

“How Do You Reconcile Debt With a Risk-Averse Society”

Or

“Should Financial Services Flame or Quench This Cycle of Risk & Reward”

**(Financial Services Club – Lloyds’ Building Tuesday, Feb 27)
Intro Slide.**

Slide 2 "Annual income twenty pounds, annual expenditure nineteen nineteen six, result happiness. Annual income twenty pounds, annual expenditure twenty pounds ought and six, result misery." - Mr Micawber – Pickwick Papers

Good evening ladies and gentlemen and thank you Chris for your kind words of introduction. Thank you also Michael for that comprehensive viewpoint of debt and all its complexities.

Before I attempt to add my twopennysworth to the questions posed at the start with specific reference to debt and credit, I think it is worth taking a step back and looking first at risk in general.

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Is it better to have an appetite for risk or to be risk averse, or should we aim to be risk neutral? How do we measure risk? Isn't there a risk in either overstating risk or understating risk? Or have we becoming more conservative if we are more risk averse merely by overstating the actual expected risk?

There are many examples. Did the government over-react when it spoke openly about the possible risks associated with the MMR vaccine? Was it providing the leadership we expect from a government when it said there was nothing to worry about? Many people felt that as it had raised the subject in the first place this only meant the government was covering something up and there must be something to worry about.

Litigation and the fear of it clearly has a role to play and we are certainly inheriting some of those traits from the United States. But it has reached a pretty low point when whole counties of schools have to close after a light dusting of snow, because their risk analysis told them they might be liable to litigation if a child falls and blames the educators.

Sir Digby Jones that well know purveyor of his own opinion put it well in a recent television documentary: “The growing aversion to risk and enterprise because of our national obsession with safety is paralyzing our youngsters’ creativity and creating a generation of cotton-wool kids.”

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So where does one start? How about asking whether saving lives is more important than saving money? The most likely answer is yes. But can we always say that an absolute preference for the former is acceptable?

If we agree with that premise, and in the context of the NHS we might, but how do we then reconcile that with pouring billions of dollars into space exploration? This was a question raised a couple of years ago by NASA scientist Scott Higginbotham shortly after the Space Shuttle Columbia disintegrated on re-entry killing all 7 astronauts on board. As he pointed out, each Space shuttle comprises over 2.5 million different parts, all built and supplied by the lowest cost bidder.

Of course every care is taken to prevent malfunctions and have backups where possible, but certain systems are critical and if one of those fails those on board are dead. As he noted, space exploration is still in its infancy – “so it’s not a matter of if it’s going to happen again – it’s when!”

Some people might say it’s therefore not worth the risk. Fortunately many more still believe it is - as investment that pushes both technology and science to the edge has not only advanced space exploration, but had countless other spin-off benefits for industry and people worldwide.

But Higginbotham also pointed out that while the Second World War cost millions of lives, it was on balance considered worth the risk. Today, however, he suggests that only a few soldiers have to die in a foreign

country before the clamour starts for the troops to be pulled out. Well, that's not a discussion I want to get into tonight.

However, one might say that this example does start to demonstrate the extent to which we have become more risk averse.

Of course world wars are a long way from banking and the credit markets, although money has been at the root cause of more than a few conflicts. I would therefore like to spend the next few minutes examining some of the behavioural factors that certain researchers believe dictate individual's levels of risk appetite – and how it appears more and more financial institutions are indeed “fanning the flames” of potentially dangerous levels of credit risk, without actually taking much risk themselves.

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I put up the quotation from Dickens' Pickwick Papers by way of a starting point. It is quite easy to understand how a shortfall of sixpence between income and expenditure 150 years ago might well have caused misery. But my how all that has changed.

Today that shortfall, and indeed much bigger ones, are actively encouraged by banks, credit card companies and other financial organizations seeking to make their living by providing those that want to buy something beyond their current means with the wherewithal to have exactly what they want now and to pay for it later. This is not a new debate and we all know exactly how we end up paying for it later.

Michael earlier referred to “Prospect Theory” in which Daniel Kahneman and Amos Tversky discussed how people make different choices about risk alternatives in different situations. This applied particularly well to financial decisions.

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It might be believed in some quarters that the management of risk by financial institutions is, at least in part, designed to protect the least capable, less educated and least well-off members of society. However, by many measures these groups of people are often the biggest risk takers – witness the disproportionately large numbers of these members of society who purchase lottery tickets.

They know full-well that the odds are stacked against them (at 14 million to one) but also know that they have to take bigger proportionate risks in order to improve their opportunities and consequently their circumstances. Many better-educated people will also understand the risk and think the gamble worth taking, but only a very small portion of the better-educated and well-off group of society is likely to bother.

So what about basic attitudes towards money? It is probably not a surprise to discover that another study has concluded that “People tend to be unrealistically optimistic about future events and would expect more good things to happen to them more often than their peers.”

I am sure a lot of people in England like me took that same approach last Saturday afternoon before the rugby game kicked off in Dublin. In complete defiance of all the expert opinion we firmly believed England were going to win. The facts of the eventual record defeat speak for themselves.

Another question that researchers have examined include whether risk tolerance decreases with age, particularly as younger investors and borrowers have a greater number of years to recover from losses caused by excessive risk appetite. But with mortgage companies now talking about 50 or 60-year loans as a way around the recent acceleration in house prices that has sharply reduced opportunities for first-time buyers, perhaps there is going to be less and less opportunity to recover from commitments and/or mistakes early in one’s working life?

Another consideration is whether gender plays a factor in risk tolerance, with females often believed to have a lower tolerance for risk than males. On this aspect, some studies show that husbands or male partners in couples will tend to overestimate the size of the family’s net worth and gross income, while the wife will underestimate – but in turn she will generally estimate the family owes more in debts than the husband.

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So with all this knowledge and research at their disposal are financial institutions doing their best to be both responsible in their credit practices in

a way that allows consumers the freedom of choice, but also saves them from potentially destructive risk appetites?

Credit scoring certainly goes some way to address this as it allows a lender to examine a track record to establish patterns of past behaviour as a predictor of likely future responsibility. However, there are other social issues to consider which might just be beyond the intuitive capabilities of technology alone.

Lenders also might consider they provide more than enough information to potential borrowers about the products, the risks and obligations, but is it really enough?

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However, we have reached a position where personal debt in the UK had risen to a total of £1,291 billion at the end of 2006, more than 10 percent higher than a year earlier and nearly triple the level it stood at 10 years ago.

According to Credit Action, the vast majority of this is mortgage debt at around £1 trillion, but other consumer credit lending totaled an outstanding £213 billion. And at current growth rates it is increasing by £1 million ever 3-1/2 minutes.

This is not necessarily bad if it can be managed and repaid. But the downside of this rapid growth – which is clearly good for financial institutions as the combined UK high street banks will end up disclosing combined profits for 2006 of nearly £40 billion when the current reporting season ends – the downside is that it appears from a variety of data sources that more and more people are getting into trouble.

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There were 27,644 individual insolvencies in England and Wales in the third quarter of last year, a staggering 55% increase on the same quarter in 2005. IVA's are growing at a rate of nearly 120% per annum, and it is estimated that the total number of insolvencies for 2006 will be around 110,000 – rising to more than 150,000 this year – that's bigger than the population of Exeter.

A recent survey by the Bank of England estimated that 6 million people in the UK are struggling with their finances and that 7.7% of homes are struggling to repay their mortgages.

Is this the result of a responsible lending regime by financial institutions or irresponsible borrowing by individuals?

Well another survey by the online site Uswitch found that 8 out of 10 borrowers in the last 12 months were provided with loans without lenders carrying out any checks into their ability to repay the debt. Of more concern, it said some 1.6 million loans were approved without incomes have been properly verified. Nearly half those loans, 760,000, were intended for consolidating existing debt – yet in 90% of case no borrowers were asked for any proof that previous loan commitments had or would be settled.

There were 34,600 mortgage repossession actions initiated in the third quarter of last year, up 15% on the same period in 2005, while it is estimated that more than 15,000 borrowers had not paid a penny back on their mortgages in the previous 12 months.

So is this responsible lending and is this a pattern being seen elsewhere in the developed world. Not really, it is estimated that the UK is responsible for a third of all unsecured consumer debt in Western Europe and that the average personal UK debt is twice the levels across the rest of Western Europe.

I can go on with statistics about the levels of failure to pay council tax, the rising level of what Ofgen calls “fuel poverty” or the rising burdens on Citizens Advice Bureaux and other agencies. But I think the point is being made.

Let’s look a little more specifically at one area – credit cards. A market of huge competition given all the new entrants in recent years. At the end of 2006 there was a total outstanding on credit cards of £55 billion – with 75% of those balances carrying interest charges.

The average interest rate charged on credit cards is currently 16.85%, or around 11.5% above the current base lending rate.

In the previous year, 2005, it was estimated by direct marketing researchers that banks and lending institutions distributed 1.26 billion items of junk mail inviting individuals to take out new cards or loans. This equates to 27 enticements to take on more credit for every adult in the country. Not surprisingly there are now more credit cards in the UK – 75 million – than people. So maybe we start to get an idea of how exactly the flames are being fanned.

Just a personal anecdote at this stage. I had lunch with a friend of mine last week who used to be a bank manager with one of the big high street banks and is now a director of another financial institution. He told me that his brother-in-law had been loaned over £40,000 over the past 5 years by the different arms of the same high street bank he used to work for. This included the combination of overdraft, loan, car finance and credit card.

He has absolutely no ability to pay that back. He is unemployed, having worked as a self-employed DIY handyman and gardener in recent years, lives in rented council accommodation and has no assets. He is in the process of negotiating between bankruptcy and an IVA.

But more interestingly, the bank probably doesn't care. As part of the package of "financial services" it sold to his brother was a credit default insurance policy. The claim on this, combined with the high interest he has so far paid on what elements of the debt he is able to service will probably mean they have already recouped the profit they had assigned to that set of debt in the first place.

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So we come back to the information available to borrowers and their desire or interest in acting upon that information. Is it fair for a lending institution to say merely that "the risks are all pointed out in the small print."

Getting back to some of the earlier demographic research and conclusions I touched on, some surveys show that low income groups are much more

likely to be less discerning when it comes to credit. So “Do the Poor Pay More?” Well generally it looks like yes. Purchasing habits tend to focus more on the underlying product – the car, or washing machine – rather than the finance. And even if in hindsight they find they had been misled or even cheated, these individuals are much less likely to seek redress than their, better-educated and better-off counterparts. We are seeing this now through the mass of publicity across the media about the reclaiming of bank charges and the way the banks are continually capitulating and repaying those fees rather than face cross examination in public about how they are justified.

But more information and transparency from financial institutions is not, I believe, the only answer. Individuals need to be taught how to shop better – more money/credit and physical goods – and they need to be made more aware of the redress mechanisms available to them. And the banks and other lenders have a central role to play in this regard.

Information on its own does not necessarily translate into decision making power or even informed decision-making. Some studies have referred to this as “informed powerlessness.”

Financial institutions therefore need to recognize that the offering of credit carries with it the responsibility to make sure customers understand both what they are committing to and what they are able to continue to be able to service and repay. I remember back in the 1970’s when you had to have funds deposited with a building society for months before they would even consider putting you on an approved list to possibly be approved for mortgage finance. This process meant interviews with physical individuals who often knew you or other people who did.

Going back to my friend’s brother-in-law. He noted that if he had been the bank manager responsible for those applications virtually all would have been turned down, aside say from some help to finance a vehicle and equipment that might help him do his freelance work better.

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So it gets back to knowing your customer. And while financial institutions are ploughing millions of pounds into investing in technology that both gives them a better understanding of the data activity in their customers’

accounts and appeases the regulators that they are doing something, more needs to be done.

Just like many institutions once saw the arrival of internet banking as the low cost nirvana that would herald the demise of the grossly expensive and inconvenient branch network and now realize customers expect choice in delivery channels – so too should they be re-introducing some good old fashioned personal knowledge and interaction with customers before granting them vast sums of credit.

Only in this way will individuals be better-empowered and have a chance to become more risk averse, as well as allowing banks to demonstrate more prudence in their business operations than certain actions to date seem to suggest. Otherwise there is little doubt they will continue to be actively fanning the flames of irresponsible credit expansion – something I think they don't really want to take credit for.

One last thought about risk. If we really are becoming more risk averse is there any evidence we are providing resources from this credit binge or liquidity boom that will help us in times of need?

Some might argue that with so much invested in property and the sharp rises seen in underlying assets there is not too much of a problem. Certainly the price of an average house increased at the rate of £45 a day last year, which is 3-1/2 times faster than in 2005. All of this has left the estimated value of private housing stock in the UK at the end of 2006 at £3.8 trillion – or some 3.5 times the outstanding mortgage debt of £1.1 trillion.

But when we look more closely at savings, the paper-thin veneer is exposed. One in three people failed to save anything at all last year, according to a study by the Alliance & Leicester, while over half of us have less than two month's salary tucked away in something we could access reasonably quickly – which suggested that over 50% of us could survive financially for only 17 days should we face sudden financial hardship.

It is not a pretty picture – but as long as all things remain equal, which employment levels staying high, house prices at least remaining stable and

interest rates showing no more major shocks there might not be any meltdown.

However in this industry we all know that the only thing we know with any uncertainty is that something is going to happen that we don't expect. It's what Donald Rumsfeld 3-years ago called the "Unknown Unknowns" – and we know what sort of a mess that's ended up in.

THANK YOU