The affordability challenge

Experian Briefing Paper

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Executive summary

Managing consumer affordability is a significant challenge for the UK credit industry and is a top priority for the industry's regulatory authorities.

This briefing paper offers background, information and advice on assessing affordability for UK lenders, who are facing increasing pressure to demonstrate that they are lending responsibly while increasing lending volumes.

The paper outlines the latest regulations relating to responsible lending and highlights the wider macroeconomic factors that are behind the increased focus on affordability and responsible lending.

Central to responsible lending is an assessment of customer affordability. This paper outlines the key indicators of affordability that lenders should assess in their decision-making processes. Recommendations are provided on how affordability assessments can be successfully incorporated into lenders' credit risk management processes.

Introduction

Affordability is a measure of a consumer’s financial capacity to fund new and outstanding debts, now and in the future.

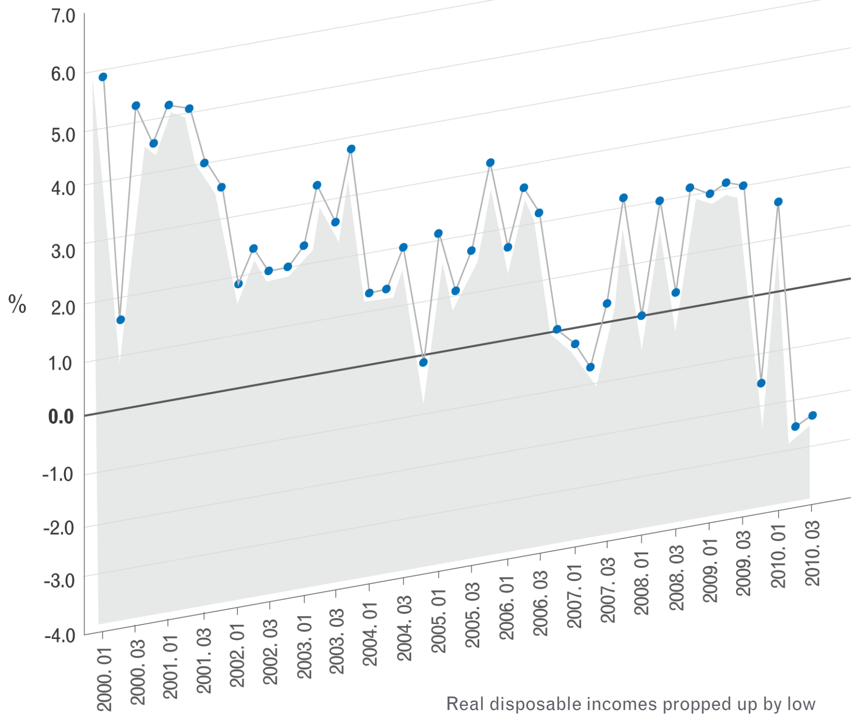
Accurately assessing affordability is a central requirement for any company offering credit to consumers. These requirements are set out in recent guidelines from the Office of Fair Trading and similar sentiments are expressed in the FCA’s Mortgage Market Review consultation paper. These aim to ensure that lenders only extend credit to those who are able to repay the debt out of their regular income or savings within a reasonable time period.

The latest guidance has placed the responsibility for demonstrating affordability with the lender. What’s more, lenders are expected to check and, where necessary, independently verify, any income and expenditure information provided by consumers. It is the lender’s responsibility to ensure that their affordability assessments are as accurate and robust as possible.

The economy is also fuelling the drive towards more responsible lending. Irresponsible lending in the US sub-prime mortgage market was blamed, by some, as one of the major causes of the credit crunch. In the current post-recession period, disposable incomes are decreasing (reference chart 1), Government spending cuts (reference chart 2) are having a significant impact on wage settlements and the level of benefits and many jobs are under threat. In addition, VAT rates have increased, putting even more pressure on disposable incomes.

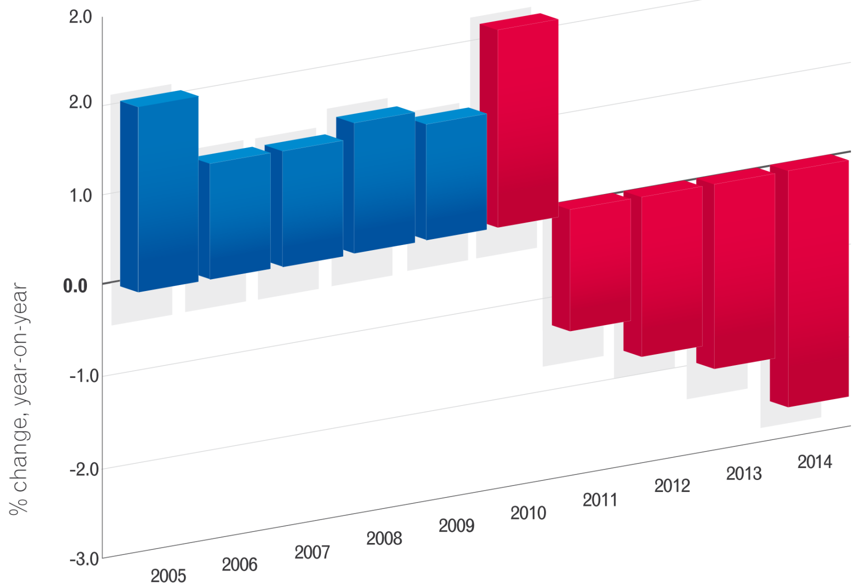
In short, it has never been more important for lenders to make prudent lending decisions – taking into account regulatory obligations and the impact of wider economic factors on individual lenders. Failure to do so could put additional financial pressure on consumers and lenders at a time where there is still uncertainty over the prospect of a double-dip recession in the UK.

Chart 1: Real disposable income



Real disposable incomes propped up by low interest rates and fewer than expected job losses (Q4 2007 – Q3 2009)

Chart 2: Government spending



Sources: National Statistics, Experian, June 2010 Budget

Policy tightening is expected to raise £81bn by the year 2014-15. The overall impact will depend on policy mix, offsetting mechanisms and the strength of the private sector.

Regulatory drivers

A raft of regulations exists in relation to responsible lending and assessing affordability for organisations that offer credit to consumers.

These regulations are constantly being extended and revised, and new legislation introduced.

Most recently, in response to the current economic situation and widespread pressure on disposable incomes, new guidelines have been issued which place the responsibility for demonstrating affordability firmly with the lender. The onus is very much on the lender to not only ask the right questions but also to verify income data and factor in the impact of wider economic conditions (now and in the future), when assessing a borrower's ability to repay credit.

Office of Fair Trading (OFT) Irresponsible Lending Guidelines

In March 2010, the OFT published its irresponsible lending guidance, which clearly outlines the business practices which it considers constitute irresponsible lending. The guidance sets out the standards the OFT expects from businesses engaged in lending if they are to be considered fit to hold a consumer credit licence. It covers the whole lending process from the initial lending decision right through to handling arrears and defaults

Under Section 25 of the Consumer Credit Act, the OFT has a duty to ensure that licences are only held by businesses that are fit to hold them (known as the 'Section 25 Test'). The new irresponsible lending guidelines set out the practices that might lead the OFT to revoke a licence. These include exploiting consumers who are vulnerable or in difficulty, and not offering fair treatment to all customers.
The guidelines set out the expectation that lenders will conduct a reasonable assessment of affordability and monitor repayments. If customers fall into difficulties with their repayments, the lender is expected to show forbearance in resolving the problem.

Consumer Credit Directive

The Consumer Credit Directive (CCD) was adopted by the European Council in May 2008, and legislation implementing its provisions came into force for lenders in June 2010. The Directive sets out regulations for the 'assessment of creditworthiness' by lenders. It states that before making a regulated consumer credit agreement, or significantly increasing the amount of credit provided, a creditor must assess the debtor's creditworthiness.

This creditworthiness assessment must be based on sufficient information obtained from the debtor, where appropriate, and from a credit reference agency, where necessary. Once again, the emphasis is on the lender to ensure that the customer is creditworthy. Sufficient checks must also be carried out to verify independently the information provided by the borrower.

Financial Services Authority (FCA) Mortgage Market Review

In mid 2010, the FCA published a consultation paper entitled 'Mortgage Market Review: Responsible Lending'. In this comprehensive review of the mortgage market, the FCA calls for 'affordability tests' for all mortgages and makes lenders ultimately responsible for assessing a consumer's ability to pay. It calls for selfcertified mortgages to be banned, along with products that contain certain 'toxic combinations' of features that put borrowers at risk. It aims to ensure that lenders do not profit from people in arrears and requires all mortgage advisers and brokers to be accountable to the FCA. The consultation process closed on 16 November 2010 and the FCA is currently compiling its response.

The thrust of all the new regulations relating to lending is that lenders are responsible for realistically assessing a borrower's ability to repay and that information provided by borrowers needs to be checked and independently verified by lenders.

New data sources could help lenders better assess affordability. It is important that lenders contribute towards consultations to make more relevant data available.

Macroeconomic factors

Once you know exactly what your customers look like, it is possible to determine the ways in which they are likely to behave.

As well as the regulatory pressures on lenders, the wider macroeconomic environment is exerting a significant influence on the credit market and on borrowers' ability to repay their debts.

The characteristics of the latest recession and the subsequent tentative recovery are quite different from those seen in the 1990s. Disposable incomes, for example, were propped up during the recession by the reduction in interest rates coupled with fewer job losses than expected due to reduced working hours and pay freezes. Real disposable income fell more sharply during the last quarter of 2009 due to a number of factors (reference chart 1). These include public-sector spending cuts (reference chart 2) and job losses, fewer pay increases and promotions, benefit cuts, the VAT increase and inflation (reference chart 5). This means that many households are facing increased outgoings at the same time as incomes remain relatively static or are falling.

The immediate future looks no less gloomy (reference chart 3), as the Government's spending cuts begin to bite, unemployment is likely to rise (reference chart 6) and interest rates are likely to increase towards the end of this year (reference chart 4), making borrowing more expensive.

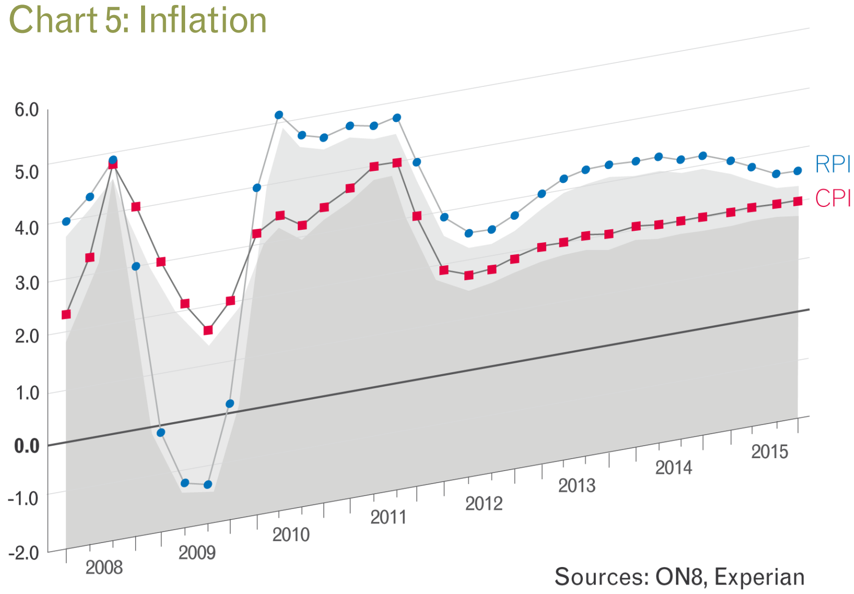
Chart 3: Outlook: slowdown ahead

The short term forecast is for an economic slowdown coupled with rising unemployment. In the longer term a growth in GDP is forecast with the private sector easing public sector job cuts.

Chart 4: Interest Rates

Interest rates are expected to move towards the trend rate of 4 to 4.5%.

Chart 5: Inflation



Sources: ON8, Experian

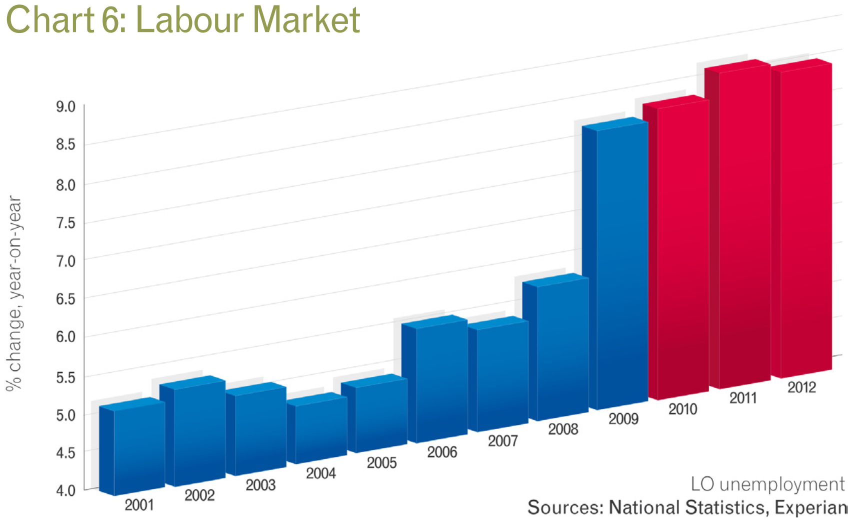
The rise inVAT and increase in energy bills are one off factors, hence the forecast drop in CPI during H2 2011. It is then expected to move towards the
2% target.

All of these macroeconomic factors mean that prudent credit risk management is now more important than ever. The recent economic crisis has vividly demonstrated how irresponsible lending can lead to a credit crunch which in turn can precipitate a global downturn, and the pressure is on lenders to ensure that credit is only extended to those who can genuinely afford it.

The wider macroeconomic factors will impact consumers in certain sectors or locations more than others. Public-sector workers are one group that is being directly impacted by the cuts, and certain industries have fared worse than others in the recession. Workers in these sectors are likely to be experiencing severe pressure on their disposable incomes.

The macroeconomic impacts are, therefore, being felt to varying degrees by different sectors of the population. Lenders need to understand how the wider economy is impacting each individual customer when making an assessment of affordability and how that feeds into the performance of the portfolio as a whole.

Chart 6: Labour Market



Sources: National Statistics, Experian

The labour market remains weak as public sector cuts bite. The unemployment rate will edge up to peak in 2011.

Affordability explained

Regulation and the state of the economy mean it is now essential for lenders to make accurate and realistic judgements of a consumer's ability to fund debt, both in the short and long term.

That means assessing a whole range of 'affordability indicators' in order to determine any borrower's ability to keep up repayments under existing conditions and in the event of 'future shocks'.

In its guidance, the OFT advises that creditors take reasonable steps to assess a borrower's likely ability to pay off the maximum amount of credit available in a way that is sustainable for the long term. To qualify for a given amount of credit, the borrower should be able to make the required repayments without undue difficulty, whilst continuing to meet other debt repayment obligations and reasonable regular outgoings. Furthermore, borrowers should be able to repay the debt within a reasonable period of time, using their regular income or savings.

It is no longer acceptable to offer credit on the basis that borrowers will simply be able to 'service the debt' over many years by making the minimum permissible repayment. Credit limits must therefore be set in line with the borrower's current disposable income and any reasonable expectations of future disposable income.

Affordability will clearly depend on the type of credit product being offered, and the amount of credit to be provided. However, to make an accurate assessment of affordability for any customer, a number of 'affordability indicators' need to be taken into account, including:

- The borrower's effective disposable income at the time the credit is sought – and likely future disposable income
- The borrower's credit history
- The borrower's existing and future financial commitments, including any repayments of other financial products and significant non-credit commitments (such as rent, council tax, utility bills, etc)
- The vulnerability of the borrower – vulnerability may arise if the borrower has some form of disability

To support affordability assessments, lenders can use affordability calculators. These assume a reasonable level of domestic outgoings on day to-day expenditure for different household structures and types. The Office of National Statistics (ONS) Family Spending Survey data is a useful source of expenditure data.

Changes are also being made to the data available to lenders, to help them better assess affordability. Historically, credit scores have focused on an individual's 'propensity to pay', rather than their 'ability to pay'. These estimates have been based largely on the incidence of historical arrears. With the advent of tools such as the Consumer Indebtedness Index (CII) the assessment of propensity to pay has analysed in much greater detail an individual's use of credit through metrics such as utilisation of limits on revolving facilities and the velocity with which credit has been accumulated.

Moving on from the CII, solutions have been developed that attempt to complete the picture by assessing the level of non-credit expenditure and income: the goal being to estimate disposable income and true affordability. This technology has been built into a score such as the Affordability Index. One problem inherent in such solutions has been the absence of reliable income information.

To address this concern current account providers are now sharing credit turnover information with the credit reference agencies (CRA) which represents a step forward for the estimation of income and affordability because it offers the possibility of a more reliable source of income information. Now, a range of new metrics and credit scores are being developed using this data which will help lenders to more accurately establish an individual's 'ability to pay'.

Best practice

It is important to understand a customer's risk, level of indebtedness and affordability both now and in the future.

There may be examples where a consumer's level of indebtedness is low, however due to their disposable income they are unable to afford the credit offered or applied for. Assessment of affordability can vary greatly from lender to lender and by type of credit. Often, there is little ongoing assessment of affordability.

Regulatory and economic drivers have increased the focus on responsible lending practices and it is essential that lenders have robust affordability assessments in place. Here are a few top tips for achieving this:

1. **Data Strategy** – Review the data used within the affordability assessment process ensuring it is fit for purpose. Balance the need for data capture with usage of data from other available sources.

2. **Algorithm Design** – Ensure that indebtedness and affordability algorithms are well designed and clearly documented. Consider how income and disposable income are estimated and what tolerances are in the algorithms.

3. **Policy Design** – Overall decisions should be based on risk, indebtedness and current/future affordability. The rigour of the assessment should be consistent with the credit exposure. Again, the policy should be well documented.

4. **Process** – Indebtedness and affordability assessment should be carried out throughout the customer lifecycle; origination, customer management, pre-delinquency, collections and debt recovery. Align affordability assessment for automated and manual decision making processes.

5. **Systems** – Make sure that algorithms can be easily implemented and amended.

6. **Monitoring** – Monitor the performance of your affordability assessment and update accordingly.

Experian Solutions

Now that lenders are required to undertake their own thorough assessments of affordability, many are looking for specialist support.

Experian has developed a range of solutions to help lenders assess affordability and make the most informed and responsible lending decisions. These solutions include services to help lenders measure the key affordability indicators for each borrower, and to assess the impact of wider economic factors on individual borrowers.

A critical element of responsible lending is assessing indebtedness and affordability, areas in which Experian has been researching and developing decision support tools since 2000. From a lending perspective:

Indebtedness is a measure of the credit burden associated with a consumer's debt profile. Experian's Consumer Indebtedness Index (CII) uses credit bureau data to identify individuals who are up to date with their credit repayments at present, but who, as a result of their levels of indebtedness, are likely to experience payment problems in the near future.

Affordability is a measure of a consumer's financial capacity to fund their outstanding debts, now and in the future.

Experian's **Affordability Metrics** enable full CAIS members to robustly assess different elements of affordability at the point of credit application or extension, in line with the recent guidelines, and consist of three main elements:

1. **Income Estimation & Verification**
Experian is working with Current Account Turnover (CATO) data provided by UK banks to develop a method of reliably estimating income. Incomes supplied on a credit application can be checked against this data to provide an independent view of an applicant's level of income.

2. **Disposable Income Calculation**
Both the OFT and FCA suggest using a disposable income calculation to best assess affordability, and this calculation is at the heart of Experian's Affordability Metrics. Experian is able to combine an income estimate with a detailed assessment of credit and non-credit expenditure to derive a reliable estimate of disposable income. In order to reflect the fact that consumers can use credit as well as income to fund their lifestyles, Experian uses the term 'Effective' Disposable Income, or EDI.

3. **The Affordability Index**
The Affordability Index (AI) uses credit application data and the EDI to refine the credit risk assessment provided by the CII. The AI can then be used to make better accept/decline decisions, particularly on marginal applications with low affordability or on referred applications with high affordability.

Future Delphi combines Experian's powerful credit bureau data assets with a unique set of national, regional and local economic data to augment the Delphi score and to make it more tolerant of changes in the economy. The use of economic data at the local and regional level brings the economy much closer to the individual than has been possible in the past and provides a mechanism for capturing the impact of economic changes on regions and households within a credit score. It stabilises the calibration of credit scores during times of economic change, makes them forward looking and provides a convenient mechanism for scenario testing.

Equity Check compares CAIS mortgage balances with house valuation models in order to provide full CAIS members with an estimate of the potential equity available.

Mortgage Shock identifies people with a mortgage who have suffered an interest rate shock, have mitigated by changing to an interest only mortgage or changing the term or who would be vulnerable to an interest rate shock. For example people who are on interest only mortgages or people whose account is approaching an anniversary of opening. The product also provides a detailed breakdown of the customer's mortgage borrowing

Conclusion

Economic events have heightened the need for robust affordability assessment and the outlook for economy remains uncertain.

Increasing regulatory requirements have confirmed the need for sound affordability assessment. In fact, a serious breach of the irresponsible lending guidelines could jeopardise an institution's credit license.

When making an assessment of affordability, the level of assessment should be congruent with the credit exposure. A compromise should be made between data capture and maintaining an acceptable customer experience.

There also needs to be a balanced approach between assessing affordability at application point and future sustainability.

Comprehensive affordability and indebtedness assessments should be carried out before granting credit or significantly increasing credit to a borrower. There is often limited monitoring of indebtedness or affordability criteria when assessing past decisions. Monitoring of existing customers should also be carried out.

As lenders, you may need to identify weaknesses in your affordability assessment process and put a roadmap in place of how you plan to address them.

Experian has a range of solutions and data that can help you with your affordability assessment. These solutions address the regulatory requirements to verify income, undertake an 'ability to pay' check, assess current and future affordability and carry out indebtedness checks.

For more information

To find out more or to book a free consultation please email CreditServices@uk.experian.com

About Experian

Experian is the leading global information services company, providing data and analytical tools to clients in more than 65 countries. The company helps businesses to manage credit risk, prevent fraud, target marketing offers and automate decision making. Experian also helps individuals to check their credit report and credit score, and protect against identity theft.

Experian plc is listed on the London Stock Exchange (EXPN) and is a constituent of the FTSE 100 index. Total revenue for the year ended 31 March 2009 was $3.9 billion. Experian employs approximately 15,000 people in 40 countries and has its corporate headquarters in Dublin, Ireland, with operational headquarters in Nottingham, UK; Costa Mesa, California; and São Paulo, Brazil.

For more information, visit http://www.experianplc.com

Riverleen House
Electric Avenue
Nottingham
NG80 1EH
T: 44 (0) 8700 12 11 11
www.experianbi.co.uk

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