Policy Briefing
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Poverty and social exclusion: Review of household debt

Background

The Wales Centre for Public Policy (WCPP) was commissioned by the Welsh Government to conduct a review of international poverty and social exclusion strategies, programmes and interventions. As part of this work, the Centre for Analysis of Social Exclusion (CASE) at the LSE was commissioned to conduct a review of the international evidence on promising policies and programmes designed to reduce poverty and social exclusion across twelve key policy areas. This briefing summarises the findings on household debt.

Introduction

There is evidence that Welsh households have been under particular financial strain during the Coronavirus pandemic. Households with children, people who are unemployed, or people with disabilities have been more likely to face debt problems (e.g. arrears on bills, falling behind with payments). There is evidence that financial capability and literacy in Wales are low, as is the case internationally. Financial literacy and education are an integral part of the Financial Capability Strategy for Wales and of the Financial Inclusion Strategy for Wales more broadly.

Action on household debt alleviation, prevention and rehabilitation is therefore important in light of recent increases in problem debts among low-income households, and the role of debt in entrenching poverty and affecting several dimensions of social exclusion.

> **An approach that tackles the causes of household debt should be based on an understanding of the mutually reinforcing relationship between poverty and debt.**

Evidence of policy effectiveness

Common approaches to addressing household indebtedness (e.g. debt advice and debt relief, regulation and improved access to low-cost credit opportunities, the boosting of financial literacy and capability, and asset-based welfare policies) largely do not tackle the root causes driving demand for borrowing among low-income households (namely low income). As such, they cannot be considered ‘silver bullets’.

However, a holistic, integrated financial inclusion strategy will need to include all these elements, and other factors that bear on households’ financial resources, as well as their interaction with the social security system.

Financial literacy

Increasing financial literacy can lead to improved budgeting and financial management, thus increasing the ability to save, manage existing debts, develop effective repayment plans, seek the best interest rates and avoid arrears. Low financial literacy is associated with debt accumulation and high-cost borrowing.

Financial literacy and capability programmes can be delivered through schools and further education establishments, as part of asset-based welfare policies, debt counselling services, or within active labour market policies.

The overall effects of financial education on financial literacy and related behaviours are small and depreciate rapidly with time. Even positive study results find that effects depend on the target population and the type of financial behaviour. Importantly, it appears that the effects are weaker for those on low income and in relation to debt in comparison to savings.

A number of characteristics can impact effectiveness, including providing financial education at a 'teachable moment' – i.e. when teaching is directly linked to decisions of immediate relevance. Rather than one-size-fits all, interventions which are tailored to a target group are also more effective.

Financial education alone is largely ineffective in changing financial behaviours, but combining interventions (e.g. financial education, goal setting, and counselling) can improve outcomes. Making financial education mandatory worsens outcomes. It is also important to pay attention to structural aspects affecting engagement, such as digital inclusion.

Asset-based welfare policies

Asset-based welfare policies can produce 'asset-effects': holding financial assets, even of relatively low value, appears to produce both monetary and non-monetary benefits, for instance in relation to family stability, physical health and psychological well-being.

Savings-related behaviours can be an important driver of social mobility: children of low-income, high-saving parents are more likely to experience upward income mobility.

Match funding for savings; auto-enrolment; government backing; and benefit guarantees are key ways to increase coverage and to support low-income households to save. Linking asset policies to financial education and social services also has positive effects. Conversely, tax incentives benefit those who pay higher taxes rather than people experiencing poverty.

Overall, many asset-based welfare policies don't address the fundamental problem that low-income households live financially precarious lives and don't have spare income to save. They should thus be seen as complementary rather than alternative to strong welfare states.

Debt advice services

Debt advice services can have a positive impact on managing finances and reducing and preventing debts, both in the short- and longer-term, especially for low-income debtors. They can also have a direct impact on mental health, social well-being and quality of life. However, these services are more likely to alleviate rather than resolve financial difficulties.

Barriers to access include lack of capacity/long waiting times; quality of service provision; user fees; and lack of awareness or social stigma. Effective programmes provide customised advice, are grounded in the establishment of trusted relationships with customers but also with creditors and authorities, and rely on registered, professional, trained advisors.

Debt advice services can serve as a point of contact and referral to appropriate services (e.g. mental healthcare, employment and welfare services), resulting in a holistic approach.

Debt relief services

There is a lack of robust evaluation of the impact of various debt relief and settlement solutions. Looking beyond financial effects, debt relief has been found to have positive and significant effects on cognitive functioning and anxiety.

Barriers to accessing debt settlement procedures include strict application of criteria or administrative/procedural costs. Other factors include the types of debts excluded, timing, and their consistency with incentives for people to maximise their income and seek work during the settlement period. Taken together, this suggests debt solutions should be considered in the context of social security arrangements.

There is an important social protection role for relief policies and personal insolvency law to play and alternative debt solutions are important for vulnerable households for whom bankruptcy processes are often unaffordable and complex.

Nevertheless, the decline of bankruptcy and Debt Relief Order procedures in the UK, and the rise of Individual Voluntary Arrangements and Debt Management Plans, can be seen as a shift towards privatisation of personal insolvency. This shift understands debt relief less in terms of its protective role and more as a tool that seeks to avoid threats to financial stability.

> **Alleviating and rehabilitating measures are important to provide a fresh start and mitigate the negative effects of debt on health and well-being.**

Access to credit opportunities

Financial deregulation and inadequate social safety nets are often recognised as drivers of increased financial difficulties.

Regulation of credit is widely recognised as an essential preventive measure for consumer protection, for instance by shifting risks from consumers to suppliers and avoiding increased risks associated with informal borrowing. However, borrowing restrictions can have negative consequences on overall household financial situations and on financial inclusion.

Interest rate caps, including caps on high-cost, short-term credit in the UK, are a tool to protect vulnerable clients from predatory lending practices, as people with low incomes and poor access to credit often rely on relatively small loans with high interest rates. However, there is evidence that interest rate caps often result in limiting access to finance, particularly for younger and poorer segments of the population, as high-risk borrowers end up being excluded from the formal financial system.

Other side-effects reported in the international literature include increases in non-interest fees and commissions (particularly disadvantaging those with low financial literacy), lower number of institutions and reduced branch density.

High-cost credit products have adapted and evolved around the substantial regulation coming in force in the UK since 2014, while also leveraging on the opportunities afforded by digital technologies, thus remaining a major source of indebtedness. Even outright bans of high-cost credit solutions appear not to be effective for those on low-income customers, who shift to using non-prohibited alternatives.

A key issue is that these measures do not address systematic causes of the demand for high-cost products. Demand reflects key drivers such as financial insecurity and precarity, or the inadequacy of state welfare provision; but also increasing financialisaton creating a two-tier system of credit.

Insights into the lived experience of borrowers are particularly important to understand demand. These products have characteristics that borrowers appreciate – the online application process is simple and anonymous (avoiding the shame associated with debt); access to credit and repayment are quick and matches everyday expenditure needs.

Such insights also highlight negative experiences with face-to-face retail lenders, the inadequacy of alternative products (e.g. they may offer more credit than needed) but also the desire to be responsible and not be a burden.

Alternatives in relation to these needs include community/social finance and credit unions which offer personal microloans and savings products but also non-financial services (e.g. financial education and advice). Governments, including in the UK, have been promoting their expansion to improve financial inclusion of disadvantaged groups.

Promising actions

The review concludes with promising actions to consider in the Welsh context as emerging from the analysis of the international literature:

1. An **approach that tackles the causes of household debt** should be based on an understanding of the mutually reinforcing relationship between poverty and debt.
    - Strategies to increase disposable income and reduce expenditure (e.g. cost of childcare, food, fuel, transport, housing) should be considered to **increase households' resources**.
    - **Council tax reform** is particularly important in light of the regressive characteristics of the current system and the key role played by this type of arrears as a cause of indebtedness.
    - While beyond the remit of the Welsh Government's devolved powers, there is a strong case to call for **changes to the design of Universal Credit and its system of payment in arrears and repayment of advances.**
2. **Alleviating and rehabilitating measures** are important to provide a fresh start and mitigate the negative effects of debt on health and well-being.
    - **Greater coordination between debt advice services and other agencies and services** can help identify households at risk of indebtedness and facilitate early intervention. Debt advice services can also serve as a point of contact and trigger a range of referrals to appropriate services. Data-sharing opportunities should be evaluated.
    - **Improved links between debt advice and debt relief services** can tackle lack of awareness of debt solutions. This can strengthen consumer protection and prevent debtors making unsuitable arrangements.

Find out more

For the full report see Bucelli, I., and McKnight, A. (2022). ***Poverty and social exclusion: review of international evidence on household debt.*** Cardiff: WCPP.

About the Wales Centre for Public Policy

Here at the Centre, we collaborate with leading policy experts to provide ministers, the civil service and Welsh public services with high quality evidence and independent advice that helps them to improve policy decisions and outcomes.

Funded by the Economic and Social Research Council and Welsh Government, the Centre is based at Cardiff University and a member of the UK's What Works Network.

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