University of BRISTOL

Standard Life FOUNDATION

DOES BORROWING BEHAVIOUR INFLUENCE FINANCIAL WELLBEING?

Key findings from a rapid evidence review

July 2019

Standard Life Foundation commissioned the University of Bristol to conduct a rapid evidence review to understand people's borrowing behaviour and how it impacts their financial wellbeing. This involved a structured, critical analysis of around 150 relevant items and an assessment of their methodological strengths and weaknesses.

KEY FINDINGS

- **Income strongly influences borrowing behaviour.** Low-income households are less likely to use consumer credit than those on higher incomes, but more likely to use high-cost lenders when they do borrow, often to make ends meet.
- **Owning assets has some relation to borrowing behaviour.** Homeowners have higher levels of borrowing than non-homeowners; their borrowing is linked to their level of housing assets. However, we lack evidence on the effects of savings on borrowing.
- **Psychological factors shape borrowing behaviour, but not as much as socio-demographics.** There are complex interactions between different psychological factors; and one can mediate (and moderate or amplify) the effects of another. Psychological effects seem less powerful in explaining borrowing behaviour than other personal factors, such as income.
- **Macro-economic conditions play a major role in shaping people's financial situations, their access to borrowing and the cost of borrowing.** Aggregate consumer borrowing rises when macro-economic conditions are good and falls when they deteriorate. At firm level, credit card design and marketing (such as credit limit increases and zero-interest offers) encourage borrowing. Speed, convenience and easy access attract borrowers to use high-cost credit, particularly where they have few other credit choices.
- **Lower financial literacy is linked to poor borrowing behaviours and over-indebtedness.** There are concerns young people, with lower financial capability overall, are particularly at risk from poor borrowing decisions. The evidence is weak regarding the impact of financial literacy programmes (which tend to focus on financial knowledge) upon financial behaviour.

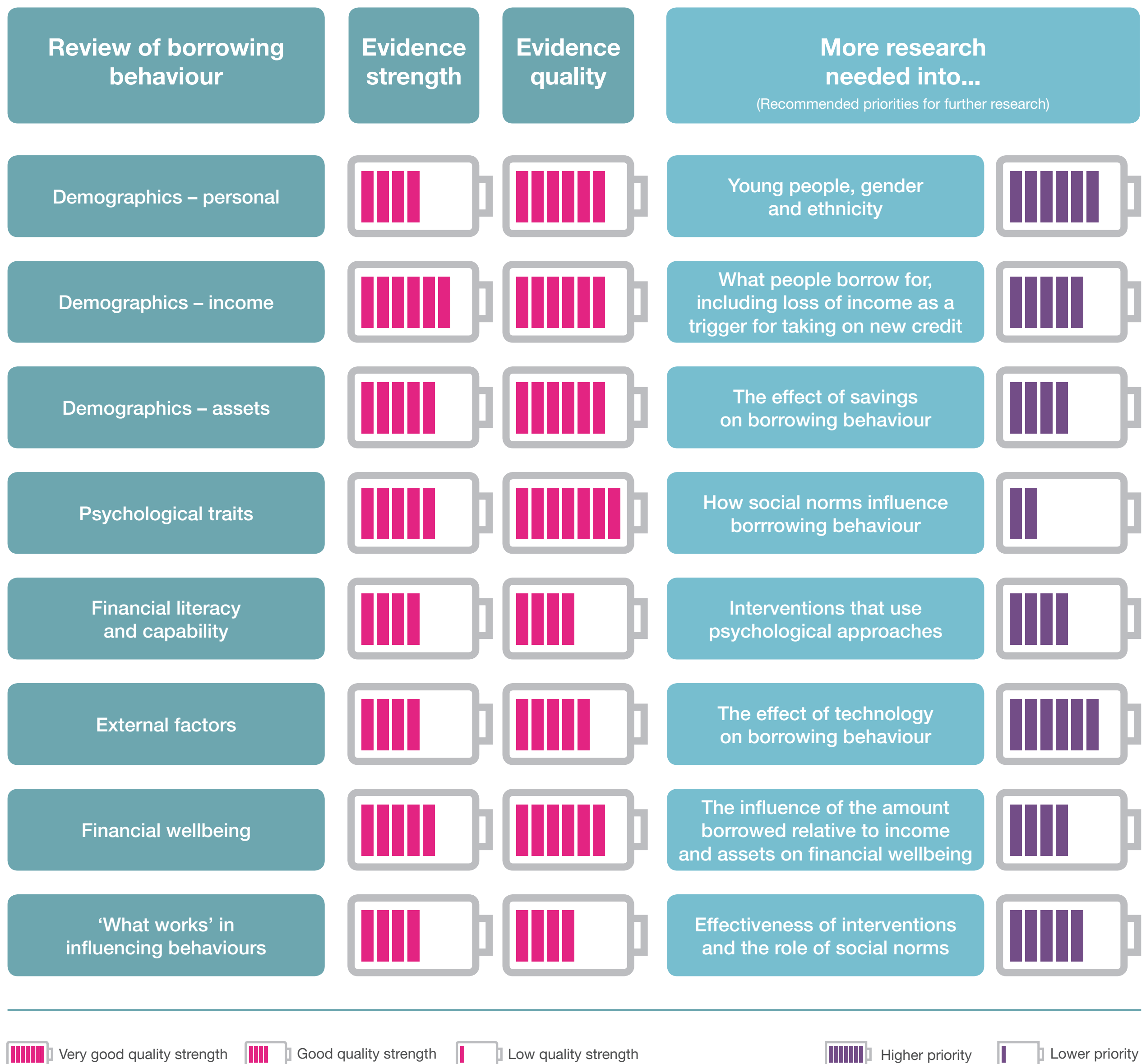
ABOUT THIS STUDY

This rapid evidence review critically assessed the evidence about the relationship between borrowing and financial wellbeing. We looked at what the evidence told us about personal and external factors that influenced borrowing behaviour and what factor protected against poor borrowing or repayment behaviour.

The evidence review identified 375 items: 310 academic papers and 65 pieces of 'grey literature'. From this, we conducted a structured, critical analysis of 149 relevant items. We also assessed the methodological strengths and weaknesses of each item.

Overall, the evidence we found was of high quality, with the most relevant evidence related to the socio-economic and psychological factors that shape people's borrowing behaviour. Figure 1 gives a summary of the strength and quality of evidence we found, along with evidence gaps.

Fig. 1 – Summary of strength and quality of evidence



KEY FINDINGS

Income and housing assets strongly influence borrowing behaviour

Five high-quality quantitative studies showed that economic and financial factors (including income) exert strong influence on consumer borrowing, even accounting for personality traits. In the UK and elsewhere, the evidence shows levels of consumer borrowing increase as household income grows.

Although they borrow less, low-income households are more at risk of financial difficulties from their debt burdens. This was evidenced by four good-quality studies that showed low income households used borrowing to pay for essentials such as food and household bills; and 12 good-quality studies that found low-income households were more likely to borrow from high-cost lenders.

In addition, we found strong evidence that income shocks were a major trigger for repayment problems and financial difficulty, comprising 10 good-quality studies from the UK and US. However, there was also some evidence that households try and guard against the impact of income shocks through precautionary credit card borrowing.

Compared to previous cohorts, young people nowadays borrow more as debt becomes normalised

There is strong evidence about patterns of age-related borrowing, from 15 studies that (apart from two literature reviews) use quantitative research methods and mainly originate in the US and UK. The evidence shows borrowing increases with age, typically peaking when people are in their 30s and 40s, and then declines. Compared to previous cohorts, young people nowadays borrow more as debt becomes normalised. At the same time, young people are vulnerable to poor borrowing decisions resulting in outcomes such as repayment difficulties and problem debt. There seems to be little evidence about why young people start borrowing;or how and why patterns of borrowing change over the life-cycle.

While psychological factors shape borrowing behaviour, they are not as influential as socio-demographic factors

There is a large, good quality evidence base about the psychological factors that shape borrowing behaviour, comprising around one-third of the total evidence we reviewed (54 of the 149 studies). Much of it focuses on the US and the UK; and mostly uses quantitative research methods. A few studies are based solely on research with university or school students, but these are the exception.

The evidence shows complex interactions between different psychological factors; and the capacity for one to mediate (and moderate or amplify) the effects of another. The strongest evidence about specific psychological traits shows that conscientiousness, general self control (or low impulsivity), and self-identity (particularly self-worth and self-esteem) can protect against poor borrowing behaviours. There is some evidence that behavioural biases influence borrowing behaviours, which helps explain the (seemingly) irrational behaviour of co-holding borrowing and savings.

Even so, the evidence suggests that the power of psychological effects to explain borrowing behaviour is less important than other personal factors, especially income and other socio-economic characteristics.

External factors play a major role in shaping people's financial situations, their access to borrowing and the cost of borrowing

Our evidence about the effect of macro-economic conditions on borrowing behaviour comes from seven high-quality studies covering a range of issues, that mostly originate in the UK and US. Put simply, aggregate consumer borrowing rises when macro-economic conditions are good and falls when they deteriorate. Low interest rates are shown to be the second most important predictor of household debt to income ratios.

There is robust evidence from nine high-quality studies about the strong influence of marketing on people's borrowing behaviour, across a range of credit products. Studies using data from a range of Western economies indicate that pre-approved credit card solicitation, reward programmes and zero-interest offers (also called 0% balance transfers) encourage credit card borrowing.

There is strong and consistent evidence from 10 studies in the UK and US that the way credit cards are designed and marketed (notably with regard to credit limit increases and minimum payment features) can risk people borrowing on credit cards over long periods of time; borrowing more; and paying more to borrow. There is also solid evidence about the links between the design of high-cost credit and borrowing behaviour from seven studies that mainly originate in the UK and are generally high-quality. Speed, convenience and easy access attract borrowers to use high-cost credit, particularly in the context of limited other credit choices.

Lower financial literacy is linked to poor borrowing behaviours and over-indebtedness

In total, the evidence base for the links between financial literacy, financial education and borrowing behaviour is made up of 28 studies which are mainly quantitative research of moderate relevance; and medium to high quality. Six medium-quality quantitative studies offer only weak evidence about the links between financial literacy, borrowing and over indebtedness. However, five mostly good-quality studies do highlight that young people are at particular risk of poor borrowing behaviours.

On balance, the evidence (based on nine studies, eight of them quantitative) suggests that using financial education to improve financial literacy has little or no long-lasting effect on people's borrowing behaviour in the face of other factors such as behavioural biases. The limited evidence appears stronger for financial capability and coaching programmes that focus more on psychology and behaviour. There is some evidence that information and advice can help offset low financial literacy, by reducing behavioural biases.

The balance of evidence is towards the detrimental effect of borrowing on wellbeing

We identified 20 studies that provide good-quality, relevant evidence about the relationships between borrowing behaviour and financial wellbeing, mostly from the UK and US.

Across a range of measures, the balance of evidence is towards the detrimental effect of borrowing on wellbeing. This occurs in relation to exposure to any borrowing; types of borrowing (mostly focused on credit cards and high-cost credit); persistent borrowing; and the reasons for borrowing. The amount borrowed in relation to someone's income and assets did not feature in the literature, however. There is some evidence to suggest that the cost of credit per se is problematic, although this is not unequivocal. How households respond in relation to their borrowing behaviour when they get into financial difficulty is crucially important for their outcomes.

POLICY IMPLICATIONS

Bringing the evidence together, there are five borrowing behaviours associated with good financial wellbeing:

- Not needing to borrow to pay for essentials
- Borrowing with restraint and avoiding over-borrowing
- Keeping on top of debt repayment
- Reducing the cost of borrowing
- Recognising and acting on the warning signs of potential problems

Not needing to borrow to pay for essentials

The evidence suggests that interventions to promote income adequacy and/or curb excessive living costs (such as housing and utility costs) are likely to have a positive 'downstream' impact by reducing the need for lower-income households to borrow for essentials.

Borrowing with restraint and avoiding over-borrowing

The evidence shows that young people in particular might benefit from advice and support to make good borrowing decisions (including deciding not to borrow). Ways to help people reduce their borrowing and avoid costly or unsustainable borrowing include

1. teaching them the personal development tools they need and
2. developing products that facilitate self-control or circumvent people's tendencies towards impulsivity. On the supply side, interventions should focus on making sure that lenders conduct proper affordability checks to avoid over-lending (especially in 'boom' times); and there is good access to affordable credit (especially when credit conditions tighten).

Keeping on top of debt repayment

UK banks and credit card firms are now required to do more to identify borrowers in persistent credit card and overdraft debt and help them reduce their borrowing. There may also be a place for psychologically and behaviourally oriented interventions to provide borrowers with advice and support to keep on top of their debt repayment.

Reducing the cost of borrowing

High borrowing costs are associated with lower financial wellbeing and so there is significant potential benefit (especially for lower-income borrowers) from using regulation to reduce the costs of high-cost credit; and boosting the availability and take-up of affordable credit. To be effective, efforts to deliver affordable credit alternatives should be designed around low-income borrowers' needs, preferences and behaviours, for example regarding product features.

Recognising and acting on the warning signs of potential problems

While over-indebtedness and problem debt are outside the scope of this review, we know that how households respond when they get into financial difficulty is crucially important for their outcomes; and that serious problem debt often results in significant detriment. There seems therefore a strong case to help borrowers recognise and act on the warning signs of potential problems – something that has proved challenging to achieve, according to lenders and debt advisers.

The UK regulator has proposed new rules and guidance for firms to identify borrowers at risk of financial difficulty and to intervene earlier to help them. The growth in personal and transaction data may offer one way to do this, with the potential to use this data to give borrowers feedback and helpful behavioural nudges.

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The Personal Finance Research Centre, University of Bristol

An independent research centre based at the University of Bristol, specialising in social research across all areas of personal finance.

www.bristol.ac.uk/geography/research/pfrc

Standard Life Foundation

An independent charitable foundation supporting strategic work which tackles financial problems and improves living standards. Its focus is improving the lives of people on low-to-middle incomes in the UK.

www.standardlifefoundation.org.uk

The full report is available at:

www.standardlifefoundation.org.uk/ourwork/publications