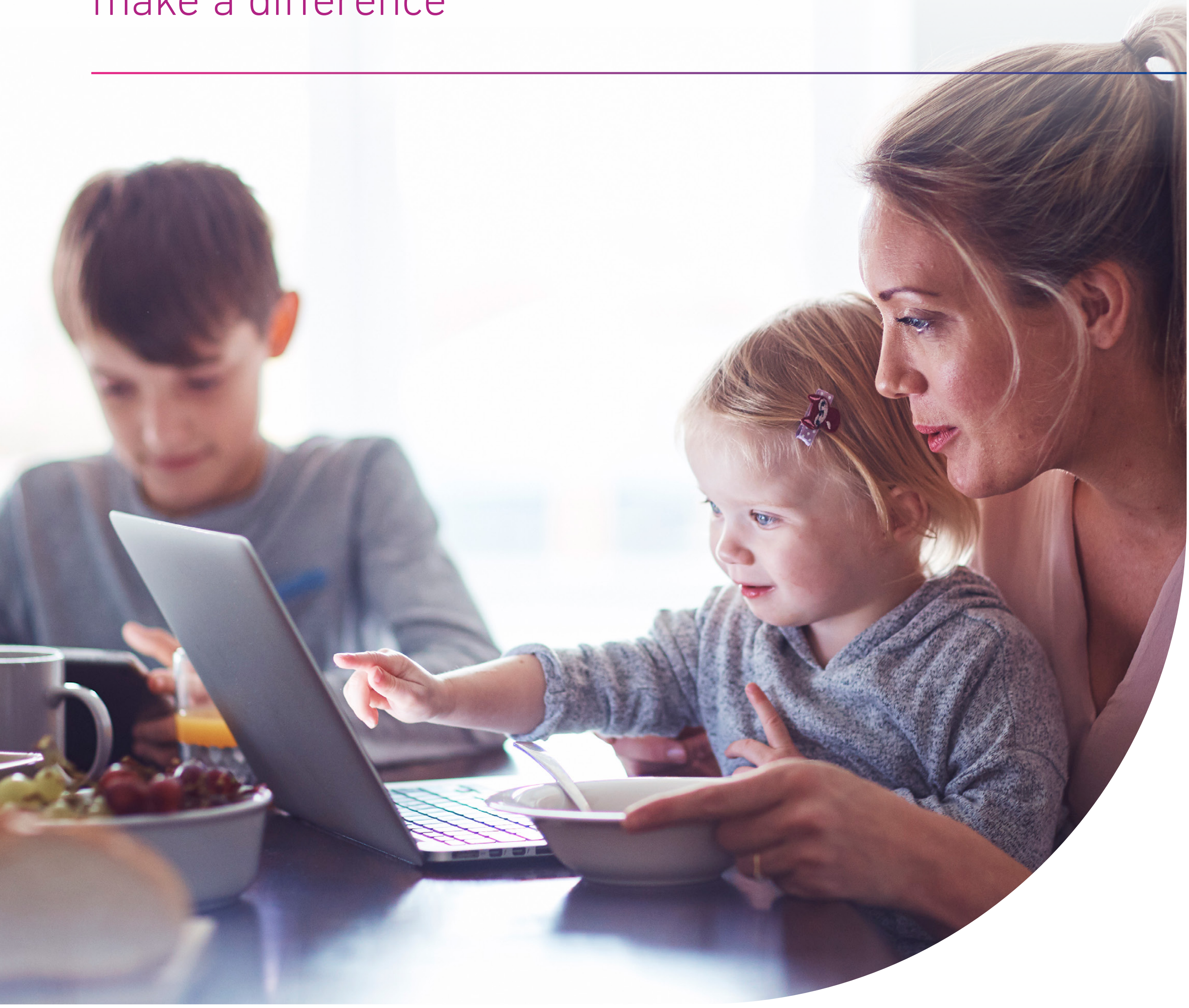
White Paper

Rethinking affordability

Where we believe change can make a difference



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Executive summary

One of the most important considerations facing us as an industry is how we manage responsible lending.

Last year (2017), the Financial Conduct Authority (FCA) began consulting on proposed changes to their rules and guidance on assessing creditworthiness in consumer credit. The initial Consultation Paper[1] suggested that organisations will need to reconsider the tools they use to measure a consumer's creditworthiness, namely credit and affordability risk.

Alongside this consultation, the introduction of Open Banking this year means the banking and financial services markets will now be subjected to much higher levels of competition. Lenders are able to carry out real-time analysis of bank account data. One of the ways in which this can be of benefit is in being able to better understand an individuals income and expenditure, which is far more granular than what we see in traditional processing.

While some speculated that Open Banking would signify an end to traditional banking, at Experian we believe that contrary to this, it has the opportunity to reignite it. However, businesses - new and old - must put themselves in a strong position in order to benefit. The reason we perceive Open Banking as a significant opportunity is because of the potential for greater insight from bank account data, which can be used to make better credit decisions, as well as enhance a customer's entire experience by understanding them better.

At the moment, we are seeing the levels of personal debt increase and currently they exceed where they were three decades ago.

These unsustainable levels of indebtedness (how much a person owes in personal debt), reinforces the need to revisit and improve decision-making to ensure people are protected.

This paper explores and expands on our views and beliefs of where the opportunities lie for better affordability assessments, and what good customer outcomes could, and should, look like.

At Experian, we have a core belief in the power of data to achieve better customer and business outcomes and have therefore invested significantly in an Open Banking platform, APIs and data aggregation.

We have embraced new technologies including Artificial Intelligence (AI) and Machine Learning, to categorise transactions and automate decisions. We are excited at the potential this technology possesses to change the whole area of affordability, particularly by extending it across the whole credit lifecycle to personalise the customer journey, which will create a better experience for everyone.

In addition to Open Banking we have been investing in many other areas too. From new data sources through to enhancements across our decision technology. This is a continued investment which we believe will bring a solid footing to build upon through today's data fuelled, digital economy.

In this paper we outline our views on some of the key influences and challenges we need to overcome to embrace the data-powered future and how we can move to a place where assessing whether to lend is fair, transparent and valuable to all, and easy to achieve.

StepChange estimates that over 2.5 million people are using credit cards just to meet everyday living costs and emergency expenses and 16 million people in the UK have savings of less than £100.

Gaining better intelligence from more aggregated data is an opportunity to better prevent and pre-empt challenges for people and support them by identifying what is genuinely affordable for them.

[1] Source: https://www.fca.org.uk/publications/consultation-papers/cp17-27-assessing-creditworthiness-consumer-credit

The FCA's commitment on creditworthiness

In late July 2017, the FCA published its long-awaited Consultation Paper CP17/27 entitled Assessing creditworthiness in consumer credit, against a backdrop of concerns about the risk of potential harm to consumers from a culture of poor practice by lenders. After considering all feedback, the FCA expects to publish a Policy Statement with final rules and guidance this year.

The Consultation Paper distinguishes the two components of creditworthiness: affordability and credit risk. Affordability means how difficult it may be for the customer to repay. Credit risk is the risk to the lender that the customer will not repay the credit. The Consultation Paper sets out how and when firms should use a customer's income and expenditure information, along with tighter lending rules and policies to inform a decision.

In setting out their recommendations, the FCA expressed its desire not to be prescriptive, but to set out important principles which underline the need to apply proportionality to lending decisions and focus on delivering better customer outcomes. It also highlights the benefits of implementing automation and technology.

Importantly in relation to affordability, the FCA proposed that only the borrower's individual income should be used in the assessment, not household income. This is likely to represent a significant departure from current industry practice.

The FCA acknowledges the industry-wide challenge of focussing on credit risk at the expense of a genuine assessment of affordability. However, lenders will need to do more in their assessment of how much a customer can afford and introduce new methods to do this appropriately.

These regulations should not be a barrier to business, but an opportunity. It introduces a set of standard which provide a foundation for better decision-making and gives businesses the freedom to keep their individual variables. Having greater access to data will help lenders have more visibility of a person's individual circumstances. This is not only reflective of the FCA's guidance, but can help create processes and new products as a result of having a better understanding of who is suitable for what.

This connection of data, we believe, can bring new insights into the lending assessment, giving a much more effective and single indicator of a person's ability to repay, while also considering the needs of both credit risk and affordability risk.

There is an even bigger opportunity to combine data sources to create new variables to better inform decisions. Advances in AI will enable outputs from technology which can bring new ways of understanding and using this data to enhance the opportunity for tailored modelling. This is exciting and will help businesses to make 'intelligent decisions' that are agile, scalable and quick.

Customers must come first. In its consultation, the FCA called for more transparency and fair lending to secure a greater degree of protection for borrowers.

Open Banking – new opportunities for all

The emergence of the UK's Open Banking initiative and the European Union's Payments Services Directive 2 (PSD2) are landmark events. We believe they put the UK ahead of the rest of the world in terms of creating an open data architecture which will benefit customers, organisations and society at large. Alongside other similar data sharing initiatives, we are seeing the whole data sharing ecosystem starting to take form. This is a powerful opportunity for everyone.

The PSD2 operates in a similar way to Open Banking in requiring banks to provide third party providers with a person's bank account data through a standardised set of APIs – including payment APIs. This will open up access to all payment accounts including credit cards, payment cards and current accounts. This will enable new market entrants to challenge the ascendancy of established brands.

Current methods of assessing affordability are widely acknowledged to be sub-optimal and in some cases the customer experience is poor, inconvenient and intrusive. It is also, in some cases, not inclusive. Digital processes are not always efficient and smooth simply by virtue of being electronic. People can become frustrated with lengthy forms and abandon credit applications quickly.

There is a clear need to access more accurate data which is specific to the individual and can help inform conversations. Potentially, organisations will face the challenge of having to assess both individual and household income and expenditure, depending on the product. As a result we could see even more data points being brought in, in order to make a decision. Without a proper structure equipped to quickly consume and use this data, we could see more friction in decision-making.

Alongside data there is also a need for speed and convenience. This is driven by the rising use of digitally-enabled tools and services, but equally by business requirements to process applications as quickly and efficiently as possible. Decisions need to be swift, but they also need to be accurate, fair and responsible.

To achieve this, technology needs to be fast. This is where we believe advanced analytics - and specifically a categorisation engine - that features Machine Learning, offers an appropriate scalable solution. Not only can it understand and learn from the data it is fed, it can do so at scale and at speed. This can not only help you make fast decisions, but more informed and better ones, as it has the ability to understand more than we have been able to ever before.

This is particularly prevalent in the engine we have created. It not only understands data fast, it categorises it into meaningful and usable categories that can be fed into automated decision systems, or presented to an underwriter in a way they can understand it easily, and quickly. It also presents more granularity of insight to determine what the decision should be. With our research showing that a large proportion of decisions being reached today are made subjectively, this enhanced insight is important to ensure that any decision is made fairly and accurately moving forward. The engine can consume new data sets, such as data from the bureau or alternative data sources, which will further enhance insight to better inform a decision.

3 things we see the open data landscape influence:

1. Customers have been given a choice whether to consent to the sharing of their data in order to access better products and services and save time.
2. Firms who obtain consent to use a person's bank account data can use this insight to have more meaningful and valuable conversations with them.
3. We will see more competition arise as a result of bank account data being shared, with more people better understanding the value they receive from what, and from who. Switching providers will be a likely occurrence as a result of this transparency and understanding of what best suits their needs.

The ways we will see lending transform

Open Banking, alongside new data and more demanding customer expectations, will likely spur a lot of change across traditional finance. It is our belief that this change is a good thing as it all comes back to a single common point: that more data, and more understanding, can enable more opportunity which is rewarding to the customer and will help to achieve better customer outcomes.

We believe the benefits of being able to ingest and utilise the data available today far surpasses being able to decide whether to lend or not. This data architecture offers organisations the opportunity to be more efficient across operations, help digitise and modernise decision-making, predict and pre-empt credit difficulties and to have better conversations. It will help tailor the user experience of each individual which can then broaden the opportunities for better lending. Currently there are limitations in firms abilities to understand what opportunities exist and where. Here are four specific areas where we expect to see significant change:

- **The introduction of online affordability**
  A hugely significant change to the application process will be the introduction of online affordability checks with no delay or break to the application.

- **Understanding a customer better – always**
  In the future, lenders will be able to run an affordability assessment across their whole portfolio to give an early indication of a person who may be nearing financial distress. At the other end of the spectrum it can help those who do have the financial capacity for more products and enable you to identify which ones are suitable for them.

- **Making finance more inclusive – for all**
  An important point to consider here is the potential for Open Banking to benefit those customers who are currently financially excluded by moving them back into mainstream lending. Because the insight from bank account data provides a more complete picture of the individual, lenders will be able to make much more sophisticated assessments of a person's affordability. An example includes the self-employed who will typically have small, frequent deposits into their bank account. Being able to identify and categorise these deposits as income and demonstrate a clear pattern over time will make lending much more accessible to this group.

  Other examples could include new to market credit, or new to country residents, who typically have a 'thin credit file' (a lack of credit history).

- **New data variables**
  It's not uncommon for people to ask whether Open Banking will bring an end to credit scores. We don't believe it will. Why not? Because credit scores provide a measure of an individual's credit risk, i.e. how an individual has managed their credit in the past, whereas bank transactions reflect a customer's affordability risk, namely their ability to pay based on income and expenditure. These two data points complement, rather than compete against each other. With the potential to now add even more intelligence into scoring, through new data and new analytical techniques, the two points can be further enhanced.

The opportunities afforded by the availability of bank account data means it is advisable to review and re-address your credit risk policies and lending rules. Better data could be an opportunity to strengthen your portfolio by offering personalised solutions at a lower cost. Data which is more reflective of a customer's financial well-being will allow you to make better decisions which will be a benefit to everyone.

The importance of consent

It stands to reason that the more data which is available, the better informed a lender is to make a decision on a customer's ability to pay.

However, Open Banking relies on consent of the customer. Without this, data will not, and cannot, be shared. It is therefore a business imperative to find better ways to communicate with your customers about what value they will receive if they do permit to sharing it.

The concept of customers controlling their data isn't new. It comes as part of an overall shift in the Government and amongst regulators towards empowering customers – for example through the General Data Protection Regulation (GDPR). The GDPR sets out the rights of individuals to gain easier access to the data companies hold about them and that organisations are responsible for obtaining people's consent to collect information about them.

We need to foster an environment of trust where individuals are willing to give consent in order to gain access to financial products and services that are right for them. This can be done by clearly communicating the new processes and the benefits they will bring to individual customers.

Experian has a vision of the tools we can create so lenders are able to build engagement and trust in Open Banking. For example, a dashboard which continually analyses the customer's spending in order to give personalised advice on new services or offers, or warn them if they are about to go into arrears or financial difficulty. In addition it allows the customer to control, and see, who they share, or have shared, information with.

By merging credit information with statement information and applying advanced analytics, we can provide fresh insight on what product(s) a customer can afford. Categorisation of a person's entire financial circumstance, such as combining income and expenditure with savings, and pension and investment information, will provide a much more holistic view of that individual. This will enable you to build a stronger long-term relationship with each customer.

Bank account information will provide a more granular view of a person's financial behaviours which in turn will help make more inclusive and accurate decisions for them.

The appropriate use of data is more important than ever. We need to be in a place where we are seen as responsible, and we are demonstrating this in everything we do.

Putting the customer at the heart of every lending decision

Everyone in the credit supply chain has a responsibility to make good decisions. It is fundamental that we always focus on the best interests of customers and minimise the risk of financial distress.

Affordability checks requires the lender to assess whether someone will be able to afford the repayments throughout the credit agreement. The FCA is not expected to prescribe the specifics of what the industry needs to do as yet, but it has made its position clear on the responsibility lenders have to protect their customers.

The answer to this, we feel, lies in the data: sharing it more effectively and using better analytics to understand it. How this is done will undoubtedly continue to vary amongst lender and across products – but the foundations of responsible, fair lending should be consistent across all decision-making. Lenders must go the extra mile to extend protection for customers into every step of the lending process, even if that means the product cannot be offered at that time. Lenders must also understand all of the assets available, and how it can be brought together in the most appropriate and effective way. This understanding is something we can provide.

Consent needs meaning
If customers feel they have little choice but to give consent to bank account data being shared in connection with a lending application, then it could arguably undermine the purpose of the consent framework under Open Banking.

Customers need to be given a choice whether to share their data and lenders are mandated to seek this consent. However, if consent is not given, lenders need to consider what alternative data sources can be used to support a decision without being overly intrusive, such as bureau data.

We have been testing variables of alternate data sources and found some huge benefits in introducing certain ones. We can clearly see the value in doing this in certain circumstances from both an open banking perspective and broader.

Consider the wider impact of any decision
If a customer perceives the sharing of their data will not result in a positive lending decision and their application is rejected, they may resort to unregulated lending because they cannot access mainstream credit. It is important to ingrain best practice lending at every stage, but also to consider the whole picture of a decision. If you accept, or reject, what will that mean for the customer?

Uncovering the value of new data
Our tools for categorising bank account data can be applied across your whole portfolio to assess a person's financial stability, and therefore what headroom they might have for additional credit or maintaining their outstanding credit commitments. The benefit of this is not only that its scalable across your entire customer base (for those who consent), but you can continually monitor customer behaviour to help you manage the relationship based on that customer's individual circumstances and needs. Most importantly the opportunity to aggregate and categorise bank account data on this scale will enable you to predict change before it happens.

People before process
Getting your processes and systems right will give a positive outcome for everyone. Put people before processes, empower your employees to do the right thing, embed the culture that says the customer comes first and make use of technological tools to identify vulnerability much earlier. You can go the 'extra mile' through understanding what support your customers may require and helping to broker the connection. For example, connecting customers who are in financial distress with a debt support agency.

We have been working on connecting decisions and how debt services can be brought into the decision outputs in our DataLab. We have seen some significant opportunities arise which offer greater potential to be more customer centric end to end.

The customer sits right at the heart of this new world of data-driven insight. Every organisation needs to gain each customer's trust and focus on their well-being.

In June 2018, the FCA announced their proposed changes to high-cost credit: "Our immediate proposed changes will make overdraft costs more transparent and prevent people unintentionally dipping in to an overdraft in the first place. However, we believe more fundamental change is needed"[2]

Today lenders can personalise lending decisions and offer credit that's more closely aligned to an individuals personal circumstances, offering products that give customers access to credit, but also protect people from over-borrowing.

All firms must be able to show consistently that fair treatment of customers is at the heart of their business model[3]

² Source: Andrew Bailey, Chief Executive , Financial Conduct Authority. May 2018

³https://www.fca.org.uk/news/press-releases/agenda-priorities-consumer-credit

The role of analytics in affordability

In analysing and categorising vastly more data to help process the initial credit application and manage repayments, analytics will also continue to play an integral role in scoring and to inform decisions. Data has always driven decision-making but the new tools to integrate that data will add certainty and help you make a qualified assessment. There is scope for everyone to benefit from these opportunities.

Machine Learning is a method of teaching computers to analyse large datasets and find patterns and trends in the data to make predictions. By training a machine to process repetitive validation, without the assumptions humans make, you can focus your attention on the most complex lending models responsible for the biggest exposures.

At Experian all of our analytical developments are underpinned by our mantra of FACT. Fairness, accuracy, the customer and transparency.

We believe organisations need to be able to aggregate and categorise new and different types of data to draw meaningful insights.

At Experian, we have created a machine-based learning system that can achieve over 90% accuracy in identifying income and expenditure when analysing (unseen) transaction data for the first time. We can categorise twelve months' worth of bank transactional data in one second. We feed it into automated decision software and append other data sources, and this better informs credit decisions and reduces the time to offer.

This brings a significant opportunity for you to amend your lending rules and create new rules based on a more intelligent and personalised view of your customers.

The machine could identify an opportunity where you may need to have a conversation with the customer. For example, to tailor an APR due to a change in customer circumstance, offer more suitable products, or identify financial stress. The data could be used to support a customer with a 'thin credit file' to access credit. It provides a more granular view that enhances the traditional credit score in these circumstances and offers an opportunity to engage with those who, until now, are most often declined credit because of this invisible credit history.

Bank account data is categorised into segments to identify spending patterns and financial behaviours which can then be understood on a level which far surpasses a human's assessment. This can be automated within the decision-making framework and gives a better understanding of these types of customers. Not only is the process inclusive it is also more effective for both the applicant and the lender.

Perhaps even more compelling are the findings of the engine that point to potential inefficiencies in the accuracy of affordability calculations. It suggests an unnecessarily high rate of lender referrals and declines due to low confidence in the data, rather than the customer being a higher risk. Automation can significantly reduce the cost of manual referrals and ensure that data is being used to drive decisions.

There is nervousness around the role of analytics in this context. The principles of fairness, accuracy customer and transparency (FACT) must be upheld in this process, as in any other area of lending. We appreciate some of you may continue with traditional models such as bureau-based assessments and some will combine bureau and Open Banking. A combination of both is likely to bring a much more granular level of detail which will help in decision-making, particularly for marginal decisions or consumers with complex financial lives.

We will not labour the point on advanced analytics in this paper; suffice to say that we believe it can offer incremental benefits to how lending is assessed as we move forward. The capacity of the technology to learn and adapt offers an opportunity for lenders to make the transition from current affordability measures into more sophisticated insight of what is genuinely affordable for that individual customer.

Research commissioned by Experian and conducted by Forrester, highlights how 40% of business decisions are made based on subjective opinion rather than data. As we outline within this paper, it is our belief that data can be a force for good to enhance decision-making and improve outcomes for everyone.

We believe that Machine Learning has huge potential to improve financial assessments and transform lending, as well as many other areas from fraud to marketing to supporting every business KPI.

Conclusion

By being aware of the changing trends in the customer landscape and using tools such as AI to process transactional data available through Open Banking, you will be able to generate better lending decisions at lower cost and bring significant improvements to the customer experience. You can plan for change and market products to the people most likely to need and be able to afford them in a valuable and yet responsible way.

At Experian, we have an established affordability proposition in the market based. The provision of summarised current account data and estimates offers an enhanced level of understanding when traditional bureau based decisions are not appropriate or suitable for the individual. We are not abandoning our traditional capabilities, but building on them to engineer a new architecture which includes Open Banking data, bureau data and other data sets as they become available. This approach has the ability to enhance business decisions by giving more accuracy. It is also scalable and fast which can only be a good thing as data, and the expectations of customers, continue to grow at an exponential rate. These changing components can be easily consumed, understood and met, with the right framework that enables this.

Credit scores will be vitally important and new ways of scoring using transactional insight are emerging. Without grabbing this opportunity and accessing the tools that can help you do just that, there is a high probability that you will not attain the level of success you, your customers, or indeed the FCA, expects and demand.

We are investing heavily in helping to make this happen and have a multitude of solutions to give you a customer-first approach. Today the data, analytics and technology can give more accuracy, on large scales of disparate data, fast. What this will look like will differ across each lender. This is important in encouraging innovation and transformation in the market. A one-size-fits-all approach is not the best approach to change in our view. What we believe is that the tools that can enable and support successful change are now available. In the big data economy, the role of analytics in making intelligent decisions is pivotal. The need to deliver value in any interaction or transaction is essential. And the ability to do this is here and now.

We believe that by using data appropriately you can truly make a difference to society and people's lives. You can empower your customers and help drive forwards a new standard of lending and financial management which will continue to power the UK to be one of the world's leading providers of financial services. From here, we can only continue to build on this success - and we believe this can be done effectively when underpinned by a solid footing that is purposely equipped.

As we have said throughout, it is our belief that the answer lies in data. Advanced analytics have the ability to turn data into information - from there to knowledge, and from there to wisdom. While a well coined approach, this layering is essential and each step needs to be achieved in order to move upwards successfully. This is where we need to be, enabling better customer outcomes through better understanding each and every customer and being able to consume and use the information that is available. Whether it be using traditional methods which consider new variables, or using advanced techniques such as categorisation of bank account data, all opportunities have the ability to be refined and realigned to bring better outcomes for all.

About Experian

Experian unlocks the power of data to create opportunities for consumers, businesses and society. At life's big moments – from buying a home or car, to sending a child to university, to growing a business exponentially by connecting it with new customers – we empower consumers and our clients to manage their data with confidence so they can maximise every opportunity.

We gather, analyse and process data in ways others can't. We help individuals take financial control and access financial services, businesses make smarter decisions and thrive, lenders lend more responsibly, and organisations prevent identity fraud and crime.

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About the Author

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Jon joined Experian in April 2013. He previously held a number of senior strategy and change positions in UK financial services companies, with a focus on life, pensions and investments.

Jon is responsible for developing and overseeing the delivery of strategy across all segments of the UK&I business. He works closely with business unit Managing Directors to identify and deliver new data, product and market strategies, including acquisition opportunities. Jon coordinates the development of the UK&I business strategy and is responsible for the delivery of a number of the key business strategic initiatives including Consumer Contributed Data, Affordability and ExPin.

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