Assess the affordability of each customer

Robust affordability solutions
THE AFFORDABILITY CHALLENGE

Increased regulatory focus and rising interest rates mean lenders need to revisit their measures of affordability ahead of changes. Accurately assessing both customers’ affordability and suitability are essential requirements for all lenders who wish to extend credit responsibly whilst minimising their risk exposure.

Despite the recent economic upturn, disposable incomes remain depressed, and are struggling to reach the levels seen before the credit crisis of 2007. There is no guarantee that interest rates will remain at their current historical lows beyond the end of this year, and rising rates will impact a customer’s ability to pay. Consequently, to lend responsibly requires an even better understanding of each customer’s ability to pay, which means implementing more robust measures of current and future affordability.

The Financial Conduct Authority (FCA) has outlined the need to provide and undertake adequate affordability assessments, and there is an ever increasing focus on conduct risk. These stricter requirements have put increased pressure on banks and other financial services providers to assess and continually manage their customers’ long-term affordability, in a bid to drive informed and responsible lending decisions.

As lenders struggle to balance growth with risk, and consumers face stagnant disposable incomes, there is no doubt that making prudent lending decisions is more important than ever. Failure to do so could put additional financial pressure on consumers and lenders at a time when the financial climate still looks uncertain.

‘Affordability is the measure of a customer’s financial capacity to fund new and outstanding debts, now and in the future’.
IMPLEMENTING AFFORDABILITY ASSESSMENTS

The rapidly changing economy and stronger regulatory focus makes it essential for lenders to make accurate assessments of a customer’s ability to repay debt in both the short and longer term.

Measuring a customer’s affordability, using robust processes and the most accurate data on their financial commitments, will ensure that your customers can not only pay you back at the start of the loan, but will also allow you to monitor their continuing ability to maintain payments in the future.

The decision making process needs to take into account not only risk assessment, but also levels of indebtedness and affordability. A typical affordability assessment process will include: the capture and retrieval of robust data on the customer’s financial situation, income estimation and verification, the calculation of disposable income to assess ability to repay both today and over the lifetime of the commitment, setting of affordable limits and an assessment of both indebtedness and risk.

The extent and scope of any assessment of affordability depends upon a number of factors. These include: the type of credit product, the credit amount, the borrower’s financial situation, their credit history, and potential future changes in the borrower’s circumstances.

Experian has developed new analytical tools that look at a wide range of factors, including marital status, dependents, and existing credit commitments, to provide more accurate expenditure estimations. The ability to analyse current and future affordability at both an individual and a household level will prove hugely valuable.

‘Protect your organisation and consumers from taking new facilities, which the consumer cannot afford’.
When implementing a robust affordability strategy, it is important to consider:

**Data strategy**
Review the data used within the affordability assessment process ensuring it is fit for purpose. Balance the need for data capture from the customer with usage of data from other available sources, for example, income provided by the customer compared to estimates derived from current account data.

**Process**
Indebtedness and affordability assessments should be undertaken throughout the customer lifecycle: acquisition, customer management, pre-delinquency, collections and debt recovery. Affordability assessments should be made for automated and manual decision making processes.

**Systems**
Ensure that models can be implemented and amended easily.

**Model and calculation design**
Ensure that indebtedness and affordability calculations are well designed and clearly documented. Consider how income and disposable income are estimated and what tolerances are incorporated.

**Monitoring**
Monitor the performance of your affordability assessments and update accordingly.

**Policy design**
Overall decisions should be based on risk, indebtedness and both current and future measures of affordability. The rigour of the assessment should be consistent with the credit exposure. Again, the policy should be well documented.
Assess the affordability of each customer
THE EXPERIAN AFFORDABILITY SOLUTION

You already know how important it is to lend responsibly, ensure that your customers are being treated fairly, and offer the right product at the right time, based on a thorough understanding of a customer’s financial position.

But can you be certain that your customers are supplying you with an accurate income and do you have a clear view of how much of that is disposable? Do you understand how indebted your customers are? And are you confident you are meeting conduct risk standards?

Imagine the benefits of being able to see your customer’s precise financial commitments:

- **Customer indebtedness**
  
  The Experian **Consumer Indebtedness Index (CII)** is highly predictive of credit risk, considers income based characteristics and debt profile to identify customers where borrowing suggests financial stress that could lead to more serious problems.

  Typically, the CII is used to identify highly indebted individuals and to improve overall discrimination and scorecard accuracy.

- **Income estimation**
  
  Experian also offers income estimates that provide an understanding of your customer’s income and enables changes in financial circumstances to be monitored on an on-going basis. This means that customer management strategies can be adjusted to provide appropriate lending while limiting exposure.

- **Income verification**
  
  In order to obtain a clear understanding of whether new applicants can afford additional credit, it is vital to have an accurate view of net monthly income. Experian uses Current Account Turnover data to generate a **CATO Warning Flag** that identifies applicants who have exaggerated their income. A more realistic income can then be used within the decision process to ensure that applicants are offered suitable products.

- **Disposable income**
  
  Once confident with the income associated with an individual and their household, this can be used to calculate a value for **Effective Disposable Income (EDI)**. The monthly expenditure calculation considers income, expenditure and customer demographics utilising Experian’s extensive data assets and other insightful sources.

  Incorporating assessment of disposable income into the decision process means that you can define appropriate terms of business and be confident that you aren’t lending to people who cannot afford repayments.

Experian offers a variety of solutions to meet differing business needs. Please contact us for further information at consumerinformation@experian.com or visit www.experian.co.uk/affordabilitysolutions.