Topic 4: Know how financial difficulties can arise and understand their consequences

After completing this topic, you will be able to:

- list and explain the consequences of overspending and the costs;
- list and explain other events that might cause financial difficulties;
- list and explain some of the events that would make a provider think that a customer has financial difficulties;
- list and explain action that a person might take if they are in financial difficulties; and
- list and explain legal remedies that are available to a lender or an individual.

Financial difficulties

This topic is about what happens if you overcommit yourself or spend money that you cannot really afford to spend, and find yourself in a position in which you cannot pay your loans and other credit.

Good planning and proper budgeting can help you to avoid getting into financial difficulty, but both require discipline and self-control. They also require that you prioritise your spending – that is, that you identify what is important and what is not so important.

Overspending

'Overspending' means spending more than your income, or spending more than your budget allows. Some overspending is not a problem – a little extra here and there does not usually cause any major issue – but the key is to update your budget plan and make allowances elsewhere, so that you can still afford the things for which you *have* to pay.

Case study

Eve has a big night out planned with her friends. She has budgeted to spend £60 on a new outfit.

While she is out shopping, she sees a pair of shoes that she really wants. They are £30, so she ends up spending £90. If she is just a little bit more careful over the next few weeks – one fewer coffee here, one fewer trip to the cinema there – she will be able to bring her finances back on track within a couple of weeks.

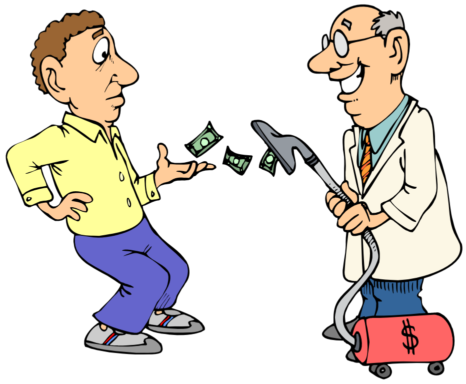
When might you have used the expression 'I have overspent' in the past?

Whatever the reason for having overspent, it is usually possible for you to deal with that overspend by cutting back on something else. You will have been able to look at your budget and adjust it, perhaps by:

- buying really basic food the following week; or
- deciding not to go out at the weekend.

You will still have been in control of your financial plan.

Overspending causing financial problems



Financial problems occur if a person does not have enough income to pay for their spending. They might then choose to borrow on a credit card or overdraft in order to keep on spending.

The following month, they will have to pay interest on their credit card balance and, if they keep on using their credit card to fund further spending, their repayments to the card company will keep on going up and up.

Activity 4a

Think about short-term lending products.

a) Which of these could be easily used to help someone to overspend?

b) What might be happening if you were overspending?

c) What would the costs of your overspending be?

Activity 4b

Yiyi visits a shop to which she has never been before. She finds some clothes that she likes and takes them to the counter to pay. They come to a total of £90.

The assistant asks her if she has a store card, and when Yiyi says 'No', tells her that if she signs up for a card, she can get a 10 per cent discount off all of her purchases at the store, including the ones that she is about to buy. The assistant also tells her that the card will let her borrow money to buy her clothes, which will be useful because she will be able to buy clothes even if she has no cash available.

Yiyi likes the idea of having a store card (she has no credit card) and she does not want to lose the £9 discount that she will get on the clothes that she is buying, so she signs up. She has to sign a document that has a lot of writing on it – but she

does not bother to read what it says. She gives all of her personal information on the document.

A week later, the store card arrives at Yiyi's house, along with a catalogue showing the latest fashions on sale at the store. She is impressed and goes back to the store the next weekend, armed with her new card. She works out how much she can save with the 10 per cent discount and buys clothes that amount to £200. She has no cash at the moment, but she knows that she can borrow on the card and pay back later.

Yiyi is pleased that she has saved another £20.

At the end of the month, Yiyi receives her store card bill through the post: she owes £290 and she has two weeks in which to pay if she is to avoid being charged interest. She still has no cash at the moment, but she can manage the minimum payment of £10, so she pays that.

Next month, Yiyi shops at the store again. When her bill comes at the end of the second month, Yiyi notices that she already owes nearly £8 in interest and that is before the new amounts that she has spent.

Six months later, Yiyi's store account is getting out of control. She owes over £1,000 to the store card company and that includes quite a lot of interest. She wonders if the card company is overcharging her, so she talks about it with Hans, a friend who works in a bank. Hans looks up the current rate of interest being charged on this particular store card and finds out that it is '30% APR'. He advises Yiyi not to spend any more money until she has cleared her debt.

a) What examples do we have that Yiyi has overspent?

b) What can she do about the £1,000 that she owes to the store card company?

c) What are the costs to her of overspending?

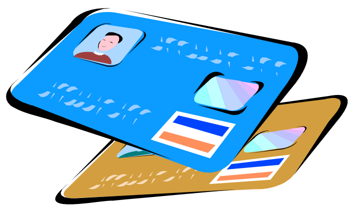
d) Can you suggest a solution for Yiyi?

Solutions to overspending

An overdraft can be a short-term solution to overspending. Using this facility for a month or two can be very convenient and, as long as the overdraft is 'authorised', it will not be too expensive. A good habit to get into is to clear the overdraft as soon as you have the money to do so – which means that it will be available again to use if you need it.

What can happen if you do not keep your spending on an overdraft under control? If the overdraft is caused by uncontrolled spending and is not planned, will it be authorised?

A credit card can also be a solution to short-term overspending, because it allows you to spread borrowing across a few months – but it can work out as an expensive way of borrowing money if the debt is not repaid for a long time. If your financial planning is not good, they too can lead to overspending problems, like the store card example in the case study above.



Cardholders who make only the minimum repayment each month will find that it will take a long time to reduce their debt.

Case study

Fiona has a credit card. She spent £100 on the card when she first got it and makes only the minimum repayment of 4 per cent.

Month	Debt from previous month £	Interest on debt @1.6% per month	New purchases on card £	Amount owed this month	Repays minimum at 4% £	Debt rolled over to next month £
Jan	0	0	100.00	100.00	4.00	96.00
Feb	96.00	1.54	0.00	97.54	3.90	93.64
Mar	93.64	1.50	0.00	95.14	3.81	91.33

In Fiona's case, if she continues making only the minimum repayments, she will *still* owe the credit card company £40 at the end of three years.

Failure to pay

If you fail to make the repayments on loans, credit cards and other forms of borrowing, the first thing that will happen is that the charges will mount up. There will be charges for:

- exceeding your overdraft limit;
- exceeding your credit card limit;
- returned payments (that is, if the direct debit payment to your card or loan is 'rejected' by your bank because of insufficient funds); and
- every letter that the bank or credit card company sends out to remind you about your failure to pay, or to inform you about the latest charge added to your account.

In the longer term, the consequences of failing to pay will be that you will be turned down for future credit applications, because you have a bad track record.

Defining 'financial difficulties'

The lending providers have all agreed a Lending Code. In the Code, there are some statements about financial difficulties, including the following.

A person could be considered to be in 'financial difficulty' when income does not cover reasonable living expenses and payments on financial products. This can be because of increased spending or reduced income owing to a change in lifestyle.

Causes of financial difficulties

The causes of financial difficulties can include:

- loss of employment;
- serious illness;
- starting full-time education; and
- relationship breakdown.

You can also add overspending to this list.

Possible signs of financial difficulties might include:

- items being returned unpaid as a result of lack of funds;
- failing to meet loan repayments or credit card minimum repayments;
- repeatedly going over credit card or agreed overdraft limits; and
- making cash withdrawals on a credit card (which can be very expensive).

Action that a person can take if they are in financial difficulties

There are many organisations and sources of advice. All of the lenders' websites give clear advice.

Activity 4c

Choose several providers' websites with which you are now familiar. Look at the advice offered to people who may be in financial difficulties. It may be in a menu called 'Help'.

Compare the similarities.

The main points that most lenders make are that you should:

- get in touch with your lender(s) straight away;
- explain in full about your financial circumstances;
- seek independent help from any of the advice organisations, such as:

   - Citizens Advice (www.citizensadvice.org.uk);
   - the Debt Advisory Centre (www.debtadvisorycentre.co.uk);
   - the Debt Advice Trust, which runs the website 'Talk about Debt' (www.talkaboutdebt.co.uk); and
   - CCCS StepChange (www.stepchange.org)
- look at other advice websites, such as that of the Financial Conduct Authority (FCA).

The lender does not want to lose money because a borrower cannot repay. If a person is in financial difficulties, the lender will want to work out the best way of helping the borrower to repay. Simple options might include:

- lowering repayments and increasing the length of the loan; or
- putting all lending into one account and paying this back over a longer period of time.

If a borrower ignores the problems, however, they are likely to get worse. We saw earlier in this topic that interest can quite quickly add up: charges accumulate; bills pile up; rent does not get paid…

You can see how financial difficulty can 'snowball' into a really serious problem.

Running away – that is, ignoring letters from the bank, not returning telephone calls and even moving rented flats – is probably the worst action that you could take. The lender(s) will always find you: they employ professionals to trace individuals.

A borrower might prefer to see an independent debt adviser rather than speak to the lender, especially if there are several lenders involved. A debt adviser will talk through all of the borrower's finances and work out the best way in which to start talking to lenders.

Legal options for an individual

There are also some legal actions that an individual can take to help them to sort out their finances.

Individual voluntary arrangement (IVA)

An individual voluntary arrangement (IVA) is an arrangement with creditors (that is, the people to whom you owe money) to repay debts either in part or in full. With the help of an adviser, you can draw up a list of creditors and then suggest your plan to them.

If it is a reasonable plan, the creditors are more likely to accept it.

Activity 4d

Janie owes three lenders a total of £50,000:

- ***she owes Lender A £25,000;***
- ***she owes Lender B £15,000; and***
- ***she owes Lender C £10,000.***

Janie and her advisers have worked out that she can afford to repay £20,000 over five years and she suggests this to the lenders as an IVA.

This means that each lender will receive less money than the amount owed.

a) Calculate how much each will get in repayment.

b) An IVA is managed by someone who is legally trained. Why do you think IVAs have to be carefully controlled?

c) What are the advantages for Janie?

Bankruptcy

If a person cannot pay their debts, they may apply for bankruptcy. This is an option if a person has little money and it will take years to pay off their debts. Bankruptcy is a legal procedure that effectively clears all debts and gives a person a fresh start. But bankruptcy cannot be kept a secret, so all of your friends and family will know about your problems.

If you become bankrupt, you will lose all of your valuable possessions and you may not be able to apply for certain jobs in the future. You have to wait a year before you can apply for credit again and, during that time, all of your spending and income will be controlled: a 'trustee in bankruptcy' will decide how your finances should be managed.

Once the bankruptcy is over, you can control your own finances again – but trying to get credit in the future will be extremely difficult. If you do find a lender willing to lend money to you, it will be at very high rates of interest because you are considered to be 'high risk'.

The bankruptcy will be on your credit record for six years.

Debt relief order

A debt relief order is a simpler form of bankruptcy, for people who owe less than £15,000. It provides a fresh start, although the details will be on your credit record for six years. Once granted, the debtor (that is, the person owing the money) will not be required to make any other repayments toward their debts during the time for which the order is in place and, assuming that the debtor's circumstances do not change during this time, their debts will be written off when the debt relief order comes to an end after 12 months.

In order to qualify for a debt relief order, the debtor must:

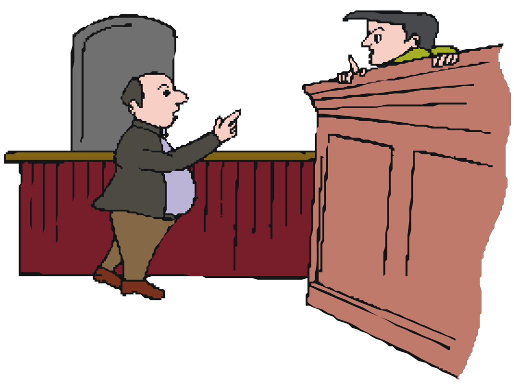
- be unable to pay their debts;
- have unsecured debts of less than £15,000;
- have assets of less than £300, excluding a car up to a value of less than £1,000;
- have surplus income of less than £50 per month; and
- not already have an existing bankruptcy order or IVA in place, or have had a debt relief order in the last six years.

Legal options for a lender or creditor

Generally, we use the term 'lender' if we are referring to a mortgage, or some other form of secured lending. We use the term 'creditor' if we are referring to unsecured debt, such as personal loans, credit cards and overdrafts. Both lenders and creditors have a number of options available to them to try to get back from you the money that you owe them.

County court judgment (CCJ)

A county court judgment (CCJ) is a legal action that a lender or creditor can take. This involves them taking you to court, and if the court agrees that there is an unpaid debt, it will order you to pay it back.



A notice will then be put on your credit record to state there is an unpaid CCJ and this can seriously affect your future applications for credit, because lenders can then see that you have proved to be an unreliable payer in the past.

The law requires a CCJ before a lender can take other action to recover its money, such as applying for repossession.

Repossession

Repossession is the action that a mortgage lender can legally take if you do not keep up with your mortgage repayments. First, the case goes to court, and if the court agrees with the lender that you have failed to pay your mortgage and that the lender did everything possible to help you (such as extended your repayment term or reduced the interest for a while), the court will give the lender permission to make you leave your home.

The lender will then sell your house, pay off the mortgage debt and, if there is any money left out of the sale proceeds, give you the change. Often, there is no change. In fact, the house sometimes sells for less than the mortgage, meaning that you still owe the mortgage lender some money even after you have lost your home.

Legal options for an individual in Scotland

There are many ways in which to deal with debt if you live in Scotland. If the situation is not too serious and creditors are not threatening to take action against you, you may benefit from a debt management plan. This is useful if you need only some advice and direction about existing debt, and feel that you will be able to deal with your expenditure if you have a little help organising your money and with planning your budget.

Trust deed

If you cannot afford your existing debt and the total that you owe exceeds £10,000, then you may qualify for a trust deed.

The trust deed is a government-backed scheme in Scotland, similar to the individual voluntary arrangement (IVA) in England, Northern Ireland and Wales. Under a trust deed, you commit to making certain payments over a specified period of time to pay back your creditors. As with the IVA, this does not involve you giving up any of your assets. After completing the terms of the trust deed, you will have cleared all of your debt.

If you have equity in your property, then you may be forced to release some of that equity to pay off some of the debt as a condition of the trust deed.

A trust deed typically lasts for three years, after which time any remaining debt is written off. Entering into a trust deed will, however, affect your credit rating in the future and evidence of it will remain on your credit file for up to six years.

Debt arrangement scheme

The debt arrangement scheme involves you making a single regular payment to an 'approved payments distributor' who, under the terms of the scheme, distributes the sum of money to your creditors. It is a free service and the main benefit is that – provided that you keep to the agreed payments – your creditors cannot take any further action against you.

Sequestration

Sequestration is what bankruptcy is called in Scotland. In sequestration, a trustee (a licensed insolvency practitioner) is appointed by the courts to recover, manage and sell off your assets (including your home in some cases) to pay off your creditors. The trustee may also require you to pay additional money from your income. Sequestration usually lasts for a year and – as with bankruptcy in England, Northern Ireland and Wales – as a result of sequestration, you may find it difficult to obtain credit in the future.

In order to apply for sequestration, you must:

- owe more than £1,500; and
- not have been made bankrupt in the last five years.

Low income, low assets (LILA)

A LILA is an equivalent to sequestration for those who have total assets valued at less than £10,000, with no single asset worth more than £1,000 and income of no more than the equivalent of the National Minimum Wage. Under a LILA, on payment of a small fee, your debts will be written off and you will be protected against further action by your creditors.

Legal options for a lender or creditor in Scotland

A creditor in Scotland has a number of options to pursue debt through the Scottish courts. These options are called 'diligences'.

Earnings arrestment

An earnings arrestment is a court order that your creditor(s) can obtain demanding that your employer deduct a certain percentage of your wages every time they are paid and pay this directly to your creditor. The amount that can be deducted is determined by law, and depends on how much you owe and how often you are paid.

Bank arrestment

A bank arrestment is a court order preventing you from accessing your bank accounts. The creditor(s) can then apply to the courts for the 'frozen' money to be paid to it (or them) to clear your debt.

Attachment

An attachment is an order that the creditor can obtain to prevent you from selling your possessions. It can lead to a 'messenger-at-arms' or 'sheriff officer' taking the items on behalf of the creditor to sell at auction to repay the debt.

Inhibition

An inhibition is an order that prevents you from selling, transferring or remortgaging your house or land until you have repaid your debt.

Repossession

In the case of a mortgaged property, if you have received two letters from your lender and yet have made no attempt to contact the lender or to reach a satisfactory arrangement with it, the lender has three options:

- to issue a 'default notice' giving you one month in which to pay the missing instalment(s) on your mortgage;
- to issue a 'calling-up notice' giving you two months in which to repay the whole outstanding amount of the loan; or
- to apply to the Sheriff Court for an 'initial writ' and a 'section 24 notice' to be issued to you. These will inform you that the lender intends to seek repossession of the property to repay the outstanding mortgage.

The Scottish government does, however, operate a 'mortgage to rent scheme' whereby your home may be purchased by a council or housing association and rented back to you, so that you do not have to leave your home.

Review questions

1. Explain in your own words how credit cards and overdrafts can be a good way of managing short-term financial problems.

2. Explain how easy it can be for credit cards and overdrafts to become a source of financial difficulties.

3. Why might the signs of financial difficulty make a lender concerned?

Learning activities

Internet

- Visit http://www.adviceguide.org.uk/england/debt_e/young_people___money_advice_videos.htm. Look at the videos ‘Scooby’s story’, which is about ignoring bank letters, and ‘Adila’s story’.
- Visit www.citizensadvice.org.uk and go to ‘Adviceguide’. Select ‘Debt and money’, and then ‘How to deal with your creditors’.
- Visit www.gov.uk and select ‘Money and tax’, then choose ‘Court claims, debt and bankruptcy’.

Group

Discuss whether you would like a credit card when you are old enough or whether you have a credit card now. Do you think that the risks of overspending and financial difficulties make it worthwhile?

Individual

- Look on the websites of three or four banks and building societies, and see what they say about financial difficulties, what advice they give to their customers and how they offer to help them.
- Download the latest version of The Lending Code (revised December 2013) and read the ‘Key commitments’ and section 9 on ‘Financial difficulties’.

Key points for Topic 4

You should now understand:

- the consequences and costs of overspending;
- other events that might cause financial difficulties;
- some of the events that would make a provider think that a customer may be in financial difficulties;
- what action a person might take if they are in financial difficulties, including an individual voluntary arrangement (IVA), bankruptcy and debt relief order;
- the legal remedies that are available to a lender or an individual. including a county court judgment (CCJ) and repossession;
- what action a person might take if they are in financial difficulties in Scotland;
- the legal remedies available to a lender in Scotland.

