Household and corporate credit vulnerabilities to rising interest rates

March 2022

Key points:

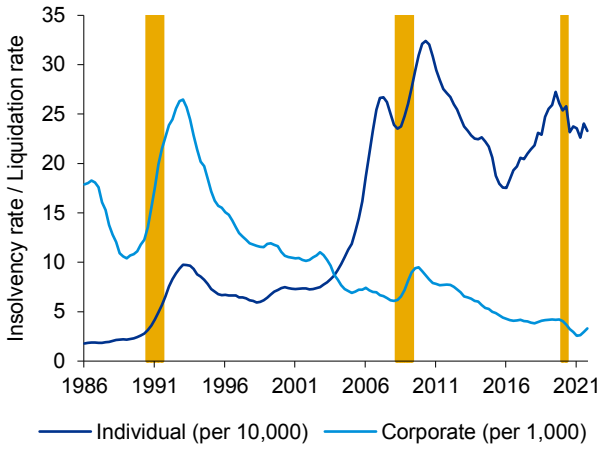
- Individual and corporate insolvency rates remain at low levels at present despite the COVID-19 shock
- Household balance sheets are stronger than during the global financial crisis, but rising taxes and energy prices will squeeze disposable incomes
- Mortgages are less vulnerable to rising interest rates given the low proportion of floating rate debt
- Unsecured debt is exposed to vulnerabilities at the lower end of the income distribution
- Corporate insolvencies remain subdued, but could rise following the withdrawal of government support, particularly among the SMEs

The rise in energy prices and the re-opening of the economy from COVID-19 restrictions, coupled with global supply chain shortages, have led to a sustained rise in inflation over the recent months. CPI inflation reached 5.5% in January – its highest level since 1992 – and we expect it to peak at 10% in October. That has prompted the Bank of England to raise interest rates twice since December, to 0.5%. This was the first increase since 2018 and the first one in two consecutive meetings since 2004. We expect two further increases this year, bringing the policy rate to 1%.

Higher pricing and interest rate environment raises two questions about credit vulnerabilities in the UK. First, whether higher interest rates could result in a spike in individual and company credit defaults via higher costs of servicing debt. And second, whether the erosion of disposable income and profits as a result of higher inflation makes certain segments of the market more prone to insolvency. In the remainder of this note, we look at the implications for mortgage debt, household unsecured lending, and corporate debt.

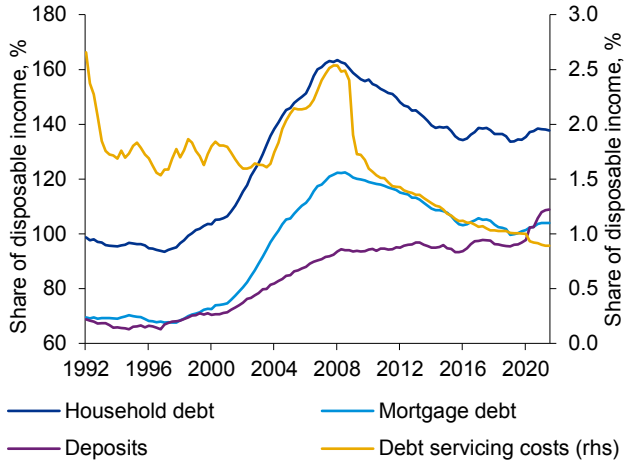
From a historical perspective, neither individual nor corporate insolvency rates look elevated at present (Chart 1).

Chart 1: Individual insolvency rate and company liquidation rate



Source: The Insolvency Service, KPMG analysis.
Note: Shaded areas indicate a recession.

Chart 2: Household balance sheet position



Source: ONS, KPMG analysis.

Over the past 30 years, sudden spikes in insolvency rates have been associated with periods of economic weakness: both series peaked following the 1990s recession and the global financial crisis. Since the onset of the COVID-19 pandemic, however, households and businesses have been partially shielded from insolvency both by the direct financial support in the form of furlough and business loans, payment deferrals on mortgages and consumer credit, as well as by temporary measures suspending insolvency procedures.

The aggregate financial position of households is more robust than during the previous recession. Households managed to reduce the overall stock of debt thanks to a combination of deleveraging and low interest rates which drive debt servicing costs (Chart 2).

On the assets side, deposits saw a steady increase, contributing to household net worth. This was partially as a result of a large increase in savings during the pandemic, which we estimate at £185bn in excess of pre-pandemic saving patterns. The proportion of highly indebted households – that is those with debt-servicing ratios above 25% – also remains relatively low.

Mortgage debt

Mortgages are the largest component of overall household debt, constituting 75% of total financial liabilities. However, there are a number of reasons why households are more insulated from the impact of higher interest rates on this form of debt than in the past. The stock of debt is down, and interest payments also constitute a lower proportion of disposable income (Chart 2).

Crucially, the share of floating-rate mortgages has fallen significantly over the past decade (Chart 3). The majority of outstanding mortgages have a fixed period of two years or more, which delays any impact of higher interest rates on most borrowers. This includes those who are coming to the end of their contracts: borrowing costs have remained low over the past five years, such that renewing a fixed-rate mortgage today would guarantee a similar or lower interest rate (Chart 4).

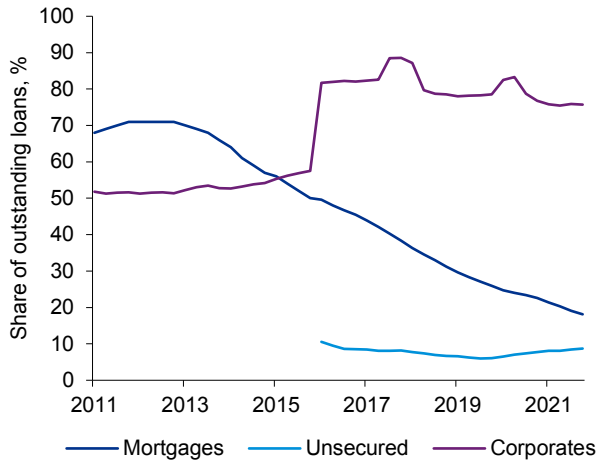
The underlying quality of mortgage debt is also relatively high. The share of high loan-to-value (LTV) mortgages (90% or more) was 4.2% in 2021 Q3, equivalent to the average over 2015-19 and down from a peak of nearly 15% in 2007. According to the Bank of England, the share of households with a mortgage debt-servicing ratio[1] at or above 40% – a threshold found to significantly increase the risk of arrears – is consistent with averages over 2017-19 and below the levels prior to the global financial crisis. Households with payment difficulties are also less likely to have a mortgage. Renters, who constitute a third of all households, make up two-thirds of those with repayment difficulties.

Unsecured debt

While unsecured debt is less sensitive to changes in policy rates (Charts 3 and 4), historically, default rates on consumer credit have tended to rise with unemployment rate. However, the UK labour market has been resilient during the COVID-19 crisis. The Bank of England estimated in mid-2020 that unemployment would need to reach around 14% for the share of borrowers with high debt-servicing ratios to reach the levels of the global financial crisis. However, the unemployment rate peaked at only 5.2% recently and is now back to around the pre-COVID levels.

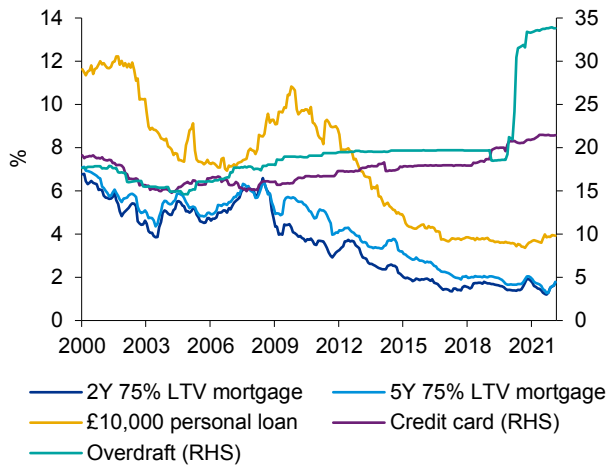
1 Mortgage interest payments as a proportion of income.

Chart 3: Share of floating rate loans



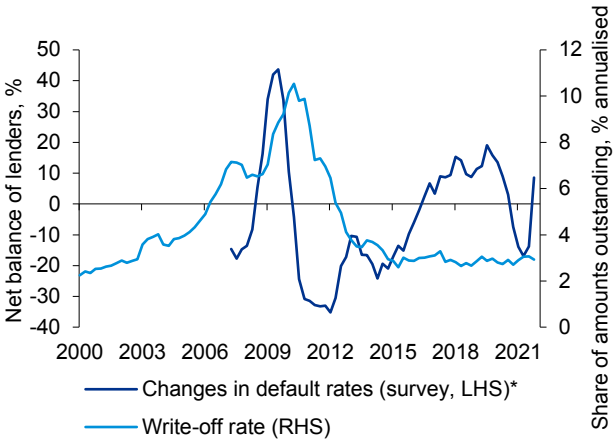
Source: Bank of England, KPMG analysis.

Chart 4: Quoted household interest rates



Source: Bank of England, KPMG analysis.

Chart 5: Indicators of defaults and write-offs of credit card loans



Source: Bank of England, KPMG analysis.
*Positive balances indicate that lenders, on balance, reported defaults to be higher than over the previous 3-month period.

The labour market benefitted from the government's support schemes during the pandemic (including the Job Retention Scheme and the Self-Employment Income Support Scheme) and from strong labour demand during the reopening phases. Payment holidays have also allowed borrowers to temporarily freeze loan repayments, although take-up rates were found to be higher for mortgages than unsecured loans.

The aggregate picture points to stable write-off rates on credit card loans at the end of 2021, in line with the average since 2015 (Chart 5). However, survey data from lenders shows a recent uptick in reported and expected default rates, suggesting potential repayment difficulties in certain segments of the market. This could be related to uneven effects of the COVID-19 crisis across the income distribution.

While higher income households were more likely to increase savings during COVID-19, unsecured debt has been more concentrated at the lower end of the income distribution. Households with problem debt are also over-represented in the lowest income deciles. In addition, these households have been found to be more likely to use unregulated financial products such as Buy Now Pay Later (BNPL) which carry greater risk due to limited affordability checks.

The existing risks will be exacerbated by the increases in energy prices and National Insurance contributions this year. We estimate that these will reduce household disposable incomes by 4.4% on average. Higher electricity and gas prices will hit lower income households most as they spent a greater proportion of their income on energy. The two expected increases in the gas price cap this year could see disposable income of households in the bottom income decile fall by 14%. This could have a significant impact on debt repayments.

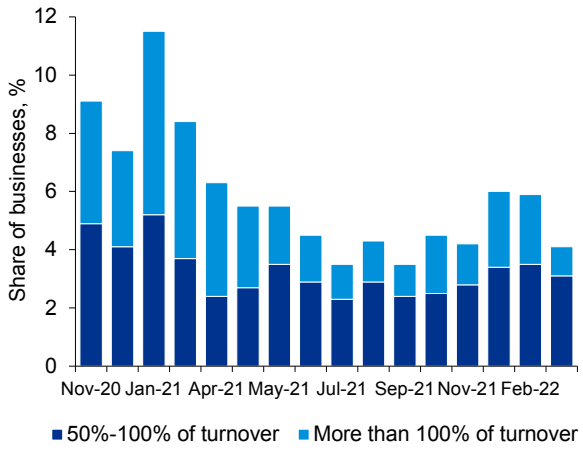
Corporate debt

Corporate balance sheets have not deteriorated markedly during the COVID-19 crisis. Corporate debt rose by £50bn since 2019 Q4 (with a peak of nearly £80bn in 2020 Q2) but as a share earnings it is now in line with the 2012-19 average of 300%. Nearly £80bn worth of emergency loans were taken out as part of the government-backed support schemes. Over a half of that (£47bn) was made up of Bounce Back Loans, which were aimed at smaller businesses. The take-up was concentrated in sectors most affected by the crisis, including hospitality and wholesale and retail.

Businesses are not reporting significant problems with meeting their debt obligations at present. Contrary to the majority of corporate debt which has a floating interest rate (Chart 3), Bounce Back Loans have a fixed rate of 2.5%. Around 4% of respondents to the ONS BICS survey currently report their debt repayments at 50% or more of turnover, a third of the share at the start of last year (Chart 6).

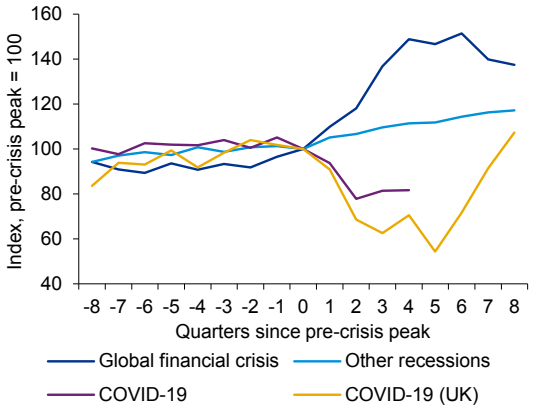
Nonetheless, corporate insolvencies could still rise in the coming quarters as the government support measures come to an end. Since the start of 2020, there have been around 5,500 fewer insolvencies than implied by pre-pandemic trends, suggesting that the support measures have suppressed some of the usual business churn. This phenomenon is not unique to the UK (Chart 7). Temporary measures have been phased out from October 2021, although some are still in place until the end of March.

Chart 6: Corporate debt repayments as a share of turnover



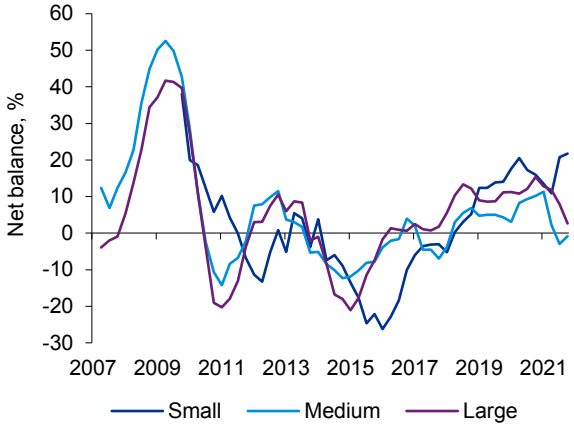
Source: ONS, KPMG analysis.

Chart 7: Corporate insolvencies in advanced economies after recessions



Source: IMF, The Insolvency Service, KPMG analysis.

Chart 8: Changes in corporate default rates by firm size



Source: Bank of England, KPMG analysis.

The SME sector appears most exposed to the risk of insolvency. Throughout the pandemic, companies reported the highest risk of insolvency among the micro (0-9 employees) and small (10-49) businesses. That coincided with a greater proportion of SMEs reporting less than one month of cash reserves. In the latest ONS survey, nearly 5% of micro companies reported low or no confidence in surviving the next 3 months, compared to less than 1% of large businesses. There has also been an uptick in default rates on loans to small businesses (Chart 8), although the level is not yet consistent with significant financial distress.

Overall, household and corporate credit vulnerabilities do not appear to pose a systemic risk at present, with risks largely limited to low-income households with problem debt and SMEs. There are many uncertainties at the moment as to how the conflict between Russia and Ukraine will evolve. The UK economy will be exposed to any further escalation, potentially putting the finances of some households and businesses under more strain.

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