FACTFILE:
GCSE ECONOMICS

Rewarding Learning

UNIT 3.3

FINANCIAL CAPABILITY – MANAGING PERSONAL FINANCES

Debt

Learning Outcomes

Students should be able to:

- demonstrate understanding of the reasons for growing levels of consumer debt;
- analyse how growing debt affects the following both positively and negatively:
  – consumers;
  – producers; and
  – the economy as a whole.

Debt:

Definition:

Money borrowed by an individual which is repayable to a lender.

Debt:

The levels of consumer debt have increased in recent times. Possible reasons for this include:

- Static/Declining levels of consumer income – consumers wish to maintain their existing levels of consumption, therefore will continue to use debt/borrowings to finance current lifestyles, despite static/declining levels of income (e.g. through loss of job or reduced state benefits).
- Affordability of Credit – in the context of low base rates of interest, many lenders have made it cheaper for consumers to borrow money, through the provision of credit facilities attracting low-cost interest charges, e.g. promotion of 0% interest deals on credit cards.
- Accessibility to credit – a relaxation of lending criteria coupled with low interest rates increases the accessibility to credit by consumers, including access to facilities such as overdrafts, credit cards and other forms of unsecured lending.
- Terms – lenders may amend the terms and conditions by which credit facilities are granted to consumers, e.g. some consumers may reschedule unsecured credit card debt, adding it to secured debt enabling the individual more time to repay, e.g. transfer of a credit card balance to an existing mortgage, provided there is sufficient equity to do so and the individual has a sufficiently high credit score.

Impact of Increasing Debt Levels:

Increasing debt levels may have the following impacts:

Consumers – a continual increase in the amount of debt could result in increased levels of insolvency/ bankruptcy by individuals, since they will be unable to afford to repay existing debts, i.e. individual cash flows are likely to decrease since outgoings will eventually exceed income levels.

Increased levels of debt will also lead to consumers being refused access to additional credit in later life due to poor credit ratings.

Producers – increasing levels of debt will initially lead to a possible increase in demand (and potentially profits), since consumers will spend more to acquire goods/services. However, when credit options are exhausted, consumers will reduce spending and this will theoretically lead to a fall in sales/demand for goods/services, therefore profits are likely to decline.

Economy – increasing levels of debt in the economy might initially lead to an increase in consumption and possible increases in the inflation rate as consumer confidence and spending rises. However, an increase in interest rates to dampen consumer spending might lead to an increase in debt repayments and possible bankruptcies as vulnerable consumers will face reduced incomes due to high levels of repayments on excessive levels of consumer debt.

Issues related to Debt:

Moral: lenders are required to clearly disclose the facts related to credit agreements to consumers prior to completion of any loan agreements. Lenders are also required to provide a 'cooling off' period for consumers to allow them to change their minds after entering a loan agreement. Lenders therefore have a moral obligation to provide this information to consumers.

Ethical: Lenders have an obligation to behave in an ethical manner when dealing with consumers and the management of their outstanding debts. A lender should allow a borrower a reasonable period of time to repay any outstanding debt and allow for any alternative arrangements in the event of any default. Lenders have an ethical obligation to conduct their affairs in accordance with industry codes of conduct.

Social: Lenders have an obligation to act in a socially responsible manner when dealing with consumers and their debt arrangements, e.g. lenders should not target vulnerable groups of consumers when advancing funds, such as those on low incomes (for example pensioners or teenagers), or charge excessive rates of interest (As measured by high rates of APR).

Legislative: lenders must abide by the rules/ regulations aimed at protecting the interests of consumers (e.g. consumer credit act) and comply with the requirements of the regulatory authorities (e.g. FCA and PRA). This also applies to the procedures related to the recovery of bad debts or consumers who face the possibility of bankruptcy.

Cultural: lenders and consumers both have a responsibility to ensure that any funds advanced to consumers are affordable. Lenders should ensure that all credit checks are undertaken prior to the advancement of funds to consumers. Consumers have a responsibility to ensure that they can afford the repayments in order to avoid bankruptcy.

Summary:

Debt is money borrowed by an individual which is repayable to a lender.

Various types of debt are available: (i) secured debt; and (ii) unsecured debt.

Increasing levels of debt will have both positive and negative impacts on consumers, producers and the economy as a whole.

There are a number of issues related to increasing levels of debt, including moral, social, ethical, legislative and cultural which all require consideration.

Review Questions:

1. Define the term 'debt'.

2. Explain the terms: (i) 'secured debt'; and (ii) unsecured debt.

3. A friend of yours, Alfie is 20 years old. His monthly salary is £800 and he has £2,000 of credit card debt. He is finding it difficult to meet the repayments each month to the credit card company. Explain two ways in which Alfie might resolve any financial difficulties in the future.

4. Loans Limited is a financial services provider specialising in credit cards for individual customers, with credit limits ranging from £400 to £20,000. Discuss the key moral, social, ethical, legislative and cultural which require consideration when lending to customers on low incomes.