SPENDING REMAINED BUOYANT

Despite this sharp drop-off in confidence, spending on credit and debit cards was strong through Q2. This reflects a combination of factors; firstly price increases, including at the petrol pump and in the supermarket, have driven up average spends. However, the number of transactions has also risen across all sectors of spending. The travel sector saw particularly strong growth - in both the number of transactions and average spend - as demand for foreign holidays, now largely free from previous Covid-19 restrictions, continued to grow (**Chart 2**).

Chart 2: Card spending in month



SOURCE: UK FINANCE

Going forward, capacity-linked restrictions for airlines and airports have the potential to dampen spending activity in this sector through the remainder of the summer, and possibly beyond.

At the same time, we have yet to see the full effect of cost-of-living pressures on spending patterns, not least because energy prices are set to increase again in October and then again in early 2023. Regardless of any efficiency savings and reductions in usage that households are able to make, the extent of the price increases for this essential spend will necessarily reduce the amount of disposable income available for discretionary spend in other areas, most significantly for lower income households.

How this plays out for consumers is, at yet, uncertain and will also vary across differing household types. For some, the reduction in income will be absorbed, reflected in a reduced capacity to save or dipping into existing savings. Taking a longer-term view, this may have knock-on impacts, including aspiring first time buyers less able to save for deposits, and reduced ability to make pension contributions. Both of these are choices which can be deferred without immediate negative impacts but have longer term consequences on those households, particularly if sustained for any significant length of time.

However, for others (and, in a theme that necessarily needs repeating, these are concentrated amongst lower-income households) the effects are likely to be more immediate. Some households' ability to spend on discretionary, and potentially on essential items, is likely to come under increasing pressure. Aggregate expenditure data, such as that shown here, does not reveal these distributional effects.

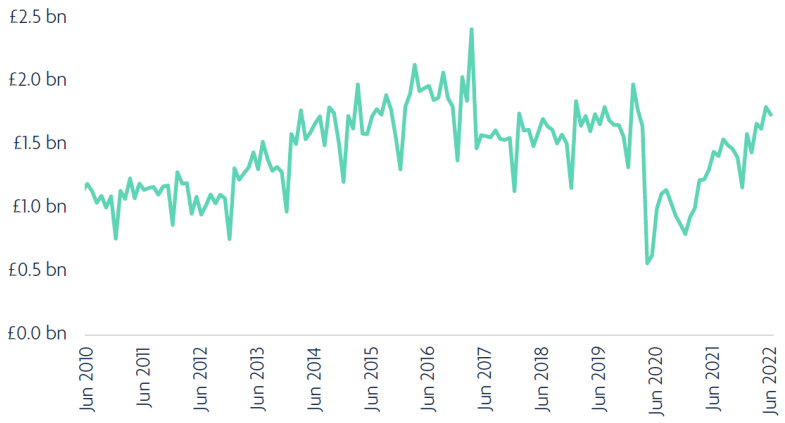
PERSONAL LOAN BORROWING ALSO STRONG

Borrowing via unsecured personal loans, generally used to fund larger purchases, also remained strong through the second quarter in another indicator that the marked drop in consumer confidence has yet to translate to a fall in spending activity (**Chart 3**).

However, with inflation forecasts increasing - the Bank of England now expecting CPI to peak at over 13 per cent - it is quite possible that borrowing activity is being brought forward to take advantage of both prices and interest rates which are lower now (possibly materially so) than they are likely to be in a year's time.

Increasing both spending and borrowing on more expensive items may seem counterintuitive at a time when households are likely to need flexibility in their budgets in the near future, but this may equally reflect rational behaviour when viewed in the context of the possibility of these items becoming unaffordable as inflation accelerates. Many of these expensive items, for example a new washing machine or cooker, may be discretionary now but, if deferred, could become more essential than discretionary if the old one breaks down in a year's time, at which point it could be out of reach. Similarly, a family holiday, already deferred for two years, may be affordable now but no longer next year, so this too may be both justified and rational depending on individual households' priorities.

Chart 3: Amounts of new personal loans from banks



SOURCE: UK FINANCE

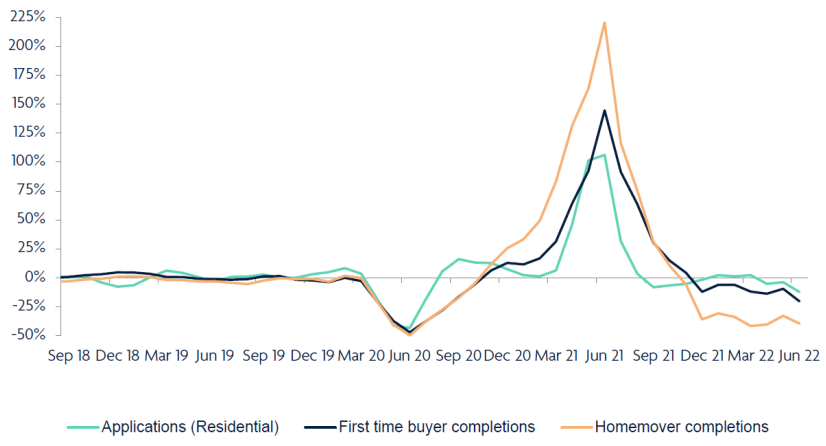
The current strength in personal loan borrowing may persist for a number of months yet as the factors described above drive behaviour. Looking further ahead, however, the outlook is likely to be one of constrained demand as inflationary pressures increase.

HOUSE PURCHASE ACTIVITY WELL DOWN ON LAST YEAR....

Borrowing for house purchase showed further contraction compared with activity levels one year ago. This is in line with expectations, Q2 2021 having seen greatly elevated activity levels as borrowers rushed to complete before the end of the second phase of the Stamp Duty holiday. Within this, and as also expected, homemover activity showed a materially greater year-on-year contraction, reflecting the much larger demand boost to homemovers from the Stamp Duty holiday (**Chart 4**).

Growth in overall mortgage application levels – a forward indicator of mortgage completions in the following quarter - began to turn negative year-on-year through Q2. Within this there are likely to be two conflicting factors at play, with the contraction in house purchase demand - compared to levels this time last year that were inflated by the Stamp Duty holiday - more than offsetting the strength in refinancing as increased numbers of fixed rate deals come to an end and customers seek a new deal.

Chart 4: Mortgage applications and completions, 3-month moving average, year-on-year change



SOURCE: UK FINANCE

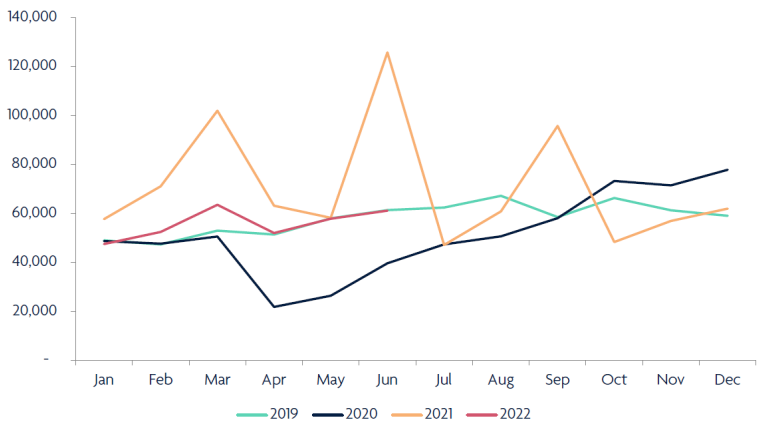
....BUT HAS REVERTED BACK TO PRE-COVID-19 ACTIVITY LEVELS

In December 2021 we set out our forward view for the next two years in our mortgage market forecasts. Within this we forecast house purchase lending activity to revert to broadly the pattern seen before the pandemic took hold, following the distortions seen over the last two years.

As can be seen in **Chart 5**, the first quarter of 2022 saw levels slightly higher than those seen before the pandemic. As we detailed in our Q1 Review this suggests that, at that point, there may have been some lingering demand stimulus from the societal changes brought about through the pandemic, including increased movement out of cities as changing work patterns meant less frequent commuting for many workers.

In Q2, activity levels followed a near-identical pattern to that seen in 2019, in line with our earlier forecasts and narrative. At present it is too early to predict when escalating cost-of-living pressures will begin to bear down on effective demand but, given current pressures from interest rates and inflation, some softening of demand is expected, whether this comes later in 2022 or next year.

Chart 5: Number of loans for house purchase, 2019 to 2022



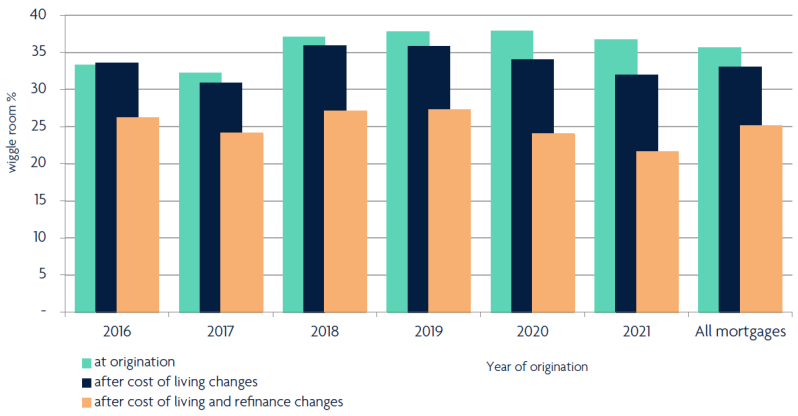
SOURCE: UK FINANCE

INCREASING COST-OF-LIVING PRESSURES AND INTEREST RATE RISES COMBINE TO PUT PRESSURE ON AFFORDABILITY

In our Q1 Review we outlined our analysis of the impact of cost-of-living pressures on recent borrowers, uprating household expenditure and net income at the time of borrowing to take account of actual inflation and wage growth to date, and that forecast through the rest of 2022. Overall, we estimated that, for the average mortgaged household, the combined impact of price, tax and income changes would translate to a reduction of a little under three per cent in their "wiggle room" - the disposable income left over after subtracting mortgage costs and basic household outgoings.

Our recent **Trends in the Economy and Lending** (TEAL) report extended this analysis to look at the combined impact of cost-of-living and interest rate increases on the 1.3 million existing borrowers set to come to the end of their fixed rates through this year as they look to refinance their mortgages. We found that, on average, households looking to refinance their mortgages would see a reduction of around seven per cent of their wiggle room from the combined impacts of cost-of-living and interest rate changes.

Chart 6: Wiggle room[1] in mortgagors' budgets, fixed rate deals maturing in 2022



SOURCE: UK FINANCE

Since publication of the TEAL report, Bank of England forecasts for peak inflation have risen to over 13 per cent and we have seen further Bank rate increases. Updating our analysis to reflect the most recent forecast available at time of writing indicates that homeowners seeking to refinance this year would, on average, see a reduction of a little under 11 per cent of the wiggle room in their budgets This would leave the average customer with around one quarter of their net income left over after refinancing onto a new deal rate (**Chart 6**).

Notes:

1: wiggle room defined as the proportion of net income left after subtracting mortgage payments, basic household expenditure and credit commitments.

2: :we estimate uprated costs for 2022 using external forecasts for full-year 2022. Confirmed increases to National Insurance Contributions (NICS) are factored into net income. Any confirmed or unconfirmed change after the time of writing are not included.

3: Refinancing rates are calculated using Moneyfacts data on rates available at different LTVs, estimating current LTV using house price and mortgage balance changes since the time of origination.

This suggests that the average borrower, whilst seeing a substantial reduction to their disposable income this year, would still be able to refinance in the open market with a material – but significantly reduced - degree of free income left over.

However, within this average there is a significant spread of circumstances. Some customers, particularly amongst lower income brackets, would be left with materially less free income. At the lower end, these borrowers could face a smaller range of refinancing options, as they may fall short of some lenders' FCA-mandated income-expenditure affordability tests. However, the widespread availability of internal Product Transfers, which are not subject to the same affordability tests, mean that most borrowers will still be able to refinance onto a new deal with their existing lender.

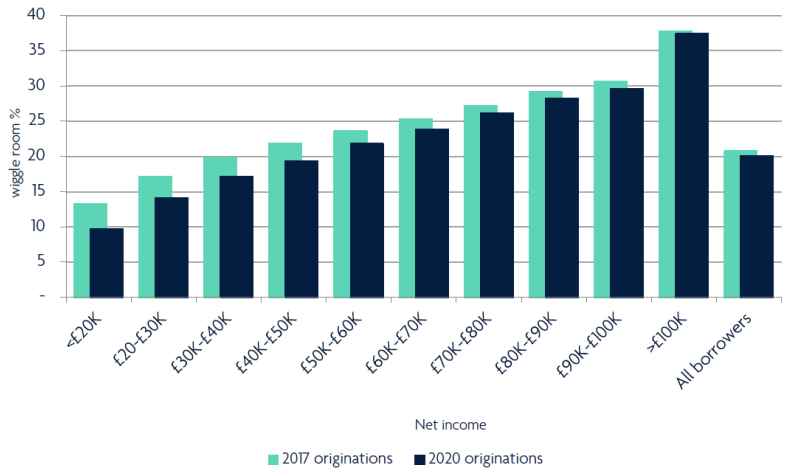
FURTHER RATE RISES WOULD PLACE MORE STRAIN ON BUDGETS, WITH SOME LEFT WITH LITTLE OR NO INCOME WITHOUT MAKING CUTS TO EXPENDITURE

The Bank has signalled that more rate increases are likely in order to control inflation and, therefore, moderate the increases in the cost-of-living pressures that are bearing down on households over the medium term. In the absence of any offsetting changes to incomes, prices or taxation this would place additional strain on budgets for those mortgage holders not on fixed rates, and further constrain their refinancing options.

Our analysis suggests that, were mortgage product rates to rise by a further 100 basis points, homeowners looking to refinance this year would see an average reduction of some 14 per cent in their wiggle room, compared to their position when they took out their previous mortgage.

Again, whilst a significant hit to household finances, this would leave the average borrower with a fifth of their take-home pay as free disposable income. However, with these effects unevenly distributed, those on lower incomes are likely to feel these combined cost pressures much more acutely. Whilst a rise of 100 basis points would still see those borrowers in the highest income brackets with over a third of their disposable income left over after refinancing, many in the lowest income brackets would be left with ten per cent or less (**Chart 7**).

Chart 7: Wiggle room if rates rose an additional 100 basis points, fixed rate deals maturing in 2022



SOURCE: UK FINANCE

In this scenario, a little under three in ten borrowers with fixed rates maturing this year would be left with ten per cent or less disposable income after refinancing if rates rose further by this amount, assuming there were no offsetting change to either prices or income. This suggests that a significant proportion of borrowers would find their refinancing options constrained on the open market. The same affordability pressures are likely to bear down on effective demand for new house purchase mortgages as we move through this year and beyond, whilst inflation outpaces wage growth.

CONSUMER SPENDING AND LENDING: SUMMARY

Whilst consumer confidence has dropped sharply there is, at this stage, little sign of this translating to an easing in either spending or borrowing behaviour. Spending remained strong, particularly in the sectors which were constrained as a result of previous Covid-19 restrictions, and it is possible that households' spending decisions may have had an element of "make hay whilst the sun shines" in Q2, with further cost-of-living pressures ahead having the potential to constrain their ability to do so later this year and next.

Meanwhile, borrowing for house purchase appears to have reverted to pre-pandemic trends – for now. Looking ahead, however, the same cost-of-living pressures are likely to bear down on effective demand.

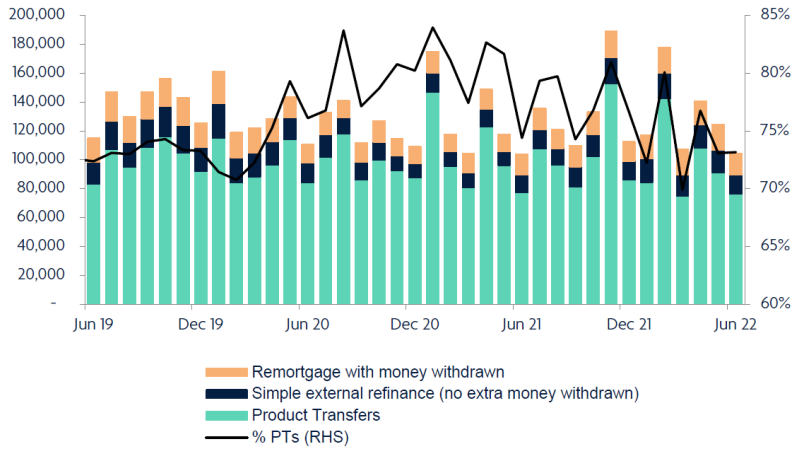
MORTGAGE REFINANCING WEAKER IN Q2 BUT FURTHER STRENGTH EXPECTED THROUGH H2

Refinancing overall dropped off through Q2, compared with the particularly strong levels seen in Q1. However, the decline was concentrated in internal retention (Product Transfer) business. External remortgaging, both with and without equity withdrawal, grew compared with the same time last year (**Chart 8**).

There are two likely drivers of this changing pattern: firstly, Product Transfer volumes tend to be "lumpy" with individual lenders reaching out to their customers as they draw to the end of fixed rate periods to discuss new deal options. This segment of refinancing activity is therefore dependent on the new business patterns of individual lenders in the past, in particular two and five years ago, as almost all new business has been for two- and five-year fixes for some years now.

Secondly, a shift towards increased external refinancing now may reflect increased borrower appetite to find the best deal available on the wider market as rates move upwards more rapidly than they have done in over a generation of mortgage borrowing.

Chart 8: Number of residential remortgages and internal product transfers



SOURCE: UK FINANCE

We expect refinancing activity – both via Product Transfers and on the open market - to remain strong through the rest of 2022 and then increase next year, with a further 1.8 million customers set to reach the end of their fixed rate deals. In addition, there are a little over one million homeowner mortgages currently on lenders' Standard Variable Rates (SVR) who are free to move without incurring early redemption charges. For many of these, the potential savings from refinancing onto a new deal have not been sufficient to outweigh the time and cost to source and arrange a new deal, particularly as mortgages on SVR are typically considerably older and therefore have much lower balances than other rate types, and many historic SVR rates have been lower than new product rates for a number of years. Remaining on SVR has therefore been the cheapest as well as easiest option for those borrowers.

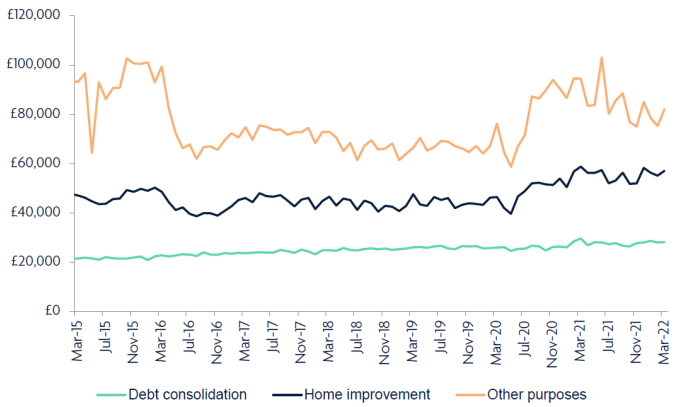
However, with rates rising sharply, the equation may have changed for some, particularly for those with larger balances. As such, we may well see increased appetite to refinance amongst the cohort of borrowers on SVR, although remaining on SVR will still be the best option for some with lower balances and/or only a few years to go on their current mortgage.

EQUITY WITHDRAWAL FOR HOME IMPROVEMENT CONTINUES TO INCREASE AS COSTS RISE

A little over half of total external remortgaging involves an element of equity withdrawal, which can be for home improvements, consolidation of other (more expensive) debt or other purposes. There was no increase in the incidence of debt consolidation (which can be an early sign of overall household payment stress) in Q2, nor did the average debt consolidated show any rapid increase.

In contrast, however, the average amounts withdrawn for home improvement spiked in the early months of the pandemic, rising sharply from around £40,000 to over £50,000 by the beginning of 2021. Since then, average home improvement borrowing remained on an upward trajectory, with the average amount borrowed for home improvements approaching £60,000 by the end of Q2 2002 (**Chart 9**).

Chart 9: Average value of equity withdrawal through residential remortgages



SOURCE: UK FINANCE

This reflects both the Covid-19-triggered increased demand for homeowners to expand and improve their existing living spaces (which like changing working patterns, appears to have outlived the pandemic to some extent), and also the significantly increased costs of doing so as building labour and materials costs continue to rise.

This trend looks unlikely to abate in the short term and may, in fact, become more pronounced if affordability constraints from cost-of-living and interest rates rises restrict opportunities for existing homeowners to move up the housing ladder into larger properties.

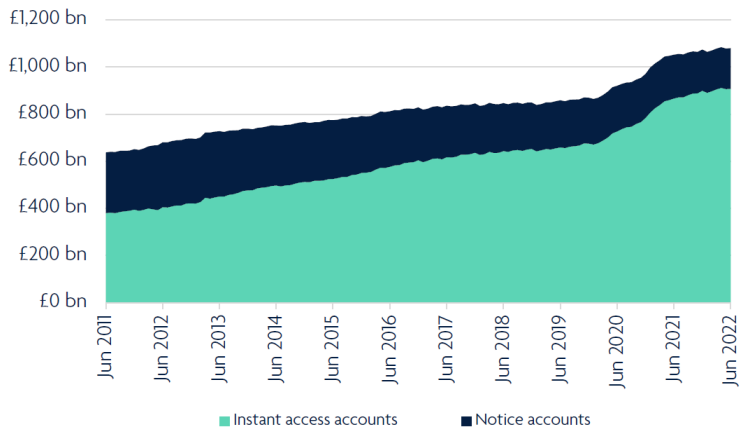
SAVINGS GROWTH GROUND TO A HALT IN Q2 AS COST PRESSURES INCREASED

Growth in household deposits, which had seen significant increase through the early months of the pandemic as social restrictions limited the avenues for spending, has eased from early 2021 as these restrictions were progressively lifted.

In Q2 2022, deposit growth slowed further to virtually zero (**Chart 10**). In addition to the increased spending seen in the quarter, not least in the travel sector, it is possible that this may partly reflect the wider cost increases, bearing down on the ability of households to save monthly income.

Interest rates on notice accounts have begun to increase and are now significantly above the levels seen in late 2021 before Bank Rate began to rise. However, there has been no increase in the amount of savings held in notice accounts, although the accumulated additional savings through the past two years have not, at this stage, shown sign of reversing. Instead, households are continuing to keep their money in instant access accounts. This is rational behaviour, as the escalating cost-of-living makes it more likely these savings will be needed at short notice. In addition, interest rates on notice accounts, whilst higher than seen in recent years, are lagging well behind inflation with the real rate of return firmly negative.

Chart 10: Personal deposit account balances



SOURCE: UK FINANCE

HOUSEHOLD REFINANCING AND SAVINGS: SUMMARY

Whilst mortgage refinancing fell away compared with the very strong levels seen in Q1, activity remains robust with borrowers shopping around for the best deals as rates move upwards. Large numbers of borrowers free to move without penalty this year and next point to strong volumes through this period, whilst increased demand from homeowners to adapt and improve their living spaces will support equity withdrawal.

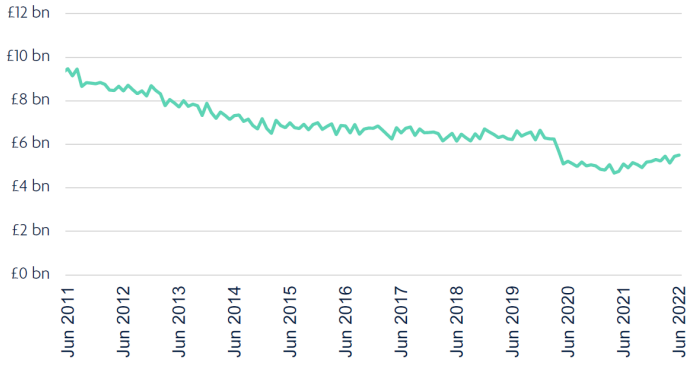
Meanwhile, the accelerated growth in household savings has levelled off but, for now, the incidence of households dipping into these savings as costs rise is not sufficient to lower the total level of deposits, as those on higher incomes still have excess income, whilst those on lower incomes are more likely to be the ones dipping into their savings in the face of rising household bills.

OVERDRAFT UTILISATION CONTINUES TO CREEP UP BUT STILL WELL BELOW PRE-PANDEMIC NORMS

At the other end of the household balance sheet overdraft levels, which had dropped sharply in line with the rise in deposits through the early stages of the pandemic, continued to rise gradually in Q2 (**Chart 11**). However, at around £5.5 bn, the total overdraft debt held with high street lenders is still some five per cent below the levels seen prior to the pandemic are more likely to be the ones dipping into their savings in the face of rising household bills.

Increased levels of overdraft utilisation can be another early sign of household financial stress. At this stage, however, we are not seeing "normal" levels of overdraft debt, let alone elevated levels. However, as with deposits, there are distributional effects within the aggregate figures (although not identifiable within the available data), and again these are likely to be correlated with income.

Chart 11: Overdraft balances outstanding



SOURCE: UK FINANCE

Constrained spending during the past two years, combined with the temporary industry-wide extension of interest-free overdrafts to all personal current accounts during 2020, helped borrowers across the income spectrum to pay down expensive overdraft debt. However, as costs rise, these fall more heavily on the lower income brackets who, for the same reason, have been less able to build up savings in the same way as higher-income households over the past two years.

As with the overdraft data this suggests that, at the aggregate level, households' ability to pay for their monthly outgoings has not been negatively impacted by cost-of-living pressures, with the growth in credit card usage instead a sign of increased use of cards as a payment method. However, within the aggregate picture it is likely that some consumers' ability to pay off their card balances each month is becoming more constrained.

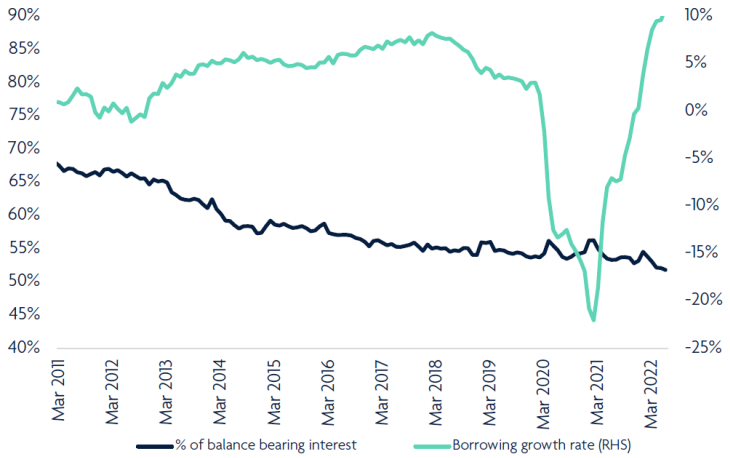
The aggregate figures, therefore, are likely to mask some level of increased overdraft usage for those with more constrained incomes who will already be feeling the strain from inflation and tax changes.

CREDIT CARD DEBT GROWS BUT MORE REPAID EACH MONTH

Outstanding credit card debt rose by almost ten per cent in Q2, continuing the recovery from the prolonged period of contraction seen through the pandemic whilst social restrictions restricted the avenues for spending (**Chart 12**). As with the previous quarter, however, and continuing the long-term trend, the proportion of balances bearing interest continued to fall. In Q2, 52 per cent of card balances were interest-bearing, with the remaining 48 per cent attracting no interest (which includes both those balances that are paid off each month and any which are non-interest bearing for other reasons).

As with the overdraft data this suggests that, at the aggregate level, households' ability to pay for their monthly outgoings has not been negatively impacted by cost-of-living pressures, with the growth in credit card usage instead a sign of increased use of cards as a payment method. However, within the aggregate picture it is likely that some consumers' ability to pay off their card balances each month is becoming more constrained.

Chart 12: Credit card balances outstanding



SOURCE: UK FINANCE

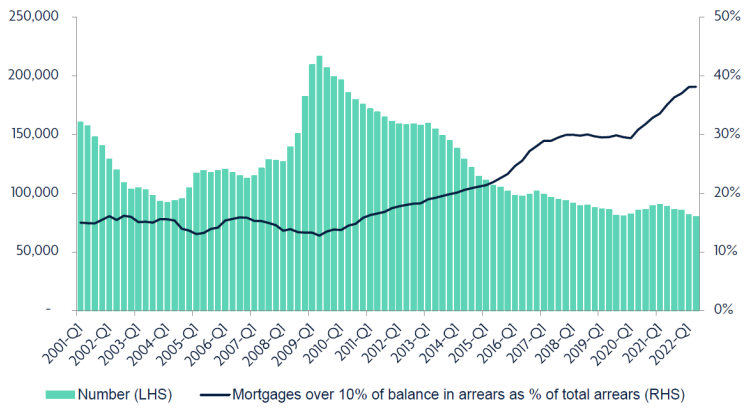
MORTGAGE ARREARS FALL OVERALL, BUT TENTATIVE SIGNS OF EARLY ARREARS INCREASING

The total number of customers in arrears on their mortgage continued to fall in Q2, the fifth successive quarter of decline. This continued downward trend has come despite escalating costs of living and Bank Rate rises totalling 115 basis points from last December through to June, which will have fed through to mortgage payments for around two million borrowers who are on variable rates (**Chart 13**) suggests that - at the aggregate level - households' ability to pay for their monthly outgoings has not been negatively impacted by cost-of-living pressures at this stage.

However, within the overall arrears figures we have seen two indicators showing signs of reversal.

Firstly, the number of borrowers in heavier arrears – representing 10 per cent or more of the mortgage balance – has fallen for the second successive quarter. This provides further evidence that the backlog of these heavier arrears cases, which would normally have moved through to possession as a last resort in the borrowers' best interests but had instead accumulated whilst the Possessions Moratorium was in place, is now starting to clear.

Chart 13: 1st charge homeowner and buy-to-let mortgages in arrears



SOURCE: UK FINANCE

However, at the other end of the arrears spectrum, early arrears saw a small increase in Q2. The number of homeowner arrears cases representing between 2.5 and 5 per cent of the balance rose fractionally - by 170 cases - to 25,160. Although this rise in itself is very small it follows a period, beginning in Q3 2020, when these early arrears cases fell significantly - by a cumulative total of 7,560 cases until this most recent quarter.

As we set out in our Q1 Review, reportable mortgage arrears take some time to build up and so inflation early in the year, as well as the first interest rate rises, were not expected to feed through to arrears figures at that stage. With the most significant elements of the cost-of-living squeeze only taking effect in April, the modest rise seen in early arrears by the end of the quarter was largely expected.

However, we do expect further, and larger, increases in mortgage arrears. As set out earlier in this Review, the combined pressures from interest rate rises and inflation will remove a significant proportion of free disposable income for households and some, including a disproportionate amount amongst lower-income households, will face difficulties in meeting their mortgage and other credit commitments.

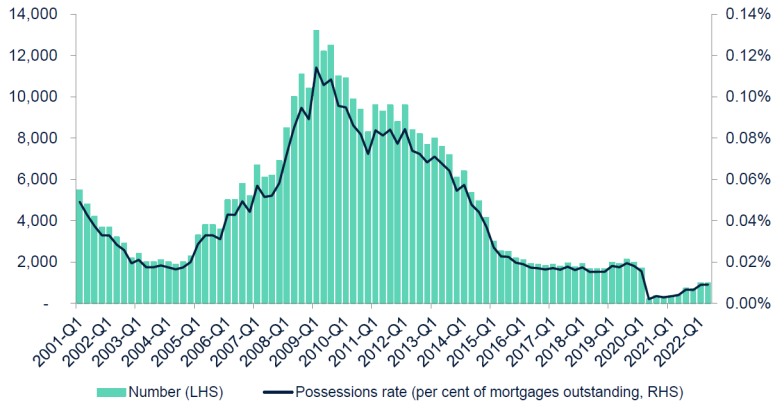
MORTGAGE POSSESSIONS FLAT IN Q2 AS LENDERS WORK TO CLEAR THE BACKLOG

Possessions activity was flat in Q2 (**Chart 14**). Just under 1,000 mortgaged properties were taken into possession, unchanged from Q1, as the industry and courts continue to work gradually through the backlog of paused possession cases from 2020 with sensitivity to customers' circumstances. As such the number of possessions remains significantly below typical levels, even at a low point in the cycle.

We expect possessions to increase through the year as this process continues. However, it is unclear whether the rate of increase will see the numbers reach the 7,700 forecast at the end of 2021, with lenders working through the backlog of cases with sensitivity to borrowers' positions.

When interpreting these numbers It is also crucial to keep in mind that that these possessions relate to cases where the borrower, under normal circumstances, would have gone through possession – as a last resort – in 2020. Many of these customers will have seen their debt positions deteriorate over the intervening two years and now need to have this final resolution to prevent further deterioration.

Chart 14: Number and proportion of 1st charge mortgages taken into possession in period



SOURCE: UK FINANCE

Despite the significant cost-of-living and interest rate pressures weighing on all households, including those with mortgages, we do not expect this to translate into greatly increased possession activity. Although the wider economic outlook has weakened significantly unemployment, which has historically been the key driver of arrears and, ultimately, possessions, is forecast to rise only relatively modestly. As such we expect customers facing difficulty to have more options to mitigate their situations.

Lenders stand ready to help customers facing financial difficulty with a range of forbearance measures and we urge these customers to talk to their lender at the earliest opportunity to discuss their situations.

Nonetheless, with arrears set to increase, some rise in possessions is to be expected for that small cohort of customers who, faced with these cost increases, fall into arrears from which they cannot ultimately recover. However, given the time taken for heavy arrears to accrue and the range of forbearance tools which lenders can explore with these customers, we do not expect any "new" possessions cases – those arising from the cost-of-living squeeze or other adverse economic factors, to translate into possessions activity until the end of 2023 at the very earliest.

HOUSEHOLD DEBT: SUMMARY

As we reached the midpoint of the year, aggregate data suggests household finances are still in good shape, which is positive news with cost-of-living pressures set to accelerate. However, within the aggregate picture there are early signs that some borrowers are already feeling the strain. Faced with these pressures, some changes in spending and borrowing patterns are inevitable going forwards as those households most impacted flex their overall household budgets to cope as best they can.

Despite this, the most squeezed households will face an overall essential spend and payment burden which exceeds their income, and this will push some into arrears on their unsecured debts and mortgages. Customers worried about their ability to meet their payments should talk to their finance providers at an early stage, to discuss what options will best help them navigate the challenges to their finances that lie ahead.

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